CLIFFORD CHANCE

UNLOCKING THE PREDICTIVE POWER OF AI IN THE INVESTMENT MANAGEMENT INDUSTRY

— THOUGHT LEADERSHIP

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The fast-paced development of artificial intelligence (AI) presents increasing opportunities for the financial services industry. AI typically "learns" through data points that are fed into its system. Firms using AI-powered tools in the provision of financial services need to navigate the risks of using such technology, including ensuring that there is data integrity to mitigate against the risk of embedded biases within the system's decision-making process. Transparency and explainability are key to ensuring that AI decision-making processes can be clearly articulated to clients and regulators. This article considers the impact of the developing regulatory landscape in the EU and the UK on AI in financial services, focusing on the provision of investment advice and portfolio management services.

Key Points:

- Investment advice and portfolio management services are heavily regulated in the EU and the UK, including under MiFID2, which requires a suitability assessment.

- Robust systems and governance arrangements are essential when using AI in the provision of financial services such as investment advice and portfolio management services. AI-powered products and services should be reviewed regularly and be fit for purpose.

- Firms should monitor AI regulatory and market developments, including the passage of the new AI Act in the EU and the UK's proposal for a principles-based framework which will apply to the use of AI.

In an effort to create cost efficiencies and to streamline complex processes, financial services providers are increasingly exploring incorporating AI and machine learning techniques into their services.

Arguably, the most fundamental benefit of AI technology lies in its ability to analyse large pools of data for pattern recognition. For example, to identify trends and outliers, generate predictive analytics and spot anomalies. Generally, this can be used to identify opportunities, predict market movements and manage risk by adjusting strategies. Some firms are using or considering the use of AI technology to assist with the provision of investment advice or portfolio management due to the innate ability of AI to recognise patterns in market data, and we expect this to increase.

In the current environment, firms are unlikely to rely wholly on AI technology to provide investment advice or portfolio management services without any human intervention (particularly given that these are regulated activities in the EU and the UK). However, there appears to be a growing trend towards using AI for tasks which provide more of a support function in the overall service provision (such as analysing data sets to determine how to weight allocations in model portfolios or implementing trades).

The existing regulatory framework governing the provision of investment advice and portfolio management services in the EU and the UK is generally technology neutral, however regulators are increasingly focusing on how to regulate AI. In the EU, the new AI Act, which will specifically govern the use of AI in commercial contexts, has reached provisional agreement in trialogues, whereas the UK proposes cross-cutting principles rather than a separate piece of legislation.

We look forward to the developing landscape regulating the use of AI generally. However, until these measures become legally binding, the existing financial services regulatory framework provides a set of principles that must be complied with when deploying AI technology in the context of financial services. These may vary depending on the specific financial service in question.

MiFID2 and suitability requirements

One of the key pieces of legislation governing the provision of investment advice and portfolio management services in the EU and the UK is the regime implementing MiFID2[1]. This imposes various requirements on firms providing such services, notably including requirements to provide suitable

1. Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast).

personal recommendations to their clients or to make suitable investment decisions on their behalf. The suitability assessment is considered to be one of the most crucial conduct of business obligations which ensures investor protection. In summary, it requires firms to consider whether investment advice or discretionary investment decisions in the context of portfolio management meet the client's risk profile needs.

While there is no guidance specifically outlining the regulatory expectation for meeting the suitability requirements when using AI technology, the European Securities and Markets Authority (ESMA) issued guidelines in 2018 on the MiFID2 suitability requirements, including steps firms should take when offering robo-advice, which have also been adopted in the UK[2] . ESMA reminded firms to:

- **Implement appropriate systems and controls to ensure that tools used as part of the suitability process are fit for purpose and produce satisfactory results.** For example, risk-profiling software could include controls of coherence to highlight contradictions between different pieces of information collected.

- **Regularly monitor and test the algorithms that underpin the suitability assessment** to ensure consistency of any suitability assessment conducted through automated tools. Firms should ensure that there is appropriate system-design documentation setting out the purpose, scope and design of the algorithms, with decision trees or decision rules, where appropriate, in addition to clearly documenting the scope of algorithm testing.

- **Implement policies and procedures to manage any changes to algorithms,** including monitoring and keeping records of any such changes. This includes having security arrangements in place to monitor and prevent unauthorised access to the algorithms.

