Commission de Surveillance du Secteur Financier

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Robo-advice

There is no commonly accepted definition of robo-advice. Often it is used as a wide or undefined catch-all term for all sorts of online investment advisors using computer-based technologies. The fundamental element of robo-advice is that it consists of the provision of advice on investment products using technological means and that, globally, it incorporates a computer-based technology into portfolio management processes. In particular, robo-advisors classify clients into predetermined categories that best correspond to their profile and subsequently propose and potentially implement an asset investment allocation. Portfolios can thus be constituted, monitored, streamlined, rebalanced and reported on. Belonging to the world of FinTech, robo-advice leverages the current technological possibilities and could be described as digital investment services.

Robo-advice relies on the incorporation of computer-based technologies into portfolio management processes. As per clients' stated preferences in terms of time horizon, risk, investment sectors/themes and objectives, the technologies, primarily through the use of algorithms, optimise various elements of wealth management from investment selection, asset allocation, to product selection and trade execution. It might be a fully automated process or a hybrid one involving some human intervention.

Robo-advice attracts a growing number of consumers such as millennials to manage their assets, to seek financial information, education or recommendations, to compare the costs, features and benefits of different products or different providers, and to purchase products/services. As a consequence of the automation of processes, robo-advisors may typically charge lower advisory fees compared to conventional advisors. By providing a cost-effective and partially or fully automated but yet personalised and cost-sensitive investment service while imposing a limited minimum investment threshold (or no threshold at all), robo-advice may grant access to services, which are traditionally restricted to private banking customers, to a greater number of average, often less wealthy, customers. It should be noted that although the potential prime clients for robo-advice services are new entrants, existing private banking customers are likely to be interested in transitioning into automated but yet personalised services.

Certain market participants consider that this phenomenon is forecast to grow and traditional investment managers as well as banks are reacting by incorporating robo-advisory tools into their portfolio of products.

The business models of robo-advice

Robo-advisors may operate under different business models having various degrees of automation and of human intervention as well as involvement in the investment process as a whole. The different models intermingle in most cases and, as robo-advice is a relatively recent phenomenon, are still evolving.

Besides the use of algorithms to compute portfolios, robo-advisors often handle the clients' orders and pass them on to brokerage firms for execution. In some cases, clients hold a securities account with their robo-advisor which practically entails that the investment, in its material form, and the monies pass through the robo-advisor. In other cases, only the advice and the order transit through the robo-advisor and the client that wishes the robo-advisor to execute its advice, must hold a securities account to which the robo-advisor has access. In either case, in addition to the realisation of the client portfolio, the investments might be automatically and periodically adjusted by the robo-advisor to avoid deviation from the original recommended asset allocation.

Robo-advisory services can be fully automated and provide end-to-end services: from investment advice to investment management and maintenance on the markets. Alternatively, robo-advisory services can mingle human intervention and automation. The latter is in fact the dominant model. The core of robo-advice, distinguishing it from other digital toolkits for wealth management, relies on the automated risk and preferences profiling of the clients followed by an algorithmically made investment recommendation.

Robo-advisors may also perform part of the investment service, be it the advising and the management or the advising and the operative part.

Authorisation and licenses for robo-advice

At EU level, no specific regulation of robo-advice exists. Therefore, in order for robo-advice to develop, the risks to be appropriately mitigated and investors sufficiently protected, several Member States have created bespoke domestic regulatory frameworks relying on both EU and domestic legislation and regulations. As a matter of fact, depending on the business model, the nature of the services, the structure of the platform including the agreement with the users, the robo-advisors may fall within the ambit of existing EU and domestic legislation in those Member States.

In Luxembourg, digital financial advice services, in the same manner as traditional financial advice services, are subject to the regulatory requirements of the CSSF. That said, the emergence of innovation in financial services has triggered the need to consider the appropriate supervisory approach(es).

The licensing

The type of licensing required by a robo-advisor to perform its activities depends on the operating model chosen including the services provided, the contractual arrangements and the structure of the platform.

Robo-advisors need to register as investment adviser (Article 24 of the Law of 5 April 1993 on the financial sector, as amended ("LFS")) like traditional, non-automated financial advisors that limit themselves to advisory services and do not intervene in the implementation of the advice provided by them. Whenever robo-advisors use the technology to manage portfolios as per client's mandates on a discretionary client-by-client basis, they need to register as private portfolio managers (Article 24-3 of the LFS). Robo-advisors need to register as brokers in financial instruments (Article 24-1 of the LFS) when their servicing consists of the role of an intermediary by either encouraging parties to be brought together with a view to the conclusion of a transaction, or in passing on their clients' purchase or sale orders without holding the investments of the clients. In cases where a robo-advisor executes orders on behalf of clients and in relation to one or more financial instruments, then the robo-advisor has to apply for an authorisation as a commission agent (Article 24-2 of the LFS). These authorisations implement the MiFID framework into national law. In any of these cases, robo-advisors have to be compliant with the MiFID/ MiFIR framework.

To obtain a license, a formal application needs to be submitted to the CSSF. The format of the application varies with the nature of the robo-advice activity envisaged. The CSSF verifies that the legal requirements necessary for the granting of the license are fulfilled.

Regulations

- Law of 5 April 1993 on the financial sector, as amended (the "LFS")

https://www.cssf.lu/en/document/law-of-5-april-1993-coordinated-version/

- Law of 13 July 2007 on markets in financial instruments (the "MIF")

https://www.cssf.lu/en/document/law-of-13-july-2007-coordinated-version/

Forms

https://www.cssf.lu/en/publication-data/