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Digital advisory services: a focus on Singapore's proposals and a comparative global analysis

Summary

The Monetary Authority of Singapore ("MAS") recently issued a new consultation paper (the "CP") on its proposals to facilitate the provision of digital advisory services (also known as robo-advisory services) in Singapore. The proposals seek to support innovation in financial services by recognising the unique characteristics of digital platforms and represent another step by the MAS to encourage technological innovation in the financial services industry.

What are digital advisory services?

"Digital advisory services" refers to the provision of advice on investment products using automated, algorithm-based tools. These tools can be in the form of either "professional-facing tools", which financial professionals use to help them service their clients, or "client-facing tools", which clients can use directly with limited or no human adviser interaction. The latter are used by digital advisers to provide digital advisory services.

The MAS recognises that digital advisers may provide digital advisory services under a range of different business models. The licensing and regulatory requirements applicable therefore differ between business models. Broadly speaking, digital advisers may currently be required to be licensed (or exempt from licensing) for:

> fund management or dealing in securities under the Securities and Futures Act (Cap. 289) (the "SFA"); and/or

> providing financial advice on investment products under the Financial Advisers Act (Cap. 110) (the "FAA").

A global outlook

Globally, the take-up of digital advisory services is fast gaining popularity among the growing segment of technology-savvy and self-directed consumers. The MAS has welcomed the offering of digital advisory services as it has the potential to improve consumers' access to low-cost and more efficient advice, and it is not alone in considering the regulatory implications of digital advisory services.

Below is a quick overview of the approaches adopted by various major financial regulators globally. A clear regulatory trend appears to be that regulators across jurisdictions are currently opting to publish guidance rather than entirely new regulations, suggesting that regulators generally view digital advisory services as fitting into existing regulatory regimes.

Regulators are continuing to watch this area with interest, and it remains an area of fast-paced change.

> **UK** – the Financial Conduct Authority ("FCA") has:
  > identified digital advisory services as one of its core priorities for the second year running;
  > been consulting on the implementation of proposals arising from the Financial Advice Market Review, and has (amongst others) been proposing draft guidance for providers of automated advice;
  > focused on automated advice as part of its initiative to "bridge the advice gap" and to ensure that there is affordable and accessible advice for the greatest number of consumers; seeing automated advice as a solution that can be rolled out for the mass market;
  > highlighted in its 2017/18 business plan that it views technological innovation (including robo-advice) as a key trend; and
  > aimed to produce a package of measures to take effect in January 2018, in parallel with MiFID II.

> **US** – the following guidance has been published:
  > the Financial Industry Regulatory Authority published a report in March 2016 on digital investment advice, which may be helpful for firms seeking to develop a US offering. The report outlines regulatory principles and effective practices in five key areas: governance and supervision of algorithms, customer profiling, governance and supervision of portfolios and conflicts of interest, rebalancing and training; and
  > the Securities and Exchange Commission ("SEC") published guidance in February 2017 for digital advisers with suggestions on meeting disclosure, suitability and compliance obligations under the US Investment Advisers Act of 1940.
Australia – the Australian Securities & Investments Commission ("ASIC"): 

- established a robo-advice taskforce in 2015, to investigate the suitability of potential entrants into the sector;
- consulted in March 2016 on its proposed guidance on providing robo-advice to retail clients, and issued its regulatory guide on the same in August 2016; and
- asserts that the Australian regulatory regime is “technologically neutral”, and therefore the obligations applying to the provision of traditional and robo-advice are the same.

Hong Kong – the Securities and Futures Commission:

- published a consultation paper in May 2017 on its proposed guidelines on online distribution and advisory platforms. The proposed guidelines contain specific guidance on the provision of robo-advice on an online platform; and
- confirmed in its consultation that digital advisers must comply with all applicable conduct requirements.

Consistent with the abovementioned global regulatory trend, the MAS has similarly provided guidance in the CP in respect of the governance and supervision of algorithms under existing regulations. The MAS has also, however, proposed certain incremental changes to Singapore’s applicable regulatory regime. The MAS’ guidance and proposed legislative changes are discussed further below.

**Key proposals of MAS**

We outline below key aspects of the MAS’ proposals set out in the CP.

