

US securities and exchange commission's division of investment management issues guidance regarding robo-advisers

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Abstract

Purpose – To explain a guidance update issued in February 2017 by the staff of the Division of Investment Management (Staff) at the US Securities and Exchange Commission (SEC) on how robo-advisers may meet their disclosure, suitability and compliance obligations under the Investment Advisers Act of 1940 (Advisers Act).

Design/methodology/approach – Examines the update's guidance on three areas – the substance and presentation of disclosures, the provision of suitable investment advice, and the adoption and implementation of effective compliance programs – and then raises practical considerations for robo-advisers.

Findings – The update reflects the Staff's increasing concern about the potential risks of the robo-adviser platform and provides a listing of key issues that the SEC's Office of Compliance Inspections and Examinations (OCIE) – which recently added "electronic investment advice" as a new focus for its 2017 examinations – may zero in on when examining robo-advisory firms.

Practical implications – Robo-advisers should carefully review the Staff's update to evaluate whether their firms' operations address the guidance.

Originality/value – Practical advice from experienced securities regulatory lawyers.

Keywords United States, Securities and Exchange Commission (SEC), Office of Compliance Inspections and Examinations (OCIE), Compliance, Electronic investment advice, Robo-advisers

Paper type Technical paper

On February 23, 2017, the staff of the Division of Investment Management ("Staff") at the US Securities and Exchange Commission ("SEC") issued a guidance update (IM Guidance Update No. 2017-02 or the "Update") reflecting the Staff's suggested guidance as to how robo-advisers may meet their disclosure, suitability and compliance obligations under the Investment Advisers Act of 1940 (the "Advisers Act")^[1]. The Staff recognizes that robo-advisers – investment advisers that use algorithmic and other technology-based programs to provide clients with discretionary asset management services – face unique challenges in complying with their fiduciary requirements under the Advisers Act given their limited human and typically online delivery of investment advice^[2]. In fact, the SEC's Office of Compliance Inspections and Examinations ("OCIE") recently added "electronic investment advice" as a new focus area for its 2017 examination priorities^[3]. The Update reflects the latest chapter in the Staff's increasing concern

regarding the robo-adviser platform and the potential risks of this alternative advisory business model.

The Update provides guidance for robo-advisers, focusing on three areas identified by the Staff:

1. The substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers;
2. The obligation to obtain information from clients to support the robo-adviser's duty to provide suitable advice; and
3. The adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated advice[4].

Substance and presentation of disclosures

Registered investment advisers must provide full and fair disclosure of all material facts (including conflicts of interests) concerning the advisory services provided to clients so that clients can make informed decisions about whether to enter into or continue an investment advisory relationship with the adviser[5]. Because robo-advisers generally provide their investment advice to clients through electronic means (e.g., email, websites, mobile applications and other electronic mediums), the Staff believes that robo-advisers may encounter certain unique issues when providing clients with appropriate disclosures regarding the limitations, risks and operational aspects of the robo-adviser's services[6]. Because a robo-adviser's clients generally receive investment advice through an online platform, rather than from a natural person, the Staff suggested that robo-advisers consider the following when designing their disclosures:

- how they explain their business model;
- how they describe the advisory services that they offer; and
- how they present the information to clients[7].

Each of these considerations is further discussed below.

Explanation of the business model

The Staff identified the following items that robo-advisers should consider disclosing to clients (in addition to other required information) when explaining their business model and related risks. Many of these items center around the algorithm or investment process/model that the robo-adviser may use to manage client accounts. The robo-adviser should:

- State that an algorithm is used to manage client accounts.
- Describe the functions associated with the algorithm. For example, a robo-adviser could explain in greater detail that an algorithm generates recommended portfolios based on information provided by the client and that the client's accounts are invested and rebalanced by the algorithm.
- Describe the assumptions and limitations of the algorithm. For example, if an algorithm is based on modern portfolio theory (e.g., a portfolio's expected return is maximized for a given level of risk), the robo-adviser should describe the assumptions behind, and any associated limitations with, such theory so that clients are better informed of the basis behind the algorithm.
- Describe the particular risks that are inherent in the use of an algorithm. For example, a robo-adviser might disclose that the algorithm could rebalance client accounts without considering market conditions, or on a more frequent basis than the client might expect, or that the algorithm may not address prolonged changes in market conditions.

