# THE REGULATION OF ROBO-ADVICE

LAWS428

Word Count: 2916

The speed at which technology is changing the financial services industry is both exciting and challenging. National regulatory bodies have been faced with the

difficult task of regulating these fast moving new technologies that are part of the Fintech phenomenon – including robo-advice. Regulators across the globe have approached this digital financial advisory platform in different ways. As with all emerging technologies, the challenge for regulators of robo-advice is to keep pace with the technology and allow it to flourish, while safeguarding consumers from adverse outcomes and unintended consequences. There is a fundamental distinction between robo-advice and human advice – in both their risks and their advantages. Regulators have employed a number of strategies in response to the regulatory challenges posed by this emerging technology.

Fintech refers to innovative technology that is positively disruptive, as it is redefining the way consumers access financial services[1]. Under the Fintech umbrella, the term robo-advice encompasses multiple different variations of personalised financial advice. For the purposes of this essay, robo-advice can be defined as using algorithm-based software to provide automated investment recommendations to clients online[2]. The advice is generated from the client's answers to a series of questions about their financial situation, including risk profile, assets, investment goals and plans for retirement[3].

There is no doubt that the prevalence of robo-advice in the market will continue to grow. In the US alone, in 2019 robo-advisors had $283 billion in assets under management, a 10% increase over the previous year[4]. The growth in robo-advice reflects a win-win proposition for both parties. Robo-advice is cheaper for financial services firms to provide, to distribute widely and to scale up. A large proportion of people are deterred from seeking financial advice due to the high costs of human advisors[5]. Although lacking confidence when making financial decisions, those with fewer assets reap fewer benefits from traditional advice, creating a major gap in the market[6]. Automated advice eliminates the need for expensive human advisors[7]. As a result, it is viewed as the mechanism to bridge this 'advice gap', as a more cost-effective solution suitable for a wider range of investors[8]. The younger generation is also apprehensive about receiving financial advice – the use of technology is more accessible and engaging to this demographic[9].

The complete lack of human interaction largely distinguishes robo-advice from face-to-face advice. One of the key differences raising questions for regulators is the absence of a traditional client-advisor relationship[10]. Regardless of whether or not

[1] FinTechNZ "About FinTechNZ" (2020) <www.fintechnz.org.nz/about-fintechnz>.
[2] Deloitte & Avaloq *Emerging Models of Digital Wealth Advisory* (Deloitte Tax & Consulting, 2017) at 10.
[3] Phillip Maume "Regulating Robo-Advisory" (2018) 55 Tex.Int'l L.J 49 at 61.
[4] Statista "Robo-Advisors" (2020) <www.statista.com/outlook/337/613/robo-advisors/north-america#market-globalRevenue>.
[5] Bob Ferguson, Head of Strategy & Competition Division, FCA "Robo Advice: An FCA Perspective" (Westminster and City, 2017 Annual Conference on Robo Advice and Investing, 11 October 2017).
[6] Bob Ferguson, above n 5.
[7] Maume, above n 3, at 19.
[8] Dan Jones, Joanna Khoo & Gracie Liang "Digital advice exemption: better late than never" (16 November 2017) Russell McVeagh Publication <www.russellmcveagh.com/insights/november-2017/digital-advice-exemption-better-late-than-never>.
[9] Deloitte & Avaloq, above n 2, at 7.
[10] Maume, above n 3, at 5.

the recommended financial products are suitable for that particular investor, the advice is given purely based on the responses to the questions asked by the robo-advisor. Risk factors or personal circumstances that are outside the scope of what the scripted questions ask are not taken into account. Comparatively, a human advisor engages with their client on a much more personal level, and as a result the advisor can get a better idea of the client's true wants and needs. That being said, human advisors are not perfect and will often get things wrong or provide inconsistent advice based on the same set of inputs. The difference here is that should a human advisor miss the mark, the client is able to express their discomfort or doubt, whereas robo-advisors cannot react to a response and alter the advice accordingly. This absence of human intuition places doubt on whether current regulations can be adapted to deal with robo-advice.

