

Finance Watch response to the public consultation on FinTech: a more competitive and innovative European financial sector

Brussels, 15 June 2017

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Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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We agree to the publication of this response.

Finance Watch welcomes this consultation and strongly supports the principles of technology neutrality - i.e. similar activities and risks are to be subject to similar regulations - and integrity-enhancement - i.e. improving market transparency without creating unwarranted risks.

1.1. What type of FinTech applications do you use, how often and why? In which area of financial services would you like to see more FinTech solutions and why?

Based on our current information it appears that most FinTechs are operating as payment service providers or P2P lending platforms. Consumer banking and (robo-advisory) investment management services are gaining in popularity, too.

With regard to banking and P2P-lending, in particular, most surveys of P2P borrowers reveal that the convenience of using a web-based platform is the highest ranked benefit. For P2P-lending, perceived advantages include lower transaction costs and shorter processing times for the loan application process. Other benefits include 24/7 accessibility and a simple and user-friendly application process, and greater flexibility: unlike banks, many P2P platforms allow borrowers to cancel loan contracts prematurely without paying a prepayment penalty.

Finance Watch would generally welcome innovative FinTech solutions that concentrate on providing incremental value and better useability for consumers. These should include, in particular:

- Platforms for consumers to interact online with providers of financial services in a way that provides a maximum of security, transparency and granular protection of personal data. Among the principal issues that will need to be tackled, for Fintechs and in the broader context of web-based consumer services, is the need to restore to consumers control of their personal data. This will be ever more imperative as providers of web-based consumer services are seeking to leverage their repositories of consumer data and profiles across a wide range of offerings, including financial services.
- In the sector of sustainable finance, FinTech could mobilize domestic savings at scale to enable long-term investment directed at long-term sustainability of the real economy through investment in sustainable development innovations and in resilient and sustainable infrastructures.
- More FinTech or financial platform solutions could be offered by traditional bank institutions itself. Present-day online banking solutions are hampered frequently by a need to be backward-compatible with banks's legacy systems and databases, which are often outdated and not designed for useability. In this regard, the challenge is for incumbents to become more agile and responsive. Banks have all the prerequisites for setting up P2P lending platforms: large customer bases, expertise in the assessment of credit risk, technical knowledge and experience in the area of online banking, and methods of processing payment transactions. Local banks like savings and cooperative banks could easily offer own community crowdfunding solutions. There is no need to leave the field to non-bank service providers.

Question 1.2: Is there evidence that automated financial advice reaches more consumers, firms, investors in the different areas of financial services (investment services, insurance, etc.)? If there is evidence that automated financial advice reaches more consumers, firms, investors in the different areas of financial services, at what pace does this happen? And are these services better adapted to user needs? Please explain.

Early observations seem to indicate that automated financial advice could be particularly useful to reach new segments of the population who have either not had access to professional financial advice in the past or who have been reluctant to engage out of a perceived lack of knowledge or apathy. From this point of view, automated financial advice could be effective in promoting financial inclusion and improving financial literacy. It is important, however, to maintain appropriate safeguards against potential side effects, both for consumer protection and financial stability, e.g. the risks of mis-selling and herding.

1.3. Is enhanced oversight of the use of artificial intelligence (and its underpinning algorithmic infrastructure) required? For instance, should a system of initial and ongoing review of the technological architecture, including transparency and reliability of the algorithms, be put in place? What could be effective alternatives to such a system?

Enhanced oversight of the use of artificial intelligence is indeed required, including transparency of the algorithms, in order for supervisors to be able to detect early on risks of pro-cyclical behaviour, herding and bubbles in the making. Given the potential impact on consumer protection and financial stability it is essential in our view that supervisory authorities are in a position to monitor and regulate the use and impact of algorithms, instead of letting them remain “black boxes”.

As a guiding principle, providers of web-based services must be responsible for their algorithm-based commercial decisions to stand up to the same legal standards as their traditional competitors. An open and transparent approach is necessary: if the algorithms themselves are largely impenetrable to supervisory scrutiny and, arguably, protected by commercial secrecy, providers will still have to accept responsibility for the outcomes, which must be lawful and equitable.

