SEC’s February 2017 “IM Guidance Update: Robo-Advisers”

• Introduction

• “Substance and Presentation of Disclosures”
  ➢ Explanation of Business Model
    – $216,806,864
  ➢ Scope of Advisory Services
  ➢ Presentation of Disclosures
    – Are key disclosures presented prior to the sign-up process?
    – Are key disclosures specially emphasized?
    – Should some disclosures be accompanied by interactive text?
    – Have the disclosures been presented and formatted appropriately for the mobile platform?
SEC’s February 2017 “IM Guidance Update: Robo-Advisers” (cont.)

• “ Provision of Suitable Advice”


  - Regulation of Investment Advisers by the U.S. Securities and Exchange Commission (March 2013)
    - Enforcement Actions
    - IM Guidance Update: Robo-Advisers
SEC’s February 2017 “IM Guidance Update: Robo-Advisers” (cont.)

• “Provision of Suitable Advice” (cont.)
  ➢ Reliance on Questionnaires to Gather Client Information
    – Elicit sufficient information?
    – Sufficiently clear?
    – Handle inconsistent client answers?
  ➢ Client-Directed Changes in Investment Strategy
SEC’s February 2017 “IM Guidance Update: Robo-Advisers” (cont.)

• “Effective Compliance Programs”
  ➢ Reliance on algorithms
  ➢ Limited (if any) human interaction with clients
  ➢ Internet-based advisory services
What’s Next?

• Electronic Investment Advice
  ➢ “Oversight of computer program algorithms that generate investment recommendations”
C1. [Initialize.] Set $a_j \leftarrow 0$ for $0 \leq j < s$, $a_j \leftarrow 1$ for $s \leq j < n$, and $w_j \leftarrow 1$ for $0 \leq j \leq n$. If $s > 0$, set $r \leftarrow s$; otherwise set $r \leftarrow t$.

C2. [Visit.] Visit the combination $a_{n-1} \ldots a_1 a_0$.

C3. [Find $j$ and branch.] Set $j \leftarrow r$. If $w_j = 0$, set $w_j \leftarrow 1$, $j \leftarrow j + 1$, and repeat until $w_j = 1$. Terminate if $j = n$; otherwise set $w_j \leftarrow 0$ and make a four-way branch. Go to C1 if $j$ is odd and $a_j \neq 0$, to C5 if $j$ is even and $a_j \neq 0$, to C6 if $j$ is even and $a_j = 0$, to C4 if $j$ is odd and $a_j = 0$.

C4. [Move right one.] Set $a_j \leftarrow 1$, $a_{j-1} \leftarrow 0$. If $r - j > 1$, set $r \leftarrow j - 1$; otherwise if $r = j - 1$ set $a_{j-1} \leftarrow 1$, return to C2.

C5. [Move right two.] If $a_{j-2} \neq 0$, go to C4. Otherwise set $a_{j-2} \leftarrow 1$, $a_j \leftarrow 0$. If $r = j$, set $r \leftarrow \min(j + 2, 1)$; otherwise if $r = j + 2 \leq n$ set $r \leftarrow j - 1$. Return to C2.

C6. [Move left one.] Set $a_j \leftarrow 1$, $a_{j-1} \leftarrow 0$. If $r = j > 1$, set $r \leftarrow j - 1$; otherwise if $r = j - 1$ set $r \leftarrow j$. Return to C2.

C7. [Move left two.] If $a_{j-1} \neq 0$, go to C6. Otherwise set $a_j \leftarrow 1$, $a_{j-2} \leftarrow 0$. If $r = j - 2$, set $r \leftarrow j$; otherwise if $r = j - 1$, set $r \leftarrow j - 2$. Return to C2.
What’s Next? (cont.)

- Marketing materials
- Data protection
- Disclosures relating to conflicts of interest

• “What Level of Interaction with a Person is Important to You?”
• “What Information is the Robo-Adviser Using to Create a Recommendation?”
• “What is the Robo-Adviser’s Approach to Investing?”
• “What Fees and Costs Will the Robo-Adviser Charge?”
Algorithm Design and Oversight

• Internal vs. Third-Party Provider

• Development
  Ø Investment and risk professionals close involvement
  Ø Coding control procedures

• Initial Review
  Ø Policy committees involved in due diligence review and implementation
  Ø Testing and review
    – Consistent with firm’s approach?
    – Methodologies, strategies and assumptions
    – Normal vs. stressed market performance (e.g., Betterment and Brexit)
    – Expected outcomes?
    – Document diligence and testing efforts
    – Third-party legalese/disclaimers (MA’s policy)
Algorithm Design and Oversight (cont.)

• Maintenance and Oversight
  ➢ FINRA’s Principles of Effective Practices: Governance and Supervision of Algorithms (ensuring resulting advice is consistent with securities laws and FINRA rules)
  ➢ Ongoing review and testing by compliance/tech professionals (procedures, personnel and processes)
  ➢ Can you explain to regulators, if asked, how the tool works and how it complies with regulatory requirements?
    – WA: If you can’t explain in plain English what your robo-advisory tool does, you probably shouldn’t be using it.
    – Does the description given to the regulators match that given to clients?
Algorithm Design and Oversight (cont.)

- To assess the competence of algorithms regulators will require:
  - Explanations of the models and the data upon which the models are based;
  - Evidence regarding the appropriateness of the data used to create the model;
  - Explanations of the outcomes that the algorithms are seeking;
  - Evidence that the algorithms perform in the way that they are designed;
  - Evidence of how the creators of the robo-adviser are measuring whether the algorithm is succeeding and what they are doing in response; and
  - Explanations of what other alternatives the robo-adviser creators considered and rejected.
Data Protection and Cybersecurity

• Aggregate and share client information only as necessary to facilitate client’s stated objectives
• Data encryption, third-party risk management, cybersecurity insurance, business continuity plans, incident management frameworks
• Due diligence assessments of third-party providers
Thank you!

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