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## **Consultation Paper 260: Further measures to facilitate innovation in financial services**

Governance Institute of Australia (Governance Institute) is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are unrivalled.

Our members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies, as well as in the not-for-profit (NFP) and public sectors. Our membership includes company officers of the holders of Australian Financial Services Licences (AFSL) and those who work in financial services compliance. They frequently are those with the primary responsibility for dealing and communicating with regulators such as the Australian Securities and Investments Commission (ASIC) and we have drawn on their expertise in this submission.

### **General comments**

Thank you for the opportunity to provide feedback on ASIC's proposed approach to facilitating innovation in financial services, which is contained in Consultation Paper 260.

Governance Institute notes that the cornerstone of ASIC's regulation of financial services entities is the AFSL regime. An important aspect of this is to provide consumers with a more consistent framework of consumer protection in which to make their financial decisions and to set minimum standards of competency and ethical behaviour of AFSL holders. In applying for and maintaining an AFSL, a holder must satisfy important criteria to ensure that they not only have adequate financial resources but that they have the competence, skill and experience to act efficiently, honestly and fairly in providing the relevant financial services.

Governance Institute understands that ASIC is committed to encouraging innovation in financial services and has put significant resources into helping financial technology (fintech) start-up businesses navigate ASIC's regulatory framework.

Governance Institute is of the view that any attempts to assist fintechs should not be at the expense of regulatory compliance and governance. Any weakening of consumer protection and compliance would seriously undermine ASIC's regulatory framework in the financial services area.

Financial services are undergoing significant technological innovation and change. New technology and innovation are accompanied by unanticipated risks — indeed, the financial

services sector has witnessed spectacular implosions due to the impacts of unforeseen risks. Our view is that proper checks and balances should remain in place regardless of the innovative nature of the new business. Governance Institute is of the view that the licensing regime for financial services should not be suspended for applicants with new business ideas. We are unaware — and at no point does the Consultation Paper point to any empirical evidence — of the current licensing scheme as having prevented a sound business based on new technology from coming to market.

We note that the AFSL regime was introduced in March 2004 to provide order to a financial services sector that lacked experience, credibility and qualifications, and the proposals set out in the Consultation Paper do not provide sufficient explanation of why this basic intent of regulation should be overturned for new businesses, simply because they utilise new technologies. We note that many new businesses have had to expand their experience and undertake new qualifications in order to meet AFSL requirements, and it will be difficult to explain why these businesses had to meet regulatory requirements while others do not.

Governance Institute sets out our concerns below about the proposals contained in Consultation Paper 260, in particular the proposal to introduce a regulatory sandbox exemption.

### **AFS licensing exemption for limited service testing or regulatory sandbox exemption**

Governance Institute is concerned that ASIC's proposal to give conditional industry-wide relief to allow new Australian businesses to test certain financial services for a six-month period without needing to obtain an AFSL undermines ASIC's regulatory framework, which currently only allows entities that hold an AFSL to provide financial products and services to consumers.

We note that ASIC proposes to retain some basic consumer protections as part of the regulatory sandbox exemption, namely, requiring internal dispute resolution procedures; membership of an external dispute resolution scheme; and adequate compensation arrangements. However laudable these safeguards appear to be, they don't address our key objection to the proposal which is that unlicensed entities that do not satisfy any of the other comprehensive licensing requirements will be allowed to provide financial services to consumers, regardless of any limitation of waiver that ASIC imposes.

We make the following comments concerning the regulatory sandbox exemption proposal:

- Client, products and exposure limits do not overcome our central objection to the proposed regulatory sandbox exemption. Licensing is an onerous obligation but an important one, and we consider that there are important reasons why licensing requirements exist and should continue to apply to new businesses. An exemption to holding an AFSL means that many of the important statutory obligations contained in s 912A of the *Corporations Act 2001* will not apply to entities testing financial services on consumers. Important safeguards such as financial reporting requirements, financial adequacy requirements and client money requirements will not apply to entities operating under this exemption. It appears from the proposal that these entities will not be obliged to ensure adequate supervision and monitoring of their authorised representatives or to ensure their authorised representatives and staff are adequately trained and competent to provide the services. There is also no mention in the paper of any obligation on the entity's part to have adequate resources to provide the financial services.
- AFS licence applications are a point-in-time assessment of an entity before it begins providing financial services. It is an important opportunity for ASIC to vet and scrutinise the application. Under the regulatory sandbox exemption proposal, no licence application process will be undertaken before services are offered. There will be no chance for ASIC to vet the proofs that the sandbox entities have adequate systems, personnel, policies or business structures.

