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Submission to ASIC on Consultation Paper 254: *Regulating digital financial product advice March 2016*

I would like to provide some comments on ASIC's Consultation Paper 254: *Regulating digital financial product advice* dated March 2016 (**CP254**).

CP254 sets out ASIC's proposed guidance on how it will apply the organisational competence obligations on licensees delivering digital financial product advice (**Robo-advice**) and requirements to monitor and test algorithms which produce the advice. Further, it provides guidance on how Robo-advice providers should meet the best interests and other obligations in Div 2 of Pt 7.7A of the *Corporations Act*. It includes a proposed draft of the relevant Regulatory Guide RG000 *Providing digital financial product advice to retail clients*.

ASIC seems to be taking an even-handed approach while presenting specific guidance in the area which is of benefit to the industry. It properly stresses that there are no carve-outs from the legal requirements for Robo-advice – the law being technology-neutral - and that even if functions are out-sourced, the licensee remains responsible for the performance of those functions.

In relation to several of the policy positions taken in the Paper, I would like to make the following comments:

Organisational Competence requirements (Proposal B1)

1. ***Responsible Manager requirements***: The organisational competence requirement of a minimum of one Responsible Manager (**RM**) qualified and experienced to give Robo-advice with a six-month transition period would appear to be reasonable. However, it is hoped that the Commission adopts a *facilitative approach* in the assessment of applications for approval of new RMs in this area, since there is not a large pool of individuals who already have the necessary qualifications and experience in Robo-advice from which to choose. This may present practical difficulties, especially if external recruitment of a new RM is necessary.

2. ***Training and Competence Standards for Advisers***: at this stage it is noted that ASIC does not intend to apply the usual retail adviser training and competence standards to Robo-advice, on the basis that no 'person' will actually be providing advice. This is a sensible starting position, but may need to be reviewed in time, due to the inherent risk that Robo-advice does not meet the best interests duty. For example, one matter that may need to be considered is whether staff of the licensee involved in reviewing Robo-advice (discussed in Part C of the Paper) should meet the required training and competence standards.

Monitoring and testing digital advice algorithms – Certification (Proposal C1)

ASIC will require detailed monitoring and testing of algorithms which produce Robo-advice, but will not require any formal compliance certification, either internal or externally provided.

The Paper correctly refers to a similar area, in the certification of Automated Order Processing (**AOP**) systems of market participants under the Market Integrity Rules. These rules (originally ASX Rules[1]) previously required that a qualified external party give a compliance certification for all new systems, but this requirement was changed some years later, so that a qualified person within the market participant could give the certification.

However, given the increase in the use of AOP in recent years, and increasing concerns about the market disruption that may be caused by algorithms, the requirements were strengthened in 2014 with new measures requiring controls over filters and 'kill switches', and a new requirement for annual reviews (which can be done internally).

If the growth of Robo-advice reflects that of AOP systems in trading, which appears likely, the controls and certification requirements for Robo-advice systems may need to be revisited. This is particularly the case, given the potential for large-scale losses from the malfunction of Robo-advice systems, especially those covering a wide client base.

Scaled advice and expectations on client communications – 'actively demonstrating' understanding (Draft RG000.94)

Scaled advice is a concept that emerged during the FOFA reform process, which acknowledges that clients do not always require holistic financial product advice. It is relevant in sectors that don't traditionally give overall financial planning advice, like stockbroking, where usually clients only require limited advice on, for example, which shares to buy or sell. It will be particularly relevant and useful in Robo-advice.

If scaled advice is given it is important that the client understands this.

ASIC makes some useful suggestions at draft RG000.94 as to measures to communicate the limits of advice to the client where scaled advice is given:

[1] Originally ASX Business Rule 2.2.2(1); currently ASIC [ASX&Chi-X] Market Integrity Rule 5.5&5.6

> As a minimum, you should:
> • explain to the client from the outset what advice is being offered and what is not being offered (i.e. the scope of the advice);
> • require the client to actively demonstrate that they understand that the advice they are seeking is within the scope of what is being offered by the digital advice model;
>
> Note: You could do this in a number of ways. One way might be to require that clients acknowledge the scope of the advice being offered and what is not being offered. Alternatively, you might require clients to answer questions to actively communicate that the advice they are seeking is within the scope of what is being offered by the digital advice model. We encourage you to consider other alternatives, and to conduct testing to ensure that your chosen methods are effective and take into account specific client needs.
>
> • at key points in the advice process, inform the client about the limitations and potential consequences of the scope of advice;
>
> Note: We use the term 'inform' because we do not think that wordy disclaimers or fine print are sufficient

