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E-Commerce from a Regulator's Point of View

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I should like to thank the organizers of this Conference for the honour of inviting me to speak at Wolfsberg. I thank them especially for the opportunity to step back from the day-to-day hurly burly of regulating Internet brokers, alternative trading systems and electronic initial public offerings (IPOs) and trying to keep track of the bewildering range of alliances, joint ventures and linkages between exchanges and clearing houses that are being driven by e-commerce to try and focus on the longer term, more fundamental issues of where e-commerce is taking the art of regulation and what it means for the role of securities and futures regulators in the future. There is little consensus regulatory literature as yet and most of what there is relates to responses by particular regulators to particular problems that have already arisen in their jurisdictions, some of which appear to be unique to the US. Accordingly, the views I express about the more fundamental issues are tentative and my personal views, not those of the Securities and Futures Commission (SFC), and do not represent a common view amongst regulators.

At the risk of confirming your prejudices about regulators, I intend to focus on e-commerce's impact on the width of regulatory jurisdiction and on the manner in which it is exercised. At this level, it seems to me that e-commerce has four main effects. First, it brings about a very significant widening of jurisdiction and an increase in the relative authority of regulators at the national level. It does this partly by bringing the

statutory regulators into a closer, more direct, and more equal relationship with retail investors; partly by giving regulators new areas of direct jurisdiction over intermediaries, whether firms, exchanges or clearing houses; and partly by increasing statutory regulators' authority and status relative to their historical partners in co-regulation - exchanges - and opening the possibility of new partnerships in regulation with new players. Secondly, because e-commerce transcends national boundaries, it forces regulators to evolve international regulatory networks to cope with greater cross-border co-operation and competition between exchanges, quasi-exchanges and clearing houses. Thirdly, partly because of increasing internationalization, partly because the increase in statutory regulators' jurisdiction is so great and partly because the rate of change in the securities and futures industry has been so greatly accelerated by e-commerce, regulators are forced to re-examine the traditional style of regulation. In my view, this implies a move away from reliance on detailed, black-letter rules to a style of regulation which specifies general principles and desired ends and outcomes and which leaves it to the industry to fill in the blanks in the light of evolving best practice. Fourthly, regulators need to understand that e-commerce has the potential to do a great deal of the regulators' work for them; by empowering retail investors increasingly to make their own self-directed investment decisions on the basis of much more easily accessible information and increasing the investment opportunities available to them, e-commerce has the ability to drive a "race to the top" in the quality of markets and of investor protection.

Before discussing these propositions in detail, I should put Hong Kong into context. Although Josef was very complimentary about Hong Kong's level of preparedness for e-commerce, Internet usage in the Hong Kong securities and futures industry is so far surprisingly low compared to the United States and other regional markets like Korea. Only about 20 of more than 500 brokers provide Internet broking and it accounts for only about 1% of stock market turnover. Despite this low level of penetration, Hong Kong stands out amongst developed market regulators in two aspects. First, in the Report of the Steering Committee on Enhancing the Financial Infrastructure, it has

produced a publicly available high-level blue-print for exploiting on a market-wide basis the potential efficiencies e-commerce provides in relation to clearing, settlement and other back-office issues. The Report envisages a single clearing arrangement for cash and derivatives, a single integrated high-security network for the financial community, scripless markets and a path towards straight through processing.

Secondly, in its Guidance Note on Internet Regulation, the SFC has made it clear that Hong Kong residents are free to seek out and take advantage of financial services and products made available over the Internet and that the SFC will exercise jurisdiction over offshore service providers less aggressively than its international counterparts. Whilst this policy reflects the characteristics of Hong Kong as a geographically small but cosmopolitan international city, it also presents an opportunity to enhance investor choice, increase investor sophistication and drive the Hong Kong market to higher standards of disclosure, corporate governance and investor protection through increased competition and changing retail investor expectations. When local retail investors trade in overseas markets, they find higher standards in these areas and it becomes increasingly necessary for the local market to offer an overall package of proper disclosure and investor protection that matches best overseas practices - not merely for the sake of satisfying the expectations of foreign institutional investors but also to retain the local retail investor base.

A similar process of raising standards can be observed in all markets where retail investors are now trading more actively through the Internet. As retail investors become more sophisticated and self-directed, they are making new demands to which regulators, who have always regarded retail investors as their core constituency, have had to respond by eroding traditional franchises and privileges and facilitating increased competition. Examples from the US include the Securities and Exchange Commission's (SEC) initiatives in relation to Regulation ATS, Rule 390 of the New York Stock Exchange and market fragmentation in response to retail demand for better execution.

The increasing trend for retail investors to trade without human intermediation and advice is also leading statutory regulators to change their emphasis, to move away from reliance on mandating duties of proper advice on intermediaries and towards more direct communication with investors. Means of doing this include providing investors with material information over the Internet, such as via the SEC's EDGAR system or Hong Kong's Electronic Investor Resources Centre and increasing the transparency of regulatory activities by such means as "town meetings", enforcement "sweeps" and joint international action in relation to the "high-tech" phenomenon. The Financial Services Authority (FSA) is exploring the possibility of direct contact with investors at the point of decision by providing them with software that would automatically provide regulatory information and warnings when a financial services site is accessed, together with intelligent hyperlinks to other sites where investors could obtain additional information to assist in decision-making.

