Robo-Advisers and Advisers Act Compliance

Investment Management Webinar

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Stephanie Monaco is a member of the Corporate & Securities practice in Mayer Brown’s Washington DC office. She advises investment management firms, investment companies and hedge funds across a broad range of investment management needs. Formerly an attorney with the US Securities and Exchange Commission, Stephanie brings a deep understanding of the regulatory environment to counseling clients on issues of compliance and product development.
Overview of Robo-Advisers and Their Programs

What is a robo-adviser?

• An investment adviser that uses algorithmic and other technology-based programs to provide clients with discretionary asset management services, typically with limited human interaction through an online, electronic-based delivery model.

• Robo-advisers offer varying levels of human interaction – some provide limited, or no human interaction between the client and investment advisory personnel. Others provide advice through investment advisory personnel using interactive platforms and models to generate investment recommendations that are then discussed with the client.
Overview of Robo-Advisers and Their Programs

• The Staff of the Division of Investment Management (“Staff”) and the Staff of the Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission have been monitoring robo-advisers and evaluating how they meet their obligations under the Investment Advisers Act of 1940 (“Advisers Act”).

• The Staff issued a guidance update (IM Guidance Update No. 2017-02, the “Update”) in late February focusing on robo-advisers that provide services directly to clients over the internet. The Update describes what the Staff says are unique considerations that robo-advisers should keep in mind as they seek to meet their Advisers Act obligations and specifically their disclosure, suitability and compliance obligations.

• In addition, OCIE listed “electronic investment advice” as a new focus area for its 2017 examination priorities.
Advisers Act Considerations

• The update focuses on three specific areas identified by the Staff:
  
  – The substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers.
  
  – The obligation to obtain information from clients to support the robo-adviser’s duty to provide suitable and individualized advice.
  
  – The adoption and implementation of effective compliance programs reasonably designed to address particular concerns when providing automated advice.
Disclosure

• 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.

• Robo-advisers provide advice through electronic means (e.g., email, websites, mobile applications) rather than a natural person.

• In the Update, the Staff identified what it believes to be the unique challenges robo-advisers face when providing disclosures to clients regarding the limitations, risks and operational aspects of the investment advisory services they offer.
Disclosure

Explanation of Business Model and Related Risks

• Describe the algorithm and how it’s used, its limitations, its risks, whether the adviser has the ability to override the algorithm.
  — Inform clients that an algorithm is used.
  — How does the algorithm work and what it is used for?
  — What are the algorithm’s assumptions and limitations?
  — What are the risks inherent in using an algorithm?
  — Are there any circumstances when the robo-adviser may override the algorithm to manage client accounts?
Disclosure

Explanation of Business Model and Related Risks (cont.)

• Describe any third parties involved in the development, management or ownership of the algorithm and any related actual or potential conflicts of interest.

• Explain the fees charged directly by the robo-adviser and any other costs that client may bear, directly or indirectly.

• Explain the degree of human involvement.

• Describe how client-provided information is used and whether the adviser has access to other client information or accounts (e.g., ability for client to link account to other accounts with third parties or other client accounts with adviser or its affiliates).
Scope of advisory services

- Clearly describe investment advisory services offered
  - A comprehensive financial plan?
  - Providing tax advice?
  - Considering information about client’s other accounts with the robo-adviser, its affiliates or that otherwise was provided by client?
Disclosure

Presentation of disclosures

• Limited human interaction between investment advisory personnel and clients presents unique issues when communicating key information and risks.
  – Effectiveness – are key disclosures provided prior to the sign-up process such that the client can make an informed investment decision?
  – Emphasis – are key disclosures specifically emphasized through various design features?
    • Use of pop-up boxes, interactive text, access to additional information
  – Mobile platform formatting
Suitability

As part of their fiduciary duty to act in the best interests of their clients, registered investment advisers must make a reasonable determination that the investment advice provided is suitable given the client’s financial situation and investment objectives.

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 to gather client information in order to make suitability determinations for their clients.
Suitability

Client questionnaires

• Robo-advisers use online questionnaires to form the basis for their investment advice.

• If there is no human interaction involved in the robo-adviser’s program, there is no opportunity to explain the context for the questions asked, to ask follow-up questions about a client’s responses, to provide assistance to clients completing the questionnaire or to address inconsistencies in client responses.
Suitability

Client questionnaires (cont.)

• The Staff suggests that robo-advisers consider certain factors when evaluating whether its questionnaire is designed to elicit sufficient information to support its suitability obligation:
  - Do you have enough information for the algorithm to work effectively?
  - Are the questions clear? Does it provide additional clarification or examples?
  - How are you addressing inconsistent responses? Use of design features to alert a client when responses appear to be inconsistent? Inconsistent answers flagged for follow-up by the robo-adviser?
Suitability

Client-Directed changes in investment strategy/portfolio

• If clients have the opportunity to select investments other than those recommended by the robo-adviser, the robo-adviser needs to be able to assess the suitability of the selection.

• Staff suggests using pop-up boxes or other interactive features to explain why the adviser believes particular investments may be more appropriate and bring to the client’s attention potential inconsistencies between the client’s questionnaire responses and the investments they are selecting.
Compliance Policies and Procedures

Rule 206(4)-7 Compliance Programs should be designed to address the unique nature of robo-advisory services. In addition to adopting and implementing written policies and procedures that are relevant to traditional investment advisers, the Staff suggests robo-advisers consider adopting and implementing policies and procedures that address the following:

- Algorithm management
  - Development, testing and backtesting of the algorithmic code
  - Who does the testing?
Algorithm management (cont.)

- Post-implementation monitoring of algorithm performance

1. Is the algorithm performing as described?

2. When algorithm changes are considered, how would the changes impact client accounts? Any adverse effects? When is disclosure required?
Compliance Policies and Procedures

• The client questionnaire and whether it is collecting information sufficient to support the robo-adviser’s suitability obligations.

• Oversight of any third parties that develop, own or manage the algorithm or software.

• Data privacy and cybersecurity – the protection of client accounts and key advisory systems and procedures to prevent, detect and respond to cybersecurity threats.
Regulatory Risk Takeaways

• Have the limitations in the algorithm been adequately disclosed?

• Is the description of the level of customization accurate?
  – If non-existent, have you evaluated the Investment Company Act status of the program?

• Has a robust model management compliance program been built and is it being applied?
Reminders

- A recording and link to the materials from this program will be distributed by email to you in the next day or two.

- For those applying for CLE credit, please note that certificates of attendance will be distributed within 30 days of the program date.