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Transformation of Investment Advice: Digital Investment Advisors as Fiduciaries

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Abstract

It is not surprising that the investing public seeks accessible, low-cost, and reliable advice. This chapter discusses how digital, or robo-advisors have triggered a dramatic upheaval in how investment advice is formulated, delivered, and applied on an ongoing basis to actively managed retail investment accounts. The availability of digital advice is promoting the important policy objective of expanding access to retirement advice to a growing segment of underserved and undersaved Americans. In addition to discussing the socio-economic and technological factors that accelerating the growth of digital investment advisors, the chapter also discusses how such advisors fit within the existing legal and regulatory framework governing retail investment activities. It concludes with a look ahead anticipating how digital advice will continue to disrupt the financial services industry.

Keywords

Financial advisory, investing, investment advice, fiduciary, fiduciary regulation, robo-advisor

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The Disruptive Impact of FinTech on Retirement Systems

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The Transformation of Investment Advice: Digital Investment Advisors as Fiduciaries

Jennifer L. Klass and Eric L. Perelman

The landscape for investment advice is shifting, and an innovative model has emerged that combines technology and investment expertise to deliver high-quality advice at a lower cost than traditional investment advisory services. Digital or so-called 'robo-advisors' that use algorithms and technology to offer discretionary investment advice through a digital interface continue to experience a rapid growth in popularity. A recent survey of the industry found that digital investment advisory programs accounted for managed assets in excess of $200 billion globally (Eule 2018; AT Kearny 2015). The term 'digital advisor' encompasses a broad range of business models. Digital advisors include both independent investment advisors that focus on offering digital advice directly to retail consumers, as well as established financial industry incumbents who include a 'digital' offering among a broad suite of advisory and brokerage services. Other digital advisors pursue an intermediary model where they partner with financial institutions to develop 'white label' digital advisor programs, or serve as a sub-advisor or technology provider to such firms' proprietary digital programs.

Although humans are actively involved in the design of digital advisory offerings and formulation of investment advice, the degree to which humans are involved in the delivery of that advice varies depending on the business model. In its purest form, a digital advisor will only provide asset allocation advice and investment recommendations through a digital interface. Clients are able to contact the firm by e-mail, chat, or telephone only for technical support or to ask operational or administrative questions. Increasingly, however, digital advisors operate a so-called 'hybrid' model under which clients have the option to consult with financial advisors. Under the hybrid model, financial advisors supplement the digital advisor's automated functions and serve as an additional resource for clients.

Regardless of the business model, digital advisors generally leverage technology to automate both the client experience and the portfolio management process. Other common characteristics of digital advisors include:

- Primary reliance on a digital (web-based and mobile) interface to interact with clients, collect client profile information through an investor questionnaire, facilitate the account opening process and deliver account communications;
- Comparatively lower advisory fees than traditional advisory services and low or no account minimums. Digital advisors typically charge a single 'wrap' fee that covers discretionary management services and execution of client transactions. Many digital advisors have positioned themselves as a low-cost alternative to investment advisory products that offer a more comprehensive suite of services;
- A focus on goals-based investing where clients define their objectives based on specific life goals (e.g., saving for a house, retirement or a child's education) and measure performance based on progress toward that goal, rather than focusing exclusively on maximizing portfolio returns measured in relation to a benchmark;
- Personalized asset allocation recommendations generated by matching client profile information with a diversified portfolio of low cost, tax efficient, exchange-traded funds (ETFs);
- Discretionary investment advice that leverages algorithms to automatically monitor client positions against target asset allocation and risk thresholds associated with a client's investment strategy;
- Automated rebalancing designed to monitor for drifts from the intended asset allocation and generate trade orders for execution in order to 'rebalance' the client's account back to its intended asset allocation, as well as leveraging cash in-flows and out-flows to rebalance an account; and
- Implementation of certain investment strategies designed to minimize a client's tax burden (e.g., tax-loss harvesting[1] or asset placement[2]).

The emergence of digital advice is particularly significant for investors who were not previously able to access any advice because of the minimum balances required by other service models, but investors at every level of wealth have been drawn to the value, accessibility, and transparency offered by digital advice.

Many industry participants have commented on the transformative potential of digital investment advice. Of particular note, the former Chair of the US Securities and Exchange Commission (SEC) observed that digital investment advice holds the 'positive potential to give retail investors broader, and more affordable, access to our markets' (White 2016: n.p.). This chapter explores the application of fiduciary standards to digital advisors. It concludes that fiduciary standards, such as those incorporated into the Investment Advisers Act of 1940 (Advisers Act), are flexible principles that digital advisors and their nondigital counterparts (traditional advisors) are equally

capable of satisfying. Investors benefit from this regulatory flexibility, which encourages innovation and permits the development of more varied services. Indeed, the Advisers Act already accommodates investment advisors with a wide variety of business models, investment strategies, and services. This chapter also explains that the products and services offered by digital advisors are not unique, but instead are technologically enhanced versions of advisory programs and services that have long been subject to this flexible regulatory framework. Finally, this chapter discusses the innovative and powerful ways that digital advisors can more effectively serve their clients, including by harnessing the efficiencies of technology and insights from behavioral finance.

