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Financial Markets Policy
Ministry of Business, Innovation & Employment (**MBIE**)
PO BOX 3705
WELLINGTON

Financial Services Legislation Amendment Bill

1. Introduction

- 1.1 This submission is made on behalf of MinterEllisonRuddWatts, a national law firm with one of New Zealand's leading financial services law practices. It relates to the consultation draft of the Financial Services Legislation Amendment Bill (**Bill**). The submission reflects our own views, and not necessarily those of any of our firm's clients.
- 1.2 For the reasons outlined below, we have focussed this submission on certain questions of the **Consultation Paper** in respect of the Bill, relating to the provision of "automated personalised advice" or "robo-advice" (in this submission we use our preferred term, "**digital advice**"). We have set out in the Appendix what we mean by "digital advice" and "digital advisers" in the context of this submission.
- 1.3 We will not comment on the other matters raised in the Consultation Paper, in relation to the review of either the Financial Advisers Act 2008 (**FA Act**) or the Financial Service Providers (Registration and Dispute Resolution) Act 2008.
- 1.4 In February 2016 we made a submission on the November 2015 Options Paper published by MBIE (**2016 Submission**).¹ In that 2016 Submission we focussed on digital advice issues. This followed the findings of an in-house survey of 80 young lawyers in our Auckland office and a further focus group of six young lawyers. For convenience we referred to this group, all of which were under the age of 30, as **Millennial Professionals**.
- 1.5 As discussed in our 2016 Submission we considered our best contribution to the reform process would be to look at the FA Act review from the perspective of young working law graduates, and in particular how accessible, accurate and affordable financial advice could be provided to this cohort through enabling digital advice. Paragraph 2.1 of our 2016 Submission sets out a summary of our points on this.
- 1.6 The five main points in paragraph 2.1 of our 2016 Submission have been fully or substantially addressed in the draft Bill and the Consultation Paper. Therefore, except for two specific comments on the Bill set out below, we support the Bill and Consultation Paper as they relate to digital advice.
- 1.7 In this submission we have decided that our best contribution would be to continue to focus on digital advice and leave it for others to address broader issues in their submissions.

¹ Our 2016 Submission can be found here: <http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/options-paper/options-paper-submissions/Minter-Ellison-Rudd-Watts.pdf>

2. Summary

2.1 In this submission we have set out:

- (a) in Part A, two specific comments on the Bill in response to the Consultation Paper; and
- (b) in Part B, our recommendations, based on detailed research of overseas jurisdictions, as to how MBIE could ensure that the eventual digital advice regime is fit for purpose – in that it provides the best outcomes for consumers, advice providers and the New Zealand fintech industry.

Part A: Issues with the Bill

- (c) Under the proposed transitional period the realistic earliest timing for obtaining a digital advice licence is around April 2019. This is too late. New Zealand consumers, fintech firms and the New Zealand economy are ready for digital advice now. Digital advice should be enabled earlier by way of earlier licensing of digital advisers or a class exemption from the FA Act.
- (d) Sophisticated digital advice providers should be regulated under the Financial Markets Conduct Act 2013 (**FMCA**) financial advice regime but, because of the ancillary discretionary services they may provide, some providers may fall within the discretionary investment management service (**DIMS**) regime in the FMCA. We think that the Bill should explicitly exempt such providers from the DIMS regime to ensure that the right services are regulated by the right legal requirements.

Part B: Recommendations for a Successful Digital Advice Regime

- (a) The Bill must be drafted to ensure that the licensing and regulation of digital advice in New Zealand is both sufficiently flexible to enable innovation and sufficiently robust to protect consumers.
- (b) Ensuring that quality information is disclosed will have a critical role in establishing and supporting consumer trust in digital advisers. Key requirements for disclosure should be reflected in the disclosure regulations.
- (c) Digital advisers should employ information gathering and analysis techniques, and suitable means of client engagement, to ensure that the advice provided is suitable for the particular client.
- (d) The Code of Conduct should set minimum expectations for suitability of advice, to underpin consumer confidence and set market expectations.
- (e) The eligibility criteria for a licence to provide digital advice should establish expectations for review and monitoring of the advice algorithm to ensure it is functioning correctly.
- (f) The eligibility criteria for a licence to provide digital advice should require digital advisers to ensure they have sufficient cyber-security in place.
- (g) To ensure that the recommendations above are implemented and complied with by the digital advice platforms, the eligibility criteria and/or the Code of Conduct should require digital advisers to have in place adequate compliance programmes and to establish appropriate governance structures.