But the widening of the regulators' role in this way does not imply a reduction in the obligations they impose on intermediaries but rather the reverse. Regulators are not saying that, because investors have more information and autonomy, regulators will relax intermediaries' obligations to "know the client" and provide "suitable advice"; rather they are considering extending these obligations to cover the new forms of interaction with clients that e-commerce makes possible. The SEC, for example, is considering the circumstances in which these obligations apply as a result of the use of data-mining to profile investors and present them with information and investment alternatives that are to some degree customized. Similarly, regulators in Australia and Hong Kong are considering the ways in which Internet brokers should discharge their duties of due skill, care and diligence towards the integrity of the market in relation to possible market misconduct or insider trading.

In a further development, regulators are tending to extend their jurisdiction over e-commerce by extending the general concept that an intermediary must be "fit and proper" to impose requirements on e-business that were not explicitly applied to non-electronic business. For example,

they are requiring the maintenance of adequate capacity, security and contingency plans and requiring investors be given warnings of the disadvantages of technology such as possible delays and outages. By a natural progression, regulators have now begun to review not only the fairness and transparency of market operators' trading systems but also their capacity, robustness, scalability, security and functionality.

Paralleling this tendency to regulate more about regulatees' businesses has been a trend for statutory regulators to regulate intermediaries directly in areas in which they were previously regulated indirectly through Self-Regulatory Organizations (SROs) or exchanges. This trend is most pronounced where exchanges have demutualized and abandoned or lost most of their previous SRO role. In Hong Kong, for example, although the demutualized exchange retains the ability to enforce its trading rules and manage its business risks from market participants, it is in the process of transferring to the SFC its previous front-line role in regulating intermediaries' conduct towards clients and is becoming dependent on the statutory regulator to provide it with information it previously gathered directly from its members. In Australia and Hong Kong the Exchanges have also lost aspects of listing regulation to the statutory regulators - in relation to the regulation of their own listings and where there are possible conflicts of interest in regulating the listings of business partners or competitors. Both regulators felt they should stop there, since it is an open question whether a profit-making exchange would have an adequate core business without the ability to brand itself through its administration of listings, but it is interesting that the UK has now gone one step further, with the London Stock Exchange (LSE) totally relinquishing its listing authority role to the FSA.

Whilst more direct regulation by the statutory regulators rather than an exchange or SRO has the advantages that it is backed by statute and is less likely to be perceived as cosy and self-interested, it cannot be cross-subsidized out of the business operations of the Exchange as it previously was and becomes subject to public sector resource constraints. Accordingly, the style of regulation has to become risk-based and the regulators have to rely largely on guidance. In addition, to cope with the higher pace of change in the industry, the

style of regulation has to be flexible. These considerations imply the delegation of more rule-making power to the regulator by the legislature and also imply that the regulator should rely as much as practicable on high-level General Principles rather than on detailed black-letter rules to guide conduct.

Another consequence of exchanges losing much of their historical self-regulatory role is a change in the nature of the special relationship they previously enjoyed with the statutory regulators and governments, as they become more obviously businesses subject to regulation rather than partners in regulation. This reduces the ability of exchanges to protect their historical franchises and privileges and those of their members and, particularly where there is competition or the threat of competition from electronic communications networks (ECNs), presents the statutory regulator with opportunities to outflank industry vested interests previously unified behind the exchanges. But the regulator also loses the ability to engage with the industry through a single organ and foregoes all of the benefits for itself and the industry of modulating its regulation of the industry by transmitting regulation through an industry body. Except possibly in the US, it seems unlikely that industry-wide SROs will evolve to fill this gap; pure unsubsidized self-regulation is expensive and the interests of industry participants are diverging rather than converging under the influence of e-commerce. In this connexion, it is noteworthy that regulators are beginning, for a number of reasons, to focus more closely on their relationship with the operators of clearing and settlement systems, with whom all industry participants must have a direct or indirect relationship. Whilst at present this focus is driven primarily by risk management concerns, I do not think it is fanciful to envisage settlement system operators becoming the new partners of the statutory regulators in co-regulation of the industry.

The trends discussed above all relate to the ways in which e-commerce is leading to a widening of statutory regulators' roles and a strengthening of their status relative to market participants, with the major benefits being a greater responsiveness by regulators to the

needs of retail investors and, in the longer term, the adoption of a more flexible style of regulation. I now turn to discuss an aspect of e-commerce that appears likely to undermine the effectiveness of statutory regulators but which I believe will in practice reinforce the trends towards greater flexibility and higher levels of investor protection. E-commerce is essentially borderless whilst the jurisdiction of securities regulators stops at the border.

