Electronic Commerce

Cutting cybertape — building business

Corporate Law Economic Reform Program

Proposals for Reform: Paper No. 5

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The Government is seeking comments from interested parties on the detail of the proposals in this paper which should be forwarded to the following address:

First Assistant Secretary
Business Law Division
The Treasury
Parkes Place
PARKES ACT 2600

Telephone: 02 6263 3960
Fax: 02 6263 2882
Email: clerp@treasury.gov.au

Copies of this paper are available from the Australian Government Publishing Service and on the Treasury web site (http://www.treasury.gov.au).

Enquiries concerning the paper can be made to:

Brenda Berkeley
Tel: 02 6263 3972

Michael Rosser
02 6263 3962

Michael Willcock
02 6263 3982

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ABBREVIATIONS

ABS	Australian Bureau of Statistics
ALRC	Australian Law Reform Commission
ASC	Australian Securities Commission
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
CASAC	Companies and Securities Advisory Committee
CCIS	Coordination Committee for Information Services
CDs	Certificates of deposit
CGS	Commonwealth Government securities
CHESS	Clearing House Electronic Sub-register System
CLERP	Corporate Law Economic Reform Program
ECHO	Exchange Clearing House Limited
ELS	Electronic lodgment service
EM	Enterprise Market
FSI	Financial System Inquiry
IOSCO	International Organization of Securities Commissions
IPAC	Information Policy Advisory Committee
ISC	Insurance and Superannuation Commission
RBA	Reserve Bank of Australia
RITS	Reserve Bank Information and Transfer System
RTGS	Real Time Gross Settlement
SEATS	Stock Exchange Automated Trading System
SEP	Single Entry Point
SFE	Sydney Futures Exchange
SYCOM	Sydney Computerised Overnight Market
UNCITRAL	United Nations Commission on International Trade Law

PART 1: REFORM PROPOSALS

PROPOSAL NO. 1 — ENFORCEMENT ISSUES RAISED FOR THE AUSTRALIAN SECURITIES COMMISSION WITH THE ADVENT OF GLOBALISATION AND NEW TECHNOLOGIES

The Australian Securities Commission (ASC) should continue its vigilance in relation to the regulatory concerns posed by developments in electronic communication and commerce, and maintain an active enforcement strategy to deal with those concerns.

It should also continue its participation in the work of the International Organization of Securities Commissions (IOSCO), which is addressing enforcement challenges and opportunities arising from the increasing use of the Internet.

PROPOSAL NO. 2 — ENHANCED FLEXIBILITY FOR THE ELECTRONIC LODGMENT AND INSPECTION OF INFORMATION UNDER THE CORPORATIONS LAW

The provisions of the Corporations Law providing for the lodgment and inspection of documents with the ASC will be amended to ensure that they are flexible enough to accommodate changes in communications technology so as to allow electronic as well as paper-based methods to be used.

The Corporations Law will focus on the information that must be lodged or may be inspected with the ASC, rather than on its format or the physical media in which it is stored. The Law will specify the information the ASC should obtain and permit to be inspected, while practical matters of detail, such as the methods of communication which may be used for that purpose, will be set out in regulations or in rules determined by the ASC.

PROPOSAL NO. 3 — NEW ARRANGEMENTS FOR COLLECTION OF FEES BY THE ASC

The ASC will be given greater flexibility to receive documents and requests for service in electronic form.

As a result, the current fee collection structure will also be amended to ensure that the means and timing of fee collection accommodates those electronic commerce methods.

PROPOSAL NO. 4 — RECOGNITION OF ELECTRONIC COMMUNICATION METHODS IN THE CORPORATIONS LAW

To facilitate electronic communication between companies and their members, as well as the retention of company records in electronic form, the Corporations Law will be amended to recognise electronic communication methods, thereby providing a more modern and technologically-neutral legislative framework.

PROPOSAL NO. 5 — RECOGNITION OF CLOSE-OUT AND MARKET NETTING ARRANGEMENTS

Under the current contract-based close-out and market netting arrangements, there are some legal uncertainties about whether contractual provisions would be allowed to operate notwithstanding the insolvency of a party to the netting contract. This uncertainty has the potential to affect the international competitiveness of Australian financial institutions.

To overcome these uncertainties, the Government will develop legislation, along the lines recommended by the Companies and Securities Advisory Committee (CASAC) Netting Sub-Committee, to provide a more certain and robust legal framework for close-out and market netting arrangements. This legislation will ensure that these netting arrangements will operate, notwithstanding the insolvency of a party to the arrangements.

PROPOSAL NO. 6 — ELECTRONIC SETTLEMENT OF TRANSACTIONS IN COMMONWEALTH GOVERNMENT SECURITIES (CGS)

The *Commonwealth Inscribed Stock Act 1911* and Regulations will be amended to enable the electronic transfer of the direct beneficial and legal interests in Commonwealth Government securities (CGS). This will enable transactions in CGS to be settled electronically, as well as through existing paper based means.

PART 2: INTRODUCTION

In announcing the Corporate Law Economic Reform Program (CLERP), the Treasurer referred to the need for Australia to keep pace with technological innovation and the increasing globalisation of the business environment if it is to remain internationally competitive. While modern commercial practices are characterised by technological innovation, Australian law, in some respects, fails to take account of that innovation and is out of touch with the needs of contemporary business operations.[1]

This paper proposes a number of reforms to Australia's business laws to facilitate electronic commerce. The proposals have been developed in consultation with the business community; in particular, the Government's Business Regulation Advisory Group (see Appendix A).

'Electronic commerce' is a term increasingly used in media reports, government policy documents and business fora. It is a relatively imprecise term which means different things in different contexts. In this paper, 'electronic commerce' refers to business transactions on, or using facilities provided by, electronic networks.[2]

Electronic commerce can replace traditional face-to-face ways of doing business and transactions effected through the exchange of paper-based documents. Instead, business can now be transacted quickly over long distances between parties who may never meet (or, indeed, who may not know the identity of each other).

The increasing internationalisation of markets and economies highlights the need to ensure that policies maximise the competitiveness and efficiency of the domestic economy. Australia's laws must promote the development of systems and market practices that will reduce legal uncertainty and

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1 See, for example, Australian Law Reform Commission Report No 80, *Legal Risk in International Transactions (ALRC 80)* 1996, at pp 130-135, and *Financial System Inquiry Final Report (FSI Report)*, March 1997, at pp 501-502.

2 This definition is derived from one adopted for the purposes of ALRC 80 — see ALRC 80 at p 130. The Broadband Services Expert Group, in its 1994 report *Networking Australia's Future*, AGPS 1994, refers to the integration of 'communications and data management to allow business to automatically interchange information' (at p 114).

transaction costs, and increase trading efficiency. This will, in turn, facilitate the competitiveness of Australia's markets in the global trading environment.

2.1 ECONOMIC IMPLICATIONS OF ELECTRONIC COMMERCE

An economic approach has been adopted by this paper in analysing the issues raised by electronic commerce. This is consistent with the overall approach taken in considering issues under CLERP. The following areas have been given particular emphasis.

Market Freedom

Competition plays a key role in driving market efficiency and increasing community welfare. It is important to ensure that regulatory interventions support and do not hinder the operation of the competitive process. The benefits that electronic commerce offers, and its increasing use across a wide range of markets, make it important that regulation does not impede the evolution of new electronic technologies and products. The regulation of electronic commerce, while providing for the protection of investors against unnecessary risk, should not be so heavy-handed as to impede market efficiency and competition.

Competition in financial markets has already resulted in the provision of cheaper and more varied services to consumers and the development of more efficient market practices, such as the more effective management of financial risk. The long term result of these developments will ultimately be increased investment and economic growth.

Investor Protection

A central theme of the Financial System Inquiry report was improving the efficiency and competition in the financial system without compromising its stability. Many of the recommendations designed to increase competition were premised on the introduction of world best practice in controlling the risks of disruption to the system.

Regulation should ensure that all investors have access to information regarding potential investment risks. The increased use of electronic commerce

has implications for the security of investments. The implementation of real time gross settlement is expected to help mitigate systemic risks inherent in the payments settlement system.

However, as an inherently less visible form of trading, electronic commerce can raise concerns regarding the security of transaction processes. Concerns include whether the transaction has been accepted by the other party, and whether the details of the transaction remain confidential or can be accessed by outside parties.

A further potential concern for investors are the risks associated with international electronic transactions involving cross-border payments and securities settlements. Globalisation can help to reduce risks to investors by allowing them to diversify across a wider variety of investments in several countries. However, it is nevertheless desirable for other legal jurisdictions to effectively regulate their financial systems. These are issues being examined by other agencies and fall outside the scope of this paper.

Information Transparency

Efficient and competitive markets require potential buyers and sellers to have access to sufficient information to assess the potential risks and rewards of investments and thereby allow them to decide whether to proceed with transactions. Under Australia's corporate law regime, the Australian Securities Commission (ASC) is empowered to act to promote the efficient provision of this information to potential investors.

Cost Effectiveness

The regulatory framework for business needs to take into account the direct and indirect costs which are imposed by regulation on business and the community as a whole. It is therefore important for the benefits, whether intangible or in the nature of the public good, to be weighed-up against these costs.

Regulatory Neutrality

Regulation for electronic commerce needs to recognise that there are a range of different technologies available for use by business to suit their various needs. It is important that the regulation is designed to be 'technologically neutral' so

as not to directly influence the technology choices of business. Regulation should also be equally effective in meeting its aims, such as facilitating the fair transaction of goods and services, irrespective of the electronic commerce technology being employed.

Business Ethics and Compliance

The use of electronic commerce raises difficult issues for all nations regarding compliance and enforcement, given its use of non-physical means of conducting transactions. In particular, it offers the ability to transact business in 'cyberspace' ie outside the national boundary of the domestic regulatory authorities. This has implications for traditional jurisdictional control by the corporate and consumers affairs regulators, taxation agencies etc. It also raises issues of privacy.

2.2 ELECTRONIC COMMERCE IN CONTEXT

In many ways, the impact of electronic commerce to date has been most strongly felt in the world's financial markets. This is not surprising since much financial market activity takes the form of wholesale business-to-business transactions and it is business that is more likely to:

- have invested in the technical infrastructure required for electronic commerce (although infrastructure costs are falling rapidly);
- be comfortable with transactions which are not conducted face-to-face; and
- be motivated by the need to reap efficiency benefits in their operations.

The combined effect of technological advances (particularly in computing and telecommunications), business innovation and financial deregulation have contributed to the increasing globalisation of international capital and product markets. The international integration of the markets for banking services, securities and derivatives has led to a profound transformation of financial flows. Capital and production are considerably more 'footloose' or mobile than in previous times. As the Financial System Inquiry noted, '[t]rading in many instruments is now global, reflecting the ability of technology to break dependence on physical location'.[3] Ultimately, electronic linkages between markets could lead to their aggregation, resulting in the emergence of regional

3 *FSI Report*, op cit, at p 116.

or truly global securities markets. Such developments would raise complex issues of international recognition and co-regulation by national securities regulators.

Globalisation has coincided with higher levels of economic efficiency in domestic and international capital and product markets. Allocative efficiency has been enhanced as freer global capital markets facilitate the direction of savings to investments providing the highest returns, regardless of national boundaries. Capital can also flow more easily from developed countries to emerging economies, thereby presenting new opportunities for investors. Technical efficiency has been enhanced as outputs are produced at lower costs and transaction costs are reduced. Dynamic efficiency has been enhanced as the global provision of financial services allows firms to respond more quickly to changes in input costs, technology and consumer tastes.

