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Robo-Advisers on Center Stage in 2017: Evaluating Compliance under SEC Guidance and Rule 3a-4

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Automated investment advisers, generally known as "robo-advisers," have taken center stage in the ever-changing world of investment advising and financial technology. Headlines such as "Robo-Advisers: Not just for Millennials Anymore?"[1] and "The Great FinTech Robo Advisor Race"[2] are indicative of how pervasive and competitive the robo-adviser industry has become. The bench of robo-adviser options has expanded beyond start-ups that target younger investors looking for simpler and cheaper investing options, such as Wealthfront and Betterment.[3] Either through acquisitions or in-house development, major financial firms like BlackRock, Charles Schwab, and Vanguard have started to offer their own robo-advising options.[4] And, as the market for robo-advisers develops, some robo-advisers, such as True Link Financial, have started designing systems that target older clientele nearing retirement.[5]

Conceptually, robo-advisers, which are typically registered investment advisers, use innovative technologies to provide discretionary asset management services to their clients through online algorithmic-based programs.[6] A client who wishes to utilize a robo-adviser enters personal information and other data into an interactive, digital platform through a questionnaire. Based on the information provided, the robo-adviser generates a portfolio for the client and subsequently manages the client's account. In managing accounts, robo-advisers typically provide services such as portfolio planning, asset allocation, risk assessments, account re-balancing, and tax harvesting.[7]

Underneath the sheen of the robo-adviser business, regulators and compliance professionals are racing to catch up with the growing industry. Commissioner Kara Stein of the US Securities and Exchange Commission (SEC) stated in a speech at Harvard Law School in 2015, "The [SEC] is now challenged with thinking through what it means to regulate a robo advisor. This concept did not even exist when most of the laws applicable to investment advisers were drafted."[8]

Throughout the agency, the SEC has increased its attention on robo-advisers in 2017. In February 2017, the SEC's Division of Investment Management (DIM) took a significant leap in the regulation of robo-advisers by issuing guidance (the Guidance) on how robo-advisers should structure their disclosures and analyze their compliance with federal investment adviser laws and regulations.[9] Simultaneously, the SEC's Office of Investor Education and Advocacy issued a bulletin on how investors can navigate the field of robo-advisers.[10] And, the SEC's

Office of Compliance Inspections and Examinations announced that robo-advisers would be a priority for 2017 examinations.[11] The Guidance does not introduce any new rules or regulations, but it does identify common issues for robo-advisers and presents sets of rhetorical questions for robo-advisers to ask themselves as they structure their disclosures and business models.

This article reviews the Guidance and discusses the areas of compliance it highlights for robo-advisers. In addition, it discusses how robo-advisers may fall out of compliance with Rule 3a-4 under the Investment Company Act of 1940 (the 1940 Act), which allows for robo-advisers to avoid registering as investment companies.[12] And finally, this article presents ways in which robo-advisers can think through their business models, disclosures, and other items in order to comply with the rules and regulations of federally registered investment advisers under Rule 3a-4 and the Investment Advisers Act of 1940 (the Advisers Act).[13]

The SEC Guidance Update on Robo-Advisers

In February 2017, DIM issued the Guidance to address the rise of robo-advisers.[14] The Guidance sets forth unique considerations that robo-advisers face in meeting their legal obligations, and provides guidance on how robo-advisers can better ensure compliance.

Robo-advisers, like all registered investment advisers, are subject to the substantive and fiduciary obligations of the Advisers Act.[15] The Guidance focuses on three areas identified by SEC Staff. The three areas are: (1) the substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers; (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.[16]

In order to have adequate disclosures, the Guidance suggests that robo-advisers consider the most effective way to communicate to their clients the limitations, risks, and operational aspects of their advisory services.[17] Most robo-advisers provide information through websites. In the Guidance, DIM suggests that robo-advisers consider the clarity of the descriptions of the investment advisory services they offer and use reasonable care to avoid creating a false implication about the scope of services provided.[18]

As registered investment advisers, robo-advisers must ensure that they are providing suitable advice to their clients.[19] Noting that most robo-advisers accumulate information about their clients through questionnaires, the Guidance instructs robo-advisers to ensure that their questionnaires are designed to elicit sufficient information to devise suitable initial and ongoing investment advice, and that the questionnaire is sufficiently clear.[20] In addition, under the Guidance, robo-advisers should consider whether they will allow client-directed changes or whether everything will be controlled by the adviser's algorithms.

Finally, robo-advisers must have sufficient written policies and procedures designed to comply with Rule 206(4)-7 under the Advisers Act, just like a more traditional investment adviser.[21] The Guidance instructs that when developing its compliance program, a robo-adviser should be mindful of the unique aspects of its business model rather than assume that a compliance program for a traditional adviser will also work for an automated investment adviser.[22]

Issues Raised by the SEC's Guidance: The Regulatory and Compliance Landscape Facing Robo-Advisers

The Guidance identifies issues in the areas of the substance and presentation of disclosures, the provision of suitable advice, and the adoption and implementation of effective compliance programs.[23] In addition, it briefly mentions the issue of whether a robo-adviser may fail to comply with the "safe harbor" in Rule 3a-4 under the 1940 Act.[24] All four areas

raise distinct legal issues for robo-advisers. However, as discussed in the sections below, the areas, such as suitable advice and Rule 3a-4's requirement of individualized advice, overlap each other in various ways. The following sections expand upon the substantive duties and requirements of robo-advisers mentioned in the Guidance, particularly Rule 3a-4.

