

# In Robo-Advisers You Trust: Or Do You?

This article highlights potential problems regarding what the Financial Industry Regulatory Authority (FINRA) refers to as digital investment advisers, but what we hereinafter call robo-advisers, and is not intended as an argument against their use. We accept as fact the usefulness of computerization as we accept the uselessness of unpassed regulations, write attorneys Milton Vescovacci and Adam Miller.

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**By Commentary by Milton Vescovacci**



**By Adam Miller**

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Which do you trust more to invest your hard earned cash: a computer or a seasoned, trained licensed financial adviser? If a computer was your answer, then we hope this article gives you pause before taking the inevitable leap of faith required anytime you exchange money with another, human or otherwise, for a promise of a return on your investment. This article highlights potential problems regarding what the Financial Industry Regulatory Authority (FINRA) refers to as digital investment advisers, but what we hereinafter call robo-advisers, and is not intended as an argument against their use. We accept as fact the usefulness of computerization as we accept the uselessness of unpassed regulations. Of robo-advising we, like everyone else without experience in coding complex computer algorithms, know nothing about

how or what voluminous data is processed in the nanosecond it takes a robo-adviser to decide where best to invest your money. What we do know, however, is there are specific issues involving the suitability requirement and fiduciary duty imposed on robo-advisers.

A robo-adviser, for the purposes of this article, is a fully automated, algorithm-based financial adviser that provides investment advice based on a client's responses to a pre-programmed questionnaire—all done online with no human service. These are among over 200 robo-adviser services, with varying levels of human service, available in the United States. Robo-advisers are appealing to investors for a number of reasons, mainly by eliminating a potentially costly human “middle man” and being accessible 24 hours, 7 days a week. Where approximately 92 percent of human financial advisers require their clients have at least \$100,000 in assets, some robo-advisers will take on a client with a minimum account balance of zero. Obviously, this is designed to appeal to large swaths of the population hitherto unable to afford financial advice. With roughly one out of every two nongovernmental employees not participating in some kind of retirement plan, easy-to-use robo-advisers target a large market with a clear need. However, providing financial advice to such large percentages of investors raises concerns over whether robo-advisers meet the suitability standards of FINRA Rule 2111, and fulfill their fiduciary duty under the Investment Advisers Act of 1940, as amended (the Advisers Act), and the impending change to the definition of “fiduciary” under the Employee Retirement Income Security Act of 1974, as amended (ERISA) promulgated by the U.S. Department of Labor.

FINRA Rule 2111 requires a broker-dealer to use reasonable diligence to obtain and analyze a customer's investment profile, which includes, but is not limited to “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 to the member or associated person in connection with such recommendation.” To comply with this

rule, robo-advisers ask a series of generic questions. Take, for example, a leading robo-adviser's questionnaire. After entering your age, income, the amount of money to be invested, checking the box confirming you reviewed the 136-page client agreement (which most people may not read), and then linking your robo-adviser account to your bank account, the robo-adviser then invests your money based on its algorithmic formula. It is assumed you know your liquidity needs and risk tolerance. But, what if your grasp on your finances is not as firm as you thought, and a simple follow-up question would have helped? Or, what if your risk tolerance or liquidity needs change? A robo-adviser is generic and does not know, nor has the capability, to follow up with a subjectively understandable question. A robo-adviser is not able to see your facial expressions or your body language to gauge the certainty in your responses to personalized questions. Of course, there is no guarantee a human investment adviser, sensitive to tone and demeanor, would have asked the same follow-up question. Presumably a seasoned, trained licensed human investment adviser would know to ask follow-up questions. The human investment adviser has the ability to do such follow-up where a robo-adviser does not. And, remember, robo-advisers may target people who have probably never used a financial adviser and may not be familiar with financial terms and concepts.

Recognizing the limited interaction between robo-advisers and clients, the Division of Investment Management of the U.S. Securities and Exchange Commission (SEC) released a guidance update in February 2017. The guidance update provided the following list of factors for robo-advisers to consider including in their questionnaires to ensure compliance with the suitability requirement:

- Whether the questions elicit sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on his financial situation and investment objectives;

- Whether the questions in the questionnaire are sufficiently clear and whether the questionnaire is designed to provide additional clarification or examples to clients when necessary (e.g., through the use of design features, such as tool-tips or pop-up boxes); and

- Whether steps were taken to address inconsistent client responses, such as:

- Incorporating into the questionnaire design features to alert a client when his responses appear internally inconsistent and suggest that the client may wish to consider such responses; or

- Implementing systems to automatically flag apparently inconsistent information provided by a client for review or follow-up by the robo-adviser.

Whether all robo-advisers are following this guidance is impossible to know, and complaints to the SEC are strictly confidential. But suitability is just one aspect of the overall fiduciary duty of a financial adviser.

The Advisers Act imposes a fiduciary duty on some financial advisers. Thus, financial advisers owe their clients and prospective clients an affirmative duty of utmost good faith, full and fair disclosure of all material facts, and employ reasonable care to avoid misleading their clients and prospective clients.

Each investor is unique, such is the nature of life. The broad guidance provided by the SEC above does not—and probably cannot—state with sufficiency the degree and depth of follow-up questions and additional investigation a robo-adviser must complete in order to truly meet the suitability requirement for each investor. In fact, it is the automated, uniform nature of the robo-adviser that prevents it, at least for the time being, from fully carrying its fiduciary obligations, and there are very little, if any, regulations to change that.

Only one state to date, Massachusetts, has addressed the “inherent” inability of robo-advisers to meet their fiduciary obligations in its 2016 policy statement on the matter. According to the policy statement:

A traditional investment adviser representative will usually:

- 1) Meet with and gather information from clients as part of a due diligence process,
- 2) provide personalized investment advice to clients with an eye to the information gathered,
- 3) use that information to make appropriate investment decisions on clients' behalf, and
- 4) act in the best interests of his or her clients, unless otherwise disclosed.

However, fully automated robo-advisers:

- 1) do not meet with or conduct significant (or any) due diligence on a client,
- 2) provide investment advice that is minimally personalized,
- 3) may fail to meet the high standard of care that is imposed on the appropriateness of investment advisers' investment decision-making,
- 4) specifically decline the obligation to act in a client's best interests.

Obviously, federal and state regulators know that they need to do a lot more oversight over robo-advisers and their automated systems, evidenced by their guidance and policy statements. However, with the technological components introduced into such oversight by these automated algorithm-based systems used by robo-advisers, federal and state regulators may not yet have the technical know how to properly perform such oversight. Also, because the algorithms are private and confidential information, not enough is known about the risks of using robo-advisers.

We don't know how well these robo-adviser systems will react to trading market collapses because there hasn't been one in a while. Some people are concerned about the risk of robo-advisers putting all similar responding clients into the same investments, lacking true diversification. Others are concerned about potential glitches in the code or algorithms of robo-advisers leading to possible trading losses. If such losses occur, will robo-advisers be subjected to legal liability? Will their insurance cover claims attributed to their robo-adviser activities?

Clearly, the robo-adviser concept is taking hold in the investment advisory, insurance and banking sectors of the economy and its applicability to other industries will make it a tool to be explored and used. As usual, caveat emptor is advised.

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