Costs and Benefits

Globalisation of the world's financial markets has already provided benefits to Australia in a number of different contexts. Australian investors now have increased choice and enjoy the opportunity to participate in foreign capital markets. Foreign companies, in turn, benefit through increased access to Australian capital, and add to the liquidity and depth of Australia's domestic markets.

Electronic commerce offers the potential to further improve the efficiency of capital and product markets. Use of electronic commerce can reduce costs to both buyers and sellers, particularly those costs directly involved in completing the transaction. Harnessing developments in computer and communications technologies can reduce search costs by making it easier and quicker for buyers and sellers to find each other and pay for the goods or services provided. Such reductions in transaction costs, particularly for dealings between parties located in different countries, can be of a sufficient magnitude to foster trade. As the Financial System Inquiry noted:

> 'International sales of financial services are not a new phenomenon. However, they have been restrained at the retail level by transaction costs. New technologies may reduce these costs, making it easier to provide financial services in many countries where the service provider does not have a physical presence.'[4]

4 Ibid, at p 293.

At the macroeconomic level, electronic commerce promises to provide a boost to overall economic growth in the medium to long-term, by improving market development and efficiency. The size of markets will expand as larger numbers of buyers and sellers are able to find each other and as the volume and value of cross-border transactions increase. Information on prices, usually the key factor in determining whether trade occurs, will become more readily available. As a result of these factors, it can be expected that the markets for many types of goods and services will expand and new markets will continue to emerge, providing more choice for consumers, as well as increasing the opportunities for producers to exploit economies of scale and scope.

As with most forms of structural adjustment, some costs will accrue, particularly in the short term. Firms will be required to outlay funds to acquire and maintain the means to engage in electronic commerce. Returns on these outlays may be small until such time as their customers and potential customers 'find' them through electronic means. Firms which do not make such investment however risk being left behind by the competition. On the other hand, there is considerable debate regarding the pace at which electronic commerce is likely to increase, with the more cautious warning that some smaller businesses may make the mistake of investing too quickly in the new technology. Central to this is whether growth in revenue from sales via electronic commerce is matched by growth in realised profits.

Electronic Commerce in Australia

Electronic commerce is already well established in Australia's securities and futures markets. Automated systems for recording and storing information are an integral part of the operation of the capital market and provide the foundation for increasing reliance on electronic methods of transacting. The combination of the potential for electronic technology to offer efficiency gains, together with capital market demands for maximum efficiency, can be expected to continue to lead to the development of new technology to facilitate the operation of the market.

Systems in Australia's securities and futures markets, such as SEATS, SYCOM, CHESS and the ASX's foreshadowed Enterprise Market (EM), as well as the greater use of technology in Australia's OTC markets have contributed to the reduction of transaction costs, in time as well as money. These systems are described at Appendix B.

New developments in payment systems offer the prospect of further reductions in costs, and hence increased efficiency. The widespread move to real-time gross settlement, the development of more legally certain regimes for

the netting of market participants' obligations, and the transaction of wholesale high-value payments across a number of separate systems owned and operated by the private sector (Austraclear) and the Reserve Bank of Australia (the RITS system), also promise to contribute to reduced transaction costs. Increased electronic trading in various Commonwealth and State government and private debt securities can be expected to do the same.

The Future

The rate of development of electronic commerce in the future depends upon businesses and, in the case of retail transactions, consumers, gaining access to appropriate facilities. This in turn depends on the costs of obtaining this access, and on businesses being confident that long term benefits to their marketing, customer service and sales opportunities will ensue. Another factor affecting the development of electronic commerce is confidence (or lack of it) in the security of the transaction process.

In the longer term, while Australian firms will benefit from improved access to international markets, foreign companies will also be better placed to compete for business here. Australian firms will come under increasing competitive pressures and will need to exhibit flexibility to cope with those pressures. The increase in competition for product markets may also force structural adjustments in the labour market.

2.3 SCOPE OF THIS PAPER

It is paradoxical that many of the issues affecting the development of electronic commerce in Australia's financial markets and business community, that electronic commerce brings into focus, do not require dramatic changes to existing legal rules, while others require resolution across the whole legal system. This paper does not seek to provide answers to those latter issues, two of which, in particular, have the potential to greatly enhance confidence in electronic commerce and, hence, to expand electronic commerce opportunities across the whole economy. These issues (a national authentication framework and legal recognition of digital signatures), and other relevant policy work being undertaken elsewhere in government, are referred to in Appendix C.

This paper aims instead to canvass responses to matters within the Treasury portfolio where there is a role for government in either providing a more certain legal environment or removing legal or regulatory impediments to electronic commerce developments. It deals with many, but not all, of the

electronic commerce issues arising in the Treasury portfolio. It does not, for example, canvass issues in the area of taxation, which is being addressed separately within the portfolio. Rather, the paper addresses high priority issues affecting financial markets and business identified in the reports of the Small Business Deregulation Task Force[5] (by facilitating the emergence of a Single Entry Point for small business, as discussed in Part 4), and the Financial System Inquiry and the Australian Law Reform Commission (by providing a more certain legal framework for netting arrangements, as discussed in Part 5). The paper also points to the need for ongoing review of a number of legislative and regulatory arrangements affecting business to ensure that they do not impede electronic commerce.

2.4 CORPORATE LAW ECONOMIC REFORM PROGRAM — OTHER ELEMENTS

This paper will not revisit electronic commerce issues that have been, or will be, canvassed in other papers issued under CLERP. In summary, those issues are as follows.

Fundraising

Electronic commerce provides new ways of engaging in fundraising activities. The review of the fundraising provisions of the Law, being undertaken as part of CLERP, examines ways the Law can be made more responsive to the use of electronic communication methods for corporations seeking equity from individual investors — see generally Part 4.3 of the CLERP Fundraising paper. Areas which have been considered are: the electronic lodgment of prospectuses; and the potential uses of electronic communication technology in the distribution of prospectuses and information about securities investments.

Under proposals advanced by the CLERP Fundraising paper, the ASC will be able to accept electronic lodgment of a prospectus, without requiring the separate lodgment of a paper version. The ASC will have to be satisfied that the electronic prospectus is in a format compatible with its information systems and that the prospectus can be securely distributed electronically, so that it cannot be altered.

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5 *Time for Business*, Report of the Small Business Deregulation Task Force, November 1996.

The sharehawking prohibition would be limited to situations involving direct contact with potential investors, so that electronic distribution of prospectuses will be permitted under the Law.

Market Structures and Regulation

As already noted, electronic commerce, and technological developments generally, are changing the ways financial markets operate and are structured. For example, technology offers new ways for market participants to interact, or gives rise to new products. The futures and securities markets project being undertaken as part of CLERP will examine, *inter alia,* ways in which the Law should be amended so as to reflect the impact of technology on these markets and to ensure that the Law's regulatory arrangements are appropriate, having regard to that impact.

2.5 PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND SECURITIES

The Parliamentary Joint Committee on Corporations and Securities is currently inquiring into the implications for the Law, the ASC and securities exchanges of global electronic capital raising and share-trading, focusing on the Law and equity-related securities.[6] This is a welcome initiative that will promote public debate and understanding of the issues. The Committee's recommendations will be carefully considered by the Government.

6 See the Committee's issues paper *Virtually no liability? Securities markets in an electronic age,* Parliamentary Joint Committee on Corporations and Securities, June 1997.

PART 3: ENFORCEMENT AND INVESTMENT ADVISING ISSUES IN AN ELECTRONIC ENVIRONMENT

Modern communication technology, particularly the Internet, has greatly widened the distribution of offers of securities. Any person with access to the Internet anywhere in the world can potentially access a prospectus located on the Internet and apply for securities offered in that prospectus.[7] Likewise, advertisements for securities and unauthorised information about securities can be distributed without restriction via electronic communication methods.

The low cost and simplicity of the electronic distribution of securities information makes it very attractive for securities offerors. For potential investors, Internet, e-mail or even facsimile access to securities information is quick and inexpensive. The advent of secure on-line trading sites for low cost securities dealings offers significant time and cost savings for individual investors. Electronic communication methods therefore have the potential to enhance the availability of information about securities and reduce transaction costs. As information forms the foundation of capital market efficiency, greater dissemination of reliable information is a welcome development.

3.1 ENFORCEMENT

In general, the enforcement issues in the electronic environment are similar to those seen in traditional markets and the same types of regulatory objectives apply. However, easier distribution of, and access to, securities information comes at a cost and may require new more flexible strategies by regulators. Law enforcement must face and overcome problems in obtaining reliable evidence of the identity of those involved in securities offences committed via the Internet and establishing the jurisdiction in which an offence is perpetrated.

7 Many jurisdictions, particularly in North America and Europe, have introduced requirements for 'jurisdiction clauses' in prospectuses and offer documents. These clauses prevent the issuer from accepting applications form foreign investors. The ASC is discussing the use and content of jurisdiction clauses with other members of International Organization of Securities Commissions (IOSCO).

A recent report from the Electronic Commerce Task Force of the Commonwealth Law Enforcement Board stated that establishing 'the real and substantial link between an electronic activity and a geographical territory may be a practical problem which could defeat the application of the existing law'.[8] A legal offering in one jurisdiction may be illegal in another and may be innocently communicated to the second jurisdiction.[9] Illegal offerings may also be made intentionally, with the deliberate intention of evading securities laws.

While the technology for identifying criminal activity on the Internet is improving through the development of indexes, search services and guides that focus on specific topics,[10] tracking Internet crime presents a formidable challenge for regulators.

3.2 INVESTMENT ADVICE

A related area of concern is investment advising. Investment advisers are required to be licensed under the Corporations Law, and the Law applies to the provision of advice using the Internet. The Financial System Inquiry has recommended that a single system of investment adviser licensing should be established. Recommendation 13 of the Inquiry's report concludes that the ASC licensing of securities dealers and futures brokers should be combined in one licensing regime with other forms of licences (investment advice and product sales, general insurance brokers and financial market participants) to be administered by the proposed Australian Corporations and Financial Services Commission.[11]

The enforcement problems arising in the area of securities advising are similar to those already discussed. The source of an electronic tip can be difficult to identify, and uninformed or scurrilous tipping can affect the price of securities or create a false market. Advice on securities investments from an unlicensed adviser is illegal and the ASC will act to prevent its dissemination. Failure to disclose commissions paid to investment advisers is a further example of an illegal activity which presents new deterrence and enforcement challenges in the electronic environment.

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8 *Report of the Electronic Commerce Task Force to the Commonwealth Law Enforcement Board*, November 1996, p 35.

9 See Yelland, P, 'Liability dangers in online share floats', *The Australian*, 20 May 1997, p 3.

10 See 'The Total Librarian', *The Economist (Review)*, 14 September 1996, p 12.

11 *FSI Report*, op cit, at p 245.

In implementing the recommendation of the Financial System Inquiry for a single system of investment adviser licensing, the Government will therefore take into account the need to establish a licensing regime which appropriately recognises and highlights the obligations of securities advisers when relying on electronic media to provide investment advice.[12]

3.3 REGULATORY RESPONSE

It would be wrong to assume that the law does not currently apply to activities carried out by means of novel technologies. Many illegal activities of concern in this context are not unregulated, nor are they unpunishable. Difficulties of enforcement do not mean that such activities occur in a legal vacuum. Furthermore, international co-operation by the ASC with its overseas counterparts, through the International Organization of Securities Commissions (IOSCO), is helping to address enforcement difficulties which can arise.

As was noted earlier in this Part, many of the issues that electronic commerce bring into focus affect the broad range of commercial transactions across the economy beyond securities dealings and therefore require a general resolution across the entire legal system. In this regard, an information-based offence which can be committed on paper or by spoken word, for example defamation, can equally be committed on the Internet. For this reason, a broader response to law enforcement issues accompanying developments in Internet technology is required.

