FINANCIAL PLANNING
ASSOCIATION of AUSTRALIA

22 July 2016

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

**By email**: InnovationHub@asic.gov.au

Re. Further measures to facilitate innovation in financial services

Dear Sir,

The FPA welcomes the opportunity to provide a submission on encouraging innovation in financial services. The FPA believes genuine innovation should be encouraged. However, we are opposed to ASIC providing an automatic exemption from the requirements of the licensing regime. In our view, each proposal for relief must be assessed on its net benefits.

We also do not support ASIC limiting its proposed flexible approach to meeting the organisational competence requirements, in the way it has outlined. We believe that if flexibility does not increase risk to consumers, the broader industry should also allowed to use this option. There are other ways, which we detail in our submission, to encourage innovation which don't deny flexibility to the broader financial services industry.

If you have any queries or comments, please do not hesitate to contact me.

Yours sincerely

**Dimitri Diamantes**
*Policy Manager*
Financial Planning Association of Australia[1]

[1] The Financial Planning Association (FPA) has more than 11,000 members and affiliates of whom 9,000 are practising financial planners and 5,500 CFP professionals. The FPA has taken a leadership role in the financial planning profession in Australia and globally:

- Our first "policy pillar" is to act in the public interest at all times.
- In 2009 we announced a remuneration policy banning all commissions and conflicted remuneration on investments and superannuation for our members – years ahead of FOFA.
- We have an independent conduct review panel, Chaired by Mark Vincent, dealing with investigations and complaints against our members for breaches of our professional rules.
- The first financial planning professional body in the world to have a full suite of professional regulations incorporating a set of ethical principles, practice standards and professional conduct rules that explain and underpin professional financial planning practices. This is being exported to 24 member countries and the 150,000 CFP practitioners that make up the FPSB globally.
- We have built a curriculum with 17 Australian Universities for degrees in financial planning. As at the 1st July 2013 all new members of the FPA will be required to hold, as a minimum, an approved undergraduate degree.
- CFP certification is the pre-eminent certification in financial planning globally. The educational requirements and standards to attain CFP standing are equal to other professional bodies, eg CPA Australia.
- We are recognised as a professional body by the Tax Practitioners Board

# FURTHER MEASURES TO FACILITATE INNOVATION IN FINANCIAL SERVICES

FPA submission to:
ASIC

22 July 2016

## INTRODUCTION

The FPA is strongly in support of innovation in the provision of advice to Australian consumers. However, such support should not come at the cost of denying flexibility to the industry at large. Nor should it mean that consumers are placed at additional risk.

In principle, we believe there should be a level playing field across all ASIC regulated advice and product distribution businesses. This means ASIC should maintain its general principle of being channel and technology agnostic in its regulation.

If the AFSL application/RM burdens are too high for a new business, ASIC should consider generally removing or simplifying them if they feel the current risk environment justifies this. If not, these requirements shouldn't be lessened.

If a company wants to try something novel and really innovative, ASIC should give it the ability to test this. (Throughout our submission, we refer to the testing environment as the sandbox.) Therefore ASIC's prime consideration for allowing new fintechs to test their new technology should be based on the firm's ability to prove it is being truly innovative rather than just providing a heavily automated version of an existing process or technology.

Further, we also need to consider need and risk. Is there a net benefit to Australian consumers after risk is taken into account? While the sandbox proposal is novel and exciting, in its proposed operation it places consumers at risk from inexperienced product providers. Further, we are concerned as to whether businesses who need regulatory assistance to get to market, would have appropriate compensation resources if needed.

We also question whether providing a default environment for new fintech offerings may lead to businesses which would have the ability to meet their regulatory obligations prior to testing, seeking to avoid these obligations. We accept that smaller firms are more likely to need relief, but again this should be demonstrated based on the novelty of the solution they have developed.

We believe this lens provides a fairer and more effective way to encourage innovation and, in turn, we believe an automatic exemption is inappropriate.

In summary, each case needs to be judged on its merits. We should not let our excitement for the idea of innovation blind us to the risks and place consumers in a riskier environment.

## A. BACKGROUND TO THE PROPOSALS

### A1

In light of the barriers to innovation in financial services that they have identified, ASIC is considering the following options:

(a) Option 1—provide additional guidance about how they assess whether a responsible manager has the appropriate knowledge and skills under Option 5 of RG 105 (including what ASIC may consider to be appropriate knowledge and skills)

(b) Option 2—modify their guidance under Option 5 of RG 105 to allow heavily automated (but small-scale) businesses to rely, in part, on signoff from an appropriately experienced third party in order to meet their organisational competence obligation

(c) Option 3—provide a conditional, industry-wide exemption to allow new Australian businesses to test certain financial services for six months without holding an AFS licence (also referred to as the 'regulatory sandbox exemption')

(d) Option 4—a combination of Options 1–3 (ASIC's preferred option)

(e) Option 5—maintain the status quo

A1Q1 Do you agree that ASIC should put in place additional measures to facilitate innovation, or maintain the status quo? Please provide reasons.

The FPA supports flexibility and innovation in the financial services industry. However, we believe that administrative flexibility that doesn't increase risk to consumers should be available to the industry generally; and that relief from licensing requirements should be based on a close examination of the costs and benefits of the particular case.

With the exception of Options 2 and 3, we agree, in principle, with ASIC putting in place additional measures to facilitate flexibility. A flexible approach by the regulator will help increase the efficiency of the industry.

Option 2 is unduly limited in scope. If there is to be no additional risk to consumers, why limit the proposal to small-scale, heavily automated firms? There are other ways to encourage these firms. While we support ASIC taking a more flexible approach, in our view all measures implemented should be available to all existing participants in - and those seeking to enter - the industry, unless there is good reason otherwise.