PART A: ISSUES WITH THE BILL

3. Transitional Issues

- 3.1 In this paragraph we respond to questions 33 and 34 of the Consultation Paper, regarding transitional issues.
- 3.2 Currently the Consultation Paper provides that digital advice may only be provided under a full licence. Applications for a full licence will open on 28 February 2019. Firms will be able to elect their licence effective date. All firms must be licensed by 28 February 2021.
- 3.3 Based on previous experience under the FMCA licensing processes, it is likely that the minimum processing time for a relatively smooth licence application will be in the order of two to three months. This means the earliest realistic timing for the licensing of the first digital advice provider will be April or May 2019.
- 3.4 This timeline is too long, for the following reasons:
- (a) New Zealand consumers are ready to receive digital advice now. In our 2016 Submission we highlighted the reasons why Millennial Professionals and other consumers want the option of receiving digital advice as soon as possible. This included an “advice gap” in the market where consumers, particularly those with limited resources, currently find it hard to access financial advice suitable for their needs. Millennial Professionals also identified other benefits such as accuracy, independence, convenience and cost that digital advice platforms offer.
 - (b) Innovative New Zealand businesses are ready and willing to provide digital advice now. Further delay negatively impacts the viability of these business. Further, and perhaps most importantly, it inhibits businesses from developing their initial business models in line with international best practice, by incentivising them to commence operations with reduced-functionality models in order to comply with the current sub-optimal regulatory environment. This is a concern that has been expressed to us by market participants.
 - (c) New Zealand risks being left behind comparable jurisdictions. We pride ourselves on being an innovative country with a responsive regulatory regime. The Minister of Commerce and Consumer Affairs recently described fintech as a fast growing sector with exciting opportunities for New Zealand companies and consumers.² Any delay in enabling fintech applications such as digital advice that are in line with global best practice, risks putting New Zealand further behind our international competitors and limits the potential international opportunities for New Zealand businesses. Innovative talent and capital investors may be drawn to other countries which are trying to position themselves as the Asia Pacific hub for fintech innovation. This would be a loss to the New Zealand economy. As one market participant told us, “it would be very easy for New Zealand to be left behind”.
- 3.5 We note that the Financial Markets Authority (**FMA**) has also recently expressed its support of the early adoption of digital advice as a means of increasing access to financial advice for consumers.³

² <http://www.nztech.org.nz/nz-governments-role-in-driving-the-pace-of-fintech-development-with-fintechnz/>

³ See the FMA's *AFA Information Report*, at: <https://fma.govt.nz/news/media-releases/fma-releases-afa-information-report/>

- 3.6 Digital advice should be enabled earlier than 2019. This could be done in one of two ways:
- (a) A specific digital advice licensing process could be developed for full digital advice licensing in August 2018 (at the time of transitional licensing for other financial advice providers). The duties, disclosure requirements and liability regime in the Bill would apply to digital advisers from this point. Any requirements not yet covered by legislation could be imposed by way of licence conditions. This is our preferred option.
 - (b) If option (a) is not available, MBIE could work with the FMA to consider how digital advice could be enabled by way of a class exemption from the current FA Act. The exemption conditions would substantially replicate the requirements for digital advisers that are intended to be imposed by the Bill, with digital advisers still required to go through a licensing process in accordance with the current legislative timetable.

4. Interaction with DIMS

- 4.1 The Bill should better regulate when the digital advice or DIMS regimes apply, particularly with respect to complex financial advice and financial planning services.
- 4.2 As discussed in the Appendix, the best examples of the sophisticated digital advice and financial planning platforms that we have seen are the US-based businesses. Many of these have an automatic rebalancing or other automatic investment component to them. Worldwide, the combination of advice and portfolio management services is common.⁴ New Zealand would benefit from enabling such businesses. A platform may use multiple sources to rebalance a portfolio, including deposits, dividends, reinvestments or even withdrawals. Typically, a firm would use investment inflows and outflows to restore the target asset allocation of the investment portfolio, i.e. inflows to purchase under-weighted assets and outflows to withdraw from over-weighted asset classes.⁵
- 4.3 Under the FMCA, automatic portfolio rebalancing and other discretionary investment into financial products may be a DIMS.⁶ Where a person acts as a provider of a DIMS to retail clients that person must be licensed by the FMA.⁷ Under the Bill, financial advice provided as part of providing a DIMS is not regulated financial advice if it is provided by a person under a DIMS licence.⁸ Therefore, the internationally successful models of sophisticated digital advice and investment planning would likely be governed by the DIMS regime in New Zealand instead of or as well as the financial advice regime. That would not be a good outcome for the following reasons.
- 4.4 First, automatic portfolio rebalancing may be a relatively ancillary part of a digital advice business, with the principal activity of such businesses being the provision of financial advice – perhaps in the form a detailed investment planning service. Compared with traditional DIMS, which is aimed at sophisticated investors and may include broad investment discretions, any discretionary investment services offered by digital advisers

