InteractiveBrokers

SPOTLIGHT ON

Robo Advisers and their Compliance Obligations

The contents of this Spotlight have been prepared for informational purposes only and should not be construed as legal or compliance advice.

Robo-Advisers Overview

Definitions: Robo-advisers use digital platforms to provide automated, algorithmic investment management and financial planning services to clients. Robo-advisers require little to no human supervision, instead depending on the algorithm and client-supplied information.[1] When first using a robo-adviser, clients are generally prompted to complete a questionnaire about their investment goals and financial situation. The questions, which gather information on age, risk tolerance, and time horizon, are used as data points and plugged into the robo-adviser's algorithm. This data allows the robo-adviser to allocate a client's investment among asset classes and build portfolios based on an individual client's investment objectives. [2]

While all robo-advisers use algorithmic investing strategies, different robo-advisers propose unique value propositions. For example, certain robo-advisers are better equipped for ESG focused investing and some exclusively invest in sustainable funds.[3] The robo-advisers also differentiate on cost and account minimum requirements.

Market Trends: The amount of assets under management with robo-advisers globally was $980 billion US dollars in 2019 and is expected to rise to $1.40 trillion US dollars in 2020. Although the market for robo-adviser services is significant and still increasing, the amount at which it has been growing year-to-year has been decreasing since 2018.[4]

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[1] Jake Frankenfield, *What is a Robo-Advisor?,* Investopedia (2020), https://www.investopedia.com/terms/r/roboadvisor-roboadviser.asp (last visited April 27, 2020).

[2] Dana Anspach, *What is a Robo Advisor and How Do They Work?*, The Balance (2019), https://www.thebalance.com/what-is-a-robo-advisor-and-how-do-they-work-4097134 (last visited April 27, 2020).

[3] Barbara Friedberg, *5 Best Robo Advisors for Managing ESG Funds*, US News & World Report (2019), https://money.usnews.com/investing/articles/best-robo-advisors-for-managing-esg-funds (last visited April 27, 2020).

[4] *Robo-Advisors Worldwide*, Statista (2020), https://www.statista.com/outlook/337/100/robo-advisors/worldwide#market-globalRevenue (last visited April 27, 2020)

Assets under Management | Assets under Management Growth

Source: Statista (COVID-19 impact will be implemented Q2 2020), September 2019; Selected region only includes countries listed in the Digital

Compliance Issues

Robo-advisory firms leverage the technologies of algorithmic trading as a selling point to clients in marketing and solicitation. Since these technologies are new, however, conveying how the robo-adviser technology works accurately and honestly to clients is crucial in upholding fiduciary duty.

Misrepresenting performance or how proprietary technology builds portfolios can lead to violations of the Investment Advisers Act ("Advisers Act"), specifically Section 206 (2) and Section 206 (4)-1.[5] With such encompassing technologies, where human interaction is at a minimum, systems must be in place to ensure that the technology performs services as promised to clients and complies with regulations.

Another area of concern with robo-advisers is the information-gathering process, usually done with online questionnaires. Some experts claim that the online questionnaires overly generalize financial situations and goals, are too ambiguous, and can mislead clients. These questionnaires, therefore, do not gather the specificity needed to fulfill an adviser's fiduciary duty, but rather sort clients into the robo-adviser's preset products.[6] In addition, there is an argument to be made that standard online questionnaires miss the subtleties of a client's financial situation that human connection and conversation have a chance to pick up on.

Since algorithmic trading removes human interactions from investment management, many employee-based conflicts of interest do not exist for robo-advisers. While this may be an attractive quality of robo-advisers, this does not necessarily mean that no conflicts of interest

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[5] Julie DiMauro, *Robo-adviser enforcement cases highlight advertising, solicitation compliance*, Reuters (2019), https://www.reuters.com/article/bc-finreg-robo-advisers-solicitation-com/impact-analysis-robo-adviser-enforcement-cases-highlight-advertising-solicitation-compliance-idUSKCN1PU228 (last visited April 28, 2020).

[6] *Investor Alert: Automated Investment Tools*, SEC and FINRA (2015), https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html (last visited April 28, 2020).

exist. Many robo-advisers started by institutional money managers promote and invest in affiliated services and products, a possible situation for a major conflict of interest.[7]

SEC Regulatory Guidance

In February 2017, the Securities and Exchange Commission (SEC) issued regulatory compliance guidance for online robo-advisers. The guidance focused on three main issue areas specific to robo-adviser compliance.

1. **Disclosure to Clients**

   Although disclosures are heavily regulated for all investment advisers, robo-advisers must be more careful and inclusive with their disclosures. The lack of human interaction means that a client's decision to enter into an investment advisory relationship with the robo-adviser is informed predominantly by "electronic disclosures made via email, websites, mobile applications, and/or other electronic media."[8]

   To better inform clients about the robo-adviser through disclosures, the SEC guidance recommends including more information about the technology in more descriptive disclosures.

