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Client Alert
Commentary

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Policing the Robots — Robo-Advice Under MiFID II

Do robots give suitable advice? ESMA proposes updates to suitability guidelines to address robo-advice.

Given the technological evolution of the advice market, firms offering a robo-advice service are faced with a challenge — ensuring that the advice given by a robo-advisor is suitable. ESMA has taken advantage of the more general updates to the suitability requirements under MiFID II to incorporate its views on the robo-advice market into the 13 July 2017 consultation paper on "Guidelines on certain aspects of the MiFID II suitability requirements". The proposed Guidelines will replace the existing Guidelines on suitability under MiFID I, published by ESMA in 2012.

Firms offering, or looking to offer, robo-advisory services should take note of the additional factors regulators are likely to expect them to consider when offering these services. Firms should ensure that these factors have been taken into account and incorporated into the technology supporting their robo-advisors. It is likely that the FCA will expect to see these points considered when firms take advantage of its regulatory sandbox or advice unit.

ESMA's Concerns

ESMA considers that the use of robo-advice for the provision of investment advice and portfolio management services raises some specific investor protection issues, in particular:

- The nature, quality and presentation of information given to clients when services are provided through an automated tool.
- The actual suitability assessment, in particular, when this involves using an online questionnaire with limited or no human interaction.
- The organisational arrangements of firms offering robo-advice.

Consequently, ESMA has expanded on some areas of the existing Guidelines and included practical examples to help firms apply the MiFID II suitability requirements to automated or semi-automated systems.

A number of the guidance points now include specific robo-advice examples to help firms understand regulatory expectations.

Factors for Firms to Consider

The draft ESMA Guidelines suggest that firms providing robo-advice should consider the following factors in the context of the suitability assessment:

The service

- The level of human interaction offered to recipients of robo-advice, and how clients are made aware of any potential assistance on offer. For instance, if clients can get in touch to ask questions, whom do they need to contact and how?
- Firms should include a statement that an algorithm is used and indicate what purpose the algorithm serves. Firms should also consider whether they provide clients with sufficient information about the purpose of the algorithm, and when and why the firm might override it.

Presentation of information

- Do firms present information to clients in a clear, understandable manner, particularly when there is no human interaction?
- Is the presentation of information appropriate for the format used (for example, if the platform can be viewed on a mobile device, is the platform set up to display correctly on a mobile)?
- Are questionnaires for clients worded and set out clearly? Do they offer additional clarification, if needed (for example, pop up explanations or illustrative examples)?
- Do firms word the questions objectively? Or, do the questions lead clients to certain answers? Do firms use “no answer” options too frequently (particularly when collecting information on the client’s financial situation)?
- Do firms design questionnaires for clients to prevent clients from manipulating the outcome, or from being drawn to overstate their knowledge and experience?

Explanations to clients

- Firms should provide clients with a description of how the firm will use information gathered to provide investment advice or portfolio management services.
- Firms should consider whether they clearly inform clients that the answers they provide will have a direct impact on the firm’s suitability assessment and the investment recommendations made.
- Firms should explain any help offered to clients in filling out online questionnaires and explain the measures in place to deal with inconsistent or anomalous client responses to online questionnaires.
- Do firms design disclosures to be effective (are they emphasised and should such information be accompanied by interactive text and further explanations)?

Systems and controls

- Are appropriate written policies and procedures in place to help mitigate the increased risk exposure associated with providing automated services to clients with limited human interaction?
- Is the firm comfortable that the information collected from clients online allows the firm to assess suitability in accordance with its obligations?

- If clients can update their own profiles, are measures in place to prevent clients from making certain products appear suitable for them when they are not?

- Has a firm disclosed any conflicts of interest that might arise as a result of third-party involvement with the algorithm?

- Does the firm have appropriate systems and controls to assess the overall consistency of information provided by clients (for example, a client may indicate that they are comfortable with a high level of risk but demonstrate a low capacity for loss)?

- Does the firm have adequate policies and procedures in place to address the risk of cybersecurity threats, to ensure the proper protection of client accounts, and to manage the use of social and other electronic media to market the firm's service in compliance with the financial promotions rules?

- Does the firm have robust record-keeping arrangements in place to capture all relevant data from the robo-advisor?

Staff knowledge and competence

- Do staff involved in setting up client questionnaires, defining algorithms relating to the suitability assessment, and checking compliance with the suitability requirements have appropriate skills, knowledge, and expertise?

- Do relevant staff have an appropriate understanding of the technology and algorithms used to provide robo-advice, and are they able to understand and review the advice algorithms generate?

Next Steps

Stakeholders should respond to the consultation by 13 October 2017. ESMA expects to publish a final report and its final Guidelines in the first half of 2018 (*i.e.,* after MiFID II has come into force).

Existing and potential providers of robo-advice services should think carefully about the additional risks such services present in terms of investor protection, and how providers can enhance their systems and controls to ensure that they are fully compliant with the MiFID II requirements.

Although it is unlikely that the draft Guidelines will be finalised until after 3 January 2018, firms may wish to start thinking about how they can factor the Guidelines into their processes now, and put appropriate measures in place as a matter of best practice in these areas.

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