The Substance and Presentation of Disclosures

All registered investment advisers, including robo-advisers, have a duty to make "full and fair" disclosures to clients in order to avoid misleading them.[25] The information in such disclosures must be "sufficiently specific" so that a client can understand the investment adviser's business practices and conflicts of interest.[26] The Guidance breaks down the issues pertaining to the substance and presentation of disclosures into three categories: (1) explanation of business model; (2) scope of advisory services; and (3) presentation of disclosures.[27]

Robo-advisers are unique in their nature, at least as compared to traditional investment advisers.[28] By relying on automated systems, a potential or current client carries a greater degree of the burden for understanding the systems and disclosures of robo-advisers. However, the duty still lies with the robo-adviser to ensure that its disclosures are clear and comprehensible.[29]

Therefore, a robo-adviser must think through what is necessary to understand about its business model when drafting disclosures. For instance, when explaining its business model, a robo-adviser should disclose elements that are particular to the risks of using a robo-adviser as well as the specific robo-adviser's algorithm.[30] A robo-adviser should be clear about the scope of its services and should consider explaining what services it does not provide.[31] And finally, a robo-adviser must think critically about how to present its disclosures, utilizing all available technological tools to ensure that potential or current clients not only see disclosures but understand them.[32]

In addition to describing its services, a robo-adviser may wish to consider detailing the development, testing, and back testing of the algorithmic code and the post-implementation monitoring of its performance.[33] A robo-adviser may also wish to provide an explanation of how any changes to the algorithmic coding may materially affect an investor's portfolio.[34] A robo-adviser may want to not only consider describing the process in which a client's answers to the questionnaire are used to create a suitable personalized investment strategy based on the client's investment objectives, but also to consider describing the process for how it crafted its questionnaire and how each answer potentially affects investment strategies.[35]

The Provision of Suitable Advice

In the words of Commissioner Stein, "The lynchpin of investment adviser regulation is the fiduciary duty."[36] One element of the fiduciary duties of investment advisers is to provide suitable investment advice.[37] This requirement generally means that 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."[38]

The requirement of "suitability" has led many to opine as to whether robo-advisers inherently cannot meet an investment adviser's fiduciary duty of care because robo-advisers' automated systems may not allow for sufficient tailoring toward individual clients.[39] Commissioner Stein rhetorically pondered such a question in her remarks in 2015 when she stated that the concept of robo-advisers "bumps up against what we would traditionally think of as a fiduciary."[40]

In order to provide "suitable advice," investment advisers must understand a client's investment objectives and financial situation.[41] A client's investment objectives and financial situation include elements such as risk profile and financial picture, investment goals such as retirement and college savings, and investment timeline.[42] However, these concepts

can be complex for each investor. For instance, risk tolerance is comprised of at least two dimensions: risk capacity and risk willingness.[43] In addition, in providing investment advice to a client based on the client's full financial picture, an investment adviser should consider whether or not a client should invest or should save instead.[44]

Robo-advisers generally accumulate the information necessary to make determinations about their clients' investment objectives and financial situations based on a questionnaire designed by the robo-adviser.[45] The questionnaire then uses the data inputs from the client and assigns an investment portfolio based on the client's risk profile and investment goals.[46] This structure could cause difficulties for robo-advisers in their pursuit of providing suitable investment advice. The questionnaire must be extensive enough to elicit responses from a client that adequately portray the client's current financial landscape such as whether and how much the client is risk averse, and whether the client has any retirement investments, pools of savings, or debt. The questionnaire must also adequately gauge the client's prospective investment goals and timeline.

With limited or no human availability, robo-advisers may limit a client's ability to provide additional context to their answers. A questionnaire opens the door to the possibility that a client may provide contradictory answers to questions. And last, but not least, a questionnaire is a one-time informational input that may not adequately understand how a client may behave in a market shock situation.

To adequately assess their potential and current clients, robo-advisers should ask themselves a key question, as framed by the Financial Industry Regulatory Authority (FINRA): "What information is necessary to build a customer profile with sufficient information to make a sound investment recommendation?"[47] A robo-adviser's questionnaire should assess both a client's risk capacity and risk willingness.[48] It should assess whether investing (as opposed to saving or paying off debt) is appropriate for the client.[49] It should seek to obtain information on all of the required investment profile factors or have a reasonable basis for believing that a particular factor is not necessary.[50] A robo-adviser may wish to include hypothetical questions about various market shock situations in order to gauge the potential ways a client may react in strained financial circumstances to better calibrate their investor profile. And, the questionnaire should have a mechanism to resolve any contradictory answers provided by the client, such as pop-up boxes identifying the inconsistencies and asking the client to fix the issues.[51] Finally, robo-advisers should consider providing periodic questionnaires to existing clients, at least annually, but maybe even more frequently, in order to assess whether or how a given client's investment priorities may have changed.

