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The New Rules on Robo-Advisory Services

THE NEW RULES ON ROBO-ADVISORY SERVICES

by

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The efforts of the Securities and Exchange Commission (the “Commission”) to be pro-active in the regulation of technological innovations relating to securities offerings and investments in Nigeria is commendable. The Commission continues to strive to fulfil its mandate as the primary regulator of the Nigerian securities markets although the speed of innovation often leaves it with no other choice but to play “catch-up”. One of such efforts is the recently released Rules on Robo-Advisory Services (the “Rules”) in Nigeria. By these Rules, the Commission is proactively pre-empting the introduction of robo-advisory services (“RAS”) into the Nigerian assets management space.

Understanding RAS: The “What”, the “Why” and the “How”?

Robo Advisory Services (“RAS”) are investments services, including investment advisory services, provided on digital platforms to end-clients of such digital platforms using designed algorithms. The operator of the platform is the Robo Advisor (“RA”). RAs provide automated, algorithm-driven financial planning services with little or no human supervision.² The Rules define digital advisory services as the “provision of investment advice using automated, algorithm-based tools which are client-facing, with little or no human adviser interaction in the advisory process”. They define “Robo Adviser” as “a person who provides digital advisory services.”³

The need for financial inclusion has been a large contributor to the rise of RASs and RAs. Even now, RAs charge significantly lower fees than non-Robo, traditional investment advisers. The minimum net worth or account required to access the services of a traditional investment adviser made their services available largely only to high-net-worth individuals and institutional investors. With RAs and RAS, retail investors and financially-prudent individuals can get quality investment advice and asset management services. Accessibility is another reason why RASs are becoming quite popular. Since they are digital, RAS can be accessed once a client has a smartphone. Clients can also easily track and monitor their investments as these platforms are easy to set up and client-friendly.

RASs rely on pre-designed algorithms to provide clients with investment advice and options tailored to the investment appetite and strength of the clients. The client is typically required to complete an online survey or questionnaire to determine the (i) level of risk of investment they are willing to take; (ii) length of investment they are interested in; (iii) purpose of investment and (iv) amounts they are willing to invest. Once the client provides the answers to these questions, the RAS gives the client some investment options that it may consider suited to the client’s agenda.

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² <https://www.investopedia.com/terms/r/roboadvisor-roboadvisor.asp> accessed on June 9, 2021.

³ Rule 1.

The Provisions of the Rules

Scope of Application: The Rules apply to all Capital Market Operators and persons (individual and corporate) offering or seeking to offer digital RAS in the Nigerian capital market. The Rules define “Fully Robo Advisers” to mean Robo advisers with no human adviser intervention in the entire advisory process.

Registration: RAs are subject to the registration requirements (as corporate advisers or individual advisers) under Rules 96(1) and (2) of SEC Rules and Regulations, 2013 (as amended) (the “SEC Rules”).⁴ RAs are required to comply with all applicable business conduct requirements set out in the Investment and Securities Act, 2007 (as amended) (the “ISA”), including the SEC Rules, and other regulations, notices or guidelines issued pursuant ISA. It is expected that RAs will have to abide by the rules that apply to traditional investment advisers including those on the qualifications of an investment adviser’s representative, abiding by the Commission’s code of ethics, carrying out risk assessments of the clients and the performance of fiduciary duties.

Outsourcing: Where the RA outsources the development and maintenance of its client-facing tools to a third party, the RA shall ensure that it carries out prior “due diligence” checks on the third party to assess risks that may be associated with the arrangement. Also, the third party is not required to be registered with the Commission.⁵ The Rules does not address whether the management of the RA would be ultimately held accountable for the proper development, monitoring, and testing of the client-facing tools outsourced to a third-party.

Client’s Choice: As explained in the preceding paragraphs, the RA provides the client with advice that may suit the client’s investment strength, based on the information provided in the survey completed by that client.⁶ That client is, however, not bound to choose from the provided recommendations. Where the client chooses an alternative investment outside the RA’s recommendations, the RA is bound to implement that client’s choice. The RA implements the accepted recommendations or the client’s alternative choices by relaying the same to the relevant capital market operator for execution where the RA is not licensed to execute transactions on behalf of clients.⁷

It would mean that a client may be able to sue the RA if it fails to rely on its choice. Furthermore, where it appears that a client intends to revise, reject, or amend an RA’s recommendation or undo a revision they made to the RA’s recommendations (a rebalancing), the procedures stipulated in the Rules, including the obtention of that client’s express consent or written authorization respectively, must be complied with.⁸

Fund/Portfolio Manager: Where an RA intends to be involved in managing a client’s assets/portfolio, the RA must apply to the Commission for registration as a Fund/Portfolio

⁴ Rule 2.

⁵ Rule 3(ii) and (iii).

⁶ Rule 4.

⁷ Rule 5(a).

⁸ Rule 5(b)-(c).

Manager.⁹ Therefore, an RA can, in addition to providing investment advisory services, also manage clients' funds and portfolio.

