LOWENSTEIN Sandler

INVESTMENT MANAGEMENT

SEC STAFF ISSUES GUIDANCE UPDATE ON ROBO-ADVISERS

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On February 23, 2017, the U.S. Securities and Exchange Commission ("SEC") Division of Investment Management (the "Division") issued guidance with respect to various regulatory matters of particular importance to automated advisers, more commonly known as "robo-advisers" (the "Guidance"). The Guidance comes on the heels of the SEC's Office of Compliance Inspections and Examinations ("OCIE") priorities letter released in January 2017, which identified the robo-adviser business model as a top focus of the SEC's examination program and the November 2016 Fintech Forum, where issues relating to how robo-advisers conduct their business were discussed at length. The Guidance incorporates both SEC staff observations and input from various robo-advisers with respect to the current regulatory regime affecting these types of advisers, but it stopped short of announcing any new rules or changes to existing rules that would address robo-advisers' businesses.

The Guidance provides robo-advisers with suggestions about how to meet disclosure, suitability, and compliance obligations under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Therefore, we advise that all federally registered robo-advisers familiarize themselves with the Guidance to best ensure compliance with applicable rules and regulations. While the Guidance focuses on robo-advisers that provide services directly to clients over the internet, it also may be helpful for other types of digital advisers and instructive to other registered investment advisers.

In this article, we discuss the likely impact the Guidance will have on robo-advisers, focusing primarily on (i) the substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services the robo-adviser offers; (ii) the obligation of the robo-adviser to obtain information from clients to support the robo-adviser's duty to provide suitable advice; and (iii) the need of the robo-adviser to adopt and implement an effective compliance program reasonably designed to address particular concerns relevant to providing automated advice.

Substance and Presentation of Disclosures

Explanation of Business Models

Given the unique aspects of robo-advisers' business models, including their reliance on algorithms and the internet as 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 Division suggests robo-advisers consider how they explain their business models and the scope of the investment advisory services they provide, as well as how material information is presented to clients. Robo-advisers should consider providing information such as (i) a statement that an algorithm is used to manage individual client accounts; (ii) a description of the algorithmic functions used to manage client accounts; (iii) a description of the assumptions and limitations of the algorithm used to manage client accounts; (iv) a description of the particular risks inherent in the use of an algorithm to manage client accounts; (v) a description of any circumstances that might cause the robo-adviser to override the algorithm used to manage client accounts; (vi) 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 that such an arrangement may create; (vii) an explanation of any fees the client will be charged directly by the robo-adviser and any other costs the client may bear, either directly or indirectly; (viii) an explanation of the degree of human involvement in the oversight and management of individual accounts; (ix) a description of how the robo-adviser uses the information gathered from a client to generate a recommended portfolio and any limitations on the use of such information; and (x) an explanation of how and when the client should update information he or she has provided to the robo-adviser.

Scope of Advisory Services and Presentation of Disclosures

Robo-advisers, like all registered investment advisers, should use reasonable care to avoid creating a false impression about the scope of

the investment advisory services they offer, which may materially mislead clients. Robo-advisers are advised not to mislead clients by implying, for example, that the robo-adviser is providing a comprehensive financial plan if it is not in fact doing so, or that information other than that collected by a questionnaire is considered when getting investment recommendations if such information is not in fact considered.

Because of robo-advisers' reliance on online disclosures to provide information to clients, robo-advisers are reminded to carefully consider whether their written disclosures are designed to be effective (*e.g.*, are not buried or incomprehensible). In presenting such disclosures, robo-advisers should consider whether the key disclosures are (i) presented prior to the sign-up process so that information necessary to make an informed investment decision is available to clients before they engage the robo-adviser or make an investment with the robo-adviser; (ii) specially emphasized; (iii) accompanied as necessary by interactive text or other means to provide additional details to clients who are seeking more information; and (iv) presented, formatted, and adapted appropriately for viewing on a mobile platform.

Provision of Suitable Advice

An investment adviser's fiduciary duty includes an obligation to act in the best interests of its clients and to provide only suitable advice. Therefore, the investment adviser 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.

