

POLICY STATEMENT

ROBO-ADVISERS AND STATE INVESTMENT ADVISER REGISTRATION

“Robo-advisers” have emerged in the investment advisory marketplace as a purported low-cost, low-hassle alternative to traditional investment advisers and broker-dealers, employing asset-allocation models and algorithms to invest client portfolios, typically in exchange-traded funds.¹ Robo-advisers market themselves to persons who might desire professional investment services without the need for human relationships or large account sizes. One well-known research firm has predicted that assets under management at robo-advisers will

The mandate of the Massachusetts Securities Division (the “Division”) is investor protection. To serve this mandate, the Division is tasked with ensuring that all investment advisers meet the fiduciary obligations they assume when they provide investment advice for compensation. This policy statement is intended as guidance to robo-advisers seeking registration in the Commonwealth.⁴

As set out below, it is the position of the Division that fully automated robo-advisers, as currently structured, may be inherently unable to carry out the fiduciary obligations of a state-registered investment adviser.

¹ Exchange-traded funds are themselves touted as a low-cost alternative to traditional investments such as stocks, bonds, and mutual funds.

² CERULLI ASSOCIATES, *Retail Direct Firms and Digital Advice Providers 2015: Addressing Millennials, the Mass Market, and Robo Advice* (2015).

⁴ Persons who engage in the business of providing investment advice for compensation are generally considered “investment advisers” under the Massachusetts Uniform Securities Act and the Investment Advisers Act of 1940 (hereinafter “Advisers Act”). MASS. GEN. LAWS ch. 110A, § 401(m) (2011); 15 U.S.C. § 80b-2(a)(11) (2015). Providers of investment advice to Massachusetts clients must register with and be regulated by the Commonwealth of Massachusetts or the U.S. Securities and Exchange Commission (hereinafter “SEC”) unless otherwise exempt or excluded. Most of the robo-advisers popular today are registered with the SEC either as large investment advisers, as internet advisers, or as multi-state advisers. Advisers with regulatory assets under management of \$100 million or more are required to register with the SEC. Advisers operating exclusively over interactive websites and advisers operating under the laws of fifteen or more states can opt to register with the SEC. Exemptions from Prohibition on Commission Registration, 17 C.F.R. § 275.203A-2 (2011). This policy statement is not intended to apply to federally registered investment advisers.

The Duties of an Investment Adviser

As the term implies, “robo-advisers” are investment advisers. All investment advisers, including robo-advisers, owe the fiduciary duties of loyalty and care to their current and prospective investment advisory clients.⁶ These duties originate generally in judicial interpretations of the Advisers Act, the common law, and Blue Sky laws,⁷ and are central to the investment advisory profession, as they embody the principle that a professional who earns a living by managing other people’s money must do so with care and loyalty to those people:

An adviser’s relationship with its clients is fundamentally one of “trust and confidence.” This flows from the fact that clients consent to having the adviser act on their behalf, making the clients vulnerable to the adviser. The law provides some measure of protection for clients in light of that vulnerability by imposing on advisers fiduciary duties owed to their clients.⁸

Traditional Investment Advice

A traditional⁹ 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,

⁶ SEC Staff, *Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, at 36 (January 2011) (“Under the Advisers Act, an adviser is a fiduciary. This fiduciary standard applies to the investment adviser’s entire relationship with its clients and prospective clients, imposes upon investment advisers the “affirmative duty of ‘utmost good faith, and full and fair disclosure of all material facts,’ as well as an affirmative obligation to ‘employ reasonable care to avoid misleading’” their clients and prospective clients.” (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1962)).

⁷ *Id.* at 1-4.

⁸ Lorna A. Schnase, *An Investment Adviser’s Fiduciary Duty*, at 1 (Aug. 1, 2010), <http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/lornaschnaseFiduciary-Duty-Paper.pdf>.

⁹ There is nothing in the law that precludes internet-based advisers from complying with the law in the way that follows. Likewise, there is nothing in the law guaranteeing that human contact will discharge an adviser’s fiduciary duty.

- 3) use that information to make appropriate¹⁰ investment decisions on clients' behalf, and
- 4) act in the best interests of his or her clients, unless otherwise disclosed.

Perhaps the primary reason that individual investors hire investment professionals is to gain access to professionally personalized investment advice. A client may understand his or her own financial situation and objectives, but may lack the time or expertise to invest accordingly, and so hires a professional to do so for a fee or other compensation. The professional investment adviser agrees to use his or her expertise to manage the client's investments in accordance with the client's financial situation and objectives, and takes on a fiduciary duty to manage the client's investments carefully and loyally. If the professional fails to discharge this duty, he or she may be liable to the client and to securities regulators.

Fully Automated Investment Advice

The term "robo-adviser" has been applied to advisers that are fully automated and to advisers that utilize asset allocation algorithms in combination with human services. The concerns raised in this policy statement apply primarily to fully automated robo-advisers, but each adviser must be evaluated on a case-by-case basis. Fully automated robo-advisers usually:

- 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,¹¹ and
- 4) specifically decline the obligation to act in a client's best interests.