Where an RA acting in this dual capacity and a client decides to take alternative investment decision which is contrary to the recommendation or advice of the RA, the RA must rely on the client's choice and, in addition, get the client to put the decision in writing and also state that he (the client) takes responsibility for his investment decision.¹⁰ This will unless otherwise proven pass the risks that might be associated with the investment to the client where the RA can show that it acted diligently in handling the client's choice of investment.

Governance and Supervision of Algorithms: Since the client-facing tools are primarily based on algorithms, the board and senior management of the RAs are required to ensure that there are governance and supervisory arrangements to mitigate against fault or bias in the algorithms being used by the RA. The RA must be adequately staffed with competent persons who have expertise in the development and use of the algorithms.

The staff must be adequately trained to use the client-facing tool. Furthermore, and there must be proper documentation on the design and development of the algorithms used.¹¹ The Principal Officers of an RA must be persons who have relevant and requisite experience in fund management and technology. More so, while the Rules allows the Board and Senior Management to delegate the day-to-day operations of the client-facing tools, they remain ultimately accountable for the proper development and monitoring of the tools.¹²

Client-facing Tool: The Rules provide amongst other things, that the RA must ensure that all necessary information needed to make proper analyses and recommendations to the client are included in the development of the tools. It must have in place controls to identify and eliminate clients who are unsuitable for investment and ensure that sufficient tests are carried out prior to the launch of the tool. RAs should also develop and implement internal policies and procedures to address technology risks.¹³

Compliance: RAs shall comply with anti-money laundering and anti-terrorism legislation. They must also take steps to ensure that specific risks associated with non-face-to-face business relations with a client are addressed. Such specific risks include identification difficulties, impersonation and fictitious applications.¹⁴

Disclosure: RAs must disclose all material information that will enable clients to make informed investment decisions. The disclosure must be made in clear, simple English. Basic information about the algorithms used must also be provided. RAs must also disclose to clients where the algorithms are designed to direct clients to invest in products managed by their affiliates. There

⁹ Rule 3(v).

¹⁰ Rule 3(iv).

¹¹ Rule 6.

¹² Rule 6(e).

¹³ Rule 7.

¹⁴ Rule 10.

must also be a disclosure in writing to clients of actual or potential conflicts of interest that may arise in connection or in association with any product provider.¹⁵

Overseas-listed Investment Products: RAs are to ensure that overseas-listed investment products on their platforms are not offered in violation of applicable laws and regulations. They must also issue risk-warning statements to their clients on these products at the points of account opening.¹⁶

Advice and Exemption: The Rules mandates RAs to have a reasonable basis for recommending any investment product to a person who may reasonably be expected to rely on the recommendation. In addition, the Rules provides for a list of factors that the RA must take into consideration while collecting information from the client in other to determine and analyze the client's suitability for any investment product. The factors include the: (i) financial objectives of the client; (ii) risk tolerance of the client; (iii) employment status of the client; (iv) financial situation of the client; (v) source and amount of client's regular income; and (vi) financial commitment of client.¹⁷

However, a fully-automated RA that involves no human adviser may decide not to collect all of the information pertinent to these factors where the terms on which the advice is sought and provided meet certain pre-conditions. Among the pre-conditions are that: (i) the advice is fully-automated, with no human intervention in the advisory process except for human interventions in providing technical assistance; (ii) the RA's threshold questions effectively identify and eliminate unsuitable clients, and identify and follow up on inconsistent responses provided by clients; (iii) a disclosure is made to the clients that the recommendation provided has not taken into consideration their financial circumstances; and (iv) the advice is limited to instruments within the regulatory purview of the Commission.¹⁸

Clients Assessment: RA must have in place tools to assess whether a client possesses the relevant knowledge and experience to invest in the investment product. If it is discovered that a client lacks the relevant knowledge and experience to make a wise investment in a given product, the RA must warn the client and/or offer advice to the client about the risks involved.¹⁹

Conclusion

The making of the Rules is a welcome development. The pro-active action of the Commission here is commendable because RAs and RASs are not yet widely available in Nigeria. Perhaps, to encourage the entry of RASs into the Nigerian market, the Commission may also consider the advice given by RASs as "fintech products" for the purposes of the recently-passed Regulatory Incubation Guidelines.²⁰ The Regulatory Incubation (RI) Programme established under those

¹⁵ Rules 11-13.

¹⁶ Rule 14.

¹⁷ Rule 15.

¹⁸ Rule 16.

¹⁹ Rule 17.

²⁰²⁰ See <https://sec.gov.ng/circular-on-the-sec-regulatory-incubation-program/> last accessed August 18, 2021.

Guidelines was conceived as an interim measure to aid the evolution of effective regulation to accommodate the innovations being introduced by FinTech players without compromising market integrity.

The RI Programme makes it possible for FinTech players to submit proposed innovations to the Commission for further consideration. If approved, the Commission will give guidance to the FinTech player on the applicable regulatory regime and regulatory requirements. The RI Programme offers Fintech Players an opportunity to grow their knowledge of the regulatory environment, and the Commission a platform to learn more about the Fintech sub-sector and its aspirations. The RI Programme should enable the Commission better to appreciate the nuances involved in the operations of RAs and update and revise the Rules as may be necessary or desirable.

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