Client Update
SEC Issues Guidance for Robo-Advisers

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On February 23, 2017, the Division of Investment Management (the "Division") of the Securities and Exchange Commission ("SEC") published guidance (the "Guidance") with respect to issues faced by so-called robo-advisers under the Investment Advisers Act of 1940 (the "Act").[1] The Guidance notes that robo-advisers have become more popular in recent years with their offerings of computerized investment advice using algorithms to make investment recommendations and allocations. The Division issued the Guidance in light of robo-advisers' distinguishing features from traditional investment advisers, particularly their reliance on algorithms, limited human interaction with clients and provision of advisory services over the internet.[2]

The Guidance focuses on three areas:

- The substance and presentation of client disclosures;

- The obligation to obtain information in support of suitable recommendations; and

- The adoption and implementation of effective compliance programs.

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[1] *Robo-Advisers*, SEC IM GUIDANCE UPDATE No. 2017-02 (Feb. 2017), https://www.sec.gov/investment/im-guidance-2017-02.pdf. The SEC on the same date published a Q&A-style investor bulletin addressing several issues with respect to robo-advisers. SEC, Investor Bulletin: Robo-Advisers (Feb. 23, 2017), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-robo-advisers.

[2] For more information regarding the use of robo-advisory services by broker-dealers, see our March 2016 Client Update on FINRA's report on digital investment advice. FinTech companies of all types need to be aware of their regulatory issues. *See* Lee A. Schneider, Max Shaul & Clare Lascelles, *Regulatory Priorities for FinTech Firms—and Investors—in the Coming Year*, J. TAXATION & REGULATION OF FIN. INST., Mar-Apr. 2016, at 5.

ADEQUATE CLIENT DISCLOSURES

Given that the robo-adviser business model involves little or no direct person-to-person contact, the SEC emphasizes the importance that customer disclosures be clear, comprehensive and specific. Robo-advisers should ensure that their client disclosures are reader-friendly and explain the use of algorithms, the scope of the investment advisory services and any potential risks unique to the robo-adviser model (both in general and as may be relevant to the specific advisory service).

For example, disclosures should educate clients on the meaning of algorithms and how they work to generate recommendations or allocations. Clients should receive descriptions of how the technology evaluates the data it receives (including, as applicable, from client input and otherwise) to provide the advisory service; of any risks associated with the use of algorithms (*e.g.*, conflicts of interests with third-party developers, use of stale data and matters not considered); of the nature and scope of the services provided (including different levels of service and pricing); and of the degree of human involvement in its oversight and management.

Additionally, robo-advisers should ensure that their disclosures are not misleading. All statements must be clear in describing the scope and limitations of services (*e.g.*, whether a recommended portfolio is structured to achieve a specific investment target or to provide a comprehensive investment plan).

SUITABILITY

As is the case with investment advisers generally, robo-advisers have an obligation to render only suitable advice to clients based on the client's financial situation and investment objectives. To this end, client questionnaires should be designed to elicit sufficient information from the client to ensure that the robo-adviser may render initial recommendations and ongoing investment advice that are suitable for the client based on his or her financial situation and investment objectives. To ensure that clients understand the questionnaire and to increase the likelihood of more accurate responses, firms should consider including examples or design features, such as "tool-tips" or "pop-up boxes," to supplement certain questions and explain the impact of particular responses. As an additional control, firms might consider developing an automated process to evaluate questionnaires as compared to other information collected to identify inconsistent client responses for further inquiry or review. A firm should also consider providing the client with the opportunity to provide additional information or context concerning the client's response.

Many robo-advisers give clients the opportunity to select portfolios other than those that they have recommended. The Guidance observes that some robo-advisers do not provide clients with the opportunity to consult with investment advisory personnel about how the client-selected portfolio relates to the client's stated investment objective and risk profile, and its suitability for that client. The Guidance suggests that robo-advisers take steps to ensure that clients understand the impact of any client-initiated changes to the investment strategy recommended by the firm. Robo-advisers can do so by providing educational materials to explain the criteria of particular portfolios that may be more appropriate for a client's specific investment objective(s) and risk profile. The technology may also include design features to notify clients of potential inconsistencies among stated objectives and selected portfolios.

COMPLIANCE PROGRAMS; INVESTMENT COMPANY ACT ISSUE

Under Rule 206(4)-7 of the Act, investment advisers are required to adopt an internal compliance program addressing the robo-adviser's fiduciary and substantive obligations under the Act. The Guidance outlines suggestions for robo-advisers to consider when adopting and implementing written policies and procedures in light of the new or enhanced risks posed by the rendering of advice through technology and limited human interaction.

In addition to adopting policies and procedures to reflect the disclosure and suitability requirements discussed above, robo-advisers should consider policies and procedures to address changes to algorithms and the process for client notifications. Given the reliance on automated systems, the compliance program also should address the development, testing and deployment of algorithms to ensure the technology performs as expected. The supervisory structure surrounding the use of third parties should also be addressed. Lastly, robo-advisers should implement strong cybersecurity protocols, given the internet-based nature of the services.

While the Guidance focuses on the Act, it notes that robo-advisers should consider whether the organization and operation of their programs raise an investment company status issue under the Investment Company Act of 1940 (the "ICA"). The SEC points particularly to Rule 3a-4 under that ICA, which creates a nonexclusive safe harbor from the definition of "investment company" for advisory programs that meet certain requirements related to provision of an individualized service. Under these programs, a client's account typically is managed on a discretionary basis in accordance with pre-selected investment objectives. Clients with similar investment objectives often receive the same investment advice and may hold the same or substantially the same securities in

their accounts, raising the question of whether these accounts are, collectively, an investment company. The Guidance notes that, to the extent that a robo-adviser believes that its organization and operation raise unique facts or circumstances not addressed by Rule 3a-4, it may wish to consider contacting the Division for further guidance.

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The Guidance provides important information for robo-advisers to consider when they start their businesses as well as when they make upgrades or changes to their technologies. We will continue to monitor developments in this area and provide relevant updates. Please do not hesitate to contact us with any questions.

For additional information on developments in the FinTech world, listen to Lee Schneider's podcast, "Appetite for Disruption," available here, with cohost Troy Paredes. Episodes one and two relate to robo-advisers.