As a consequence the Government has moved to comprehensively respond to the legal issues arising from electronic commerce by convening an Electronic Commerce Expert Group under the auspices of the Attorney-General. The Expert Group comprises members from the private sector, academia and from two State government agencies (see Appendix C for more information on the Expert Group).

The Expert Group has been asked to report on the development of a national legal framework for the implementation of electronic commerce transactions.

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12 ASC Policy Statement 118 (particularly Part IV of the Statement) sets out the ASC's views on the licensing implications of investment advice given over the Internet. The Statement notes the ASC's views that most of the licensing provisions apply to investment advice on the Internet in much the same way as they apply to investment advice on any other medium, but also recognises the difficulty in enforcing the Law in relation to persons located overseas who provide advice on the Internet to Australian investors.

The Expert Group is to report to the Government in March 1998. Of particular importance will be the Group's recommendations dealing with early resolution of questions relating to digital signatures and authentication.

Australian Securities Commission

The ASC has taken a number of steps to proactively respond to the challenges posed by developments in electronic communications. In May 1996 the ASC published a package of consultative documents on electronic commerce. The package was released to inform market participants of the ASC's overall approach to regulatory issues arising from the increased use of information technology and to stimulate debate and comment on the regulatory implications of developments in electronic commerce. In July 1996 the ASC launched a dedicated information sheet titled 'Investing on the Internet'. The information sheet provides advice to Internet users on the questions they should ask when thinking of investing and the dangers they may face in doing so. In September 1996 the ASC issued Policy Statement 107 on Electronic Prospectuses which set out when electronic prospectuses would be permitted. The Policy Statement indicated that the use of electronic prospectuses should be allowed where the policy underlying the prospectus provisions of the Corporations Law was satisfied.

The ASC is also one of 16 securities and futures authorities, regulating some of the world's larger, more developed and internationalised markets, that make up the Technical Committee of IOSCO. The Technical Committee released, on 22 September 1997, its *Report on Enforcement Issues Raised by the Increasing Use of Electronic Networks in the Securities and Futures Field*. This initial report focuses on the Internet's opportunities and challenges for securities and futures regulators in the enforcement context. The issues discussed and the recommendations contained in that report are to be considered by the Technical Committee's Internet Task Force. The Commission plays an important role in the work of IOSCO in relation to this and other regulatory issues, and will host the IOSCO Annual Conference, in Sydney, in 2000.

The guiding principles that the ASC applies when considering issues arising from electronic communications matters, are as follows:

- technology is a positive development — it is a tool for changing and improving markets and opening new investment opportunities;
- the ASC should be facilitative and receptive to market developments — it is concerned with the achievement of regulatory objectives not technological solutions; and

- the ASC considers that the same fundamental principles and rules that apply to regulation of traditional markets apply to electronic commerce and that new rules should not be more onerous than those currently in place.

Proposal No. 1 — Enforcement Issues Raised for the Australian Securities Commission with the Advent of Globalisation and New Technologies

The Australian Securities Commission (ASC) should continue its vigilance in relation to the regulatory concerns posed by developments in electronic communication and commerce, and maintain an active enforcement strategy to deal with those concerns.

It should also continue its participation in the work of the International Organization of Securities Commissions (IOSCO), which is addressing enforcement challenges and opportunities arising from the increasing use of the Internet.

PART 4: ELECTRONIC SERVICE DELIVERY

4.1 ELECTRONIC LODGMENT AND ACCESS TO INFORMATION ABOUT COMPANIES HELD BY THE ASC

The Corporations Law requires that information about companies be provided to the ASC. The Law also generally obliges the ASC to keep the information and to make it available for inspection by members of the public. A member of the public may obtain a copy of the information from the ASC and the copy may be *prima facie* evidence of the information it contains.

These rules have a number of policy objectives.

- By giving details such as the name, address of registered office and identity of directors, they provide substance for the legal personality conferred by the Law on bodies registered under it.
- They play a role in making information about companies available to shareholders, creditors and the marketplace generally to enable them to make more informed decisions. (The information involved includes certain financial information, information about transactions for which shareholder approval is required, and takeover and fundraising disclosures.)
- They facilitate compliance with the Law. Information lodged with the ASC can be used by it to monitor compliance with the Law and to take remedial or enforcement action.

The means of achieving these goals should ideally allow information to be provided to the ASC in a timely manner at the least expense to the parties concerned. However, the technical operation of the Corporations Law has traditionally contemplated that the provision of information to the ASC be provided under physical notices, reports and forms.[13] More recently, however,

13 For example, there are currently over 400 forms prescribed or approved for the purposes of the Law, some of which are used fewer than 10 times a year.

the ASC's electronic lodgment program (EDGE) has not been paper-dependent.

EDGE

EDGE enables the electronic lodgment with the ASC of certain information required under the Law. Among the documents that can be lodged electronically are annual returns and a range of other notifications of relevant events such as changes in registered office, allotments of shares and changes in office holders.

The ASC's electronic search facilities also provide a means through which businesses can obtain information from the ASC's data bases of real commercial value. In March 1997, the ASC launched a full on-line company search facility whereby the public can search the corporate data base (ASCOT) and the ASC's document retrieval network (DOCIMAGE), via a hyperlink from the ASC's Internet Home Page to certain information brokers who are electronically linked to the ASC's information systems. This facility enables businesses and members of the public, both in Australia and overseas, to connect to a broker and obtain on-line information available at any ASC Business Centre.

Electronic lodgment of routine information with the ASC provides lodgers with the certainty that their records match the ASC's. It also saves time in lodging documents, by eliminating reliance on mail or messenger services and reducing re-working time caused by errors in form filling.[14]

As the following table illustrates, the electronic lodgment of documents with the ASC is rapidly increasing.

Document Lodgment Trends with ASC

	Electronically lodged	Total lodged	Percentage lodged electronically
1994	19,721	259,182	7.6
1995	132,023	1,046,115	12.6
1996	487,706	1,721,474	28.3
1997 (to 1 July)	313,306	909,969	34.4

Under the Law as it currently stands, EDGE cannot completely replace the need for paper documentation. Lodging agents are obliged to retain signed paper originals of the information lodged electronically with the ASC. These

14 ASC brochure, *EDGE Electronic Lodgment: How to participate*, 1995.

paper originals form the basis of enforcement action by the ASC for non-compliance. This situation arises because of the need to link, by means of a signature, the person who is obliged to lodge relevant information and the information that is lodged. The development of digital signatures will, however, obviate the need for the retention of paper originals for this purpose.[15]

Many other provisions of the Law were also drafted in a pre-electronic era and do not specifically contemplate electronic communications. Use of words and concepts like 'signature', 'attachment', 'copy' and others may create uncertainty about the extent to which electronic media may be used in place of physical media. The emphasis in the Law on paper-based communications unnecessarily complicates the Law and compliance with it. It is inconsistent with the flexibility of format and delivery that is necessary to stay abreast of developments in electronic commerce. Modernising and streamlining the Law therefore offers significant potential benefits to business as well as a fillip to the development of electronic commerce.

The right to access by the public to information given to the ASC is also expressed in terms of inspecting a 'document' lodged with the ASC.[16] The term 'document' is in turn defined in section 9 of the Corporations Law by reference to a variety of physical media and encompasses paper records, CD ROM's, disks and other physical media. However, there is doubt whether the present definition extends to electronic impulses or messages by means of which information is sent by, for example, e-mail over the Internet.

To facilitate electronic commerce in business regulation, it is desirable to remove the definition of 'document' and replace it with the broader and more flexible concept of required information or a record. The use of such a concept will ensure that the Law is flexible enough to accommodate technological change as it occurs. As long as the information is provided in a form that the ASC can handle and make publicly accessible, there is no need to require that the information be in a paper format. This would allow business to take advantage of developments in communications technology but at the same time will not be prejudiced by a failure to do so.

The work currently undertaken by the ASC to facilitate the electronic lodgment and inspection of information tests the construction of a number of provisions in the Corporations Law. While the ASC has been able to achieve a great deal within the existing legislative framework, further amendments are

15 Work on legal recognition of digital signatures, being undertaken by the Attorney-General's Electronic Commerce Expert Group, is referred to in Appendix C.

16 See section 1274(2)(a) of the Corporations Law.

required to allow the ASC to take full advantage of communications technology for the lodgment and inspection of information.[17] Amendments are also desirable to allow the ASC's full participation in the Single Entry Point (SEP) initiative.[18]

4.2 SINGLE ENTRY POINT (SEP)

The Small Business Deregulation Task Force, in its November 1996 report entitled *Time for Business*, proposed ways to reduce the compliance burden on small business. It identified the requirements on a small business to provide information to a variety of government agencies as one source of compliance burden, given that much of the information was duplicated. To address this problem, the Task Force recommended the establishment, by 1 July 1998, of a mechanism for the collection of the most commonly sought information from small business and its distribution within government through a single entry point.[19] The Task Force considered that the implementation of this recommendation would result in reduced costs for small business; higher revenue for government through increased economic activity; and lower government costs through greater efficiency in administration.[20]

The Government announced its response to the Task Force's report on 24 March 1997,[21] indicating agreement to the SEP proposal. As a first step, the Government undertook to introduce, by 1 July 1998, a single process for the initial registration requirements of four Treasury portfolio agencies — the Australian Taxation Office (ATO), the ASC, the Australian Bureau of Statistics (ABS) and the Insurance and Superannuation Commission (ISC). The coverage of more collection requirements (such as annual update information), the

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17 Other policy issues, the resolution of which will greatly facilitate electronic business regulation by all levels of government, are the development of an authentication framework and legal recognition of digital signatures, referred to in Appendix C.

18 Enactment of the proposed Company Law Review Bill would assist in the ASC's participation in the SEP. The further amendments proposed in this part would, however, enhance the ASC's electronic business regulation capability.

19 *Time for Business*, op cit, at p 103.

20 Ibid, p 105. The SEP may also have the beneficial by-product of providing an incentive to increase small businesses' access to information technologies which are a pre-condition to electronic commerce, thereby facilitating greater small business participation in electronic commerce opportunities.

21 *More Time for Business*, Statement by the Prime Minister, the Hon. John Howard, MP, 24 March 1997.

addition of other Commonwealth agencies, and links to State-based SEP projects, have been identified as desirable further steps.

Implementing the Single Entry Point

The way in which the SEP is to be implemented is currently being studied by a Task Force co-ordinated by the Department of Workplace Relations and Small Business, and including officers seconded from the four Treasury agencies. The Task Force is exploring a range of complex financial, administrative, technical and legal issues, in consultation with stakeholders. The outcome of the Task Force's work will be taken into account by the Government when deciding on an implementation strategy for the SEP and necessary legal and administrative arrangements for its operation.

The ASC's electronic lodgment system (EDGE) and the ATO's electronic lodgment service (ELS) already seek to allow for the use of electronic commerce by members of the public in their dealings with the agencies, as well as for many of the agencies' own functions. Both systems make wide-spread use of intermediaries, such as accountants and legal firms, as lodgment agents.

The SEP will build on these initiatives. However, it is apparent that the laws authorising the collection of information from the public by the four Treasury agencies need to be considered to take account of electronic business regulation. The SEP provides added impetus to respond to this need.

The detail of the amendments to the legislation under which the four Treasury agencies operate and collect information will differ between the various statutes. Generally speaking, the issues that amendments need to address relate to:

- the format in which information is collected; and
- the way in which payments (which often accompany compliance with regulatory obligations) may be made to the agencies.

