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 @InvAssoc  @The Investment Association

26 October 2020

Dear Alp,

**RE: Public Comment on the use of artificial intelligence and machine learning by market intermediaries and asset managers**

The Investment Association (IA) welcomes the opportunity to comment on these proposals.

This consultation arrives at an opportune time as we witness the growth in adoption of Artificial Intelligence (AI) and Machine Learning (ML) within the investment management industry. We broadly agree with the proposals outlined and particularly their proportionality and outcomes-based nature. We would however support a more technology neutral approach in line with the UK and European regulators and a focus on creating good outcomes for investors.

We hope that this feedback is useful and would welcome further involvement in future discussions on this topic.

Yours sincerely



John Allan  
Senior Operations Specialist



## IA Response to IOSCO Consultation on the use of AI and ML by market intermediaries and asset managers

### About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 43% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

### Executive summary

In the wake of the recent COVID-19 pandemic and the subsequent acceleration in interest in and adoption of new technologies, this consultation comes at an opportune time.

We welcome the proposed non-binding guidance seeking to assist in providing appropriate regulatory frameworks in the supervision of investment managers when adopting AI and ML and in particular the emphasis on taking an outcomes-based, and proportionate approach.

We support the development of a regulatory AI and ML framework to protect and provide transparency to investors that can be adopted across jurisdictions and aid cohesion and an alignment of aims amongst international supervisory authorities. This may help expand the use of the technology for the benefit of investors given that some firms have opted to not use, or limit their use of AI and ML until the regulatory framework becomes consistent globally, or clearer domestically.

We would caution against focusing too much on the technology rather than outcomes for investors, and also the prospect of a prescribed senior management function, which could jeopardise existing clear lines of functional responsibility.

We also note that there is a notable absence of a reference to data ethics in this consultation. Whilst the nebulous nature of this concept is not something that should be explicitly regulated, it is an important consideration for firms to ensure the proper and ethical use of data when implementing AI solutions.



## Answers to selected questions

### 1. Do you agree with the proposed definition of AI and ML?

Yes – we agree with the definitions as they cover the various nuances of AI application, which can be simple or more sophisticated. We likewise agree that ML is a subset and a specific application of AI that harnesses inductive reasoning.

### 2. Do you see any risks or challenges around AI and ML which are not mentioned in the report?

The report provides a comprehensive overview of the risks as they are currently understood, and as they relate to known use cases. However, as AI and ML usage remains at a nascent stage we should be prepared to address new, or adapted, risks that cannot always be foreseen if new use cases are developed or as new forms of interconnectedness emerge.

We should be alive to the concentration risks in a crowded AI/ML provider market and where there is a scarcity of expertise. The ECB refer to this in their response to the European Commission's FinTech Action Plan, noting that as resource constraints can restrict firms from developing their AI capability in-house, there is a general reliance on third parties which come with their associated outsourcing risks.<sup>1</sup>

The report contains a finding that most firms rely on existing governance arrangements when implementing AI and ML. We agree that this is generally the case and maintain that in most cases is the appropriate course of action; creating a new set of governance arrangements risks creating inconsistency and it is preferable to concentrate on the outcomes rather than process. There are challenges around understanding and technical expertise, but AI and ML is not a unique case in that respect and firms should be allowed to retain governance consistency as long as clear responsibilities and accountability are well documented.

### 3. Do you agree that the guidance set out in Chapter 6 of the Consultation Report is appropriate to address the potential risks associated with the general use of AI and ML by market intermediaries and asset managers? If not, please provide details.

Overall, we welcome the non-binding nature of the guidance and the emphasis on proportionality according to the complexity of the activity, risk profiles, and the potential impact that the technology has on client outcomes and market integrity, rather than firm size. We will now comment on each of the measures in turn.

#### *Measure One - Governance*

The governance of AI and ML is very important, as is any other part of the business. Senior management should have oversight over the development, testing, deployment, monitoring and controls of AI and ML and are accountable for the outcomes of the AI and ML models. It is important that senior management are equipped with appropriate technical knowledge required to effectively oversee the firm's use of AI and ML techniques, and in many cases, as in some other matters too where they do not have such knowledge, they should designate appropriate senior personnel within the firm to support them in discharging this oversight role while retaining ultimate accountability. Likewise, it is important that firms understand the data being used to train their algorithms to be able to

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<sup>1</sup> ECB: [Consultation Response to FinTech Action Plan](#), August 2020



identify and mitigate potential errors and biases. Firms that are well advanced with AI and ML will already have these arrangements in place to some extent.

On the suggestion that there should be a formal requirement for a designated senior manager, we believe that there is a risk that introducing these type of technology-specific measures may lead to a slippery slope where we regulate processes and technologies more closely than the actual outcomes delivered. In nearly all use cases, there will be an existing senior manager designated for the function, and any use of AI or ML within that function would be the responsibility of that role holder. If we instead designate an SMF<sup>2</sup> (in the UK) for AI and ML more generally, the lines of accountability may instead become less clear as they will overlap with function-based responsibilities. If we assume for one moment that the senior manager will not be a technical expert and is being supported by a team of individuals with the relevant skill set and knowledge, then they could be the resource available to each relevant SMF to understand how the function they are responsible for is being delivered. Moreover, as the use of AI permeates many different aspects of the business as well as the fact it can be used in a variety of simple or complex forms, it may be that in the future it would simply not be feasible for an individual to have oversight for its implementation across a global firm for instance.