⁴ International Organisation of Securities Commissions, *Update to the Report on the IOSCO Automated Advice Tools Survey: Final Report*, page 7. See:

<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD552.pdf> (**IOSCO Final Report**),

⁵ For more details on discretionary mandates provided by digital providers in the US, see: FINRA, *Report on Digital Investment Advice*, <https://www.finra.org/sites/default/files/digital-investment-advice-report.pdf> (**FINRA Report**).

⁶ Under section 392 of the FMCA a person (**A**) provides a DIMS where A decides which financial products to acquire or dispose of on behalf of an investor (**B**) and, in doing so is acting under an authority granted to A to manage some or all of B's holdings of financial products.

⁷ Section 388(c) of the FMCA.

⁸ See clause 13 of the proposed new Schedule 5 of the FMCA, to be introduced by the Bill.

is likely to involve limited discretions (e.g. limited to rebalancing in accordance with an asset allocation plan) and therefore lower risk. The Bill excludes financial advice given only as an ancillary part of a business from being regulated financial advice.⁹ We recommend that MBIE amends the Bill to extend a similar exemption to services that may amount to a DIMS provided only as an ancillary part of provision of regulated financial advice.

- 4.5 Secondly, given the principal business of digital advice platforms is providing advice, it seems sensible to us that these businesses should be regulated within the framework of the new digital adviser regulation, rather than as a DIMS (the regulatory framework of which is similar to the regulation of a financial product). For example, the requirements of the new Code of Conduct would not currently apply to the provision of advice under a DIMS.
- 4.6 Thirdly, we submit that enabling digital advisers to execute investment plans for clients will produce better consumer outcomes. From discussions with industry participants we understand that often consumers of financial advice fail to take steps to implement the financial advice, because of the friction points in taking action. Enabling financial advisers to execute investment plans for clients would remove one of these friction points and lead to overall better consumer outcomes.
- 4.7 We submit that MBIE should carefully consider the circumstances under which digital advisers should be regulated as financial advice providers, and when they are regulated as DIMS providers. In particular, we would like to see the Bill include a clear exemption for digital advisers providing ancillary DIMS services from being regulated under the DIMS regime.
- 4.8 Once the legislation has been finalised, it will be important for the FMA to provide market guidance on the difference between a digital advice service and a DIMS. This would be consistent with recommendations for regulators from the International Organization of Securities Commissions.¹⁰ However, this is not a substitution for clear law in the first place.

5. **PART B: RECOMMENDATIONS FOR A SUCCESSFUL DIGITAL ADVICE REGIME**

- 5.1 Enabling innovation in the provision of digital advice will assist consumers, innovative businesses and the New Zealand fintech industry. In order to do this, we submit that the regulation of digital advice in New Zealand should be both sufficiently flexible to enable innovation and sufficiently robust to protect consumers.
- 5.2 These goals align with the policy development objectives in the Consultation Paper, being:
- (a) consumers can access the advice and assistance they need;
 - (b) advice improves consumers' financial outcomes and makes them better off; and
 - (c) consumers have access to effective redress.¹¹
- 5.3 We have looked at a number of other jurisdictions¹² for lessons on how to meet these objectives. It is critical that the New Zealand regime aligns with global best practice, both

⁹ See clause 7 of the proposed new Schedule 5 of the FMCA, to be introduced by the Bill.

¹⁰ IOSCO, *Research Report on Financial Technologies (Fintech)*, February 2017, page 35. See: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf>

¹¹ Consultation Paper, page 7.

¹² We reviewed digital advice material from the US, UK, Australia, Europe (ex. UK) and Canada, as well as aggregated international reports on digital advice regulation such as the IOSCO Final Report.

to ensure the regime works best for New Zealand consumers and to enable New Zealand digital advisers to scale internationally. In this section we set out the results of this research and our recommendations on actions MBIE should take.