The proposal, under Option 3, for a general exemption from the strict requirements of the licensing regime should be rejected. Rather, requests for relief should continue to be assessed case-by-case, based on consideration of need (of the firm) and of the trade-off between true innovation and risk to the consumer. (We note that the UK Financial Conduct Authority's (FCA's) approach to assessing applications for relief is based on the testing business showing: genuine innovation; consumer benefits; understanding of regulation; and need for support.[2])

However, we would support ASIC giving special weight to applications for relief for truly innovative business ideas, especially for testing the idea. This would reduce barriers to innovative firms entering the market, and in turn promote the spill-over benefits of innovation.

[2] see http://www.fca.org.uk/static/documents/project-innovate-criteria.pdf

To be clear, a heavily automated business is not necessarily innovative. Nor is yet another automated risk profiling tool or an ETF investing tool. Firms should demonstrate they are genuinely innovative. Simply being heavily automated is not enough. A close investigation is required to decide whether the firm is offering something genuinely novel and beneficial.

We would also support giving special consideration to the size of the firm, as smaller firms may find it particularly difficult to enter the market. But, again, being small and heavily automated does not make a firm truly innovative (let alone innovative enough to outweigh the extra risk).

In summary, a general exemption is inappropriate as there is a need to ascertain whether there is a net benefit. This requires a close examination and a judgement. We should not let our excitement for the idea of innovation blind us to the risks.

Further, we would support providing access to the sandbox, for true innovation regardless of its source; for example, whether or not the firm is an existing AFSL. (Even an existing AFSL, the modified disclosure and compensation arrangements of the sandbox might be highly attractive.) We see no good reason for restricting relief based on factors that aren't indicative of innovation, risk or need.

### A1Q2 What benefits do you consider will result from ASIC's proposed approach?

ASIC's preferred option, a combination of Options 1-3, includes the following advantages:

- Option 1 would provide clarification for the whole industry, reducing unnecessary uncertainty and cost
- Option 2 would reduce costs; however, as discussed, if (as we assume) third-party sign-off won't materially increase risk, this option should be available to the entire industry
- As discussed above, we strongly oppose Option 3

### A1Q3 What disadvantages do you consider will result from ASIC'S proposed approach?

As mentioned, Option 2 is unduly limited in scope. If increased flexibility would not materially increase risk to consumers, there is no strong reason for limiting the approach to a narrow group of firms. While encouraging innovation is important, so is promoting efficiency across the industry. Providing flexibility to the entire industry will enhance its efficiency. And, as discussed below at A1Q4, there are other ways to encourage innovation. In a nutshell, the disadvantage of ASIC's proposal is that it represents a wasted opportunity to enhance the efficiency of the broader industry.

As mentioned, we disagree with Option 3. We believe this approach will put consumers at an excessive risk of inappropriate advice and product placement, relative to the current regime. We believe that consumer protection is a proper constraint on the industry and should not be eased except in special cases.

Special cases include an emergency situation where the risk of no advice outweighs the risk of advice under relaxed consumer protections. In our view, pursuing the policy goal of encouraging innovation is not a special case. In turn, we strongly recommend that, in relation to Option 3, ASIC continue to assess each particular case on its merits, including consideration of risk to consumers and innovation benefits. As mentioned, special weight could be given to firms seeking to test their innovative business idea, without automatically allowing such firms to enter the sandbox.

Another potential disadvantage of Option 3 is that, even if the client is not put at excessive risk, there would need to be adequate compensation arrangements in place. It may be difficult or prohibitively

expensive for providers (especially smaller ones) to obtain professional indemnity insurance. Alternatives such as group schemes would need to be considered.

In our view, these alternative schemes would need to, at least, mirror professional indemnity schemes. This would imply that they would need to be funded by government (or the broader industry, which would require government intervention).

If there is no appetite for such intervention, the only alternative is reducing the quality of compensation. In our view, this is unacceptable as consumers are exposed to a greater extent, in circumstances where risk is high. It irrelevant that providers must disclose to consumer the risks (including special risks) the consumer faces; as already mentioned, our starting point is that reforms must not excessively weaken consumer protections.

An alternative to Option 3 is to create a virtual sandbox where providers can simulate how consumers would be expected to respond to the provider's business. The simulation would be based on a simulation model and a detailed data set.

### A1Q4 Are there any other options we should consider to meet our regulatory objective of further facilitating innovation, while ensuring that appropriate protections apply to all financial consumers?

We would suggest the following positive measures to encourage innovation:

- ASIC introduces a priority service for all providers, which would provide faster service to all firms who pay an additional fee. As discussed, below the fee could be waived, reduced or deferred for truly innovative firms (especially small firms).
- ASIC waives (or reduces below cost) fees and levies charged (e.g. assessment) to truly innovative firms (especially small firms). Alternatively, such firms can defer payment of fees and levies until they can afford it, under a similar system to HECS-HELP used in the education system.

This provides special support for these firms (in line with the policy objective), without exposing consumers to any extra risk.

## B. Additional guidance and flexibility on organisational competence

### B1

ASIC proposes to provide additional guidance on how they assess submissions about a responsible manager's knowledge and skills under Option 5 of RG 105. This will include:

(a) more detail about what is expected of a prospective AFS licensee to include in its submission; and
(b) examples of situations where a responsible manager generally would (or would not) be considered to have the appropriate knowledge and skills

B1Q1 Do you agree with this proposal? Please give reasons for your answer.

Broadly, the FPA agrees with the proposal - as we understand that the approach does not depart from ASIC's existing approach, which we support. However, digital advice providers raise a special issue, namely that there may be no natural person providing the advice. This has consequences, such as that the proposed professional standards legislation will not apply as there is no 'relevant provider', which by definition is a natural person.

We strongly believe that all advice should be provided by a natural person. Attributing responsibility for advice – and attaching personal consequences for failure to meet obligations – to a natural person is a critically important way to manage the risk from advice being provided through commercial enterprises that have limited liability.

Further, given the ease with which the digital advice business could control the algorithm that underpins their software, only senior management that have relevant skills under the organisational competence requirements could be expected to have the power, knowledge and skill to drive change to the algorithm. For this reason, we recommend that responsible managers must provide the advice.

