NOS CHERS VOISINS

ROBO-ADVISORS: INVESTOR PROTECTION, TO CODE OR NOT TO CODE?

By **Melvin Tjon Akon**, Associate, Bonn Steichen & Partners[1]

As 'brilliant' as HAL 9000 in *2001: A Space Odyssey*, as 'malign' as Agent Smith in *The Matrix* trilogy or as 'dumb' as Dum-E in *Iron Man* – asking around about robots which invest your money in financial instruments (securities) may evoke extreme responses. In reality, there is no single 'investment robot algorithm'. Automated investment advisory, or management software tools (robo-advisors) differ considerably in terms of key configurations.[2]

Robo-advisors are a recent innovation in the European retail financial services space and a popular example of "Fintech". They have raised investor protection questions, which we will discuss by comparing draft Luxembourg legislation with United States federal regulation. The purpose of this discussion is to present a high-level – and non-exhaustive - analysis of key obligations.

We will explore these rules with the following stylized fact pattern. The investment firm **InvestCo** offers **YouAlpha**, a robo-advisor providing retail investors with investment advice and portfolio management services using machine learning, economic models and robotic process automation. To offer its portfolio management services, InvestCo engages brokers for the purchase and sale of securities, including the algorithmic brokerage firm **TradeCo**. YouAlpha is provided entirely via the internet. Each month, InvestCo's investment committee (composed of human executives) determines the set of liquid securities from which YouAlpha can compose the clients' portfolios. InvestCo outsources the design and maintenance of YouAlpha's software to a specialized firm, **BrainFinance**. InvestCo charges the users of YouAlpha subscription fees and transaction fees. It now considers to include securities from certain third parties in YouAlpha, in exchange for payments under a "revenue sharing" agreement[3].

