MiFID II Meets the Rise of Robo-advisers

Rules that require investment firms to act in their clients' interests will be broadened to include the use of robo-advisers under proposed guidelines for MiFID II.

European Union regulators have raised a number of concerns about the protection of investors offered robo-advice, and are currently grappling with how and to what extent to regulate the market. Asset managers should anticipate stricter controls over automated advice and be ready to boost operational capabilities to minimise the impacts.

Updated suitability requirements shine spotlight on robo-advisers

In July, the European Securities and Markets Authority (ESMA) published draft guidelines for the suitability requirements under MiFID II which consider the use of robo-advice for the first time. Originally introduced under MiFID I in 2007, the suitability requirements are an instrument to enhance investor protection. They compel firms to assess their clients' knowledge and experience, financial situation and objectives before offering them investment advice and portfolio management services. The updated guidelines reinforce that firms remain responsible for their clients' best interests, regardless of the use of automated tools and other emerging technologies that replace human interaction.

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Risks in the rise of the machines

As the cost of human advice rises, investors and asset managers have started to turn to automated processes. Regulators and the industry view robo-advisers as bringing benefits, including the provision of advice that is more consistent and more up to date than that offered by humans. It can also be recorded more readily while reducing auditing costs. However, the rise of robo-advisory services has also triggered investor protection concerns. Regulators see potential risks in consumers having limited access to information from automated units and a limited ability to process the information given.[1] There are also concerns about technical flaws that might arise due to errors, hacking or manipulation of algorithms, along with the threat of legal disputes due to the unclear allocation of liability.[2]

In highlighting these concerns in the guidelines, ESMA identified three areas of specific need for investor protection related to:

- The information provided to clients when investment advice and portfolio management services are delivered through an automated tool
- The assessment of suitability (with particular attention to the use of online questionnaires with limited or without human interaction);
- The organisational arrangements that firms should implement when providing robo-advice.[3]

KEY INSIGHTS

- New suitability guidelines shine a spotlight on robo-advisers' role in investor protection.
- Firms will need to enhance information systems to assess clients' suitability through automated tools.

On the first aspect, ESMA highlighted that firms providing robo-advice should be aware that the ability of a client to make an informed decision might be based solely on electronic disclosures made via email, websites, mobile applications or other electronic media. The level of human-to-human contact can vary according to account sizes and invested amounts. So firms will need to consider how to explain their automated model and the purpose of their investment advice and portfolio services in a clear and simple way to ensure potential clients understand it.[4] They will also need to provide an explanation of the degree of human interaction available to clients and clarify how clients might gain access to firms' personnel, where possible.

Suitable investors need suitable information systems

The assessment of suitability is one of the most important obligations for investor protection, given it applies to the provision of any type of investment advice and portfolio management. Ensuring automated tools can obtain the necessary information from potential clients will be a key operational challenge for investment firms.[5]

Under the new guidelines, firms will be required to provide clients with a statement on suitability (the so-called 'suitability report') prior to the conclusion of a recommended transaction, and also to more strictly consider their risk tolerance and ability to bear losses. ESMA is concerned that robo-advisers might offer an investment based purely on clients' responses to online questionnaires, which might be too short or not allow for follow-up questions. So investment advisers would be compelled under the guidelines to address inconsistencies in client responses or set up systems to provide clients with assistance to fill out their questionnaires. Firms providing robo-advice will also need to take into account the specifics of their business model when designing and implementing organisational arrangements, and seek to minimise the risk exposure brought by algorithms and the limited human interaction by formulating written policies and procedures.[6]

> Ensuring automated tools can obtain the necessary information from potential clients will be a key operational challenge for investment firms

Firms are likely to face additional costs to meet these requirements, especially those that have not already built information systems that comply with the 2012 guidelines on suitability under MiFID I. The costs will relate to the review or update of the questionnaires and of the algorithms and models used to match clients' profiles with suitable financial instruments.[7] They can also expect additional HR costs linked to informing clients on the qualification of staff serving compliance functions or providing investment services.[8]

ESMA said it will consider responses from industry and other stakeholders to the guidelines in Q4 2017 but does not expect to publish its final draft until as late as Q2 2018. Asset managers should anticipate further changes in the final guidelines and be certain that enhanced systems and controls on investor protections will be required to service clients via automated advice.

> Firms providing robo-advice will also need to take into account the specifics of their business model when designing and implementing organisational arrangements

1. ESMA (July 13, 2017) Guidelines on certain aspects of the MiFID II suitability requirements 2. Ibid. 3. Ibid. 4. Planet Compliance (August 14, 2017) What the ESMA MiFID II Suitability Consultation Means for Robo-Advisors 5. Law 360 (July 13, 2017) ESMA Weighs Tougher MiFID Robo-Advice Client Protections 6. Ibid. ESMA 7. Financial Times (September 29, 2016) Robo-advice must meet MiFID II Suitability Standards 8. Ibid. ESMA

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