Broadly, the proposals cover:

- governance and supervision of algorithms;
- suitability of advice;
- portfolio management; and
- execution of investment transactions.

**Governance and supervision of algorithms**

Part A of the CP sets out the MAS’ expectations in relation to digital advisers’ development of algorithms for use in client-facing tools.

Broadly, the MAS sought views on:

- developing the client-facing tool — the MAS expects digital advisers to ensure that the methodology of the algorithm behind the client-facing tool is sufficiently robust. For example, algorithms must be able to both collect and analyse all necessary information to make a suitable recommendation. Prior to the launch of a client-facing tool, and prior to making changes to the tool, the MAS expects the tools to be back-tested and expects a gap analysis to be performed against the Notice and Guidelines on Technology Risk Management. It is not clear whether back-testing and gap analysis will be required prior to any change to the client-facing tool, or whether there will be any materiality threshold or discretion for digital advisers. Further clarity from the MAS on this point would be welcomed.

**Client-facing tools**

The MAS’ guidance is consistent with the considerations highlighted in the SEC Guidance Update for digital advisers to address their risk exposures. The SEC also suggests that digital advisers should have written policies and procedures to address areas such as the prevention and detection of, and response to, cybersecurity threats, in connection with the marketing of advisory services. In Singapore, such policies and procedures are already expected pursuant to the MAS’ Risk Management Guidelines.

- monitoring and testing of algorithms — the MAS requires digital advisers to have policies, procedures and controls to monitor and test their algorithms to ensure that they perform as intended. In particular and amongst others, digital advisers are expected to have processes in place to enable them to suspend the provision of advice should an error or bias arise within the algorithm.

- providing information on algorithms and conflicts of interest — the MAS expects digital advisers to disclose to clients the reason for the selectivity and limitations of the recommendations by the algorithm, in addition to their existing disclosure requirements on conflicts of interest. Beyond this, the MAS has not yet expressed a view on (a) the extent/content of disclosures that should be made to clients regarding the algorithm itself, and (b) the medium for such disclosures. This is an area to watch with interest.

- responsibility of the board and senior management — the MAS has made clear that the board and senior management of an institution are responsible for the maintenance of effective oversight and governance of the client-facing tool, which is consistent with expectations already imposed in the existing MAS Risk Management Guidelines. Further tailored MAS guidance on board and senior management responsibility in the context of digital advisory services would be welcomed.

**Board and senior management**

ASIC explicitly requires digital adviser licensees to have at least one “responsible manager” who meets the minimum training and competence standards for advisers.
Suitability of advice
In a welcome recognition of the differences between the business models of digital and conventional financial advisors, the MAS is prepared to grant case-by-case exemptions to client-facing tools which are fully automated, from the need to collect full information on the financial circumstances of the client, as currently required by MAS Notice FAA-N16, when advising on traditional exchange traded funds ("ETFs").

Suitability
The FCA has underlined in its guidance consultation that suitability requirements must not be reduced where investment advice or portfolio management services are provided in whole or in part through an automated or semi-automated system.

Suitability is also a concern of the SEC; its Guidance Update provides digital advisers with recommendations on how client questionnaires can be designed to elicit adequate information to fulfil their suitability obligations. The SEC has also stated that investment advisors owe their clients a fiduciary duty to provide suitable investment advice.

When assessing requests for this exemption, MAS will:

- consider whether the online processes of the digital adviser exert influence over the amount a client will invest;
- require digital advisers to demonstrate that their threshold questions can effectively filter out unsuitable clients;
- require institutions to provide a risk disclosure statement to their clients; and
- expect digital advisers to have controls in place to identify inconsistent responses provided by the client.

The MAS has also made clear that, even if this exemption is granted, digital advisers would still be required to take reasonable steps to collect information on the financial objectives of its clients. It is not clear what “reasonable steps” the MAS may expect a digital adviser to take; ideally, the MAS will provide further clarity on this in due course.

“Suitability is not an optional extra, but a fundamental component of the way an investment advisor advises its clients.”

Portfolio management
The MAS sought views on three proposals in respect of portfolio management:

- **provision of incidental fund management services** – currently, a licensing exemption exists only in respect of unlisted collective investment schemes ("CIS"), and allows licensed financial advisers ("FAs") to assist their clients in executing their transactions in investment products without the requirement for an additional licence for fund management under the SFA, so long as such execution services are ancillary to the financial advisory services offered by the adviser. The exemption is proposed to be expanded to include listed CIS, and extended to exempt FAs.

