

POLICY STATEMENT

STATE-REGISTERED INVESTMENT ADVISERS' USE OF THIRD-PARTY ROBO-ADVISERS

Robo-advisers have experienced a significant growth in popularity in the financial services industry, based in large part upon their perceived simplicity, their ease of accessibility, and their ability to service investment advisory clients who may not have sufficient assets to establish a relationship with a traditional investment adviser. The Massachusetts Securities Division (the "Division") recently issued a policy statement outlining the way in which it will evaluate robo-advisers seeking to register as investment advisers with the Commonwealth of Massachusetts.¹ In the course of conducting examinations and reviewing applications for registration for investment advisers, the Division continues to monitor these developing trends. In doing so, the Division has noted an increasing number of state-registered investment advisers that work in conjunction with third-party robo-advisers to provide concurrent investment advisory services to their clients. In light of these industry developments, the Division issues this Regulatory Guidance to provide its state-registered investment advisers who establish concurrent or sub-advisory relationships with third-party robo-advisers with guidelines on how to best comply with the Massachusetts Uniform Securities Act and meet the fiduciary duties owed to their clients.

I. Disclosure under the Massachusetts Uniform Securities Act

To the extent that a state-registered investment adviser utilizes a third-party robo-adviser's services to provide asset-allocation and trading functions to clients, the state-registered investment adviser, at a minimum:

- Must clearly identify any third-party robo-advisers with which it contracts; must use phraseology that clearly indicates that the third party is a robo-adviser or otherwise utilizes algorithms or equivalent methods in the course of providing automated portfolio management services; and must detail the services provided by each third-party robo-adviser;
- If applicable, must inform clients that investment advisory services could be obtained directly from the third-party robo-adviser;
- Must detail the ways in which it provides value to the client for its fees, in light of the fiduciary duty it owes to the client;
- Must detail the services that it cannot provide to the client, in light of the fiduciary duty it owes to the client;
- If applicable, must clarify that the third-party robo-adviser may limit the investment products available to the client (such as exchange-traded funds, for example); and
- Must use unique, distinguishable, and plain-English language to describe its and the third-party robo-adviser's services, whether drafted by the state-registered investment adviser or by a compliance consultant.

¹ See Policy Statement: Robo-Advisers and State Investment Adviser Registration, issued April 1, 2016 (accessible at <http://www.sec.state.ma.us/sct/sctpdf/Policy-Statement--Robo-Advisers-and-State-Investment-Adviser-Registration.pdf>).

Identification of Third-Party Robo-Advisers and Explanation of their Services

The state-registered investment adviser must clearly identify the robo-advisers with which it contracts to allow them to provide concurrent investment advisory services to the client. In doing so, the state-registered investment adviser should identify the entity as a robo-adviser or should use other phraseology that clearly indicates that the third party is an entity that utilizes algorithms or equivalent methods in the course of providing automated portfolio management services. This identification should also include the factors considered by the state-registered investment adviser in choosing to affiliate with the robo-adviser, which should include, but are not limited to, the following:

- An explanation as to why the state-registered investment adviser chose to affiliate with the specific robo-adviser as opposed to other third-party affiliations it may have considered;
- Any conflicts that may result from the state-registered investment adviser's affiliation with the robo-adviser;
- Any additional fees that may be incurred by the client due to the state-registered investment adviser's affiliation with the robo-adviser;
- The benefits the state-registered investment adviser believes its clients will receive from its partnership with the robo-adviser; and
- Any disadvantages the state-registered investment adviser believes its clients may incur because of its partnership with the robo-adviser.

Furthermore, the state-registered investment adviser should provide a detailed explanation as to the services provided by the third-party robo-adviser. The state-registered investment adviser should make the client fully aware of the existence of such affiliation: in no situation should the client learn of the arrangement only after entering into an investment management agreement with the state-registered investment adviser.

Notification that Clients Could Receive Services Directly from Third-Party Robo-Adviser

If applicable, the state-registered investment adviser must also inform clients that they would be able to receive investment advisory services directly from the third-party robo-adviser without using any of the services provided by, or paying any additional fees to, the state-registered investment adviser.

Description of Value Provided to Client by State-Registered Investment Adviser

In light of the state-registered investment adviser's fiduciary duty to its clients, the state-registered investment adviser must clarify the ways in which it provides value to the client for the fees it collects over and above the value provided by the third-party robo-adviser. For example, the state-registered investment adviser may provide value to the advisory relationship by working with the client to establish financial goals and practices; by providing comprehensive and ongoing financial planning and investment monitoring services for the client; by continuously re-evaluating the client's financial portfolio; and/or by other methods that the state-registered investment adviser must clearly explain. In outlining these services, the state-registered investment adviser should distinguish the services it

provides from those offered by the third-party robo-adviser in order to demonstrate the value of the state-registered investment adviser's services.