Further, in our view, a digital advice business that does not have a traditional adviser review and sign-off every piece of advice before it is delivered to consumers should only be able to meet the organisational competence requirements by responsible managers who meet the educational and professional standards – and legal requirements, such as the best interests duty under the *Corporations Act* - applied to traditional advisers, providing the advice.

Unless the requirement is an organisational competence requirement, there would generally be no individual providing the advice and no way of ensuring advice is aligned with the financial situation of the particular consumer. We can't imagine that this gap is an intended consequence of the regulation of the professional and educational standards of advisers; or other legal provisions.

The need for a natural person to provide advice raises further questions. Digital advice is typically provided continually. It doesn't stop when individuals are sick or take leave. Further, the algorithm which writes the advice doesn't exist in a vacuum. Changes are being made continually; and the adviser (a natural person) should be continually assessing - albeit on sample basis - the quality of the output of the advice program. Given this environment, it would strain the idea that a natural person could be providing advice if that person is not present at work around the time the advice is delivered to the consumer.

We accept that, unlike traditional advice, the digital advice that will be provided in respect of any given set of facts is known with high confidence and specificity when the algorithm is known (i.e. before the advice is provided). However, there is the ever-present risk that the algorithm will produce unintended results. A responsible manager who meets the professional, ethical and educational standards of traditional advisers should be present in the business to monitor advice so that no unintended advice is provided. Given the risk that a responsible manager may be away from work, we recommend that each digital advice provider has at least two responsible managers.

To be clear, we are not suggesting such a responsible manager needs to be on duty whenever the digital advice service is operating, which we expect would be 24 hours a day, seven days a week. But a responsible manager with that meet the required professional and educational standards should be present on a day-to-day basis.

### B1Q2 Do you think the examples provided are helpful? If not, why not?

We think the examples are helpful.

### B1Q3 Subject to the other proposals in this paper, is there anything else you think should be covered in the updated guidance on Option 5 of RG 105?

As discussed above, the FPA's view is that ASIC should make clear that organisational competence requirements cannot be met where advice is provided but no natural person is providing it. In the case of a digital advice business where advice output isn't reviewed and provided by a traditional adviser, we recommend that, in order to meet their organisational competence requirements, responsible managers must be providing the advice and meet the same professional and educational standards as existing advisers. Further, we recommend that each digital advice business has at least two responsible managers that each meet these standards to allow for one being away from work.

## B2

ASIC proposes to amend RG 105 so that a small-scale, heavily automated business would be able to meet its organisational competence obligation by nominating responsible managers in the following two categories:

(a) responsible managers (as currently defined in RG 105) that have knowledge and skills that are relevant to some, but not all, aspects of the financial services the business will provide; and
(b) an appropriately regulated and experienced professional third party that will provide sign-off for the remaining aspects of the business's financial services.

To rely on B2, we propose that businesses will also need to meet the terms set out in proposals B3 and B4.

B2Q1 Do you agree with this proposal? Please give reasons for your answer.

The FPA has two main concerns. First, the proposal should be extended to all licensees and those seeking licences. Assuming this way of satisfying the organisational competence requirements poses no additional material risk to consumers, there is no good reason to require the rest of the industry to meet those requirements in a more burdensome way. Further, the proposed regulation is a blunt instrument as, generally, firms are excluded. A better alternative, as discussed at A1Q4 above, is to provide cost savings to truly innovative firms to reflect their spill-over benefits to the industry, while allowing all firms to meet the organisational competence requirements under Option 2.

Secondly, our assumption does not hold unless all advice is provided by a natural person who meets the professional and educational standards required of traditional advisers; and other requirements such as the best interests duty under the *Corporations Act*. We accept that a third-party should be allowed to sign-off on some aspects of the financial services provided. However, as discussed above, even heavily automated businesses pose the ever-present risk that the algorithm driving digital advice will produce unintended output. A responsible manager who meets these standards should always be present to do this monitoring. For this reason, we recommend that an internal responsible manager of the business be required to meet the same professional and educational standards as traditional advisers.

Further, a digital advice business produces advice continually and a responsible manager may be away. For this reason, we strongly urge ASIC to require that each digital advice provider has at least two internal responsible managers that meet the same educational and professional standards as traditional advisers.

A firm having multiple responsible managers raises a further issue. In our view, it isn't possible for a group to meet the professional and educational standards where the members collectively (but not individually) meet all the elements. The key point is that legal, professional and educational standards are interconnected. For example, ethical principles influence what assumptions are made; and the best interests duty under the *Corporations Act* potentially limits what subject matter can be advised on. Conversely, critical reasoning skills are needed to apply ethical principles.

An adviser is required to determine from their myriad obligations, an integrated whole. By contrast, committees are characterised by compromise; we shouldn't expect that a group in which no individual meets all the obligations of a traditional adviser will identify (let alone feel bound by) the integrated whole.

We don't believe our recommendation would put an unreasonable burden on firms. Why? We would expect that senior managers of businesses entering the digital advice would typically already have a degree (or higher) in a business- or finance-related discipline. While the educational requirements would ultimately be a matter for the new standards-setting body, we would expect that once the new

standards regime commences a person with such a qualification would be able to satisfy the degree requirements through doing a bridging course in financial planning.

The cost to responsible managers to pass an exam, complete CPD and be covered by a code of ethics would be small, especially considering they could meet code monitoring requirements by joining an approved professional association. Yes, they would have to spend time studying for the exam, but given the exam requirement won't apply before 1 January 2019, existing senior managers of digital advice start-ups will have time to prepare without delaying their business plans; and prospective future managers of such start-ups will be on notice of the requirements and should make time to prepare.

### B2Q2 What sort of professionals should ASIC accept as responsible managers that provide sign-off?

In general terms, ASIC should accept a broad range of professionals, including auditors, accountants, lawyers, financial analysts and financial planners. However, regardless of their profession, the individual should possess a deep understanding of the required skills and knowledge that the internal responsible managers lack.

### B2Q3 Are there any other situations where this type of flexibility should be available?

As discussed above, flexibility should be extended to all the industry (both existing providers and those seeking entry). (However, as also discussed, for digital advice providers, each responsible manager should meet the whole professional and educational standards applicable to traditional advisers and, further, there should be at least two responsible managers per digital advice providers.)