Good advisers ensure that the limits of advice are made clear to the client, both through documentation and ongoing communications. Where there is no 'person' giving advice, this is obviously a challenge. While it is agreed that fine print disclaimers are not always effective, some weight needs to be given to the account opening documentation (including FSGs, SOAs etc), which already needs to be *clear, concise and effective*. If as is suggested by ASIC above, the Robo-advice client should be '*actively demonstrating*' throughout the course of receiving advice that the limits of the advice are understood, in the on-line environment this could have its own risks. It could lead to the risk of 'click-throughs' by the client, where they receive so many dialogue boxes requiring a response, that in frustration they simply 'click through' them all without really noting them. Accordingly, it should be acknowledged that as with all clients, 'upfront' or one-off disclosures to clients can be effective, so that constant 'active demonstration' of a client's understanding may not always be necessary.

Putting client in better position (Draft RG000.90 – RG000.94)

In the draft regulatory Guide, ASIC has again stated its view, as previously expressed in RG175[2] that in enforcing the best interest duty it will test to see if the licensee's conduct and advice '*…will result in the client being in a better position if the client acts on the advice provided*'. This 'better position test' is one that emerged in the discussions and background to FOFA, and is an expression that is not without difficulty.

In his Second Reading speech on 24 November 2011, then Minister Shorten, presenting the previous Government's first FOFA Bill[3], made reference to the concept of clients being 'better off':

> Financial planners and those who work in the financial services industry implicitly understand that the brand of financial advice needs renewal following a string of collapses including Storm, Trio and Westpoint. I believe that the vast majority of financial planners do see their role as making their dealings with customers such that, after having dealt with the planner, the customer is better off than if the customer had never sought financial advice to begin with. (Hansard at 13751)

Minister Shorten then went on to set out two key measures that are integral components which go to the heart of boosting professionalism, namely the best interests duty and

[2] ASIC Regulatory Guide 175 *Licensing: Financial product advisers – Conduct and disclosure* October 2013 at RG175.224 et seq

[3] *Corporations Amendment (Future of Financial Advice) Bill 2011*

conflicted remuneration. As to the best interests duty, he stated that it is really about acting in the client's best interests and not their own:

> Firstly, the bill imposes a statutory best interests duty on financial advisers. As its name suggests, the duty requires advisers to act in the best interests of their clients, and to put their client's interests ahead of their own. (Hansard at 13751):

In his *Second Reading speech* on 22 March 2012, the Minister described the best interest duty as follows:

> Third, the bills impose a statutory best interest duty on financial advisers. This will be a legislative requirement to ensure that financial advisers are focused on what is best for their clients. While this will ultimately lead to better advice in many cases, it is about regulating conflicts. It is not about regulating for the best investment return. As I have said previously in the House, the best interest duty does not require that advisers give the best advice. It does not require perfection in statements of advice by applying the benefit of hindsight. The duty strikes a balance between certainty and flexibility for the financial adviser. (Hansard at 4097)

The best interests duty in section 761B does not say that the advice provider must act in such a way as to result in the client being in a better position if the client acts on the advice provided. It says that the provider must act in the *client's best interests*. It was always feared that the '*better position*' expectation of ASIC in its enforcement of the best interests duty, drawing on the Minister's comments above, would become a substantive '*better position test*'. While there is no authority from decided cases yet on the matter, a '*better position test*' is clearly in the minds of those at the Financial Ombudsman Service in its consideration of complaints. It is hoped that it is not adopted by a Court. It should not be part of a relevant tribunal or court's analysis of a case to ask: '*Was the client in a better position because of the provider's advice or service?'* The proper test under the *Act* should be *'Did the provider act in the client's best interests?'*

Thank-you for the opportunity to present these comments for the consideration of the Commission. Should you require further information please contact me on 0417 168804 or email douglas.clark@dcconsulting.com.au .

Yours sincerely,

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