Drivers behind the Growth of Digital Advice

Americans find themselves in the midst of what many commentators and governmental officials have termed a 'retirement savings crisis' (USGAO 2017; Samuels 2018). On the one hand, people are increasingly responsible for managing their own retirement savings because of the disappearance of defined benefit plans, deteriorating confidence in the long-term viability of the social security system, and concern that social security payments will provide insufficient retirement income. Only 18 percent of American workers today reportedly are very confident that they will have enough money for a comfortable retirement, and participation in employee savings plans is at historic lows (Greenwald et al. 2017; USDOL 2017). Moreover, more than half of current households approaching retirement have no savings, and a large proportion of those with savings do not have enough to maintain their standard of living in retirement (USGAO 2017). Many of those able to maintain their standard of living may only be able to do so due to rising property values (Fox 2018). On the other hand, many investors who would benefit from professional advice are not able to meet the high account minimums that often accompany access to financial advisors (Fischer 2016).

Against this backdrop it is not surprising that there is tremendous hunger among the investing public for accessible, low-cost, and reliable advice. While some investors may still seek the services of a traditional advisor—and have sufficient assets to qualify for those services—others seek a different sort of advisory experience, at a different price point, to help them navigate the complexity of saving for retirement and other financial milestones. The availability of digital advice promotes the important policy objective of expanding access to retirement advice to a growing segment of underserved and undersaved Americans.

At the same time, the growing awareness of the importance of fees in driving investment outcomes has led both investors and digital advisors to

focus on the benefits of exchange-traded funds (ETFs). The maturation and growth of the ETF market over the last two decades has produced a broad range of products covering different asset classes, markets, styles, and geographies (ICI 2017). ETFs, which are traded intraday and are offered without the sales loads and internal distribution costs that can drive up expense ratios in other investment products, are a transparent, low-cost, and tax-efficient investment option. In addition, the passive index bias that is prevalent in the ETF market fits well with the diversification tenets of Modern Portfolio Theory. The use of passive ETFs allows digital advisors to create and manage inexpensive, broadly diversified global portfolios correlated to particular risk and return characteristics.

The growth of digital advice has also been accelerated by advances in technology that allow for a more personalized, efficient, and seamless user experience. This appeals to the growing number of consumers who expect their financial providers to keep pace with the user experiences offered by other consumer services and who are comfortable relying on digital solutions to help manage their financial lives.[3] Banks and financial services firms are capitalizing on this trend by developing digital advice solutions designed to attract new clients and provide a broader range of services to existing clients (Desai 2016; Flood 2016). Like digital advisors, these traditional advisors also recognize that such solutions appeal to the investing needs and expectations of a previously underserved segment of the investing public (Terekhova 2017).

Digital Advice is Fiduciary Advice

A key distinction between digital and traditional advisors is the more limited nature of the client interaction in the robo-setting. Nevertheless, the fact that digital advisors do not interface with their clients in the same way as traditional advisors does not mean that they are not fiduciaries to their clients, or that they cannot fulfill the fiduciary standards that govern an investment advisory relationship.

Fiduciary duties are imposed on investment advisors 'by operation of law because of the nature of the relationship between the two parties' (SEC 2013: n.p.). This is made enforceable by Section 206 of the Advisers Act, which applies to all firms meeting the Advisers Act's 'definition of investment adviser, whether registered with the [SEC], a state securities authority, *or not at all*' (SEC 2011a: n.p.). Investment advisors, including digital advisors, have an affirmative duty to act with the utmost good faith, to make full and fair disclosure of all material facts, and to employ reasonable care to avoid misleading clients (*SEC v. Capital Gains Research Bureau, Inc.* 1963). Sections 206(1) and (2) of the Advisers Act make it unlawful for an

investment advisor 'to employ any device, scheme, or artifice to defraud any client or prospective client' or to 'engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client' [Investment Advisers Act of 1940 § 206(1) and (2)].

The concepts of fraud in Sections 206(1) and (2) are based on common law principles[4] and include a duty of loyalty and a duty of care. The duty of loyalty refers to the obligation to act loyally for the client's benefit, which requires that the advisor place the client's interests ahead of its own.[5] The duty of care refers to the obligation to act with the care, competence, and diligence that would normally be exercised by a fiduciary in similar circumstances.[6]

As noted above, the Supreme Court has interpreted Sections 206(1) and (2) as establishing a federal fiduciary standard for investment advisors (*SEC v. Capital Gains Research Bureau, Inc.* 1963). Accordingly, it is an accepted legal principle that investment advisors, particularly advisors that are managing client assets on a discretionary basis, are fiduciaries (SEC 2011b). Below we explain the source and parameters of an investment advisor's fiduciary duties, and discuss how these duties—the duty of care and the duty of loyalty—apply to the contours of the digital advisory relationship.

Further, the Staff of the SEC's Division of Investment Management (SEC Staff) took a definitive step towards recognizing digital advisors as fiduciaries in guidance released in February 2017 (February 2017 Guidance) (SEC 2017). This guidance confirms that digital advisors registered as investment advisors with the SEC are subject to the substantive requirements and fiduciary obligations of the Advisers Act, even in the case of digital advisors with more limited business models.