¹⁰ Robert E. Plaze, Strook & Strook & Lavan LLP, *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission*, at 14 (February 2006), <http://www.stroock.com/siteFiles/PAFile120.pdf> (providing that the SEC, for example, has stated that "[a]dvisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives.") The Division expects investment advisers to provide advice under standards at least as high as these.

¹¹ Melanie L. Fein, *Robo-Advisers: A Closer Look*, 7 Banking & Insurance eJournal 174 (2015).

Currently, robo-advisers and traditional advisers shoulder the same fiduciary duty.¹² However, robo-advisers tend to differ from traditional investment advisers in the services that they actually provide. As a result, commentators¹³ and regulators¹⁴ have questioned whether and to what extent robo-advisers can be investment advisers and therefore fiduciaries. The SEC and the Financial Industry Regulatory Authority have jointly cautioned investors that:

an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation ... An automated investment tool may not assess all of your particular circumstances, such as your age, financial situation and needs, investment experience, other holdings, tax situation, willingness to risk losing your investment money for potentially higher investment returns, time horizon for investing, need for cash, and investment goals. Consequently, some tools may suggest investments (including asset-allocation models) that may not be right for you.¹⁵

Fully Automated Robo-Advisers – Due Diligence

Robo-advisers in the Commonwealth cannot fully satisfy their fiduciary obligations if they fail to perform the initial and ongoing due diligence necessary to act in the best interests of their clients. Specifically, robo-advisers' failure to conduct due diligence, as well as robo-advisers' depersonalized structure, may render them unable to provide adequately personalized investment advice and make appropriate investment decisions.

Robo-advisers provide any internet user with access to an automated investment tool that allocates the user's liquid resources, commonly among exchange-traded funds, using only the answers that the user provides in response

¹² The duty borne by a robo-adviser may change in the future based on the manner in which automated investment advice is regulated.

¹³ Blaine F. Aikin, *Duty of Due Care and Robo-Advisers*, INVESTMENT NEWS, Oct. 11, 2015, <http://www.investmentnews.com/article/20151011/FREE/310119994/duty-of-due-care-and-robo-advisers>; Editorial, *Can robo-advisers be fiduciaries?*, March 20, 2016, <http://www.investmentnews.com/article/20160320/FREE/303209998/can-robo-advisers-be-fiduciaries>.

¹⁴ Kara M. Stein, Commissioner, SEC, Remarks at Harvard Law School's Fidelity Guest Lecture Series: Surfing the Wave: Technology, Innovation, and Competition (Nov. 9, 2015).

¹⁵ SEC's Office of Investor Education and Advocacy and the Financial Industry Regulatory Authority, Inc., *Investor Alert: Automated Investment Tools*, May 8, 2015, <https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html>.

to a brief questionnaire completed at the initial stage of the onboarding process.¹⁶ In this way, robo-advisers gather some information from prospective clients, but may not gather sufficient information to enable them to discharge their fiduciary duties by providing personalized and appropriate investment advice.

For example, robo-advisers typically do not conduct due diligence on assets held outside of a client's account or inquire about this information from clients. Rather, the robo-advisers will require the client to agree that he or she is responsible for any assets outside the account. Robo-advisers attempt to disclaim this due diligence duty by stating that they do not provide financial planning or wealth management services.¹⁸ However, assets held outside of a client's account directly impact the client's total financial picture and, accordingly, the investment adviser's ability to personalize advice and make appropriate investment decisions.

Similarly, robo-advisers often leave it to the client to provide essential updates about changes to the client's financial situation, needs, and objectives.¹⁹ Robo-advisers often disclaim any ongoing duty to inquire about these questions in the agreements that clients are required to sign, and frequently decline to conduct periodic reviews of client accounts. Changes to a client's financial or personal situation could broadly affect the appropriateness of investment decisions made by the adviser and the extent to which decisions are personalized.

In addition, since robo-advisers' information-gathering process commonly consists in a brief online questionnaire, there may be regulatory concerns that the adviser is unable to determine independently the identity of the user (at the outset or at any time after), whether that user is a senior citizen, a person with diminished capacity, a child, or otherwise; nor do robo-advisers otherwise take any steps to verify that the information provided by clients is accurate – instead relying on the information initially provided by the client as true and valid. This practice also raises serious concerns about a robo-adviser's ability to spot clients with diminished capacity or clients who may not understand their financial picture sufficiently to provide accurate answers to the questions asked.

¹⁶ See Fein, *supra* note 11 (noting that one commentator refers to this questionnaire as a “personality quiz.”)

¹⁸ When asked by the Enforcement Section of the Division whether they provide investment advice in light of a client's total financial picture, certain robo-advisers responded that they do not because they do not provide “financial planning.”

¹⁹ Traditional investment advisers sometimes contractually require the client to provide such essential updates. This practice, standing alone, is not necessarily a violation of fiduciary duty.

