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Digital Advice Platforms: Compliance & Legal Challenges[1]

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DIGITAL ADVICE PLATFORMS: COMPLIANCE & LEGAL CHALLENGES

I. OVERVIEW OF DIGITAL MARKETPLACE

A. Self-Directed Brokerage. Online brokerage accounts over which clients exercise full direct investment discretion.

B. Pure Robo-Adviser Model. Discretionary asset management services offered to clients through online algorithmic-based programs whereby investment decisions are digitally made for an investor based on various financial models and assumptions used to translate data inputs provided by the investor, with little or no human interaction available.

C. Hybrid Robo-Adviser Model. Typically characterized by a digital robo-adviser that also provides for periodic or optional meetings with a financial advisor. The hybrid model provides for semi-dedicated human relationships to exist in support of the digital advice.

II. APPLICABLE LAWS AND REGULATIONS

A. General. Robo-advisers that are registered with the U.S. Securities and Exchange Commission ("SEC") are subject to the substantive requirements and fiduciary obligations of the Investment Advisers Act of 1940 ("Advisers Act"). Many robo-advisers are dually registered with the Financial Industry Regulatory Authority ("FINRA") as member broker-dealers. Such robo-advisory services are thus subect to applicable FINRA rules – notably, FINRA's supervision and suitability rules. Robo-advisers can further fall within the reach of state securities laws and regulations, federal banking laws and regulations and the Department of Labor laws and regulations.

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[1] This outline is of necessity summary in nature and should not be relied on as legal advice. The information contained in this outline is current as of February 8, 2019 and reflects the views only of the author and not necessarily the other panelists participating in the program for which this outline was prepared. The author gratefully acknowledges the assistance of Naim Culhaci, associate in Latham & Watkins' Financial Institutions Group, in preparing this outline. The information contained in this outline regarding specific legal or regulatory matters has been obtained from publicly available sources.

B. The Investment Company Act and the Rule 3a-4 Safe Harbor. The SEC has taken the position that investment advisory services that are provided on a discretionary basis to a large number of advisory clients may be deemed to fall within the definition of an "investment company," unless they comply with a nonexclusive "safe harbor" under Rule 3a-4 under the Investment Company Act of 1940 (the "Investment Company Act").[2] Accordingly, unless the requirements of the Rule 3a-4 safe harbor are satisfied, robo-advisers may be subject to the requirements of the Investment Company Act.

1. The requirements of the Rule 3a-4 safe-harbor include the following:

    i. Each client's account is managed on the basis of the client's financial situation and investment objectives.

    ii. The client has the ability to impose reasonable restrictions, including the designation of particular securities or types of securities that should not be purchased for the account.

    iii. Some personnel of the investment adviser who are knowledgeable about the account and its management are reasonably available to the client for consultation.

    iv. At least annually, the investment adviser contacts the client to proactively try to determine if there have been any changes to the financial situation or investment objectives.

    v. At least quarterly, the investment adviser notifies the client in writing reminding the client to contact the firm if there are any changes to the financial situation or investment objectives.

    vi. Clients receive at least quarterly a statement of all activity in the account (including transactions made, contributions and withdrawals pertaining to the account, fees and expenses charged to the account, and beginning and ending values).

    vii. Clients retain all rights of ownership in the underlying securities, including the right to engage in shareholder votes for securities in the account, to sue a security issuer (without being required to proceed jointly with other shareholders), to receive notification of trade confirmations and related documentation, and withdraw funds at any time.

2. On its face, the requirements of Rule 3a-4 present a challenge to a fully automated digital advice offering. For example, it may be a challenge for some business models to provide the ability to contact human personnel for questions, or to impose reasonable restrictions on investments, including the

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2 *See* Status of Investment Advisory Programs under the Investment Company Act, SEC Release IC-22579 (March 31, 1997) (final rule).

designation of particular securities or types of securities that should not be purchased for the account.