ASIC's proposed model means that, generally, firms would not have access to a potentially less onerous way of satisfying regulatory requirements available to a special group. In our view, the proposed relief measure is a blunt instrument and would waste an opportunity to enhance efficiency across the industry. The extra cost to ASIC (if any) of assessing applications or renewals under the proposed flexible option could be reflected in the user fees for that option.

Rather than basing the encouragement of innovation on denying flexibility to most firms, we'd recommend that ASIC reduce, waive or defer fees and charges for genuinely innovative firms (especially small firms).

### B2Q4 Are there any risks associated with this proposal? If so, what are they?

With appropriate amendments, applying the proposed amendments won't materially increase risk. For reasons discussed above, the required amendments are that for digital advice providers, each responsible manager should meet the whole professional and educational standards applicable to traditional advisers and, further, there should be at least two responsible managers per digital advice providers.

### B2Q5 Please estimate any cost savings that a new business would expect to realise from this proposal.

We have no data on this issue. However, it seems likely that third-party sign-off would be cheaper than the extra cost of employing someone in-house with the required skills and knowledge.

**B3**

ASIC proposes that a professional third-party responsible manager providing sign-off under proposal B2 would be required to examine all the relevant material and certify that the AFS licensee is materially compliant with ASIC-administered legislation.

ASIC proposes that:
(a) sign-off would be required every 12 months, or on significant changes to the AFS licensee's operations; and
(b) the AFS licensee would need to lodge a copy of the sign-off with ASIC. Responsible managers who provide a sign-off that contains false or misleading statements may commit an offence under s1308 of the Corporations Act.

### B3Q1 What sort of sign-off should a third-party responsible manager be required to provide?

The third-party responsible manager should be required to certify, based on an examination of all the relevant material, in respect of the whole of say the next 12 months that the firm being assessed is highly likely to possess, at a sufficiently senior level to be effective, the required skills and knowledge not covered by the internal responsible managers. This is the standard against which the third-party would assess a firm. It would also form the basis for assessing whether, in certifying that a firm has met the standard, the third-party has met its professional and legal responsibilities.

To facilitate consistency, ASIC should issue a standard that lists the positive and negative indicators of the standard being satisfied; and provides examples of where the standard is satisfied and where it is not.

### B3Q2 Is an annual sign-off appropriate?

Annual sign-off is only appropriate where there is no material change to the business, such as a change in the types of services offered; the departure of an internal responsible manager; significant change to algorithm (e.g. rebuild, new modules or new functionality).

**B4**

ASIC proposes that proposal B2 will only apply to AFS licensees that:
(a) provide financial services to no more than 1,000 retail clients; and
(b) only give advice on, or arrange for another person to deal in, liquid financial products, non-cash payment facilities, and products issued by a prudentially regulated business.

B4Q1 Do you agree with our proposed restrictions on the types of business eligible for this flexibility? For example, is a limit of 1,000 clients appropriate?

The FPA disagrees with this restriction. As already discussed, if the intention is that this flexibility will not increase risk to each consumer, why not allow all financial services providers to avail themselves of a potentially less burdensome option? The competitive advantage ASIC wishes to afford small-scale, heavily automated digital advice businesses could be achieved by providing special assistance to them where they are genuinely novel or innovative, rather than handicapping other businesses.

In a nutshell, capping the number of retail clients and the types of products doesn't seem relevant if there is already no materially increased risk to each consumer.

B4Q2 Are other restrictions—such as an exposure limit on investment products—also warranted?

For similar reasons to those mentioned immediately above, exposure limits don't seem relevant if there is already no materially increased risk to each consumer from the flexible approach.

## C. AFS licensing exemption for limited service testing

### C1

ASIC proposes to give conditional, industry-wide relief to allow new Australian businesses to test certain financial services for one period of six months without needing to obtain an AFS licence. We refer to this as the 'regulatory sandbox exemption'.

We propose to place the restrictions and conditions outlined in proposals C2–C9 on the licensing exemption to ensure that:
(a) the risk of poor consumer outcomes is minimised; and
(b) activities carried out under the exemption are limited to early-stage testing (i.e. concept validation).
We will continue to consider requests for an individual exemption by businesses that do not meet the terms of the industry-wide relief.

C1Q1 Do you agree with this proposal? Please give reasons for your answer.

The FPA is strongly opposed to a blanket licencing exemption. ASIC's proposed safeguards - for example, limiting the exemption to advising on (or arranging for other to deal in) simple products; and the caps on investments - will reduce consumer risk *on average*. However, there's a myriad of possible business models, which expose consumers to wildly varying risk levels that may be difficult to assess. The only reasonable way to assess the risk, is for the regulator to assess each business case on its merits.

However, we would support ASIC giving special weight to applications for relief for truly innovative business ideas. This would reduce barriers to innovative firms entering the market, and in turn promote the spill-over benefits of innovation.

To be clear, a heavily automated business is not necessarily innovative. Nor is yet another automated risk profiling tool or an ETF investing tool. Firms should demonstrate they are genuinely innovative. Simply being heavily automated is not enough. A close investigation is required to decide whether the firm is offering something genuinely novel and beneficial.

We would also support giving special consideration to the size of the firm, as smaller firms may find it particularly difficult to enter the market. But, again, being small and heavily automated does not make a firm truly innovative (let alone innovative enough to outweigh the extra risk).

We would also support ASIC taking into account the sorts of factors outlined in proposals C2-C9 when assessing the risk of a proposal. However, rather than mechanically and strictly applying those proposals, we would highlight that what is more important is the overall risk of the proposal (relative to its benefits).

In summary, a general exemption is inappropriate as there is a need to ascertain whether there is a net benefit. This requires a close examination and a judgement. We should not let our excitement for the idea of innovation blind us to the risks.

As discussed, in our view ASIC's proposed approach would only be appropriate if reasonable compensation arrangements were put in place. If it is difficult or prohibitively expensive for new providers (especially smaller ones), alternatives such as group schemes would need to be considered.

