Bloomberg Law

Securities Regulation & Law Report™

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INVESTMENT ADVISERS

Robo-Advisers: More Complex Than They May Appear

BY RICHARD D. MARSHALL

It has been projected that by 2020, robo-advisers will manage approximately $500 billion in client assets, a 2,500 percent increase from 2015 levels. [Cerulli Associates, Retail Direct Advisers and Digital Advice Providers 2015: Addressing Millenials, the Mass Market, and Robo Advice (2015).] Many of the largest money managers have already invested heavily in robo-advisers and already offer such products to their clients. [Goldman Building Robo-Adviser to Give Investment Advice to the Masses, Reuters, May 21, 2017.] The growing popularity of robo-advisers has been explained as resulting from two trends. First, there has been an explosive growth in the offering and selling of a wide range of products on the internet. The investing public has become accustomed to such on-line sales and values the convenience and cost savings associated with such marketing. At the same time, advances in technology and the increasing automation of the markets have made robo-advisers more practical. Ever more sophisticated automation tools now make it more practical for complex investment strategies to be implemented automatically.

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Given these trends, it is not surprising that, in February 2017, the SEC issued an Information Guidance [IM Guidance 2017-02.] and Investor Alert [February 23, 2017] on robo-advisers. While these authorities appear on their face to be simple, complex legal issues underlie this guidance and raise legal issues robo-advisers need to consider.

What Is a Robo-Adviser?

According to the SEC,

> [r]obo-advisers, which are typically registered investment advisers, use innovative technologies to provide discretionary asset management services to their clients through online algorithmic-based programs. A client that wishes to utilize a robo-adviser enters personal information and other data into an interactive, digital platform (e.g., a website and/or mobile application). Based on such information, the robo-adviser generates a portfolio for the client and subsequently manages the client's account.
>
> Robo-advisers operate under a wide variety of business models and provide a range of advisory services. For example, robo-advisers offer varying levels of human interaction to their clients. Some robo-advisers provide investment advice directly to the client with limited, if any, direct hu-

man interaction between the client and investment advisory personnel. For other robo-advisers, advice is provided by investment advisory personnel using the interactive platform to generate an investment plan that is discussed and refined with the client. Robo-advisers may also use a range of methods to collect information from their clients. For example, many robo-advisers rely solely on questionnaires of varying lengths to obtain information from their clients. Other robo-advisers obtain additional information through direct client contact or by allowing clients to provide information with regard to their other accounts.

How Are Robo-Advisers Regulated?

Any debate about whether robo-advisers should be regulated as investment advisers has been resolved by recent regulatory pronouncements. The SEC's IM Guidance states that ''[r]obo-advisers, like all registered investment advisers, are subject to the substantive and fiduciary obligations of the Advisers Act.'' The Massachusetts Secretary of State has similarly stated that ''robo-advisers' are investment advisers'' [Policy Statement, Robo-Advisers and State Investment Adviser Registration (April 1, 2016).]

The Massachusetts Secretary of State also correctly notes that ''[m]ost of the robo-advisers popular today are registered with the SEC either as large investment advisers [Adviser Act Section 203A and Rule 203A-1.], as internet advisers [Advisers Act Rule 203-2(e).], or as multi-state advisers [Advisers Act Rule 203A-2(d)]. Advisers with regulatory assets under management of $100 million or more are required to register with the SEC. Advisers operating exclusively over interactive websites and advisers operating under the laws of fifteen or more states can opt to register with the SEC.'' [Id.]

Although FINRA has issued guidance on robo-advisers, a robo-adviser need not register as a broker-dealer. [FINRA Report on Digital Investment Advice (March 2016).] Like all investment advisers, robo-advisers can trade for client accounts without registering as broker-dealers. [InTouch Global, LLC, SEC No-Action Letter (Nov. 14, 1995) (citing PRA Securities Advisers, L.P., SEC Denial of No-Action Request (Mar. 3, 1993).] However, if a dually registered broker-dealer and adviser offers a robo-adviser, the dual registrant must comply with both SEC and FINRA standards for this product.

What Special Challenges Do Robo-Advisers Confront in Satisfying Their Disclosure Obligations?

The IM Guidance notes that:

> because client relationships with robo-advisers may occur with limited, if any, human interaction, robo-advisers should be mindful that the ability of a client to make an informed decision about whether to enter into, or continue, an investment advisory relationship may be dependent solely on a robo-adviser's electronic disclosures made via email, websites, mobile applications, and/or other electronic media. Furthermore, given the unique aspects of their business models, including their reliance on algorithms and the internet as a means of providing advisory services, robo-advisers may wish to consider the most effective way to communicate to their clients the limitations, risks, and operational aspects of their advisory services.

