

The Robo Cop of Robo-Advice

The penetration of technology in the financial services sector, or what is now commonly referred to as "Fintech", is transforming the business models of Australian Financial Services (AFS) licensees who offer traditional financial product advice. AFS licensees are now designing algorithms as a means to providing financial advice ('digital advice'), which requires no direct involvement by human advisors. Digital advice can have cost benefits and makes professional financial advice more readily accessible by investors.

The *Corporations Act 2001* (Cth) (Corporations Act) is technology neutral in that the obligations that apply to providing non-digital advice and providing digital advice are the same (see below for more on when an AFS licence is required). The Australian Securities and Investments Commission (ASIC) recognises that how an AFS licensee complies with the obligations imposed on them will vary according to the nature, scale and complexity of their business. To assist providers of digital advice operating in Australia, ASIC has published Regulatory Guide 255 – Providing digital financial advice to retail clients (RG 255).

AFS licence requirements

A person who carries on a business of providing financial services (for example, providing financial product

advice) in Australia must hold an AFS licence, or must be an authorised representative of an AFS licensee, unless an exemption applies.¹ Financial product advice is broadly defined as any recommendation or statement of opinion that is intended to, or could reasonably be regarded as being intended to, influence a client in making a decision about a particular financial product.² For Fintech businesses, this requires the business to either obtain their own AFS licence or become an authorised representative of an AFS licensee before they can provide digital advice where such

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Key takeaways

- The requirement for persons who provide financial product advice in Australia to obtain their own AFS licence or become an authorised representative of an AFS licensee applies to those wanting to provide digital advice through algorithms.
- Existing AFS licensees wanting to provide digital advice need to consider whether their current licensing arrangements allow them to do so.
- ASIC has published RG255 to assist providers of digital advice when operating in Australia.
- ASIC has set out its position on certain issues it considers to be unique to the provision of digital advice including how the organisational competence obligation is satisfied and adequate risk management systems are maintained and the steps that should be adopted when providing scaled advice in order to satisfy the duty to act in the best interests of retail clients when providing personal advice.

¹ *Corporations Act 2001* (Cth), ss 911A and 911B.

² *Corporations Act 2001* (Cth), s 766B; note: this is a shortened version of the definition.

digital advice constitutes a financial service.

Financial product advice can be either 'personal advice' or 'general advice'. Personal advice is financial product advice that has, or might reasonably be expected to have, considered one or more of a person's objectives, financial situation and needs³ and carries additional regulatory requirements.

As part of any AFS licence application by a digital advice provider, ASIC may request information about the level of human review or involvement in relation to the personal advice generated by the algorithm used in the business. On the other hand, existing AFS licensees wanting to provide digital advice will need to consider whether their current AFS licence will allow them to do so and whether they have the required resources and processes in place.

Regulatory obligations

ASIC has stated that the obligations set out in their Regulatory Guides (RG) apply equally to traditional financial product advice (i.e. non-digital advice) and digital advice. However, in RG 255, ASIC sets out its position in relation to certain issues that are unique to the provision of digital advice.

Meeting the organisational competence obligation

AFS licensees are required to:

1. maintain competence to provide the financial services covered by their AFS licence⁴; and

2. ensure that their representatives (if any) are adequately trained and competent to provide those financial services.⁵

In assessing competence, ASIC requires natural persons providing financial advice to demonstrate that they have undertaken a combination of training, qualification and experience.⁶ Since algorithms are being used to generate digital advice, these training and competence criteria do not apply to businesses that solely provide digital advice (however, they would still apply to hybrid models where there is some human involvement in the advice provided). In these circumstances, AFS licensees providing digital advice are required to have at least one responsible manager who meets the minimum training and competence standards that apply to advisers to satisfy their organisational competence obligations.

Monitor and test algorithms

AFS licensees have an obligation to establish and maintain adequate risk management systems.⁷ ASIC considers that this obligation requires an AFS licensee that provides digital advice to regularly monitor and test the algorithms that underpin the advice provided. To comply with this obligation, ASIC expects AFS licensees to:

1. have appropriate system design documentation that clearly sets out the purpose, scope and design of the algorithms;

2. have a documented test strategy that explains the scope of algorithm testing (e.g. test cases, defect resolutions, final results etc);
3. keep records describing any changes to the algorithms and the reason for those change(s) (such as market changes or changes in the law) (e.g. keeping earlier versions of the algorithm);
4. have adequate resources in place to monitor and review the performance of algorithms (e.g. at least one person within the business who has an understanding of the technology and algorithms used and have the adequate number people with the appropriate qualifications and experience to conduct timely and regular reviews of the quality of the advice provided); and
5. appropriate internal procedures to ensure the steps above have been followed (e.g. sign-off processes).