In our view, these schemes would need to mirror professional indemnity schemes. This would imply that they would need to be funded by government or the industry broadly, which would require government intervention.

Assuming there is no appetite for such intervention, the only alternative is reducing the quality of compensation. In our view, this is unacceptable as consumers are exposed to a greater extent, in circumstances where risk is high. It irrelevant that providers must disclose to consumer the risks (including special risks) the consumer faces; as already mentioned, our starting point is that reforms must not put consumers at excessive risk.

An alternative is to create a virtual sandbox where providers can simulate how consumers would be expected to respond to the provider's business. The simulation would be based on simulation model and a detailed data set. We understand the UK's FCA is working with industry to develop a virtual sanbox.

However, the FPA accepts that businesses would prefer to test actual consumer responses (rather than simulated ones). We also accept that the small-scale testing a sandbox affords can mitigate against failed large-scale speculative enterprises. On the other hand, the proposed 'one-size fits all' approach may expose some consumers to excessive risk, and given the limits on investment amounts the results of testing may not be representative of real-life as other consumers may treat the small investment as too small to care about.

We believe there is a middle ground between the status quo and ASIC's proposal, which would encourage innovation without exposing consumers to excessive risk. We'd recommend businesses seeking to use the sandbox propose – based on the risks to consumers of the particular business model - what disclosure, protection, and compensation they will provide to customers. (The sandbox sponsors will act as gatekeepers to help manage ASIC's workload and to ensure that only high-quality applications need to be reviewed by the regulator.)

This allows firms to propose alternatives to prohibitively or unattractively expensive orthodox compensation arrangements, such as professional indemnity and consumer compensation schemes and self-insurance by the firm doing the testing. But the onus is also on those firms to propose novel ways of effectively dealing with risk. Further, firms with stronger risk management frameworks could accept larger investments (even from retail investors), providing test results that a more useful. (The results of the testing will still be distorted as 'real-life' disclosure, protection and compensation requirements will be prescribed at a higher level. However, this appears to be the best available option.)

A dedicated team within ASIC would assess each application on its merit, in particular how well the consumer risk is managed. We understand this option is more burdensome for ASIC that the proposed option. However, the potential for large-scale financial disasters (albeit across small investments amounts) is reduced. Further, ASIC will develop knowledge and skills in assessing applications, incrementally, rather than taking a leap of faith upfront.

On another issue, the limited class of firms to which the exemption applies raises issues of principle and practice. As a matter of general principle, each firm should be able to use the exemption unless there are strong policy reasons for exclusion. We accept that, given there is a trade-off between risk and innovation, only innovative firms should be granted relief (unless there is some other relevant policy benefit). However, there is no reason to think that firms that aren't small-scale, heavily automated businesses won't also be innovative.

We accept that small business find regulatory hurdles especially burdensome. However, it is dangerous to simply assume that all new small-scale, heavily automated providers will contribute more to innovation (relative to the risk) than others. Rather, ASIC should consider each case on its merits, regardless of the class of firm; and size of firm should be a relevant (but not determinative) characteristic for ASIC to consider in assessing an application for relief.

On a practical note, the proposed exemption would create an incentive for firms not otherwise covered, to restructure. For example, an existing firm that wants to test a digital advice idea, potentially using existing clients, may create a new entity so as to fall within the exemption. Complex anti-avoidance provisions (and associated monitoring) would be required to prevent this sort of exploitation. This regulatory cost could be reduced by adopting a more flexible approach.

### C1Q2 Do you agree the exemption should only apply to new Australian businesses? If not, who else should be eligible, why and on what conditions?

All businesses (whether new or existing; and Australian or foreign) should be eligible with their submissions judged on their merits. Excluding existing or foreign businesses cuts off a potential source of innovation and competition.

Costs of assessment would be based on the cost to ASIC of assessment. However, ASIC can encourage small-scale, heavily automated businesses by putting their applications to the head of the queue and charging them less (or nothing, or deferring the fee) for assessment.

### C1Q3 Please estimate any cost savings that a new business would expect to realise from this change.

We don't have such data.

### C1Q4 Please estimate any additional costs or savings that consumers might be expected to incur as a result of this change.

We don't have data on which to base these estimates.

## C2

ASIC proposes that the industry-wide AFS licensing exemption should only apply to:
(a) giving financial advice in relation to listed or quoted Australian securities, simple managed investment schemes and deposit products; or
(b) arranging for other persons to deal in the products in C2(a).
ASIC will continue to consider requests for an individual exemption by businesses using a different business model.

C2Q1 Our industry-wide proposal only covers giving financial advice and arranging for other persons to deal in a financial product. Do you believe there are other financial services that should be covered by the licensing exemption? If so, what risks would a wider exemption create and how could these risks be mitigated?

To truly encourage innovation in advice, the sandbox needs to cover a much broader range of products and services than advice and arranging for other persons to deal in a financial product. If ASIC wants to encourage an innovative and more competitive financial services marketplace, it needs to encourage innovation across the board.

Only novel ideas that provide a net benefit should be included; yet another risk profiling tool or ETF investing tool is not innovative. To be clear, all innovation should be encouraged, regardless of who is innovating or what they are innovating. Yes, who and what are factors that should be taken into account in assessing risk. But we would caution against ruling truly innovative ideas out in advance.

Without a broad-based approach, consumers will benefit from the cost savings and quality gains in the areas of advice and obtaining a financial product, but financial products (such as managed investments) and ancillary services (such as preparing a will) in respect of which advice is given aren't given the same encouragement to improve. To put it bluntly, more people might be able to access quality advice, but the vehicles for implementing that advice may be stagnant.

We accept that, *on average*, some sectors of the market pose more risk to consumers than others. However, the actual level of risk a particular business poses to consumers is driven by that firm's business model. Again, rather than providing a blanket exemption and then limiting the magnitude of losses to consumers, a broader range of financial services should be able to access the sandbox with the onus on the particular business to propose disclosure, protection and compensation arrangements tailored to the size and scope of risk to consumers.