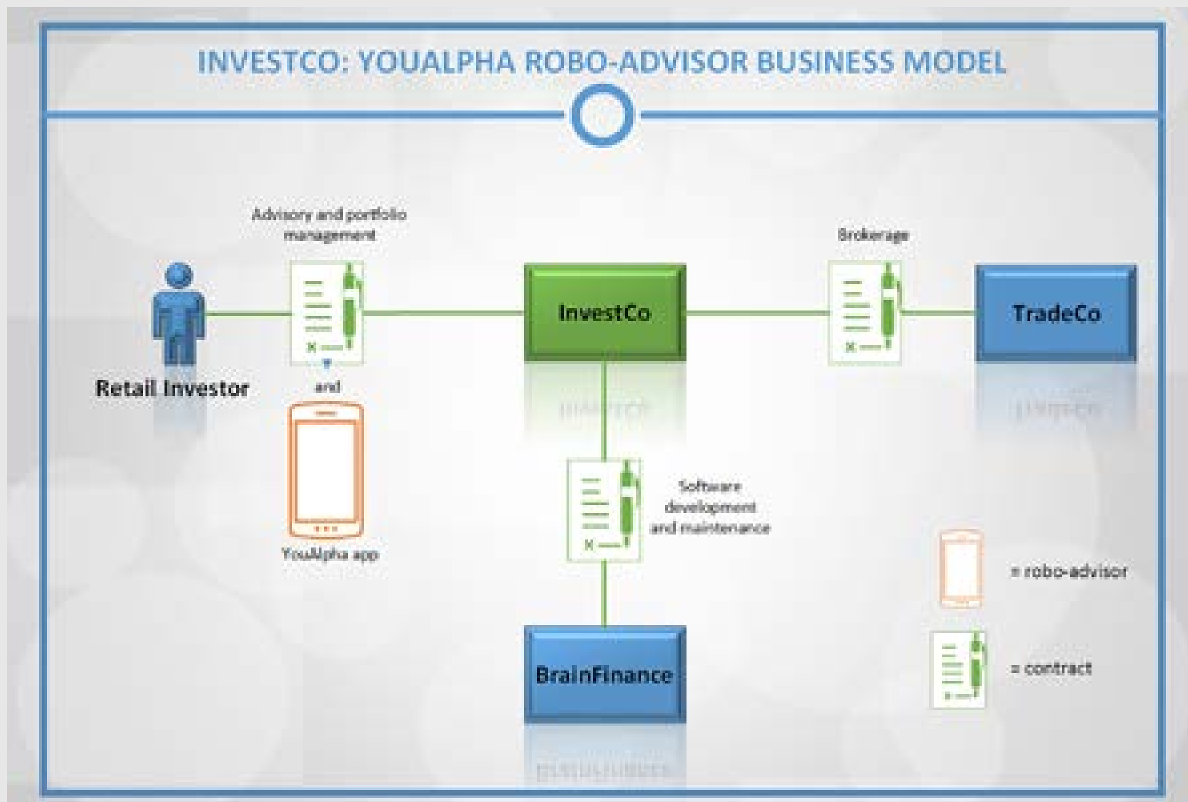
Regulation in Luxembourg

Investment advice and portfolio management with respect to securities, are activities covered by EU Directive 2014/65/EU (the **Markets in Financial Instruments Directive** or **MiFID II**) and Regulation (EU) 600/2014[4]. Currently, the draft law (*projet de loi*) 7157[5] on markets in financial instruments transposing MiFID II and amending the law of 5 April 1993 on the financial sector in Luxembourg law (the **Draft Law**), is being considered by the legislator. MiFID II recasts Directive 2004/39/EC (**MiFID I**) and adds new rules. From January 2018, investment firms will have to comply with the Draft Law. Just like under MiFID I, they will need authorization to provide investment advice or portfolio management services. We will apply the Draft Law to our example.

Protection by codification of rules

As a general duty, InvestCo must act honestly, fairly and professionally in accordance with the best interests of its clients. This duty is a foundational principle of the Luxembourg investor protection regime.

Not every investor is as "savvy" as Warren Buffet. Therefore, under the Draft Law, InvestCo must categorize its clients as professional clients or retail clients. Professional clients, who possess the experience, knowledge and



Crédit : Melvin Tjon Akon

expertise to make their own investment decisions and properly assess the risks that they incur, enjoy less regulatory protection than retail clients (non-professional clients). Before offering investment advice or portfolio management, InvestCo must request and evaluate information from the client or potential client (such as his or her knowledge and financial situation), to make sure that the proposed offering via YouAlpha is suitable and in accordance with the investor's risk tolerance. Before concluding the transaction (or without undue delay if the client can delay the transaction), InvestCo must communicate the outcome in a statement on suitability to the (potential) client.

When selecting brokers, InvestCo must act in the best interest of its clients. In its turn, TradeCo must take all sufficient steps to obtain, when executing orders, the best possible result for these clients, a rule known as the "best execution" rule.

InvestCo must structure its revenue model within the limits of the Draft Law, which provides clear rules on receiving and making payments by InvestCo from or to third parties in connection with YouAlpha services. InvestCo cannot receive or make such payments, if it offers a client investment advice on an independent basis or portfolio management services. If it offers non-independent investment advice, InvestCo may make or receive payments, but it should be able to respect the general duty to act in the client's best interest. In addition, the payments must be clearly disclosed and documented.

InvestCo must provide its clients with certain information, *inter alia* about the firm, YouAlpha, its investment strategies and fees. It must also inform the client whether it offers investment advice on an independent basis. Furthermore, it must clearly disclose information about conflicts of interest and the steps taken to avoid those conflicts of interest, if those steps are not sufficient to prevent harm to the client's interests. At all times, this information must be fair, clear and not misleading.

In terms of IT, InvestCo must have appropriate and proportionate systems, resources and procedures in place to ensure continuity and regularity in the performance of YouAlpha. Since it outsources software maintenance to BrainFinance, InvestCo must have effective measures in place to safeguard information processing systems, assess operational risks related to the outsourcing and control access to client data by BrainFinance's employees. TradeCo is required to put in place effective systems and risk controls to ensure that its trading systems are resilient and are subject to appropriate trading thresholds.

US federal regulation

Providing investment advice is an activity covered by the Investment Advisers Act of 1940 (the **IAA**). Managing a client's portfolio requires effecting transactions in securities for the account of others, which is covered by the Securities Exchange Act of 1934 (the **Exchange Act**). Both acts are United States federal laws, supervised by the United States Securities and Exchange Commission (the **SEC**), which issues rules and guidance under these acts[6].

