Published on *The National Law Review* https://natlawreview.com

SEC Weighs In on Robo-Advisers: Disclosure, Suitability, and Compliance Obligations

Article By:

Steven W. Stone

The SEC’s Guidance recognizes that robo-advisers are fiduciaries, and provides suggestions on how they can meet the substantive requirements of the Investment Advisers Act of 1940.

On February 23, 2017, the ***US Securities and Exchange Commission’s*** (SEC’s) Division of Investment Management (IM) released IM Guidance Update 2017-02 (Guidance),[1] which focuses on “robo-advisers,” or investment advisers that use technology to provide discretionary asset management services to clients through online algorithmic-based programs. The Guidance focuses on three key areas: disclosure, suitability, and compliance programs. It highlights various considerations that robo-advisers should keep in mind as they seek to meet their legal obligations under the Investment Advisers Act of 1940 (Advisers Act).

The Guidance focuses on robo-advisers that provide services directly to clients online, but the SEC staff notes that it may be helpful for other types of robo-advisers as well as other registered investment advisers that use algorithms or digital tools when formulating advice or monitoring client accounts. The Guidance was released simultaneously with an Investor Bulletin issued by the SEC’s Office of Investor Education and Advocacy, which aims to educate individual investors about robo-advisers and help them decide whether to use robo-advisers to meet their investment goals.[2]

The Guidance follows on the heels of increased SEC activity around fintech and digital investment advice. On November 14, 2016, the SEC held a Fintech Forum that included a panel discussion about digital investment advice. More recently, on January 12, 2017, the SEC’s Office of Compliance Inspections and Examinations (OCIE) released its Examination Priorities for 2017 (the Examination Priorities), which noted that this year OCIE will examine both robo-advisers that primarily interact with their clients online and advisers and broker-dealers that leverage automated investing functions as one component of a service model that provides access to human financial professionals.[3]

Our Perspective

- The Guidance confirms that robo-advisers registered with the SEC are subject to both the substantive requirements and the fiduciary obligations of the Advisers Act, even in the case of robo-advisers with more limited business models. This should eliminate any uncertainty, raised by some critics, as to whether robo-advisers are able to meet fiduciary standards and whether the existing regulatory framework is flexible enough to accommodate the robo-adviser business model.

- The SEC staff takes a flexible, rather than one-size-fits-all, approach, emphasizing that robo-advisers have a wide variety of business models and offer a range of advisory services, and consequently may have a “variety of means” to meet their regulatory obligations. In doing so, the SEC staff validates the concept that robo-advisers may define and limit the scope of the advisory services they provide.

- In the area of suitability and client profiling, the Guidance clarifies that there is no quantitative test as to the minimum number of questions or list of factors that a robo-adviser must consider in order to build an appropriate client profile and provide an investment recommendation. Rather, the robo-adviser must collect sufficient information to conclude that its initial recommendations and ongoing advice are suitable and appropriate for a particular client based on the client’s financial situation and investment objectives, presumably as such concepts are applied in the context of the robo-adviser’s business.

- The Guidance does not substantively address how robo-advisers may meet their obligations under Investment Company Act Rule 3a-4, which provides discretionary investment advisory programs with a nonexclusive safe harbor from the definition of an “investment company” (e.g., a mutual fund). However, the SEC staff did remind robo-advisers to consider their obligations under Rule 3a-4 and other federal securities laws, and it encouraged robo-advisers to contact the SEC staff for further guidance if they believe that their organizations and operations raise unique facts or circumstances “not addressed” by Rule 3a-4.

- A number of the SEC staff’s disclosure recommendations relate to the use of algorithms by robo-advisers. While we understand the SEC staff’s emphasis here, the concept of an “algorithm” is very broad, and disclosure regarding the use of technology has not historically been a topic of SEC guidance. We note that the use of algorithms is arguably not any more significant for digital advisers than for traditional advisers, which have long relied on technology in formulating and delivering investment advice. One might just as well question whether the failure to use technology to develop investment advice should be disclosed as a material risk in today’s world. Disclosure regarding the use and limitations of algorithms should, in any event, depend on whether the use of such algorithms is material to the investment adviser’s decisionmaking process.

- We expect that the recommendations in the Guidance will be incorporated into OCIE’s exam module for robo-advisers. Because the SEC staff’s views are offered in the form of recommendations that firms might consider, we would hope that the OCIE exam staff will not apply each of the recommendations to all robo-advisers and cite for deficiencies any adviser who does not follow all of the SEC staff’s recommendations. In this regard, firms may wish to consider the SEC staff’s recommendations and, as part of their annual Rule 206(4)-7 reviews or Form ADV annual updating amendments, document which of the recommendations in the Guidance they adopt and the rationale for why the other recommendations were determined to be inapplicable to their business models.