Reliance on Questionnaires to Gather Client Information; Client-Directed Changes in Investment Strategy

Robo-advisers largely rely on online questionnaires to garner information from prospective clients. Due to the limited interaction between robo-advisers and their clients, in conjunction with such use of online questionnaires, robo-advisers should consider whether their questionnaires are designed to elicit sufficient information to support their suitability obligations. In doing so, robo-advisers should consider factors such as whether (i) the robo-adviser can conclude that its initial recommendations and ongoing investment advice are suitable based on the information provided by the questionnaire; (ii) the questions are sufficiently clear and/or the questionnaire is designed to provide additional clarification or examples to clients when necessary; and (iii) steps have been taken to address inconsistent client responses within the questionnaire.

Many robo-advisers give clients the opportunity to select portfolios other than those they have recommended. Consistent with the robo-adviser's obligation to act in its clients' best interests, a robo-adviser should consider providing commentary as to why it believes particular portfolios may be more appropriate for a given objective and risk profile. Robo-advisers may wish to consider whether pop-up boxes or other design features would be useful to alert a client of potential inconsistencies between the client's stated objective and the selected portfolio.

Effective Compliance Program

Rule 206(4)-7 under the Advisers Act requires every federally registered investment adviser to establish an internal compliance program that addresses the adviser's performance of its fiduciary and substantive obligations

under the Act. To comply with the rule, registered investment advisers must adopt, implement, and annually review written policies and procedures that are reasonably designed to prevent violations of the Advisers Act, as well as appoint a chief compliance officer to oversee such policies and procedures. In developing its particular program, a robo-adviser should be mindful of its unique business model. Thus, in addition to adopting and implementing written policies and procedures that address issues relevant to traditional investment advisers, robo-advisers should consider whether to adopt and implement written policies and procedures that address areas such as (i) the development, testing, and backtesting of the algorithmic code and the post-implementation monitoring of its performance; (ii) the questionnaire eliciting sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that particular client; (iii) the disclosure of changes to the algorithmic code that may materially affect that client's portfolios; (iv) the appropriate oversight of any third party affiliated with the algorithmic code or software modules utilized by the robo-adviser; (v) the prevention and detection of, as well as response to, cybersecurity threats; (vi) the use of social and other forms of electronic media in connection with the marketing of advisory services; and (vii) the protection of client accounts and key advisory systems.

The SEC recognizes that there may be a variety of means for a robo-adviser to meet its obligations to its clients under the Advisers Act and that not all of the issues addressed in the Guidance will be applicable to every

robo-adviser. Federally registered robo-advisers and other investment advisers should take care to re-examine their existing compliance program in light of the Guidance.

Practice Insights in Developing Compliance Programs for Robo-Advisers

Lowenstein Sandler has assisted numerous robo-advisers in tailoring their compliance programs to the unique risks posed by digital platforms. As the SEC recognized, there are a variety of means for a robo-adviser to meet its obligations to clients under the Advisers Act. While every robo-adviser is different, high-risk areas among robo-advisers tend to converge. For example, marketing and solicitation activities pose unique compliance issues in the robo-adviser context given the frequent use of social media accounts for advertising, paid advertisements (including through spokespeople), and digital referral arrangements (algorithmically driven or otherwise). In developing a customized compliance program, robo-advisers have many options available to them. For example, the chief compliance officer can review all advertisements (including advertisements posted through social media and spokesperson transcripts) prior to release. The robo-adviser can also designate a firm social media account controlled by managers and the chief compliance officer rather than by employees using personal social media

accounts for business purposes. In addition, the chief compliance officer can train employees on advertising guidelines, including communication with the media. Alternatively, employees can be prohibited from speaking to the media without chief compliance officer training and approval. Solicitation activities can also be preapproved by the chief compliance officer with the assistance of outside counsel, including analyzing any such arrangements under the Cash Solicitation Rule (promulgated under the Advisers Act) and any relevant state laws, rules, and regulations. In all of these areas, certain market practices have emerged and will continue to emerge in this space.

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The Guidance may be found here. Please contact the authors of this article with any questions related to the Guidance or if you require assistance developing best-in-class policies and compliance programs for your firm consistent with the Guidance and in accordance with all applicable rules and regulations and industry standards.

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