

12 August 2016

Mr Richard McMahon
Acting Senior Manager
Deposit-takers, Credit and Insurers
Australian Securities and Investments Commission
Level 5, 100 Market St
SYDNEY NSW 2000

By email: InnovationHub@asic.gov.au

Dear Mr McMahon,

**AFA Submission – Consultation Paper 260
Further measures to facilitate innovation in financial services**

The Association of Financial Advisers Limited (AFA) has served the financial advice industry for 69 years. Our objective is to achieve Great Advice for More Australians and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are required to be practising financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

Summary of the AFA's position on innovation in financial services

The AFA supports efficient and effective regulation of the financial services sector but it should never be at the expense of consumer protections. The future viability of the sector and the integrity of the advice profession requires appropriate limits and safeguards be in place for certain consumers of those services. Just as wholesale clients (who are appropriately and correctly categorised as such) are entitled to waive some restrictions over their access to some services, so too should some consumers of financial services be entitled to operate in an environment where additional risks may arise provide they cannot be taken advantage of and are fully aware of those risks.

This is the foundation of responsible modern innovation. Appropriate freedoms – even the freedom to make mistakes – should be permitted where the risks are known prior, damage is appropriately limited and a regulator closely oversees the developments. Provided damage can be limited to levels acceptable to the public, some mistakes can provide the best form of feedback to resolve problems and overcome evolutionary barriers. Provided it is safe to do so, risks can be experienced by some for the greater good of the remainder. Some examples of where this has happened in the wider world are:

- We would not have such an advanced, inter-connected and globally aware society if it were not for conditional limited liability of company directors contributing to driving commerce and trade amongst communities – both domestic and international,
- We would not have as efficient photovoltaic technology today if it were not for the strictly administered solar car race along the Stuart Highway that has sections without speed limits,
- We would not have reasonably priced hybrid and electric vehicles today if it were not for the highly regulated formula one racing car industry testing the technology first, and
- We would not have accessible 3D printing today if it were not for the medical research development grants imposing controls that supported reasonable early use of the technology.

The AFA considers that as financial advisers face the challenges of professionalisation, they must think beyond the horizon and toward the future that consumers want from financial services and how they wish to engage with those future services. The challenge to think beyond the horizon and be a leader in adaptive change sometimes needs breathing space to test new ideas and attract investment. So too must some start-up ideas in the financial services be appropriately supported if financial services will adapt to changing consumer needs.

We consider that ASIC's proposals to further facilitate innovation in financial services go a long way to setting reasonable conditions and limits upon those who will likely provide financial services under the proposed relief. We appreciate that the benefits of the relief will not be widely attractive to many when the costs and effort involved with operating under the licensing relief are compared to the costs and effort involved with applying for and operating an AFS licence. We will not apologise to those who feel the measures do not go nearly far enough because this is necessary in our view to maintain our high standard of consumer protections in Australia.

An important consideration in preparing ASIC guidance should be the extent to which the licensee intends to provide advice, and separate consideration of the differences between personal and general advice. Multiple research works have demonstrated the value of good personal financial advice and we wish to see that the amount of quality personal financial advice in Australia is also encouraged to expand. This may well be supported by innovative technologies. Where the personal interaction with an adviser is not present and where consumers are unclear as to the "type" of advice being provided (personal or general, or no advice) to them from a tech-driven solution, there is risk of a poor customer experience and outcomes.

To this end we consider that at no time should the guidance being developed by ASIC allow for personal financial advice to be provided in the absence of the licensee obligations to hold suitable PI cover, including run-off cover, and membership of an EDR scheme. Whilst we generally consider that these go hand in hand with the requirement to hold an AFS licence and we expect all personal advice should be provided only under a suitably authorised AFS licence, the proposal that a non-extendable six-month exemption from holding an AFS licence to facilitate innovative testing of financial service systems is only a reasonable proposal in the AFA's view if it is subject to a mandatory requirement to comply with all licensee obligations during the testing period – even though a licence is not required during that temporary period.

We have accordingly recommended some additional measures, especially for the proposals around AFS licensing relief on testing grounds. Some of our recommendations are for ASIC to take into account when considering case-by-case notifications under the proposed relief measures; others apply more broadly to most situations we envisage this relief applying to, whilst others are about ASIC's continued regulation of these measures.