6. Flexible Licensing

6.1 As discussed in the Appendix, digital advice is a wide concept encompassing a broad range of services with varying levels of complexity. Further, businesses that provide digital advice will range from large financial institutions to the small and innovative start-up businesses. The licensing regime must be sufficiently flexible to cater for these differences. In particular:

- (a) Smaller start-up businesses seeking to provide innovative digital advice services will often have limited resources. Licensing should therefore be “right-sized”, and should not be a barrier to entry for these businesses.
- (b) In addition to being right-sized, licensing should be sufficiently flexible to enable many different advice services. For example, a digital adviser that provided traditional “class advice”, such as equities research, will now be providing regulated financial advice and will be required to be licensed. However, the client risks in respect of this type of general advice are likely to be lower than, for example, a detailed financial planning and investment service. The licence requirements and conditions should reflect these different risk profiles.

6.2 The Bill should enable a flexible approach to licensing by requiring the FMA to have regard to the size and complexity of a business (including of the advice it provides) when considering a licence application. An example of the flexible approach can be taken from the FMA’s “Quick guide to licence applications for small businesses providing DIMS”.¹³

7. Adequacy of disclosure

7.1 As noted in our 2016 Submission, digital advice consumers are concerned to know that they are being provided with sufficient information about the digital adviser and the service being provided.¹⁴ Consumer confidence will be a critical factor in the success of digital advisers. From our 2016 Submission process, Millennial Professionals emphasised that it was the quality of information that is disclosed by a digital adviser, rather than quantity, that matters and they are happy to rely on the regulator’s licensing process to ensure that a digital adviser was capable and reliable. Examples of information Millennial Professionals wanted digital advisers to clearly disclose include incentives, potential conflicts, fees, and the limitations of the advice provided.

7.2 Traditional human financial advisers can communicate the scope, limitations and risks of advice to clients through back and forth conversation with their clients. This is potentially more difficult for digital advisers, who rely on one-way information input from clients and on algorithms to provide advice. Additionally, consumers may also be less likely to comprehensively read information provided in digital form, meaning that it is even more important to ensure that any information provided is concise and fit for purpose. The disclosure regulations will therefore perform a critical role in establishing and supporting consumer trust in digital advisers.

7.3 Lessons for the optimal disclosure requirements can be drawn from recent publications from the Staff of the Division of Investment Management of the US Securities and Exchange Commission (**SEC**)¹⁵ and the Australian Securities and Investments

¹³ See here: <https://fma.govt.nz/assets/Guidance/140618-licensing-small-dims-businesses-guide.pdf>

¹⁴ 2016 Submission, paragraph 6.6.

¹⁵ SEC, *Guidance Update*, February 2017. See: <https://www.sec.gov/investment/im-guidance-2017-02.pdf> (**SEC Guidance**).

Commission (**ASIC**)¹⁶, as well as other international regulatory publications. Based on a review of these publications we recommend that the disclosure regulations, supported by commensurate duties in the Code of Conduct, should require digital advisers to:

- (a) ensure that client communications are clear, concise, effective and timely. This means digital advisers should put their client's needs first when designing their communications and disclosure, and ensure that key information relevant to the client is provided at the right time in the decision-making process. This disclosure requirement will be supported by the new duty to put the client's interests first;¹⁷
- (b) when providing disclosure, consider the technological medium through which advice is being provided. As noted in our 2016 Submission, increasingly digital advice will be delivered through new and different technological channels.¹⁸ For example, disclosure information that is suitable for a laptop computer may not be suitable for the smaller screen of a smart phone. Key disclosures should be highlighted in a technologically useful manner, e.g. through the provision of pop-up boxes;¹⁹ and
- (c) explain to the client at the outset, and at key points in the advice process, the limitations the scope of advice, any potential conflicts or biases inherent in the digital advice platform and the potential consequences, limitations, conflicts or biases. For example, digital advisers should be careful not to mislead clients by implying the advice is of a different type, e.g. that a comprehensive financial plan is being providing when it is in fact not doing so²⁰ and clarify if the algorithm is designed to only advise on certain financial products;²¹ and
- (d) provide an explanation of the business model of the digital adviser, for example a statement that an algorithm is used to generate advice and a description of the degree of human involvement (if any) in the preparation of the advice.²² As noted in our 2016 Submission, many sophisticated Millennial Professionals see the provision of advice without human involvement to be a benefit (for example, because of the lesser risk of unconscious bias),²³ so it will be important to understand what the human involvement is, as well as the incentives, checks and balances that apply.

8. Suitability of Advice

- 8.1 Overseas regulators have noted that digital advice raises specific issues in respect of the suitability of the advice it provides to clients. Digital advisers often obtain information based primarily, if not solely, on client online questionnaires. This method of information collection may not give the client a chance to provide additional information, nor to permit the human advisers to ask follow-up or clarifying questions.²⁴

¹⁶ ASIC, *Regulatory Guide 255 – Providing Digital Financial Product Advice to Clients*, August 2016. See: <http://download.asic.gov.au/media/3994496/rg255-published-30-august-2016.pdf> (**ASIC Guidance**).

