

UK regulation of FinTech – the fundamentals are sound

This is a transcript of a speech given by Kirstene Baillie a Partner at Fieldfisher LLP at the inaugural FinTech Europe 2016 event in London on 27th October 2016.

I always hesitate when anyone mentions the phrase "the fundamentals are sound". Often it is said when something potentially troubling occurs: It is frequently used to offer reassurance but perhaps when there is little cause for optimism. I think though we can have slightly more confidence when, in respect of UK FinTech regulation, we say the fundamental regulatory principles in the UK are sound.

Subject to a few reservations and danger areas which I shall identify, there is a relatively positive and constructive approach from the UK FCA. This should help FinTech businesses and help established firms use FinTech solutions.

A changing marketplace

Undoubtedly, technology is having a huge impact – and is driving transformation of the financial services sector including: how consumers use and access financial services, how we utilise mobile and digital channels, and how firms use smart data and advanced analytics within their institutions and look to use alternative models such as cloud technology and block chain.

Certainly, these changes bring with them a new set of risks. As will arise for any new or improved business model, a new set of business risks needs to be addressed.

When devising a new business model, one should look at use of technology from three perspectives – the consumer's interests, the regulator's interest and the firm's perspective. Striking an appropriate balance between providing what the customers might want in managing the firm's commercial risks moving to a new business model (such as the challenge of moving from old legacy systems) and at the same time comply with all regulatory issues is not a straightforward issue. As accurately summarised by Chris Woolard in a speech in November 2015, "*the balance between innovation and risk is not easy to get right*".¹

Consistent and principled regulatory approach

My proposition is that the fundamentals of the regulatory approach are long established and, despite attention to some of the FinTech regulatory issues, these fundamentals remain essentially unchanged. This should be a positive help to UK FinTech businesses.

The FCA's recent actions have confirmed two basic points:

- **the technological neutral approach continues**

¹ Chris Woolard, Director of Strategy and Competition at the FCA, Speech 10 November 2015

There has been a longstanding technological neutral approach. It is important to note though that this does not mean treating every channel in exactly the same way. It means that there is a neutral approach taken.

There has recently been consideration of the alternative "digitally conducive" regulatory environment, but the FCA in March indicated that they were not keen on changing their approach.

- **the principles based approach continues**

The FCA still think that a principles based approach gives them more flexibility and helps future-proof regulation.

"We are keen to address, where possible, any areas of regulation that depend on the use of a particular technology and could therefore inhibit new innovation.

However, we believe that the use of principles and broad rules in our Handbook provides flexibility for the emergence of new technology. It also offers greater durability than technology-specific guidance, which risks becoming outdated as innovation continues".

The problem with future-proofing regulation by sticking to basic principles and broad rules is that, from the compliance person's perspective, there is no easy tick box approach. One point I would make though is that a tick box approach often does not work well. And generally it never works well in a fast developing area.

The challenge of course is how the FCA might work with firms and provide guidance on how to apply principles to new technological developments.

Issues to address

Certainly there are some potential hindrances to address:

- The UK has a wide scope of regulated business – wider than in many other countries. New businesses have to be cognisant of the breadth of the regulatory scope and seek positively to comply with regulatory requirements.
- At least for the present, the UK must implement EU measures.

Whilst there have been various European Commission initiatives looking at E-Commerce matters, most of these are at the discussion stage (for example on robo advice and block chain technology). UK based firms within the scope of EU driven regulation are still subject to various traditional constraints when developing online business models.

There are clearly outdated EU provisions, as have been identified in the Responses to the Commission's Call for Evidence on the EU regulatory framework for financial services. Indeed the UK FCA in its February 2016 Response, and the HM Treasury Response, identified various rules outdated due to technological change. Take, for example, the Distance Marketing Directive referring to faxes and floppy discs.

So, for such time as there must be compliance with the EU provisions, by necessity the UK provisions reflecting these may hinder development of some online business models.