The Fiduciary Standard of Care is Defined by the Scope of the Relationship

As a threshold matter, no uniform or 'single' standard of care applies to all investment advisory relationships. Under both common law and the Advisers Act, the applicable standard of care may be defined by contract, and the concepts of reasonable care and skill that are at the heart of any standard of care necessarily must be judged in relation to the scope of services agreed to by the client (Frankel et al. 2018).

At common law, the standard of care an agent owes to a principal varies depending on the parties' agreement and the scope of their relationship [Restatement (Third) of Agency § 8.01 cmt. C]. An agent also owes to the principal a duty of care, which requires the agent to act with the care, competence, and diligence agents would normally exercise under similar circumstances. However, the agent and principal may agree to raise or lower

the duty of care by contract. Even under trust law, which imposes higher obligations on trustees than exist under agency law, the scope of fiduciary duties is subject to the terms of the trust. A principal component of the common law duty of care is the requirement that a trustee act prudently in light of the purposes, terms, and other circumstances of the trust. The duty of prudence encompasses the duty to exercise reasonable care and skill and to 'act with a degree of caution suitable to the particular trust and its objectives, circumstances, and overall plan of administration' [Restatement (Third) of Trusts § 77, cmt. B]. While the trustee and beneficiary cannot agree to waive the trustee's fiduciary obligations under the duties of loyalty and care in their entirety, trust law, especially trust fiduciary law, is default law that can be modified by the terms of the trust (Laby 2008). Thus, the trustee and beneficiary may agree to modify or relax the default obligations of prudence through the terms of the trust so long as they do not 'altogether dispense with the fundamental requirement that trustees not behave recklessly but act in good faith, with some suitable degree of care, and in a manner consistent with the terms and purposes of the trust and the interests of the beneficiaries.'[7]

Consistent with the common law, an investment advisor may limit the scope of its relationship with a client. In fact, it is not uncommon for investment advisors of all types to limit the scope of their services and authority based on the nature of the advisory relationship with their clients. For example, many traditional advisors prepare financial plans that speak to clients' overall investment objectives and financial circumstances at a particular point in time, thus disclaiming the responsibility to update the information on an ongoing basis. They also may provide asset allocation services or recommend investment strategies by researching and monitoring managers or funds, yet disclaim responsibility for making the underlying investment decisions with respect to those investment strategies or funds. Traditional advisors provide advice in connection with particular transactions by providing transition assistance to institutional investors transferring assets from one investment manager to another, yet disclaim responsibility for selecting individual securities to be bought or sold; they also may provide discretionary investment management services for one segment of a client's overall investment portfolio, and simultaneously disclaim responsibility for the management of the client's remaining assets. Finally, advisors may provide nondiscretionary investment advice that cannot be implemented without the prior consent of a client; or provide pricing or evaluation services that are limited to judging the appropriate price of a particular security or basket of securities.

The SEC has long recognized that investment advisors come in many shapes and sizes (SEC 2011b). Rather than creating a prescriptive regulatory regime based on each discrete business model, the SEC has created a

flexible, principles-based regulatory regime focused on an investment advisor's fiduciary duty to 'make full and fair disclosure' of all material facts, including conflicts of interest between the advisor and its clients and 'any other material information that could affect the advisory relationship.'[8] The SEC has generally viewed the negotiation of the terms of an advisory relationship to occur at arm's length, provided that the investment advisor has satisfied its disclosure obligations, including disclosure about the advisor's business, material conflicts of interest, disciplinary information, and other information, so that prospective clients can decide whether to enter into an advisory agreement with the advisor.[9]

Further, in the February 2017 Guidance, the Staff took a flexible, rather than one-size-fits all approach, emphasizing that digital advisors have a wide variety of business models and offer a range of advisory services, and consequently may have a 'variety of means' to meet their regulatory obligations. The SEC Staff therefore validates the concept that digital advisors may define and limit the scope of the advisory services they provide. In this regard, the SEC Staff provided a series of recommendations for how digital advisors may meet their fiduciary obligations under the Advisers Act. We discuss a number of these below.

Establishing a Reasonable Basis for Digital Advice

Although there is no comprehensive list of the obligations that flow from fiduciary duty under the Advisers Act, it seems clear that part of that duty is to ensure that an advisor has a reasonable basis for its advice (Lemke and Lims 2018). The extent to which a digital advisor's client profiling process provides a reasonable basis for the advice it provides (i.e., its 'suitability') has been a central focus of regulatory guidance and industry commentary. In a typical digital advisory program, an initial asset allocation recommendation is made on the basis of a series of questions (an investor questionnaire) designed to gather information about the client's investment goals for the account. The length and types of information requested by a digital advisor's questionnaire vary from firm to firm. As discussed below, under established regulatory principles and the 2017 Guidance, the information captured in the client-profiling process should be evaluated in relation to the nature of the advice that is provided.