¹⁷ ASIC Guidance, paragraph 97.

¹⁸ 2016 Submission, paragraphs 3.2 to 3.6.

¹⁹ SEC Guidance, page 5.

²⁰ SEC Guidance, page 5; IOSCO Final Report, page 11.

²¹ European Supervisory Authorities, *Joint Committee Paper*, page 23.

²² SEC Guidance, pages 3 and 4; This was also a concern of the European Supervisory Authorities. See European Supervisory Authorities, *Joint Committee Discussion Paper on Automation in Financial Advice*, 4 December 2015, page 22. See here:

<https://www.esa.europa.eu/documents/10180/1299866/JC+2015+080+Discussion+Paper+on+automation+in+financial+advice.pdf>

²³ 2016 Submission, paragraphs 3.11 and 3.12.

²⁴ SEC Guidance, page 6. See also, IOSCO Final Report, page 10.

- 8.2 This was not perceived as an issue for the Millennial Professionals in our 2016 Submission, who all considered themselves to be sophisticated enough to confidently operate and interpret questionnaires and to understand the limitations of digital products.²⁵ Indeed, provided the algorithm is correct, digital advisers can be more reliable than a human adviser through greater computing power, the reduction of human error and the removal of unconscious bias.
- 8.3 However, there is a need for the Bill to set market expectations in order to promote consumer confidence, particularly for less technologically sophisticated investors. In particular, we have been told by industry participants that businesses developing digital advice algorithms approach this with varying levels of experience in providing financial advice. Developers will need to be presented with an upfront explanation of the regulatory requirements, so that they are focussed not just on providing technological solutions, but on ensuring that these are providing the best results for consumers. In particular, the Code of Conduct should set market expectations in respect of suitability of advice. This should be supplemented by FMA guidance in due course.
- 8.4 Specifically, digital advisers should be required to:
- (a) ensure information-gathering methods elicit sufficient information to allow the digital adviser to conclude that its initial and ongoing advice is suitable and appropriate for the client;²⁶
 - (b) test for inconsistencies in the answers given by a client (for example, answers that indicate both low risk tolerance and a maximum growth objective), and to address inconsistencies:
 - (i) incorporate features into questionnaires to alert clients to inconsistent responses to ensure the inconsistency is intended by the client;²⁷
 - (ii) consider stopping the client from completing the questionnaire until the inconsistency is resolved,²⁸ or filter the client out of the digital advice process if the process is not suitable for the client; and²⁹
 - (iii) monitor and, if required, flag inconsistencies to the digital adviser so that either the digital adviser,³⁰ or a human adviser,³¹ can intervene in the advice process;
 - (c) where a client is able to select a portfolio other than the portfolio recommended by the digital adviser, explain to the client why the initial portfolio was selected for the client and alert the client to the risks associated with not following the advice; and
 - (d) identify where a client requires advice outside of the scope that the digital advice platform is capable of providing, filter the client out of the digital advice process (or require the client to talk with a human adviser).³²

²⁵ 2016 Submission, paragraph 3.11.

²⁶ Sufficiency of information gathering was seen by the European Supervisory Authorities to be a source of potential risk for digital advisers. See their *Joint Committee Discussion Paper*, page 21.

²⁷ SEC Guidance, page 7. FINRA Report, page 10.

²⁸ The Canadian Securities Administrators, *Guidance for Portfolio Managers Regarding Online Advice*, https://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20150924_31-342_portfolio-managers-online-advice.pdf - although note that Canada operates a “hybrid model” where advising representatives oversee algorithm generated advice (**CSA Guidance**).

²⁹ ASIC Guidance, paragraph 106.

³⁰ SEC Guidance, page 7.

³¹ CSA Guidance, page 3.

³² ASIC Guidance, para 103; IOSCO Final Report, page 11.

8.5 Ultimately the question of suitability of advice is something that both human and digital advisers will grapple with. Just as human advisers use systems to reduce this problem, we are optimistic that sufficiently sophisticated digital advice systems will eventually overcome these issues. Until that point, however, we consider that appropriate regulation and regulatory guidance are necessary to assist digital advisers and provide consumers with appropriate protection.