One possible approach would be to create standardised testing frameworks for the approval and periodical re-certification of relevant algorithms. Algorithms used in AI infrastructures could be tested, for instance, using standardised data samples, to ensure compliance with relevant legal provisions and detect issue, e.g. breaches of personal data protection or evidence of bias and discriminatory practices.

1.4. What minimum characteristics and amount of information about the service user and the product portfolio (if any) should be included in algorithms used by the service providers (e.g. as regards risk profile)?

Given the risk of discrimination of clients by using software and algorithms tools for the assessment of credit risks to use of data input should be strictly limited to the legitimacy of the purpose for which the data is processed and the adequacy and relevance of the data used for that purpose. It is essential that customers are

given visibility of the personal data that is being used, and processed, by the algorithm and have the possibility to object against certain data, or data sources, being included.

Regulators must be aware of growing concerns about stereotyping. Recent scientific findings have confirmed the very real risk of algorithms developing built-in discriminatory biases. It is incumbent upon the legislator to introduce mechanisms and processes that monitor and test algorithms for evidence of such biases. Where such biases are revealed there has to be a thorough regulatory review of their compatibility with law and fundamental rights.

1.5. What consumer protection challenges/risks have you identified with regard to artificial intelligence and big data analytics (e.g. robo-advice)? What measures, do you think, should be taken to address these risks/challenges?

As in other areas of web-based consumer services, there is a risk that the rights of users to privacy and the adequate protection of identifiable personal data are severely eroded. Recent efforts by the European Commission to expand the protection of citizens' privacy to electronic communications providers and to impose data protection by design and by default should be extended, in a forward-looking way, to the area of financial services.

As we start to appreciate how big data analytics and artificial intelligence can be used to effectively influence behaviour, we must ensure that it does not lead to consumer manipulation and that clear and effective guidelines are drawn. Likewise, we know that social media distribution channels offer instant emotional gratification¹. There is therefore a case for special monitoring and ensuring that these channels do not lead to unsuitable impulse purchases.

As traditional financial advisors generally have a limited understanding of the risks in the most complex products that they sell, robo advice could increase the quality of advice and the understanding of the products. Past experience shows however that there is a big difference between understanding how a product works and being able to assess the probability of risks, and consequently that disclosure of factual information has a limited impact on customers' understanding of the risks they take.

In respect of the above, we would therefore suggest that existing safeguards, such as mandatory "cooling off" periods and cancellation rights, are applied and reinforced, where necessary, to forestall the incidental or deliberate use of behavioural biases to the detriment of the customer.

Finally, the inherent cross-border nature of online services and the absence of any direct interaction between the customer and the provider increases the risk of exposing customers to unsuitable, if not fraudulent offerings and/or financially unsound providers. It is important, therefore, that FinTech market participants comply with prudential standards on a par with traditional providers and that customers are

¹ <https://www.ama.org/publications/MarketingNews/Pages/feeding-the-addiction.aspx>
<http://www.medicaldaily.com/facebook-addiction-activates-same-brain-areas-drugs-how-social-media-sites-hook-you-320252>
<https://www.psychologytoday.com/blog/brain-wise/201209/why-were-all-addicted-texts-twitter-and-google>

able, in a simple and reliable way, to verify the identity and status of a provider. Prudential supervision of online providers should be organised at the European level.

1.6. Are national regulatory regimes for crowdfunding in Europe impacting on the development of crowdfunding? In what way? What are the critical components of those regimes?

At present the market for crowdfunding is highly fragmented, not least due to differences in national regulation. Regulation of crowdfunding in Europe remains the task of national legislators and supervisory authorities as there is no bespoke, single European regulatory framework for crowdfunding, crowdinvesting and peer-to-peer lending. National regulators' approaches towards crowdfunding often differ from state to state with regard to retail investors protection, existing platform resolution schemes, platform licensing and monitoring by national regulators. These differences create significant obstacles and discourage cross-border activity of platform operators and their users.

Legal barriers are in particular disadvantageous for the development of the European crowdfunding industry as web-based business platforms need large markets and a high number of users to become economically successful. But it is also relevant for national borrowers who are limited in many cases to a narrow choice of local incumbent banks.

