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**Master of Laws**

**Regulation of Online Investing (LAWS 3088)**

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**Research essay topic**

“The regulatory balance in the provision of online investment tools to retail clients – is it safe to provide tools where retail clients prescribe their own suitability?”

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## 1. Introduction

The Internet facilitates access to an enormous amount of information and online tools not previously available to retail investors.<sup>1</sup> The Internet reduces the role of financial advisers and full service brokers. Online tools assist investors to make investment decisions. This raises issues as to what online tools trigger the Australian law personal advice obligations requiring a reasonable basis for advice having regard to the investor's circumstances. This is in contrast to online tools which only provide general advice.

While online tools empower investors, investors may not recognise their own vulnerabilities. This paper will consider whether the current Australian law regulatory response (the distinction between personal and general advice) is appropriate, in light of these online characteristics, to encourage an appropriate use of online tools but at the same time not stifling the financial education of consumers. The paper assumes that online tools which constitute personal advice under Australian law would not be provided (given the difficulty of complying online with the reasonable basis and statement of advice obligations applying to personal advice to retail clients).

## 2. Executive Summary

This paper concludes that the Australian law personal advice/general advice distinction is an appropriate balance in the context of online tools. This distinction facilitates the provision of useful online tools (those which constitute general advice such as certain risk profilers). Where the distinction would categorise a tool as personal advice (for example certain push technology), it is appropriate that such a tool be classed as personal advice giving rise to the reasonable basis for (personal) advice obligations. However, this paper notes that given evidence of online investors' behaviour and the difficulty encountered by non-advised retail clients in comprehending complex online information, the general advice warning required under section 949A of the *Corporations Act* (Cth) is not sufficiently blunt to jolt or caution online investors to make (particularly, online) investment decisions with proper consideration. A more effective warning is recommended for online tools.

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<sup>1</sup> Australian Securities & Investments Commission, *Survey of online trading websites*, August 2000, p 5.

### 3. Background

Given the Australian Government policy to encourage savings for retirement and improve retail client's understanding of financial matters, regulation should facilitate the provision of financially educative online tools which assist investors. However, any online tool which amounts to a recommendation for a particular financial product or a class of financial product ought to be subject to the personal advice obligations (that is ought to require (as personal advice does require) a full investigation of the client's circumstances to ensure the advice is appropriate).

The regulation of online financial tools should have regard to the characteristics of the Internet (such as immediacy and interactivity) to ensure the regulatory objectives of facilitating *informed* investment decisions in light of the online environment. The Internet facilitates ease of access to invest, empowers investors by the access to financial information but facilitates disintermediation (that is, bypassing advisers and brokers, and investing without engaging these gatekeepers).<sup>2</sup>

There is an overwhelming amount of financial information available online.<sup>3</sup> In espousing regulatory policy to the online environment it is important that the characteristics of the Internet, and the manner in which investors operate or respond to information online be considered.<sup>4</sup> Online characteristics described below necessitate regulatory approaches that differ from the offline world.<sup>5</sup> For example, online investing is more likely to be done without an adviser.<sup>6</sup>

#### *Characteristics of Internet information*

Two characteristics of online information which distinguish it from the offline environment are (1) immediacy and (2) interactivity.<sup>7</sup> This leads to a tension in the online environment between investor empowerment and investor vulnerability. The online environment facilitates retail client access to information and tools previously only available to professional investors.<sup>8</sup> Access to this

<sup>2</sup> Coffee, John C "Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation" (1997) 52 *Business Lawyer* 1195 at 1200.

<sup>3</sup> See Kinsky R, *Online Investing on the Australian Sharemarket* (2<sup>nd</sup> edition), Wrightbooks, Australia, 2005.

<sup>4</sup> See "Developments in the Law – The Law of Cyberspace" (1999) 112 *Harvard Law Review* 1574 at p 1583.

<sup>5</sup> Segal, J "Managing the Transition to Cyberworld" (2001) 19 *Company and Securities Law Journal* 519 at 521.

<sup>6</sup> Johnston, I "No Dave, you can't do that: the regulatory challenges of e-commerce, and an update on financial services legislation", presentation to the National Insurance Brokers Association conference 2001, p 6, available at, [http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=NIBA\\_1001.pdf](http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=NIBA_1001.pdf).