Summary of the AFA's recommendations

The AFA considers that to adequately protect consumers under ASIC's proposed innovation measures, we recommend that:

1. Option 4 proposed by ASIC (at paragraph 31) is the most responsible, flexible and effective option to further facilitate innovation in financial services;

RG 105 Option 5 Responsible Managers

2. An annual sign-off by a professional third-party responsible manager is appropriate where an AFS licensee has other appropriate controls in place and the licensee must comply with the other licensee obligations under section 912A and 912B of the Corporations Act;
3. The eligibility conditions on third-party Responsible Manager sign-off should be annually and independently reviewed to determine whether those conditions remain appropriate for the future or should be changed;
4. Appropriate controls around conflicts of interest rules should be a condition of ASIC's approval of a third-party Responsible Manager providing competency sign-off for compliance with financial services laws (i.e. outsourcing compliance and monitoring services);

Temporary AFS licensing relief

5. Financial services providers who seek to operate under the six-month testing relief should be required to clearly articulate for ASIC and their 'sandbox sponsor', prior to proceeding, how retail clients will be serviced and able to access further advice at the end of the testing period;
6. Financial services providers who seek to operate under the six-month testing relief should be required to have professional indemnity insurance policies that provide for run off cover for retail clients for a period of no less than two years after the policy ceases; and
7. The conditions, timeframe and product type restrictions exempting innovative new financial services from holding an AFS licence while testing should be annually and independently reviewed to determine whether those conditions remain appropriate for the future or should be changed.

Reasons for the AFA's recommendations

Recommendation 1 – A mix of controls and relief is the most responsible and effective regulatory option

The AFA considers that ASIC has correctly identified the key barriers facing innovation in financial services and agree that ASIC's regulatory toolkit should be expanded to overcome the issues.

Maintaining the status quo is not an option in our view. A core problem with modern regulation is the 'catch-up effect' faced by a technologically advanced and inter-connected public – regulation is rarely ahead of the curve and is often relegated to playing catch up on developments after they have become accepted and widely used. Innovation usually drives regulation, not the other way around.

This creates a problem because the time lag between developments and regulation can leave members of the public vulnerable and create loopholes for operators to exploit. A core expectation of any regulated population is the need for a level playing field – that is, the need to be treated the same as competitors. It is therefore welcome to see ASIC taking a proactive and facilitative approach to regulating financial services that operate on the fringes of the current regulatory net.

On their own, Options 1 to 3 would add further tools by which ASIC can relieve some financial service operators who don't quite fit in the box of the mainstream AFSL applicants. Each option is worthy of adding to ASIC's regulatory toolkit and we agree with ASIC's assessment of the inherent benefits of each, provided adequate consumer protections are attached to the relief granted.

However, looking beyond the horizon the AFA can envisage a likelihood that implementing only one or another of the proposed options could constrain a financial service operator who sees the space differently to others, and this could constrain the next big thing in financial services or something that adds significant value to consumers of tomorrow's financial services.

For this reason, we consider that all three options should be available for ASIC to use with discretion and in the right circumstances. Provided that each measure is accompanied by no diminishment in consumer protections, equally appropriate expectations around monitoring and supervision of those services, periodic reviews and access to meaningful regulatory guidance, Option 4 appears to provide ASIC with flexibility to adapt its regulatory requirements to suit a licensing situation that calls for it.

Recommendation 2 – Permitting third-party RM sign off not at the cost of consumer protections

The Responsible Managers (RMs) of an AFS licensee have an important function. They are the individuals in each business who are primarily responsible for overseeing that the business is complying with its legal obligations and ensuring that the technical expertise is present in each financial service provided. You cannot operate a financial services licence without an appropriately qualified and experienced RM.

Not all AFS licensees have a sole RM. ASIC does not report on how many RMs each AFS licensee has, but in our collective experience more licensees than not have multiple RMs these days. Even small business advice practices are likely to have more than one RM because the demands of the RM role take away from client-facing, and therefore income producing, time. Many licensing consultants recommend sharing the duties across RMs, not just to share the workload but also to ensure adequate succession planning is in place and to mitigate against key person risk.

In many situations where there are multiple RMs, the RMs have different areas of responsibility due to having different experiences, qualifications and perspectives. In an age where rising costs and increasing competition are being driven by changing consumer demands and needs, fragmentation of financial services is a natural consequence – especially when everyone is looking for that edge to reduce costs or set themselves apart from the pack. Technology is at the core of all this and the AFS licensing system should accommodate people who have technological expertise, especially if that could deliver great advice to more Australians.

