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18 October 2019

Department of the Senate
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Parliament House
Canberra ACT 2600
Email: fintech.sen@aph.gov.au

Dear Select Committee on Financial Technology and Regulatory Technology ("**Select Committee**"),

Re: Financial Technology and Regulatory Technology

Pepperstone Group Limited ("**Pepperstone**") welcomes the opportunity to make a submission to the Committee on Financial Technology ("**FinTech**") and Regulatory Technology ("**RegTech**").

Pepperstone is a global CFD and margin foreign exchange ("**FX**") contract issuer that was established in 2010 in Melbourne, Australia. We are an online financial services business that has over 68,000 clients and supports an annual client trading turnover of \$3.7 trillion. We currently have over 120 employees in Australia as well as offices in the United Kingdom ("**UK**"), Dubai and Cyprus.

Pepperstone is licensed and regulated by the Australian Securities and Investment Commission ("**ASIC**"). The group also holds a UK Financial Conduct Authority ("**FCA**") authorisation and has recently been granted in-principle approval for a Category 4 licence by the Dubai Financial Services Authority ("**DFSA**"), via its locally incorporated subsidiaries in the UK and Dubai International Financial Centre, respectively.

Pepperstone is proud of its success as a FinTech firm operating in Australia. We support many other FinTech and RegTech firms as part of that success. Pepperstone is a digital native business that uses cutting edge cloud technologies and leverages the latest in Machine Learning ("**ML**") and Artificial Intelligence ("**AI**") to support its core business. Through the application of advanced AI technology, Pepperstone has enhanced its RegTech capability in processing client applications using AI image recognition analysis to identify manipulated and fraudulent images, introduced transaction monitoring for purposes of Anti-Money Laundering ("**AML**"), implemented risk management of real-time trades and improved the efficiency of client on-boarding and sales experience.

Our clients are also keen technology users. For example, trades from Expert Advisor systems at any time make up 20 – 50% of our trading volume. Our clients also utilise a number of other risk management, technical analysis and trade tracking software products as part of their day-to-day trading strategies.

As an established FinTech firm operating in Australia, which has also experienced regulatory oversight in many other jurisdictions, we believe we can provide a unique insight into the opportunities and hurdles associated with FinTech and RegTech.

We fully support the committee's terms of reference to look at ways of supporting FinTech businesses in Australia. We believe these businesses are becoming increasingly important contributors to the Australian market because:

- FinTech businesses are often first adopters and the biggest users of other FinTech and RegTech businesses;
- the demand for FinTech products is increasing and Australian consumers will continue to access the benefits of FinTech offerings regardless of where those offerings are based;
- having Australian firms offer FinTech products and services provides far more transparency and better protection for Australian consumers; and
- FinTech helps to make aspects of products and services more efficient and cost effective, which promotes competition.

We believe that the main considerations for FinTech firms looking to be established in Australia are:

- a broad, flexible, strong regulatory system;
- government and regulators that are transparent and supportive;
- continuing dialogue between government, regulators and FinTech providers both as they establish but also as they evolve into larger businesses, in view of the fact that many of the individuals involved may not be as familiar with even some of the basic regulatory requirements that have been engrained into more traditional businesses;
- a global licensing/recognition regime – this does not necessarily need to be equivalent regulation but a formal, regulator-controlled document or portal that allows for investors to look at the regulation and protections available in each jurisdiction, enabling them to make educated decisions based on what is important to them; and
- ongoing education to assist the general public to engage appropriately with genuine FinTech offerings.

We believe that one of the main hurdles for FinTech firms looking to establish in Australia is the difficulty in reconciling traditional regulatory frameworks and business models with a rapid and constantly evolving sector.

Many in the financial services industry, and our industry in particular, have also suffered recently from rapidly increasing regulatory costs, a movement towards more prescriptive requirements which can limit core offerings, and an increase in regulatory uncertainty. It is now at the stage where we may no longer be able to commercially compete with similar offerings provided by entities outside of Australia's regulatory remit.

