LUCY FREW'S FINTECH COLUMN: APRIL 2016

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Lucy Frew is a Partner in Kemp Little LLP's Financial Regulatory practice. Lucy shares her views on topical FinTech issues with our subscribers.

In this edition of her column, Lucy considers recent developments relating to the Financial Markets Advice Review (FAMR), items of interest for FinTech's arising from the FCA's 2016/17 business plan, the FCA's regulatory sandbox and HM Treasury's draft innovation plan for financial services. Lucy also considers what a vote in favour of Brexit will mean for FinTech firms.

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RESOURCE INFORMATION

RESOURCE ID

4-627-1366

RESOURCE TYPE

Article

JURISDICTION

United Kingdom

STATUS

Law stated as at 29-Apr-2016

FCA BUSINESS PLAN 2016/17

The theme of "innovation and technology" retains its status as one of the key priority themes based on the FCA's assessment of risk in its latest business plan, published on 5 April 2016. There are no real surprises here, with the FCA hammering home at every opportunity the message that it recognises that technology has the potential to increase competitiveness, innovation and efficiency, creating real benefits for both consumers and firms, but that it also creates risks. Firms are told to focus on both infrastructure and culture to ensure that new technologies benefit both consumers and markets.

Reading between the lines, FinTechs should expect a focus on their financial promotions communications, especially those involving peer-to-peer lending and equity crowdfunding platforms.

Key risks highlighted by the FCA are around operational resilience, cybercrime, protection of information and financial exclusion. The FCA also highlights risks around authorised firms outsourcing processes to specialised external firms that have developed advanced technology (essentially, FinTechs). The FCA considers that this could give rise to risks if it leads to the FCA having less oversight of the "disruptive implications" of these technologies, and that such "delegation of control could affect a firm's responsiveness and resilience in a crisis". The regulator is clearly concerned by the complexity inherent in the IT systems that underpin the financial markets. To date, the FCA has, essentially, outsourced any supervision of third party providers to authorised firms by requiring them to comply with various requirements in the Senior Management Systems & Control (SYSC) sourcebook (relating, for example, to due diligence, contractual terms, supervision, monitoring, access, contingency plans, exit arrangements and others) when they outsource. It is worth noting that the FCA has traditionally not mentioned technology in any substantive manner in the SYSC sourcebook. It will be interesting to see if this is an area where the FCA decides to change its approach.

The UK's referendum on EU membership is touched on only very briefly in the business plan. The FCA is considering the immediate and short-term consequences of any vote to leave the EU, such as the potential for increased market volatility. It recognises that longer term consequences of any vote to leave would depend on the UK's eventual relationship with the EU, which would depend on the outcome of negotiations between the UK government and the EU, and does not speculate further. Which, inevitably, leaves us to fill the gaps, and in that vein this column ends with my thoughts on some possible implications of Brexit on FinTechs (see *Brexit*).

FCA AND HM TREASURY'S FINANCIAL ADVICE MARKET REVIEW REPORT (FAMR)

The FAMR recognises that automation of the financial advice industry is needed to address the current "advice gap" (defined in FAMR's *call for input* as situations in which consumers are unable to get advice and guidance on a need they have at a price they are willing to pay). The FAMR *final report* (published in March 2016) is to be welcomed in that it recognises that regulatory intervention is very much required in two broad areas: improving regulatory clarity around advice and increasing regulatory support for innovative firms. Essentially, the FAMR wants banks or others to solve the advice gap by providing automated advice. For banks, however, the main concern is that regulations still leave too much room for interpretation and, by extension, future possible risk. After years of massive compensation claims springing from mis-selling and other issues, banks are understandably cautious. This may represent an opportunity for challengers.