   For example, robo-advisers should disclose a statement that claims use of an algorithm, the assumptions and limitations of the algorithm, the risks of using the technology, and any circumstances in which the adviser would override the algorithm.[9] If the robo-adviser uses a third party, then the robo-adviser should disclose the nature of the relationship and any potential conflicts of interest. Robo-advisers must also be specific and careful in describing the scope of the technology's services, as to not mislead clients into believing they are receiving services (such as tax advice or financial planning) that they are not.[10]

2. **Suitable Advice**

   When it comes to suitable advice, the SEC is concerned with the effectiveness and sufficiency of online client questionnaires. Without human interaction, both the client and the adviser lose the opportunity to explain the questions being asked, ask follow-up

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[7] Megan Ji, *Are Robots Good Fiduciaries? Regulating Robo-Advisors Under the Investment Advisers Act of 1940*, vol.117 *Columbia Law Review*, 1572 (2017).

[8] *IM Guidance Update: Robo-advisers*, SEC, 3 (2017).

[9] Amy Ward Pershkow and Stephanie M. Monaco, *Robo Advisers and Advisers Act Compliance*, Mayer Brown, 7-8 (2017).

[10] Andrew J. Davalla and Donald S. Mendelsohn, *SEC Issues Guidance on Robo-Advisers*, Thompson Hine (2017).

questions, or evaluate any inconsistencies in the responses.[11] The SEC suggests developing questions that do gather sufficient information from clients to better provide advice suitable to the client's individual financial situation and goals. Questions should be clear and include additional clarifying information or examples if necessary. To address inconsistencies, robo-advisers should develop ways to alert clients of their inconsistencies or flag them for follow-up.[12]

The other area of concern for suitable advice is in relation to robo-advisers that allows clients to choose portfolios or investments other than the ones recommended by the algorithm. In these situations, the SEC recommends that robo-advisers assess the suitability of the clients' choices and inform the clients if their choices are inconsistent with their financial situation and goals.[13]

3. **Compliance Programs**

Robo-advisers should develop compliance programs to cover the unique aspects of robo-advisory services in addition to the policies relevant to traditional investment advisers. Some of the unique aspects highlighted by the SEC include algorithm management, questionnaire management, and robo-advisory specific cybersecurity threats.[14] For algorithm management, robo-advisers should develop processes for development, testing, and monitoring the algorithm as part of their compliance programs. If any third parties are involved, then the robo-adviser should have a process for screening and selecting those third parties, especially if involved with the algorithm. When changes are made to the algorithm, the robo-adviser should have a system for determining how the changes will affect client accounts and when disclosures are necessary to convey the change. [15]

SEC Enforcement Actions Examples

In late 2019, the SEC acted against two robo-advisers for misleading clients.

Wealthfront, one of the biggest robo-advisers by assets under management, was accused of improper advertising, failing to maintain an adequate compliance program, and misleading clients about a tax loss strategy. Wealthfront had claimed from 2012 to 2016 that its algorithm would maximize tax benefits by avoiding "wash sales," which prevent the sale of a security to

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[11] *IM Guidance Update: Robo-advisers*, SEC, 6 (2017).

[12] Amy Ward Pershkow and Stephanie M. Monaco, *Robo Advisers and Advisers Act Compliance*, Mayer Brown, 12-13 (2017).

[13] Andrew J. Davalla and Donald S. Mendelsohn, *SEC Issues Guidance on Robo-Advisers*, Thompson Hine (2017).

[14] Amy Ward Pershkow and Stephanie M. Monaco, *Robo Advisers and Advisers Act Compliance*, Mayer Brown, 15-18 (2017).

[15] *IM Guidance Update: Robo-advisers*, SEC, 7-8 (2017).

be recognized at a loss if the same security is purchased again later. In that four-year time period, about 31% of Wealthfront accounts had some "wash sales" because Wealthfront was not effectively monitoring the platform's accounts. In addition to misleading clients on the services they were receiving, Wealthfront advertised and solicited clients without the proper disclosures and documentation. [16]

The second robo-adviser, Hedgeable, was accused of providing misleading information about its investment performance. To solicit clients, Hedgeable posted comparisons of its own performance with that of two other competitor robo-advisers. The postings came without proper disclosure, but also completely misrepresented performance. Hedgeable only included about 4% of client accounts in their performance calculations, accounts with higher-than-average returns. The SEC also discovered that the adviser did not maintain proper documentation or an effective compliance program. [17]

Form ADV Disclosures for Robo-Advisers

Since robo-advisers have unique ways of conducting their business and interacting with their clients, the disclosures they include in their Form ADV must necessarily be distinct from those provided by traditional advisers. Below is a list of the areas in the Form ADV Part 2A, the Brochure, disclosures that robo-advisers should consider including or customizing:

- Description of types of robo accounts and their strategies;
- Descriptions of any additional strategies offered on top of the investment strategy (i.e., tax-loss harvesting);[18]
- Policies around allowing clients to set up investment restrictions/limitations;
- How the robo-adviser determines a client's profile (e.g., questionnaires asking about risk averseness, financial situation, and investment goals);
- The limitations associated with a questionnaire's ability to gather necessary information, especially if all interactions with clients are online;
- Methods for clients to address changes and update their financial situation, investment objectives, risk tolerance, and investment restrictions;[19] and
- Assumptions, limitations, and risks associated with the robo-adviser's algorithm.