After the 2008 global financial crisis many consumers lost trust in their banks, creating positive market conditions for the rise of robo-advice[11]. With the absence of real communication comes the absence of human error[12]. This could mean a more accurate advice platform than the traditional route, lifting the burden of liability[13]. However, it must be acknowledged that all the beneficial elements of robo-advice depend on whether the software is well designed and provides accurate information[14]. This has been labeled the 'black box' challenge[15]. Regulators have no understanding of how these opaque algorithms receive input and generate an output of advice, potentially creating a major gap in their oversight of robo-advisors[16]. If a recommendation was problematic in some way and required legal examination, the error could be rooted in a poorly designed algorithm – yet regulators do not have the expertise to analyse the 'black box'. Moreover, the ability of robo-advice to scale to large numbers of people means that any errors or biases in the algorithms that drive the advice can be magnified[17].

Digital advisors are not immune to the potential for bias, and a reliable mechanism is crucial for the successful provision of robo-advice. Tom Baker and Benedict Dellaert contended that while it is plausible to trust that a robo-advisor will be well designed, it would be naïve not to question the provider's true intentions as to whether the algorithms generated an output in the best interests of the consumer[18]. The risk of biased advice likely increases with large firms, as there may be a number of conflicts of interest at play with a greater presence in the market. Some intermediaries still receive a commission from pushing certain financial products[19]. Regulators therefore must be wary that institutions developing robo-advice applications may be motivated by compensatory incentives. That being said, for regulatory purposes, it is

[11] Serge Darolles "The Rise of Fintechs and Their Regulation" (2016) 20 Financial Stability Review 85 at 86.
[12] Maume, above n 3, at 68.
[13] Maume, above n 3, at 68.
[14] Tom Baker & Benedict Dellaert "Regulating Robo Advice Across the Financial Services Industry" (2017) 103 Iowa L.Rev. 713 at 724.
[15] Prince Sarpong *Robo-Advisors: Exploring and Leveraging the Competition* (Centre for Financial Planning Studies, January 2020) at 3.
[16] Prince Sarpong, above n 15, at 3.
[17] Tom Baker & Benedict Dellaert, above n 14, at 732.
[18] Tom Baker & Benedict Dellaert, above n 14, at 724 & 732.
[19] Tom Baker & Benedict Dellaert, above n 14, at 723..

arguably valid to assume competency, considering a digital advice provider would likely only be granted a license if their platforms were in working order. Again, this comes back to a possible responsibility on regulators to conduct a hands-on evaluation of the actual operation of the digital advice service – are they well equipped to test this complex technology?

Striking a balance between promoting innovation, and protecting investors whilst maintaining a fair and efficient market has always been a challenge for financial regulatory bodies[20]. Whether regulators like it or not, the competitive market will continue to evolve as companies strive to stay ahead of their competition and offer the most revolutionary technology[21]. As an example, the objective of the UK's Financial Conduct Authority (FCA) is to promote competition, as it is beneficial for consumers, firms and the wider economy[22]. Innovation is a driver of competition, which in turn leads to a more efficient market[23]. There are doubts that imposing specific regulations on digital advice could discourage creativity and prevent robo-advisory companies from entering the market, particularly if they are stricter than the traditional regulatory scheme[24]. At this point, there is no certainty that a tailored regime would impose more onerous rules. Philip Maume considered that as automated advice does not exercise discretion due to personal circumstances like a human advisor, the platform might even be subject to lighter regulations, such as removing fiduciary duties[25]. Regulators should not shy away from the establishment of more appropriate standards purely due to fears that innovation will be discouraged. Companies are all too aware of the allure of new technology that draws consumers in.

Serge Darolles said that regulators must "provide a level playing field for all participants, but at the same time foster an innovative, secure and competitive financial market"[26]. The level playing field in this context refers to fair and equal competition between market participants[27]. Newcomers and long-existing players of the market should be subject to the same obligations when providing a financial advice service to maintain this fairness and equality[28]. It could be argued that creating a new set of regulations tailored to govern robo-advice may deliberately or inadvertently impose higher standards on digital advice providers, thereby unduly favoring traditional advisory companies. Maume disputes this argument in that requiring a level playing field is regarding the service itself, not the service provider[29].