The Advisers Act does not dictate the minimum amount of information that must be collected to make a reasonable determination that investment advice is appropriate for a client. In fact, unlike the investment suitability rules promulgated by the self-regulatory organization for broker-dealers, the Financial Industry Regulatory Authority (FINRA), the Advisers Act does not prescribe the amount or types of client profile information that are required

to be collected in any respect. In 1994 the SEC proposed, but did not adopt, a suitability rule[10] that would have required investment advisors to conduct a reasonable inquiry into a client's financial situation, investment experience, and investment objectives before providing advice.[11] However, the proposing release makes clear that 'the extent of the inquiry would turn on what is reasonable under the circumstances.' For instance, a 'comprehensive financial plan' may, according to the proposing release, require extensive personal and financial information about a client, including current income, investments, assets and debts, marital status, insurance policies and financial goals. The implication is that an advisory program that is not offering comprehensive financial planning would not require the collection of such extensive information.

What is required to make a reasonable determination is a qualitative rather than a quantitative inquiry, and the type or amount of information relied upon by an advisor to make a recommendation may vary without compromising the advice. Former SEC Chair Mary Jo White, in public remarks addressing digital advisors, has acknowledged that '[j]ust like a conversation with a "real person" about a client's financial goals, risk tolerances, and sophistication may be more or less robust, so too there is variation in the content and flexibility of information gathered by digital advisors before advice is given' (White 2016: n.p.). Even the more prescriptive FINRA suitability rules provide broker-dealers with the flexibility to omit certain information from a customer profile if the broker-dealer determines that information would not be relevant to making a suitability determination in light of the applicable facts and circumstances (FINRA Rule 2111.04).

The appropriate question is therefore not how *much* information an advisor is collecting, but rather whether the information the advisor decides to collect is appropriate in relation to the nature of the advice that is provided (FINRA 2016). It follows that where advisors, digital or otherwise, provide assistance with specific and identifiable investment goals such as college or retirement savings, they need not collect the same degree of information, or conduct comparable due diligence, to that which may be required for a more expansive investment strategy. In the February 2017 Guidance, the SEC Staff emphasized the importance of designing an investor questionnaire that permits the advisor to collect sufficient information on which to make an investment recommendation. The SEC Staff (2017) outlines the following as key considerations that digital advisors should evaluate when designing their investor questionnaires:

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

- Whether the questions are sufficiently clear, and whether the investor questionnaire is designed to provide additional clarification or examples to clients when necessary; and
- Whether steps have been taken to address inconsistent client responses, such as incorporating into the investor questionnaire design features to alert a client when their responses appear internally inconsistent or implementing systems that automatically flag any inconsistent information provided by a client for further review or follow-up by the digital advisor.

Further, digital advice must be understood in relation to its place in the market. Many clients who choose a digital advisor have affirmatively chosen *not* to enroll in a comprehensive financial planning or investment management service. Instead, these investors have opted for goal-based wealth management (e.g., accumulating for retirement, planning for college education, saving for a vacation home). Rather than lumping all assets together and managing them in relation to a particular benchmark, goal-based wealth management allows clients to create a separate 'bucket' of assets for each goal and define an investment strategy that is unique to that particular goal. Investors continue to have the option of working with an investment advisor that will provide a more comprehensive solution that considers outside resources, debt, financial history, career, anticipated medical expenses, and a myriad of other factors that could potentially influence the advice provided to an investor. However, the cost of such advisory programs will proportionally rise based on the scope of services provided.

Digital Advisors and Conflict of Interest Mitigation

One of the positive features of digital advisors from a fiduciary perspective is that they typically present fewer conflicts of interest. As fiduciaries, all advisors owe their clients a duty of loyalty [Restatement (Third) of Agency § 8.01 and Restatement (Third) of Trusts § 78(1)]. In common law, this involves refraining from acting adversely or in competition with the interests of clients, and not using clients' property for the advisor's benefit or for that of a third party [Restatement (Third) of Agency§ 8.01–8.05].The duty of loyalty consists of the principles that advisors deal fairly with clients and prospective clients, seek to avoid conflicts of interest, disclose all material facts for any actual or potential conflicts of interest that may affect the advisor's impartiality, and not subrogate client interests to their own. Consistent with common law, the federal regulatory framework governing investment advisors is a disclosure-based regime that does not preclude an advisor from acting where there is an actual or potential conflict of interest, provided that full and fair disclosure is made to clients.

By emphasizing transparent and straightforward fee structures, prevailing digital advice business models inherently minimize conflicts of interest associated with traditional investment advisors. Digital advisory offerings are typically comprised of ETFs that, in comparison to mutual funds, offer little room for revenue streams and payment shares that would otherwise create a conflict of interest for investment advisors (e.g., 12b-1 fees, subtransfer agent fees). The absence of such compensation factors means that comparatively fewer conflicts of interest are present even where digital advisors are affiliated with some of the ETFs that they recommend, and independent digital advisors reduce such conflicts even further. Moreover, digital advisory solutions eliminate the representative-level conflicts of interest typically present in the nondigital advisory context because there is little or no role for financial advisors who receive incentive-based compensation in an online offering. Accordingly, digital advisory solutions are less susceptible to the financial incentives that create conflicts of interest, disclosure, and sales practice and supervisory issues resulting from the compensation paid on accounts recommended and managed by financial advisors (FINRA 2016; SEC 1995).