In relation to both issues, the preferred policy response is to ensure that legislation imposes technology-neutral requirements which afford flexibility as to the means by which the requirements may be satisfied. More detailed prescription of processes to be followed can be set out in delegated legislation or guidelines issued by relevant agencies. In other words, legislation should specify what is required, and subsidiary rules can amplify how those requirements are to be satisfied from time to time in ways which reflect emerging technologies.

Proposal No. 2 — Enhanced Flexibility for the Electronic Lodgment and Inspection of Information under the Corporations Law

The provisions of the Corporations Law providing for the lodgment and inspection of documents with the ASC will be amended to ensure that they are flexible enough to accommodate changes in communications technology so as to allow electronic as well as paper-based methods to be used.

The Corporations Law will focus on the information that must be lodged or may be inspected with the ASC, rather than on its format or the physical media in which it is stored. The Law will specify the information the ASC should obtain and permit to be inspected, while practical matters of detail, such as the methods of communication which may be used for that purpose, will be set out in regulations or in rules determined by the ASC.

4.3 COLLECTION OF FEES BY THE ASC

The ASC collects fees in respect of mandatory lodgment of Corporations Law documents and when it provides a corporation or person with a service, such as provision of information from its database or the consideration of applications for relief from or modification of the Law.[22] The ASC wants to provide corporations and the public with the ability to lodge and recover information using electronic media. However, the existing law relating to the collection of fees impinges on this goal.

Currently, under the Corporations Law, there is often a requirement to pay a fee contemporaneously with the lodgment of a document or a request for

22 While a company must pay a fee when lodging an annual return, documents lodged for the purpose of advising, for example, changes to the directors or the registered office, do not attract a fee unless they are lodged late.

service (usually to provide information).[23] As a result, the current fee collection structure is document and request based — when a document is lodged or request for service is filed, a fee must be paid.

The nexus that exists between, on the one hand, the lodgment of a document or the request for a service and, on the other, the payment of a lodgment or request fee, constrains wider use of electronic lodgments and applications.

Currently, when a document is lodged or a request for information is made via an electronic medium (such as the Internet or e-mail), there is no opportunity for a contemporaneous payment of the required fee. While a document could

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23 This requirement arises from the structure of sections 22 and 25 of the *Corporations Act 1989 (the Corporations Act)* and section 9 and Part 9.10 of the Corporations Law.

Section 22 of the *Corporations Act* states that the Governor General may make regulations prescribing all matters required or permitted to be prescribed under the Corporations Law. Under section 25 of the *Corporations Act*, regulations may prescribe a number of fees (including fees that are taxes) for anything that is a 'chargeable matter' 'Chargeable matter' is defined in section 9 of the Corporations Law, and includes a variety of situations including:

- the lodgment of a document;
- the registration of a document; and
- the inspection or search of a register kept by, or a document in the custody of, the ASC.

Part 9.10 of the Corporations Law contains various provisions relating to fees for chargeable matters. Under section 1351:
'where:

(a) the regulations prescribe a fee for a chargeable matter; and
(b) the fee is imposed by a provision of an Act of this jurisdiction; the fee must be paid to the Commonwealth for the matter.'

As a general rule, any fees that have been prescribed for a chargeable matter must be paid at the time the document or request is made to the ASC. There is a difference, however, between the lodgment of a document and a request for service. Section 1354 states:

'(1) This section applies where;
  (a) a fee is payable under section 1351 for the lodgment of a document; and
  (b) the document was submitted for lodgment without payment of the fee.
(2) The document is not taken not to have been lodged merely because of the non-payment of the fee.
(3) However, if the amount of the fee is ascertainable, the fee is a debt due to the Commonwealth and payable by the person whom the Commission determines in writing to be the person who it is reasonable to expect would have paid the fee if the fee had been paid when the document was submitted for lodgment.'

In contrast, where the ASC service being utilised is a request for service, section 1355 applies. Section 1355(1) states that:

'Where a fee is payable under section 1351 for a matter involving the doing of an act by the Minister or the Commission, the Minister or the Commission must not do that act until the fee is paid.'

be validly lodged electronically it would generate a debt payable to the Commonwealth and could not at present be processed until the fee was paid.

Another problem is the earmarking of a fees payment with the lodgment or request to which it relates. As the regulations prescribe specific fees for specific activities, it is important to identify each payment / activity couplet.

This problem could be overcome with interactive technology that could identify each electronic lodgment or request with a specific electronic payment. Alternatively, the payment and lodgment / request nexus could be relaxed so that the ASC could undertake activities as requested and use either credit or debit accounts with the customer in question.

A range of possible payment methods that could be utilised, include:

- payment via electronic exchange;
- a credit system whereby the ASC would be able to use an invoicing system for services rendered;
- a debit system whereby a customer would be able to 'top up' their account and have funds removed as services are rendered; or
- allowing companies to tentatively register or lodge documents electronically on the proviso that payment is received within a stated period.

Another possible solution would be to sever completely the nexus between document or request lodgment, and the payment of a fee. Under this approach, the entire basis of fee collection could be altered. Instead of a fee per transaction based on 'chargeable matters' as defined by section 9 of the Law, operating costs could be recouped, for instance, through the levying of an annual license fee on corporations payable on, for example, the anniversary of incorporation rather than, as at present, the lodgment of the annual return. This approach would afford the ASC's use of whatever fee collection procedures are commercially viable, but the wider implications and possible manner of implementation would need to be carefully assessed and are not being put forward as policy options by the Government at this time.

Proposal No. 3 — New Arrangements for Collection of Fees by the ASC

The ASC will be given greater flexibility to receive documents and requests for service in electronic form.

As a result, the current fee collection structure will also be amended to ensure that the means and timing of fee collection accommodates those electronic commerce methods.

4.4 Other Measures to Recognise Electronic Communication under the Corporations Law

There is a need to amend other existing procedural requirements of the Corporations Law to recognise electronic means of communication.

This task has already commenced. The provisions of the Corporations Law dealing with register keeping obligations were amended in 1995 [24] to provide that if a register of members, option holders or debenture holders is kept on computer, the company and a person wishing to inspect the register may agree that the person can access the information by computer. A person who obtains a copy of a register may now also obtain it on floppy disk, although the disk need not be formatted for the person's preferred operating system.

However, this is one of the few areas in the Law which specifically addresses the use of electronic technology. For example, the convening of a company meeting is 'by notice in writing'.[25] While the wording of the provision does not necessarily exclude the sending of an e-mail to provide the required notice, e-mail is not specifically contemplated by the legislation.

Recommendation 91 of the report of the Financial System Inquiry,[26] in calling for the amendment of legislation to allow for electronic commerce, highlights an important means of achieving that objective; namely, by amending legislation to allow the electronic provision of notices and documents.

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24 The *First Corporate Law Simplification Act 1995*, section 216F.
25 Corporations Law, subsection 247(2).
26 *FSI Report*, op cit, at p 63.

Amending the Corporations Law in this manner would provide a more modern and technologically-neutral legislative framework. The following changes will significantly improve the recognition of electronic communication methods under the Law.[27]

- Directors' meetings should be able to be held or called using any technology consented to by all the directors (ie without directors being physically co-located).
- Instead of physically meeting together, directors of public or proprietary companies should be able to use a circulating minute in order to pass a resolution. The minute should be able to be passed between directors in any physical or electronic form that allows them to sign the document.
- Proprietary companies should be able to use a circulating minute in order to pass a resolution. As with directors' resolutions, the minute should be able to be passed between members in any physical or electronic form that allows them to sign it.
- A notice of a members' meeting should be able to be sent to members either personally, by post, or by fax or other electronic form if the member has notified the company of this possibility.
- The notification of a proxy should be able to be sent to the registered office of a company by fax or in electronic form.
- Financial records should be able to be kept in an electronic form, provided they can be converted into hard copy and be made available for inspection.

These changes, when enacted, will be a significant step towards modernising the Law to take account of the increasing use of electronic communication. They will facilitate communication between companies and their members, as well as the retention of records in electronic form, thus reducing transaction costs. As a result, businesses will be able to operate more efficiently while still meeting the information needs of their members and their record-keeping obligations under the Law.

27 These changes were initially contained in a Bill, formerly known as the Second Corporate Law Simplification Bill, which was the subject of examination and report in 1996 by the Parliamentary Joint Committee on Corporations and Securities. On 13 November 1997, the Treasurer announced the Government's intention to proceed with the Bill, now known as the Company Law Review Bill, with some amendments.

Proposal No. 4 — Recognition of Electronic Communication Methods in the Corporations Law

To facilitate electronic communication between companies and their members, as well as the retention of company records in electronic form, the Corporations Law will be amended to recognise electronic communication methods, thereby providing a more modern and technologically-neutral legislative framework.

PART 5: SETTLEMENT SYSTEMS

5.1 REDUCTION OF SETTLEMENT RISK

The Financial System Inquiry noted that an important objective of intervention in financial markets is to maintain the stability of the financial system, since major disturbances in the financial markets or the failure of financial institutions can involve considerable costs to economic growth, the safety of investments and the public purse.[28] In particular, the Inquiry considered that the payments system deserves special regulatory attention because of its close links to systemic risk.[29] Those links arise because the payments system may be the transmission mechanism for systemic instability.[30]

Risks to systemic stability may arise from a number of sources. The payments system — in particular, the settlement systems whereby obligations arising between financial institutions are settled — represents one of the most significant sources of systemic risk.

> 'Systemic risk in the financial sector is greater than elsewhere in the economy because of the potential for financial distress in one institution to be communicated to others.
>
> This contagion may result from a loss of customer confidence or because the failure of one institution to settle its obligations directly may cause the failure of other fundamentally sound institutions. The financial system is seen as vulnerable to contagion effects because of the mismatch between the liquidity and maturity profile of the assets and liabilities of

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28 *FSI Report*, op cit, at p 363.

29 Ibid, at p 223. The term 'payment system' refers to the mechanisms provided by financial systems to enable funds, or value, to be exchanged between parties. The operational framework of the payments system is comprised of the various payment instruments, such as cash, cheques and debit and credit cards; and the financial institutions (and others) providing payments services, including the recording, communication, distribution and settling, and in most cases, the holding of transaction balances.

30 Ibid, at p 363.

> financial institutions, particularly banks, and the interconnections of the financial system through payments mechanisms.'[31]

Systemic risk arising from settlement risk — the failure of an institution to settle its obligations with one or more other institutions — is exacerbated where the settlement of high value payments is deferred, as is currently the case in the payments system.[32]

Real Time Gross Settlement and Payments System Netting

The Reserve Bank of Australia (RBA), in common with other central banks, seeks to foster sound risk management practices. Worldwide, central banks are adopting a number of arrangements to decrease systemic risk in relation to deferred payment transactions. Two of the most significant means of reducing settlement risk, and hence reducing counterparty exposures, are the establishment of real time gross settlement (RTGS)[33] arrangements for high value payments, and promoting greater legal certainty for the netting of deferred payment transactions.

The Financial System Inquiry noted that the RTGS system to be implemented by the RBA will represent world best practice.[34] By April 1998, high-value payments (accounting for more than two-thirds of the value of cleared payments in Australia) will start to be settled on a RTGS basis. RTGS will ensure that each high-value payment is settled irrevocably as it is cleared. That is, payment will be settled as it occurs rather than the settlement obligation being deferred until the next day, as is the current practice.

The Financial System Inquiry also recommended that netting legislation to cover failure by participants in the payments system be expedited.[35] Netting involves the off-setting of payment obligations between two or more parties so as to produce, for each party, a single net amount owed to or by that party. As

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31 Ibid, at p 363.

32 The *FSI Report* provides information on the turnover of Australian financial markets which are the source of most of the transactions in the payments system — ibid, at pp 366-7.