<sup>7</sup> Bradley C "Online Financial Information: Law and Technological Change" (2004) 26 *Law & Policy* 375 at 375 and 376.

<sup>8</sup> Bradley C "Online Financial Information: Law and Technological Change" (2004) 26 *Law & Policy* 375 at 375 and 376.

information empowers investors (empowerment should be encouraged). However, the flipside of empowerment is that investors may be vulnerable if they do not know how to use, digest and harness this information in a non-advisory online situation.<sup>9</sup> Regulators should not assume that investors experience online information the same way they experience offline information.<sup>10</sup> Investors operating online (or offline) are not necessarily rational and may be affected by investor biases<sup>11</sup>; however these biases more readily present themselves online where immediacy and interactivity are encouraged on the Internet given the speed and ease of access of the online environment.<sup>12</sup> Further, Internet investors rely less on a financial adviser.<sup>13</sup>

These online characteristics raise the issue whether the current regulatory response is appropriate for online investment tools.

#### 4. The current Australian law protection provided to online investors using online tools – distinction between personal and general advice.

The regulatory protection provided to investors using online investment tools is the regulation of the personal and general financial product advice.

Financial product advice is defined to mean a recommendation or opinion intended to influence, or which could reasonably be regarded as being intended to influence, a person in making a decision in relation to a particular financial product or class of financial product.<sup>14</sup> Financial product advice is either personal advice or general advice.<sup>15</sup> Personal advice is provided where the provider has considered, or a reasonable person might have expected the provider to have considered, one or

<sup>9</sup> Bradley C, "Information Society Challenges to Financial Regulation" (Winter 2006) 37 *The University of Toledo Law Review* 307 at 309. Also see Task Force to Modernise Securities Regulation in Canada, *Canada Steps Up*, Final Report, Chapter 4 "Understanding how investors make investment decisions and better meeting the needs of investors", October 2006, available at <http://www.tfmsl.ca/index.htm>. The research supporting this report notes that when information overload occurs, there is a tendency for retail investors to tune out and not try to process the information (see page 56 of Chapter 4).

<sup>10</sup> Bradley C, "Information Society Challenges to Financial Regulation" (Winter 2006) 37 *The University of Toledo Law Review* 307.

<sup>11</sup> Langevoort, D "Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation" (15 April 2002) Berkley Olin Program in Law & Economics, Working Paper Series, Paper 64, at p 25 (this paper is now published at 97 *Nw. U. L. Rev.* 135 (2002-2003)).

<sup>12</sup> A former SEC Chairman has stated "I'm concerned about the great influx of new and relatively inexperienced investors who may be so seduced by the ease and speed of Internet trading that they may be trading in a way that does not match their specific goals and risk tolerance." See Levitt A "Plain Talk about On-line Investing" Speech at the National Press Club, 4 May 1999, available at <http://www.sec.gov/news/speech/speecharchive/1999/spch274.htm>

<sup>13</sup> Unger, Laura "On-Line Brokerage: Keeping Apace of Cyberspace" (1999), page 3 (available at <http://www.sec.gov/pdf/cybrtrnd.pdf>).

<sup>14</sup> *Corporations Act 2001* (Cth) ("*Corporations Act*"), section 766B(1).

<sup>15</sup> *Corporations Act*, section 766B(2).

more of the objectives, financial situation and needs of the person to whom the financial product advice is directed.<sup>16</sup> General advice is any financial product advice which is not personal advice.<sup>17</sup> Personal advice to retail clients brings with it the obligation to provide a statement of advice and, importantly, the requirement to have a reasonable basis for the (personalized) advice having regard to the client's specific personal circumstances.<sup>18</sup> Generally, factual information is not financial advice, if the context is such that the provision of that factual information is not intended to influence a decision in relation to a financial product.<sup>19</sup>

Providers of online tools seek to ensure that the tools are classed as general advice and not personal advice because it is practically impossible to comply with the personal advice reasonable basis of advice and statement of advice obligations in an online environment.<sup>20</sup>

The only relevant regulatory requirement when providing general advice to a retail client is to warn the client that the online information and tools do not consider the client's objectives, financial situation and needs.<sup>21</sup> The industry standard general advice warning states to the effect:

"The information on this site has been prepared without taking account of the objectives, financial situation or needs of any particular individual. For this reason, any individual should, before acting on the information on this site, consider the appropriateness of the information, having regards to the individual's objectives, financial situation and needs, and, if necessary, seek appropriate professional advice."<sup>22</sup>

Given retail investors have difficulty digesting information online and in light of the empirical evidence about investors tending to trade more often when moving to an online environment, and

<sup>16</sup> *Corporations Act 2001*, section 766B(3).