The many differences between robo and human advisors means the nature of the service is entirely different with respect to the risks. Holding them to the same

[20] Dan Jones, Joanna Khoo & Gracie Liang, above n 8.
[21] Deloitte & Avaloq, above n 2, at 2.
[22] Bob Ferguson, above n 5.
[23] Bob Ferguson, above n 5.
[24] Tom Baker & Benedict Dellaert, above n 14, at 746.
[25] Maume, above n 3, at 62.
[26] Serge Darolles, above n 11, at 90; in Maume, above n 3, at 79.
[27] Maume, above n 3, at 80.
[28] Maume, above n 3, at 79.
[29] Maume, above n 3, at 79.

standard could be inefficient, impractical and defeat the purpose of the level playing field in the first place. The sooner regulators acknowledge that digital advice service is effectively different in its nature to human advisors, the sooner they can develop suitable standards that will not leave any gaps. Given the numerous challenges faced by regulators in dealing with a fast evolving robo technology that sits alongside traditional human advice, regulators around the world have used a variety of strategies to encourage innovation and competition at the same time as safeguarding consumers.

A regulatory sandbox is a modern mechanism that has been employed in the robo-advice context. In the UK, to address new Fintech technologies the FCA has employed the strategy of a regulatory sandbox, allowing firms to test new products and services under their supervision and guidance[30]. A specialised Advice Unit for digital advice was set up in 2016 with a similar function[31]. With the purpose of encouraging innovation, institutions eligible to receive this service will not be subject to the normal regulations immediately[32]. Eligibility criteria include "genuine consumer benefit", "potential to deliver low cost advice to underserved consumers" and "need for regulatory input"[33]. Out of 119 applications, 30 businesses have been rejected to take part in the Advice Unit[34]. In its Business Plan 2017/2018, the FCA offered guidance as to the development of streamlined advice services, including robo-advice[35]. In accordance with their Business Plan, the FCA carried out a review of automated investment services[36]. Their findings included an inadequate amount and quality of client information gathering, and a lack of in-house governance processes, such as cyber security[37]. The FCA sent feedback letters to the firms they reviewed, and consequently a number of them improved their disclosure and suitability processes[38]. The FCA will be carrying out ongoing assessments of individual robo-advice firms, giving them the opportunity to make necessary changes, rather than taking regulatory action once the mistake has been made. It is fair to say that the FCA has a very progressive outlook on the future of robo-advice, and how to restrict it in a way that embraces and encourages technological development.

A key issue for regulators is whether robo-advice should be governed under the traditional regulatory framework, with the risk of inconsistency, or to create specifically tailored regulations, which could disrupt the level playing field of the market. The Financial Markets Authority (FMA) in New Zealand has taken a transitional approach, through the current Financial Advisers (Personalised Digital

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[30] Financial Conduct Authority *Business Plan 2016/17* (June 2016) at 32.
[31] Financial Conduct Authority, above n 20, at 32.
[32] Financial Conduct Authority, above n 20, at 32.
[33] Cristian Angeloni "UK regulator rejects 30 robo-advice applications" (20 March 2020) International Adviser <https://international-adviser.com/uk-regulator-rejects-30-robo-advice-applications/>.
[34] Cristian Angeloni, above n 33.
[35] Financial Conduct Authority *Business Plan 2017/18* (May 2017) at 4.
[36] Financial Conduct Authority "Automated investment services – our expectations" (21 May 2018) <www.fca.org.uk/publications/multi-firm-reviews/automated-investment-services-our-expectations>.
[37] Financial Conduct Authority, above n 36.
[38] Financial Conduct Authority, above n 36.

Advice) Exemption 2018 and the upcoming enactment of the Financial Services Legislation Amendment Act 2019 (FSLAA).