These points are discussed in more detail below.

What makes a successful FinTech business?

In order to discuss the opportunity for consumers when it comes to FinTech and RegTech and barriers to providers of FinTech and RegTech services, it is useful to consider how and why Fintech firms are finding success.

FinTech firms are often labelled as disruptors of traditional business but we believe this is not the best way to view them.

Most successful FinTech opportunities arise from taking one aspect of a typical and traditional service or product offering and combining innovation in technology with a new business strategy to strip out the inefficiencies and costs. The result is the delivery of a more affordable, accessible offering for consumers and businesses.

FinTech firms will often operate in a nebulous way. They are willing to pivot (constantly change strategies), even in material ways, until they arrive at the perfect combination of factors that gives them the best competitive edge.

It is the combination of innovations in technology as well as business strategy, and the rapid adoption of new strategies, which magnifies the differences between FinTech and traditional offerings and is often the reason why FinTech can seem so disruptive.

It is also why regulators often struggle to adequately supervise and monitor FinTech using their traditional regulatory frameworks. This is because:

- regulators tend to focus efforts on new technology **or** on new business strategies, without considering the combination of both and how they intersect, leading to potential unintended consequences when they impact one aspect without considering the other;
- it can be difficult for regulators to keep up with the extreme pace at which FinTech firms are introducing new products/strategies; and
- the rapid pace of FinTech innovation means that at times regulators lack the technical understanding of new offerings to recognise them as genuine alternatives more traditional offerings.

In our view, FinTech firms will still seek out opportunities (whether in Australia or elsewhere) and Australian consumers will still seek out their products and services, regardless of whether the Australian Government and regulatory environment empowers and supports them.

Aside from the obvious economic benefits, keeping and encouraging the operation of FinTech businesses in Australia will enable better oversight and consumer protection.

What drives FinTech success?

We believe it is important to address two fundamental drivers of success for FinTech providers to encourage and support their businesses in Australia:

1. flexibility; and
2. cost.

Flexibility

It is the ability of FinTech firms to be flexible and leverage technology in a unique way, adjusting in short time frames where required, that gives them the competitive edge.

Flexibility used to be equated with factors such as hardware, skills and communication speeds. The commoditisation of technology and the availability of inexpensive tech solutions, along with greater access to development skills and tools means small start-ups and even individuals have the ability to operate competitively in an environment that was previously dominated by large, well-capitalised entities.

One of the main impactors on flexibility in the current environment is increasing regulatory requirements and restrictions, which can severely limit the type of products that can be offered and the ability for FinTech firms to pivot into alternate strategies in cost-effective ways.

Australia has a good reputation as a safe regulatory environment and its principles-based regulations offer some significant advantages when it comes to the efficient, flexible operation of FinTech providers. This is because Australian regulations are broad enough to capture anything novel, without being overly restrictive or burdensome on smaller start-ups because the sophistication of the required controls are based on the nature, scale and complexity of each business.

FinTech businesses will not always fit neatly into existing regulation and norms, meaning they may be able to bypass certain obligations if they choose or operate in a way that appears completely different from established models of regulatory compliance. The challenge for regulators is how to keep up with and effectively oversee an industry that is constantly breaking new ground.

When confronted by something operating in an unexpected way, there can be a temptation for a regulator to make their rules more prescriptive to better define a Fintech's business or bring it more into line with their current understanding of traditional products or services. We are seeing evidence of this in Australia.

In our view, a prescriptive approach to regulating rapidly evolving industries will negatively impact legitimate FinTech firms by restricting their operational capabilities. For this reason, it is very important for Australian regulators to maintain their principles-based approach to enable FinTech businesses to retain the flexibility that allows them to be competitive.

We are not suggesting the removal of all regulatory requirements. This in itself can encourage misconduct, which can impact consumers and lead to mistrust of innovation - there is a balance that needs to be reached.