Providing scaled advice in the best interest of the client

AFS licensees have an obligation to act in the best interests of the retail clients when providing personal advice ('best interests duty').⁸ Where non-digital advice is provided, the AFS licensee is able to limit the scope of their advice (i.e., 'scaled advice') and communicate the limited nature of this advice through conversations (whether face-to-face or by telephone) with the retail client.

For digital advice only providers, such conversations are not possible because there is no natural personal

⁵ *Corporations Act 2001* (Cth), s 912A(1)(f)

⁶ *RG105 Licensing: Organisational competence*

⁷ *Corporations Act 2001* (Cth), s 912A(1)(h)

³ *Corporations Act 2001* (Cth), s 766B(3).

⁴ *Corporations Act 2001* (Cth), s 912A(1)(e)

⁸ *Corporations Act 2001* (Cth), s 961B(1)

directly involved in providing the advice. In these circumstances, ASIC emphasises that digital advice providers ensure that their client communications are user-focused, clear and timely and are provided at the right time in the decision-making process.

Some steps that ASIC considers that digital advice providers should adopt when providing scaled advice in order to satisfy the best interests requirement include:

1. Clearly explaining to the client the scope of advice (i.e. what services the tool does and does not provide). For example, the initial screen may inform the client that the provider does not advise on particular matters;
2. Requiring clients to actively demonstrate that the advice being sought is within the scope of the digital advice model. For example, this may require the client to fill out a questionnaire to identify the specific needs of the client before the advice is generated;
3. Informing the client about the limitations and potential consequences of the scope of the advice. For example, the digital advice model may have a pop up message asking the client to acknowledge the limited scope of the advice before proceeding;
4. Informing the client about the key concepts, risks and benefits associated with the advice being provided throughout the advice process;
5. Filtering out clients for whom the advice being provided is not appropriate. For example, a digital advice provider may use a combined (or hybrid) model whereby if the client's responses

to the questionnaire are inconsistent with the digital advice model, the model will notify the client and the digital advice provider of such inconsistencies and a representative of the digital advice provider can subsequently contact the client to discuss the client's needs;

6. Informing the client how they can withdraw from the advice being provided and any associated costs;
7. Explaining to the client the dispute resolution process available should they have a complaint; and
8. Explaining to the client why they will be in a better position if they follow the advice.

In RG 255, ASIC provides some examples of scaled digital advice that is in the client's best interests.

Compensation arrangements

AFS licensees must have adequate compensation arrangements (e.g. professional indemnity insurance) for compensating clients for losses suffered as a result of any breach of their obligations under Chapter 7 of the Corporations Act. ASIC notes matters that are unique to digital advice providers when assessing the adequacy of compensation arrangements include:

1. consideration of the potential for widespread losses in the event that the algorithm is flawed; and
2. regularly reviewing the business' business model and assessing the potential for losses.

Cyber security and privacy considerations

Digital advice providers are just as likely, if not more likely, to be susceptible to cyber security threats

then non-digital advice providers, especially if a business uses cloud technology. As digital advice involves the collection and use of personal information, digital advice providers should also be mindful of Australian privacy laws which impose additional obligations in relation to cyber risks and information security.

Final remarks

While fintech operators seek to disrupt existing business models, it is important for those operators to consider how their existing regulations might apply to them. In many cases, those regulations may not easily apply to new technologies.

Helpfully, ASIC has in RG255 provided guidance on how digital advice providers can satisfy the AFS licensing requirements. These licensing requirements were imposed without the knowledge of how technology would come to disrupt the provision of financial services in the future.

Technology is not only disrupting business but regulation as well. The challenge is for regulators to keep up with fintech advancements to allow new products to be developed whilst having regard to the regulatory objectives.

See also:

- ["Caught in the \(Privacy\) Act – The Ashley Madison data breach report"](#)
- ["Big Data, Big Opportunities, Big Privacy"](#)
- ["Is your organisation thinking about 'Privacy Everyday'?"](#)

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