- Describe the circumstances that might cause the robo-adviser to override the algorithm. For example, the robo-adviser could explain to clients (if applicable) that the program may override the algorithm's recommendations and halt trading or take other temporary defensive measures under stressed market conditions.
- If the robo-adviser uses a third party in the development, management or ownership of the algorithm, describe this process to clients and explain any associated conflicts of interest that such arrangement may create. For example, the third-party provider may offer the algorithm at a discount to the robo-adviser, but the algorithm may direct clients into products from which the third party earns a fee.
- Provide an explanation of any fees that the robo-adviser will charge directly to clients as well as any other direct or indirect costs that clients will pay in connection with its platform. For example, the robo-adviser should describe the fees or expenses clients may pay in connection with the advisory services provided, including any custodian or mutual fund expenses or brokerage and other transaction costs that the client will bear.
- Explain the degree of human involvement in its oversight and management of individual client accounts. For example, does the robo-adviser have investment advisory personnel who oversee the algorithm? Do such personnel also monitor each client's account?
- Describe how the robo-adviser uses the information gathered from a client to generate a recommended portfolio. For example, if a robo-adviser uses questionnaires to gather client information, the robo-adviser should disclose to clients whether the responses to such questionnaires are the sole basis for the robo-adviser's advice. In addition, if the robo-adviser has access to other client information or accounts, it should explain to clients whether such information is used in generating investment advice.
- Explain how and when a client should update information he or she has provided to the robo-adviser[8].

The scope of advisory services

The Staff believes that robo-advisers must carefully consider whether disclosures to clients provide sufficient clarity regarding the scope of their advisory services and what clients should expect from a robo-adviser should a relationship be established. The Update provided the following examples of issues that robo-advisers should keep in mind when drafting descriptions related to the scope of their advisory services. The robo-adviser should not imply that:

- It provides clients with a comprehensive financial plan unless it does so. For example, a comprehensive financial plan should not be implied if the robo-adviser does not take into consideration a client's tax situation or debt obligations or if the investment advice is only targeted to meet a specific goal (such as paying for a large purchase or college tuition) and does not take into consideration a client's broader financial situation.
- A tax-loss harvesting service also provides comprehensive tax advice.
- It considers information outside of that collected by the client questionnaire when generating investment advice, if it does not actually consider such information. This outside information may include data from other client accounts held with the robo-adviser, its affiliates or third parties, as well as any supplemental information submitted by the client[9].

Presentation of disclosures

Because robo-advisers' disclosures to clients are provided through the internet (or other electronic means), the Staff believes that robo-advisers should carefully evaluate the effectiveness of their disclosures and whether clients can easily understand important

information about the robo-adviser and the services being offered and provided[10]. The Update described the following considerations for robo-advisers when evaluating their presentation of disclosures to clients in a digital setting:

- Are key disclosures presented to clients prior to the sign-up process so that clients have the information necessary to make an informed investment decision before they engage, and make any investment with, the robo-adviser?
- Are key disclosures emphasized in a special or highlighted way, such as through noticeable design features like pop-up boxes?
- Are certain disclosures accompanied by interactive text or other means to provide additional details to clients who are seeking more information? Such design features could include additional explanatory messages that appear when a cursor is positioned over important disclosures or a separate “Frequently Asked Questions” section that provides context and further explanations on key issues and questions.
- If the robo-adviser utilizes a mobile platform (e.g., a smartphone or a tablet app) as part of its service, has the presentation and formatting of disclosure been appropriately adapted so that clients can easily view such information on mobile devices?[11] For example, the presentation of such information may need to be re-designed given the smaller screen size of such devices when compared to computer desktop screens.

Provision of suitable advice

As part of their fiduciary duties to act in the best interests of clients, registered investment advisers must make a reasonable determination that the investment advice they provide to clients is suitable given the client’s financial situation and investment objectives[12]. In contrast to traditional advisory relationships where investment adviser personnel typically interact with clients to form a basis for the investment advice given, robo-advisers rely on other techniques in making investment suitability determinations for clients.

Reliance on questionnaires to gather client information

The Staff noted that many robo-advisers primarily rely on questionnaires completed by clients to obtain key information, which is then used to formulate investment recommendations for client accounts[13]. The Staff also discussed potential issues associated with a robo-adviser’s reliance on questionnaires to determine suitable investment decisions for clients. It noted that the lack of human interaction inherent in a robo-adviser platform relationship may present suitability issues associated with the formulation of investment advice. The Staff explained that online questionnaires may not be designed to permit clients to give additional context to their responses and that certain robo-advisory programs may not be designed to permit advisory personnel to follow up with clients regarding their responses, address potential inconsistencies in client responses, or provide clients with assistance in completing the questionnaire[14].

Because of the added importance that questionnaires play in the formulation of a robo-adviser’s investment advice, the Staff recommended a number of factors that robo-advisers consider when evaluating the effectiveness of their questionnaires:

1. Do 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?
2. Are the questions sufficiently clear, and is the questionnaire designed to provide additional clarification or examples to clients when necessary? For example, does the questionnaire have certain design features (such as interactive text or pop-up boxes) to address these issues?