Relatedly, due to their construction, robo-advisers may not provide clients with the opportunity to provide client-directed changes to the client's investment strategy. Alternatively, robo-advisers that do allow for client-directed changes may allow for client customization, but without any interaction with the adviser providing an explanation as to why certain investment decisions were made for a given client. Thus, in order to fulfill its duty of providing suitable investment advice, a robo-adviser may wish to also have pop-up boxes explaining reasons behind certain investment decisions or have personnel available to answer questions.[52] This would provide any client wishing to direct changes with explanations as to the origin of the investment strategy and how changes may affect the investment strategy.

Effective Compliance Programs

Robo-advisers, like all registered investment advisers, are required to comply with the compliance program requirements of Rule 206(4)-7 under the Advisers Act.[53] As the Guidance explains, Rule 206(4)-7 requires every registered investment adviser to establish a compliance program that is designed to prevent, detect, and correct violations of the Advisers Act.[54]

In adopting Rule 206(4)-7, the SEC designated certain items for investment advisers to focus on when constructing compliance programs. To the extent the issues may be relevant, the SEC expects that each adviser construct written policies and procedures that discuss: the portfolio management process, trading practices, proprietary trading of the adviser, accuracy of disclosures, the safeguarding of client assets and records, record keeping, marketing advisory services, processes to value client holdings and assets, and business continuity plans.[55] In addition, Rule 206(4)-7 requires that investment advisers conduct annual reviews of their policies and procedures and designate a chief compliance officer.[56]

For a robo-adviser, the challenges in crafting a compliance program lie in the "unique aspects of its business model."[57] First, robo-advisers must construct written policies and procedures that cover the standard issues required in a Rule 206(4)-7 compliance manual, such as explanations of how the robo-adviser will safeguard client assets and privacy, its marketing practices, and its business continuity plans.[58] But second, a robo-adviser must evaluate its own unique business model, such as its portfolio management algorithms, the client questionnaires, and the design of client services. A robo-adviser should consider how to condense these unique aspects of robo-advising into written policies and procedures that adequately describe its practices in a way that satisfies its obligations under Rule 206(4)-7.[59]

Are Robo-Advisers Constructed to Satisfy Rule 3a-4?

The Guidance briefly questions in passing whether robo-advisers are investment companies under the 1940 Act and its rules, specifically Rule 3a-4.[60] Rule 3a-4 provides a "safe harbor" from the definition of "investment company" for certain programs that provide investment advisory services.[61] As the SEC provides in the adopting release, the safe harbor is intended for investment advisory programs that provide the same or similar professional portfolio management services on a discretionary basis to a large number of advisory clients having relatively small amounts to invest.[62]

The principle behind Rule 3a-4 is that investment advisory programs that provide similar services to a large number of clients could fall into the definition of "issuer" under the 1940 Act.[63] Under Section 3(a)(1) of the 1940 Act, issuers primarily engaged in the business of investing must register as investment companies.[64] An issuer includes any organized group of persons that issues or proposes to issue any security, and the clients in an investment advisory program, taken together, could be considered to be an organized group of persons.[65] Thus, if the group of investors is considered an issuer, then they would be required to register as an investment company under the 1940 Act.

The safe harbor in Rule 3a-4 allows for investment advisory programs to avoid registration as investment companies if the programs meet six key conditions: (1) each client's account must be managed on the basis of the client's financial situation and investment objectives; (2) the sponsor of the program must obtain sufficient information from each client to be able to provide individualized investment advice; (3) the sponsor and portfolio manager must be reasonably available to consult with each client; (4) each client must have the ability to impose reasonable restrictions on the management of the account; (5) each client must be provided with a quarterly account statement and, at least annually, the adviser must check to see whether there have been any changes in the client's financial situation or investment objectives; and (6) each client must retain a certain level of ownership of the securities in the account.[66]

Several elements of Rule 3a-4 may already be met by a robo-adviser under its obligations as a registered investment adviser, such as those described above in the section regarding the suitability of advice.[67] The suitability of advice requirement is closely related to a core pillar of Rule 3a-4: the "individualized treatment of clients."[68] The SEC focused primarily on

individualization in adopting the rule.[69] In its adopting release for Rule 3a-4, the SEC noted that advisers may qualify for the safe harbor from registration under the 1940 Act even if "clients of an investment advisory program with similar investment objectives may hold substantially the same securities in their accounts in accordance with a portfolio manager's model. . . ."[70] However, the SEC reiterated that despite the allowance for similar actions for multiple clients, investment advisers for clients must still provide advice that is suited for each client's individualized investing situation.[71]