1.7. How can the Commission support further development of FinTech solutions in the field of non-bank financing, i.e. peer-to-peer/marketplace lending, crowdfunding, invoice and supply chain finance?

The EU's initiatives so far are limited to the collection of data and information via workshops, setting-up a stakeholder group, and providing financing for studies and surveys. Furthermore, the EU Commission refers to the existing EU Directives on consumer protection, which can be applied to the protection of financial platform users and are mostly implemented in the national laws of EU member states. Hence, the regulation of crowdfunding in Europe remains the task of national legislators and national financial authorities. This national segmentation means that there is, effectively, no unified European financial market for non-banking financial services including crowdfunding.

We understand that the European Commission does not see a need so far for harmonising EU legislation on crowdfunding because overall volumes are still small compared to other financial sectors and cross-border activities are very limited.² It is, however, questionable whether this argumentation takes proper account of cause and effect. Harmonised pan-European regulation would give financial service platforms and their users the necessary legal confidence and certainty to expand their activities freely within EU borders without national legal barriers. EU-wide regulation would open market opportunities and promote the development of non-banking financial businesses.

² The EU Commission wrote in March 2016: "Given the predominantly local nature of crowdfunding, there is no strong case for EU level policy intervention at this juncture." European Commission, "Crowdfunding in the EU Capital market Union", Commission Staff Working Document, SWD(2016) 154 final, page 31.

1.8. What minimum level of transparency should be imposed on fund-raisers and platforms? Are self-regulatory initiatives (as promoted by some industry associations and individual platforms) sufficient?

At present there are no uniform, legally defined disclosure standards for crowd lending to ensure that lenders have a clear and accurate understanding of the risks associated with using a specific P2P platform. Of course, lenders are warned that P2P-investments could lead to a total loss of the invested amount, in accordance with EU consumer protection law. However, this information on its own does not enable users to conduct adequate risk-return analysis and platforms rarely provide users with professional, quantitative risk analysis tools that would assist them in conducting a thorough assessment.

There is also a shortage of standardised, regulated information that would allow users to compare the performance statistics of competing P2P lending platforms. Platforms usually publish investment statistics including gross interest rates, bad debt rates, default rates etc. on their web pages and clients normally receive monthly performance statistics for their individual portfolio. But methods, e.g. for calculating risk-adjusted net returns, differ considerably from platform to platform because national laws and regulators have yet to define a common standard for measuring the performance of P2P-loan investments. Furthermore, there are no disclosure standards for information about borrowers or the platforms' own credit assessment methods. This makes it impossible for investors to assess and compare the quality of platforms and so make a careful selection of the "right" platform.

Some aspects of the above risks are covered, at least in part, by existing EU law, e.g. the cooling-off period and the right to receive minimum pre-contractual information. There is, however, still a lack of a specific, standardised disclosure regime for the promotion of P2P investments with retail investors, which should integrate as well the findings of behavioural economics and take inspiration from the legislative work carried out on Key Information Documents for UCITS and PRIIPs.

National associations of P2P-platforms, which represent most platforms, are currently working to establish trust by committing members to sign a code of conduct of operating rules. These codes of conduct could be either very detailed, even including disclosure standards for member platforms, or formulated quite vaguely, depending on the national association. However, experience in other industry sectors reveals that such industry associations often lack both the appropriate tools and the intrinsic motivation to enforce compliance with a given code of conduct. Experience with self-regulation in the financial sector has proven, time and again, that self-imposed codes of conduct are not a substitute for a single European framework setting mandatory legal standards.

1.9. Can you give examples of how sensor data analytics and other technologies are changing the provision of insurance and other financial services? What are the challenges to the widespread use of new technologies in insurance services?

Finance Watch is very sceptical of the use of biometric data for the purpose of customer profiling. With individual pricing insurances are losing its social function of being a solidarity pool with risk sharing mechanisms so that the costs of high-risk customers are shared amongst all insurers in that market.