Nonetheless, the UK regulator's direction of travel is clear.

The FCA's focus on innovation and technology

The FCA supports the suggestion that

"rules should accommodate and not prevent the use of on-line services and channels, and should support the development of financial technology solutions".²

The Treasury made their position clear in the Consultation Paper on Innovation for Financial Services published on 22nd April 2016:

"The Government's vision is for UK financial services to be the most competitive and innovative in the world, delivering greater choice and value for consumers."

The FCA's 2016 / 17 Business Plan had an entire section on innovation and technology. In the CEO's introduction to the Business Plan published in April 2016, she stated:

"The impact of technology is one of the fastest evolving of this year's priority themes. In particular, the potential of technology to improve not only how products and services are designed but how they are distributed. This year we will foster new ways to help firms of all sizes develop novel ideas for market through our "regulatory sandbox" which offers firms a safe space to test innovation, reducing the regulatory burden whilst achieving greater compliance."

Clearly there are risks. In the Business Plan, the FCA identify various of these, including one that flags up that rigid regulation itself may stifle innovation in financial services. The FCA is keen to ensure that regulation does not have this effect.

Helpful UK regulatory initiatives

There are some major UK regulatory initiatives which focus on FinTech issues and what FinTech can offer. And I would highlight for you, in particular, those regarding smarter consumer communications.

The FCA have been busy in generating various papers within 2016 on a number of initiatives – see the attached timeline for details. With its document "Our Future Mission", which was published just this month, the FCA explains its continuing initiatives for 2017.

To pick out a few details of 2016 activities for you:

- **The regulatory sandbox**

Within Project Innovate is one major initiative which is the regulatory sandbox which opened in May. It should offer a safe place in which businesses can experiment with innovative product services, business models and delivery mechanisms without incurring all the normal regulatory consequences.

The first tranche of participants are now in process both in the regulatory sandbox and in the advice unit.

² The FCA's February 2016 Response to the Commission's Call for Evidence on the EU regulatory framework for financial services.

One important point to note though that the FCA stress is that the sandbox is not just for new firms. It is also for established incumbent firms.

- **Cloud data storage**

Finalised Guidance was issued in FG 16/5 on cloud data storage and the use of third party providers in July. It is recognised that the use of cloud data storage through third party providers is a key factor in many firms' plans to develop and innovate.

- **Digital and mobile solutions**

In the Feedback Statement on Regulatory Barriers to Innovation and Digital and Mobile Solutions (March 2016) there was recognition that some of the new data protection laws under the new General Data Protection Regulation (GDPR) probably will be a barrier. The FCA have relayed the feedback they received to the Information Commissioners Office (ICO) that stakeholders are concerned that some of the proposed GDPR rules could prevent the development of emerging digital and mobile solutions.

- **RegTech**

The Feedback Statement on RegTech issued in July (FS 16/4) concerns the subset of FinTech which focusses on technologies that may facilitate the delivery of regulatory requirements more efficiently and effectively so reducing the regulatory burden on firms and driving costs savings. The FCA indicate that they want to concentrate their efforts on increasing their engagement and collaboration with the RegTech community, "using our convening authority to help bring together market participants to work on shared challenges" and to act as a catalyst for change that helps to unlock the potential benefits of technology innovation.

The FCA are promoting their TechSprint events as being helpful: the first considered consumer access to financial services and a second event is to look at unlocking regulatory reporting.

RegTech is seen as having the potential to free up large sums of operational and capital expenditure currently spent on compliance.

- **Smarter Consumer Communications**

Smarter Consumer Communications has long been a focus and we are now starting to see some outcomes from this work stream of the FCA.