Rule 3a-4 sits atop a progeny of SEC no-action letters and other actions by DIM taken to determine whether advisory programs qualified as investment companies.[72] In issuing Rule 3a-4, the SEC referenced the body of no-action letters issued by DIM and stated that the existing guidance would remain in effect, even after the promulgation of Rule 3a-4.[73] While not a no-action letter, the SEC adjudicated the issue of "individualization" in the context of whether a managed investment program is an investment company under the 1940 Act.[74] In the settled case of *In re Clarke Lanzen Skalla Investment Firm, Inc.*, Clarke Lanzen Skalla Investment Firm, Inc. (CLS) created a managed asset investment program that pooled discretionary advisory accounts and invested the assets of the pooled accounts in a substantially similar manner in mutual funds.[75] The SEC found that CLS's program was an unregistered investment company, reasoning that "if clients of a managed discretionary account program . . . *do not receive individualized advisory services* and do not retain sufficient indicia of rights traditionally associated with individual ownership of the securities purchased for their accounts, the pool of nominally separate client accounts in the program may be an investment company."[76]

The principle of individualization even relates to the sixth condition of Rule 3a-4. As noted above, the sixth condition of Rule 3a-4 is that each client must retain a certain level of ownership of the securities in the account.[77] When discussing this condition in the rule's release, the SEC stated, "[T]he indicia of ownership . . . are those that provide clients with the ability to act as owners of the securities in their accounts."[78] To satisfy this level of client control, Rule 3a-4 provides several elements: (1) an ability for clients to withdraw securities and cash; (2) a right to vote securities, or delegate the authority to another person; (3) a right to receive trade confirmations; and (4) legal rights as security-holders to proceed directly against the issuer of any security in the client's account.[79] The first and third factors are relatively straightforward. The second factor provides that a client must have the right to vote proxies or delegate his or her right to vote proxies to another person under an investment program.[80] For the fourth factor, the SEC incorporated providing clients with legal rights into individualized advisory services by stating, "[A] key element of providing *individualized* advisory services is that a client have the same rights as a person holding the securities outside an investment advisory program."[81] Thus, to the extent a client would have the right outside the investment program, a client must be able to "proceed directly against the issuer of any security in the client's account and not be obligated to join any person involved in the operation of the program, or any other client of the program."[82]

Due to their structure, robo-advisers may qualify for the safe harbor under Rule 3a-4, but they must closely monitor their structure and activities. Critics of robo-advisers have argued that the nature of automated investment advice may not be able to qualify for Rule 3a-4.[83] For instance, as noted above in connection with issues about the suitability of advice, a robo-adviser's questionnaire may not provide sufficient information to adequately manage a client's account on the basis of the client's financial situation. Or, a robo-adviser may not have sufficient communication avenues available for clients to consult with the sponsor or portfolio manager.[84]

Therefore, it is critical for robo-advisers that would like to avoid registration as investment companies to structure their advisory services in a manner

that emphasizes individualized advice for clients. In the Guidance, the SEC suggests that robo-advisers worried about satisfying Rule 3a-4 can contact SEC Staff.[85] However, even before that step, it is important for robo-advisers to evaluate how their business model, questionnaire, and algorithms will service each client's investment objectives and financial situation not just under the suitability standard, but also through the lens of individualization.

To meet this standard, robo-advisers should consider emphasizing certain aspects relating to client input and interaction in their construction (and corresponding disclosures). For instance, robo-advisers should consider allowing for as much client information as possible in the questionnaire through follow-up and hypothetical questions. Robo-advisers should also avoid considering a reliance on investment pools based around overly simplified characterizations of each client's investment and risk profile.[86] The investment program itself should incorporate as many aspects as possible of a client's current and future financial situation. Robo-advisers should also evaluate the structure of their investment programs to ensure that a client retains an "indicia of ownership" over his or her account with measures such as providing the client with the ability to withdraw securities or cash and with transaction confirmations. Finally, robo-advisers must calculate the rights provided to their clients and consider whether they will develop a policy that will delegate proxy voting rights to the robo-adviser and whether the investment program as constructed restricts the rights of clients to bring suits against any issuer of a security in their account.

Methods Robo-Advisers Can Use to Comply with their Regulatory Burden

From a compliance standard, robo-advisers have much to consider when constructing their business model and drafting their compliance materials. As Commissioner Stein said, the rules and regulations governing investment advisers were designed for human based interactions, thus leaving robo-advisers with the compliance task of squeezing an oval peg into a round hole. The Guidance provides many valuable questions that robo-advisers should ask themselves as they are thinking through their disclosures and compliance programs.[87] However, there are several fundamental issues that robo-advisers must tackle, specifically complying with Rule 3a-4.

The following presents a series of rhetorical questions for robo-advisers to consider that present some of those raised by the Guidance as well as the additional questions addressing Rule 3a-4. The questions start as bigger picture topics to consider while designing a robo-adviser business model and whittle down to questions relating to the specific compliance issues provided by the Guidance. Because of the overlap of Rule 3a-4, fiduciary requirements and compliance program requirements, efforts by robo-advisers to satisfy one issue may satisfy another.