The individual risk pricing will lead to a different distribution of insurance premia: the distribution curve is likely to “flatten out”. Overall, there will be fewer insurance customers treated as “average” risk and paying average premia. Customers who are identified as higher risk could ultimately face **unaffordable** levels of premia and end up becoming effectively uninsurable.

There is ample statistical proof that poverty and poor health are going hand in hand. Therefore, it is quite clear that such an individual pricing of insurance premia leads at the end to a discrimination of low income groups within the society. Unaffordability or unavailability of insurance may marginalise high risk individuals and exclude them from participating in social and recreational activities.

1.10. Are there already examples of price discrimination of users through the use of big data? Can you please provide examples of what are the criteria used to discriminate on price (e.g. sensor analytics, requests for information, etc.)?

Example 1: Health insurance

The use of wearable devices like smart watches, is increasing in popularity. More and more insurers become involved by collecting personal data of individuals and tracking a number of policyholder behaviours including the number of steps taken, the number of minutes of activity throughout the day, resting heart rate and number of hours and quality of sleep. Insurance started already to reward their customers for healthy living style by rewards through third party partners (e.g. cash back on groceries, discounts on flights, vouchers) and reduced premiums in some circumstances. It would appear a logical next step for insurers to pre-select customers based on their individual risk profiles and to avoid higher-risk customers as clients.

Example 2: Car insurance

Car insurance is being transformed by the use of telematics devices that measure various aspects of how, when and where a car is driven. They collect data such as time of day, vehicle speed and braking tendencies of the driver. Some devices also use GPS technology to assess vehicle location, whether the driver takes breaks on long journeys, total mileage and number of journeys. These devices open the potential for insurers to offer usage-based insurance (‘UBI’) products, as well as to determine an insurance premium that more accurately reflects an individual’s risk (or risk for a vehicle).

Question 1.11: Can you please provide further examples of other technological applications that improve access to existing specific financial services or offer new services and of the related challenges? Are there combinations of existing and new technologies that you consider particularly innovative?

Distributed Ledger (“blockchain”) technology could be a potentially very promising approach to providing a high degree of transparency to financial –sector users, both in terms of authenticating and tracking transaction data and to identify and authenticate users and financial instruments. The effectiveness of this technology is reliant, however, on the availability of a suitable, permissioned network of trusted nodes and safe and transparent protocols. The potential of this technology should be analysed, both in the context of FinTech and beyond.

Question 2.2: What measures (if any) should be taken at EU level to facilitate the development and implementation of the most promising use cases? How can the EU play its role in developing the infrastructure underpinning FinTech innovation for the public good in Europe, be it through cloud computing infrastructure, distributed ledger technology, social media, mobile or security technology?

The EU has long had an excellent track record in fostering large-scale innovation and setting global standards, e.g. for mobile communications. This advantage appears to have been lost of late: data communications and web-based services are dominated frequently by non-European providers. Many of these digital markets are inherently oligopolistic and European players are increasingly at risk of becoming marginalised or being acquired by larger overseas competitors. As Big Data and AI applications become increasingly widespread and mission-critical, holding ever larger amounts of personal data of EU citizens, it becomes imperative for data processing infrastructure (cloud services) to be located in EU jurisdiction and under the unequivocal rule of EU law. A similar approach should be applied, in our view, to trusted networks hosting distributed ledgers.

2.4. What are the most promising use cases of technologies for compliance purposes (RegTech)? What are the challenges and what (if any) are the measures that could be taken at EU level to facilitate their development and implementation?

It is understandable that financial institutions intend to reduce costs of compliance with financial regulation by using intelligent software programs to automate and to standardize the interface to the regulatory authority. However, regulators should be aware that the increasing use of RegTech also has its disadvantages and it is therefore questionable if regulators and the EU commission should take measures to facilitate their development.

RegTech increases complexity: RegTech adds another intermediate layer of technology to already highly complex financial regulation and will increase its complexity further. Instead of reducing the complexity of financial regulation self-learning software should now be tasked with managing the complexity. This contradicts the EU commission's initiative of "better regulation".

