Internet Use and Securities Firms[1]

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1. Effects of Internet Use by the Securities Industry

Today, use of the Internet by the securities industry is increasing rapidly. In 1994, an American securities firm introduced the first Internet based stock brokerage service. In 1996, when E*TRADE started an impressive advertising campaign for its Internet based services, real growth and expansion of Internet use by the securities industry began.

Since then, significant changes have emerged in the securities industries due to the introduction of various Internet based services. Among other advantages, the Internet provides a cheap and efficient means for the securities brokers to collect and execute orders from individual investors. As a result, a number of new securities firms utilizing the Internet to provide deep-discount brokerage services have entered the sector, and traditional securities firms providing brokerage services through branch networks and their sales forces are facing a serious challenge. The traditional firms have also started to utilize the Internet to enhance their customer services, by, for example, providing customer account information over the Internet.

However, the Internet has not completely replaced intermediaries such as securities firms that connect investors with corporations raising funds on secondary markets. It is true that several attempts were made to implement revolutionary ideas such as Internet direct stock offerings or bulletin board systems by-passing securities brokers. Some of these attempts were very successful and well publicized by the media. However, it appears that such attempts are not having a significant impact on the securities market as a whole. Securities firms (brokers and underwriters) still play an important role in terms of filling the information gap between those seeking funds and those looking for investment opportunities. Moreover, even if the information gap is filled by the vast amount of information provided over the Internet, most individual investors are just too busy to monitor and analyze all the information they get. Therefore, it is inevitable for them to seek someone with expertise who will do such monitoring and analysis on their behalf. There, the role of intermediaries will remain unaffected.

In any event, from the individual investor's point of view, the way they invest has dramatically changed through the introduction of various Internet-based services. Before the Internet, most individual investors did not have any access to real-time market quotes or

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financial news provided by the information vendors. Now the individual investors have access to various real-time information sources. They can even use diverse charts to understand the market situation and their own portfolio. The Internet has become an indispensable tool for individual investors when making investment decisions. It is fair to say that the ability of the average individual investor has been significantly enhanced by using Internet-based services. In a sense, some of the more sophisticated and experienced individual investors are now playing on a level field with the institutional investors.

2. Current Use of the Internet by the Japanese Securities Industry

The Internet-boom in the securities industry is not something unique to the United States. In other markets, like Europe and Asia, the Internet is also becoming a crucial tool for securities firms' retail marketing strategies.

In Japan, more and more securities firms are trying to utilize the Internet. Currently, 25 securities firms out of about 220 firms active in retail business offer Internet trading services to their clients (Table 1). In addition to these, a number of firms, including several newly established firms, are planning to offer Internet based trading services. One example is E Trade Japan, a joint venture between US E*TRADE and Softbank Corporation, that started operations in late April.

Table　On-line Trading Services Provided by Japanese Securities Firms (As of May 1999)

Date of Commencement	Securities Company	Service Name
Apr-96	Daiwa Securities	Home Trade
Jul-96	Nikko Securities	Home Trade One-Internet
Jan-97	Imagawa Misawaya Securities	WEBBROKER
Jan-97	Nomura Securities	Nomura Home Trade
Jul-97	Marusan Securities	Internet Home Trade
Oct-97	Yutaka Securities	Yutaka Securities Home Trading System
Nov-97	Utsumiya Securities	Utsumiya Securities Internet Trading
Feb-98	Cosmo Securities	COSMO Internet Home Trade
Feb-98	Tokai Maruman Securities	Tokai Maruman Securities Communications Trading
Feb-98	Maruhachi Securities	Maruhachi Home Trade
Apr-98	Meiko National Securities	Meiko National Securities Communications
May-98	Matsui Securities	Netstock
May-98	Dai-ichi Securities	Dai-ichi Home Trade Club
Aug-98	Iwai Securities	Iwai Net
Aug-98	Okasan Securities	Okasan Home Trade Zaitaku-Zanmai
Aug-98	New Japan Securities	Internet Home Trade
Aug-98	Wako Securities	Wako Home Trade
Sep-98	Towa Securities	Internet Home Trade
Dec-98	Nissan Securities	Internet Trading
Mar-99	Century Securities	Century Home Trade
Mar-99	Taiheiyo Securities	Dolphin Net Club
Mar-99	Hinode Securities	Internet Trading
Apr-99	Universal Securities	UnivNet
Apr-99	Doshima Kanto Securities	Money-Navi
May-99	Orix Securities	Orix On-line

Source:　Nomura Research Institute

Use of the Internet by the Japanese securities industry has several characteristics that are not seen in the United States.

Firstly, Internet trading services for individual investors were started by large full-service securities firms engaged in various businesses other than retail stock brokerage, such as underwriting and institutional brokerage.　On the other hand, US Internet trading services were started by small discount brokers.　The first Internet based trading service in Japan was introduced by Daiwa Securities, the second largest securities broker, in April 1996.　The other two of the “Big Three”, namely Nomura and Nikko, also provide Internet trading facilities for private clients.

For these big brokers, Internet services are an important supplement to traditional sales channels such as branch networks.　Through the Internet, they have succeeded in capturing a new type of investors, such as office workers that cannot be reached by sales persons during business days, or scientists working in research laboratories in remote places.　They also emphasize the convenience provided by the Internet services, such as orders placed any time 24 hours a day.

Secondly, as Japan has not yet completely deregulated fixed commissions for stock brokerage, individual investors cannot reduce their transaction costs by directing their orders to Internet services. Full liberalization of commissions is expected to be implemented on 1 October 1999.