<sup>17</sup> *Corporations Act 2001*, section 766B(4).

<sup>18</sup> *Corporations Act 2001*, sections 945A (reasonable basis for advice) and 946A (statement of advice obligation).  
<sup>19</sup> Communications that consist of only factual information (that is, objectively ascertainable information whose truth or accuracy cannot be reasonably questioned) will generally not involve the expression of an opinion or recommendation and will not, therefore, constitute financial product advice. See Australian Securities and Investments Commission *Licensing: The scope of the licensing regime: Financial product advice and dealing – An ASIC guide* (Reissued May 2005), paragraph 1.2.4.

<sup>20</sup> For example, E-Trade Australia's disclaimer states (no doubt legally advised) "You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided on this website. *E\*TRADE Australia does not provide investment advice to online retail clients.*" (Text has been italicised by the author of this paper.)

<sup>21</sup> The warning is required by *Corporations Act*, section 949A. There is also a requirement to provide retail clients with a financial services guide (*Corporations Act 2001*, sections 941A and 941B) if providing a financial service (which includes providing general advice). However, the FSG merely sets out the services provided and the terms, and other mandated information. It does not operate as a warning or guide to retail clients as to what should be considered having received general advice.

<sup>22</sup> This disclaimer is from the ComSec website at <https://www.comsec.com.au>.

with over-confidence, the above disclaimer (albeit compliant with current law) is too light a protection (or caution) as it is not meaningful to a person not versed in financial matters.<sup>23</sup>

**5. What are the dangers of online investment tools as a response to the tide of information?**

*(a) No gatekeeper or external "sanity check"*

The Internet reduces the role of advisers. Advisers provide professional advice and a "sanity check" over the retail client's learning from online information. Securities regulation for online tools needs to have regard to this non-advisory aspect. If online tools are too specific or suggest a "call to action"<sup>24</sup> then arguably, *especially in a non-advisory context*, it is appropriate policy that the such tools not be available where the online tool cannot undertake a full analysis of the client's objectives, and where a non-advised client may not understand the limits of the tool's specific output.

*(b) Click here problem*

Related to the difficulty of retail clients digesting online information and tools is that the ease of trading online (just "Click here") potentially encourages quicker (and therefore, potentially less considered) decision making as trading is just a mouse click away (with no need to speak to an adviser).<sup>25</sup>

**6. Regulatory response to the dangers of online tools and information**

The regulatory conundrum is in seeking to meet the following two objectives.

*Firstly*, it is appropriate to ensure that online investment tools do not constitute personal advice.

Where a client may reasonably expect that the client's personal circumstances have been considered

<sup>23</sup> The author suspects the less financially literate would not understand that the disclaimer means that investors need to consider various matters such as asset allocation and diversification when making investment decisions. As investors don't know what they don't know, this disclaimer, while meeting the legal requirement (imposed by section 949A *Corporations Act*), does not bring home to a (financially) illiterate investor that a number of factors should be considered when making investment decisions.

<sup>24</sup> See US discussion in part 6 of this paper.

<sup>25</sup> Kingsford Smith, D; and Williamson, K; "How Do Online Investors Seek Information, And What Does This Mean for Regulation" 2004 (2) *The Journal of Information, Law and Technology* 12 (see "Introduction" section of the Kingsford Smith article).

by the online tool, then the tool involves the provision of personal advice and should be regulated as such. As a practical matter a tool which crosses the "personal advice" line will not be made available by industry because of difficulty of meeting the personal advice obligations online. Investment tools available via online brokers have as an objective that they not constitute personal advice.

The *second* objective is to encourage the provision of useful educative material.

The conundrum is obtaining the right balance between outlawing online tools which provide personal advice<sup>26</sup> (assuming the personal advice reasonable basis obligations are not able to be complied with) but at the same time facilitating useful financial tools (as general advice). This balance is something ASIC is well aware of.<sup>27</sup>

### *Australia*

In Australia the line is drawn between personal advice and general advice.