RegTech ignores behavioural and cultural aspects within the organisation: software solutions can be helpful in data collection, analysis and reporting. However, analysis and monitoring of data only covers one aspect of ensuring compliance. Ethical and responsible behaviour is at least as critical for compliance and cannot be replicated solely by an exchange of datasets. .

Regulators also have a key role in reinforcing the importance of individual morality and responsibility in decision making. They need to consider whether compliance decisions by firms and employees are taken in a context that promotes moral reasoning rather than as part of, for example, 'tick box compliance', which risks reducing the salience of ethics in firms' decision making.³

³ See FCA, Behaviour and Compliance in Organisations, Occasional Paper 24, Dec. 2016.

Question 2.7: Which DLT applications are likely to offer practical and readily applicable opportunities to enhance access to finance for enterprises, notably SMEs?

We see particular potential for the use of DLT in the issuance and transfer (trading on-/off-exchange, settlement, registration) of securities. Due to the enhanced transparency and authentication features of DLT, low-frequency and/or low-volume transactions could be executed and settled without the need for expensive proprietary infrastructure and systems. This could lower the hitherto often prohibitive cost of issuing and trading financial instruments for SMEs. It could also significantly enhance the liquidity of SME securities, improve transparency and may even encourage new models of participation and governance.

In additions to the trading of equity and debt securities smart contracts, based on DLT technology, could also automate other simple, highly standardised financial transactions, such as trade finance instruments or export guarantees.

Question 2.8: What are the main challenges for the implementation of DLT solutions (e.g. technological challenges, data standardisation and interoperability of DLT systems)?

The viability of a DLT solution depends critically on the integrity of the underlying trusted network. A balance must be found between the objective of providing broad access and maximum transparency and the need to protect the integrity of the data and the network itself. Permissioning of nodes and the continuous monitoring of the integrity of the ledger are likely to be major challenges.

Formats and protocols should be standardised for certain types of ledgers, at a minimum at the European level but ideally on a global basis, to ensure interoperability. Another known challenge, that could affect commercial applications, in particular, is the still uncertain performance of DLT in terms of processing/speed scalability.

Question 3.1: Which specific pieces of existing EU and/or Member State financial services legislation or supervisory practices (if any), and how (if at all), need to be adapted to facilitate implementation of FinTech solutions?

Finance Watch would caution against any suggestions to diverge from existing financial-sector regulation, in particular prudential standards, in an attempt to promote FinTech solutions. It is, in our view, deeply misguided to assume that deregulation is a panacea to liberate innovation and jump-start growth. It is well known that areas that are particularly successful in producing and promoting technological innovation are characterised, first and foremost, not by permissive regulation but by a combination of excellent infrastructure, world-class education, a highly-skilled workforce, good access to funding, including risk capital, and a large addressable home market with few barriers. Europe scores highly on some of these criteria but has well-known deficiencies in some of the others. Finance Watch is confident that robust public investment in digital infrastructure and digital skills, improved access to venture and early-stage funding and the implementation of the digital single market could be significantly more beneficial for the development of a lively FinTech sector in Europe than experimentation with the regulatory environment.

3.4. Should the EU introduce new licensing categories for FinTech activities with harmonised and proportionate regulatory and supervisory requirements, including passporting of such activities across the EU Single Market? If yes, please specify in which specific areas you think this should happen and what role the ESAs should play in this. For instance, should the ESAs play a role in pan-EU registration and supervision of FinTech firms?

New financial services, such as P2P lending and crowdfunding, need a pan-European regulatory framework. Specific and uniform European regulation is necessary to provide financial service platforms and their users with the necessary legal confidence and certainty to expand their activities freely within EU borders, without national legal barriers. By the same token, consumer protection and prudential standards also need to be guaranteed at the European level.

Question 3.8.2: Would there be merits in pooling expertise in the ESAs? Please elaborate on your reply to whether there would be merits in pooling expertise in the European Supervisory Authorities.

Yes. Sectoral specialisation of ESAs is no longer appropriate. FinTech platforms tend to unbundle existing business models into smaller pieces and reassemble these elements into new business models. Some of the features and risks of these models are known but others could be new and platform-specific. This means that the Fintechs cannot be easily assigned to a specific sector of the financial system: banking, insurances or capital markets. Finance Watch would therefore support the creation of cross-sectoral, pan-European prudential and financial conduct authorities.

