Client Update
FINRA Releases Report on Digital Investment Advice Tools

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As technology becomes the predominant means for delivering financial services, industry regulators have focused more keenly on the development, implementation and monitoring of technology-driven "tools" that have been developed to deliver such services. Last week, the Financial Industry Regulatory Authority ("FINRA") turned its attention to so-called robo-advisory services as utilized by broker-dealers.

On March 15, 2016, FINRA released a report (the "Report") discussing digital investment advice tools, which it defined as technologies developed or acquired by financial services firms in connection with developing customer profiles and providing investment advice.[1] Certain of these tools are used by industry professionals in providing financial services to clients while others are accessed by clients on a self-directed basis. The Report gives useful insight into how FINRA views such tools under existing concepts of suitability and conflicts of interests as well as governance and supervision. It also provides lists of principles and effective practices with respect to the various aspects it discusses.

Broker-dealers can expect the matters covered in the Report to begin appearing regularly on FINRA examinations, so we recommend careful consideration of its concepts and findings as a guide for firms utilizing such tools.

I. GOVERNANCE AND SUPERVISION

The Report states that firms should establish adequate governance and supervisory procedures with respect to (a) selection or development of tools to ensure a full understanding of their features and functionality, (b) how

[1] The text of the Report is *available at* http://www.finra.org/sites/default/files/digital-investment-advice-report.pdf.

registered representatives and/or customers will utilize the tools and (c) implementation and ongoing monitoring of the tools and their usage.

According to the Report, many digital advisory tools employ algorithms that translate data inputs into suggested trading strategies or investment advice, such as asset allocation portfolios or the timing of tax-loss harvesting. The Report recommends, among other things, that firms carefully review and test all aspects of the tool, including the financial models and assumptions underlying these algorithms, to fully understand how it will function in a variety of usage scenarios. This testing should be designed to discover any biases or preferences embedded in the algorithms. For example, if a digital tool purports to, among other things, measure the impact of macroeconomic shocks on investor portfolios, the broker-dealer should determine what assumptions are made about the effect of particular shocks on the correlations in asset price movements. Through these insights, the broker-dealer should assess the circumstances in which the tool may provide inappropriate results for some or all customers and take steps to mitigate such situations.

The Report encourages firms to frequently assess and tailor the analytical assumptions used in their chosen digital tools to ensure that they reflect each client's investment strategies (e.g., passive vs. active portfolio management). It is also prudent for firms to adequately supervise the registered representatives using these tools and review the relationship between a tool's output, the client's objectives, and the ultimate recommendations given by such representatives to customers. These concepts align with the Report's discussion of the suitability issues associated with utilizing such tools, addressed next.

In sum, this portion of the Report stresses the importance of a thorough understanding of any investment tools that a broker-dealer decides to deploy so that they can be properly integrated into the firm's business and addressed in the firm's compliance and supervisory structures.

II. CUSTOMER PORTFOLIOS AND SUITABLITY

The Report discusses the use of digital tools in connection with the construction and rebalancing of portfolios, and particularly the associated suitability and conflict of interest issues. These concepts are well-established in FINRA rules and interpretations, and the Report applies them to the digital context in a very traditional manner, essentially saying: even when using technology, make sure you have appropriate information about the customer to recommend or realign a portfolio suitable to his/her needs and disclose any conflicts of interests that may be present.

FINRA Rules 2090 and 2111, and related interpretations, mandate that broker-dealers use a reasonable level of diligence to know the essential facts about a customer at account opening and thereafter in making investment recommendations. Rule 2111 includes a nonexclusive list of information that broker-dealers and their registered persons should consider when assessing the suitability of a recommended security or investment strategy: "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose." By implication, the registered person also must have sufficient knowledge of the recommended securities to seek to ensure that they match the customer's needs.