### *United States*

In the US the line is whether or not a "recommendation" has been made which then brings into play US law suitability obligations.<sup>28</sup> In light of the increased use of the internet, NASD Regulation, Inc issued guidance in April 2001 concerning suitability obligations in the electronic environment in its Notice to Members 01-23.<sup>29</sup> NASD Rule 2310 requires an NASD member to have reasonable grounds for believing that a recommendation to a customer to purchase or sell any security is

<sup>26</sup> For the purposes of this paper it is assumed that industry will not offer online if to do so required all the legal obligations arising from personal advice (as distinct from general advice).

<sup>27</sup> In response to industry concerns that various online superannuation calculators may have involved the provision of personal advice and therefore a general industry reluctance to make them available, ASIC issued facilitative class order relief to enable limited use of superannuation calculators: ASIC Class Order [CO 05/611] *Relief for providers of superannuation calculators*.

<sup>28</sup> See Lowenfels, Lewis D, and Bromberg, Alan R, "Suitability in Securities Transactions" (1999) 54 *Bus. Law*. 1557 for a detailed discussion of the US suitability doctrine generally. NASD Rule 2310 requires that a broker only recommend a customer those securities which are suitable to the investment objectives and peculiar needs of that particular customer. The New York Stock Exchange does not have a suitability rule *per se* however the NYSE "know your customer" and "due diligence" Rule 405 is generally interpreted as including suitability obligations. Rule 405 states that (NYSE) members must "use due diligence to learn the essential facts relative to every customer..." As put by Lowenfels and Bromberg, the suitability doctrine entails matching (i) the investment objectives, peculiar needs and other investments of the particular customer with (ii) the characteristics of the security which is recommended.

<sup>29</sup> NASD Notice to Members 01-23 "Online Suitability – Suitability Rule and Online Communications" April 2001, available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_003887.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003887.pdf).

suitable for the customer. This is analogous in the Australian context to provision of personal advice (which requires a reasonable basis for the personal advice). Essentially, if given the content, context, and manner of presentation of a communication, it would be viewed as a “call to action” or suggestion that the customer engage in a securities transaction, this would be a recommendation giving rise to the (US) suitability obligation.<sup>30</sup>

### *United Kingdom*

The UK line is whether or not the advice constitutes regulated financial advice or, instead, generic (and unregulated) financial advice. Regulated financial advice is, broadly, advice to investors on the merits of buying and selling *particular specified investments*.<sup>31</sup> The UK FSA has proposed a definition of generic financial advice as “tools that use information about individuals’ circumstances to help them to identify and understand their financial position and their needs and to plan their finances”.<sup>32</sup> Generic advice does not result in a recommendation for a specific product or service.<sup>33</sup> However, generic advice would allow identification of product types that might meet the client’s needs,<sup>34</sup> which in Australia might stray into personal advice.

## 7. Types of online tools – general advice or personal advice?<sup>35</sup>

The more specific an output of an online tool is, then the more likely it is to constitute personal advice and probably more specifically useful and educative. The less specific the output of a tool is

<sup>30</sup> NASD Notice to Members 01-23 “Online Suitability – Suitability Rule and Online Communications” April 2001, page 2, available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_003887.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003887.pdf). Also see Friedman H M *Securities Regulation in Cyberspace* (looseleaf service), 3rd Ed with 2005 Supplement, Aspen Publishers Inc, USA New York NY, Chapter 16, p 16-31.

<sup>31</sup> Financial Services Authority “Financial Capability: developing the role of generic financial advice” August 2005, page 10, available at [http://www.fsa.gov.uk/pubs/other/fin\\_cap\\_gen\\_advice.pdf](http://www.fsa.gov.uk/pubs/other/fin_cap_gen_advice.pdf).

<sup>32</sup> Financial Services Authority “Financial Capability: developing the role of generic financial advice” August 2005, page 6, available at [http://www.fsa.gov.uk/pubs/other/fin\\_cap\\_gen\\_advice.pdf](http://www.fsa.gov.uk/pubs/other/fin_cap_gen_advice.pdf); and Financial Services Authority “Building Financial Capability in the UK: the role of advice” July 2004, page 2, available at [http://www.fsa.gov.uk/pubs/other/role\\_advice.pdf](http://www.fsa.gov.uk/pubs/other/role_advice.pdf).