Importantly, digital advisors remain subject to the fiduciary norms of the Advisers Act and therefore have a duty to make full and fair disclosure of all material facts to, and employ reasonable care to, avoid misleading, clients. As stated by the SEC Staff in the February 2017 Guidance, the information provided by a digital advisor to its clients must be sufficiently specific so that clients are able to understand the advisor's business practices and conflicts of interest, and must be presented in a manner that clients are likely to read and understand (SEC 2017). The SEC Staff views the substance and presentation of disclosures as particularly important in the digital advisor context, because, in the absence of any human interaction, clients may look solely to electronic disclosures in order to make an informed decision about whether to enter into an investment advisory relationship with a digital advisor. As a result, the SEC Staff has noted that digital advisors should consider disclosing certain information regarding the limitations, risks, and operational considerations of certain defining aspects of their business model and advisory services. This includes disclosure about the following areas, among others:

Methodology and services. A description of the assumptions and limitations of algorithms used to manage client accounts, together with a description of the particular risks inherent in the use of an algorithm to manage client accounts, an explanation of the degree of human involvement in the oversight and management of individual client accounts (e.g., that investment advisory personnel oversee the algorithm but may not monitor each client's account); a description of how the digital advisor uses the information gathered from a client to generate a recommended portfolio and any limitations, such as whether responses to an informational questionnaire are the sole basis on which advice is provided.

Limitations and scope of advisory services. A description of any circumstances that might cause a digital advisor to override the algorithm used to manage client accounts. For instance, digital advisors should disclose whether they might suspend or delay trading or take other temporary defensive measures in stressed market conditions. Further, digital advisors should be precise about the nature and extent of the advisory services that are provided; digital advisors that do not offer a comprehensive financial plan should be precise about how advice is being provided with respect to specific financial goals identified by the client, and digital advisors should further not create the implication that their algorithms consider information outside of an investor questionnaire if that is not the case.

Conflicts. A description of any involvement by a third party in the development, management, or ownership of the algorithm used to manage client accounts, including an explanation of any conflicts of interest such an arrangement may create (e.g., if the third party offers the algorithm to the digital advisor at a discount, but the algorithm directs clients into products from which the third party earns a fee). Digital advisors should also disclose any financial incentives they may have to recommend particular investment products, including proprietary ETFs for which they or an affiliate receive advisory fees, licensing fees, distribution and servicing fees, revenue sharing or other compensation.

Fees and expenses. An explanation of any fees the client will be charged directly, such as advisory fees, as well as any other costs that the client may bear either directly or indirectly such fees and expenses investors bear in connection with an investment in the underlying investment products, custodial services, and brokerage and other transaction costs.

The SEC Staff further views the presentation of disclosures as a key component in meeting a digital advisor's fiduciary obligations to clients, given that the client relationship and display of key disclosures will take place primarily, if not entirely, through an online or application-based interface. With respect to the timing of disclosure, the SEC Staff suggests that digital advisors present 'key disclosures' prior to the sign-up process, so that information necessary to make an informed investment decision is available to clients prior to entering into an investment advisory relationship. The SEC Staff has also provided guidance on effective disclosure to clients can be made through the types of interactive online interfaces or mobile platforms that are commonly used. Specifically, the SEC Staff recommends that digital advisors emphasize key disclosures through design features such as pop-up boxes, or include interactive text (e.g., hover-over boxes that function as 'tooltips') or other means of providing additional details to clients who are seeking more information (for instance, through an FAQ section).

Application of the Existing Regulatory Framework for Investment Advisory Services

Digital advisors are a disruptive and competitive alternative to traditional advisors, but the advisory services they offer build upon the traditional advisory framework and its regulatory structure, rather than depart from it. The range of advisory services offered by digital advisors—from online asset allocation recommendations to discretionary managed accounts comprised of diversified portfolios of ETFs—follow well-worn regulatory paths governing the use of electronic media, the use of interactive websites to deliver advice, and the governance of separately managed account and wrap fee programs. Further, the history of these services underscore that the Advisers Act is a flexible and technologically neutral regulatory regime that has accommodated technological change, innovation in products and services, and evolving business models.

Electronic media. In 1995, the SEC published its first interpretation on the use of electronic media to deliver regulatory communications. This release and the others that followed recognized the power of technology and, specifically, the electronic distribution of information, to 'enhance the efficiency of the securities markets by allowing for the rapid dissemination of information to investors and financial markets in a more cost-efficient, widespread, and equitable manner than traditional paper-based methods' (SEC 1995). In providing this guidance, however, the SEC also clearly established the principle that the securities laws are technologically neutral. The use of electronic media did not change the substantive provisions of the federal securities laws. In fact, the SEC specifically stated that the guidance set forth in the 1995 release 'addresses only the procedural aspects under the federal securities laws of electronic delivery, and does not affect the rights and responsibilities of any party under the federal securities laws.' In the 1995 release and in a subsequent release in 1996 extending the same principles to the delivery of required communications under the Advisers Act, the SEC was clear that the 'liability provisions of the federal securities laws apply equally to electronic and paper-based media.'