We have two recently published conclusions in this area:

- one³ deals with some specifics, including removing the obligation to produce short reports for UCITS and non-UCITS fund managers from 22nd November 2016.
- the second⁴ sets out a number of initiatives and heralds a number of further consultations. It is likely that this will lead to:
 - the FCA consulting on good disclosure guides including digital disclosures in 2017,

³ FCA PS 16/23 Policy Statement and Final Rule changes removing a number of ineffective disclosure requirements relating to CP 15/32 of October 2015

⁴ FCA FS 16/10 Feedback Statement regarding Smarter Consumer Communications following up on Discussion Paper of June 2015

- within the FCA's Asset Management Market Study, in which the FCA is looking at how investors make choices and whether they have the information they need, an interim report is expected in Q4 2016⁵ and a final report in 2017;
- the FCA consulting on how best to move on from traditional based communications materials, with a consultation planned early in 2017; and
- consideration of the use and definition of the term "durable medium", again with a consultation in early 2017.

Overall, this is indicative of trying to suggest there should be a new mind set on how communications should be formulated. With any new methods of communicating, one needs to rethink from scratch the best way to communicate the relevant information so as to enable the consumer to make an informed decision.

In addition to these initiatives for UK regulated firms, the FCA is also developing an international approach – note not just a Eurocentric approach. It is developing various FinTech Co-Operation Agreements, so far having entered into these with Australia, Singapore and Korea.

The FCA's "mission" for 2017

To conclude on the regulatory piece, I mentioned earlier that the FCA have this week issued a document - "Our Future Mission". The FCA plan considerable further work in 2017.

Just to pick out three key points:

- **Use of data science**

Data science should offer a series of tools which should allow the regulator to extract useful information from increasingly large complex and varied data sets. These techniques should have great potential when used in regulation.

- **Following the spirit of regulation**

The FCA believe meeting standards is about the purpose of the requirement as well as the letter of the law. I agree!

Complying with the spirit of regulation has always been important, and a fundamental premise which I have been urging clients to follow for a long number of years.

The FCA say that, if a firm only focusses on the letter of the law, both firms and regulators would end up with an ineffective tick box approach with firms concentrating on compliance rather than actually improving outcomes for their customers.

Also it should be remembered that, when supervising firms, the FCA is setting minimum standards in its Principles for Business and Senior Managers Regimes. (It is always open to firms to deliver more.)

- **Further work on transparency and disclosure**

⁵ The Interim Report has now been issued – MS 15/2.2 November 2016. See our separate [Briefing Paper on the Asset Management Market Study findings](#)

It is not just about putting certain content requirements into disclosures, it is also about the quality of disclosure. There is a point that "less can be more".

Also it is clear that customers do not always respond to disclosure in the way that many policy makers and regulators have assumed and behavioural economics will be taken into account in adapting the regulatory response.

The opportunity for firms to take the initiative themselves

Progress in all these areas should not though simply rely on FCA initiatives, and then firms seeking to comply. There is much that firms can, and should, be doing in the meantime.

- **Improving Terms & Conditions:** Firms could make progress on improving the clarity of Terms & Conditions themselves, in advance of any FCA initiatives. Developing more straightforward, shorter and simplified Terms & Conditions is still something to be embraced by various established firms.
- **Improving the functionality of firms' websites** would be worthwhile. Websites are increasingly viewed as the source of useful information. Projects to improve these could be undertaken in advance of further regulatory reliance being put on websites providing information.
- There are **various industry based initiatives**, such as the development of a Glossary for Investors by the Investment Association. The FCA is supportive of these but it is incumbent on industry groups to generate momentum for some of these – not just the regulator.

There is therefore much which can be a matter of self-help now rather than waiting for the regulators to require matters to change under further regulation.

Focus on the commercial issues first

By way of an order of events, I would recommend that firms should really consider new commercial issues for new commercial business models first, and then see about applying regulation and the FCA's Principles. This may be a surprising comment from a lawyer but the reality of the position has always been, and should remain, that you look at the commercial business position first, work out how to deal with your customers best and how to formulate the business model.