33 According to the 1995 RBA press release announcing the move to RTGS in Australia, a number of countries have had RTGS systems carrying a range of high-value payments for some time, including the US, Switzerland, Japan, Germany, Denmark, Finland and Sweden. Several developing Asian countries now have, or are planning, RTGS systems, including Thailand, South Korea, Singapore, New Zealand and China. RTGS is also a requirement for countries wishing to participate in Economic and Monetary Union within the European Union.

34 *FSI Report*, op cit, at p 378.

35 Ibid — see Recommendation 59 at p 381.

part of an international trend towards providing legal recognition for multilateral netting, the US and Canadian governments have recently introduced legislation which provides legal certainty for multilateral netting payments.

On 19 August 1997 the Government announced that it would introduce legislation to ensure the effectiveness of the RTGS system, and provide greater assurance for current netting arrangements, in the Australian payments system. The proposed manner of implementation of the Government's decisions on RTGS and netting are set out in Box A.

Box A: Reducing Settlement Risk in the Payments System

To reduce settlement risk in the payments system, the Government is developing legislation to clarify the effect of the insolvency of a participant in the payments system on practices central to the operation of that system, namely real time gross settlement and multilateral netting of participants' obligations. Amendments, outlined below, will ensure that the insolvency of one participant does not adversely affect the ability of other participants to meet their own obligations in the payments system, thus reducing the risk that the failure of one participant could precipitate the failure of others.

Payments made after Liquidation or Voluntary Administration

When a voluntary administration or court-ordered liquidation commences, any payments or property transfers made thereafter by the relevant company are void. Under the 'Zero Hour Rule', a court-ordered liquidation is taken to be effective from the previous midnight. There may also be some uncertainty about the time of commencement of a voluntary administration.

Under RTGS, payments are settled irrevocably at the time they are made. The possible application of the Zero Hour Rule means that payments made on a RTGS basis (including those to settle certain multilateral net obligations), between midnight and the time a liquidation order was made, could be void.

Continued

Legislation will be developed by the Government to ensure that transactions through nominated real time gross settlement systems will not be able to be rendered void by the operation of the Zero Hour Rule. The protection will only apply to transactions undertaken on the day the insolvency practitioner is appointed, and will be limited to payments in those systems at the core of the payments system. The RBA will be able to approve settlement systems for exemption from the Zero Hour Rule.

Multilateral Netting and Unfair Preferences

Currently, the settlement of multilateral net positions for all payments in the payments system is achieved by payments across exchange settlement accounts at 9.00 am on the next day. Even following the introduction of RTGS, this system will continue to operate for low value retail payments.

There is, however, a risk that if a participant in the payments system were to fail, its liquidator may try to require net payments made under multilateral netting arrangements to be set aside as 'unfair preferences'. This means other participants could be required to meet their larger gross obligations to the failed participant, but would have merely a right to prove in the liquidation for the debts owed to them by the failed participant.

The Law already recognises the concept of set-off ie where one party holds money of a second party, and the second party owes money to the first party, the first party is entitled to claim, or 'set-off' the money in satisfaction of the outstanding claim against the second party. Netting can therefore be seen as a contractual extension of set-off. There is, however, some uncertainty as to whether the multilateral netting arrangements would satisfy the formal preconditions for the recognition of set-off under the Corporations Law.

The legislation being developed by the Government will ensure that multilateral netting arrangements in the payments system for the settlement of low-value retail payments are not able to be set aside as 'unfair preferences' The RBA will be able to approve multilateral netting arrangements in the Payments System to which this protection will apply.

5.2 CLOSE-OUT AND MARKET NETTING

In addition to netting in the payments system, it is common market practice for participants entering into a wide range of financial market transactions to net their obligations and settle only their net positions. Two common forms of financial market netting are bilateral close-out netting and market netting under the rules of a central counterparty, such as a stock exchange or futures exchange.

Bilateral close-out netting permits a party to a financial contract to terminate the contract if the counterparty becomes insolvent, to calculate the termination values of the obligations of the parties, and to set off the termination values so calculated to arrive at a net amount payable by one party to the other.

Market netting is used where transactions are netted under the rules of a stock exchange, futures exchange or clearing house. These may provide for the novation to a clearing entity of contracts entered into by exchange members, and the setting off of obligations under those contracts in the event of default by the member and for the purposes of settlement.

The Financial System Inquiry has alluded to the increasing complexity and scale of activities in wholesale markets and the resulting increase in systemic risk. Much of that complexity and scale flows from, or is made possible by, the use of electronic commerce. The Inquiry pointed out that close-out and market netting are particularly important for wholesale market participants which commonly have large numbers of unsettled high-value obligations to both receive and pay.[36] Further, legally sound netting of obligations arising from financial market transactions provides participants with significant benefits in terms of cost savings and considerable reductions in counterparty credit risk.

The Financial System Inquiry recommended that the recommendations of the Companies and Securities Advisory Committee (CASAC) Netting Sub-Committee should be adopted and enacted.[37]

Why Reform is Needed

The CASAC Netting Sub-Committee assessed the legal issues relating to netting contracts. Committee members included representatives from legal firms, the Sydney Futures Exchange, the Australian Bankers Association and

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36 *FSI Report*, op cit, at p 379.

37 Ibid — see Recommendation 91 at p 502.

the RBA. The Netting Sub-Committee's Final Report entitled *Netting in Financial Markets Transactions* was released on 7 July 1997.

The Netting Sub-Committee recommended the enactment by the Commonwealth of a Close-out and Market Netting Act to ensure that close-out and market netting provisions would be allowed to operate notwithstanding the insolvency of a party to the netting contract, on the basis that recovery of the net sum calculated under the netting provisions would be subject to the normal insolvency rules.

Under the Sub-Committee's proposals, a Close-out and Market Netting Act would encompass monetary obligations arising under a financial contract (such as an interest rate or currency swap) or a market contract (such as the purchase or sale of a securities or a futures contract) and other obligations such as an obligation generated by the provisions of a netting contract. Such an Act would also cover master netting contracts.

The Netting Sub-Committee found that there are a number of legal issues, not yet clarified by case law, which raise some doubts about the effectiveness of financial markets netting arrangements under Australian law.

In particular, there is concern that obligations may not be limited to the net amounts owed, and that the law may allow a liquidator of an insolvent party to 'cherry-pick' by disclaiming unfavourable contracts, while holding the other party to contracts which are favourable. Such an outcome could be disastrous to the other party, which would have to pay all its obligations but be unable to set-off those of its counterparty.

If there is any risk that this outcome could occur, the risk must be taken into account as part of the credit risk process when a financial institution considers whether to enter into a financial contract. The result could be to inhibit contracting and consequently deny counterparties the benefits which can flow from financial contracts such as financial derivatives, and also to reduce liquidity in the market. It is important that the netting arrangements are effective in the home jurisdiction of each counterparty.

CASAC's work is consistent with an international trend towards providing legal recognition for netting arrangements. The Report by the Committee on Payments and Settlement Systems of the Group of Ten Countries encouraged wider adoption of netting arrangements in foreign exchange transactions.[38]

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38 Bank for International Settlements, *Settlement Risk in Foreign Exchange Transactions*, Report of the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, Basle, March 1996.

Australian banks are constrained in their participation in international netting arrangements because of the lack of legal certainty that they would have priority in the case of liquidation.

Many other countries have enacted legislation to clarify their netting laws. The Netting Sub-Committee's Background Paper (August 1996) discusses legislative reforms in other countries, particularly the United States, the United Kingdom and Ireland, while noting that reforms have now been adopted in a significant and growing number of industrialised countries.

The fact that clarifying legislation has been thought appropriate elsewhere, coupled with a concern (both in Australia and overseas) that the absence of netting legislation in Australia could affect the international competitiveness of Australian financial institutions, provides a compelling case for legislation.

For example, the 1988 Capital Accord (as amended in 1995) published by the Basle Committee on Banking Supervision has laid down certain requirements which must be satisfied before netting arrangements will be recognised for capital adequacy purposes. In Australia, legal doubts concerning netting are preventing this from taking place. Clarification of the law on netting will enable banks to take into account a wide range of netting arrangements in measuring their exposures. This in turn will have the effect of reducing the amount of capital a bank is required to hold to satisfy the RBA's capital adequacy requirements.

In that regard, the RBA has indicated that the passage of legislation along the lines of a Close-out and Market Netting Act as proposed by CASAC would resolve its concerns regarding the certainty of close-out netting arrangements and enable the Bank to recognise bilateral close-out netting for the purpose of calculating a bank's capital requirements.

Uncertainty created by the absence of such legislation in Australia is also preventing Australian banks from participating in the Exchange Clearing House Ltd (ECHO), an institution set up in London to reduce foreign exchange settlement risk through formal netting arrangements. Similar issues also arise if an Australian incorporated entity wishes to participate in other international clearing houses such as the London Metals Exchange.

In light of these considerations, enactment of a legislative framework to support netting arrangements would ensure that contractual netting provisions would be allowed to operate notwithstanding the insolvency of a party to the netting contract. The CASAC Netting Sub-Committee also recommended that the netting legislation clarify the status of netting arrangements by providing that sections 11F and 16 of the *Banking Act 1959*, sections 45, 52, 53 and 187 of the *Life Insurance Act 1995* and section 86 of the

Reserve Bank Act 1959 will not interfere with bilateral close-out netting under a master agreement.

The Sub-Committee's proposals mean that, in the case of a bank, the application of sections 11F and 16 of the Banking Act would be clarified by allowing the applicable netting contract to operate before the calculation of the 'assets' of the bank which are protected for the bank's depositors. That is, the assets protected for depositors would be the net assets and liabilities of the bank determined after the operation of any applicable netting contracts.

As in the case of multilateral netting in the payments clearing system, a Close-out and Market Netting Act would give preference to the contracting parties to the netting contract over the other creditors of the failed counterparty.[39] By ensuring that netting agreements are enforceable in an insolvency, a Close-out and Market Netting Act would mean that netting agreements would be enforceable which currently may not be enforceable. While this would lead to the reduction in the amount of claims against an insolvent company, it would also lead to a reduction in the pool of assets available to satisfy claims against the company.

This is justified on the basis of the certainty the arrangements will give to participants in wholesale financial markets. Without this certainty, the risk of systemic disruption flowing from the failure of one participant would be markedly increased. Lack of such certainty will increasingly discourage foreign counterparties from dealing in Australian markets. It is already inhibiting Australian banks from participating in international initiatives to reduce settlement risk in foreign exchange markets.

Financial System Inquiry

The Financial System Inquiry recommended that legislation to give legal certainty to bilateral netting of financial transactions as proposed by the CASAC Netting Sub-Committee should be expedited. The Financial System Inquiry noted[40] that the main concerns are to clarify that netting will not be

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39 It would be necessary to ensure that a Close-out and Market Netting Act contained provisions to limit the scope for abuse. For example, a counterparty facing insolvency may seek to enter into transactions under a netting arrangement for the purpose of benefiting one creditor to the detriment of other creditors. Hence, a Close-out and Market Netting Act should not seek to protect netting arrangements from all forms of legal challenge — the courts should retain a power to void certain transactions, for example, where it appears that the counterparties had notice of an impending insolvency.

40 *FSI Report*, op cit, at p 379.

affected by the depositor and policy holder protection provisions of the Banking Act, the Reserve Bank Act and the Life Insurance Act respectively, and to remove concerns that insolvency law will be applied before the completion of the netting process. The Financial System Inquiry also noted that Australian banks are constrained in their participation in international netting arrangements because of the lack of legal certainty that they would have priority in a wind-up.[41]

5.3 COUNTERPARTY AND SETTLEMENT RISK IN INTERNATIONAL TRANSACTIONS

The implementation of RTGS and the provision of legal certainty to multilateral netting for low-value retail payment clearing systems, bilateral close-out netting and financial market netting will help to mitigate systemic risks domestically.