<sup>33</sup> Financial Services Authority “Building Financial Capability in the UK: the role of advice” July 2004, page 2, available at [http://www.fsa.gov.uk/pubs/other/role\\_advice.pdf](http://www.fsa.gov.uk/pubs/other/role_advice.pdf).

<sup>34</sup> Financial Services Authority “Financial Capability: developing the role of generic financial advice” August 2005, page 6, available at [http://www.fsa.gov.uk/pubs/other/fin\\_cap\\_gen\\_advice.pdf](http://www.fsa.gov.uk/pubs/other/fin_cap_gen_advice.pdf).

<sup>35</sup> The analysis below as to which types of online tools and information may constitute personal advice and which constitute general advice is heavily based on the analysis in an excellent article (written in the US context): Libin, Nancy C, and Wrona, James S “The Securities Industry and the Internet: A Suitable Match” 2001 *Colum. Bus L. Rev.* 601. The analysis in part 7 of this paper, heavily based on the Libin and Wrona article, applies Australian law (the “general” versus “personal” advice distinction) whereas in the US the analysis is around whether there is a “recommendation” or a “call to action” to buy or sell a security which then gives rise to the NASD rule 2310 suitability obligation to have a reasonable basis that the recommendation is appropriate for the client.



the more likely it will be general advice (or factual information) and not personal advice; however, a less specific output may be less useful. It is along this scale that the Australian law “general” versus “personal” advice distinction needs critiquing as it applies to online tools. This is assessed by some examples below.

(a) *Risk profilers*

Risk profilers provide a general indication of an investor’s risk tolerance and a possible mix of asset classes that may be appropriate for the investor (for example a suggestion that a portfolio of 50% Australian and International shares and 50% in fixed interest and cash investments may suit the investor’s risk profile). In Australia, while views may differ, this would generally be regarded as general advice<sup>36</sup> and would not be personal advice because the output is either factual information (a doubtful view) or (a better view) general advice provided the output is framed to ensure it is clear that the investor’s personal circumstances have not been considered and that the output is indicative only and does not reflect the client’s personal circumstances.<sup>37</sup> Essentially, these would not be personal advice because a reasonable investor would not consider the output to have considered a person’s personal circumstances where a proximate and prominent disclaimer is provided that the risk profiler has not considered the person’s personal circumstances. In the UK and US such risk profilers would not involve a recommendation of a specific product or service hence would not be subject to the US law suitability doctrine nor be considered regulated financial advice in the UK. Risk profilers should be encouraged because research indicates that investors do not well understand asset allocation principles and diversification.<sup>38</sup>

(b) *Unsolicited emails*

Unsolicited emails sent by online brokers to clients suggesting that a client would benefit from purchasing a particular stock or purchasing stocks in a particular sector would probably constitute

<sup>36</sup> Asset allocation advice about the allocation of a person’s funds among one or more of shares, debentures, managed investment products, superannuation products and other classes of assets are taken not to be a financial service (or financial advice) under *Corporations Regulations 2001 (Cth)*, regulation 7.1.33A. It is possible that some risk profilers meet this exemption. Others may not depending on how the output is framed.

<sup>37</sup> See the risk profiler available at the Vanguard site: [http://www.vanguard.com.au/Personal\\_Investors/Learning\\_Lounge/Investing\\_Tools/Risk\\_Questionnaire/](http://www.vanguard.com.au/Personal_Investors/Learning_Lounge/Investing_Tools/Risk_Questionnaire/). The disclaimer on the Vanguard site states the information is not advice. Perhaps it is not personal advice but views might differ as to whether it was purely factual information or general advice.