Despite reputations for disruption, in our experience many FinTech firms are willing to work with regulators to raise industry standards if it means providing a better, safer service to consumers.

Firms recognise that a strong regulatory framework is critical to reducing misconduct and an appropriately broad, principles-based approach taken by regulators to new and emerging product and service offerings will increase consumer trust and confidence in innovation whilst ensuring appropriate protections. An ongoing and constructive dialogue between industry and regulators is necessary to achieve appropriate oversight whilst continuing to support FinTech firms to operate with the flexibility they need to be successful.

Recommendations

- maintain a broad, principles-based approach to regulation, particularly when it comes to FinTech; and
- work closely with industry to improve transparency and investor protection in ways that are not overly burdensome to FinTech firms.

Cost

A primary driver for FinTech firms is to reduce as much of the cost of a traditional product or service as they can. The cost of operating in one jurisdiction versus another therefore becomes a key factor in a decision about where to base a FinTech business that can operate from anywhere.

Regulatory costs are a material consideration for FinTech firms operating in Australia. Since the Royal Commission Royal Commission into Misconduct in the Banking, Superannuation and Financial

Services Industry (“**Royal Commission**”) financial services firms in multiple sectors have experienced a significant increase in regulatory information requests and enhanced reporting requirements, resulting in substantive logistical and financial burdens that are prohibitive and even crippling for smaller providers.¹

We fully support the efforts of Australian regulators to seek out and act on the misconduct at the heart of the Royal Commission and in other sectors, and we acknowledge that a robust approach is at times necessary to achieve this. However, to continue to foster and grow Australian FinTech businesses, consideration must be given to the costs of compliance for legitimate firms that have built their business models around low-cost solutions.

Recommendations

- Regulators should adopt a proportionate approach to compliance obligations to avoid overly burdensome costs on entities within their regulatory remit.

Regulatory uncertainty is currently a key hurdle in Australia

The recent introduction of the product intervention power in Australia and ASIC’s use of that power is likely to have a material impact on Australia being a jurisdiction of choice for innovative products.

When the power was first being considered by the Financial Systems Inquiry (“**FSI**”), there were a number of concerns raised that misuse of the power could lead to *“uncertainty, constrain innovation, detract from consumer accountability and introduce costs that may be borne by consumers.”*²

There was also concern that the power *“should not significantly affect innovation”,* that it should not *“prescribe terminology or restrict product features, due to the potential constraints on product innovation”*.³

The FSI felt these concerns could be addressed in the design and implementation of the power. Specifically:

- *“If the power is used effectively, it should not significantly affect innovation. The power is expected to be used infrequently and as a last resort or pre-emptive measure. In addition, this power is not intended to be used for pre-approval of products as this is likely to result in moral hazard: the perception that no regulator intervention implies a low-risk product.*
- *This power is not intended to alleviate consumers from bearing responsibility for their financial decisions. This would be made clear when the power is implemented.*
- *Firms with robust product design and distribution practices should not face additional regulatory costs as the focus would be on products being distributed to consumers who do not understand the central features of the products, such as risk. ASIC engagement with potentially affected firms would allow these firms to change their practices before any use of the power, thereby limiting public reputational damage.*

¹ See ASIC CP 311 *Internal dispute resolution: Update to RG 165* at <https://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-311-internal-dispute-resolution-update-to-rg-165/>

² See Financial System Inquiry Final Report Recommendation 22 *Introduce product intervention power* http://fsi.gov.au/publications/final-report/chapter-4/product-intervention/#P167_38865.