Accordingly, the AFA supports ASIC's proposal to provide greater guidance on AFS licensing applicants who have one or more RMs applying to be RM through Option 5 of RG105. As more people with technological expertise are attracted to the industry, there should be greater flexibility and certainty about how their applications to be RM are assessed. But allowing RMs to steer the ship so to speak through being individually assessed on their individual competence should not be at the cost of overall organisational competence.

Likewise, with small-scale heavily automated financial services. Although we consider that there will be a minority of situations where ASIC's proposal to relieve an AFS licensee from having all RMs to be employed or operate substantially within the business, a third party RM should only be permitted where ASIC is satisfied that this will not diminish the safeguards for the consumers of those services. If an RM is to be brought into a financial services business because of their technological experience, their expertise in a particular product or strategy or their experience in managing risks for part of a business, their day-to-day absence must not be to the detriment of the clients.

Accordingly, the AFA supports ASIC's proposal for third-party RMs to be permitted to operate in some financial services businesses, supervising their allocated aspects of the business through annual sign-offs, but only because of the conditions proposed by ASIC that:

- The financial service is heavily automated – and therefore presumably thoroughly tested;
- The financial service is small-scale – so limiting exposure to losses from errors;
- The amounts that clients can invest via such a business is also limited; and
- Another appropriately competent RM remains responsible for the day-to-day operations, importantly including the monitoring and supervision of the financial services.

Only with these controls in place can the AFA feel that the measures taken lately to professionalise and remove conflicts within the sector will not be diminished.

Recommendation 3 – Independent annual reviews of third-party RM sign-off eligibility conditions

As not every customer solution will fit the mould of today's business models we need to have some flexibility to accommodate alternative models. This is necessary if we are to keep up with the imagineering that is challenging the financial services sector, and to ensure that tomorrow's business models are appropriately supported to deliver innovative solutions to meet consumer demands. This need to keep up with the times is because things change given sufficient time. It is for this reason that we consider the conditions set by ASIC must also be able to adapt to change.

The AFA appreciates why ASIC is seeking input from the public and its regulated population to test whether the proposed eligibility conditions (no more than 1,000 clients and specified financial products) is appropriate. There is probably little current evidence to say whether this is the right mix of safeguards. Although we can say that the types of proposed product limitations appear to limit risk generally, and limiting exposure to 1,000 clients is better than extending exposure to 10,000 or 1 million, not every financial product is homogenous in its product class and not every consumer of financial services is the same as the next. Further, as ASIC does not currently have a wide range of product intervention powers, it is not appropriate in our view to set-and-forget the eligibility conditions .

Accordingly, we recommend that for this form of licensing relief to be effective the eligibility conditions should be reviewed at least annually and preferably by an independent party to ASIC. Only time will tell whether the safeguards are adequate. Only through new information, future complaints, some hindsight and practical experience can we say for sure whether something is the right mix. So too must there be a mechanism to review these measures to determine ongoing effectiveness at balancing the need to facilitate innovation while maintaining consumer protections.

On the issue of whether financial exposure limits on investment products are also warranted, we recommend that this be assessed by ASIC on a case-by-case basis – subject to the aforementioned independent reviews. Limiting the product classes that can be partially monitored by an offsite RM to only liquid financial products, non-cash payment facilities, and products issued by a prudentially regulated business could be sufficient to limit the risks that consumers face because these types of products are generally considered to have lower risk profiles. But if it turns out that there is a rise in complaints, for example in life insurance policies issued through heavily-automated web-interfaced issuers, then ASIC should have the ability to change that just as it has the ability to impose remediation programs to address systemic issues within such businesses. Likewise, if the systems of one of these types of businesses does not appear to have adequate controls in place, for example to prevent consumers from taking out \$5 million of life insurance cover without evidence of affordability of premiums, ASIC should impose exposure limits as a licence condition where it is appropriate to do so.

The AFA appreciates that this imposes a high standard of due diligence upon ASIC's consideration of certain licence applications or applications seeking to change RMs and this can lead to delays in processing and some loss of competitive advantage for those affected applicants. We consider this is an appropriate safeguard given this proposed relief is currently untested and in a formative stage.