- While the recommendations in the Guidance are thoughtful and provide useful suggestions for robo-advisers, the SEC staff’s recommendations are not legal obligations and do not represent the views of the Commission. It is important to recognize that the SEC staff’s disclosure recommendations do not have the force of law and do not necessarily give rise to disclosure obligations under Advisers Act Section 206 or Form ADV. For instance, a number of the disclosure areas referenced by the SEC staff relate to business practices that are not required to be disclosed by Section 206 or Form ADV unless they present material conflicts of interest. Consequently, while it is certainly a matter of best practices for robo-advisers and other advisers that use automated investment tools to consider these topics when formulating disclosures, the failure to address any of the SEC staff's points should not be viewed as a per se breach of fiduciary duty under Advisers Act Section 206.

Substance of Disclosures

The SEC staff observes that because client relationships with robo-advisers may occur with limited, if any, human interaction, a client's decision about whether to enter into or continue an investment advisory relationship may depend solely on disclosures that are delivered through electronic media. This, combined with the prominent role that technology plays in determining and delivering investment advice, led the SEC staff to suggest that robo-advisers should be thoughtful about the most effective way to explain their business models and the scope of advisory services they provide, as well as the associated risks and limitations. Below is a list of the SEC staff's recommendations with respect to disclosures, accompanied by our observations:

Methodology and Services	That an algorithm is used to manage individual client accounts. *Most every investment adviser relies on technology to some degree to manage individual client accounts. Accordingly, we believe the SEC staff's recommendations were likely designed to address situations where algorithms actually generate investment recommendations or decisions.* How algorithmic functions are used to manage client accounts. *It seems reasonable that advisers who use hundreds of algorithmic and other technology functions to manage accounts would not be expected to disclose each algorithm and its use in managing client accounts, unless it were material to an adviser's investment recommendations.* The assumptions and limitations the algorithm used to manage client accounts. *Note that robo-advisers should only be required to disclose to clients the material assumptions and limitations of an algorithm. Many if not all of these assumptions and limitations may already be disclosed through the robo-adviser's website and user interface, to the extent they include a discussion of the firm's investment methodology.* The degree of human involvement in the oversight and management of individual client accounts. How and when a client should update information he or she has

	provided to the robo-adviser.	
Risks and Limitations	The particular risks inherent in the use of an algorithm to manage client accounts (e.g., that the algorithm might rebalance client accounts without regard to market conditions or more frequently than the client might expect). *Note that robo-advisers routinely rebalance client portfolios based on parameters that are unrelated to market conditions. The parameters, which should be referenced in the adviser's disclosure, are generally established by the adviser and implemented by the algorithm.* The particular circumstances that might cause the robo-adviser to override the algorithm used to manage client accounts (e.g., that the robo-adviser might halt trading or take other temporary defensive measures in stressed market conditions). *Although there has been substantial confusion in the robo-adviser space over this point, robo-advisers do not "halt trading" in securities. Rather, they exercise their discretion as to when to place orders on behalf of client accounts. Robo-advisers should consider whether their disclosures clearly explain their brokerage practices, including in the context of stressed market conditions, but robo-advisers are no different from any other discretionary investment adviser that has the ability to determine when to trade on behalf of client accounts.* How the robo-adviser uses information gathered from a client to generate a recommended portfolio, and any limitations. *Traditional and robo-advisers both rely on static questionnaires that form the primary, if not sole, basis for the adviser's investment recommendations. From a suitability perspective, we continue to recommend that robo-advisers document the basis on which they have made the determination to select particular factors or questions that they incorporate into their online questionnaires, particularly if such questionnaires are very limited in nature. Ideally, the use of particular factors or questions is tied to a particular investment rationale.*	
Conflicts	Any involvement by a third party in the development, management, or ownership of the algorithm used to manage client accounts, including an explanation of any conflicts of interest that such an arrangement may create. *In addressing this disclosure point, firms that rely on private-label solutions should consider the extent to which third-party robo-advisers are involved in their digital offerings. If the third-party robo-advisers are actively involved in providing investment advisory services and dictating the investment options for client accounts (which may include their own proprietary products), firms should*	

	consider the conflicts of interest that this presents.
Costs	Any fees that the client will be charged directly by the robo-adviser and any other costs that the client may bear either directly or indirectly. *This disclosure is already expressly required under Form ADV.*

The SEC staff further observes that robo-advisers should take care to avoid creating a "false implication" about the scope of the services they provide. The SEC staff notes that a robo-adviser could mislead clients by implying, for example, that (i) it is offering a comprehensive financial plan, where the robo-adviser's advice is only targeted to meet a specific financial goal; (ii) a tax-loss harvesting service also provides comprehensive tax advice; or (iii) the algorithm considers information outside of a questionnaire when generating investment recommendations, if such information is not actually considered.