³ *Ibid.*

- *The regulator would be accountable for the use of its power, and it would be subject to post-implementation review. ASIC would be expected to engage with potentially affected firms and to consult with Council of Financial Regulators colleagues before any use of the power, including consulting with APRA where prudentially regulated firms may be affected.*⁴

There is some evidence that ASIC's recent actions since receiving the product intervention power appear to be contrary to these requirements in that:

- the power was granted in April 2019 and ASIC has already undertaken three product intervention consultations prior to the release of its general guidance on how it intends to use the product intervention power;⁵
- ASIC has used the power to recommend eight major aspects of law reform on our industry (CFD and margin FX issuers), which has been operating in the same way for 17 years in Australia. ASIC is proposing to implement these reforms in extremely tight implementation time frames, and in a way is severely impacts the products we can offer in Australia;⁶
- there is little evidence that ASIC sought to consult with industry on its concerns ahead of its decision to use the product intervention power, despite the willingness of established industry participants to engage in discussions; and
- ASIC appears to be using the product intervention power before considering the design and distribution obligations, which were implemented at the same time the product intervention power became available.⁷

ASIC has publicly stated that it is likely to consider using product intervention more frequently rather than allowing current regulatory requirements to stand. For example, in a recent ASIC statement about the limits of disclosure (which is currently a core aspect of the Australian regulatory regime) it stated:

“Going forward ASIC is taking a more consumer outcome-focused approach, making the most of our enhanced regulatory tool kit. This includes the use of our new product intervention powers (PIP) when warranted”

No financial services firm, particularly a FinTech firm, can operate in a regulatory environment that may change materially in unexpected ways. This is especially harmful when the regulatory intervention impacts the core features of the products that can be offered to investors.

Recommendations

- regulators must take care to ensure that regulatory intervention does not impact innovation or unnecessarily restrict the products that can be offered in Australia without good reason;
- product intervention measures should be taken as a 'last resort' and only used in the most serious of cases once all other avenues of enforcement have been exhausted; and
- the Government and regulators should actively work towards establishing regulatory certainty, which will allow firms to innovate in an environment where they

⁴ Ibid.

⁵ See ASIC CP 316 *Using the product intervention power: Short term credit*, ASIC CP 322 *Product intervention: OTC binary options and CFDs* and ASIC CP 324 *Product intervention: The sale of add-on financial products through caryard intermediaries*.

⁶ See ASIC CP 322 *Product intervention: OTC binary options and CFDs*.

⁷ See *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019*.

- know the established boundaries and have comfort that those will not change unexpectedly.

When simple technology unknowingly crosses the line

Another important consideration regarding FinTech businesses is that often the low-cost environment they try to operate under means they only seek a limited amount of independent and professional advice prior to evolving their systems.

Add to this the fact that many of the individuals involved have no past experience with traditional businesses and regulation and it can mean that many are not aware when their evolving innovation goes from being unregulated to regulated. It can also mean that they are not familiar with the simplest of regulatory requirements.

The recent compliance issues with AfterPay Pty Ltd (“**AfterPay**”) appears to be an example of this risk being crystallised.⁸

This can also impact overseas FinTech firms expanding to Australia, that do not have an adequate understanding of how Australia requirements impact their business differently to their local regulations.

While global regulatory consistency can assist with this, there will always be minor discrepancies between the regulatory regimes.

Australia’s principles-based regulatory environment lends itself to enabling FinTech businesses to adjust to and comply with regulatory requirements more quickly and effectively than in a more rules-based, prescriptive regulatory regime. We believe that regulators should build on this by creating even greater transparency regarding local obligations that will apply to new types of products and services, simplifying key requirements as much as possible, and engaging with new entrants in a proactive way so that they are aware of how regulations will impact them in future should their businesses change.

Recommendations

- create a series of simple or easy to understand, well-marketed, key guides for new types of products so FinTech firms will know where they stand under Australian obligations from establishment; and
- increased collaboration with FinTech firms to encourage stronger regulatory awareness and compliance (while also enabling regulators to obtain invaluable industry intelligence).

Global regulatory recognition will greatly assist

The mass commoditisation of global products and services has brought about a desire for global regulatory alignment to provide consistency for FinTech firms wanting to operate in multiple jurisdictions and to avoid regulatory arbitrage.

Regulatory equivalence is extremely difficult to implement in practice given the differences between various legislative regimes and when FinTech businesses, technologies and strategies are evolving and changing so quickly. Attempting to achieve equivalence in all innovative products is likely to lead to over-regulation limiting innovation.