Recommendation 4 – Outsourcing compliance functions only with appropriate conflicts of interest conditions

The AFA considers that where a licensee proposes to use a third-party RM to deliver some aspects of its compliance function, if that individual is to be paid for their services ASIC should require the licensee to implement controls to manage conflicts of interest. It is an unfortunate result of some people's perception of professional services that 'you do what the client wants'. We do not subscribe to this view. The AFA considers that, amongst other things like expertise, good communication and a good moral compass, being a professional requires honesty, fearlessness and robustness – that is, professionalism often requires the professional to tell their client things that they may not want to hear. This should not be affected by whether, by whom and how much the professional is paid.

Where a person is utilised to verify that financial services are compliant with the law and in the consumers' best interests, the end assessment should be free of influence from the subject. The compliance and supervision function of any business is – together with the complaints function – the best form of feedback that a business can have. Where a compliance function is paid for, whether through an employment agreement or another form of paid arrangement, there is an inherent conflict between the interest of the compliance person for tenure and the interest of the public and

clients to have an impartial assessment. This should not be news to people and history is unfortunately littered with examples of supposedly impartial, but inherently conflicted, audits in the business world being performed – Enron being the worst example in modern history which resulted in the ‘Big 5 accounting firms’ losing one of its number due to systemically poor management of conflicts. History is the greatest teacher and we should learn from those regulatory mistakes.

The types of professionals that ASIC should accept as responsible managers that provide sign-off depends on which aspect of licensee responsibility is not already covered by an internal Responsible Manager’s competence. Some third-party RMs can bring technical competency to an AFSL licensee, such as ICT, coding or software development experience, while others could equally validly bring legal experience, technical experience within a financial product issuer or overseas experience. It is conceivable that ASIC’s proposed relief could result in responsibility for part of the supervision, monitoring, auditing and compliance part of the business being provided by an individual who is external to the business.

For this reason, the AFA considers that conflict of interest rules must be required as a condition of operating AFS licences where any aspect of compliance will be delivered by a third-party RM. While we support appropriate relief from licensing requirements, this should not be at the expense of consumer protections and the conflicts of interest requirements are an integral part of the financial services structure. Examples of ways that conflicts of interests could be managed with third-party RMs is:

- forward provision of payment to third-party RMs for their services,
- prohibiting or limiting short-term RM arrangements,
- remuneration or fee reviews to be conducted by an independent expert, and
- conditions preventing the licensee from influencing the timeframes the RM has to adequately review all relevant material or their access to that material.

Recommendation 5 – Temporary AFS licensing exemption conditional upon continuity of advice after the testing phase

The proposal to exempt some financial services providers from having to hold an AFS licence for six months can be fairly described as ‘revolutionary’. Since the first licensing requirement was introduced in the 1989 it has been fundamental to the protection of consumers of those services and the integrity of the system that the public and other participants of the industry can have confidence that every provider in the industry has been permitted by the regulator to do so or risk very serious sanctions. ASIC is now proposing to use the power granted to it under section

911A(2)(l) to undermine that fundamental pillar of confidence – subject though to very strict conditions upon eligibility for exemption and conditions on operating in that environment.

The most important condition in our view is the limited timeframe the exemption applies. ASIC has been very clear in the Consultation paper to say that it will not extend the temporary licensing exemption beyond six months. This therefore gives the provider a predetermined six months to decide whether it will apply for an AFS licence at the end of the testing period or to negotiate becoming an authorised representative of an existing licensee.

Although ASIC's average time to consider a licence application can range in any given year from 5 weeks to 5 months, depending on the complexity of the licensee's structure, the amount and experience of RMs, the complexity of the financial products being applied for and other factors that can be beyond a prospective licensee's control, a licence application takes between several weeks to several months to prepare before it is ready for lodgement. With the authorised representative option, there are difficulties as well. An innovative service provider may be reluctant to take this option if it might result in the value of their intellectual property that gives them their edge being compromised or diminished. We can envisage some negotiations taking some time to finalise as well. The other aspect is that if an exempted provider needs to put in place systems that largely replicate a full AFS licensee, becoming an authorised representative may not be attractive given the investment and effort already undertaken less than six months prior.

The concern here is not so much for whether the six month testing period is an adequate timeframe for providers to focus on testing the services while it decides whether or not to apply for a licence or become an authorised representative of a provider. The issue is what the fixed testing period means for the customer.