A further concern is the risk associated with international transactions involving cross-border payments and securities settlements.

The Financial System Inquiry suggested that counterparty risk may prove more resistant to control in cross-border transactions than in domestic ones.[42] Foreign exchange transactions are particularly vulnerable to counterparty risk because a foreign exchange transaction requires the counterparties to make two separate payments in their respective payments systems. The fact that such transactions often do not settle simultaneously because of time-zone differences means that some degree of risk may be unavoidable — a party in one time zone which transfers funds to its counterparty (thereby discharging its obligation) incurs a risk that its counterparty might fail to complete its leg of the transaction by transferring the matching funds. This is what happened in 1974 upon the failure of Herstatt Bank, where several of its counterparties irrevocably paid deutschmarks to Herstatt in Frankfurt before the counterpart US dollars had been paid by Herstatt's correspondent bank in New York. Once Herstatt was closed, its correspondent bank suspended the outgoing US dollar payments, resulting in losses by Herstatt's counterparties to the transaction.

41 Ibid, at p 379.
42 Ibid, at p 379.

The risks associated with foreign exchange settlements are further compounded by the need to rely on correspondent banking arrangements. Payment cancellation deadlines and reconciliation times can often extend settlement risks.

However, some risk reduction measures may be available.

- The Report by the Committee on Payments and Settlement Systems of the Group of Ten Countries encouraged wider adoption of netting arrangements in foreign exchange transactions.[43]
- As already noted, it has been argued that Australian banks are constrained in their participation in international netting arrangements (eg ECHO) because of the lack of legal certainty that they would have priority in the case of liquidation.[44]
- The Financial System Inquiry report[45] refers to two proposals emerging from the Group of 20 (G20).
  - — under one proposal, there would be a single global clearing system providing payments matching, multilateral netting and settlement services; and
  - — another proposal is for a global clearing house bank to settle simultaneously both legs of participating members' foreign exchange transactions in a range of currencies where there are overlapping hours of operation and RTGS arrangements.

The Financial System Inquiry concluded that, at least in the medium term, systemic risk will remain of concern in the high value payments system, and that further efforts will be necessary to control risks involving cross-border payments and securities settlements, and other risks sourced internationally. Counterparty risk may prove more resistant to control in cross-border transactions. Whatever action may be adopted to mitigate those risks, implementation of RTGS and the provision of a secure legal basis for netting is likely to offer a good platform for developing cross-border transaction risk controls.

43 Bank for International Settlements, op cit.
44 *FSI Report*, op cit, at p 379.
45 Ibid, at pp 379 and 380.

Proposal No. 5 — Recognition of Close-Out and Market Netting Arrangements

Under the current contract-based close-out and market netting arrangements, there are some legal uncertainties about whether contractual provisions would be allowed to operate notwithstanding the insolvency of a party to the netting contract. This uncertainty has the potential to affect the international competitiveness of Australian financial institutions.

To overcome these uncertainties, the Government will develop legislation, along the lines recommended by the Companies and Securities Advisory Committee (CASAC) Netting Sub-Committee, to provide a more certain and robust legal framework for close-out and market netting arrangements. This legislation will ensure that these netting arrangements will operate, notwithstanding the insolvency of a party to the arrangements.

PART 6: DEBT SECURITIES

6.1 COMPOSITION AND TRENDS IN DEBT SECURITIES MARKETS

In line with the growth in other financial markets in Australia, the market for debt instruments has expanded markedly since the beginning of the 1980s. A number of factors were behind this expansion — deregulation, increased recourse to direct financing (particularly relevant to private debt financing) and the substantial increase in the amount of funds to be raised (mainly through issuance by public authorities). The short-term debt market, for instruments with terms from a day or two up to one year, encompasses the markets for short-term bank securities (such as bank bills and negotiable certificates of deposit), Treasury Notes and State Government and private commercial paper. Long-term debt markets are dominated by Commonwealth and State Government bonds. The term of these instruments is at least one year. Corporate bonds and mortgage-backed securities make up the remainder, but by international standards the markets for these tend to be small, although their market share has been increasing over the past couple of years.

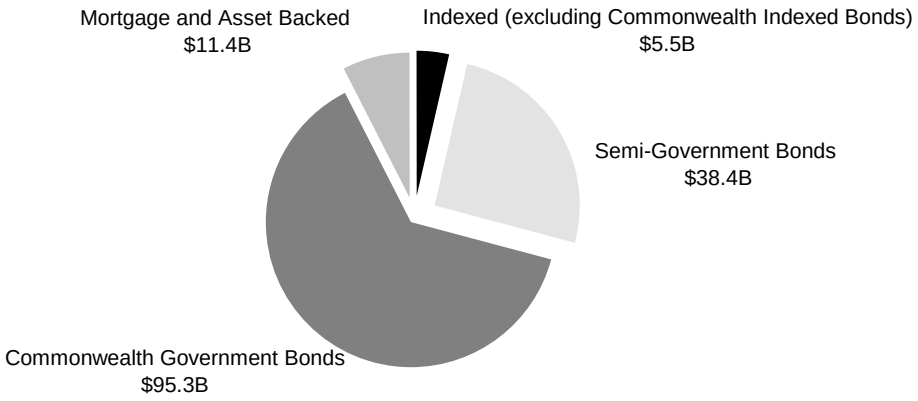
The Australian bond market is well developed and highly liquid, with most trades of long and short-term debt securities being conducted over-the-counter (OTC) between banks and other institutions. There are only limited trades conducted on organised exchanges and directly between companies. OTC trades are cleared by either Austraclear or the RBA's clearing system RITS. It is estimated that around 90 per cent of trading in Commonwealth and State Government bonds is handled dealer-to-dealer, with the remaining number executed by brokers (including through their screen trading systems).

A brief description of various debt instruments is provided at Appendix D.

The market for Commonwealth and State Government securities tends to dominate other markets for debt securities, mainly due to the size of these markets (see Chart following). Approximately 98 per cent of turnover of

long-dated securities involves Commonwealth and State Government bonds.[46] Turnover in these markets has increased due to a significant increase in debt in these markets arising from successive Commonwealth and State Governments' Budget deficits.

Chart 1: Stock Of Australian Debt Securities (Face Value)*[47]



* as at Feb 1997

In Australia, the corporate bond market is relatively underdeveloped compared with other countries, with most corporates raising long-term debt through public issues in offshore markets or through swaps. Corporates tend to tap offshore markets due to the depth and liquidity available in those markets compared with the domestic market, resulting in more competitive pricing.

The 1997-98 Budget estimates envisage the repayment of $25 billion of debt over the four years from 1997-98 to 2000-01. It is anticipated that this reduction in outstanding Commonwealth debt will lead to increased opportunities in the

46 The Allen Consulting Group Pty Ltd, *Australia's Capital Markets — A Report on Australia's Capital Markets*, June 1996.

47 Macquarie Bank Debt Markets, *Debt Market Perspectives*, April 1997, at p 23.

domestic corporate debt market as well as for other non-government securities, such as mortgage and asset-backed securities.[48]

6.2 ELECTRONIC COMMERCE IN DEBT SECURITIES

Debt securities markets have been transformed by computerisation (in both information management and telecommunications), which 'has brought both a new order of operational efficiency and a new order of legal uncertainty'.[49] The legal uncertainty relates to changes to the legal nature of the securities, which is a consequence of a process known as dematerialisation — the shift from paper-based securities systems to electronic records. The elimination of physical certificates or documents of title representing ownership of securities means that securities exist only as computer records. Dematerialisation produces immobilised securities, whereby the securities are stored by custodians or depositaries rather than held by the owners.[50]

Securities may be characterised as either bearer securities (including certificates of deposit, bills of exchange and promissory notes) or registered securities (such as most domestic holdings of CGS). In the case of a registered security, ownership is shown by inscribing the owner's name on a register, and a transfer of legal ownership in the security only takes place when the register is amended. A person physically holding or in possession of a bearer security is entitled to be paid on maturity of the security. The owner of the security is not registered with the issuer. Losing a bearer security means the loss of the entitlement which the security evidences. That is, legal ownership of a bearer security can be transferred by physical delivery.

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48 Malleson Stephen Jaques, *Banking Law Update*, July 1997, Number 99 reports that Standard & Poor's Rating Group estimates that Australia's securitisation market is now the second most active in the world after that of the USA. This activity is attributed to the greater acceptance of securitisation; the cost of funding advantages offered by securitisation over traditional forms of debt financing; and the lower levels of debt issuance by the government sector and investor demand from superannuation funds.

49 Benjamin, J *Law of Global Custody*, Butterworths, London, 1996, at p12. The following discussion is largely derived from Benjamin. See especially Chapter 3.

50 Dematerialisation has had a large effect in financial markets. For example, most of the securities traded on the New York Stock Exchange are immobilised in the possession of a depositary. Cede & Co, the nominee of the Depositary Trust Company (DTC) of New York, is listed as the shareholder of record of 60 to 80 per cent of outstanding shares of all publicly traded companies. See N Papaspyrou *Immobilisation of Securities — Part One: Proprietary Rights of Indirect Holders* [1996] 10 JIBL 430. CHESS is a similar facility in relation to securities traded on the ASX — see Part 3 of this paper.

Negotiability

This ease of transfer characterising bearer securities is a feature of negotiability — and negotiability makes these securities attractive instruments for the market. However, it appears that a major impact of computerisation on bearer securities is the loss of their negotiable status.[51] A test of negotiability is that a negotiable instrument may be passed from hand to hand like money, and that the person holding the instrument may sue directly in his or her own name. The strongest argument against dematerialised securities remaining negotiable is their intangibility, which means that they cannot be held or delivered. That is, dematerialised securities are not capable of possession at common law, and are not instruments.

Statute of Frauds

State and Territory legislation derived from the Statute of Frauds[52] permits the assignment of certain interests only where particular formalities and restrictions are observed. These include the requirements that the assignment of the interest be in writing and that written notice of the assignment be given by the assigner. It is arguable that these requirements apply to certain transactions of debt securities, thereby posing a constraint on the development of electronic means for issuing, and trading in, debt securities. This constraint would take the form of requiring transfers of equitable interests in a debt security to be in writing.

Overcoming the implications of these two issues, to allow for electronic trade in debt instruments generally, raises a number of issues, including in relation to the Commonwealth's constitutional power to enact enabling legislation. This is an issue on which the Treasury will seek legal advice in the course of its review of the Bills of Exchange Act referred to below.

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51 The argument for this conclusion is in Benjamin, op cit, at pp 16-20. She contends that dematerialised securities are not 'instruments', nor capable of physical delivery, nor capable of being sued upon by the holder from time to time, and cannot be negotiable instruments.

52 The Statute of Frauds is picked up in the laws of the States and Territories. See, for example, section 23C(1)(c) of the *Conveyancing Act 1919* (NSW) which provides that 'a disposition of an equitable interest or trust subsisting at the time of the disposition, must be in writing signed by the person disposing of the same or by his will, or by the agent thereunto lawfully authorised in writing'. There are corresponding provisions in the legislation of the other States.

6.3 COMMONWEALTH GOVERNMENT SECURITIES

Constitutional Basis for the Issue of Commonwealth Government Securities

Paragraph 51(iv) of the Australian Constitution provides that Parliament has power to make laws for the peace, order and good Government of the Commonwealth with respect to borrowing money on the public credit of the Commonwealth. The very wide ambit of this power would appear to allow the Commonwealth to arrange for the borrowing of money on its behalf through any technological means available.