The Safe Harbor under Rule 3a-4

A robo-adviser that does not want to register as an investment company may wish to design its advising methods to comply with the conditions of Rule 3a-4.[88] In particular, a robo-adviser may wish to consider:

- How to allow for as much individualized investment advice for each client as possible (for example, how may each client's investment objectives create different investment outcomes from similarly situated, but not identical clients and if or how a client can manually affect the investment decisions created by the algorithms, based on the client's specific investment goals and financial situation);
- How to design a questionnaire that will extract enough information from a potential client so that the investing algorithm will be able to take into consideration the potential client's full financial situation and investment objectives (for example, risk profile, current income, current savings, current retirement savings,

existing debt, other investment accounts, financial objectives such as investing timelines, financial goals such as purchasing a home, paying for college, as well as how the client may react to potential future changes to his or her financial situation);
- How to design the investment algorithm to sufficiently accommodate all of the data from the questionnaire in a way that can meet each client's specific financial situation and investment objectives;
- How to accommodate any nuance (for example, through additional pop-up questions, supplemental questionnaires, etc.) that is received in a questionnaire response in the investment algorithms in order to be able to provide individualized investment advice;
- Whether it will allow for its representatives to be available to consult with each client (for example, by phone, email, or chat services);
- Whether it will allow each client to have the ability to impose restrictions on the management of the account (for example, prohibiting the investment in certain types of securities);
- How it will design a system to, at least annually, provide a follow-up questionnaire to determine whether there have been any changes in the client's financial situation or investment objectives; and
- How to allow each client a certain level of ownership over the securities in the account (for example, the rights to withdraw securities or cash, exercise or delegate proxy voting, and receive transaction confirmations).

The Provision of Suitable Advice

In addition to some of the foundational questions above, robo-advisers, once operating, have an obligation to act in the best interests of their clients and to provide only suitable investment advice. Very similar to the questions above for satisfying Rule 3a-4, a robo-adviser should consider whether its questionnaire is designed to extract sufficient information to provide suitable advice to clients. In addition to the factors listed above regarding Rule 3a-4, robo-advisers should consider factors such as:[89]

- Whether the robo-adviser has methods to evaluate if its initial recommendations and ongoing investment advice are appropriate for each client;
- Whether the questions in the questionnaire are sufficiently clear; and
- Whether the questionnaire is designed to address inconsistent client responses.

The Substance and Presentation of Disclosures

Because of the limited human interaction of robo-advisers, robo-advisers may wish to consider effective ways to communicate the limitations, risks, and operational aspects of their advisory services in their disclosures. Robo-advisers should draft clear and straightforward descriptions of their investment advisory services that are easy to find. For instance, a robo-adviser should be careful only to state that it is providing a comprehensive financial plan if it is in fact doing so.[90] A robo-adviser should also consider whether and how to make its disclosures interactive, complete with any additional information or styling necessary to understand the disclosures.[91] And, when explaining their business model, robo-advisers may wish to disclose information regarding their particular business practices and related risks, such as:[92]

- How an algorithm manages individual client accounts;
- A description of the algorithmic functions used to manage client accounts;
- A description of the particular risks inherent in the use of an algorithm for investment advice and management (for example, susceptibility to market shocks)[93];
- Whether there are situations in which the robo-adviser may override the algorithm;[94]

- Whether there is any involvement by a third party in the development, management, or ownership of the algorithm used to manage client accounts;
- A description and explanation of any conflicts of interest any arrangements with third parties may create; and
- An explanation of any fees the client will be charged directly by the robo-adviser, and of any other costs that the client may bear either directly or indirectly.

Effective Compliance Programs

Finally, robo-advisers must construct compliance programs that comply with Rule 206(4)-7. In addition to written policies and procedures, robo-advisers should consider issues, such as:[95]

- The development, testing, and back testing of the algorithmic code and the post-implementation monitoring of its performance;
- As mentioned above regarding suitable advice, whether the questionnaire allows the robo-adviser to evaluate whether its initial recommendations and ongoing investment advice are appropriate for that client;
- How changes to the algorithmic code may materially affect client portfolios;
- The oversight of any third party that develops, owns, or manages the algorithmic code or software modules utilized by the robo-adviser; and
- What types of cybersecurity protection measures the robo-adviser has in place.

Conclusion

In 2017, robo-advisers have established themselves as a market force in the world of financial advising. With estimates of $2.2 trillion assets under management by 2020, it does not appear that robo-advisers will be exiting the market any time soon.[96] The SEC and other regulators are catching up to ensure that these digital platforms comply with pre-digital laws, regulation, and guidance. The Guidance is an invaluable tool for clarity on what issues robo-advisers should be paying attention to and how they might be able to approach compliance. However, it is just a first step. Additional issues, such as Rule 3a-4 compliance, still lurk at every turn. The good news is the structural, fiduciary, and disclosure obligations on robo-advisers overlap. With the Guidance as a starting place, robo-advisers are now better able to understand where and why they are vulnerable, and also how they can strengthen their regulatory compliance.