Instead, we believe that jurisdictions and regulators should consider approving a single, certified source of truth, whether via a formal document or online portal, that offers simplified, clear disclosure

⁸ AUSTRAC orders audit of Afterpay’s compliance with financial crime legislation - <https://www.austrac.gov.au/austrac-orders-audit-afterpays-compliance-financial-crime-legislation>.

which clarifies the different regulatory restrictions and obligations that apply to various FinTech products being offered in their country. This global comparison can then be provided to investors so that they can make educated choices about which jurisdiction they want to obtain their financial service from.

Under this model, regulators may still choose to implement regulatory requirements that are comparable with other regimes but they will retain the flexibility to adjust their approaches to suit their unique commercial and regulatory environments.

From an Australian perspective, this would allow Australian consumers to make informed decisions about the different regulatory protections available to them when choosing their products and services. It will also enable Australian regulators to continue to evolve and adapt with the rapidly changing FinTech sectors that they oversee, without the burden of rigid, prescriptive and potentially inapplicable international constraints.

It can also reduce the time and cost spent by FinTech firms and regulators of implementing and adjusting to constant regulatory reform, enabling the firms to devote time and resources on growing businesses and regulators to improving oversight.

Recommendations

- the Government and regulators should increase their focus on offering consumers and businesses global regulatory clarity (as distinct from equivalence).

Impact on traditional businesses

FinTech businesses have already made significant inroads in disrupting large, established financial services companies in Australia, as evidenced by the disruption of traditional banking offerings by cryptocurrencies, neobanks and buy-now-pay later services such as Afterpay.

Traditionally brand and reputation were the main consideration for consumers but behavioural economics analysis is informing us that brand is no longer important for younger generations, even when it comes to higher risk products.⁹

While FinTech has and will continue to impact the bottom line of traditional businesses, we have already seen a number of techniques used by those impacted businesses to adapt and evolve, including:

- focusing on the fact that they can offer a wider range of products and services (as distinct from FinTech, which derives its competitive advantage from focussing on one key aspect);
- promoting face-to-face/human interactions;
- emphasising reputation, reliability and longevity; and
- setting up sub-brands or expanding current offerings to match FinTech offerings.

This shows that it is possible for traditional businesses and FinTech firms to coexist and thrive in Australia, provided the right environment and support is created for both sectors.

Australians will continue to seek out and acquire FinTech offerings, regardless of where they originate from. By creating a supportive, flexible environment to encourage FinTech offerings to establish and stay in Australia, while enabling traditional business models to adapt, the Australian Government and regulators will ensure a positive impact on the Australian economy whilst enabling better regulatory oversight and consumer protection.

⁹ ASIC Report 427 *Investing in hybrid securities: Explanations based on behavioural economics* page 6, March 2015.

Recommendations

- Government and regulators should engage proactively with traditional businesses about how they can evolve and provide support to enable them to deal with impacts arising out of FinTech disruption; and
- Government should continue to support a strategy of embracing FinTech, in recognition of the demand for these offerings.

In Conclusion

Pepperstone is proud of its success as a FinTech firm operating in Australia and we fully support the Government's intentions in this Select Committee. We believe that Australia provides a unique opportunity for FinTech businesses to grow and thrive, provided that they are afforded the appropriate levels of support and flexibility to operate within the local regulatory environment.

We are concerned that after the Royal Commission and with the introduction of the product intervention power, Australia is starting to move away from its key advantage which is a principles-based regulatory environment that is flexible, stable and supporting of innovation. We are also concerned that regulators are taking a more adversarial and ideological approach to industry participants, rather than encouraging an environment of collaboration which we believe benefits industry, regulators and consumers.

We hope this submission has provided some assistance to the Select Committee. We are happy to provide additional information if required.

Yours Sincerely,

Tamas Szabo
Group CEO
Pepperstone