<sup>38</sup> Deaves, R, Dine C, Horton W “How are Investment Decisions Made”, 24 May 2006, Research Study commissioned by the Task Force to Modernise Securities Regulation in Canada, *Canada Steps Up*, Volume 2, Research Studies, October 2006 at p 247. The Deaves Research Study is available at [http://www.tfmsl.ca/docs/V2\(3\)%20Deaves.pdf](http://www.tfmsl.ca/docs/V2(3)%20Deaves.pdf).

personal advice if the context reasonably led the client to believe the email had considered the client's personal circumstances (even if, in fact, the personal circumstances of the client would not and could not be considered without a fact find). Of course, brokers doing this, legally advised, would include a general advice warning disclaimer and assert that the advice was general advice only as the disclaimer would be such that a reasonable client ought not then to consider the email as personal advice. However, in the context of an unsolicited email suggesting a share or class of securities, such a disclaimer is unlikely to be effective. To the extent such suggestive emails were considered personal advice, the disadvantage is that potentially helpful guidance may not be available to investors, however from a policy perspective it is appropriate that this only be available to investors if the online broker had a reasonable basis for the email suggestion having undertaken an investigation into the client's personal circumstances.

(c) *Research libraries*

Provided access to research libraries online are made available to clients by clients "pulling" the report from the online brokers' website, and provided the research report clearly states that it has not considered the personal circumstances of any reader, then this is general advice. It is appropriate from a regulatory policy perspective that these be made available. There is no real risk in a client construing the report as a recommendation to them to buy or sell the financial product the subject of the research report, and hence no harm in making it available as general advice.

(d) *Online interactive tools*

Where a tool allows a customer to indicate an investment goal or input personal information such as age, financial condition and risk tolerance and the tool provides an output purportedly based on the entered client personal circumstances, the output is something which has had regard to the client's personal circumstances (or at a minimum, a reasonable person would think so<sup>39</sup>). Therefore, the output has crossed over into the "personal advice" space.<sup>40</sup> Clearly, if a tool purports to have considered a client's circumstances, then it should be treated as personal advice requiring the advice to be reasonable having regard to all the client's personal circumstances. It is appropriate that these tools not be available to clients unless the tool is sufficiently sophisticated to enable the

<sup>39</sup> Personal advice as defined in *Corporations Act 2001*, section 766B(3)(b).

<sup>40</sup> In the NASD Notice to Members 01-23 "Online Suitability – Suitability Rule and Online Communications" April 2001, at page 3 this is given as an example of an online tool which would give rise to the NASD suitability requirement. Available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_003887.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003887.pdf).

necessary consideration of the client's personal circumstances. To this end, to the extent the personal versus general advice distinction would make these interactive tools unavailable as personal advice, that is not inappropriate as it would be unhelpful for investors to act on such tools if the tools did not undertake a detailed consideration of the client's objectives, financial situation and needs. How online *interactive* tools (probably personal advice) differ from bland risk profilers (probably general advice) is a matter of degree dependent on the degree of interactivity and specificity.<sup>41</sup>

(e) *Data mining and push technology*<sup>42</sup>

"Push technology" (or data-mining technology) allows firms to determine customers' perceived preferences by monitoring customer behaviour (whether or not known to the customer), and then, based on the observations, send or "push" specific investment suggestions that the customer purchase or sell a security.<sup>43</sup> For example, an online broker may know from the clients' online transactions that they trade in "value" stocks. The broker may then use this information to "push" information on a particular stock or sector that is trading at a low price/earnings multiple. Generally, this would probably fall on the "personal advice" side of the line, unless the broker could argue that the "pushed" information was following a request by the online client for information about "value" stocks to be sent by the broker to the client. That is, absent the client request, it is likely a client might reasonably consider their personal circumstances have been considered and that a "disclaimer" disputing that is the case would be unlikely to be effective.<sup>44</sup> Keeping push (data mining) tools in the personal advice domain is appropriate.<sup>45</sup> Brokers who

<sup>41</sup> From February 2005, NASD members have been permitted to offer online investment analysis (projections) under certain conditions relating to disclosure (including as to assumptions and whether the full universe of investments have been considered). However, members must still ensure compliance with the NASD suitability Rule 2310. See: "Investment Analysis Tools SEC approves NASD Interpretive Material to Rule 2210 regarding member firms' use of investment analysis tools; Effective Date: February 14, 2005" available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_012413.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_012413.pdf). Also see Kingsford Smith, D "The Same Yet Different: Australian and US Online Investing Regulation" (Winter 2006) 37 *The University of Toledo Law Review* 461 at 489 to 490.

<sup>42</sup> See Friedman H M *Securities Regulation in Cyberspace* (looseleaf service), 3rd Ed with 2005 Supplement, Aspen Publishers Inc, USA New York NY, Chapter 16, p 16-35 for a description of the technology used in the US.