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NOTES

1 Richard Eisenberg "Robo Financial Advisers: Not Just for Millennials Anymore?," Forbes (Dec. 6, 2016, 10:35 AM), *https://www.forbes.com/sites/nextavenue/2016/12/06/robo-advisers-not-just-for-millennials-anymore/#68d1d8862738.*

2 Fulgani Desai, "The Great FinTech Robo Advisor Race," Forbes (Jul. 31, 2016, 11:54 PM), *https://www.forbes.com/sites/falgunidesai/2016/07/31/the-great-fintech-robo-adviser-race/2/#63f675395213.*

3 Wealthfront, *https://www.wealthfront.com/* (last visited Apr. 7, 2017); Betterment, *https://www.betterment.com/* (last visited Apr. 7, 2017); *see also* Lael Brainard, Gov., Bd. of Govs. of the Fed. Reserve Sys., "The Opportunities and Challenges of Fintech," Conference of Financial Innovation at the Board of Governors of the Federal Reserve System, Washington, D.C. (Dec. 2, 2016), available at *https://www.federalreserve.gov/newsevents/speech/brainard20161202a.htm* (stating how robo-advisers are helping to make investing and retirement planning cheaper and more accessible).

4 Desai, *supra* n.2 (listing the robo-advising options now provided by major investment firms, such as Future Adviser by BlackRock, Schwab Intelligent Portfolios by Charles Schwab, and Personal Adviser Services by Vanguard).

5 Eisenberg, *supra* n.1; True Link Financial, *https://www.truelinkfinancial.com/* (last visited Apr. 7, 2017).

6 US SEC, IM Guidance Update No.. 2017-02, Robo-Advisers, at 1 (2017), *https://www.sec.gov/investment/im-guidance-2017-02.pdf* [hereinafter Robo-Advisers Guidance].

7 Desai, *supra* n.2.

8 Kara Stein, Comm'r, SEC, "Surfing the Wave: Technology, Innovation, and Competition," Remarks at Harvard Law School's Fidelity Guest Lecture Series (Nov. 9, 2015), available at *https://www.sec.gov/news/speech/surfing-wave-technology-innovation-and-competition-remarks-harvard-law-schools-fidelity*.

9 Robo-Advisers Guidance, *supra* n.6.

10 US SEC, Investor Bulletin: Robo-Advisers (Feb. 23, 2017), *https://www.sec.gov/oiea/investor-alerts-bulletins/ib_robo-advisers.html.*

11 US SEC, Examination Priorities for 2017 (2017), *https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.*

12 15 U.S.C. §§ 80a-1–80a-64 (2016); 17 C.F.R. § 270.3a-4 (2015).

13 15 U.S.C. §§ 80b-1–80b-21.

14 Robo-Advisers Guidance, *supra* n.6.

15 15 U.S.C. § 80b-6.

16 Robo-Advisers Guidance, *supra* n.6, at 2.

17 *Id.* at 3.

18 *Id.* at 5.

19 *Id.* at 6.

20 *Id.*

21 17 C.F.R. § 275.206(4)-7; *see also* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,713 (Dec. 24, 2003) (to be codified at 17 C.F.R. pt. 275) [hereinafter Rule 206(4)-7 Adopting Release], available at *https://www.sec.gov/rules/final/ia-2204.htm.*

22 Robo-Advisers Guidance, *supra* n.6, at 7.

23 *Id.* at 2.

24 15 USC. §§ 80a-1–80a-64; 17 C.F.R. § 270.3a-4.

25 Robo-Advisers Guidance, *supra* n.6, at 3 (*citing* SEC v. Capital Gains Research Bureau, Inc., 375 US 180, 186, 194 (1963)).

26 Robo-Advisers Guidance, *supra* n.6, at 3 (citing Amendments to Form ADV Adopting Release, 75 Fed. Reg. 49,234, 49236 (Aug. 12, 2010) (to be codified 17 C.F.R. pt. 275)).

27 Robo-Advisers Guidance, *supra* n.6, at 3-5.

28 *Id.* at 3.

29 *Id.* (citing Amendments to Form ADV Adopting Release, *supra* n.26, at 49,236).

30 Robo-Advisers Guidance, *supra* n.6, at 3.

31 *Id.* at 5.

32 *Id.*

33 *Id.* at 8.

34 *Id.*

35 *See id.*

36 Stein, *supra* n.8.

37 Robo-Advisers Guidance, *supra* n.6, at 6 (citing Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997) (to be codified 17 C.F.R. pt. 270) [hereinafter Rule 3a-4 Adopting Release]).

38 Robo-Advisers Guidance, *supra* n.6, at 6.

39 Blaine F. Aikin, "Duty of Due Care and Robo-Advisers," Investment News (Oct. 11, 2015, 12:01 AM), *http://www.investmentnews.com/article/20151011/FREE/310119994/duty-of-due-care-and-robo-advisers.*

40 Stein, *supra* n.8.

41 Robo-Advisers Guidance, *supra* n.6, at 6 (citing Rule 3a-4 Adopting Release, *supra* n.37, at 15,102).

42 *See* Robo-Advisers Guidance, *supra* n.6, at 6.