3. How are inconsistent client responses addressed by the robo-adviser? For example, does the robo-adviser:
 - Incorporate design features into the questionnaire to alert a client when his or her responses appear internally inconsistent and suggest that the client may wish to reconsider their responses?
 - Implement systems to automatically flag apparently inconsistent information provided by a client for review or follow-up by robo-adviser personnel?[15]

Client-directed changes in investment strategy

The Staff also provided guidance in situations where a robo-adviser permits clients to select portfolios other than those recommended by the robo-adviser (e.g., permitting the client to adjust away from the recommended portfolio to a more aggressive or conservative one)[16]. The Staff explained that in these types of situations, the robo-adviser should be mindful of its obligation to act in the client's best interests and should consider providing commentary to clients as to why it believes particular portfolios may be more appropriate given the client's investment objective and risk profile[17]. The Staff suggested that pop-up boxes or other similar design options may be appropriate to alert clients of potential inconsistencies between the client's stated investment objectives and the selected portfolio[18].

Effective compliance programs

Robo-advisers, like other registered investment advisers, must maintain a compliance program and related written compliance policies and procedures that are reasonably designed to prevent violations of applicable federal securities laws[19]. The Staff explained that in designing and evaluating their compliance programs, robo-advisers should consider the nature of their firm's operations and the risk exposures created by such operations so that their compliance program can be tailored appropriately based on such risks[20].

A robo-adviser platform presents certain operational risks that are unique to its specialized business model, particularly its dependence on algorithms and other similar models that formulate investment advice for clients and the online electronic platform that delivers such investment advice[21]. In recent years, the SEC's examination and enforcement staff have placed a greater focus on advisory operations that utilize quantitative investment models (including the testing, review and monitoring of such models)[22] as well as the risks associated with cybersecurity breaches and threats to which advisers are increasingly prone[23]. Given these issues and their applicability to the robo-adviser platform, the Staff recommended that a robo-adviser's compliance program contain policies and procedures that address the following matters:

1. The development, testing and backtesting of the algorithmic code and the post-implementation monitoring of its performance. A robo-adviser should seek to ensure that:
 - the algorithm's code is adequately tested before, and periodically after, it is integrated into the robo-adviser's platform;
 - the code performs as represented to clients; and
 - any modifications to the code would not adversely affect client accounts;
2. Whether the questionnaire elicits 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;

3. The disclosure to clients of changes to the algorithmic code that may materially affect their portfolios;
4. The appropriate oversight of any third party that develops, owns or manages the algorithmic code or software modules utilized by the robo-adviser;
5. The prevention and detection of, and response to, cybersecurity threats;
6. The use of social and other forms of electronic media in connection with the marketing of advisory services (such as websites, Twitter, compensation of bloggers to publicize services and “refer-a-friend” programs); and
7. The protection of client accounts and key advisory systems^[24].

Practical considerations

The Update provides an overview of the Staff’s concerns regarding the robo-adviser program and also provides a listing of key issues that OCIE staff may focus on when examining robo-advisory firms. Robo-advisers should carefully review each focus area discussed in the Update to evaluate whether their firm’s operations address the Staff’s guidance and incorporate any other best practices within the industry. Some practical tips to consider:

- Do your electronic disclosures appropriately address and explain the unique, electronic business model associated with a robo-advisory account, as well as its scope, inherent risks and the special role of any algorithms and other investment models that formulate investment recommendations?
- How do you present disclosure to clients? Have you considered utilizing the methods suggested in the Update? Are your disclosures formatted in a way that clients can easily understand? Have you considered the types of devices used to access the robo-adviser’s platform (e.g., smartphone/tablets vs computer desktops)?
- Is the questionnaire used to gather information from clients appropriately comprehensive?
- Does your platform have electronic tools, additional disclosures or design features (such as interactive text or pop-up boxes) to permit clients to follow up with the adviser for additional guidance when completing the questionnaire?
- Does your platform have electronic tools or other design features (such as pop-up boxes) that alert clients of potential inconsistencies between the client’s stated investment objective and any client-directed changes to a recommended portfolio? Do these design features request the client’s acknowledgement that he or she affirmatively understands these changes? Are your systems designed to capture these client acknowledgments?
- Do you have an appropriate compliance program (and related compliance policies and procedures in place) that is reasonably designed to mitigate the unique risks inherent in your electronic platform, particularly with regard to the algorithms and other investment models that formulate investment advice?
- Do you have a robust algorithm management program designed and implemented? Are such algorithms and other investment models appropriately tested and monitored by your staff (or, if applicable, an outside qualified compliance consultant)? If you utilize a third-party service provider in connection with your algorithm, do you have due diligence and other oversight procedures to monitor and review this third-party service provider and have you disclosed to clients potential conflicts of interests associated with this relationship (if any)?