C2Q2 Our industry-wide proposal only covers services that relate to listed or quoted Australian securities, simple managed investment schemes and deposit products:
(a) Are there any other products that should be covered by the proposal, such as non-Australian listed or quoted securities or general insurance contracts? If so, why and on what basis?

To truly encourage innovation in advice, the sandbox needs to cover a much broader range of financial products than listed securities, managed investment schemes and deposit products. If ASIC wants to encourage digital advice, it needs to encourage holistic advice solutions. A sandbox focussing on such a limited range of products will produce digital advice solutions for the 80% of Australians that don't receive traditional advice, focussed on ordinary savings vehicles; rather than what are typically more sensible products to meet the consumer's requirements, such as insurance, debt reduction and superannuation.

Again, rather than providing a blanket exemption and then limiting the magnitude of losses to consumers, a broader range of financial services should be able to access the sandbox with the onus on the particular business to propose disclosure, protection and compensation arrangements tailored to the size and scope of risk to consumers.

(b) Should the exemption cover services in relation to a wider range of products where the testing business only deals with wholesale clients? If so, what product classes should be included?

The fact that a testing business will only deal with financially literate clients is one factor that should be taken into account in assessing the risk to consumers of the business case. As discussed, the FPA is against a blanket exemption and would instead recommend that each business case be assessed on its merits.

While the FPA support taking into account client status as factor in assessing an application for relief, we believe that the definition of wholesale investor needs to be reviewed. One concern is that the definition assumes (wrongly, in our view) that client wealth is a good proxy for financial literacy. We strongly recommend that ASIC work with Treasury to develop a definition based on financial literacy.

(c) If you believe the exemption should be extended to less liquid or more long-term arrangements, how could any additional risk to consumers be mitigated?

As already discussed, the FPA is strongly opposed to a blanket exemption. However, we accept that relief provided on a case-by-case basis, based on merit, are appropriate. If the special risks associated with less liquid and long-term arrangements are matched with enhanced: technological safeguards; organisational controls and culture; disclosure; and compensation arrangements, we see no reason in principle for refusing an exemption to a particular firm wishing to test its digital offering.

## C3

ASIC does not propose to provide industry-wide relief to existing AFS licensees. ASIC will continue to consider requests for relief by existing licensees on a case-by-case basis.

C3Q1 Do you agree with this proposal? Please provide reasons for your answer.

As already discussed, the FPA is strongly opposed to an automatic exemption. We support granting relief on a case-by-case basis, regardless of whether or not the firm already has an AFSL. AFSL status may be a relevant factor in assessing the firm's need, but it is not conclusive.

Further, the sandbox has the potential to be a place where not only novel technological ideas, but also novel risk-management solutions. This may be attractive to existing AFSLs (an others who don't fit the narrow scope of the proposed exemption) to apply for relief under a more flexible approach than the existing relief regime.

Further, such a limited exemption creates an incentive for avoidance behaviour. For example, existing firms are incentivised to create new entities to test ideas under a watered down regulatory regime. This would require complex anti-avoidance mechanisms, using up valuable regulatory resources. A more flexible approach to relief would reduce the risk of avoidance.

C3Q2 Are there issues related to innovative services from existing licensees that could be dealt with on an industry-wide basis? If so, what are they?

For the reasons already given, no.

## C4

ASIC proposes that the AFS licensing exemption in proposal C1 should only apply where the testing business:

(a) provides services to no more than 100 retail clients, each with a maximum exposure limit of $10,000; and
(b) ensures the total exposure of all clients (wholesale and retail) is less than $5 million.

### C4Q1 Are the retail client exposure limits we have identified appropriate?

Small exposure limits are a double-edged sword. On the one hand, some consumers may treat the investment as speculative, and not behave in the same way they would in the real market (i.e. where there are no caps on investments). On the other hand, $10,000 is still a large investment for many consumers and losses could have a significant impact on their lives.

While we are against blanket exemptions, we acknowledge that investment caps provide a means for managing risk. We think that the market is in a better position to determine what investment limits will still allow for useful testing. Rather than ruling business cases out in advance based on pre-determined exposure limits, we'd recommend considering their business case as a whole.

We would also caution that anti-avoidance measures are required to ensure related businesses cannot circumvent the caps. Further, there may be a need to ensure that the total amount an individual can invest in testing businesses cannot exceed a given threshold.

### C4Q2 An alternative approach would be for the exposure limit of retail clients to vary depending on each client's total net assets:

(a) How easy would it be to comply with a more graduated exposure limit?

(b) Would any benefits with this approach outweigh the resulting complexity for the testing business?

(c) Are there any risks with a graduated approach?

While we are not in favour of a blanket exemption, we are in favour of a flexible approach to assessing risk. For example, if the business proposes to graduate exposure limits based on the particular consumer's net wealth (or some other relevant factor), this would weigh in favour of the proposal. However, a business that has a flat-dollar limit but a conservative business model may still be an appropriate candidate for relief.

There are, of course, complexities associated with graduated exposure limits. For example, is there an ongoing obligation to assess each consumer's investment-to-net wealth ratio? This may mean that the extra costs of this approach outweigh the benefits to the particular firm doing the testing. Further, there is a risk consumers will over-estimate their wealth to allow themselves to invest.

Rather than applying a one-size fits-all approach, we recommend considering each business case on its merits. For example, some digital providers may require strong evidence of wealth. This may increase their costs (including opportunity costs) but would weigh in their favour in ASIC's risk assessment.

### C4Q3 Are there other ways that we could facilitate innovation while limiting the risk of loss to any one individual?

We would strongly recommend that ASIC works with industry to develop a virtual sandbox, as is being done in the UK. The sandbox would use detailed data sets based on real-life consumers, to see how they might respond to the testing firm's new idea.

While this model has its drawbacks (including that firms won't have full knowledge of how consumers will respond to a new idea), it has the major advantage that no client will be harmed as the outcomes are simulated. It also provides firms with longer time frames to test and further develop their ideas, and even multiple attempts rather than being constrained to a 6 month period with no further opportunity to enter the proposed sandbox.