43 FINRA, "Report on Digital Investment Advice" at 9 (Mar. 2016), *https://www.finra.org/sites/default/files/digital-investment-advice-report.pdf* (defining "risk capacity" as the measurement of an investor's ability to take risk or absorb loss, and defining "risk willingness" as the measurement of the customer's attitude towards risk).

44 FINRA, *supra* n.43, at 10; Editorial, "Can Robo-Advisers Be Fiduciaries?," Investment News (Mar. 20, 2016, 12:01 AM), *http://www.investmentnews.com/article/20160320/FREE/303209998/can-robo-advisers-be-fiduciaries* (quoting Aaron Klein, CEO of Riskanalyze, "When the first robo can look at

someone wanting to invest $10,000 and say, 'That's a bad decision for you; instead of investing you should pay down student loans' … that's when we reach the point that they're actually delivering advice.").

45 Robo-Advisers Guidance, *supra* n.6, at 6.

46 *Id.* at 1.

47 FINRA, *supra* n.43, at 8.

48 *Id.* Note that the assessment of risk capacity and risk willingness is a requirement for any robo-adviser that is also a registered broker-dealer under FINRA Rule 2111. *See id.* at n.14 (citing Fin. Regulatory Auth. Rule 2111 (Suitability), available at *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859).*

49 FINRA, *supra* n.43, at 8.

50 Robo-Advisers Guidance, *supra* n.6, at 6; FINRA, *supra* n.43, at 9.

51 Robo-Advisers Guidance, *supra* n.6, at 7; FINRA, *supra* n.43, at 10.

52 Robo-Advisers Guidance, *supra* n.6, at 7.

53 17 C.F.R. § 275.206(4)-7.

54 Robo-Advisers Guidance, *supra* n.6, at 7; *see also* SEC, Information for Newly-Registered Investment Advisers (Nov. 23, 2010), *https://www.sec.gov/divisions/investment/advoverview.htm.*

55 17 C.F.R. § 275.206(4)-7(a); Rule 206(4)-7 Adopting Release, 68 Fed. Reg. 74,713, 74,716 (Dec. 24, 2003) (to be codified 17 C.F.R. pt. 275).

56 17 C.F.R. §§ 275.206(4)-7(b)-(c); Rule 206(4)-7 Adopting Release, 68 Fed. Reg. at 74,720.

57 Robo-Advisers Guidance, *supra* n.6, at 7.

58 Rule 206(4)-7 Adopting Release, 68 Fed. Reg. at 74,716.

59 Robo-Advisers Guidance, *supra* n.6, at 7.

60 17 C.F.R. § 270.3a-4. Published just after the Guidance, another piece in *The Investment Lawyer* briefly addressed the intersection of robo-advisers and Rule 3a-4. It proposed five considerations for robo-advisers in order to maintain compliance under Rule 3a-4. This section will reiterate several of those points as well as go further into emphasizing the importance of "individualization" in the structure of robo-advisers that wish to avoid registering under the 1940 Act. *See* Jesse P. Kanach, Andrew P. Cross, & Mary C. Moynihan, "As Fintech Platforms Grow Up, Investment Management Firms Face the "Problems of Tomorrow," *The Investment Lawyer*, Mar. 2017, at 13-14.

61 Rule 3a-4 Adopting Release, *supra* n.37, at 15,099.

62 *Id.*

63 Status of Investment Advisory Programs Under the Investment Company Act of 1940, 60 Fed. Reg. 39574, 39,575 (proposed Aug. 2, 1995) [hereinafter July Release].

64 15 USC. § 80a-3(a)(1)(A).

65 July Release, *supra* n.63, at 39,575. In its report on the Philanthropy Act of 1995, the House Commerce Committee illustrated that under the 1940 Act, a set of investment accounts may be an investment company. H.R. Rep. No. 104-333, at 6 (1995), *reprinted in* 1995 U.S.C.C.A.N. 619, 621-22.

66 Rule 3a-4 Adopting Release, *supra* n.37, at 15,099; *see also* 17 C.F.R. § 270.3a-4.

67 *See supra,* text accompanying n.36-52.

68 Harvey E. Bines & Steve Thel, Investment Management Law and Regulation 4-17 (3d 2015).

69 *Id.* at 3-47–3-48 (citing Rule 3a-4 Adopting Release, *supra* n.37, at 15,099).

70 Rule 3a-4 Adopting Release, *supra* n.37, at 15,102 n.12 and accompanying text (citing Qualivest Capital Management Inc., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,609 (Jul. 30, 1990) (providing no-action relief to a sponsor who had proposed to use a computerized investment allocation model to allocate client assets among money managers)).

71 Rule 3a-4 Adopting Release, *supra* n.37, at 15,102.

72 *Id.* at 15,100 (*citing* Benson White & Company, SEC No-Action Letter, [SEC No-Action Letters (1983-2003)] (CCH) (June 14, 1995); Wall Street Preferred Money Managers, Inc., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,452 (Apr. 10, 1992); Rauscher Pierce Refsnes, Inc., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,443 (Apr. 10, 1992); Westfield Consultants

Group, SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,424 (Dec. 13, 1991); Rushmore Investment Advisers, Ltd., SEC No-Action Letter, [SEC No-Action Letters (1983-2003)] (CCH) (Feb. 1, 1991); Qualivest Capital Management, Inc., *supra* n.70).