The IM Guidance specifically cautions robo-advisers to disclose the following information:

- A statement that an algorithm is used to manage individual client accounts;
- A description of the algorithmic functions used to manage client accounts;
- A description of the assumptions and limitations of the algorithm used to manage client accounts;
- A description of the particular risks inherent in the use of an algorithm to manage client accounts;
- A description of any circumstances that might cause the robo-adviser to override the algorithm used to manage client accounts;
- 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;
- 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;
- An explanation of the degree of human involvement in the oversight and management of individual client accounts;
- A description of how the robo-adviser uses the information gathered from a client to generate a recommended portfolio and any limitations;
- An explanation of how and when a client should update information he or she has provided to the robo-adviser;
- Whether the robo-adviser is providing a comprehensive financial plan;
- Whether a tax-loss harvesting service also provides comprehensive tax advice; and
- Whether information other than that collected by the questionnaire is considered when generating investment recommendations.

Can Robo-Advisers Satisfy Their Fiduciary Duties to Their Clients?

The IM Guidance cautions robo-advisers to gather sufficient information about clients to make suitable investment decisions for them and to provide advice that is personalized to each client. Massachusetts goes further, cautioning that ''[r]obo-advisers in the Commonwealth cannot fully satisfy their fiduciary obligations if they fail to perform the initial and ongoing due diligence necessary to act in the best interests of their clients. Specifically, robo-advisers' failure to conduct due diligence, as well as robo-advisers' depersonalized structure, may render them unable to provide adequately personalized investment advice and make appropriate investment decisions.'' FINRA similarly has cautioned that ''[t]here are several areas of concern regarding digital advice tools, including whether they are designed to 1) collect and sufficiently analyze all of the required information about customers to make a suitability determination; 2) resolve conflicting responses to customer profile questionnaires; and 3) match customers' investment profiles to suitable securities or investment strategies.'' [FINRA Report on Digital Investment Advice (March 2016).]

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To address this concern, as well a concern about costly errors resulting from reliance on automated trading and investment tools [See Frischer and Friedman, "Coding Errors Increasingly Lead to Regulatory Sanctions, Law 360 (Oct. 20, 2015)], robo-advisers apparently rely heavily on disclaimers of liability for unsuitable and impersonal advice and for errors resulting from software and other computer mistakes. [Melanie L. Fein, Robo-Advisers: A Closer Look, 7 Banking & Insurance eJournal 174 (2015).] This, then, leads to the question whether such sweeping disclaimers of liability are effective.

The leading SEC authority relevant to such disclaimers, Heitman Capital Management, LLC (SEC no-action letter, Feb. 12, 2007), provides that whether such disclaimers are effective turns on "the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client." An extensive and thoughtful discussion of this issue is presented in a leading treatise on investment management. [Bines and Thel, Investment Management Law and Regulation (3d ed. 2017) Section 5.02.] That discussion concludes that "the law still sharply limits the effectiveness of exculpatory clauses in investment management agreements."

However, these commentators suggest an alternative to general disclaimers that may accomplish the same objectives for a robo-adviser:

> As a pragmatic matter, it may be useful to focus on classes of exculpatory provisions that can be defended as allocating responsibility for risk. Exculpatory provisions need not be drafted in the form of general disclaimers that give little information to investors about the particular risks they will be bearing in connection with the management of their accounts. It is also possible to define terms contractually or to establish the propriety of certain procedures in ways that may achieve many of the same ends as simple disclaimers. In contrast to general disclaimers, contractual definitions and statements of procedure have the positive ring of express undertakings and offer a degree of precision in allocating responsibility for risk. For example, investment managers must diversify unless it would be imprudent to do so. Even if they cannot generally disclaim liability for failure to diversify, managers should be able to establish diversification criteria in a way which, if sound as a matter of investment theory, can prevent subsequent disputes over whether they have met their obligations. Similar tactics might be useful in any situation in which the protective power of a general disclaimer is suspect. . . .

[Id. at pp. 5-16 - 5-17.]

These commentators also argue that "investment managers may wish to reserve the right to rely on the opinions of experts whenever advisable without incurring possible liability for an expert's negligence. Opinions of counsel and certifications by accountants are among the most common types of expert opinion on which investment managers rely. Provisions protecting investment managers for such reliance have the support of authority and custom." [Id. at pp. 5-18.]

To illustrate this recommended approach, a disclaimer such as "the robo-adviser does not make suitable investment decisions for client accounts" or "the robo-adviser will not act in a fiduciary relationship with client accounts" would both likely be invalid and unenforceable. In contrast, the following risk allocating provision is much more likely to be enforceable: "The robo-adviser will rely upon information provided by the client in determining which investments are suitable for the client's account. The robo-adviser does not verify the accuracy of information provided by the client and, thus, it is the client's responsibility to provide accurate and complete information to the robo-adviser and to update that information as necessary."

Are Robo-Advisers Operating Unregistered Investment Companies?