- Have you addressed the Staff's other internet-related guidance regarding the use of social media[25] as well as electronic delivery[26] in connection with your platform?

Notes

1. IM Guidance Update 2017-02, Robo-Advisers (Feb. 2017) [hereinafter Update], available at: www.sec.gov/investment/im-guidance-2017-02.pdf
2. *Id.* at 1-2.
3. OCIE, National Exam Program, Examination Priorities for 2017 (Jan. 12, 2017) [hereinafter OCIE 2017 Exam Priorities], available at: www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf; *see also* On the Radar for 2017 Exams of US-Regulated Investment Advisers and Broker-Dealers, Mayer Brown (Feb. 13, 2017), available at: www.mayerbrown.com/files/Publication/fd1b4b8b-a26d-4468-9e21-ccdaafd103b8/Presentation/PublicationAttachment/6b1e46a1-3f82-43bc-9d7f-e970a78824ba/170213-UPDATE-PIF-IM-PE-FSRE-CS-PEFIM.pdf
4. Update, *supra*, at 2. While the Staff noted that the Update's suggested guidance focused on robo-advisers' obligations under the Advisers Act, the Staff stated that robo-advisers should consider whether their programs' organization and operations implicate other issues under the federal securities laws, including (for example) Rule 3a-4 under the Investment Company Act of 1940.
5. *Id.* at 3; *see also* *SEC v. Capital Gains Research Bureau, Inc.*, 375 US 180 (1963); Amendments to Form ADV, 75 Fed. Reg. 49234 (July 28, 2010).
6. Update, *supra*, at 3.
7. *Id.*
8. *Id.* at 3-4, 5. The Staff emphasized that disclosures should be in plain English, so that clients may be able to easily comprehend and understand these important concepts.
9. *Id.*
10. *Id.*
11. *Id.* at 5-6.
12. *Id.* at 6; *see also* Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15098, 15102 (Mar. 24, 1997).
13. Update, *supra*, at 6. These questionnaires generally solicit information on, among other things, the client's financial goals, investment horizon, risk tolerance and other key financial factors.
14. *Id.*
15. For example, the system should raise flags when a client wanting a conservative investment strategy indicates that he or she wants to invest primarily in high-yield bonds or when an elderly client indicates a long-term investment time horizon. *Id.* at 6-7.
16. *Id.* at 7.
17. *Id.*
18. *Id.*
19. *See* 17 C.F.R. § 275.206(4)-7.
20. Update, *supra*, at 7-8.
21. *Id.*
22. *See, e.g., id.* at 8 & nn.31-32; OCIE, National Exam Program, Examination Priorities for 2014, at 5 (Jan. 9, 2014), available at: www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf. In 2011, the SEC reached an administrative settlement action with two affiliated

investment advisers that used a quantitative investment model, finding that these advisers breached their fiduciary obligations to clients by allegedly concealing and delaying to fix a material error in such model, and that one adviser failed to maintain appropriate compliance policies and procedures as a result of these issues. See Release No. IA-3285 (Sept. 22, 2011), available at: www.sec.gov/litigation/admin/2011/ia-3285.pdf; Release No. IA-3149 (Feb. 3, 2011), available at: www.sec.gov/litigation/admin/2011/33-9181.pdf

23. See, e.g., Update, *supra*, at 8 n.33; OCIE 2017 Exam Priorities, *supra* (continuing its cybersecurity initiative); Adviser Business Continuity and Transition Plans, 81 Fed. Reg. 43530, 43539 (June 28, 2016) (“An adviser generally should consider and address as relevant the operational and other risks related to cyber-attacks.”); Release No. IA-4415 (June 8, 2016), available at: www.sec.gov/litigation/admin/2016/34-78021.pdf; Division of Investment Management, SEC, Guidance Update No. 2015-02, Cybersecurity Guidance (Apr. 2015), available at: www.sec.gov/investment/im-guidance-2015-02.pdf
24. Update, *supra*, at 8.
25. In March 2014, the Staff issued a guidance update on the impact of the Advisers Act’s testimonial rule on a registered investment adviser’s use of social media and provided suggested guidance regarding developing compliance policies and procedures covering social media use. Division of Investment Management, SEC Guidance Update No. 2014-04, Guidance on the Testimonial Rule and Social Media, available at: www.sec.gov/investment/im-guidance-2014-04.pdf
26. See Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233 (Oct. 6, 1995); Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Securities Act Release No. 7288 (May 9, 1996); and Use of Electronic Media, Securities Act Release No. 7856 (Apr. 28, 2000).

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