

Client Alert

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Personal Advice for Robo-Advisers: Beef Up Disclosure and Compliance

By Jay G. Baris

Robo-advisers, those automated bots that offer up personalized investment advice with little, if any, human contact, face increased regulatory scrutiny as they grow more popular. After monitoring and engaging them for several months, the SEC's Division of Investment Management lent a personal touch in guidance published in February 2017, urging robo-advisers to improve risk disclosures and compliance programs.

Recognizing that the appeal of robo-advisers has expanded beyond millennials to all age groups and classes of investors, the Division addressed the legal and practical challenges these automated advisers face as they apply new technology to deliver fiduciary services traditionally delivered face-to-face.

Robo-advisers typically rely on algorithms to generate investment advice for their clients, often with little, if any, human interaction. In its guidance, the SEC Staff focused on three principal issues relating to this advice:

1. the substance and presentation of disclosures to clients about the services offered;
2. the obligation to obtain client information to support the robo-adviser's duty to provide suitable advice; and
3. compliance programs.

While it Staff primarily focused on compliance with the Investment Advisers Act of 1940, the Staff suggested that robo-advisers could run afoul of the Investment Company Act of 1940 if they don't properly structure their advisory programs. An investment adviser that provides the same or similar portfolio management services on a discretionary basis to a large number of clients that invest small amounts may be deemed to operate an "investment company" requiring registration under the 1940 Act. Rule 3a-4 under the 1940 Act, however, exempts advisory programs of this nature from the definition of an "investment company" if they meet certain conditions designed to ensure that each program is tailored to meet a the client's individual needs. The Staff warned, however, that certain robo-advisory programs may not meet those conditions and may be subject to regulation under the 1940 Act.

Disclosure, disclosure, disclosure. The Staff noted that robo-advisers, which provide investment advice with minimal or no human interaction, face heightened scrutiny of their disclosure obligations. Robo-advisers should ensure that they explain their business model and the scope of services they provide – and the limitations of those services – in a way that clients can understand. For example, robo-advisers should "consider" disclosing to their clients:

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- that they provide investment advice using an algorithm;
- how the algorithm works (e.g., that the algorithm generates suggested portfolios and the algorithm invests and rebalances the client accounts);
- the assumptions behind and limitations of this methodology;
- the inherent risks of designing portfolios using algorithms (e.g., it may not take into account market conditions or may rebalance more frequently than generally expected);
- when and how the robo-adviser may override an algorithm used to manage an account;
- the involvement of third parties in developing, managing and owning the algorithm (including any potential conflicts of interest);
- fees that clients will pay for the automated services;
- the degree of human involvement, if any, involved in account management;
- how the robo-adviser uses the information it collects from clients to generate portfolio recommendations and the limits of this process; and
- how and when the client should update the information provided to the robo-adviser.

Scope of advisory services. The Staff cautioned robo-advisers not to mislead clients about the scope of services robo-advisers provide. For example, they should not imply that they are providing a comprehensive financial plan when they do not consider a client's tax or personal situation.

Presentation of disclosures. The Staff emphasized that robo-advisers should ensure that they present their on-line disclosures in plain English in a way that online users can understand, using features like interactive text and pop-up boxes.

Suitable investment advice. Robo-advisers, like all advisers, have a fiduciary duty to provide suitable investment advice, based on the client's financial and investment objectives. Rather than obtaining this information in person, robo-advisers rely on information they collect by electronic questionnaires. Thus, they should ensure that the questionnaires are clear and elicit sufficient information to allow them to meet their fiduciary obligations, and to identify potential inconsistencies in the information provided. Moreover, robo-advisers should "consider" using pop-up boxes or other means to highlight why they believe particular recommended portfolios may be more appropriate for a client, in light of inconsistencies between a client's stated objectives and the portfolios they select.

Compliance, compliance, compliance. Robo-advisers face challenges in designing meaningful compliance programs because, in part, the compliance requirements were established long before the technology robo-advisers use was available. Thus, the Staff said, they "should be mindful of the unique aspects" of the business model and should consider whether their compliance policies should address the following areas:

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- the development, testing and backtesting of algorithmic codes;
- whether on-line questionnaires solicit sufficient information;
- when to update clients regarding changes to the algorithmic code;
- oversight of third-parties that, develop, own or manage the algorithmic codes or software used by the robo-adviser;
- cybersecurity;
- marketing vis social and other electronic media; and
- protection of client accounts and key advisory systems.

Our take. The Staff's robo-adviser guidance is a helpful attempt to keep up with rapid changes affecting investment advisers and their clients, as advances in technology quickly outpace rules written in the pre-digital era. The guidance does not amount to new rules; rather, it provides a window into how the Staff interprets existing rules in the context of the new technology. At the very least, taking the Staff's suggestions for enhancing disclosure and compliance programs likely will minimize big surprises in future regulatory examinations.

In light of the growing number of deficiency letters that the Office of Compliance Inspections and Examinations has directed to robo-advisers, these advisers should consider retaining experienced counsel or compliance consultants to review their disclosures and compliance programs.

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