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[16] Meghan Morris, *Wealthfront, the second biggest robo-adviser, just settled with regulators over misleading clients*, Business Insider (2018), https://www.businessinsider.com/robo-advisers-agree-to-sec-settlements-for-misleading-customers-2018-12 (last visited April 29, 2020).

[17] Julie DiMauro, *Robo-adviser enforcement cases highlight advertising, solicitation compliance*, Reuters (2019), https://www.reuters.com/article/bc-finreg-robo-advisers-solicitation-com/impact-analysis-robo-adviser-enforcement-cases-highlight-advertising-solicitation-compliance-idUSKCN1PU228 (last visited April 28, 2020).

[18] *Betterment Wrap Fee Brochure (Form ADV Part 2A- Appendix 1)*, Betterment LLC (2020).

[19] *Wealthfront Advisers Client Brochure (Form ADV Part 2A),* Wealthfront Advisers LLC (2019).

The above list provides some, but not all, of the topics that robo-advisers should consider disclosing in their Form ADV and in developing their compliance programs. These disclosures are in addition to the disclosures necessary for traditional advisers. It is also important to note that those traditional disclosures should be adapted to accurately represent the robo-adviser business.

International Robo-Adviser Regulation

The United Kingdom's Financial Conduct Authority ("FCA") has issued guidance on streamlined investment products, which includes automated financial advice services. With the guidance, the FCA conducted a review of the automated investment services sector and found that most providers have unclear service offerings and fee disclosures. The FCA issued feedback to the firms reviewed, which led to many of the firms changing their practices and policies to be compliant with the original FCA guidance.[20]

The European Banking Authority, European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority released a report on automated financial advice. The report claims that the market for robo-advisers is limited in Europe and points out lack of digital financial literacy and regulatory complexity as two factors. On the regulatory complexity, for example, some countries have issued guidance for robo-advisers while other countries have initiatives to work directly with robo-advisers in terms of compliance. This complexity has pushed the European Authorities to work towards technology-neutral regulation across the European Union. [21]

In Asia, Hong Kong's Securities and Futures Commission has published "Guidelines on Online Distribution and Advisory Platforms." The guidelines require that a "suitably qualified person" test and review the validity of the advice provided on the robo-adviser platform. Investment managers can be consulted in the design and monitoring of a robo-adviser's algorithm. The guidelines also require that robo-advisers provide clients with clear explanations as to how their technology works and generates investments. [22]

Key Takeaways

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[20] Laure Fouin, Shauvik Shah and Arie van Wijngaarden, *Regulation of Online Advisors: An International Overview*, McCarthy Tetrault LLP (2019), https://www.mccarthy.ca/en/insights/blogs/snipits/regulation-online-advisors-international-overview#page=1 (last visited April 30, 2020).

[21] *Joint Committee Report on the results of the monitoring exercise on 'automation in financial advice'*, Joint Committee of the European Supervisory Authorities, 9-10 (2018).

[22] David Lee, *Keeping Pace with Asia's Evolving Robo-Advisory Regulatory Landscape*, Brink: The Edge of Risk (2019), https://www.brinknews.com/keeping-pace-with-asias-evolving-robo-advisory-regulatory-landscape/ (last visited April 30, 2020).

The algorithms used by robo-advisers present unique compliance issues, especially in relation to disclosure and suitability. Disclosures should pay attention to how algorithms are used, updated, and monitored. Compliance programs should be in place to confirm that investments are made as promised in advertising and disclosures to clients. To ensure that robo-advisers meet suitability requirements, online questionnaires must sufficiently gather data to reveal the scope of a client's financial situation and goals.

Although automatic investing removes many employee-related conflicts of interest, it may bias investments in a manner that put the adviser's interests over the clients. Algorithms should be developed to act in the best interest of clients at all times, especially when opportunities to benefit the adviser arise (e.g., investing in the adviser's affiliated products). The potential for conflicts of interest can be mitigated with proper algorithm management and full detailed disclosures.

The Form ADV should contain the groundwork of these disclosures and reflect the specific considerations of the robo-advisory business. Although robo-advisers are equally subject to the Investment Advisers Act as traditional advisers, the business model differences require distinct approaches to complying with the Act. These distinctions are highlighted by the SEC in its 2017 Guidance for robo-advisers, which is critical for new robo-advisers to understand in order to appropriately fulfill their compliance obligations.