Identification of Services State-Registered Investment Adviser Cannot Provide to Client

When a state-registered investment adviser utilizes a third-party robo-adviser's services, in light of its fiduciary duty to its clients, it must specifically identify the services it cannot provide to the client. The state-registered investment adviser must make a clear distinction to the client in explaining the services that it offers to the client, and the services offered to the client by third-party robo-advisers with which it may be affiliated or have a contractual arrangement. Depending on the specifics of that relationship, the state-registered investment adviser needs to identify the limitations in its use of the third-party robo-adviser's platform or as entity that does not provide asset-allocation and trading services to the client. Therefore, for instance, if the state-registered investment adviser will have no ability to access, select, change or customize the portfolio structure or investment products at the third-party robo-adviser, it must also make that clear to the client through appropriate disclosure.

Limitation of Available Investment Products to the Client

The state-registered investment adviser must also make clear to the client that the third-party robo-adviser, if applicable, may be limited in the type of investment products it offers to the client. Currently, most robo-advisers primarily utilize exchange-traded funds as the main investment vehicle for their clients. The state-registered investment adviser must be educated regarding the investment products utilized by the third-party robo-advisers to which they direct their clients, and will best meet their fiduciary role by working with their clients to help them understand the impact of using a third-party robo-adviser with a limited universe of investment products. If a state-registered investment adviser does not believe a third-party robo-adviser offers appropriate investment vehicles for a client (for example, in a situation where a client's portfolio requires investments other than the exchange-traded funds primarily offered by robo-advisers), the state-registered investment adviser's fiduciary duty to the client requires it to advise the client as such, and to act accordingly.

Use of Unique, Distinguishable and Plain-English Language

The Division also recognizes that many state-registered investment advisers utilize the services of compliance consultants to aid in providing required disclosures. To the extent a state-registered investment adviser utilizes a compliance consultant, the Division will continue to place the burden upon the state-registered investment adviser to ensure that the language used to describe the state-registered investment adviser's business practices is sufficiently specific to its advisory practice. A state-registered investment adviser's disclosure documents must be distinguishable from those used by other state-registered investment advisers: the Division will not accept "cookie-cutter" disclosure language that does not adequately provide information pertaining specifically to that state-registered investment adviser, nor will it accept language that is not clear to the reader.

II. Fees under the Massachusetts Uniform Securities Act

State-registered investment advisers must be cognizant of complying with the fiduciary duty they owe to their clients in light of directing those clients to third-party robo-advisers pertain to the fees charged to those clients. The Division's regulations make clear that it is a dishonest or unethical practice for a state-registered investment adviser to charge "...an advisory fee that is unreasonable in light of the fees charged by other investment advisers providing essentially the same services."²

Beyond this regulatory prohibition, excessive fees can considerably hinder a client's financial growth, and clients have increasingly become aware of the importance of fee disclosure. Furthermore, inherent in the investment adviser's fiduciary duty is for it to operate in a fashion that minimizes fees. As such, a state-registered investment adviser's fiduciary duty requires not only that it not charge excessive fees, but also that it consider its fees in light of the services provided by third parties. This requirement takes on additional importance in a situation where both a state-registered investment adviser and a third-party robo-adviser are each charging the client a separate fee.

Therefore, in reviewing initial applications made by investment advisers seeking registration with the Commonwealth, as well as in examining state-registered investment advisers, the Division will review all fees charged to a client to determine whether the state-registered investment adviser's fees are excessive. In order to allow for that review, the state-registered investment adviser must clearly disclose to the client all of its own fees as well as all fees charged by the third-party robo-adviser. Furthermore, the Division will review the state-registered investment adviser's fees with regard to (1) the state-registered investment adviser's level of services to the client; (2) other fees charged to the client by a third-party robo-adviser; and (3) fees charged by other state-registered investment advisers utilizing similar affiliations with a third-party robo-adviser. In such a review, state-registered investment advisers must demonstrate to the Division why it charges its fees, as well as how it earns the fee. Such a demonstration should focus on the specific value the state-registered investment adviser provides to the client, whether due to the state-registered investment adviser's specialized knowledge with regard to investment products, the client's individual personal circumstances, and/or for some other reason that the state-registered investment adviser must clearly identify.

² 950 MASS. CODE REGS. 12.205(9)(c)10.