This liberalization of the fixed commission system is an important part of the comprehensive reform plan of Japan's financial and securities markets started in November 1996. The reform is often called Japan's "Big Bang". Under the reform, a licensing system for the establishment of securities firms was abolished, and replaced by a much more liberal registration system. As a result, more than 30 new securities firms have been established since the reform started. There are still a dozen firms preparing to apply for registration.

Expecting tougher competition after the liberalization, some of the existing securities firms utilizing the Internet have publicly announced that they would become deep-discount brokers from the time of liberalization, and even published their commission rates effective after the liberalization. Most of the newcomers are also considering this strategy of entering the retail market as discount brokers.

For these newly established or emerging Japanese discount brokers, the situation is quite different from that faced by their American counterparts in 1975. American discount brokers had to compete with well-established full-service brokers without having any effective sales channels other than telephones. It took almost 15 years for American discount brokers to capture a meaningful market share in the industry.

On the other hand, Japanese discounters have had the Internet from the outset. In the cyber world of the Internet there is not much distinction between large established firms and small new firms. In fact, some of the securities firms active in the Internet services seem to be more popular than the Big Three and other established firms, especially among the younger generation.

Thirdly, Japanese securities firms are very concerned about security of communications over the Internet. Some firms are even utilizing the SET certification system for verifying the identity of users, which is usually used in Internet banking systems, where investors' funds can be transferred immediately. This sort of system can be recommended from the technological point of view, but it also impedes the flexibility of Internet-based systems. For instance, when investors use services protected by the SET system, they have to install software on their own PCs using a CD-ROM sent to them by their broker. They cannot place orders from PCs other than the particular PC in which such software was installed.

3. Regulatory Issues Raised by the Use of the Internet

Various regulatory issues have been raised by the use of the Internet for securities transactions. Some of the issues may be addressed by reexamining the existing regulations. However, because the Internet is an "open" network without a central location, and it can disseminate information over a wide area instantaneously, some of the regulatory issues challenge the premise upon which current securities regulations are based. In view of the openness of the Internet and the ease of communicating in complete anonymity over the net, effective enforcement of securities regulations in cyber-space has also become an important issue.

The following are examples of regulatory issues raised by the use of the Internet in securities transactions.

- Effectiveness of delivery of prospectuses, transaction reports and other documents that have been sent in paper form over the Internet.
- How to conduct private placements over the Internet, which can be accessed by the general public.
- How to regulate cross-border offers, advertising and other material on the Internet.

From the industry's point of view, the effectiveness of various documents sent over the Internet was the most imminent issue to be addressed, since the Internet could reduce the cost of the delivery significantly, if fully utilized.

The cross-border issue has also prevented the securities industry from fully utilizing the Internet. For example, some Japanese securities firms refrained from posting any information written in English on their home pages, fearing that the information might be in conflict with the US securities regulations.

But of course this was a sort of over-reaction, because if everything written in English were to be regulated by the US regulators, Australian or South African firms could never post information on the Internet for their domestic clients without consulting foreign regulators.

However, this issue may be regarded as being more theoretical than practical because it is relatively easy to make a distinction between legitimate materials posted by bona fide securities firms and materials seeking to solicit investors in other jurisdictions without proper license or other arrangements.

4. Evaluation of Regulators' Responses

Regulators in various jurisdictions have issued guidance and amended existing regulations in order to facilitate the use of the Internet by financial service providers, including securities firms. Good examples of this are the Interpretive Releases issued by the US SEC in October 1995 and May 1996, with regard to the use of electronic media by various parties. Of course, there are more examples like this including a comprehensive list of the measures taken by regulators in the IOSCO Task Force report, published by the IOSCO Technical Committee in September 1998.

Generally speaking, those initiatives by the regulators are well received by the industry. However, the cross-border issue would not be effectively addressed by the measure taken by a single regulator. Some kind of consensus among regulators from different jurisdictions is necessary to solve this problem.

Here, the IOSCO Task Force report mentioned above could provide important guidance. I myself have participated in the discussions of the Task Force and in the drafting procedure, under the Chairmanship of Mr. Georg Wittich, Chairman of the Bundesaufsichtamt fuer den

Wertpapierhandel (BAWe) of Germany. The report summarizes general characteristics of the Internet and current Internet use by market participants and market operators. It also contains 24 specific recommendations for the regulators addressing the issue of the Internet in the context of the securities regulation.

As far as the cross-border securities activities are concerned, recommendations No. 15 and 16 are especially important. Recommendation No.15 is as follows. “If an issuer’s or financial service provider’s offer or sales activities over the Internet occur within a regulator’s jurisdiction, or if the issuer’s or financial service provider’s offshore activities, in fact, have a significant effect upon residents or markets in the regulator’s jurisdiction, a regulator may impose its regulatory requirements on such activities.” Recommendation No.16, on the other hand, lists possible factors on which regulators would rely when they consider exercising regulatory authority over an Internet offer.

If most regulators make clear what sort of factors they take into account when they decide whether to exercise their regulatory authority over activities carried out through a particular web site, the securities industry can fully utilize the Internet without fearing unexpected intervention from the regulators.

Finally, the Task Force report is important, not only because it provides guidance on the cross-border issues, but also because it confirms the fundamental principle that securities regulations will not be changed by the use of the Internet. This is an important message for all investors who use the Internet for transactions and information collection on a daily basis. Investors should feel that they are protected in same manner both in the real world and in cyber space. If this cannot be achieved, and if the importance of the role of self-governance over the Internet is emphasized too much, the securities industry may lose a very effective and efficient means of marketing.