Commonwealth Inscribed Stock Act 1911

The *Commonwealth Inscribed Stock Act 1911* (the CIS Act) and the Regulations under that Act currently require that transactions and transfers of legal title in CGS to be settled through a paper based system. The CIS Act therefore does not allow CGS transactions to be settled electronically.

However, there is nothing in the CIS Act prohibiting the introduction of an electronic system for the transfer of beneficial interests in, or other choses in action relating to, CGS. In practice, the concept of granting a chose in action in relation to CGS has been developed to overcome the existing impediment to electronic transfers of the debt instruments themselves presented by the CIS Act.

This concept works as follows. Legal and beneficial ownership of securities lodged into the Reserve Bank Information and Transfer System (RITS) system by a member passes to the RBA. The RBA then grants to the member a chose in action. The chose in action is then transferred through RITS. The chose in action entitles the member to direct the RBA to deliver to the member securities of a specified description and face value. A member does not have a proprietary interest in any of the securities. Securities of the same description may be described as fungible.

It would, however, be preferable to amend the CIS Act to allow the electronic transfer of the direct beneficial and legal interests in CGS.

Proposal No. 6 — Electronic Settlement of Transactions in Commonwealth Government Securities (CGS)

The *Commonwealth Inscribed Stock Act 1911* and Regulations will be amended to enable the electronic transfer of the direct beneficial and legal interests in Commonwealth Government securities (CGS). This will enable transactions in CGS to be settled electronically, as well as through existing paper based means.

Review of the Bills of Exchange Act 1909

Under the terms of the Legislative Review Program announced by the Treasurer in June 1996, the *Bills of Exchange Act 1909* is being reviewed by a working group of officials from the Treasury, the RBA and the Attorney-General's Department. As part of the review process, interested persons and industry groups have been invited to submit their views on the operation and relevance of the Bills of Exchange Act in the market place, in light of developments in electronic commerce; in particular, the potential impact of computerisation on the issue, recording and transfer of negotiable instruments.

The issue of the effect of computerisation on the negotiability of instruments, and the scope for the Commonwealth to enact legislation providing for electronic negotiable instruments, is a focus of the review. The report of the review is expected to be finalised in early 1998. Amendments to legislation to facilitate the electronic issue and trade of these forms of debt instruments could form part of the legislative package to implement CLERP proposals.

APPENDIX A: BUSINESS REGULATION ADVISORY GROUP

Mrs Catherine Walter	(Chairman) Australian Institute of Company Directors
Mr Peter Barnett	Business Council of Australia
Mr Leigh Hall	Australian Investment Managers' Association
Mr Rohan Jeffs	Australian Chamber of Commerce and Industry
Mr Jeffrey Lucy	Accounting bodies
Mr John Murray	Small Business Coalition
Mr Robert Nottle	Australian Stock Exchange
Mr Malcolm Starr	Sydney Futures Exchange
Mr Les Taylor	Australian Corporate Lawyers Association

APPENDIX B: ELECTRONIC SYSTEMS IN AUSTRALIA

Stock Exchange Automated Trading System (SEATS)

The smooth operation of the Australian Stock Exchange (ASX) depends on the Stock Exchange Automated Trading System (SEATS). SEATS is a computer network which facilitates automated trading in securities. Traders who have access to a SEATS terminal are able to track movements in particular stocks and are able to buy and sell securities by entering data on the screen. It is often possible for a trader to conduct a purchase or sale on behalf of a client in the course of a telephone conversation with the client.[53] SEATS commenced operation in 1987 although the ASX continued to operate options trading floors after that time. The ASX is currently upgrading SEATS with an improved version to be known as SEATS 97. Following the upgrade, the system will be better equipped to handle market growth, and will enable members of the ASX to link their trading systems directly with the ASX. This will allow members to place orders on the system without needing to use particular trader workstations.

*S*ydney Computerised Overnight Market (SYCOM)

The daily operation of the Sydney Futures Exchange (SFE) relies on the open outcry system, where the contract price is determined by spoken negotiation between buyers and sellers in the trading pits of the SFE. The SFE has announced that its operations will become fully automated by March 1999. Increasingly, the SFE also relies on the Sydney Computerised Overnight Market (SYCOM). While the SFE's SYCOM began as an after hours automated trading system the SFE now also operates a number of markets during the day. The system matches buy and sell orders in the market, giving priority to price

53 Australian Stock Exchange brochure, *SEATS The Australian Stock Exchange's Electronic Trading System*.

and time. Executions can also be performed in response to offers that appear on the screen in real time. These trades are executed immediately.[54]

Clearing House Electronic Sub-register System (CHESS)

Under the Law, quoted securities may be held in uncertificated form and a securities clearing house is legally able to hold securities on behalf of the issuer. (These uncertificated securities are hence a type of 'immobilised' security — see Part 6). Securities clearing houses are not required by the Law to employ electronic technology in their clearing and settlement arrangements. However, securities exchanges need to provide a quick and reliable clearing and settlement system[55] and computer technology such as that employed by the ASX through its CHESS system provides the best basis for this complex process.[56] Under the CHESS system, a sub-register maintained by the securities clearing house records the number of securities held in uncertificated form on behalf of brokers, participating institutions and investors.

CHESS facilitates the electronic transfer of CHESS approved securities. A *delivery versus payment ('DvP')* system operates for settlements of transactions between brokers, institutional clients and other participants in the clearing house. The clearing house is able to authorise the transfer of cleared funds from a CHESS participant's bank account, thus enabling settlement to occur within a few days of the trade taking place. The clearing house can also act as the agent of the seller to transfer legal title to the shares to the buyer; transfer net amounts for each day's trading to participants' bank accounts; and post any changes to the holdings of participants.[57]

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54 Sydney Futures Exchange brochure, *Sydney Computerised Overnight Market*, February 1991.

55 The ASX's settlement system was recently ranked the third most efficient in the world in a study of settlement efficiency in 20 major markets. Australia also ranked third in the operational risk benchmark. See *ASX News Release*, 20 May 1997.

56 The legislative foundation for CHESS is set out in Part 7.2A of the Corporations Law.

57 See Butterworths *Australian Corporation Law Principles and Practice*, paragraph 7.1.0905.2.

ASX's Enterprise Market

The ASX proposes to introduce an Internet-based facility designed to cater for small to medium sized enterprise capital raising.[58] The electronic facility, to be called the Enterprise Market (EM), will comprise an Internet web page providing a 'classified ads' style electronic 'market place' for small enterprises seeking capital and potential investors. Those seeking investment funds would be able to advertise their needs on the Internet page, attaching relevant information to help fill out information gaps. Arising from its use of the Internet, the EM will allow interactive searching and browsing to maximise the opportunity for a match between an enterprise and an investor. It would facilitate investment matching irrespective of the physical location of the investor and the capital raiser. The proposed ASX service will focus on providing information to potential investors and bringing them into contact with businesses seeking investment funds.

The EM seeks to provide a maximum degree of flexibility to handle a broad range of investments and maximum convenience, accessibility and cost savings available through use of the Internet. The transaction costs of fundraising are anticipated to be lower than would be the case were full company listing to be undertaken. The EM will not be order driven with prices and cannot provide surveillance of prices. The EM is expected to commence operation in March 1998.

The facility will assist the transfer of securities in unlisted companies, including proprietary companies, in a convenient, low-cost environment. It will allow the identification of interested buyers of securities by circulating information about the securities on the EM. The seller may then engage in negotiations about the sale of those securities outside the bulletin board facility.

OTC markets

Technology has assisted the growth of OTC markets with a global daily turnover of around US$880 billion.[59] OTC transactions do not take place on a designated exchange but consist of bilateral transactions between participants who communicate by telephone and computer systems. The traditional role of the OTC market in derivatives is to permit participants to design customised

58 The Treasurer launched the facility on 20 August 1997.

59 Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivative Market Activity 1995.*

products for their individual needs. Generally, OTC markets have not provided a public price formation process.

Technological innovation has facilitated the global nature of OTC markets as well as increased transparency in these markets. For example, in May 1997, the Australian Financial Markets Association launched an information service for OTC financial markets which consolidates information vendor data into a set of Australian real-time data including live inter-bank rates and market benchmarks.[60]

60 See Australian Financial Markets Association, *Issues,* No.5 June 1997.

APPENDIX C: RECENT POLICY REVIEWS

Following is a brief overview of the issues which would relate to electronic commerce that have already been or are being examined by other inquiries and agencies, and that will not be revisited by this paper.

National Information Services Council

In 1995, the National Information Services Council published the agenda papers for its inaugural meeting as a means of raising ideas and promoting discussion on responding to developments in information and telecommunications technologies. Those papers include a paper on legal issues, which provides a useful discussion on government goals and policy objectives and the principles that should be applied in developing specific laws.[61] The Council's Legal Issues Group sounded three warnings which are still pertinent:

- **Don't panic!** The belief that the technological revolution entails the need for a legal revolution of the same magnitude is an unnecessary and panic response.
- **Be cautious, even where change is required.** Where new approaches are required, some caution should be urged. The jury is still out on many issues.
- **International comity versus national advantage.** A balance needs to be struck between measures required to keep Australia in conformity with international norms, and measures that will assist Australia's competitive advantage.

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61 National Information Services Council, Agenda papers from the first meeting of the Council, 10 August 1995, Department of the Prime Minister and Cabinet, 1995. See in particular pp 65-89.

Work of the Australian Law Reform Commission

In its 1996 report *Legal Risk in International Transactions*[62] (ALRC 80), the Australian Law Reform Commission (ALRC) analysed the effectiveness of the legal remedies available when commercial transactions cross international borders. Trans-border commerce involves legal risks associated with the application of laws in different legal jurisdictions. The key finding of the Commission's report is that Australian firms are exposed to cross-border legal problems that are costing them money and inhibiting business opportunities, and that these problems are set to increase in volume and significance with the growth in Australia's international trade and investment.[63]

It can be expected that electronic commerce will be a major factor in that growth. However, the ALRC makes the point that electronic commerce is not itself necessarily giving rise to problems such as legal risk.

> 'Essentially those cross border problems are always there, and all that the explosion — if one accepts that as a description of the growth of the Internet — all that that is doing in commercial and legal terms is highlighting for us yet again and heightening our concern about the inability of lawyers, and policy makers over a considerable period now, to develop adequate cross border law in areas such as private international law as well as substantive law and dispute resolution to reduce the legal risk that exists. That is, I am arguing that it is not the electronic nature of the trading, although this significantly speeds up transactions, which results in concern about whether the deal is secure . . . it is because we have an underdeveloped private international legal system . . .'[64]

ALRC 80 contends that these cross border legal risks, while not new, are increasing in significance, and that Australian firms (and presumably their overseas counterparts) seek to deal with these risks through pricing or other arrangements which add costs and delays and represent an impediment to business activity. The ALRC called for law reform to address these risks through law reform internationally (including, for example, multilateral agreements) and at the domestic level.[65]

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62 ALRC 80, op cit.

63 Ibid, at p 20.

64 A D Rose, 'Electronic Commerce and the Law Free Zone — the limitations of the law', speech to the Australian Securities Commission's Conference on Electronic Commerce, Sydney, 4-5 February 1997, at p 4.

65 ALRC 80, at p 20.

Domestically, ALRC 80 recommends that the priority areas of finance law reform include Australian law on netting and set-off, and Australia's legal framework for payments systems and the potential for international cooperation on legal issues relating to payments systems.

