Robos, Regulation, & Reality

A Closer Look at Automated Investment Services

Automated investment services, coined Robo-advisors, are web-based investment management services with little to no human interaction. Different from a traditional advisor's web presence, Robo-advisors are based on algorithms. Potential customers are asked to complete a short questionnaire, generally fewer than ten questions. Some only ask for age, income, and retirement status while others may ask a question or two about spousal income, risk tolerance, etc. Based on the answers to these questions, the specific Robo-advisor's algorithm will produce an investment strategy by which to manage the Client's account.

Challenging the Traditional Realm of Regulation

In her speech for Harvard Law School's Fidelity Guest Lecture Series, SEC Commissioner, Kara Stein discussed how the Securities and Exchange Commission is challenged with determining what it means to regulate a Robo-advisor when the concept of an automated investment service wasn't even a thought when the applicable laws were created. "What does a fiduciary duty even look like or mean for a Robo advisor? The idea of a robotic entity that automatically generates investment advice certainly bumps up against what we would traditionally think of as a fiduciary."[1]

Attorney, Melanie Fein[2] recently prepared a white paper for Federated Investors, Inc. aimed at determining if Robo-advisors currently operate with a fiduciary standard of care.[3] With such intense scrutiny over how human advisors operate, why would we accept anything less from an automated service? Based on a detailed review of user agreements for three leading automated investment services, Fein concludes that Robo-advisors do not fit the bill.

Lacking Personal Investment Advice

Robo-advisors provide discretionary investment management services. Simply stated, they manage their Clients' money for them. Investment advice, however, is not generally on the list of provided services. Ms. Fein found that the user agreements generally state that the Client's account will be managed in accordance with their "Plan", which refers to the generic investment strategy churned out by the algorithm in response to the brief questionnaire completed by the Client. One agreement provides that "Client understands and agrees that [Robo-advisor's] sole obligation hereunder or otherwise is to manage the Account in accordance with the Plan, and Client has not engaged [Robo-advisor] to provide any *individual financial planning services*…"[4] Another agreement similary states, "Services shall not include in person, telephonic, or other written consultation to determine the Client's financial situation and investment

[1] Stein, Kara M. Surfing the Wave: Technology, Innovation, and Competition - Remarks at Harvard Law School's Fidelity Guest Lecture Series. 9 November 2015

[2] Fein is an attorney who maintains her own law practice advising clients on matters of banking, securities, and trust law. She recently served on the adjunct faculty of Yale Law School teaching Banking and Financial Regulation. More information can be found in her professional bio.

[3] Fein, Melanie L. Robo-Advisors: A Closer Look. Prepared for Federated Investors. 30 June 2015.

[4] Client Account Agreements, pg. 4. Effective May 9, 2015. (emphasis added)

objectives."[5] An Investor Alert issued jointly by the SEC & FINRA warns, "If the automated investment tool does not allow you to interact with an actual person, consider that you may lose the value that human judgement and oversight, or more personalized service, may add to the process." [6]

Hidden Costs and Conflicts of Interest

Robo-advisors may entice potential Clients by offering their services for seemingly little to no fee; however, they may ultimately receive compensation through higher fees imbedded in the investment alternatives they choose for Clients. One agreement states that the "Client recognizes that [Robo-advisor] or its affiliates may receive commissions, and have a potentially conflicting division of loyalties and responsibilities regarding, both parties to such Agency Cross Transactions"[7], meaning the Robo-advisor serves as the broker for both parties in the transaction. As explained in the SEC & FINRA Investor Alert, it is important to understand whether the Robo-advisor is receiving any form of compensation for offering, recommending, or selling specific services or investments.

Lacking Obligation to Act in Client's Best Interest

A major component absent from each agreement that Ms. Fein reviewed is the obligation of the Robo-advisor to act in the Client's best interest. Each holds the Client, not the Robo-advisor, responsible for determining if the program and investments are right for their financial needs. **Nowhere in these agreements does the Robo-advisor obligate itself to act in the best interest of the Client.** For a product that is gaining interest in the novice investor community, Robo-advisors leave a lot of the "advising" to the investor. These agreements practically relieve the Robo-advisor of all duties except managing the Client's account as the Robo sees fit.

The Client is given a generic investment strategy based on a minimal number of basic questions to serve as the basis for all future investment decisions. As the SEC & FINRA caution, "Be aware that a[n automated investment] tool may ask questions that are over-generalized, ambiguous, misleading, or designed to fit you into the tool's predetermined options".

The Bottom Line

While automated investment services may offer benefits such as ease of use and broad availability, the SEC & FINRA urge investors to fully understand the risks and limitations associated with these products before utilizing them. The algorithms used by Robo-advisors may not produce the best investment strategy to fit a specific investor's unique financial needs which can prove detrimental to retirement savings.

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[5] Client Agreements, pg. 25. Effective October 8, 2015.
[6] Investor Alert: Automated Investment Tools. Securities & Exchange Commission. 8 May 2015.
[7] Client Account Agreements, pg. 6. Effective May 9, 2015.