The SEC recognized the presence of digital advice and its compatibility with the framework of the Advisers Act when it adopted the so-called 'Internet Investment Advisers Exemption' in 2002 (SEC 2002). This exemption permits advisors that provide personalized investment advice exclusively through interactive websites to register as investment advisors at the federal level without necessarily meeting the regulatory assets under management threshold that is typically required of an SEC registered advisor. In adopting the exemption, the SEC acknowledged that it had to create a new basis for registration that captured investment advisors that did not technically have regulatory assets under management (the exemption assumed a

business model under which advisors were not providing continuous and regular supervisory services). However, the SEC never considered changing the substantive provisions of the Advisers Act to address internet advisors solely because they provide advice through an interactive website.

Safe harbor from investment company registration. Digital advisors generally manage client assets on a discretionary basis through separately managed account and wrap programs,[12] which are subject to a longstanding regulatory regime under Rule 3a-4 of the Investment Company Act of 1940 (Company Act). Rule 3a-4 provides advisors that manage discretionary investment advisory programs with a nonexclusive safe harbor from being classified as operating an investment company (or mutual fund), which therefore requires the advisors to comply with extensive compliance and reporting requirements under the Company Act.[13] Rule 3a-4 was designed to address programs where advisors seek 'to provide the same or similar professional portfolio management services on a discretionary basis to a large number of advisory clients having relatively small amounts to invest.' Advisory programs that are organized and operated in accordance with the rule are not deemed to be de facto investment companies so long as they comply with a number of conditions designed to ensure that clients receive individualized treatment and there is no pooling of assets.

In a typical discretionary digital advice program, investors establish individual brokerage accounts to custody their assets, and the digital advisor selects and manages a portfolio of ETFs based on an asset allocation recommended by the advisor and selected by the client. Although many digital advisory services give clients the flexibility to change their asset allocation on a regular basis through a website or mobile application, the digital advisor retains the authority to manage the account based on the asset allocation parameters the client designates. This type of digital advisory service is not a radical departure from the norm. To the contrary, the wealth-management industry, which includes separately managed account and wrap fee programs, today accounts for $6.1 trillion in assets under management (MMI 2018).

Rule 3a-4 contains two key provisions that a digital advisor must satisfy in order to fit within the safe harbor. The first is that 'each client's account in the program is managed on the basis of the client's financial situation and investment objectives and in accordance with any reasonable restrictions imposed by the client on the management of the account'[17 C.F.R. § 270.3a–4(a)(1)]. The second is that the 'sponsor and personnel of the manager of the client's account who are knowledgeable about the account and its management are reasonably available to the client for consultation' [17 C.F.R § 270.3a–4(a)(2)(iv)].

With respect to the first provision relating to individualized advice, it is important to understand that this requirement of Rule 3a-4 is not a

suitability rule that requires advisors to collect specific information concerning the financial situation and investment objectives of each client, nor does the rule dictate the quantity of information that must be collected. Rather, the intent of this provision is to negate the inference that the discretionary managed account program is operating as a pooled investment company. In many cases, digital advisors do far more than simply provide online tools that allow self-directed investors to determine their own risk tolerance and investment preferences and then subscribe to a model portfolio designed for investors with similar preferences. Digital advisors may permit customization by giving clients the ability to impose reasonable restrictions on the management of their accounts by designating certain ticker or security limitations. Moreover, digital advisors typically offer many features and tools that a client or financial advisor may use to customize managed account portfolios, including tools designed to optimize an existing portfolio; portfolio allocations that clients may customize to their desired asset class mix; options to select preferences for affiliated funds or apply ESG (environmental, social and governance investing) screens; the ability to retain legacy positions; sophisticated, technology-driven portfolio rebalancing based on market changes, cash in-flows and out-flows, and risk parameters; and asset placement and tax-loss harvesting services. The result is that the digital advisory model enables clients to receive investment advice that is customized to their particular investment goals and needs.

Moreover, digital advisors are 'reasonably available' to clients consistent with Rule 3a-4. The requirement that the manager of the account be reasonably available for consultation is one of many factors that distinguish a separate account holder from a mutual fund investor. A mutual fund investor generally would not have access to the portfolio manager of the fund. But, Rule 3a-4 does not dictate how that access needs to be accomplished. Digital advisors may satisfy this aspect of the safe harbor by making appropriate personnel reasonably available to clients by phone, e-mail, or platform-enabled chat services. In addition, there is no requirement that clients have the ability to discuss their portfolio with the individuals responsible for developing the advice algorithm. Rather, the focus is one whether the client has the ability to communicate with the advisor about questions relating to the management of his or her particular account. Further, Digital advisors typically provide their clients with around-the-clock access to a great deal of interactive real-time information about the holdings, performance and attributes of their accounts. Digital advisors generally make a great deal of information about their investment philosophy and approach available to investors through articles, blogs, and social media posts.