Certain legal requirements may be impossible to disclaim contractually. In particular, the SEC has taken the position that investment advisory services that are provided on a discretionary basis to a large number of advisory clients may be deemed "investment companies" unless they comply with a nonexclusive "safe harbor" under Rule 3a-4 under the Investment Company Act. [See Status of Investment Advisory Programs under the Investment Company Act, 62 Federal Register 15098 (March 31, 1997) (final rule); 60 Federal Register 39574 (Aug. 2, 1995) (proposed rule).] To be eligible for the safe harbor, an investment advisory program must be organized and operated in accordance with certain requirements. Among these are that "each client's account in the program is managed on the basis of the client's financial situation and investment objectives and in accordance with any reasonable restrictions imposed by the client on the management of the account" and "the sponsor and personnel of the manager of the client's account who are knowledgeable about the account and its management are reasonably available to the client for consultation." One commentator has argued that "[i]t may be questioned whether robo-advisors meet these requirements to the extent they do not manage client accounts on the basis of each client's financial situation and clients do not have reasonable access to personnel who are available to consult with the client." [Melanie L. Fein, Robo-Advisers: A Closer Look, 7 Banking & Insurance eJournal 174 at (2015).]

Can Robo-Advisers Satisfy Their Compliance Responsibilities?

The IM Guidance notes that "[i]n developing its compliance program, a robo-adviser should be mindful of the unique aspects of its business model. For example, a robo-adviser's reliance on algorithms, the limited, if any, human interaction with clients, and the provision of advisory services over the internet may create or accentuate risk exposures for the robo-adviser that should be addressed through written policies and procedures." The IM Guidance particularly warns that robo-advisers must validate and test the models and computer systems they rely upon and must conduct adequate due diligence on any third-parties they may rely upon.

The first issue this guidance raises is how such validation and testing should be conducted. In many SEC enforcement actions, large and apparently sophisticated firms have been charged for inadequate validation and testing of computer systems, even though the firm did not benefit from the computer errors. An extreme example is the SEC's enforcement action against Knight Capital Americas LLC. [Admin. Pro. 3-15570 (Oct. 16, 2013).] Knight Capital, the US market maker, blamed a computer trading error that cost it $440 million on disused software that was accidentally reacti-

vated when a new program was installed. [The Telegraph] The error caused wild swings in the share prices of almost 150 companies. As well as disturbing trading, the orders left Knight nursing a loss three times the profit it made the prior year. Obviously, Knight had no motive to create a computer error that caused it to incur huge losses. Knight is also a large and highly sophisticated broker that presumably employed skilled professionals to validate and test its computer systems. Nonetheless, the SEC sanctioned Knight, finding its systems inadequate. Ominously, the SEC observed that ''[a]lthough automated technology brings benefits to investors, including increased execution speed and some decreased costs, automated trading also amplifies certain risks. As market participants increasingly rely on computers to make order routing and execution decisions, it is essential that compliance and risk management functions at brokers or dealers keep pace. In the absence of appropriate controls, the speed with which automated trading systems enter orders into the marketplace can turn an otherwise manageable error into an extreme event with potentially wide-spread impact.'' In light of examples such as this, it is unclear whether any level of validation and testing will satisfy the SEC when computer based errors occur.

It is also unclear how legal and compliance professionals should be involved in the validation and testing process. In a 2011 settled enforcement action, the SEC seemed to suggest that compliance personnel need to be involved in the validation and testing of models and computer systems. [In re AXA Rosenberg Group LLC, et al., Advisers Act Rel. 3149 (Feb. 3, 2011)]. In this enforcement action, the advisers developed three computer models which were used together as the exclusive means of selecting investments in managed accounts. One model, the Alpha Model, evaluated public companies based on their earnings and valuations. A second model, the Risk Model, evaluated risks based on numerous factors. A third model, the Optimizer Model, combined the first two models and recommended specific investments based on a benchmark chosen by the client. In April 2007, a new version of the Risk Model was developed. Due to an inadvertent error in computer coding, which was not detected for over two years, the Risk Model sent information to the Optimizer Model in a form that produced errors in the selection of stocks for investment. This error resulted in stock selections that were inconsistent with selections that would have been made if the model had worked properly.

In the press release announcing this action, a senior SEC official stated that: ''Quant managers need to ensure that their compliance policies and procedures are tailored to the risks of their model's strategies, and that compliance personnel are integrated into the development and maintenance of their investment models.'' [Press Release 2011-37 (Feb. 3, 2011)] This statement has raised concerns about the responsibilities of compliance personnel for validating and testing models. Compliance personnel frequently object that they lack the necessary expertise to perform such functions.

Conclusion

Robo-advisers raise serious and unsettled legal issues for the advisers that offer them. Although regulatory guidance appears simple, the issues involved are complex.

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