<sup>43</sup> Libin, Nancy C, and Wrona, James S "The Securities Industry and the Internet: A Suitable Match" 2001 *Colum. Bus L. Rev.* 601 at 655; and NASD Notice to Members 01-23 "Online Suitability – Suitability Rule and Online Communications" April 2001, at page 3.

<sup>44</sup> Australian Securities and Investments Commission *Licensing: The scope of the licensing regime: Financial product advice and dealing – An ASIC guide* (Reissued May 2005), paragraph 1.2.9 and note to that paragraph.

<sup>45</sup> In the United States, both the Unger report and the NASD's guidance on the suitability rule (NASD Rule 2310) consider such tools to be subject to the US law suitability obligations. See Unger, Laura "On-Line Brokerage: Keeping Apace of Cyberspace" (1999), suitability hypothetical 5, page 33 (available at <http://www.sec.gov/pdf/cybrtrnd.pdf>); and NASD Notice to Members 01-23 "Online Suitability – Suitability

might argue that such a result removes useful and educative material, should be met with the response that in the context they may be available provided the reasonable basis requirements can be met (albeit that is difficult to do in an online non-advisory context).

## 8. Should the content of Online tools be specifically regulated?

There are degrees of online calculators, risk profilers or other investing tools – some of which should be permitted<sup>46</sup> (this means classed as general advice) and encouraged as helpful educative guides which provide a framework for a subsequent investment decision. To these, the personal advice (or, in the US, suitability) obligations should *not* apply. By contrast, others such as tools using ‘push technology’ (particularly where the client does not know their data has been mined to push the information or suggestion - that is the client has not requested or “pulled” the data), should be regulated as personal advice and hence subject to the full reasonable basis obligations.

The personal advice and general advice divide is not easy to apply at the margin as it uses general concepts such as whether an investor would “reasonably expect” their personal circumstances to have been considered in the output of the tool. However, applying the legal principles (general versus personal advice) in part 7 of this paper, indicates that the regulation of online tools is generally appropriate. That is, those tools which ought to be regulated as personal advice are, and those which ought to be made available as useful tools to assist investors to understand general principles (for example, risk profilers) are readily made available as purely general advice.

It is not appropriate to push back the reasonable basis (that is personal advice) obligations back to those tools which only make a specific stock recommendation. Rather the personal advice requirements should apply to any *recommendation* which leads to (using US terms) a “call to action” (for example, push technology suggesting it’s a good time to buy consumer stocks or value stocks). Nonetheless, if appropriately presented it may be possible to discuss generic stock types without actually being a “call to action” or personal advice. This would depend on the context and a clear warning that the reference to the general stock types is not a recommendation, call to action and that the communication has not considered the client’s personal circumstances.

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Rule and Online Communications” April 2001, page 3 (the data-mining example), available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_003887.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003887.pdf).

<sup>46</sup> This paper assumes that if the online tool is classed as ‘personal advice’ that the personal advice obligations (undertaking an investigation so as to meet the reasonable basis requirement and providing a Statement of Advice) make it impractical to provide it in an online (automated perhaps) environment.

## 9. Should more focused regulatory warnings be provided for online tools?

An online tool constituting general advice is not subject to the reasonable basis obligation and is only required to include an innocuous disclaimer that the general advice provided by the tool has not been prepared taking into account the client's personal circumstances and these should be considered before acting on the general advice. In the online context this disclaimer is weak given the difficulty investors have digesting online information<sup>47</sup> and evidence indicating that online investors trade more actively, more speculatively, are more overconfident than other investors and are less profitable after going online.<sup>48</sup> Further, online investing is so easy and may involve less reflection than dealing offline<sup>49</sup> and investor biases come into play.<sup>50</sup>

*These factors require a meaningful, blunt but brief disclaimer for online investment tools.* The following suggested disclaimer assumes the tool is not personal advice (since in such case reasonable basis requirements would need to be met). A suggested warning may be:

**"The information has been prepared without taking account of the objectives, financial situation or needs of any particular individual. Before acting on the information you should, consider the appropriateness of the information, having regard to the individual's objectives, financial situations or needs and, if necessary, seek appropriate professional advice. Specifically, if you do not understand how your proposed investment fits in with your overall financial situation, your tolerance to risk, diversification of your portfolio, your cash flow needs and taxation matters you may not be sufficiently informed to make your decision without further research or advice, in which case you may need to consider your proposed investment decision further or consider taking expert financial**

<sup>47</sup> Potential investors do not know, and cannot easily verify, the quality of the information online. The Internet makes information more easily available but does not assist in assessing the quality of the information: See Black, Bernard S "Information Asymmetry, the Internet, and Securities Offerings" (1998) 2 *Journal of Small & Emerging Business Law* 91 (at 91 and 99).