The FMA has lagged behind other countries in respect of regulating digital advisory platforms. Before 2018, personalised digital advice was prohibited due to section 8 of the Financial Advisors Act 2008 (the Act), which defined a financial adviser as a 'person' providing financial advice[39]. Section 148 of the Act vested a power in the FMA to grant exemptions from compliance with the Act[40], and thus the Financial Advisers (Personalised Digital Advice) Exemption came into force on 1 June 2018[41]. Registered financial service providers can apply to provide robo-advice services in respect of eligible products, such as KiwiSaver[42]. To be approved, entities must demonstrate good character and competency and show they meet minimum standard requirements[43]. Approved providers are subject to various conditions, including disclosure requirements, compliance with code standards and retaining written records[44]. The exemption is not so much a formalised regulatory sandbox, but nevertheless an opportunity for the FMA to observe robo-advice in practice before the FSLAA is enacted[45]. However, only 9 providers have been approved as set out in Schedule 1 of the exemption[46]. It could be contended that this transition between complete prohibition of any digital advice facility and complete acceptance of robo-advice in the FSLAA is too hasty. With no prior experience of regulating automated advice, having only 9 approved entities as a sample to test the waters may not be enough. The small number of early participants also demonstrates the challenges faced by providers in developing and offering robo-advice propositions.

The FSLAA 2019 is coming into force in March 2021, and the digital advice exemption will be revoked[47]. The current requirement for personalised financial advice to be given by a natural person will be removed, enabling robo-advice to be provided by any licensed provider under the Act[48]. Clearly, the FMA has chosen the route of applying the current regulation, rather than introducing a tailored framework specifically for robo-advice. The Ministry of Business, Innovation and Employment stated that the "technology neutral [FSLAA]" will "help future proof the regime and enable new and innovative ways of providing financial advice"[49]. But is it really 'future proof'? There are arguably some gaps and inconsistencies in the Act that highlight the fundamental differences between human and digital advisors, such as the duties set out in subpart 5A[50].

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39 Financial Advisers Act 2008, s 8.
40 Section 148.
41 Financial Advisers (Personalised Digital Advice) Exemption 2018, s 2.
42 Financial Markets Authority *Exemption enabling personalised digital advice* (August 2019) at 1.
43 Financial Markets Authority, above n 42, at 2.
44 Financial Advisers (Personalised Digital Advice) Exemption 2018, s 8.
45 Financial Markets Authority "Consultation to follow on draft exemption notice" (press release, 18 October 2017).
46 Financial Advisers (Personalised Digital Advice) Exemption 2018, sch 2.
47 Ministry of Business, Innovation and Employment "What is the new regime for financial advice?" (October 2018) <www.mbie.govt.nz/business-and-employment/business/financial-markets-regulation/regulation-of-financial-advice>.
48 Ministry of Business, Innovation and Employment, above n 47.
49 Ministry of Business, Innovation and Employment, above n 47.
50 Financial Services Legislation Amendment Act 2019, subpt 5A.

In subpart 5A of the FSLAA, sections 431H to 43Q are duties imposed on a 'person'[51]. Section 431R covers duties of persons engaging a nominated representative to give regulated financial advice, which could be interpreted to include a robo-advisor[52]. Subsection 3(b)(ii) states that the financial advice provider must monitor the representative and their advice to ensure that they are complying the duties in subpart 5A[53]. Section 431M establishes a duty to comply with the ethical behaviour, conduct and client care standards under FMA Code of Professional Conduct[54]. These include acting with integrity, ensuring the client understands the advice provided and giving suitable advice[55]. Can a robotic, automated entity really act with integrity? Or when the robo-advisor generates the advice, how can the software provide clarification if a client fails to understand? They could engage with a human advisor, but that arguably defeats the purpose of easily accessible, low-cost advice.

The issue with providing suitable advice comes back to the inability of a robo-advisor to fully engage with the client and understand the broader circumstances within their personal situation that may be relevant to the advice given. Similarly to the FMA, the US Securities and Exchange Commission chose to govern robo-advice under the existing Investment Advisers Act 1940[56]. Therefore robo-advisors are subject to the same regulations as traditional advisors, including a fiduciary duty to provide financial advice in the client's best interests[57]. Melanie Fein reviewed the Financial Industry Regulatory Authority 2016 Report[58], discussing the fiduciary duty and whether robo-advisors can meet this standard of care[59]. Advising in the best interests of the client requires a relatively extensive analysis of their overall situation, taking into account a wide range of factors[60]. It was concluded that the Report emphasised that human judgment was unparalleled by digital advisors – "robo-advisors are not a substitute", they cannot carry out any such inquiry[61]. If digital advisors cannot meet the legislative standards, it could be argued that this is a clear indication that robo-advice simply cannot fit under the ordinary regulatory scheme – in both the US and New Zealand.
Maume was strong in his stance that robo-advice is inherently different from human advice[62]. It is a compelling argument that regulatory bodies should consider. Baker and Dellaert noted that holding digital advisory platforms to a stricter standard than traditional advisors would be an overreaction[63] - but different does not mean more