73 Rule 3a-4 Adopting Release, *supra* n.37, at 15,101.

74 Bines & Thel, *supra* n.68, at 3-48.

75 Securities Act Release No. 7180, Investment Company Act Release No. 21,140, Investment Advisers Act Release No. 1,501, 59 SEC Docket 1508, 1509 (June 16, 1995).

76 Clarke Lanzen Skalla Inv. Firm, Inc., 59 SEC Docket at 1511 (emphasis added); *see also* Bines & Thel, *supra* n.68, at 3-48–3-49 (presenting *In re Clarke Lanzen Skalla Investment Firm, Inc.* as a key example of the technical factors that can determine whether a program is an investment company or not); Rule 3a-4 Adopting Release, *supra* n.37, at 15,100 n.9 (citing In re Clarke Lanzen Skalla Investment Firm, Inc. an example of how an investment advisory program could meet the definition of investment company).

77 Rule 3a-4 Adopting Release, *supra* n.37, at 15,099; *see* 17 C.F.R. § 3a-4(a)(5).

78 Rule 3a-4 Adopting Release, *supra* n.37, at 15,105.

79 17 C.F.R. § 3a-4(a)(5); *see also* Rule 3a-4 Adopting Release, *supra* n.37, at 15,105 n.59.

80 Rule 3a-4 Adopting Release, *supra* n.37, at 15,105; *see, e.g.*, Kalmar Investments, Proxy Voting Policies & Vote History, *http://www.kalmarinvestments.com/proxy/proxy.asp* (last visited Apr. 12, 2017) ("The conditions that govern the Adviser's authority to vote proxies on behalf of its clients are contained in its investment advisory contract. The advisory contract states that Kalmar Investments Inc. will vote proxies on behalf of its clients unless specifically requested not to do so by the client in a written request to the adviser.")

81 Rule 3a-4 Adopting Release, *supra* n.37, at 15,106 (emphasis added).

82 17 C.F.R. § 3a-4(a)(5)(iv).

83 Melanie L. Fein, "Robo-Advisers: A Closer Look" pp. 29-30 (Jun. 30, 2015) (arguing against the adequacy of robo-advisers under US Department of Labor (DOL") and SEC rules and regulations in a piece prepared for Federated Investors, Inc.); *see also* Kitces, Michael "Are Robo-Advisers Actually an Unregistered Investment Company … Along with Some Human RIAs, Too?," Kitces.com (Feb. 22, 2016, 7:01 AM), *https://www.kitces.com/blog/rule-3a-4-of-the-investment-company-act-are-robo-advisors-a-registered-investment-adviser-ria-or-an-unregistered-investment-company/.*

84 *See, e.g.*, Tom Anderson, "Robo-Advisors May Have Too Much Control Over Your Portfolio," CNBC (July 26, 2016, 8:30 AM), *http://www.cnbc.com/2016/07/25/robo-advisors-may-have-too-much-control-over-your-portfolio.html* ("Robo-advisor accounts are discretionary. That means they have the ability to invest client assets however they *see* fit. The same goes for human financial advisors. However, clients can call their human advisors and override their decision if they want.")

85 Robo-Advisers Guidance, *supra* n.6, at 2.

86 In its own 2016 review of robo-advisers, FINRA found that most robo-advisers established between five and eight investor profiles, and then assign each client to his or her corresponding profile based on answers to the questionnaire. FINRA, *supra* n.43, at 6. Robo-advisers may wish to consider creating a larger number of investor profiles in order to allow for a larger gradient of investors.

87 Robo-Advisers Guidance, *supra* n.6, at 3-8.

88 17 C.F.R. § 270.3a-4; *see also* Kanach, Cross, & Moynihan, *supra* n.60.

89 Robo-Advisers Guidance, *supra* n.6, at 6-7.

90 *Id.* at 5.

91 *Id.* at 5-6.

92 *Id.* at 3-4.

93 *See, e.g.*, Michael Wursthorn & Anne Tergesen, "Robo Adviser Betterment Suspended Trading During 'Brexit' Market Turmoil," Wall St. J. (June 24, 2016, 7:31 PM), *https://www.wsj.com/articles/robo-adviser-betterment-suspended-trading-during-brexit-market-turmoil-1466811073* (reporting that the robo-adviser Betterment decided to halt

trading in the immediate aftermath of the United Kingdom's decision to leave the European Union in June 2016).

94 *See* Wursthorn & Tergesen, *supra* n.93.

95 Robo-Advisers Guidance, *supra* n.6, at 7-8.

96 KPMG, "Robo Advising" at 4 (2015), available at *https://home.kpmg.com/content/dam/kpmg/pdf/2016/07/Robo-Advising-Catching-Up-And-Getting-Ahead.pdf.*