I have seen good examples of this recently with some crowdfunders. Once there is a positive approach taken to engaging with whatever is required by regulation, this usually frees up a whole host of other possibilities as to what can be achieved. It is usually far preferable to embrace regulation rather than try artificially to limit the commercial offering on a technical basis. Assuming you have taken an ethical, principled approach, compliance with all manner of financial services regulation should be capable of following.

This is evident if you just consider the high level Principles to which the FCA turn when difficult issues arise. Notably, in embracing new FinTech solutions, you must have regard to how you satisfy yourselves you comply with the following:

- Management and Control: Principle 3

"A firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems".

- Customers' interests: Principle 6

"A firm must pay due regard to the interests of its customers and treat them fairly".

- Communications with Clients: Principle 7

"A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear fair and not misleading".

But all of these should, in any event, be enshrined in a regulated firm's approach doing business. I agree wholeheartedly with the FCA's emphasis on the need to comply with the spirit of these constant Principles when developing new business models.

Are recent experiences encouraging?

I have seen a variety of approaches taken by incumbent firms and new entrants into the marketplace. Some experiences illustrate contradictory themes – experience varies depending on the nature of the client and its approach to embracing new technology.

- **Traditional client embracing new robo advice models**

I can think of one relatively old-fashioned client which has embraced the robo advice option in connection with giving information on retirement options in respect of its pension products. In essence though, these on-line facilities really just formalise what was previously given by way of an explanation of the retirement options in the old world on paper.

Although various customers perhaps ought to go through to get real advice, in practice very few have done so in the first nine months of this operating. But at least it is a start of trying to shift to using the communication methods which consumers increasingly wish to use.

- **A new firm engaging with the FCA**

We are now seeing an increased willingness for new firms to start a dialogue with their regulator. Some, for example some of those in the crowdfunding space, were initially keen to minimise the impact of regulation but more recently have accepted the need to fit within the regulatory framework – and understand how this can help their business. Further, new business models can now develop and a variety of firms, including those seeking to exploit the block chain technology, are within the FCA's first tranche of firms in the Sandbox. This is all very constructive. They have worked on all the business issues and now appreciate the need to work out how to comply with FCA regulation.

- **A cautious approach, given wider regulatory initiatives**

These positive experiences though contrast with reactions which come from some long established clients. I can think of some mainstream household names who might always in the past have been the first to do a new initiative but, right now, will be much more cautious, given the introduction of the Senior Managers Regime.

The FCA may need to consider how to balance its general supervisory and enforcement work as against its desire to promote competition and innovation.

This last point, with incumbent firms in particular being quite cautious in today's regulatory environment, simply serves to reinforce the FCA's own plea for constant and open engagement.

Conclusion

I would like to conclude by emphasising the points with which I started:

- **The fundamental principles and the formal FCA Principles remain constant and consistent**
- **There is a positive acceptance of the need to move forwards in the UK FCA**

There is a willingness within the regulator to engage with firms, both new FinTech start-ups and incumbent firms, to develop guidelines as to how best to proceed.

I have worked on lots of the "disruptive" new products over the years – not just recently. When the supermarkets were trying to get into the financial services basis and they were trying to make plain English text and take over some of the established business models, the FCA's approach was much more reactionary and they were looking for problems. Now, the FCA's approach is much more positive – and indeed they are trying to collaborate the FCA's approach with firms. The sandbox is a particularly good initiative.

- **It is not though just up to the regulators**

It is necessary for new start-up FinTech firms and incumbent firms to seek to embrace regulation – and ensure that they take an appropriate approach to comply with regulation.

But that is not the end of the story. For any product or service, firms need to review the technical position: the contract law basis or other basic legal issues and devise documentation and processes on a prudent basis.

At all stages, firms must never lose sight of the commercial objectives in the interests of their customers.

What is allowed by the regulator is not the end of the process. You should work out how you best wish to devise the model. This may be delivering in excess of what the regulator requires.