If the FCA does want the main high-street banks to adopt robo-advice (as the language of the FAMR suggests) then it needs to provide much clearer guidance to resolve the current complexity of regulatory requirements, and potential implications of providing regulated advice. The glossary at Annex A of the FAMR final report defines the following shades of advice: basic advice; focused advice; general recommendation; generic advice; guidance; full advice; investment advice under MiFID; personal recommendation; regulated advice (being the activity of advising on investments under article 53 of the RAO); simplified advice; and streamlined advice. All these terms have specific meanings and regulatory implications. The FAMR's recommended amendment of the definition of "advising on investments" in the existing Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 *(SI 2001/544)* (RAO), so that it is in line with the MiFID definition, only addresses part of this. The FCA has already sought to address this issue in its January 2015 *finalised guidance (FG15/1)* on clarifying the boundaries and exploring the barriers to the development of the retail investment advice market, but more is required.

REGULATORY SANDBOX UPDATE

The Economic Secretary to HM Treasury, Harriett Baldwin, and FCA Director of Strategy and Competition, Christopher Woolard, both gave speeches at the 2016 Innovate Finance Global Summit in London recently.

The Economic Secretary announced in her speech certain policies that the UK government has adopted to support the FinTech sector, including establishing a FinTech panel, the delivery of a support function to set an overarching UK FinTech strategy and establishing "FinTech Bridges" to work with priority global markets to assist UK FinTechs to grow internationally. These initiatives are very welcome, in particular the assistance with international growth. This is because FinTechs are not always able to use the passports available to more traditional firms, as I explain below in my comments on the impact of a UK vote to leave the EU.

The FCA will start accepting applications for the regulatory sandbox on 9 May 2016. Successful firms will then be able to test out their innovative ideas using the sandbox. In his speech, Christopher Woolard confirmed that the FCA will run two cohorts within the regulatory sandbox for the first year, allowing room for both the FCA and firms to mutually learn from the process. As the FCA will be selecting firms with the "most doable" plans, it encourages firms to submit applications that have well-developed testing plans (explaining their proposition and how it meets the sandbox eligibility criteria). To help firms, the FCA has published two documents addressing *sandbox eligibility criteria* and *default standards for sandbox testing parameters* respectively. The FCA is to be applauded for this initiative. However, as with authorisation within Project Innovate, the challenge is to find a way to make the process scalable given the likelihood of increasing demand to use the sandbox.

INNOVATION PLAN FOR FINANCIAL SERVICES SECTOR

Those following FinTech developments closely will find little new in HM Treasury's April 2016 *consultation paper* on a draft innovation plan for financial services. It nevertheless serves as a useful summary of the impressive amount of ongoing and future work by UK financial services regulators to support and promote innovation in financial services. The consultation is intended to help identify what gaps there might be in the approach of the FCA, PRA, the Bank of England (BoE) and the Payment Systems Regulator (PSR) when it comes to supporting innovation, and the extent to which their work supports innovative technology and disruptive business models. It also seeks views on the extent to which regulators could better use technologies to deliver their own work more effectively. The relatively short consultation period (responses by 6th May 2016) and the fairly general consultation questions might suggest that HM Treasury has already been sounding out interested parties behind the scenes. Although, given the government's positioning of the UK as a global FinTech leader, this is would not come as a surprise.

BREXIT

And so, by no means least, to the hot word on everyone's lips: Brexit. How will a Brexit vote on 23 June 2016 fit in with Chancellor George Osborne's plans to make the UK "the FinTech capital of the world", as announced back in 2014? From a financial regulatory perspective, most mainstream UK financial institutions would have little to gain and potentially much to lose from a British decision to leave both the EU and the EEA. Is the position the same for FinTechs?

FinTechs currently operating in the UK or thinking of starting up here should bear in mind two key considerations: what would a post-Brexit UK regulatory regime look like for FinTechs and would FinTechs' ability to access the EU market post-Brexit change?