<sup>48</sup> Barber M B and Odean T "Online Investors: Do the Slow Die First?" (2002) 15(2) *The Review of Financial Studies* 455 at 481.

<sup>49</sup> Bradley C "Online Financial Information: Law and Technological Change" (2004) 26 *Law & Policy* 375 at 375 and 382. Also see Stout, Lynn A "Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?" (1997) 75 *Washington University Law Quarterly* 791. Lynn Stout argues that the reduced costs of trading facilitated by technology (online investing) tends to encourage speculative trading with the perverse and counterintuitive effect of decreasing investor welfare, and that this requires policy consideration. The view of the author of this essay is that a meaningful warning about investing online may assist in counteracting this counter-intuitive effect of online trading.

<sup>50</sup> Investor biases and empirical evidence of this is discussed in Choi, Stephen J and Pritchard A C "Behavioural Economics and the SEC" (2003) 56 *Stanford Law Review* 1.

advice. **Sound investment decisions require sound research and consideration and time to consider all these matters.”**

Disclosure as a tool to regulate has itself been subject to criticism, particularly in light of investor behavioural biases.<sup>51</sup> However, provided disclosure is short and effective (which may well be easier to say than achieve) disclosure is one means to warn investors to take investment decisions carefully. Other tools are education of investors generally (as is undertaken by ASIC, the US SEC and the UK FSA). The above disclaimer attempts to be blunt and short, to flag the risks of quick and unconsidered investment decisions, and to seek to counteract the “click here” syndrome of online investing.

## 10. Conclusion

The Australian law dichotomy between general advice and personal advice is appropriate for online tools. This is because given investors reliance on information on the Internet, any online tool which could be reasonably regarded as having considered one or more of the person’s objectives, financial situation and needs<sup>52</sup>, ought *not* be available *without* the reasonable basis obligations.<sup>53</sup> Applying this dichotomy to specific types of online tools does appear to allow (as general advice) useful tools and only “prohibits” as personal advice those tools which provide a sufficient degree of “call to action” that they ought to be the subject of a full suitability or reasonable basis investigation (which is the policy behind the personal advice obligations). The distinction between general and personal advice does not impede helpful information for investors in a non-advisory context.

The section 949A “boilerplate” general advice warning should be more blunt and meaningful so as to caution careful consideration of online investment decisions (and an example of an improved disclaimer which should be required by law is set out in part 9). There is an Australian precedent for a specific and tailored disclaimer in terms of the mandated statement in product disclosure statements that a 1% difference in fees could mean a 20% difference in the value of your

<sup>51</sup> Investor biases and empirical evidence of this is discussed in Choi, Stephen J and Pritchard A C “Behavioural Economics and the SEC” (2003) 56 *Stanford Law Review* 1 generally and particularly at pages 22, 23 and 42. The debate about overly lengthy PDSs in Australia and recent papers in Canada suggesting more effective graduated disclosure is required are examples of the realisation that long disclosure is not effective with retail clients. In the Canadian context see Kingsford Smith, D “Importing the e-World into Canadian Securities Regulation”, 20 June 2006, Research Study Commissioned by the Task Force to Modernise Securities Regulation in Canada, *Canada Steps Up*. This Research Study is available at [http://www.tfmsl.ca/docs/V5\(6\)%20Kingsford%20Smith.pdf](http://www.tfmsl.ca/docs/V5(6)%20Kingsford%20Smith.pdf).

<sup>52</sup> Personal advice as defined in *Corporations Act 2001* (Cth), section 766B(3).

<sup>53</sup> Required when giving personal advice to retail clients – see section 945A *Corporations Act 2001* (Cth).

investment over 30 years. That is, disclosure and disclaimers need to be tailored to the audience and the circumstances, and the disclaimer recommended in this paper for online tools has that in mind.

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