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[51] Financial Services Legislation Amendment Act 2019, ss 431H – 431Q.
[52] Section 431R.
[53] Section 431R(3)(b)(ii).
[54] Section 431M.
[55] MinterEllisonRuddWatts "Financial Advice Code approved and released" (7 May 2019) <www.minterellison.co.nz/our-view/financial-advice-code-approved-and-released>.
[56] Securities and Exchange Commission *Guidance Update* (No. 2017-02, February 2017) at 12.
[57] Melanie L. Fein "FINRA's Report on Robo-Advisors: Fiduciary Implications" (1 April 2016) Social Science Research Network <www.ssrn.com> at 2.
[58] FINRA. (2016). Report on Digital Investment Advice, available at http://www.finra.org/sites/default/files/digital-investment-advice-report.pdf.
[59] Investment Advisers Act 1940 USC § 206; in Melanie L. Fein, above n 57, at 1;
[60] Melanie L. Fein, above n 57, at 7.
[61] Melanie L. Fein, above n 57, at 6.
[62] Maume, above n 3, at 76.
[63] Tom Baker & Benedict Dellaert, above n 14, at 716.

onerous. The distinction relates to both its risks and its advantages – both are sophisticated and competent in their own ways. With regard to New Zealand, the FSLAA may suffice for now, but considering the nature of technology and it acceleration, the FMA may need to conduct a post-implementation review as to the application of the legislation.

To keep up with the evolving technology and effectively regulate robo-advisers, regulatory bodies may need to improve their capability and understanding of the complexities of the underlying technology. In order to develop digital advice standards, regulators would need to be more informed about the software and how it functions[64]. Perhaps it will become necessary for technology specialists to be involved in developing regulatory strategies. This may be the only successful strategy for truly understanding the design of robo-advice[65]. SEC commissioner Robert Jackson stated that there are currently around 4,000 lawyers at the SEC, but in 20 years it could very well be 2,000 lawyers and 2,000 programmers[66]. Understanding the design complexities of robo-advisors may be outside the scope of the responsibilities of regulators – particularly considering they are not obligated to know the technicalities of the actual advice given by humans. Experts in the field working alongside regulatory bodies can provide necessary explanations to help fill the void that is the 'black box'[67]

The growth of personalised digital advice in global financial services is showing no signs of abating. Robo-advisors growing to such a scale that they reshape financial product markets is a matter of when, not if[68]. Consequently, appropriate regulations must be put in place now to cater for the present and prepare for the future. This is a challenging task for regulators. Regulators are burdened by the obligation to find a balance between encouraging innovation and ensuring suitable safeguards are in place. Furthermore, the lack of human interaction and complexity of design are just two of the many challenges that regulators may struggle to manage under the traditional regulatory scheme. National regulators have taken different approaches, and it is arguably too early at this stage of robo-advice's evolution to determine which is the most successful. However, if the fact that human and robo-advice are fundamentally different is ignored, the entry of robo-advice into the mass market could be problematic.

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[64] Maume, above n 3, at 75.
[65] Prince Sarpong, above n 15, at 9.
[66] Steven Scheer "Markets regulators struggling to keep up with technology: SEC's Jackson" (21 January 2020) Reuters <www.reuters.com/article/us-usa-sec-technology/markets-regulators-struggling-to-keep-up-with-technology-secs-jackson-idUSKBN1ZJ198>.
[67] Prince Sarpong, above n 15, at 9.
[68] Tom Baker & Benedict Dellaert, above n 14, at 719.