#### *Measure 2: Testing and Monitoring*

This risks around a misbehaving or misunderstood algorithm are significant and can cause widespread disruption especially if unnoticed for a period of time because, for example, a subtle change has taken effect. We therefore support the proposed measure that firms should adequately test and monitor algorithms on an ongoing basis to ensure that they behave as expected in both stressed and unstressed market conditions and in full compliance with regulatory obligations.

Firms will typically have these measures in place already for technology deliveries and would not necessarily require new measures to be established. Firms are best placed to determine what type of changes would constitute a 'material change' and in these cases should specifically re-run the tests against the new environment, along with ongoing monitoring and testing.

#### *Measure 3: Adequate Skills and Expertise*

Continuing with the theme from our answer to Measure One, we would emphasise that the oversight and supervision of AI and ML should focus on the outcomes delivered, with the key focus being on a comparison of automated output against output delivered manually or otherwise without utilising AI or ML. We do agree that it is important to have the adequate skills, expertise and experience to develop, test, deploy, monitor and oversee the use of AI and ML within front line, compliance, risk management and senior management staff.

#### *Measure 4: Third Party Providers*

We agree that firms should have a clear service level agreement and contract with all third party service providers outlining the scope and responsibility of the provider as well as clear performance indicators.

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<sup>2</sup> Firms subject to the FCA regime are currently required to appoint an SMF for 'algorithmic trading'. This generally is a siloed function. Our comments relate to the wider use of AI and ML within investment firms which cross functional lines and where the application of a new or expanded SMF role may jeopardise the existing clear lines of accountability.



As we explain in our recent response to the updates to IOSCO's *Principles on Outsourcing*<sup>3</sup>, there are certain limitations when relying on contracts to manage outsourced relationships. Firms may have little leveraging power to negotiate such contracts which can be particularly amplified in a concentrated market. However, at present at least, this is less of a concern in this area than in some others, and of course we can expect many providers to be responsive to negotiating outsourcing agreements as a matter of professionalism. It should also be noted that as data sharing arrangements are crucial to the proper functioning of AI-based tools, it is important that there are adequate data protection provisions in place when sharing data with third party AI services.

#### *Measure 5: Disclosure*

Many firms already disclose meaningful information to their clients in a comprehensible format regarding their use of AI and ML solutions, as an aid to transparency and maintaining consumer trust. It is helpful that IOSCO shed some light on what 'meaningful information' would reasonably constitute, enabling clients to understand the nature of, and key characteristics of the products and services that they are receiving, and how they are impacted by the use of the technology.

It is useful to additionally consider the appropriate level of disclosure to clients based on the materiality or criticality of where and how AI is being applied; for example, a minor back-office use for the purposes of automating reconciliations or similar functions may not be relevant.

It is also important to distinguish between the types of information firms should share with regulators and other stakeholders compared to the level of transparency available to clients. We note that the text below the Measure does not explicitly reference disclosure to regulators and so there is a grey area here that should be clarified. We would again be concerned if regulators decided to regulate the technology itself rather than the outcomes delivered to clients, but understand that transparency and explainability are key components to the supervisory process.

#### *Measure 6: Data Quality*

Ensuring quality data inputs for AI and ML models remains important to prevent biases and inaccurate results, particularly as the underlying data is crucial to how the technology functions. This issue is also being addressed by the UK's Information Commissioner's Office (ICO)<sup>4</sup> who have provided a checklist for firms to help them collect and pre-process their data in an explanation-aware manner.

Mitigating against bias and unfair discrimination is an important risk to manage particularly regarding the use of predictive machine learning algorithms. In the UK we have welcomed recent work on helping firms increase transparency and the explainability of AI models by the FCA and Alan Turing Institute<sup>5</sup> and the ICO<sup>6</sup>.

#### **4. Do you disclose information to customers / clients on the use of AI and ML? If yes, please indicate what kind of information is disclosed.**

N/A

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<sup>3</sup> IA: [IOSCO Principles of Outsourcing response](#) September 2020

<sup>4</sup> ICO & Alan Turing Institute: [Explaining Decisions Made With AI](#) May 2020

<sup>5</sup> FCA & Alan Turing Institute: [AI transparency collaboration](#) 2020

<sup>6</sup> Ibid



## **5. What factors do you need to take into account when considering the appropriate level of information that should be disclosed to clients (including prospective clients) and other relevant stakeholders around the firm's use of AI and ML algorithms?**

To determine the appropriate level of disclosure of AI and ML algorithms, firms need to assess what information is relevant to the stakeholder in question. For instance, a client will likely need less detailed information than a regulator regarding the performance of an algorithm.

Client disclosure needs to be comprehensible and with an accurate portrayal of the circumstances relevant to them. We have had recent discussions with the FCA and the Alan Turing Institute<sup>7</sup> on this point. A first step is to identify the stakeholder in question and then consider the relevant information to present to them. It can be helpful to make a distinction between model (information that helps stakeholders understand model behaviour) and process transparency (information about the processes of system development and deployment) when considering what is 'relevant'. Although it should be noted that sometimes both types of information can be useful. There are consistencies with the discussions that would take place between a potential client and a firm on, for example, the investment process and how decisions are made by a portfolio manager. The client's needs would be assessed and the relevant information provided; the same follows in the provision of information about an AI or ML application.

There is a well-made argument for tailoring transparency to the use case where particular types of information may need to be accessible when dealing with some use cases but not when dealing with others.

## **6. How do you consider and apply proportionality to your systems and controls over the use of AI and ML?**

N/A

### **Further information**

For further information, please contact: [John Allan](#) on 020 7831 0898.

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<sup>7</sup> Ibid