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SEC Issues Robo-Adviser Guidance

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The increased popularity of automated digital investment advisory programs (often called "robo-advisers") has drawn the attention of the Securities and Exchange Commission ("SEC"). On February 23, 2017, the SEC's Division of Investment Management issued Guidance Update No. 2017-02 (the "Update"). That Update provides guidance to robo-advisers as they seek to satisfy their disclosure, suitability, and compliance obligations under the Investment Advisers Act of 1940 ("Advisers Act"). On the same day, the SEC's Office of Investor Education and Advocacy issued an Investor Bulletin to educate investors about robo-adviser programs.

The term "robo-adviser" generally refers to a registered investment adviser that uses innovative technologies to provide discretionary asset management services through online, algorithmic-based programs. Like all RIAs, a robo-adviser has fiduciary and other obligations to its clients under the Advisers Act. However, the unique nature of a robo-adviser's service model can raise special compliance issues. In the Update, the SEC staff provides suggestions for robo-advisers to consider in meeting their obligations. The Investor Bulletin also provides guidance for investors who are considering whether to use a robo-adviser.

Fiduciary Duty

As a registered investment adviser, a robo-adviser is required to comply with Section 206(4) of the Advisers Act. That Section makes it "unlawful for any investment adviser…to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and provides the source of a registered investment adviser's fiduciary obligations. All registered investment advisers – including robo-advisers – must provide investment advice that is consistent with their fiduciary duty and other requirements of the Advisers Act. To fulfill these fiduciary obligations, a registered investment adviser must:

- Act solely in the best interest of its clients;
- Provide investment advice based on a reasonable and independent basis;
- Disclose material facts, including conflicts of interest, to its clients; and
- Provide investment advice that is suitable to a client's investment objectives and personal circumstances.

Given the unique challenges and opportunities presented by these advisory relationships – which often involve online questionnaires and little, if any, human interaction – the SEC staff identifies three distinct compliance areas and provides suggestions for how robo-advisers might address them:

- 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 advice; and
- The adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated advice.

The SEC staff acknowledges that not all of the issues addressed in the Update will apply to all robo-advisers, due to variations in service models and operations. However, the fundamental nature of the guidance in the Update – disclosures, suitability, and compliance – provides robo-advisers with helpful suggestions as they develop and grow.

Disclosure Requirements

To minimize fees, robo-advisers are designed to limit the level of direct human interaction with clients. The SEC staff therefore encourages robo-advisers to identify the most effective method of providing information so that investors can make informed decisions. Robo-adviser clients may depend solely on disclosures made via email, websites, mobile applications, or other electronic media. The SEC staff therefore encourages robo-advisers to consider how and when information and disclosures are presented to clients to ensure clear, effective communication of key information, risks, and disclaimers. In addition, the SEC staff encourages robo-advisers to consider providing clients with:

- A statement that an algorithm is used to manage client accounts;
- A description of the algorithmic functions, as well as the assumptions and limitations of the algorithm;
- A clear description of the scope of services offered (to avoid misleading clients);
- An explanation of the degree of human involvement in the oversight and management of client accounts;
- A description of the particular risks inherent in the use of an algorithm;
- A description of any third-party involvement in the development, management, or ownership of the algorithm;
- A description of any circumstances that might cause the robo-adviser to override the algorithm;
- A description of any client fees or costs; and
- A description of how the robo-adviser uses information from the client to generate a recommended portfolio, as well as an explanation of how and when a client should update information provided to the robo-adviser.

The Update also encourages robo-advisers to consider whether key disclosures should be made before investors sign up for the service; whether such disclosures should be specially emphasized (*e.g.,* through design features like pop-up boxes or interactive text); and whether disclosures available on mobile platforms have been appropriately adapted for that platform.

Suitability Requirement

All registered investment advisers, including robo-advisers, must provide investment advice that is consistent with their fiduciary duty to act in a client's best interest. In meeting this obligation, the SEC staff reminds investment advisers that they "must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives."

While service models vary, robo-advisers generally collect information regarding a client's financial goals, risk tolerance, time horizon, and income through on-line questionnaires. Based on the information collected, the robo-adviser generates a recommended investment portfolio. Given the limited human interaction associated with this service model, the SEC staff encourages robo-advisers to consider whether the client information they collect is sufficient to meet the suitability requirements. They might consider factors such as:

- Whether 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 the client;
- Whether questions are sufficiently clear;
- Whether the questionnaire is designed to provided clarification or examples to clients when necessary; and
- Whether steps have been taken to address inconsistent client responses.

If clients are able to select a portfolio other than the one recommended by the robo-adviser, the SEC staff also encourages robo-advisers to explain why a specific investment portfolio may be more appropriate for certain investment objectives and risk profiles.

Compliance Programs

RIAs are required under Rule 206(4)-7 of the Advisers Act to adopt, implement, and annually review policies and procedures that are reasonably designed to prevent violation of the Act and its rules. In addition, an investment adviser must appoint a chief compliance officer to administer its compliance policies and procedures. In light of the unique nature of a robo-adviser's services, the SEC staff encourages robo-advisers to consider whether to adopt written policies and procedures that address issues such as:

- The development, testing, and back-testing of the algorithmic code, including the post-implementation monitoring of its performance;
- The ability to meet suitability obligations, based on how client information is gathered;
- Disclosure to clients regarding material changes to the algorithmic code;
- Oversight of any third party that develops, owns, or manages the algorithmic code or software used;
- Prevention and detection of, and response to, cybersecurity threats, as well as protection of client accounts and

key systems; and
- The use of electronic media in connection with the marketing of advisory services.

Practical Considerations for Robo-Advisers

The limited human interaction that is typical of many robo-adviser service models can create unique operational challenges to compliance with the Advisers Act. Thus, robo-advisers should carefully consider the SEC staff's suggestions in the context of their disclosure, suitability, and compliance obligations. In addition, the questions and considerations provided in the Investor Bulletin may assist robo-advisers as their services continue to develop and grow, especially as they interact with clients.