9. **Reviewing and testing of digital advice**

9.1 We identified in our 2016 Submission that digital advice platforms may eventually be able to utilise resources, such as “big data”, to provide a higher quality advice than human advisers.³³ While this will eventually occur, there is likely to be a transitional period in the development of sufficiently reliable algorithms where human adviser checking of digital advice may still be required.

9.2 We therefore recommend that the eligibility criteria made under the Bill should specify that a licensee must have sufficient resources (including, where necessary, human adviser resources) available to review advice for legal compliance and suitability. Digital advisers may meet this requirement in the following ways:

- (a) engage a suitably qualified human adviser to review, perhaps on a sample basis, digital advice provided to ensure it complies with the law.³⁴ This may be an adviser employed by the digital adviser or available on a contracting basis. As technology progresses however, in the Bill provision needs to be made for automated review – by an independent system;
- (b) reviews of advice should be undertaken frequently at the outset of the algorithm’s operation, and whenever changes to the algorithm are made; and
- (c) whenever reviews of the advice provided by the algorithm detect errors, and the error is likely to result in a loss to the client or breach of the law, immediate steps should be taken to rectify the error, and the algorithm should not continue to provide advice until the error is resolved.³⁵

10. **Oversight of the algorithm**

10.1 Based on overseas regulatory comment we recommend that digital advisers should be required to ensure that their advice algorithms are continuously monitored and reviewed, due to the lack of the human involvement in the process. We recommend that the eligibility criteria made under the Bill should specify this as a requirement for licensing.

10.2 To meet this review requirement:

- (a) digital advisers should engage at least one person in senior management who has a general understanding of the technology and algorithms used to provide digital advice. It may not be necessary for this person to understand the specific computer coding of an algorithm, but that person must understand the rationale, risks and rules behind the algorithms used to provide the digital advice;³⁶
- (b) if the algorithm is outsourced, the digital adviser will be responsible for having in place sufficient contractual arrangements with the outsource provider to ensure oversight of the algorithm. The engagement of this algorithm expert should

³³ 2016 Submission, paragraph 3.12.

³⁴ ASIC Guidance, paragraph 110.

³⁵ ASIC Guidance, paragraph 114.

³⁶ ASIC Guidance, page 19.

include a requirement for the expert to be available to explain the workings of the algorithm, on request, to the FMA;

- (c) regular development, testing and back-testing of the algorithmic code should be carried out, and changes to the code that affect client accounts should be disclosed;³⁷
- (d) digital advisers should have adequate documentation of decision making processes which make up the algorithm, e.g. “decision trees” or “decision rules”.³⁸ This will assist the digital adviser to have documentary evidence at hand which can be provided to the FMA as required to understand that algorithm and any potential issues that may arise; and
- (e) records of past iterations of the advice algorithm should be kept for a minimum period of time to allow reconstruction of previous versions if required for regulatory purposes.³⁹

10.3 Due to the specialised nature of digital advice and the technological basis of algorithms, it may be challenging for regulators such as the FMA to evaluate an algorithm at face value. It will likely be necessary for digital advice providers to have high quality documentary evidence of how their algorithm complies with the relevant regulatory requirements and the terms of their licence in order to satisfy the FMA or other regulator’s expectations.

11. Cyber-security

11.1 While cyber-security is not an issue unique to digital advisers, digital advisers may be more likely to be targeted by cyber-attacks due to the potential holding of client money by the provider,⁴⁰ and the storage by providers of vast amounts of personal information of clients. We recommend that the eligibility requirements for digital advisers should specifically require digital advisers to address cyber-security. This could be done in the following ways:

- (a) Overseas regulators have emphasised the importance of assessing digital adviser’s cyber-security frameworks against equivalent national standards and making it a priority for the provider. Expectations have developed for digital advice providers to have a “cyber-security policy” which is compliant with the various guidance notes issued by overseas regulators.⁴¹
- (b) In a New Zealand context this will likely involve a new undertaking by the FMA to develop a clear set of cyber-security principles and standards for digital advice providers. These new principles and standards may be based on existing New Zealand and overseas standards, so that digital advice providers can ensure they have adequate cyber-security measures in place to mitigate the threat of a potential cyber-attack.⁴²

³⁷ SEC Guidance, page 8.

³⁸ ASIC Guidance, paragraph 74. A decision tree is said to refer to a tree-like graph or model displaying the various decisions the algorithm makes and the potential consequences.

³⁹ ASIC Guidance, paragraph 74.

⁴⁰ ASIC Guidance, page 22. IOSCO, *Automated Advice Tools Final Report*, page 12. SEC Guidance, page 8.

⁴¹ ASIC Guidance, paragraph 80.