## C5

ASIC proposes that the AFS licensing exemption in proposal C1 should only apply if the testing business maintains adequate compensation arrangements.

### C5Q1 Do you believe that testing businesses will be able to obtain professional indemnity insurance to compensate retail client losses?

We have no relevant data.

### C5Q2 What other compensation arrangements could be used by testing businesses (e.g. group cover or mutual fund schemes)? What practical issues exist with other compensation arrangements?

As discussed, ASIC could allow small-scale, heavily automated firms to operate in the sandbox even though they pose a higher (but not excessive) risk to consumers than would normally be allowed. However our view, this approach would only be appropriate if reasonable compensation arrangements were put in place.

If it is difficult or prohibitively expensive for new providers (especially smaller ones) to obtain professional indemnity insurance, alternatives such as group schemes would need to be considered. In our view, these schemes would need to mirror professional indemnity schemes. This would imply that they would need to be funded by government or the industry broadly, which would require government intervention.

We would suggest that this is an appropriate area for government intervention. Given the difficulty businesses have in controlling access to some of the benefits of digital innovation, they cannot fully recoup the costs of production.

One lever government can pull is contributing to a consumer compensation fund. This would need to be done is such a way that digital firms aren't incentivised to take excessive risk. We'd recommend a co-funding model, where government and the firm share the costs of underwriting the firm's compensation risk. The higher the risk, the higher the premium and the higher the cost to the government and the firm respectively.

The government's contribution to the premium would reflect the spill-over benefits (positive externalities) of the firm's contribution to innovation. The firm would pay the remainder of the premium.

The scheme could be administered by government or a non-government insurer. Government administration may be required to ensure that risk to consumers isn't increased above a threshold level. Our firm position is that, even during testing phase and with full disclosure, consumers shouldn't be put at excessive risk.

## C6

ASIC proposes that the AFS licensing exemption in proposal C1 will apply only if the testing business:
(a) is a member of an ASIC-approved external dispute resolution scheme;
(b) complies with the modified disclosure requirements; and
(c) complies with the best interests duty and conflicted remuneration provisions as if the business were an AFS licensee.

C6Q1 Are the compliance conditions we have identified—in relation to dispute resolution procedures, disclosure and conduct (i.e. best interests duty and conflicted remuneration)—appropriate? If not, please provide reasons.

As already discussed, the FPA is strongly opposed to a blanket exemption. We accept that a modified disclosure obligations could represent an appropriate minimum threshold. However, ASIC's proposal would need to be supplemented. In particular, the testing firm would also need to include details about compensation arrangements in the FSG. (Having adequate compensation arrangements is critical to ensuring consumers aren't put at excessive risk. These arrangements won't achieve their purpose unless consumers know about them.) Further, the level of detail required in the disclosures may vary from case to case.

We are also concerned that tying testing firm's obligations to the best interest duty also means where general advice is provided, providers remain exempt. We have already seen incidences of new tools coming to market which claim to be providing general advice despite doing risk profiling and recommending (personal advice) investment products to retail consumers. For example, under ASIC's current approach a web-based applications that provides a general advice warning could select, based on the client's personal information, a finite list of products for the client to consider – and not have to meet the obligations attached to personal advice.[3] We are also concerned that the use of the term 'advice' in general advice gives the impression the application is providing advice. To avoid confusion, we'd recommend working with Treasury to remove advice from the expression 'general advice'. We'd also recommend ASIC take a stricter approach with applications that create, e.g., product short-lists based on a client's personal information. In our view, clients will rely on this short-list as advice.

C6Q2 Are there any other consumer protections that should apply to clients of testing businesses? If so, what are they?

Under ASIC's existing proposal, a complex anti-avoidance mechanism would be required to exclude firms not intended to be covered by the exemption. We'd recommend a more flexible approach that focuses on assessing the trade-off between innovation and risk, on a case-by-case basis; rather than excluding firms in advance based on categories that don't necessarily reflect the particular risk-reward trade-off accurately. A more flexible approach would reduce avoidance incentives; and heavy regulatory scrutiny of applications would reduce any remaining avoidance activity (especially where firms that don't need special support, seek it through setting up contrived business structures).

We'd also recommend that one of the conditions for relief is that there can have been no promotion of the firm's business idea prior to being granted relief by ASIC. Pre-launch promotion increases the consumer risk associated with the testing period.

Further, where it's reasonably apparent that advice is based on incomplete or inadequate information, the client would need to be warned of such, in accordance with s961H of the *Corporations Act*.

[3] RG 244 *Giving information, general advice and scaled advice* http://download.asic.gov.au/media/3336151/rg244-published-25-august-2015.pdf, Example C4, pp 17-18 (accessed 22 July 2016).

## C7

ASIC proposes that the AFS licensing exemption in proposal C1 will apply only if the testing business is 'sponsored' by an organisation ('sandbox sponsor') recognised by ASIC. ASIC proposes that sandbox sponsors will be not-for-profit industry associations or other Government-recognised entities. The ASIC approved sponsors would be named in the licensing exemption (and could be updated from time to time). We expect sandbox sponsors to only sponsor testing businesses if:
(a) that business is operated by fit and proper persons; and
(b) they have conducted a preliminary assessment that the testing business's proposed business model is reasonably sound and does not present significant risks of consumer detriment.

C7Q1 Do you support the requirement for a testing business to be 'sponsored' by an industry organisation? Please give reasons for your answer.

The FPA broadly supports this aspect of the proposal. Even though we're against a blanket exemption, we believe that sponsorship is an essential condition for relief. We see sponsorship by appropriate organisations as a good way to balance risk to consumers and burdens (including cost and time) to firms.

However, we believe that an appropriate sponsor should be a professional association. By 'professional association' we mean an organisation that promotes not only educational and technical competence in the industry, but also high standards of ethics and professionalism. A key requirement of a professional association is that it has a code of ethics and professional conduct, and a credible monitoring and enforcement mechanism. The code could be backed by the ASIC under RG 183 *Approval of financial services sector codes of conduct*.[4]

Especially in a market that is in its infancy, the law and regulators are yet to identify possible risks. It is up to professionals to co-regulate to an extent, to deal with issues as they unfold.