It is worth starting by pointing out that the FCA is streets ahead of other EU national regulators in its approach to FinTechs, both in terms of its own ongoing work (the innovation hub and regulatory sandbox, for example) and its outward focus. Indeed, whatever the outcome of the referendum, it is clear that the FCA is ready to leap-frog the EU and build direct FinTech bridges with like-minded regulators in other parts of the world. The *co-operation agreement* recently entered into by the FCA with the Australian Securities & Investments Commission (ASIC) to support innovative businesses centres on a referral mechanism that will enable the two regulators to refer, between their respective innovation hubs, innovative financial services businesses seeking to enter the other's market. Christopher Woolard has explained that the FCA aims to reduce the barriers for authorised firms looking to grow to scale overseas, and to assist non-UK innovators interested in entering the market overseen by the FCA. He adds that the FCA hopes the agreement with ASIC will be the first of many. A vote to leave the EU may well give the FCA the opportunity to "find ways of keeping regulation up-to-date with trends in innovations" without being hampered by the constraints of EU law. As the FCA explained in its *report* on developing a regulatory sandbox, "EU legislative requirements restrict flexibility of authorisation requirements (for example, capital requirements) for firms subject to those EU requirements. The FCA cannot waive requirements derived from EU law." This means that currently options for UK legislative change are unfeasible due to the limitations set by EU legislative requirements.

One possible outcome of a vote in favour of Brexit would be for the UK to leave the EU but remain part of the European Economic Area (EEA). In this case, the impact on financial sector firms, including FinTechs, may be minimal. This is because members of the EEA (which currently comprises the 28 EU member states plus Norway, Liechtenstein, and Iceland) are subject to the benefits and burdens of EU financial sector regulations and directives, including passporting rights (albeit with minimal ability to influence their development).

While a UK exit from both the EU and the EEA, could, on the face of it, have a more significant impact on traditional financial sector firms (with the loss of valuable passporting rights currently available under EU legislation), this is less likely to have so much of an impact on FinTechs, many of which are not yet of a scale to operate outside the domestic market. Of those that are, many do not have business models that fit neatly into any of the EU directives that provide passporting rights and, as such, are not currently able to passport in any case. A current challenge for FinTechs, being primarily digital and mobile-based technologies that do not recognise international boundaries, is the marketing of products cross-border. This is because individual EU member states impose their own restrictions and requirements on marketing, which means what is fine in one state may be unlawful in other. As passporting rights do not extend to cross-border marketing the loss of such rights is less likely to impact FinTechs.

Another consideration is whether FinTechs could benefit from a more light touch regulatory regime following a vote in favour of Brexit, on the basis that EU regulations would cease to apply in the UK post-Brexit and the UK government could opt to repeal the UK laws that implement EU directives? A lighter touch financial services regime is, I think, improbable. Even if the UK left the EU and EEA, the UK government could decide merely to incorporate EU regulations into UK law and retain domestic laws implementing EU directives, at least on an interim basis, given the volume of issues that would otherwise become unaddressed. In other words, the UK regulatory environment for financial sector firms generally may not change dramatically in the event of a Brexit, at least in the short-term.

Even longer term, it is probably unrealistic to expect Brexit to result in a financial regulatory revolution. First, although in some contexts the presence of the UK in EU regulatory debates may have tempered the perceived excesses of certain developments, the UK has been a driving force behind others. Second, post-crisis financial regulation often stems from commitments at an international level, which the UK would wish to honour irrespective of whether this be via EU legislation or directly. Third, some EU legislation permits a firm located outside the EU to access the EU only if it is in a country that has been deemed to have an "equivalent" regulatory regime to that in the EU. Therefore, if the UK wants to allow its financial sector firms to access the EU market, the UK may in any event need to agree to apply much EU regulation.

So, does all that mean FinTechs could actually be better off post-Brexit? Given the protracted process applicable to any member state seeking to leave the EU, the first point to note is that nothing substantive will change in the short term. However, while the exit deal is being negotiated, there is likely to be business and investor uncertainty because the legal implications of a UK departure from the EU would depend on which of the number of potential "out" models was to be ultimately agreed.

Arguably, FinTechs currently benefit less from the UK's membership of the EU as compared to financial sector firms more generally, and so the implications of a vote to leave will be less onerous. However, in the run up to the UK referendum, it seems prudent for FinTechs currently operating in the UK or thinking of starting up to consider the impact of a Brexit on their businesses, even though this may be difficult to assess without knowing what a post-Brexit landscape will, in fact, look like.