⁴² See, for example, the materials referenced in ASIC Guidance, paragraph 79.

12. Digital advice compliance programmes and governance of digital advisers

- 12.1 To implement the recommendations set out in this submission, we submit that the licensing eligibility criteria made under the Bill should require digital adviser to have in place sufficient compliance programmes and governance and supervision arrangements. These should be appropriate for the particular digital adviser, taking into consideration the size and complexity of that digital adviser's business.
- 12.2 Overseas regulators have noted that compliance programmes should:
- (a) require the digital adviser to adopt, implement, and annually review written policies and procedures that are reasonably designed to prevent breaches of the new FMCA requirements and other legal requirements. A digital adviser should be mindful of the unique aspects of the particular business model in designing these programmes, e.g. the reliance on algorithms, or the limited amount of human interaction in the provision of the financial advice;⁴³
 - (b) designate a compliance officer who is responsible for the advice policies and procedures.⁴⁴ This role could be similar in nature to that of the compliance officer required under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009; and
 - (c) provide that people within their business with the appropriate skills review both the digital advice provided (see paragraph 9, above) and the advice algorithm (see paragraph 10, above).⁴⁵
- 12.3 In particular, while digital advice platforms can operate autonomously, overseas regulators have identified the importance of having human oversight (such as by the compliance officer) at a platform level to appropriately supervise any automated advice. This will be particularly important in the earlier stages of digital advice, to ensure that algorithms are working correctly and to give consumers confidence in digital advice.
- 12.4 In terms of formal oversight processes, overseas regulators have noted that it is common practice to have some form of investment policy committee (which may be appropriate for more sophisticated digital advisers) to:
- (a) oversee the development and implementation of algorithms;
 - (b) participate in the due diligence on the tools of external providers which are incorporated into the algorithm; and
 - (c) evaluate the outcomes which the algorithm produces.⁴⁶
- 12.5 In the event digital advisers construct model portfolios, overseas regulators have noted that the above investment policy committee will likely also review the model portfolios that the algorithm will produce to ensure they match client profiles. Information about clients such as risk tolerance and asset allocations should be matched against the model portfolio produce to ensure consistency.⁴⁷
- 12.6 Appropriate governance arrangements will be critical for financial advice providers to demonstrate that they have met their duties in the new sections 431I and 431J of the FMCA, to exercise care, diligence, and skill and to comply with the Code of Conduct. We

⁴³ SEC Guidance, page 8.

⁴⁴ SEC Guidance, page 7.

⁴⁵ ASIC Guidance, page 19.

⁴⁶ FINRA Report, page 6.

⁴⁷ FINRA Report, page 6.

expect that the Code of Conduct will address governance requirements for digital advisers, and that the licensing process will set governance and supervision minimum standards.

13. **Conclusion**

- 13.1 We have presented our submission at a high level and with the intention of raising issues relevant to the final form of the Bill, the regulations, the licensing requirements and any regulatory guidance. We would be happy to discuss technical and drafting requirements in respect of the Bill and the regulations, requirements and guidance during the process of preparation of these documents.
- 13.2 Thank you for taking the time to consider this submission. Please contact us on the details below if you wish to discuss any of the matters raised in this submission.

Yours faithfully

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APPENDIX – THE DIGITAL ADVICE ECOSYSTEM

In this Appendix we set out what we mean by digital advice and digital adviser, and provide some overseas examples of digital advisers.

1. What do we mean by digital advice?

- 1.1 In this submission we use “digital advice” to refer to the whole spectrum of digital advice services. However, the common characteristic for all digital advice services is that they have limited, or no, human adviser involvement in the provision of the financial advice. A “digital adviser” is a provider of digital advice.
- 1.2 As noted in the Consultation Paper, there is no one typical digital advice service. The Bill deliberately does not define digital advice, so that it is technologically neutral and will capture future digital advice developments. Digital advice services can vary widely in scale and complexity.
- 1.3 At the less complex end of the spectrum, a digital advice platform may be a simple online questionnaire with a limited number of questions that provides a limited recommendation on what is the most suitable fund for a client to invest in.⁴⁸
- 1.4 At the more complex end of the spectrum, it could be full investment planning service, such as what is offered by Wealthfront⁴⁹, Betterment⁵⁰ or Acorns⁵¹, that requests detailed financial information from a client and provides a tailored investment planning service (including some or all of: risk profiling, asset allocation, portfolio selection, trade execution, portfolio rebalancing, tax loss harvesting and portfolio analysis). Three of these types of services are described in paragraph 2 below.