Many of these principles can be extended to AI-powered tools. This guidance is a helpful indicator of the approach that ESMA is likely to expect firms to adopt when using AI to provide investment advice or portfolio management services in a manner which is consistent with the suitability requirements in the absence of AI specific regulatory requirements. More generally, even after AI specific requirements are in place it is likely that ESMA and national competent authorities are going to apply existing principles to interpret and apply AI-specific requirements in the context of specific investment services and activities.

Other regulatory considerations

Firms must also consider a range of potentially applicable regulatory requirements when providing investment advice or portfolio management services, including:

- **Any applicable Senior Managers & Certification Regime (SM&CR):** In the UK, senior managers may be individually liable for actions taken by AI. Nikhil Rathi from the FCA has commented that: "*The [SM&CR] also gives us a clear framework to respond to innovations in AI. This makes clear that senior managers are ultimately accountable for the activities of the firm.*" This emphasis on individual liability may encourage firms to ensure that individuals retain ultimate decision-making powers when providing investment advice or portfolio management services or other AI-enabled financial services.

- **Operational resilience:** The use of AI will need to take into account the increasing regulatory focus on operational resilience in both the EU and the UK, including ensuring that management take accountability for the systems and technology used in providing services. Importantly, this may include having to put in place arrangements with any firm that is powering the AI tools so that relevant safeguards can be imposed contractually.

- **Data protection:** Firms must consider whether data retained and used by AI systems complies with data privacy legislation (including the General Data Protection Regulation).

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2 See ESMA Guidelines on certain aspects of the MiFID II suitability requirements (ESMA35-43-869)

- **Financial crime:** The FCA has noted that AI may present a risk in relation to financial crime; however, AI-powered tools also have the potential to mitigate against this risk. In this regard, the FCA has noted that regulators "*cannot prosecute a computer, but [they] can seek to prosecute the people who provided the governance over that computer*".

New regulatory considerations in the EU and the UK

The EU AI Act

Within the EU, the European Authorities have achieved consensus on the trialogue for their proposals regarding the AI Act, a legislative initiative set to exclusively cover AI. The political consensus reached on December 8 of 2023 marks a pivotal juncture in shaping the regulatory landscape for AI within the EU.

A fundamental aspect of this accord involves the formulation of regulations governing general-purpose AI models. The proposed framework employs a tiered system, prescribing rules that are universally applicable to all general-purpose AI models while introducing additional measures for those identified as posing systemic risks. This nuanced strategy recognises the varied applications of AI and seeks to address potential risks linked to advanced AI systems.

Broadly speaking, it is anticipated that the majority of AI applications within the realm of financial services will fall under the purview of general-purpose AI models, especially when they contribute to (instead of acting as the core source of) the provision of financial services.

It is imperative to note that the political agreement does not signify the culmination of the regulatory process. Additional work is necessary to finalise and ratify a comprehensive and consolidated text for the AI Act. The EU's progress on the AI Act reflects a thorough approach to AI regulation. By formulating rules, broadening prohibitions, and instituting governance, the EU positions itself as a responsible AI regulator. Committed to adapting, it addresses the dynamic AI landscape, promoting an environment conducive to ethical AI development.

UK proposals

In contrast to the EU's approach, the UK government has confirmed that there are no plans to introduce any AI-specific legislation or to put any AI principles on a statutory footing. The UK announced in an AI Regulation White Paper in March 2023 that the regulatory framework will be based on five cross-cutting principles to be "*issued on a non-statutory basis and implemented by existing regulators*", as follows:

1. Safety, security and robustness
2. Appropriate transparency and explainability
3. Fairness
4. Accountability and governance
5. Contestability and redress

Reconciling the regulatory requirements when deploying AI

Firms that use or produce AI-powered tools to provide financial services should consider the following questions:

- Who is responsible for the decisions that AI-powered tools make in providing the relevant financial service?

- Who is to be accountable for any mistakes made by the AI technology?

- Are there robust systems and checks in place in relation to the use of AI to protect systems, clients and the wider financial system?

The existing regulatory framework does not provide clear guidance on these questions. However, with regard to investment advice and portfolio management services, firms are nonetheless expected to document the governance arrangements which address these fundamental questions in relation to the use of AI technology.

We expect that when considering these principles, firms would be unlikely to have any appetite to give AI systems full autonomy or discretion to make investment decisions. Rather, we expect firms will develop solutions which use AI as a tool to aid the firm's decision-making processes, with individual financial advisers retaining their role as the primary decision-makers.

