

## CLIENT MEMORANDUM

# SEC Division of Investment Management Issues Guidance Update for Robo-Advisers

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## AUTHORS

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On February 23, 2017, the U.S. Securities and Exchange Commission's (the "SEC") Division of Investment Management (the "Division") issued a guidance update for investment advisers that provide automated advice through online algorithmic-based programs—commonly referred to as "robo-advisers."<sup>1</sup> The guidance update highlights the regulatory obligations that robo-advisers face and the scrutiny they may anticipate from SEC staff related to their disclosure, suitability and compliance obligations under the Investment Advisers Act of 1940 (the "Advisers Act"), and their reliance on the Rule 3a-4 safe harbor under the Investment Company Act of 1940 (the "Investment Company Act").<sup>2</sup>

The guidance update is a continuation of the SEC's recent focus on this evolving subset of investment advisers. SEC Acting Chairman Michael Piwowar has emphasized that as "technology continues to improve and make profound changes to the financial services industry, it's important for regulators to assess its impact on U.S. markets."<sup>3</sup> To that end, in

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<sup>1</sup> Robo-Advisers, IM Guidance Update No. 2017-02 (Feb. 2017) *available* [here](#).

<sup>2</sup> Accompanying the guidance update was an Investor Bulletin, issued by the SEC's Office of Investor Education and Advocacy, that details information that individual investors may want to analyze to make informed decisions when considering the use of a robo-adviser. See Investor Bulletin: Robo-Advisers, Office of Investor Education and Advocacy (Feb. 23, 2017) *available* [here](#).

<sup>3</sup> SEC Staff Issues Guidance Update and Investor Bulletin on Robo-Advisers, SEC Press Release (Feb. 23, 2017) *available* [here](#).

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November 2016, the SEC hosted a forum of financial technology experts to discuss the impact digital-advice providers are having on the investment advisory industry. Following the “Fintech Forum,” the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) included electronic investment advice as a 2017 examination priority and noted that examinations of robo-advisers “will likely focus on registrants’ compliance programs, marketing, formulation of investment recommendations, data protection, and disclosures relating to conflicts of interest.”<sup>4</sup> Already, as the guidance update notes, the SEC and its staff have “been monitoring and engaging with robo-advisers to evaluate how these advisers meet their obligations under the [Advisers Act].”<sup>5</sup>

### The Rise of the Robo-Advisers

The popularity of robo-advisers and robo-advisory tools has increased dramatically in recent years as the appeal of automated advice has grown across a wide range of age groups and classes of investors.<sup>6</sup> As of 2015, robo-advisers had between \$55 billion and \$65 billion in assets under management, but this figure is projected to increase to approximately \$500 billion by 2020.<sup>7</sup> The guidance update reflects a recognition by the Division that robo-advisers “represent a fast-growing trend within the investment advisory industry, and have the potential to give retail investors more affordable access to investment advisory services as well as change the competitive landscape in the market for investment advice.”<sup>8</sup>

### Highlights of the Guidance Update

The guidance update focuses on three distinct areas identified by the Division with respect to a robo-adviser’s obligations under the Advisers Act:

1. the substance and presentation of a robo-adviser’s disclosures to clients;
2. the obligation to obtain information from clients to support the robo-adviser’s duty to provide suitable advice; and
3. the adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated advice.

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<sup>4</sup> Examination Priorities for 2017, National Exam Program Office of Compliance Inspections and Examinations (Jan. 12, 2017) *available* [here](#).

<sup>5</sup> Robo-Advisers, *supra* note 1.

<sup>6</sup> Robo-Advisers, *supra* note 1.

<sup>7</sup> See “Robo Advising Catching Up and Getting Ahead,” KPMG (Dec. 2016) *available* [here](#).

<sup>8</sup> Robo-Advisers, *supra* note 1.

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### Substance and Presentation of Disclosure

Robo-advisers, like all investment advisers registered with the SEC, are subject to fiduciary obligations under the Advisers Act, including the duty to make full and fair disclosure of all material facts to clients and to employ reasonable care to avoid misleading clients. The guidance update highlights the fact that a client's relationship with a robo-adviser may occur via e-mail, websites, mobile applications and/or other electronic media, but often result in limited, if any, human interaction.