Nor do robo-advisers typically take any steps to determine that their services are appropriate for a given client. For example, there may be a client with specific tax, distribution, and income needs for whom a portfolio of various exchange-traded funds may not be appropriate. The robo-adviser leaves it to the client to determine that the automated investment service is appropriate for his or her needs. It is up to the client to “self-select” out of the service.

In part because robo-advisers may not provide the personalized and appropriate investment advice that is a hallmark of traditional investment advisory services, commentators have questioned whether robo-advisers should be thought of as broker-dealers,²⁰ or could be accurately likened to mutual funds.²¹

Fully Automated Robo-Advisers – Fiduciary Duty and Disclaimers

Robo-advisers attempt to avoid the issues raised by the structure of their automated investment services, discussed above, by specifically disclaiming various duties in customer agreements and elsewhere. These disclaimers are typically embedded in a lengthy electronic client agreement that must be “signed” by the client before services can be provided. But robo-advisers cannot act as fiduciaries as required under the law in the Commonwealth while, at the same time, disavowing their central fiduciary obligations.

For example, one client agreement of a popular robo-adviser states that that the client is responsible for determining that investments are in the best interests of his or her financial needs, whereas an investor meeting with a traditional human adviser would assume that the adviser would make, or help to make, that determination.

Another agreement requires the client to agree that he or she understands the robo-adviser’s sole obligation is to manage the client’s account in accordance with the plan the client opts into, and, in addition, that the client has not engaged the robo-adviser to provide any individual financial planning services. However, an investor meeting with a traditional human adviser would likely assume that the adviser would be obligated to manage the client’s account(s) in accordance with his or her stated and discussed investment needs and wants. Moreover, such investor would likely assume that the adviser would make reasonable efforts to

²⁰ *Can Robo-Advisors Really Be Fiduciaries?*, THINKADVISOR, Nov. 30, 2015, <http://www.thinkadvisor.com/2015/11/30/can-robo-advisors-really-be-fiduciaries>.

²¹ See Fein, *supra* note 11 (observing that a mutual fund, like the automated tools offered by robo-advisers, offers clients the ability to diversify their investment resources by participating in a given asset-allocation).

become aware of the investor's financial planning needs, to the extent that such needs are relevant to the adviser's investment decision-making.

Still other client agreements require the client to agree that he or she has not engaged the robo-adviser to provide any services beyond the automated investment tool that the client is responsible for updating and understanding. As noted, an investor would have historically been safe to assume that an investment adviser would not disclaim any and all knowledge of the investor's needs for financial or other services beyond the information directly input into a client questionnaire.

Many robo-advisory agreements go so far as to require indemnification by the client for any account losses. Such indemnification agreements have not been commonplace in human advisory relationships and may come as a surprise to current robo-advisory clients.

Fully Automated Robo-Advisers – Effectiveness of Disclaimers

Registered robo-advisers hold themselves out to the public as fiduciaries, while elsewhere disavowing their fiduciary obligations in written disclaimers. These disclaimers, of the investment adviser's duties to conduct due diligence, render personalized investment advice, and make investment decisions appropriate for the particular client, turn the fiduciary relationship on its head, and the robo-adviser's corresponding failure to satisfy its fiduciary obligations strikes at the core of its advisory relationship with the client. For state-registered investment advisers, this failure cannot be cured by written disclaimers in client agreements.

To be clear, federal law does allow federally registered investment advisers to alter their default fiduciary relationships with their clients. For example, the Advisers Act and the SEC permit registered investment advisers to disclaim aspects of their default fiduciary duty of loyalty, so long as the adviser obtains effective consent from the client.²² Ordinarily, investment advisers cannot maintain an undisclosed conflict of interest while charging a client for investment advice. However, many large investment advisers are structured in ways that create such conflicts. Instead of avoiding these conflicts, the adviser discloses them to its clients, and, at least in theory, the client gives informed consent to the conflict.

Many fully automated robo-advisers appear implicitly to take the position that the fiduciary duty of care (including the requirement to provide personalized

²² See, e.g., Advisers Act, 17 C.F.R. § 275.206(3).

and appropriate investment advice) can be significantly disclaimed with the written consent of the client.²³ However, a complete and blanket disclaimer of any fiduciary relationship would be ineffective. For the same reason, while the nature of a client's contractual relationship with an adviser can, to an extent, be narrowed by written agreement, the Division will not permit the core fiduciary relationship to be eliminated.

Fully Automated Robo-Advisers – State Registration

It is the position of the Division that fully automated robo-advisers, as they are typically structured, may be inherently unable to act as fiduciaries and perform the functions of a state-registered investment adviser. Until regulators have determined the proper regulatory framework for automated investment advice, robo-advisers seeking state registration in the Commonwealth will be evaluated under the foregoing guidance on a case-by-case basis.

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²³ This legal question concerns the nature of the investment advisory fiduciary relationship, and is not governed by statute or rule.