A firm that engages in both activities must register as an investment adviser under the IAA

and as a broker-dealer under the Exchange Act. In addition, as a broker-dealer, it must become a member of a self-regulatory organization, such as the Financial Industry Regulatory Authority (FINRA), which also imposes investor protection obligations on its members. Unlike in Luxembourg law, the US investor protection rules mainly stem from judicial decisions ('case law'), SEC rules under the IAA and SEC interpretation of the IAA.

Protection by interpretation of standards

The investment advisory relationship is fiduciary in nature[7]. As a fiduciary, the investment adviser owes a duty of loyalty to its client and has the fundamental obligation to act in the best interests of the client.

InvestCo has the fiduciary obligation of investment advisers to make only suitable investment recommendations to a client, after an evaluation of client information, including financial situation and investment experience. This fiduciary obligation is enforceable under the anti-fraud provisions of the IAA.

InvestCo must act in the best interest of the client when selecting a broker-dealer. As a broker dealer, TradeCo has a duty of best execution, requiring it to obtain the most favorable terms available under the circumstances for its customer orders.

As a fiduciary, InvestCo has an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts'. This duty and the provisions of the IAA require InvestCo to (1) disclose any potential conflicts of interest to the client, (2) seek to manage those conflicts of interest by means of procedures and (3) not provide investment advice if it would be incompatible with its duty. Disclosure is essential. Unlike in the Draft Law, it is up to the investor to evaluate if the adviser is serving two masters or only one (i.e. himself). Receiving or making payments to third parties is not expressly prohibited, but must be disclosed.

All material facts relevant to the engagement of the investment adviser must be disclosed, including conflicts of interests and compensation. Facts are material if a reasonable investor would find them important. Disclosure must be full, accurate and complete, written in language which clients can understand.

Among other IT-related obligations, the SEC requires InvestCo and TradeCo to adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. To meet substantive and fiduciary obligations, they must also have a compliance program in place and appoint a chief compliance officer. Since the compliance program must address the risk exposures created by firm's operations, the SEC advises InvestCo to consider procedures addressing the development, testing and post-implementation monitoring of the algorithmic code, as well as the appropriate oversight of BrainFinance.

With greater flexibility comes greater responsibility

With respect to form, the regimes differ considerably. The Luxembourg investor protection regime is highly codified, while the US federal regime is more based on case law and SEC interpretations of the statutes. With respect to substance, it seems that the regimes provide investor protection rules which are quite similar in nature. The main difference concerns the rules regarding payments from or to third parties and the associated conflicts of interest. The US regime focuses on disclosure, whereas the Luxembourg regime expressly prohibits them in case of portfolio management and "independent" investment advice. In practice, the US federal regime allows slightly more flexibility to structure revenue models. It imposes responsibility on investors to evaluate whether they are comfortable with the revenue model of the robo-advisor. This makes the regime relatively more attractive for financially literate investors who prefer a greater variety of propositions to choose from.[8]

Multi-market strategies for robo-advisors

The differences between the regimes in US and Luxembourg have practical implications for investment firms using robo-advisors to serve these markets ("multi-market strategies"). First, even though some rules are substantially similar, investment firms need to consider the formalities applicable to those rules. For example, information may have to be disclosed via specific forms or communicated to the supervisory authority in a specific format. Second, they have to carefully analyze their revenue models and consider whether they are portable from one market to the other. In summary, multi-market robo-advisors must be configured to properly protect investors in each market or risk "I know better than to trust a strange computer" as a response from retail investors (*C–3PO*, Star Wars).

1 Attorney–at–law, New York. The views expressed are solely those of the author.

2 For an overview of robo–advisory business models, see M. Tjon Akon, 'Robo-advisors: Regulation and Design Features for Risk Mitigation', NY Business Law Journal, 2017(1), p. 62-66.

3 Inspiration: H. Son, 'Your Robo-Adviser May Have a Conflict of Interest', Bloomberg, 27 July 2017.

4 These rules are further detailed in Commission Delegated Directive (EU) 2017/593 and Commission Delegated Regulation (EU) 2017/565.

5 ID LEGICORP 25856.

6 See in particular SEC Guidance No. 2017-02 (February 2017).

7 Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 184-85 (1963).

8 Note that the Luxembourg regime may change in the near future. The European Commission is currently considering sectoral regulation.