The guidance update suggests that robo-advisers consider providing the following disclosures, to the extent applicable, to meet their fiduciary obligations and to account for the unique nature of their operations:

- a statement that an algorithm manages each client's account based on information that the client provides to the robo-adviser (e.g., client questionnaire);
- an explanation of how and when a client should update such information;
- a description of the algorithm's functions, assumptions, limitations and associated risks;
- a description of any involvement by a third party in the development, management or ownership of the algorithm;
- an explanation of any fees that a client will directly or indirectly bear;
- an explanation of the degree of human involvement in the oversight and management of a client's account;
- key disclosures prior to the client's enrollment;
- key disclosures that are specifically emphasized through design features such as pop-up boxes; and
- disclosure accompanied by interactive text or other means to provide details to clients who are seeking additional information.

### Provision of Suitable Advice

As fiduciaries, robo-advisers also are under an obligation to act in the best interest of their clients and to provide only suitable investment advice. To fulfill this obligation, an 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.<sup>9</sup> The guidance update notes that many robo-advisers generate a recommended portfolio based primarily, if not solely, on a

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<sup>9</sup> Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) available [here](#).

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client's responses to online questionnaires that ask for, among other things, the client's age, income, financial goals, investment horizon and risk tolerance.

Given the limited interaction between robo-advisers and their clients, robo-advisers should analyze whether client questionnaires are designed to elicit sufficient information to support a suitability determination—both as to a client's initial portfolio recommendation and as to any ongoing investment advice that may be provided to the client. To that end, the guidance update recommends that robo-advisers consider, among other things, whether the adviser's questionnaire permits additional clarification or examples to clients through design features such as tool-tips or pop-up boxes, and whether the adviser takes steps to address inconsistent client responses, such as a design feature that alerts the client and/or the robo-adviser of inconsistencies.

### Effective Compliance Programs

Rule 206(4)-7 under the Advisers Act requires investment advisers to adopt, implement and annually review written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and the rules thereunder. The guidance update provides that in developing its compliance program, a robo-adviser should be mindful of the unique aspects of its business model and should consider whether to adopt and implement written policies and procedures that address:<sup>10</sup>

- the development, testing and back-testing of the algorithm before and after implementation;
- disclosure to clients of changes to the algorithm that may materially affect their portfolios;
- appropriate oversight of any third party that develops, owns or manages the algorithmic code of software modules used by the robo-adviser;
- the prevention and detection of, and response to, cybersecurity threats; and
- the use of social and other forms of electronic media in connection with the marketing of the robo-adviser's services.

### **Considerations under the Investment Company Act**

Robo-advisers must be cognizant of the regulatory pitfalls that can arise if their operations are deemed to involve activities that subject them to regulation under the Investment Company Act. Notably, the guidance update affirmatively states that robo-advisers need to evaluate whether the organization and operation of their programs raise any issues under the Investment Company Act, and in particular, Rule 3a-4 thereunder.

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<sup>10</sup> Robo-Advisers, *supra* note 1.

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Rule 3a-4 provides a non-exclusive safe harbor from the definition of investment company for discretionary investment advisory programs. As noted in the rule's adopting release, advisory programs seeking to rely on Rule 3a-4 are typically designed by investment advisers that provide the same or similar portfolio management services on a discretionary basis to a large number of advisory clients that have relatively small amounts to invest.<sup>11</sup> An advisory program that is organized and operated in accordance with the rule will not be deemed to be a de facto investment company so long as it complies with certain conditions designed to ensure that clients receive individualized advice and that the program is not simply pooling clients' assets. Among other conditions, Rule 3a-4 requires investment advisers to obtain information about each client's individual financial situation and investment objectives and to manage each client account in accordance with any reasonable restrictions imposed by the client. The rule also requires some personnel of the investment adviser, who are knowledgeable about the account and its management, to be reasonably available to the client for consultation.

Thus, the guidance update suggests that robo-advisers evaluate their ability to rely on Rule 3a-4 and to contact the SEC for further guidance if the robo-advisers "organization and operation raise unique facts or circumstances not addressed by Rule 3a-4."<sup>12</sup>

### Conclusion

The Division's guidance update together with OCIE's 2017 examination priorities confirm that regulators are continuing to observe robo-advisers and are evaluating how robo-advisers fit into existing regulatory requirements. Even as new advice delivery services evolve, the guidance update offers the clearest indication to date from the SEC and its staff that robo-advisers' structure, operations, disclosure and compliance programs will face regulatory scrutiny under the Advisers Act and the Investment Company Act. Accordingly, robo-advisers of all sizes should evaluate their advisory programs in light of the regulatory obligations emphasized in the guidance update.

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<sup>11</sup> Status of Investment Advisory Programs under the Investment Company Act of 1940, *supra* note 9.

<sup>12</sup> Robo-Advisers, *supra* note 1.

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