Presentation of Disclosures

The Guidance also takes a pragmatic approach of reminding robo-advisers to consider whether their disclosures are "effective"—meaning that they are not buried or incomprehensible. In particular, the SEC staff recommends that robo-advisers consider the following:

Timely	Whether key disclosures are presented prior to the sign-up process so that information necessary to make an informed investment decision is available to clients before they engage or make investments with the robo-adviser.
Prominent	Whether key disclosures are specially emphasized (through design features such as pop-up boxes).
Comprehensive	Whether disclosures are accompanied by interactive text or other means to provide additional details to clients who are seeking more information (e.g., through tool-tips or FAQs).
Adapted	Whether alternate channels are considered in presenting and formatting disclosures (e.g., disclosures made on a mobile platform are appropriately adapted).

Given the emphasis on the content and placement of disclosures, we would recommend that robo-advisers revisit the disclosures contained in their Forms ADV and user interfaces.

Providing Suitable Advice

The Guidance also reinforces the principle that as fiduciaries, robo-advisers have an obligation to make a reasonable determination that the investment advice they provide is suitable for a client based on the client's financial situation and investment objectives.

The SEC staff observes that many robo-advisers provide investment advice based primarily, if not solely, on client responses to online questionnaires. According to the SEC staff, in addition to varying in length and the types of information sought, many of the questionnaires do not provide clients the opportunity to give additional information or context about their responses. Consequently, the SEC staff recommends that robo-advisers take their suitability obligations into account when designing questionnaires, and consider the following:

Sufficiency	Whether the questions elicit sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on his or her financial situation and investment objectives. *We note that we assume the SEC staff is interpreting the concept of "financial situation and investment objectives" within the context of a robo-adviser business. For example, most robo-advisers rely on goals-based wealth management, which does not require a client to define an investment objective for each account, and information about a client's financial situation may be limited to retirement savings or annual income.*
Clarity	Whether the questions are sufficiently clear and the questionnaire is designed to provide additional clarification or examples to clients when necessary (e.g., through interactive text, pop-up boxes, or FAQs).
Consistency	Whether steps have been taken to address inconsistent client responses, such as design features that alert clients when their responses appear internally inconsistent and suggest that the clients may wish to reconsider their responses; and systems that automatically flag apparently inconsistent information provided by clients for review or follow-up by the robo-adviser.

Implementation of an Effective Compliance Program

The Guidance also emphasizes that a robo-adviser's internal compliance program, as required by Advisers Act Rule 206(4)-7, should address the unique aspects of the robo business model. These include the robo-adviser's reliance on algorithms, limited human interaction with clients, and provision of online advisory services. As a result, robo-advisers should consider whether to adopt and implement written policies and procedures that address the following:

Testing	The development, testing, and back testing of the algorithm, and postimplementation monitoring of the algorithm's performance, in order to ensure that • the algorithm is adequately tested before, and periodically after, it is integrated into the robo-adviser's platform; • the algorithm performs as represented; and • any modifications to the code would not adversely affect client accounts.
Suitability	The design and content of questionnaires and consideration of how the information the robo-adviser obtains from clients support the suitability of initial recommendations and ongoing investment advice.
Algorithm Modifications	Disclosure to clients of changes to the algorithmic code that may materially affect their portfolios. *We note that the materiality threshold is critical here. There may be a whole range of "changes," including those resulting from routine maintenance, testing, and system enhancements that might not*

	materially affect the management of client portfolios. Disclosure should not be viewed as an impediment to enhancing or correcting code.
Oversight	Appropriate oversight of any third party that develops, owns, or manages the algorithm or software modules. *This concept should be incorporated into the robo-adviser's vendor management and, depending on the relationship with the third party, supervisory procedures.*
Cybersecurity and Privacy	Prevention and detection of, and response to, cybersecurity threats, and protection of client accounts and key advisory systems.
Marketing	Use of social and other forms of electronic media in connection with the marketing of advisory services (e.g., websites, Twitter, compensation of bloggers to publicize services, and "refer a friend" programs).

Investor Bulletin

The Investor Bulletin concentrates on a number of considerations retail investors should take into account when deciding whether to invest with a robo-adviser. These include the following:

- The level of interaction that an investor will have with a robo-adviser, and how the form and amount of this interaction will differ from what the investor would experience with a traditional adviser.
- The extent of the robo-adviser's consideration of the investor's personal financial circumstances, and whether the investor's investment objectives are goal specific.
- How the robo-adviser develops portfolio and investment recommendations, and the limitations associated with the robo-adviser's approach to investing.
- The use of tax-loss harvesting and its value and application to the investor's particular tax circumstances.
- The total fees and costs associated with investing through the robo-adviser.

---

[1] US Securities and Exchange Commission, Division of Investment Management, "Robo-Advisers," IM Guidance Update No. 2017-02 (Feb. 2017).

[2] US Securities and Exchange Commission, Office of Investor Education and Advocacy, Investor Bulletin: Robo-Advisers (Feb. 23, 2017).

[3] According to the Examination Priorities, examinations of such entities will focus on their compliance programs (including compliance practices for overseeing algorithms that generate investment advisory recommendations), marketing, the formulation of investment recommendations, data protection, and disclosures relating to conflicts of interest.

National Law Review, Volume VII, Number 73