Question 3.9: Should the Commission set up or support an "Innovation Academy" gathering industry experts, competent authorities (including data protection and cybersecurity authorities) and consumer organisations to share practices and discuss regulatory and supervisory concerns?

We would welcome the creation of an Innovation Academy to convene stakeholders from the industry, competent authorities (including data protection and cybersecurity authorities) and consumer organisations. Consumer and civil society organisations should be adequately represented in such a forum.

Question 3.13: In which areas could EU or global level standards facilitate the efficiency and interoperability of FinTech solutions? What would be the most effective and competition-friendly approach to develop these standards?

Pan-European interoperability standards and formats for DLT infrastructures, supported by EU public authorities but open to private-sector co-operation, could be an effective way to accelerate the development and possible adoption of this technology.

3.15. How big is the impact of FinTech on the safety and soundness of incumbent firms? What are the efficiencies that FinTech solutions could bring to incumbents? Please explain.

The claim that *the emergence of new entrants and diversification of suppliers in financial services will reduce systemic risks by addressing the "too big to fail" challenges* has some merits but might require caution: it is indeed unclear at this stage whether the future leading players will not become new "too big to fail" institutions themselves. Previous experience in the field of web-based services should serve as a cautionary tale – the digital economy has so far tended to produce “winner takes all” outcomes with distinctly oligopolistic market structures. In any event, we should refrain from thinking that disruptive technologies will address, comprehensively and by themselves, systemic risks and remove the need for macro prudential policies.

4.1. How important is the free flow of data for the development of a Digital Single Market in financial services? Should service users (i.e. consumers and businesses generating the data) be entitled to fair compensation when their data is processed by service providers for commercial purposes that go beyond their direct relationship?

Merging technology with data about consumer preferences and investment performance may or may not promote better asset allocation depending on how it is done and some caution seems warranted here too. Firstly, the asset management industry is subject to fashion trends such as the recent so-called "smart beta" strategies that do not necessarily lead to better outcomes for investors. In addition, the use of consumer preference data may be used to fine tune the framing and sales pitch rather than offer objectively superior products.

The Commission acknowledges that new technologies will become increasingly able to factor in behavioural and cognitive biases. While this may lead to a lowering of investment barriers, this may also lead to customer manipulation. Behavioural and cognitive biases are indeed already significantly used in marketing, and the use of more data points promises to improve the impact of these selling techniques⁴. We must ensure that big data and the algorithms that use it work to benefit the client and not only to become more effective at selling him financial products.

Question 4.5: How can information systems and technology-based solutions improve the risk profiling of SMEs (including start-up and scale-up companies) and other users?

It is worth pointing out that small and early-stage companies are significantly more susceptible to idiosyncratic risk than larger, established organisations. Frequently, the success or failure of SMEs hinges on one, or a few, individuals. It is doubtful, therefore, that Big Data analysis based on aggregating and

⁴ <http://psychologyformarketers.com/use-cognitive-biases-effective-marketing/>
<http://digitalintelligencetoday.com/how-marketers-use-20-cognitive-biases-that-screw-up-your-decisions/>
<http://www.neurosciencemarketing.com/blog/articles/cognitive-biases-cro.htm#>

analysing comparative dataset are likely to provide reliable results. Aggregating confidential data on a company and its members from different sources, possibly without their knowledge, should not be permissible, in our view.

Question 4.6: How can counterparties that hold credit and financial data on SMEs and other users be incentivised to share information with alternative funding providers? What kind of policy action could enable this interaction? What are the risks, if any, for SMEs?

As mentioned in 4.5 above we believe that the aggregation of confidential data on a company and its members from different sources, possibly without their knowledge, for commercial purposes, e.g. credit analysis, should not be permitted. Uncontrolled and unaccountable exchange of confidential information, in particular where it concerns a privately-held company and the individuals involved, could have highly detrimental side effects that are not justified by the potential benefits. It should remain the prerogative of companies or individuals to maintain control over the disclosure of confidential information.