Firms should take the initiative in developing product terms and delivery mechanisms for new product as they move into the more digitalised environment and then engage with the FCA, rather than waiting for the FCA to tell them how to deliver these.

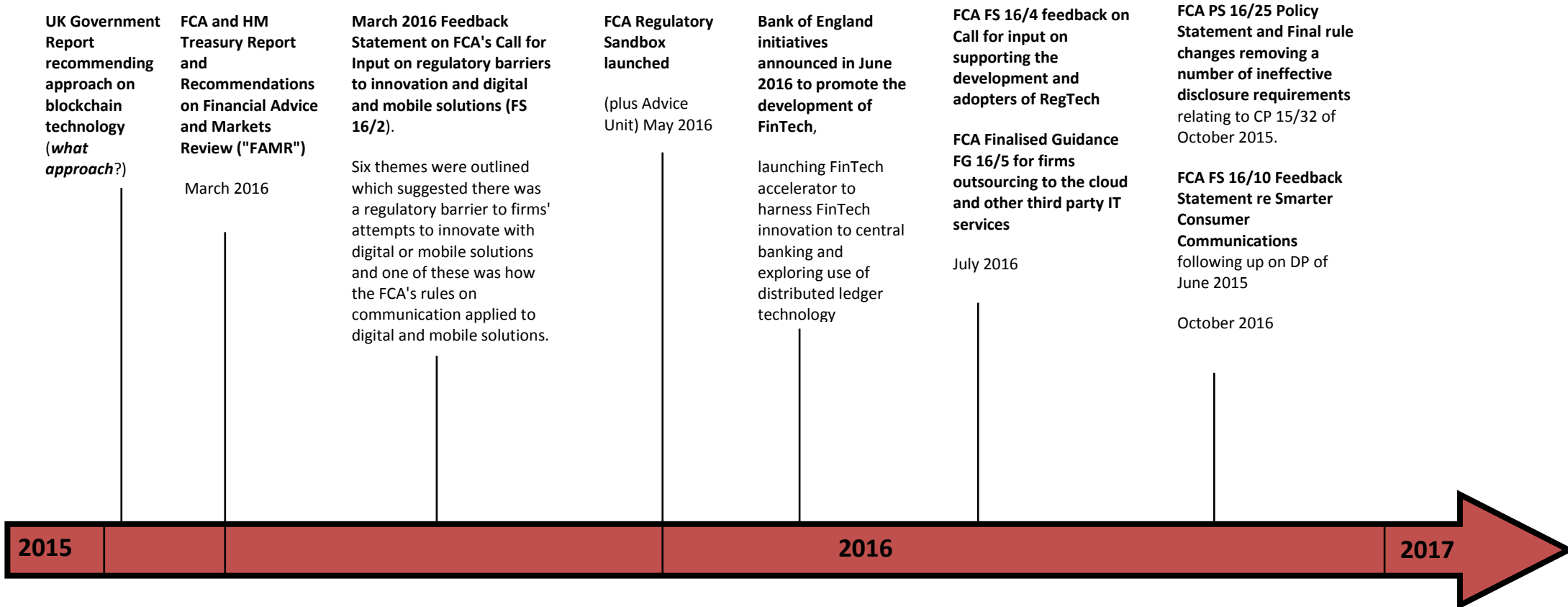
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UK FinTech initiatives in 2016



Notes:

1. FCA entering into various specific Co-operation Agreements, e.g. FinTech Co-operation Agreement with Australian regulator(March 2016), and subsequently Singapore (May 2016) and Korea (July 2016),
2. European initiatives continue, e.g. CMU and specifics – Digital single market, Commission communication of 6 May 2015 with some proposals adopted on 9 December 2015; Crowdfunding Commission Report of 2 May 2016but no action proposed for now: Robo Advice Discussion Paper by ESA's Joint Committee; Blockchain technology (June 2016) ESMA Discussion Paper to assess whether regulatory action is required;