The potential transformative impact of AI on the investment management and investment advice industry is undeniable. However, a significant challenge lies in defining and characterising its role within this field. As the financial technology sector has rapidly evolved in recent decades, there arises a crucial question regarding the applicability of existing regulatory frameworks. While these conceptual challenges are not novel, they gain renewed relevance in the context of AI's integration into investment management practices.

The dynamic landscape of financial technology prompts a re-evaluation of regulatory frameworks designed in a pre-AI era. The adaptability and versatility of AI systems introduce complexities that traditional regulations may not fully address. The pivotal issue revolves around how to accurately classify and regulate AI's involvement for the provision of investment advice and in the context of discretionary portfolio management.

A precedent in the realm of technology and finance is found in the case of *Re Market Wizard Systems* [1998] 7 WLUK 260. This legal case confronted analogous questions when automated trading signals, generated by computer systems, were introduced. The judge in this case grappled with determining whether the automated system constituted the provision of investment advice. The conclusion was that investment advice could be provided through a computer system. However, the responsibility from a regulatory perspective was firmly with the firm that developed the system.

In approaching the matter of legality and regulation, the court engaged in a "balancing exercise." This involved a nuanced evaluation to determine how the regulatory framework could be applied judiciously to the computer system in question. The court's methodology was one of equilibrium, weighing the benefits and risks associated with the automated trading signals to arrive at a comprehensive understanding of its role within the existing regulatory context but then attributing this role to the person(s) standing behind the computer system.

Similarly, as AI-powered technology becomes increasingly prevalent in investment management, a comparable approach is likely to be adopted generally. The inherent complexities of AI systems necessitate a careful balancing of interests when considering their integration into the regulatory framework. The overarching goal is to strike a harmonious equilibrium that ensures that the benefits of AI in investment advice and discretionary investment management are harnessed while mitigating potential risks. However, the responsibility for the specific use of the AI technology and for ensuring that the relevant risks are being adequately mitigated lies at all times with the firm using it.

The balancing exercise entails a meticulous examination of various facets, including the nature of AI's role, the degree of autonomy in decision-making, and the implications for investors. Questions surrounding accountability, transparency, and ethical considerations add further layers to the regulatory discourse. By conducting this careful analysis, regulators can tailor the regulatory framework to accommodate the unique features and challenges posed by AI-powered technology in the investment management space.

In navigating the evolving landscape of AI in finance, the legal and regulatory frameworks must evolve in tandem. The lessons gleaned from past cases, such as *Re Market Wizard Systems*, serve as valuable guides in addressing the intricate questions surrounding the regulation of AI in investment management. As technological advancements continue to reshape the financial industry, regulatory bodies face the imperative of adapting to these changes, ensuring a balanced and effective framework that fosters

innovation while safeguarding the interests of all stakeholders. The journey ahead involves a judicious application of legal principles and a proactive approach to crafting regulations that align with the dynamic nature of AI-powered technology in the investment management sector.

Conclusion

In conclusion, the financial services industry is on the precipice of a transformative era, marked by the integration of AI-powered tools into its operational fabric. As firms embrace these technological advancements, a critical consideration becomes navigating the intricacies of regulatory frameworks and client expectations. While AI has the potential to revolutionise the industry, it also introduces novel challengesthat demand thoughtful examination

The set of questions surrounding responsibility, accountability, and the establishment of robust systems for AI-driven financial services remains a focal point for firms operating in this evolving landscape. The existing regulatory framework, while not providing explicit guidance on these matters, places an onus on firms to:

- document compliance with applicable rules;

- put in place governance arrangements; and

- ensure that the use of the AI technology does not affect the firm's ability to adequately mitigate risks.

It is evident that firms, particularly those providing investment advice and portfolio management services, are expected to maintain control and oversight over AI systems. The notion of granting full autonomy to AI in making investment decisions appears unlikely, with firms expected to leverage AI as a tool to augment decision-making processes. The human element, embodied by financial advisers, is expected to retain a primary role in decision-making, ensuring a balanced and responsible approach.

Looking ahead, the journey involves the alignment of legal principles and a proactive approach to crafting regulations that adapt to the dynamic nature of AI-powered technology. The AI Act and similar legislative texts will be crucial in determining the path forward.

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