As discussed below, in our view sponsorship should not be a substitute for ASIC assessing for itself the benefits and costs of each business proposal. (Sponsorship by a reputable professional association may however relieve ASIC of the need to scrutinise applications as closely as would otherwise be required.) This is because, in our view, the emerging digital financial services may present special risks to consumers for a very simple reason: there is no or minimal human interaction.

Especially while the digital market is in its infancy, the regulator needs to be actively involved so that it can closely assess the communication strategies of digital business to minimise the risk of a gap or mismatch between what is being provided and what the consumer understands. By contrast, the risks associated with financial services delivered via traditional channels are well understood by the regulator; this puts ASIC in a position where it can decide whether delegating certain decision-making powers to professional associations is appropriate considering the risk.

As a general proposition, the FPA supports extensive co-regulation of some sectors of financial service. For example, traditional financial planning, has many (if not all) of the indicators of suitability for co-regulation.[5] However, an essential precondition for broad self- and co-regulation is knowledge of the market. We don't yet know the risks of the digital financial services market, but we do have reason to be conservative.

Where a potential testing business is denied sponsorship, they should be able to seek approval from ASIC directly.

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[4] http://download.asic.gov.au/media/1241015/rg183-published-1-march-2013.pdf (accessed 22 July 2016).
[5] See ACMA, Optimal conditions for effective self- and co-regulatory arrangements Occasional Paper http://www.acma.gov.au/webwr/_assets/main/lib311886/self-_and_co-regulatory_arrangements.pdf pp10-11 (accessed 19 July 2016).

## C7Q2 What types of entities should ASIC approve as sandbox sponsors?

We recommend that sandbox sponsors be professional associations focused on the provision of digital financial advice. The association would have high educational, professional and ethical requirements that all members would need to meet. And the senior managers of the testing business would all need to be members.

Rather than prescribing more detail about the type of entity, we'd recommend prescribing the types of professional who are permitted to assess businesses for the purpose of licensing relief. We'd recommend that, to assess a potential testing business, the professional association would need a dedicated committee. The committee would need to include a digital expert (such as a computer scientist or engineer); and a financial planning expert who is a member of a relevant financial planning association.

## C7Q3 How should ASIC ensure that a sandbox sponsor is only sponsoring appropriate testing businesses?

ASIC should issue guidance to sandbox sponsors. The guidance should identify the minimum requirements (for example, organisational culture and ethical standards) potential testing business must meet in order to be sponsored. Further, the guidance should explain that the purpose of relief is to assess the trade-off between innovation that wouldn't otherwise occur; and the additional risk to which consumers would be exposes relative to the general regulatory regime. The guidance should also identify factors that indicate such innovation and risk, respectively. Examples of situations that should and should not be approved would also be required.

ASIC should also conduct sample testing of sponsors to check whether the guidance is being applied correctly and use education, sanctions or banning orders for sandbox providers not doing the right thing.

## C7Q4 What circumstances should a sandbox sponsor take into account when sponsoring a testing business so that the business can rely on the licensing exemption?

We agree that sandbox sponsors should only sponsor testing businesses if:

(a) that business is operated by fit and proper persons; and
(b) they have conducted a preliminary assessment that the testing business's proposed business model is reasonably sound and does not present significant risks of consumer detriment. This might include sample testing to ensure the algorithm is consistently producing appropriate output; and a review of disclosure and compensation arrangements and any other relevant factors.

We'd also suggest following the FCA's eligibility criteria, to provide an additional layer of screening:[6]

- Is the firm in scope: Is the planned new solution designed for or supports the financial services industry?
- Genuine innovation: Is the new solution novel or significantly different to existing offerings?
- Consumer benefit: Does the innovation offer a good prospect of identifiable benefit to consumers? This criterion should continue to be met throughout the period of sandbox testing.
- Need for sandbox: What is the objective of testing? Does the business have a genuine need for testing within the sandbox framework?
- Background research: Has the business invested appropriate resources in developing the new solution, understanding the applicable regulations, and mitigating the risks?'

[6] FCA, *Regulatory Sandbox* November 2015 https://www.fca.org.uk/static/documents/regulatory-sandbox.pdf p 7 (accessed 22 July 2016)

C7Q5 What costs, if any, would testing businesses incur in obtaining sponsorship?

Testing businesses would need to make a detailed, written application; participate in interviews; and submit to workplace audits. This would require time and resources.

## C8

ASIC proposes that a testing business will need to:
(a) notify ASIC that it intends to rely on the AFS licensing exemption in proposal C1 from a specified date;
(b) provide evidence of sponsorship from a sandbox sponsor (see proposal C7); and
(c) declare that it has reasonable grounds to expect that it can operate its business for a period of six months from the specified date.
ASIC also proposes to require that testing businesses give it a short report about their test following completion of the testing period.

C8Q1 Do you agree with this proposal? Please give reasons for your answer.

As discussed, we strongly recommend that ASIC assess each proposal on its merits, albeit taking into account (or even giving strong weight) to the assessment provided by the sponsor.

If ASIC goes ahead with the proposed licensing exemption, what would the business do after the exemption period? Has thought been given to a transition period? How quickly does ASIC think they can approve the AFSL after the exemption period given current stated backlogs in approving AFSLs? A delay will potentially mean the business runs out of funds. Also, how will Fintechs cease to operate for a period of time until the AFSL is granted? Is ceasing to operate in the best interests of clients?

## C9

ASIC proposes that ASIC will have the power to withdraw the AFS licensing exemption in proposal C1.

### C9Q1 When should we exercise our power to withdraw the licensing exemption?

In the following situations:

- when there is evidence consumers are being exposed to excessive risk
- where the application for relief was based on materially inaccurate or misleading information
- where the testing business fails to meet its ongoing conditions for relief.