A decade ago, the territorial limitations of securities regulators were not all that important. International activities were restricted to isolated examples of cross-border misconduct, such as insider trading and fraud, a small number of global IPOs and the trans-national activities of several intermediaries who were not particularly important outside their home markets. Now, in contrast, regulators are faced with a situation where their domestic retail investors potentially have desktop or palmtop access to all aspects of all markets, national regulators find themselves dealing with a handful of dominant global investment banks who have relationships with up to 150 regulators and demand consistency of regulation between them, and market operators straddle national boundaries.

At retail level, the initial regulatory reaction has been to attempt to assert national jurisdiction over offshore service providers and offshore offers of securities that are available to local investors, even where the services or offers are only passively available. Many national regulators have interpreted their national legislation in such a way as to effectively oblige offshore service providers to take active steps to exclude access to their services. It is doubtful whether this approach is sustainable beyond the short term. Except in the largest markets it presents considerable practicable difficulties of enforcement. Despite the existence of memoranda of understanding providing for mutual assistance in enforcement between national regulators, resource constraints limit the amount of co-operation practically available from one regulator to another except in cases of serious misconduct; it is simply unrealistic to expect a national regulator to devote significant

resources to enforcing the licensing regime of another jurisdiction simply because a national in the second jurisdiction has used the services of a licensed intermediary in the first. More importantly, such restrictive policies deny investor choice and restrict competition; they attempt to limit the way in which the Internet empowers retail investors to make informed investment decisions to access other markets. Recently, signs have emerged in speeches by regulators in the leading developed markets that they are beginning to realize the impracticability of a restrictive approach that attempts to limit investor choice and to acknowledge that their markets will in practice become more open.

The implication is that national regulators will have to increase the level of international co-operation and show an increased willingness to rely on the integrity and effectiveness of foreign regulatory systems in deciding whether and how to assert national jurisdiction. Except within the EU, this is unlikely to take place through the adoption of a formal system of mutual recognition by one authority of another, since there are considerable institutional impediments to such an approach. In many jurisdictions, the law does not provide adequately for mutual recognition; there are issues of accountability to national legislatures and there are significant trust issues in regulators agreeing to rely on the competence and effectiveness of their foreign counterparts.

Nevertheless, regulators face an immediate need to come up with practical solutions to the issues posed by cross-border market operators and market participants and, under the pressure of necessity and without a great deal of theoretical analysis, what seems to be evolving is an international regulatory system with two main elements.

The first is a sort of spaghetti model of multiple bilateral co-operative arrangements on particular topics and in relation to particular regulatees. The individual arrangements are tantamount to limited *de facto* mutual recognition subject to the safeguard that national jurisdiction can be asserted if necessary. A very small example is the Pilot Program under which selected NASDAQ stocks are traded on the Stock Exchange of Hong Kong. Hong Kong has no nexus with the issuers; the issuers have not signed listing agreements and are not subject

to Hong Kong listing rules or disclosure standards and only those provisions of Hong Kong's securities legislation that prohibit market manipulation apply. The SFC made the pragmatic decision that, at least in relation to selected issuers, it was content to rely on the US regulatory system and the effectiveness of the SEC as providing adequate protection to Hong Kong investors. At a more systematic level, IOSCO[1] Working Party No. 2 is developing principles to guide the co-ordination of regulation when a market operator straddles more than one jurisdiction.

The second element is greater harmonization of regulatory content and practice between jurisdictions. This has become the major work of IOSCO and similar bodies and, especially since the process of international standard-setting was accelerated by a number of inter-Governmental initiatives following the Asian financial crisis, standards promulgated by bodies such as IOSCO are increasingly taking on a level of normative force. Given the wide variations in the characteristics of national markets and in their legal frameworks, harmonized standards can only be agreed at the level of broad general principles rather than detailed rules. Increasingly, national regulators are finding it convenient to incorporate these principles directly into their rules, sometimes using them to replace or to re-systematize the detailed rules they previously used. Whilst this increases the standardization of the content of regulation between different jurisdictions and facilitates international commerce, there remains a significant risk of disuniformity of administration and consequent uncertainty and cost for business. Regulators at the national level can reduce the risk of disuniformity by making a conscious effort to consult international industry bodies such as ISSA[2], IPMA[3] and ISDA[4] in formulating their administrative approaches to ensure that they are consistent with, and accommodate, international best business practice.

[1] IOSCO: International Organization of Securities Commissions
[2] ISSA: International Securities Services Association
[3] IPMA: International Primary Market Association
[4] ISDA: International Swaps and Derivatives Association

Despite occasional reservations voiced by some national regulators, I do not believe that the development of harmonized and linked regulation carries a significant threat of lower standards or of regulatory arbitrage. Experience so far shows that the tendency is to level regulatory standards up rather than down and the dynamics of international e-commerce seem likely to reinforce this tendency. As every market's technology becomes comparable, as liquidity forms larger pools, and as investors come to regard offshore investing as natural as domestic investing, I believe markets will seek to brand themselves by offering an increasingly global retail investor base and global intermediaries higher quality disclosure, corporate governance and investor protection, greater efficiency in processing transactions and greater flexibility and clarity of regulation. If this is correct, then the development of e-commerce in the securities and futures industries is likely to lead to the better attainment of the goals of regulation: investor protection, market integrity and reduced systemic risk - without imposing undue burdens on industry.