- The proposal states that sandbox entities will be required to have adequate compensation arrangements and to be a member of an external dispute resolution scheme. Without a licence application system, ASIC will not have the ability to vet the adequacy of the compensation arrangements that the proposal paper states these sandbox entities are required to have. Nor will ASIC be able to check whether these entities are in fact a member of an external dispute resolution scheme. Any vetting or scrutiny by ASIC will be 'after the event' which in our view is an unsatisfactory way to deal with financial licensing.
- The proposal provides for not-for-profit fintech hubs and co-working spaces to operate as 'sandbox sponsors'. It is unlikely that these entities will hold an AFSL, which means that they are incapable of filling the compliance gap or providing personnel who could contribute to the organisational competency of the sandbox entity. It is also difficult to see how such sandbox sponsors could 'conduct a high level preliminary assessment of the testing business, and only certify businesses where they believe the business model is reasonably sound and there are no risks of significant consumer detriment associated with testing'. We are of the view that ASIC should require any sandbox sponsor to have an AFSL, and if not, we ask why not? We are also of the view that further information on eligibility to become a sandbox sponsor is required.
- The AFSL regime is meant to provide flexibility to industry participants while at the same time providing protections for consumers. It was designed to deal with future changes in products and services. While a financial technology business may be innovative and new, it can also bring unforeseen risks. The licensing system exists to address risks of new entrants and ensure that they are covered by the same regulation as all other participants in the market. Governance Institute is of the view that the licensing regime for financial services should not be suspended for applicants with new business ideas. Scrutiny needs to be applied to all licence applications at the licence application stage irrespective of whether they are fintech businesses or not. Governance Institute considers more appropriate options for fintech companies that wish to undertake limited service testing is for them to become authorised representatives of AFSL holders or be set up as a subsidiary of a AFSL holder, so that these activities are conducted within the current licensing framework rather than outside of it. There can be many barriers to entry to market, but finding appropriately qualified and experienced AFSL holders is unlikely to be the main impediment.
- Governance Institute notes that ASIC will require prominent disclosure to consumers that the financial services are being provided in a testing environment. Governance Institute considers that disclosure has its limits. We note that ASIC is also on the public record as highlighting the limits of disclosure, given that many consumers do not read the disclosure documents and are therefore unaware of the risks involved in financial services. Disclosure, which is intended to inform consumers, is not the same as consumers actively consenting to an absence of consumer protection for a six-month period. The Consultation Paper also makes no reference to how consumer protection is restored at the end of the six-month period. We are of the view that consumers being sold services in a live test environment should at the very least be required to 'opt in' that they understand the risks involved in participating in a test and that they do not have available to them all their legal rights and protections. Only in those circumstances could ASIC be certain that the consumers have given informed consent to participating in a test.
- We do not support the proposal that an AFS licence be granted even if a suitably qualified, experienced and regulated responsible manager (RM) cannot be found. We note that ASIC already applies Option 5 of Regulatory Guide (RG) 105 and therefore provision already exists for ASIC to exercise discretion. We find that the case has not been made out as to why RG105 needs to be amended to provide exemption to new businesses that claim they cannot find appropriately qualified, experienced and regulated third parties to act as RMs.
- Governance Institute notes with interest ASIC's recent report on its compliance review of the retail OTC derivatives sector. While we note that the regulatory sandbox exemption is not intended to apply to businesses offering services involving complex financial products such as derivatives, the report contains interesting findings on the

licensing compliance of certain entities. The significant instances of non-compliance with licensing conditions, the incidences of what appears to be 'responsible managers-for-hire' who have little operational responsibility or understanding of their respective businesses and the development of a 'secondary market' in AFS licences is concerning and highlights in our view the importance of the vetting process which ASIC undertakes during the AFSL application process. Certain businesses clearly go to great lengths to circumvent processes put in place to enable ASIC scrutiny of their compliance. Governance Institute does not consider therefore that ASIC should be advocating for less scrutiny of new entrants to the market and considers the licencing process to be an important gateway to the sector.

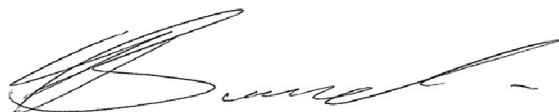
### **Additional guidance on assessing knowledge and skills under Option 5 of RG 105**

Governance Institute is generally supportive of the provision by ASIC of additional guidance in order to assist business and reduce compliance costs. We consider, however, that specific examples may work against ASIC in this instance. Applicants who consider that they fall within a specific, given example may lodge appeals in the event that ASIC rejects their application.

### **Additional flexibility for small-scale, heavily automated businesses**

We understand that ASIC is seeking to facilitate innovation in the financial services sector and we concede that legislation has not kept abreast of technological innovation. Notwithstanding this, we consider that the organisational competence requirements of the AFS licencing regime are an important and integral part of consumer protection providing for confidence in the financial market, and we do not consider that the Consultation Paper has provided sufficient rationale for the exemption proposals it sets out. Nor do we believe that outsourcing sign-off to a third party is a prudent way to satisfy organisational competence requirements.

Yours sincerely



Steven Burrell  
Chief Executive