2. Examples of digital advisers

- 2.1 In order to understand where digital advice development in New Zealand might lead, we analysed a number of different international businesses. These businesses are principally located in the United States of America (**US**), which is the most developed digital adviser market.
- 2.2 Below are three examples of different digital adviser services:

Betterment

Feature	Description
Name	Betterment Inc.
Location	New York, US
Size	US\$7.36 billion assets under management (AUM). The largest digital adviser by AUM. Approximately 280,000 accounts.
Regulation	Betterment is a registered investment advisor regulated by the SEC. It trades through Betterment Securities LLC, a FINRA–registered broker-dealer.
Investments	Betterment achieves its asset allocation by investing in index-tracking exchange traded funds (ETFs).

⁴⁸ For example, something similar to Sorted.org.nz’s KiwiSaver Fund Finder: <http://fundfinder.sorted.org.nz/find-the-right-type-of-fund-for-you>

⁴⁹ <https://www.wealthfront.com>

⁵⁰ <https://www.betterment.com>

⁵¹ <https://www.acorns.com>

Description	<p>Betterment is a digital investment advisory and investment planning service. Investors sign up through a simple online process where they fill out a questionnaire to establish their risk tolerance and investment timelines. They are presented with a personalised investment plan and, if this is accepted, asked to fund an investment account.</p> <p>Betterment takes funds from the investment account and automatically invests this in underlying ETFs in accordance with the investment plan and limited trading authorization granted by the client.</p> <p>Betterment continuously monitors the asset allocation thresholds and automatically rebalances the investment portfolios where they move outside of the thresholds. This is done using deposits, withdrawals and dividends from the portfolio.</p> <p>Betterment's point of difference is that investors are asked to elect a number of different investment goals, such as buying a house, safety net, retirement etc. Each goal has its own investment portfolio, target balance, time horizon and deposit/withdrawal schedule.</p>
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Wealthfront

Feature	Description
Name	Wealthfront Inc.
Location	Redwood City, California, US.
Size	AUM of US\$5 billion. Second largest digital adviser behind Betterment. Approximately 100,000 accounts.
Regulation	Wealthfront is a registered investment advisor regulated by the SEC. It trades through Apex Clearing Corp LLC, a FINRA–registered broker-dealer.
Investments	Wealthfront achieves its asset allocation by investing in index-tracking ETFs.
Description	<p>Wealthfront is a digital investment advisory and investment planning service. Investors sign up through a simple online process where they fill out a questionnaire to establish their risk tolerance and investment timelines. They are presented with a personalised investment plan and, if this is accepted, asked to fund an investment account.</p> <p>Wealthfront takes funds from the investment account and automatically invests this in underlying ETFs in accordance with the investment plan and limited trading authorization granted by the client.</p> <p>Wealthfront continuously monitors the asset allocation thresholds and automatically rebalances the investment portfolios where they move outside of the thresholds. This is done using deposits, withdrawals and dividends from the portfolio.</p> <p>Wealthfront allows the holding of individual securities transferred from other investment accounts, and will work these into the asset allocations of the investor's portfolio.</p>

Acorns

Feature	Description
Name	Acorns Advisers LLC
Location	Newport Beach, California, US.
Size	AUM of US\$257 million. Approximately 1.16 million accounts.
Regulation	Acorns is a registered investment advisor regulated by the SEC. It trades through Acorns Securities LLC, a FINRA –registered broker-dealer.
Description	<p>Acorns is a digital investment advisory and investment planning service. Investors sign up through a simple online process where they fill out a questionnaire to establish their risk tolerance and investment timelines. They are presented with a personalised investment plan and, if this is accepted, asked to fund an investment account.</p> <p>Acorns takes funds from the investment account and automatically invests this in underlying ETFs in accordance with the investment plan and limited trading authorization granted by the client.</p> <p>Acorns' investment plans are less tailored than Betterment and Wealthfront. It offers clients an option of one of five model portfolio options: conservative, moderately conservative, moderate, moderately aggressive and aggressive.</p> <p>Acorns continuously monitors the asset allocation thresholds and automatically rebalances the investment portfolios where they move outside of the thresholds. This is done using deposits, withdrawals and dividends from the portfolio.</p> <p>Acorns' point of difference is that it links to as many debit and credit card accounts as a client wants. Each purchase in these accounts is rounded to the nearest dollar, and the difference is transferred into the Acorns investment account, e.g. for an \$18.20 purchase, \$0.80 would be transferred to Acorns. These amounts are then invested in the client's investment portfolio.</p>