- **portfolio rebalancing activities** – the MAS proposes to recalibrate the SFA licensing exemption available to FAs conducting portfolio rebalancing activities. It is proposed that:
  - the requirement for digital advisers to obtain prior approval from a client in respect of each rebalancing transaction will be removed;
  - instead, FAs relying on the portfolio rebalancing exemption would be required to obtain their clients’ one-time prior acknowledgement in writing of the fees and terms of their discretionary portfolio rebalancing services; and
  - FAs will also be required to notify clients prior to each rebalancing transaction. It is not clear what form the MAS will expect such a notification to take, and further details in this regard would be welcomed.

- **corporate track record requirement for retail fund managers** – in a welcome recognition of certain barriers to entry faced by some providers of digital advisory services, the MAS proposes to allow digital advisers whose activities fall under fund management under the SFA to obtain a capital markets services licence to service retail investors, even if they do not meet the requirements in respect of a five-year corporate track record and/or S$1billion assets-under-management, provided that:
  - key individuals have relevant collective experience in fund management and technology;
  - portfolios recommended comprise at least 80% traditional ETFs, with a cap of 20% invested in listed shares, listed investment-grade bonds and foreign exchange contracts for hedging purposes; and
  - the digital adviser undergoes a post-authorisation independent third-party audit, one year after commencing operations.

Whilst these proposals omit certain details (for example, how many “key individuals” should an adviser have, and what is “relevant collective experience”?), we expect that the MAS will tailor the safeguards on a case-by-case basis during the course of a digital adviser’s licence application.

“The publication of the CP ... is an important step by the MAS to encourage technological innovation in the financial services industry.”
Execution of investment transactions
Licensed and exempt FAs are currently exempted from the requirement to hold a capital markets services licence for dealing in securities when assisting clients to subscribe for or redeem units in unlisted CIS. The MAS proposes to extend the licensing exemption to:

> any securities under the SFA\(^1\) (i.e. broadly, bonds and equities);
> any units in a CIS (i.e. listed or unlisted); and
> securities-based exchange-traded derivatives products that are not futures contracts,

if such dealing is incidental to an FA’s advisory activities.

To mitigate the risks arising from this approach, the MAS intends to:

> expand requirements for FAs to assess a client’s knowledge and experience for dealing in specified investment products to include listed specified investment products, in addition to unlisted specified investment products; and
> require licensed and exempt FAs to provide a prescribed risk warning statement at the point of account opening when advising on overseas-listed investment products. The requirement, and the prescribed-form statement, are intended to be introduced into MAS Notice FAA-N16.

Applications for the licensing exemption will be available on a case-by-case basis before the proposed legislative amendments.

1 This will be the definition of “securities” under the SFA as amended by the Securities and Futures (Amendment) Act 2017, which is narrower than the definition in the SFA currently in force.

Impact on your business
The publication of the CP, which is focused on the provision of digital services, is a positive development to be welcomed, and is an important step by the MAS to encourage technological innovation in the financial services industry. It fits into a broader strategy by the MAS to encourage innovation in financial services in Singapore, and by the Singapore government’s “Smart Nation” ambition.

For established financial institutions and start-ups alike, the CP provides some clarity on regulatory considerations of the opportunities and challenges facing digital advisers, how these advisers fit into the existing regulatory framework and how the framework will be adapted to accommodate them. Digital advisory services present an opportunity to provide affordable and accessible financial services, and innovative ways of servicing customers. Nevertheless, as we have discussed, there remain areas where the MAS could provide further guidance and all aspects of the proposals remain subject to discussion and change. This is a familiar theme across the globe. Accordingly, if your business involves the provision of digital advice, you should continue to actively monitor developments.

The MAS has indicated that it will be willing to entertain ad-hoc applications for certain licensing exemptions in the interim period before legislative changes are finalised and take effect. If you believe you can benefit from any of the proposed new licensing exemptions, you may wish to consider whether to approach the MAS.

Further information
If you would like to discuss the above, feel free to contact Peiying Chua or any of your other Linklaters contacts.