The Report stresses that broker-dealers and their registered persons are still subject to these new account and suitability requirements even when using a digital advisory tool. The Report states that digital tools are not a substitute for knowledge about the client or the portfolio. Nevertheless, the information required by the rules can be appropriately harvested by the software tool in order to meet these requirements. Indeed, the Report acknowledges that digital advice tools can be used to create a customer profile with the aim of finding an appropriate portfolio of securities based on their responses. The Report provides examples of profiling questions identified by FINRA, which appear designed to address the suitability factors in Rule 2111. The Report also discusses in some detail issues around how a tool handles contradictory or incomplete answers to suitability questions and determinations of customer risk tolerance.

It is therefore important for a broker-dealer evaluating advisory tools to ensure that the tool they choose includes the data points necessary to accurately profile customers and make recommendations. With respect to portfolio and allocation models, the Report recommends that firms have an independent investment policy committee or equivalent responsible for (i) determining the characteristics, such as return, diversification, liquidity and credit risk, of pre-packaged portfolios, (ii) evaluating the individual securities proposed to be included in each portfolio by a digital investment advice tool and (iii) monitoring each portfolio to ensure its performance and risk characteristics are appropriate for its investors. Firms should also consider whether a client's investment advisory needs can be met solely through a digital approach or may need to include discussions with a financial professional as well.

All of these concepts apply with equal strength in the context of portfolio rebalancing. Rebalancing can occur for a variety of reasons, such as drift from the target allocation due to performance or new market conditions and changes in the customer's circumstances or goals. Firms may rely on digital advice tools to

automatically rebalance portfolios, but should ensure that they understand and agree with the rebalancing methodologies, and that they make appropriate disclosures to customers about the service, including possibly obtaining affirmative customer consent. Among other things, the broker-dealer should disclose the triggers for a rebalancing (like assets diverging from their target allocations in excess of "drift thresholds") or if rebalancing occurs on some periodic basis. Firms should also develop safeguards on the rebalancing process to guard against poorly timed changes and/or tax effects.

In addition to the suitability requirements, the Report reminds firms that FINRA's conflict of interest principles apply with equal force to digital advice tools. Therefore, when constructing a recommended portfolio, broker-dealers should be aware of the potential of conflicts of interests embedded, consciously or unconsciously, in the digital advice tool. Financial incentives can result in the most obvious conflicts of interests, for example, if the tool would result in higher fees to the firm for investments in particular products or for directing business to affiliates.

Disclosure is an important means of countering conflicts of interest. The Report also notes that firms might mitigate any conflicts by adhering to the principles articulated in FINRA Rule 2214, such as disclosing any securities favored by the digital advice tool, explaining the reasoning behind such selectivity, and stating (if applicable) that other investments not considered may have similar or superior attributes to those securities being highlighted by the tool.[2]

III. TRAINING AND LESSONS FOR INVESTORS

The Report encourages firms to train their registered persons on the features and functionality of the tool, proper usage of the tool and human intervention, and the types of customers and situations best suited for using the tool. Training also should occur when changes to the tool are made so that personnel have the most updated information.

The Report also provides "Lessons for Investors" that address issues that customers should consider in connection with using a digital advice tool offered by their broker. The "Lessons" follow the themes articulated above around suitability, rebalancing of portfolios and conflicts of interests. For example, the Report recommends that investors consider whether their financial services firm

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[2] Rule 2214 provides for certain requirements with respect to investment analysis tools, primarily in the context of communications with the public and the exception from the general prohibition against using projections or predictions of investment results contained in Rule 2210(d)(1)(F).

is asking the questions necessary to gain a good understanding of their particular circumstances, including investment objectives and risk tolerance.

The Report also urges customers to make sure they understand any potential for conflicts of interests arising out of the tool and its functionality or recommendations that may impair the objectivity of the advice. Firms should be prepared to respond to these questions from their customers.

IV. CONCLUSION

By issuing the Report, FINRA has notified the industry that digital investment advice tools must fit within the existing broker-dealer regulatory framework. The use of such tools is not a substitute for the well-established requirements on broker-dealers and registered representatives when offering investment advice. Firms should be prepared to demonstrate to regulators, including FINRA, that they have reviewed their policies and procedures in light of the Report's recommendations.

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Please do not hesitate to contact us with any questions.