It is not surprising that the application of Rule 3a-4 looks different in the context of a digital offering, but that does not mean that digital advisors are operating unregistered investment companies. To the contrary, under digital

offerings clients still receive the benefit of personalized advice and individualized treatment, and they maintain all of the indicia of ownership of the ETFs and other securities held in their accounts. It is important to note that, to date, the SEC Staff has not substantively addressed how digital advisors in particular may meet the Rule 3a-4 safe harbor. However, in the February 2017 Guidance the SEC Staff did remind digital advisors to consider their obligations under Rule 3a-4, and it encouraged them to contact the SEC for further guidance if they believe that their organizations and operations raise unique facts or circumstances 'not addressed' by Rule 3a-4 (SEC 2017).

Algorithm governance and compliance considerations. In its February 2017 Guidance, the SEC Staff provided a number of practical recommendations to digital advisors for how they may fulfill their fiduciary and substantive obligations under the Advisers Act. These recommendations are not a departure from the fiduciary standards within the regulatory framework for investment advisors, but rather provide the SEC Staff's perspective on the application of the existing regulatory and fiduciary framework to the digital advice model. In particular, the SEC Staff views the implementation of controls around the development, testing, and back-testing of the algorithmic code used by digital advisors, as well as the post-implementation monitoring of an algorithm's performance, as a key element of an investment advisor's compliance program. The SEC Staff recommends that digital advisors adopt and implement written policies and procedures that provide for testing of their algorithms before, and periodically after, they have been integrated into the digital advisor's platform. Testing should assess whether the algorithmic code is performing as represented, and should occur on all modifications to an algorithm that is currently being used to ensure that it does not adversely affect client accounts. Further, the staff recommends that digital advisors whose algorithms or software modules are developed, owned, or managed by a third party adopt written controls for appropriate oversight of such third parties.

Digital Advice is Human Advice, with Certain Unique Advantages

Digital advisors possess unique advantages that strengthen the fiduciary relationship and promote the delivery of sophisticated, consistent advice. As discussed below, human intellect and judgment is an integral component of the digital advice model, which itself brings a number of positive features that help to serve clients in innovative and powerful ways.

First, the algorithms used by digital advisors are developed by humans, and they must be monitored and overseen by investment and technology

professionals. Rather than take human judgment out of the equation, the skill and investment expertise of these professionals is reflected in the algorithms used to manage client accounts. Digital advisors thus leverage technology to make the value provided by talented portfolio managers and investment professionals available to the broadest universe of clients. Further, digital advice presents strong advantages with respect to the consistency, precision, and predictability of advice (Philippon 2019).Unlike advice delivered exclusively by individual human financial advisors, digital advice can mitigate instances of distraction, fatigue, or human bias that can lead to negative client investment outcomes or costly trade errors.

Additionally, digital advice tools can be used to rebalance portfolios, conduct daily portfolio reviews, and apply new investment insights across many different client accounts in a way that would not be economically or operationally feasible for individual human financial advisors. This promotes faster, smarter, and more effective investment decisions, which can help client portfolios stay on track and within applicable risk thresholds and efficiently allocate even the smallest cash flows across their investment portfolio. Moreover, automated investing enables digital advisors to more effectively implement their compliance programs and meet regulatory obligations. In contrast to advice delivered through individual human financial advisors, which may be offered ad hoc, by phone, or conducted without reliable documentation, digital advice enables the consistent application of investment methodologies and strategies to client accounts, providing transparency, improved recordkeeping, and ease of audit.

Second, humans are operationally present in the delivery of digital advice. A number of digital advisors offer live customer support to assist clients and answer service-related questions. Some digital advisors offer a so-called 'hybrid model' where clients have the ability to speak with live investment advisor representatives. Digital advisors also have the capability to communicate instantaneously through email, mobile applications and their web interfaces to clients at a scale that far surpasses what an individual human financial advisor would be able to accomplish. Such communication features can be used to provide real-time account data or tailored portfolio analysis to clients at intervals of their choosing. Whereas an individual human financial advisor may be unable to reach even a small subset of its clients in a timely manner, a digital advisor may provide important and personalized account updates to its clients on a real-time basis (Fisch et al. 2019).

Finally, digital investment advice platforms are able to leverage behavioral finance insights to offer innovative services and account features in a timely and consistent way. Digital advisors may collect data and observations based on a client's online behavior (either individually or in the aggregate) and use the information to enhance the client experience and promote positive investment outcomes (Barber and Odean 2000).For instance, digital

advisors may observe that investors who look at their accounts frequently are more inclined to rebalance their portfolios in the event of minor losses that result from normal intraday market movements. In this way, digital advisors are able to focus on the actual behavioral patterns of clients, and this observed behavior tends to offer insights that clients are not aware of or may not voice to their financial advisors. Digital advisors may leverage such observations to guide investors away from missteps that could lead to negative investment outcomes. In response to actions involving contributions to or transfers from advisory accounts, for example, digital advisors can provide personalized recommendations and reminders that promote positive financial behaviors. These communications may take the form of reinforcement of savings and guidance around transfers that may have undesirable tax consequences (Barber and Odean 2013).