Financial System Inquiry

The Government established the Financial System Inquiry in order to inform its policy development with a better understanding of the competitive pressures facing the financial sector. The terms of reference directed the Financial System Inquiry to place particular emphasis on technological developments and the globalisation of financial markets.

The Financial System Inquiry concluded that facilitating electronic commerce was one of the best ways to realise the potential that technology offers providers and consumers of financial products (primarily by reducing costs, increasing access to the financial system and better allocating and pricing risk). The Financial System Inquiry saw technology and electronic commerce as important contributors to increased financial system efficiency.[66] Accordingly, it argued that 'impediments to the introduction of electronic commerce should be addressed as a high priority.'[67]

Those elements of the Financial System Inquiry's recommendations in the area of electronic commerce[68] within the Treasury portfolio and which are canvassed by this paper, are as follows:

Recommendation 91: Legislation should be amended to allow for Electronic Commerce.

Regulation should not differ between different technologies or delivery mechanisms such as to favour one technology over another. A large number of legislative amendments will be required to implement this recommendation. In addition, further amendments will be required to facilitate electronic commerce. These should include:

66 For a discussion of the main characteristics of technology-driven innovation in the financial sector, see Chapter 2 of *FSI Report*.

67 Ibid, at p 27.

68 See FSI Recommendation 91. Ibid, at p 502.

- adoption and enactment of the recommendations of the Companies and Securities Advisory Committee Netting Sub-Committee;
- review and amendment of Commonwealth, State and Territory legislation to permit digital signatures in appropriate circumstances — such legislation includes the . . . *Financial Transaction Reports Act 1988*;
- amendments to legislation and industry codes of conduct to allow electronic provision of notices and documents to improve the efficiency of financial transactions and reduce costs; and
- amendments to legislation . . . by the end of 1998 to take account of electronic transactions and record keeping . . .

Recommendation 93: International Harmonisation of Law Enforcement and Consumer Protection should be Pursued

To assist in international law enforcement and consumer protection, Australian regulatory authorities should maintain close relationships with counterparts in other jurisdictions. As far as possible, Australian law should be consistent with laws in major centres of electronic commerce.

Information Industries Taskforce (Goldsworthy Committee) Report — The Global Information Economy — The Way Ahead

The Goldsworthy Report made a wide range of recommendations aimed at ensuring that Australia exploits the opportunities offered by the burgeoning worldwide growth in the information industries. The Report proposed the development of a National Information Industries Strategy. The Report's recommendations were based on the size and rapid growth of the information industries, their power to transform business across the economy, and their strategic capacity to diffuse information and technologies throughout the economy.

The Government is considering its overall response to the recommendations of the Goldsworthy Committee report. Reforms to small company fundraising which have been proposed in the Corporations Law Economic Reform Program paper on company fundraising would be relevant to Recommendation 3.5 (relating to venture and development capital raising for small high technology businesses).

Information Policy Advisory Committee Report — A National Policy Framework for Structural Adjustment Within the New Commonwealth of Information

The IPAC Report spells out the central issues IPAC consider require addressing by the Government in responding to the challenges of the emerging information society. The Report provides an umbrella framework for positioning Australia to take advantage of developments in information technology. It emphasises the potential catalytic role which might be played by the national government.

The Government is considering its overall response to the recommendations of the IPAC report. The proposal for Single Entry Point referred to in Part 4 of this paper would be relevant to the Report's proposal for the development of a single, seamless online interface for the delivery of government services and public transactions.

Review of Business Programs (Mortimer Report) — Going for Growth: Business Programs for Investment, Innovation and Export

The Mortimer Inquiry was established to review current Commonwealth government assistance programs for business and to recommend reforms to those programs. The Review argued that a central policy aim should be achieving higher economic growth. The Review recommended adopting a 'whole of government' industry policy through consolidated business assistance programs and the allocation of $1 billion over five years for incentive packages for particular investment projects.

The Government is considering its response to the recommendations of the Mortimer Report.

National Office for the Information Economy

The Prime Minister, in recognising the importance of enhancing the co-ordination of on-line policy making across government, announced on 16 September 1997 the establishment of the National Office for the Information Economy. That Office will co-ordinate policy on the regulatory and legal infrastructure for on-line activities, including facilitating electronic commerce.

National System for On-line Authentication

On 14 October 1997, the Minister for Communications, the Information Economy and the Arts announced that the Government will facilitate the creation of a new peak body to oversee the develop of a national system for on-line authentication. Such a system is required to provide a more secure basis for, and hence more confidence in, electronic transactions. While to date parties to transactions can physically verify each other's identity if they need to, the difficulty of checking a person's identity and the authenticity of digital signatures has impeded electronic commerce. The proposed national system will hence considerably boost electronic commerce.

Electronic Commerce Expert Group

The Commonwealth Attorney-General has established an Electronic Commerce Expert Group. The Group, comprising members from the private sector, academia and from two State government agencies, has been established to report on the need for legislation (either uniform State/Territory and complementary Commonwealth legislation, or Commonwealth legislation alone) to support the national implementation of electronic commerce transactions within a framework of international standards. As such, it provides a forum for the development of a national approach to legal issues of general application. The Group will report in March 1998.

Among the issues that the Group is to consider are:

- legal recognition, retention and attribution of data messages;
- admissibility and evidential value of data messages;
- formation and validity of contracts; and
- how requirements for writing, a signature and an original can be met in an electronic medium.

Perhaps the most pressing issues, both because of the work that has already been done and because of the impact that early resolution would have in facilitating electronic commerce, are those relating to digital signatures and authentication structures.

Tax and the Internet - Australian Taxation Office Discussion Report

In August 1997 the Australian Taxation Office released a discussion report on the challenges posed by electronic commerce for taxation administration. The report was released to stimulate debate on the issues raised and facilitate Australian business taking advantage of the opportunities offered by electronic commerce while protecting the revenue base.

The report found that at this time electronic commerce had not had an appreciable impact on tax collections. However, the report found that, to the extent that Australian business suffers adverse impacts due to electronic commerce, the tax base will reduce and that this result may be reversible. It noted that a primary impediment to the development of electronic commerce is the lack of a settled legal infrastructure which it suggested would benefit from cooperative development by government agencies of electronic commerce policies.

International Standards

The United Nations Commission on International Trade Law (UNCITRAL) has developed a Model Law on Legal Aspects of Electronic Commerce. The Model Law is based on the recognition that legal requirements prescribing the use of paper based documentation constitute the main obstacle to electronic commerce. It does not attempt to define computer-based equivalents to paper documents. Rather, it deals with the basic functions of paper documents and identifies the criteria to be met in performing those functions. Once those criteria are met by data messages, the Model Law would enable such data messages to enjoy the same level of legal recognition as corresponding paper documents performing the same function.

Many of the implementation issues arising from the Model Law will be examined as part of the work of the Attorney-General's Electronic Commerce Expert Group referred to above.

Other Work

Many Government agencies and advisory groups are working on specific aspects of electronic commerce. A number of these agencies and groups are represented on the Coordination Committee for Information Services (CCIS).[69] CCIS is a high level co-ordinating body for broad policy issues which also co-ordinates the Commonwealth's response to recommendations of the Information Policy Advisory Council (IPAC) and the Online Council.

69 The membership of CCIS is the Departments of Finance and Administration, Defence, Health and Family Services, Social Security, Employment, Education, Training and Youth Affairs, the Treasury, Industry, Science and Tourism, Foreign Affairs and Trade, Primary Industry and Energy, the Attorney-General's and the Office of Government Information Technology, Australian Customs Service and the Australian Taxation Office.

APPENDIX D: DEBT INSTRUMENTS

Commonwealth Government Securities

Commonwealth Government securities (CGS) are debt instruments issued by the Commonwealth Government. CGS include:

- Treasury Notes, which are short-term discount securities with maturities of 5, 13 and 26 weeks, issued by competitive tender by the Commonwealth Government on a regular basis; and
- Commonwealth bonds, namely Treasury Fixed Coupon Bonds, Treasury Adjustable Rate Bonds and Treasury Indexed Bonds. These are of various maturities and are issued to the market by way of competitive tender. Institutions wishing to participate in the tenders must be registered with the RBA, or use registered bidders as agents.

The issue and trade of CGS is regulated by the *Commonwealth Inscribed Stock Act 1911*. The Commonwealth enjoys crown immunity from the obligations of the Corporations Law in respect of debt issues.[70]

State Government Securities

State Governments raise funds in a number of ways — in the retail market, in the institutional market through tenders or in the institutional market by private placement. They generally raise finances through the issue of debt by State Government Central Borrowing Authorities, although they have the ability to issue debt in their own name. State Government securities are also known as 'Semi-Government Bonds'.

Debentures and 'Corporate Bonds'

A debenture is the documentary evidence of the indebtedness of a body for money lent to that body. Debentures are mainly issued on the retail market

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70 See Part 5 of the Corporate Law Economic Reform Program's *Fundraising* paper.

through prospectuses by, for example, finance companies. Such securities are generally bought at face value, and held to maturity. The Corporations Law regulates the issue of debentures, through the fundraising provisions.

Some types of debentures are referred to as 'corporate bonds'. Most corporate bonds are issued in the wholesale market by banks, finance companies and large corporate entities. The domestic market for corporate bonds is small compared to the market for Government securities due to the illiquid nature of these securities. As a consequence of their illiquidity, there tends to be minimal trading in corporate bonds.

As a method of fundraising, however, debentures have some disadvantages, mainly due to administrative costs, stamp duties, compliance costs in meeting Corporations Law requirements (for example, prospectus formalities) and advances in technology opening up other avenues for fundraising by companies.

The regulation of debentures and corporate bonds will be examined in the context of the ongoing rewriting of the Law.

Certificates of Deposit

Certificates of deposit (CDs) are issued by banks and record the receipt of money on deposit and a promise to repay it with interest with a fixed or floating rate. CDs come in two forms, the 'negotiable certificate of deposit', which is payable to bearer and is accepted as negotiable in the market, and the transferable certificate of deposit, which is payable to the registered holder of the deposit.[71] Bank certificates of deposit trade at rates similar to equivalent maturities of bank accepted bills of exchange. Unlike other negotiable securities such as bills of exchange, CDs are not created under statute, but arise under private legal relations.

Bills of Exchange and Promissory Notes

A bill of exchange is a negotiable instrument defined in the *Bills of Exchange Act 1909* as an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is

71 Mallesons Stephen Jaques, *Australian Finance Law*, 3rd Ed, Longman Business and Professional, Australia, 1994, at p112.

addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to bearer.

Instead of borrowing, a company may raise finance by drawing on bills of exchange for acceptance or endorsement by a financial institution. This enables the company to obtain funds on the strength of that institution's name through the sale or 'discounting' of bills of exchange.

Bank Bills are bills of exchange issued with a bank's guarantee. There are two main forms of the bill of exchange:

- Bank accepted bills are bills on which a bank is acting as the 'acceptor' of the bill and therefore takes responsibility to pay the bill's face value to its holder on its redemption date.
- Bank endorsed bills, while not originally issued by a bank, nonetheless have a bank signed as an endorser. Generally speaking, the liability of an endorser of an accepted bill is secondary to that of the acceptor, who is primarily liable to pay the bill. In the event of the failure of the acceptor to pay the bill's face value to the holder of the bill, the drawer and endorsers become jointly and severally liable to the holder, subject to the requisite dishonour proceedings being taken.

A promissory note is also a form of negotiable instrument. It is defined in subsection 89(1) of the Bills of Exchange Act as an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to a specified person, or to the bearer.

Promissory notes are actively traded in the money market. In Australia they are also referred to as p-notes or one-name paper. In the United States they are referred to as commercial paper.

Both bills of exchange and promissory notes are regulated under the Bills of Exchange Act.