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Rise of the Machines: SEC Issues Guidance on Robo-Advisers

Genna Garver and Zach Davison*

This article explains a recent Guidance Update issued by the Securities and Exchange Commission, which contains suggestions on how a robo-adviser might address the substance and presentation of its disclosures to clients about the robo-adviser's services, the obligation to obtain sufficient information from clients to provide suitable advice, and the adoption and implementation of an effective compliance program tailored to providing automated advice.

The Securities and Exchange Commission's ("SEC") Division of Investment Management recently published a Guidance Update[1] examining how the growing industry of automated advisers—or "robo-advisers" as they have been colloquially termed—can meet their obligations under the Investment Advisers Act of 1940 ("Advisers Act") with limited human interaction. The Guidance Update comes on the heels of the FinTech Forum[2] held by the SEC last November to ensure regulation keeps pace with these rapidly evolving innovations. At the FinTech Forum, the SEC acknowledged that technology innovation is transforming key aspects of the securities industry, creating new challenges and opportunities for market participants and regulators alike that will require a coordinated response with a holistic view. In furtherance of the input received at the FinTech Forum and from monitoring and engaging with robo-advisers, the Guidance Update offers suggestions from the Investment Management Staff (the "Staff") on how a robo-adviser might address: (1) the substance and presentation of its disclosures to clients about the robo-adviser's services; (2) the obligation to obtain sufficient information from clients to provide suitable advice; and (3) the adoption and implementation of an effective compliance program tailored to providing automated advice.

SUBSTANCE AND PRESENTATION OF DISCLOSURES

Concerning a robo-adviser's disclosure obligations, the Staff reiterated the need to make full and fair disclosure of all material facts and to use reasonable

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[1] https://www.sec.gov/investment/im-guidance-2017-02.pdf.

[2] https://www.sec.gov/news/statement/white-opening-remarks-fintech-forum.html.

care to avoid misleading investors. In fulfilling its obligation to provide sufficiently specific information such that an investor can understand a robo-adviser's business model, the Staff suggests an augmented discussion about how the particular algorithm being employed works, and what the limits of that algorithm are. Specifically, the Staff recommends that a robo-adviser disclose the following types of information:

- A statement that an algorithm is used to manage individual client accounts;
- A description of the algorithmic functions used to manage client accounts (*e.g.,* that the algorithm generates recommended portfolios; that individual client accounts are invested and rebalanced by the algorithm);
- A description of the assumptions and limitations of the algorithm used to manage client accounts (*e.g.,* if the algorithm is based on modern portfolio theory, a description of the assumptions behind and the limitations of that theory);
- A description of 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 on a more frequent basis than the client might expect; that the algorithm may not address prolonged changes in market conditions);
- A description of any 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);
- A description of 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 such an arrangement may create (*e.g.,* if the third party offers the algorithm to the robo-adviser at a discount, but the algorithm directs clients into products from which the third party earns a fee);
- An explanation of any fees the client will be charged directly by the robo-adviser, and of any other costs that the client may bear either directly or indirectly (*e.g.,* fees or expenses clients may pay in connection with the advisory services provided, such as custodian or mutual fund expenses; brokerage and other transaction costs);
- An explanation of the degree of human involvement in the oversight and management of individual client accounts (*e.g.,* that investment

advisory personnel oversee the algorithm but may not monitor each client's account);

- A description of how the robo-adviser uses the information gathered from a client to generate a recommended portfolio and any limitations (*e.g.,* if a questionnaire is used, that the responses to the questionnaire may be the sole basis for the robo-adviser's advice; if the robo-adviser has access to other client information or accounts, whether, and if so, how, that information is used in generating investment advice); and
- An explanation of how and when a client should update information he or she has provided to the robo-adviser.

Beyond these categories of information, a robo-adviser should carefully describe the scope of its advisory services such that investors can fully understand the restrictions of the adviser's business model, the information being utilized in the model, and the advice being provided by the model. Robo-advisers should be careful not to mislead clients by implying the adviser is, if it in fact is not doing so, providing a comprehensive financial plan, providing tax advice, or using information other than that collected by the questionnaire to determine recommendations. The Staff also recommends that robo-advisers determine the most effective way to present their disclosures so that investors can effortlessly digest and understand the information being presented. For example, robo-advisers may wish to provide disclosures prior to the sign-up process, emphasize key disclosures through the use of pop-up boxes, accompany disclosures with interactive text, and provide an FAQ section for more detailed information.

OBTAINING INFORMATION TO PROVIDE SUITABLE ADVICE

The Staff further confirmed that unique issues exist relating to a robo-adviser's duty to provide suitable investment advice in its client's best interest. In meeting suitability obligations, the Staff urges advisers to closely consider their client questionnaires to determine whether the questions elicit necessary information, are sufficiently clear and understandable, and evoke steps that can be taken to properly address inconsistent client responses. It seems clear that a traditional questionnaire used in proffering human investment advice may be insufficient in the robo-adviser context where personnel may be unavailable to request clarification or seek additional information from the client. In situations where a client chooses a portfolio other than the one recommended, a robo-adviser should be prepared to provide commentary (*e.g.,* by using pop up boxes or client alerts) on why the chosen portfolio is more suitable for a given investment objective and risk profile.

EFFECTIVE COMPLIANCE PROGRAMS

In constructing an effective compliance program, the Staff noted that a robo-adviser should be attentive to the unique aspects of its business model—which may be entirely foreign to a given investor. To be sure, many compliance programs designed for traditional investment advisers may no longer be effective for an algorithm-based robo-adviser. Compliance policies and procedures should address risks relating to the robo-adviser's reliance on algorithms (*e.g.,* ensuring adequate testing and monitoring the algorithmic code), the limited human interaction with clients (*e.g.,* ensuring the adequacy of the questionnaire and disclosures), and the provision of services over the internet (*e.g.,* preventing and detecting cybersecurity threats, use of electronic media, and protection of client accounts). Failing to closely criticize an existing compliance program's applicability to a robo-adviser's unique model could lead to significant deficiencies down the road.

CONCLUSION

In sum, the Staff urges robo-advisers to closely scrutinize their obligations under the Advisers Act in developing cost-effective access to investment advice catered to a larger segment of the public. Alongside this Guidance Update, the SEC's Office of Investor Education published a corresponding Investor Bulletin[3] outlining a near-identical set of issues, and urging investors to carefully assess the potential risks and benefits of using a robo-adviser. To that end, advisers should be prepared to field specific questions about their business models, including but not limited to the level of human interaction provided, the type of information being gathered and applied, the investment approach, and the associated fees and costs of the program. It is likely that robo-advisers will be faced with these types of questions in the near future, especially in light of the enormous growth portended by the SEC for a larger and more diversified client base seeking out online investment advisory services. Beyond client inquiries, advisers should comprehensively assess the challenges touched on in the FinTech Forum and expanded on in the Guidance Update in light of the SEC's ongoing focus in this area.

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[3] https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-robo-advisers.