- What happens to the customer if the exempted provider has not been granted an AFS licence at the end of the testing period to continue providing financial services?
- How do they access their capital to transfer it, redeem/withdraw it or continue with the investment?
- How will taxation consequences be advised?
- How long is the provider required to be a member of an approved EDR scheme?
- How long will a provider's professional indemnity policy or other compensation arrangements cover the financial services provided after the testing period ends?
- What is the sandbox sponsor's role if the exempted provider does not continue to provide services after the testing period?

These are critically important questions that go to the heart of the integrity of the fundamental requirement to be licensed. An AFS licence is permission to provide financial services, unless exempted by ASIC. The general licence obligations require a licensee to be responsible for the financial services provided under the licence and to compensate consumers for any losses resulting from breaches of financial services laws. Records are required to be kept for at least 7 years with the expectation that these records can be used to deal with any complaints that arise after the service has been provided.

Generally, many licensees continue to operate after a service has been provided and the external dispute resolution process captures most subsequent issues, but there remains an issue with licensees who go into subsequent administration. Will exempted providers fall into the category of defaulting service providers? These are issues that need to be dealt with in ASIC's guidance.

The AFA appreciates that ASIC's proposal to restrict eligibility for licensing exemption to only financial product advice about and arranging for clients to deal in simple managed investment schemes, listed/quoted Australian securities and deposit products will mitigate against some of these issues. In particular, as the investments/deposits will be held with other financial services licensees, the clients will presumably still be able to access, transfer and redeem/withdraw their capital. But if the exempted provider does not continue to service the clients after the testing period, the clients are effectively cut loose and become orphan clients who cannot expect to receive ongoing advice about their investments/deposits.

To assist with the formulation of comprehensive guidance around these issues, the AFA recommends that ASIC require exempted providers to put in place continuity arrangements to ensure that a licensed adviser can service the clients' needs at the end of the testing period. This could be part of the sandbox sponsor's preliminary assessment that the proposed business model does not present significant risks of consumer detriment or it could form part of the notification to ASIC.

Recommendation 6 – Temporary AFS licensing relief conditional upon two-year PI run off cover

Consistent with the issues raised above, the AFA also recommends that exempted providers' professional indemnity insurance or alternative compensation arrangements must provide for adequate compensation cover for several years after the testing concludes. We consider that two-years run off cover would be the minimum way of ensuring that consumers can be compensated for any issues arising during the testing period.

We appreciate that the availability of this cover may be limited in the professional indemnity insurance market, but we also note ASIC's initial view that professional indemnity insurance may be

difficult for exempted providers to obtain. Accordingly, should exempted providers secure alternative compensation arrangements, we recommend that the terms ensure that compensation will be able to be drawn upon by consumers for at least two years after the testing period ends.

Recommendation 8 – Independent annual reviews of AFS licensing exemption conditions

As noted above at Recommendation 3, we consider that the conditions set by ASIC must be able to adapt to change. Whilst we welcome the intention behind limiting the AFS licensing exemption to specified, lower risk products, the services to only 100 clients with individual exposures of \$10,000 and the total (retail and wholesale) exposure to no more than \$5 million, we cannot say for sure whether this is an appropriate control to adequately protect consumers.

The AFA recommends that for this form of licensing exemption to be effective the exemption conditions should be reviewed at least annually and preferably by an independent party to ASIC.

Closing remarks

Licensing financial services providers play an important role in the financial services industry. It is an important barrier to entry to the sector. These barriers are important because they contribute to consumer confidence in financial services providers. Whilst existing licensees are driving a number of innovations and developments in the industry, partnering with an established provider is not always an attractive pathway for those with new ideas. Independence of thinking and independence from potential conflicts of interest is something the AFA supports as well.

The AFA accordingly welcomes ASIC's proposals as a step in the right direction and we largely support the proposals subject to the contents of this submission. The Responsible Manager proposals will give license applicants with alternative experiences and qualifications the opportunity to join with other Responsible Managers to drive innovation within those licensees. The proposals around temporary AFS licensing exemptions will give ASIC oversight of activities at the fringes of the financial services sector and encourage competition by supporting new ideas and systems. Whilst we consider that there are many safeguards proposed to protect consumers, we consider that some further work on the practicalities around the ending of the testing and subsequent consumer losses still needs to be done. We have made some recommendations about how to raise the level of safeguards and foster continual improvement. There are a number of other aspects though that we do not have answers to and we would welcome further collaboration with ASIC on resolving these issues.

If you require clarification of anything in this submission, please contact us on 02 9267 4003.

Yours sincerely,



Brad Fox
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Association of Financial Advisers Ltd