Conclusion

Under established principles of fiduciary law, digital advisors are capable of fulfilling fiduciary standards that are consistent with the scope and nature of the advisory services they provide to clients. Rather than a radical departure, digital advice reflects the technological evolution of traditional advisory services and thus fits entirely within the existing regulatory framework governing investment advisors.

Digital advice offers the investing public a high-quality, transparent advisory product that entails a different blend of services, generally at a lower cost, than traditional advisors. Digital advice can help achieve the important policy objective of addressing the retirement crisis by providing advice that is accessible to individual investors—both financially and technologically. That includes investors who do not qualify for, or may not be able to afford, traditional advice. Digital advice presents the next step in the evolution of investment advisory services, and when offered pursuant to applicable fiduciary standards and the existing regulatory requirements imposed by the Advisers Act, provides a compelling mechanism to address the demand for low-cost advisory solutions for retirement savings.

Notes

1. Tax loss harvesting is a strategy used to reduce capital gains tax exposure by selling one or more securities that can generate tax losses to offset capital gains. The proceeds of the sale are generally held in cash or, more commonly, invested in securities that provide similar market exposure.
2. Asset placement considers the tax treatment of different investments in determining whether to hold securities in taxable or non-taxable accounts.

3. A recent survey found that among affluent and high net worth investors, 64% expect their future wealth management relationships to be digital, and for those under the age of 40, 82% expect a digital relationship. A further 69% would be inclined to leave a wealth management firm if a digital component was not integrated into a wealth manager's offering. A separate survey by Wells Fargo/Gallup in found that 54% of investors would trust advice from an adviser that has 'good' applications and digital investing tools more than advice delivered by a less technologically savvy adviser (see Vakta and Chugh 2014; Wells Fargo 2016).
4. *See,* e.g., *In re Brandt, Kelly & Simmons, LLC & Kenneth G. Brandt*, SEC Administrative Proceeding File No. 3–11672 (Sept. 21, 2004) (alleging that respondent 'willfully violated Sections 206(1) and 206(2) of the Advisers Act, *which incorporate common law principles of fiduciary duties*' (emphasis added)).
5. *See* Restatement (Third) of Agency § 8.01 (2006) ('An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.'); § 8.01, cmt. b ('Although an agent's interests are often concurrent with those of the principal, the general fiduciary principle requires that the agent subordinate the agent's interest to those of the principal and place the principal's interests first as to matters connected with the agency relationship.'); *see also* Restatement (Third) of Trusts § 78(1) (2007) ('Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purposes.')
6. *See* Restatement (Third) of Agency § 8.08 ('[A]n agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances.'); *see also* Restatement (Third) of Trusts § 77 (noting that a trustee has a duty to act with the exercise of 'reasonable care, skill, and caution').
7. *See* Restatement (Third) of Trusts § 76 cmt. b(1) ('A trustee has both (i) a duty generally to comply with the terms of the trust and (ii) a duty to comply with the mandates of trust law except as permissibly modified by the terms of the trust. Because of this combination of duties, the fiduciary duties of trusteeship sometimes override or limit the effect of a trustee's duty to comply with trust provisions; conversely, the normal standards of trustee conduct prescribed by trust fiduciary law may, at least to some extent, be modified by the terms of the trust.') See also Restatement (Third) of Trustsat § 77 cmt. d(3).
8. *See Amendments to Form ADV*, Investment Advisers Act Rel. No. 2711 (Mar. 3, 2008) (Mar. 14, 2008) [hereinafter, 'Form ADV Proposing Release'] (*see* General Instruction No. 3 & n.148); *Amendments to Form ADV*, Investment Advisers Act Rel. No. 3060 (July 28, 2010) [hereinafter, 'Form ADV Adopting Release']. The Form ADV Proposing Release reflects the SEC's view that investment advisers should do more than simply identify a potential conflict of interest and should also explain generally how they address that conflict.
9. The Advisers Act recognizes the arm's-length nature of the negotiation of an advisory relationship in not requiring that an investment advisory contract be in writing, or otherwise prescribing its terms, other than with respect to the receipt

of performance compensation, assignment of the contract, and change in ownership where the adviser is a partnership.

10. *Suitability of Investment Advice Provided by Investment Advisers,* Investment Advisers Act Rel. No. 1406 (Mar. 16, 1994).
11. Although the SEC did not adopt the proposed rule, the Staff of the Division of Investment Management has taken the position that 'the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the [Advisers] Act' (*see Regulation of Investment Advisers by the US Securities and Exchange Commission* at 23 n.134).
12. A wrap fee program, as defined by the SEC's Glossary of Terms to Form ADV, is 'any advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions.'
13. *Status of Investment Advisory Programs Under the Investment Company Act of 1940*, Investment Company Act Rel. No. 22579 [hereinafter, 'Rule 3a-4 Adopting Release'] (Mar. 24, 1997). Note that Rule 3a-4 formalized a long line of no-action letters that went back to 1980 that included conditions on which the rule was ultimately based.

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