

SEC's Robo-Adviser Focus May Foreshadow Crackdown

By **Susan Gault-Brown, Sara Crovitz and Matthew DiClemente** (December 1, 2021)

Robo-advisers have seen impressive growth over the past few years — from approximately \$224 million in assets under management in 2017 to an estimated \$999 million in 2021 based on data from Statista — and they are becoming a common offering by both large and small asset managers.

This growth in assets and proliferation of firms offering robo-advice, coupled with the focus of robo-advisers on retail shareholders, has put robo-advisers in the U.S. Securities and Exchange Commission's crosshairs.

After a brief background on the SEC's interest in robo-advisers, we offer our top takeaways from the robo-adviser risk alert the SEC's Division of Examinations issued on Nov. 9[1] and a look at what may be ahead.

Background

Robo-advisers provide a range of advisory services through a variety of operating models, but share the common trait of advising and servicing clients primarily electronically rather than through traditional human interaction.

The robo-adviser risk alert provides the division's observations from its recent examinations of investment advisers that provide automated digital investment advisory services, with a focus on issues specific to or of heightened importance in the context of robo-advisers.

The SEC's effort to address regulatory issues specific to robo-advisers dates back to 2002,[2] although the first guidance focused on robo-advisers was not issued until 2017,[3] and the first enforcement actions targeting robo-advisers were not issued until 2018.[4] The new risk alert appears to have been prompted by the division's recent observation of significant growth in the industry.

Takeaways From Recent SEC Risk Alert

The Investment Advisers Act — the principal federal securities law regulating SEC-registered investment advisers — does not mention or refer to robo-advisers. Nevertheless, as a principles-based statute, its provisions apply differently to different types of investment advisers, a fact made plain in the risk alert.

Among other observations, the division makes clear that a generic investment adviser compliance program will not suffice for a robo-adviser and should be tailored to fit the robo-adviser's unique business model.

Here, in no particular order, are our other top takeaways from the risk alert.

Specific Issues for Robo-Advisers



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The risk alert highlighted the multiple areas of concern specific to robo-advisers, including failure to include elements in their policies and procedures specific to their use of an online platform or other digital tools for the provision of investment advice.

This required assessing whether the advisers' algorithms accomplished the following: (1) that the algorithms were performing as intended; (2) algorithm asset allocation or rebalancing services were occurring as disclosed; and (3) data aggregation services did not impair the safety of clients' assets as a result of the adviser having direct or indirect access to clients' credentials — e.g., pins and passwords.

The risk alert also pointed out the overall lack of written policies and procedures related to the operation and supervision of their automated platforms, increasing the risk of algorithms producing unintended and inconsistent results — e.g., due to coding errors or coding insufficient to address unforeseen or unusual market conditions, such as those caused by geopolitical events, substantial oil price movements or interest rate changes.

Failure to adequately disclose the human services offered to clients and the costs thereof, and ineligibility to claim reliance on the internet advisers' exemption per the Investment Advisers Act Rule 203A-2(e) — and therefore ineligibility to register or remain registered with the SEC — were also included in the risk alert.

Finally, the risk alert pointed out the overall lack of awareness that providing discretionary investment advice to many clients on the same or similar basis, frequently using asset allocation programs, may constitute an unregistered investment company — unless a robo-adviser properly complies with the exception from investment company status provided by Investment Company Act Rule 3a-4 or another approach.

Robo-Advisers Need Tech Inclusive Compliance Programs

Robo-adviser compliance policies and procedures should pay special attention to the construction, testing and safeguarding of algorithms and any other technology robo-advisers use to deliver advice. They should also contain a robust cybersecurity program.

Compared to advisers that rely primarily on human interaction with clients, robo-advisers' compliance programs may require a greater degree of coordination between a robo-adviser's legal and compliance personnel on the one hand, and its technology personnel on the other.

Inadvertent Investment Company Status Is a Real Issue

The SEC staff may be breathing new life into the long ignored and unenforced Investment Company Act Rule 3a-4, using over 20% of the risk alert to discuss deficiencies related to the rule.

While noncompliance with the rule is not actionable — as the rule is merely a safe harbor — noncompliance could lead to a claim that a robo-adviser is operating an unregistered investment company.

Robo-advisers relying on the Rule 3a-4 safe harbor may want to reexamine their compliance with its various requirements, paying close attention to the deficiencies cited in the risk alert.

Widespread Deficiencies

The risk alert indicated that "nearly all" of the examined robo-advisers received a deficiency letter. It noted that "most" advisers had inadequate compliance programs and that "more than one-half" of advisers had advertisement-related deficiencies.

A Look Ahead

Investor demand for sophisticated advice offered at low cost will likely continue to fuel interest in robo-advisers. As robo-advisers continue to proliferate and attract assets, that growth is likely to keep the attention of the SEC.

Robo-advisers should expect that the SEC staff will view the risk alert as having put advisers on notice of the deficiencies cited therein, making them less likely to tolerate such deficiencies in the future.

In addition, the risk alert should be considered in light of the broader examination by the SEC of digital engagement practices prompted by the meme stock frenzy in the spring and gamification concerns.

While much of the focus regarding meme stocks and gamification is on broker-dealers, SEC Chair Gary Gensler has indicated that a rule proposal addressing investment advisers' conflicts of interest related to gamification — i.e., using such practices to optimize revenue for the platform rather than investment results for clients — may be in the works.[5]

Robo-advisers should keep a watchful eye on any such proposal, as it may deliberately or inadvertently affect their business operations.

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[1] Division of Examinations, Observations from Examinations of Advisers that Provide Electronic Investment Advice, (Nov. 9, 2021), available at <https://www.sec.gov/files/exams-eia-risk-alert.pdf>.

[2] See Exemption for Certain Investment Advisers Operating Through the Internet, Advisers Act Rel. No. 2091 (Dec. 12, 2002) available at <https://www.sec.gov/rules/final/ia-2091.htm>.

[3] See Investment Management, Guidance Update: Robo-Advisers (Feb. 23, 2017), available at <https://www.sec.gov/investment/imguidance-2017-02.pdf>.

[4] See Order Instituting Administrative and Cease-and-Desist Proceedings, Wealthfront Advisers, LLC, Advisers Act Rel. No. 5086 (Dec. 21, 2018) available at <https://www.sec.gov/litigation/admin/2018/ia-5086.pdf>, and Order Instituting Administrative and Cease-and-Desist Proceedings, Hedgeable, Inc., Advisers Act Rel. No. 5087 (Dec. 21, 2018) available at <https://www.sec.gov/litigation/admin/2018/ia-5087.pdf>.

[5] See, e.g., Chair Gary Gensler, Prepared Remarks at SEC Speaks (Oct. 12, 2021), available at <https://www.sec.gov/news/speech/gensler-sec-speaks-2021-10-12>.