3. On February 23, 2017, the SEC's Division of Investment Management released IM Guidance Update 2017-02 (the "IM Guidance") focusing on robo-advisers. The guidance did not substantively address how robo-advisers may meet their obligations under Rule 3a-4, but stated that to the extent that a robo-adviser believes that its organization and operations raise unique facts or circumstances not addressed by Rule 3a-4, such adviser may wish to consider contacting SEC staff for further guidance. As such, the guidance appeared to indirectly confirm the need for robo-advisers to meet the conditions of Rule 3a-4 in order to not be deemed investment companies and subject to registration under the Investment Company Act of 1940.[3]

III. REGULATORY REQUIREMENTS

A. Existing Regulatory Guidance. The most significant regulatory guidance for robo-advisers to date has been the IM Guidance issued by the SEC on February 23, 2017 and the FINRA Report on Digital Investment Advice released by FINRA in March 2016 (the "FINRA Report"). Both the IM Guidance and FINRA Report have adopted a cautionary tone with respect to robo-advisers, highlighting the areas of regulatory compliance to which robo-advisers should pay particular attention. At the state level, the Massachusetts Securities Division ("MA Securities Division") has published a policy statement (the "MA Policy Statement") taking a harsher tone with respect to robo-advisers and going as far as to say 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".[4] Below we address the particular areas of regulatory compliance that were highlighted in the statements made by the SEC, FINRA and the MA Securities Division.

B. Disclosure Requirements: One of the key areas that the SEC's IM Guidance focused on was the need for robo-advisers to provide their clients with adequate disclosure under the Advisers Act. The SEC particularly focused its guidance on the substance of disclosures to be made and the presentation of such disclosures to clients.

As a fiduciary, an investment adviser has a duty to make full and fair disclosure of all material facts to, and to employ reasonable care to avoid misleading, clients. The SEC highlighted that such disclosure is particularly significant in the robo-advisory context because (i) of the lack of human interaction and the general inability to explain such material facts to the client through conversation and (ii)

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[3] U.S. Securities and Exchange Commission, Division of Investment Management, "Robo-Advisers," IM Guidance Update No. 2017-02 (February 2017).

[4] Massachusetts Securities Division, Policy Statement: Robo-Advisers and State Investment Adviser Registration (2016).

the unique aspects of the robo-advisory business model and the various limitations, risks and operational aspects that come with this business model.

At the same time, SEC acknowledged in the IM Guidance that while some robo-advisers operate under a pure robo-advisory model whereby the platform provides investment advice directly to the client with limited if any direct human interaction between the client and investment advisory personnel, others operate under a hybrid model whereby investment advisory personnel discuss and refine the interactive platform to generate an investment plan that is discussed and refined. Accordingly, a higher degree of investment advisory personnel interaction with clients may at least partially release the pressure of the disclosure analysis.

1. <u>Substance of Disclosures</u>. The types of disclosure mentioned by the SEC in the IM Release can be categorized as pertaining to (i) the business model, (ii) the scope of advisory services and (iii) conflicts of interest.

    i. <u>Explanation of Business Model</u>. The SEC specified that a robo-adviser should consider including the following types of information with respect to its business model.

        1. A statement that an algorithm is used to manage individual client accounts.

        2. A description of the algorithmic functions used to manage client accounts (e.g., that the algorithm generates recommended portfolios; that individual client accounts are invested and rebalanced by the algorithm).

            a. It does not appear that the SEC expects specific technical descriptions of the algorithms used to be disclosed to clients but rather a general description of the function of the algorithms vis-à-vis the client's portfolio, including any rebalancing activity.

        3. A description of the assumptions and limitations of the algorithm used to manage client accounts (e.g., if the algorithm is based on modern portfolio theory, a description of the assumptions behind and the limitations of that theory).

            a. Again, it appears that what the SEC is seeking here is a disclosure of the material assumptions and general type portfolio theory underlying the algorithm, rather than a comprehensive list of the technical assumptions underlying the algorithms.

        4. A description of the particular risks inherent in the use of an algorithm to manage client accounts (e.g., that the algorithm might rebalance client accounts without regard to market conditions or on a more frequent basis than the client might

expect; that the algorithm may not address prolonged changes in market conditions).

a. Robo-advisers frequently rebalance client portfolio based on a "glide path" (i.e., the planned gradual decrease in the allocation of funds to equities) or other factors unrelated to market conditions. The SEC expects that parameters and procedures around such rebalancing be clearly disclosed.

b. It should be noted that rebalancing is also a topic that FINRA highlighted should be disclosed to customers, including (i) describing any drift thresholds and whether they differ by asset class and (ii) whether the rebalancing takes place on a scheduled basis (i.e., monthly, quarter or annually).

5. A description of any circumstances that might cause the robo-adviser to override the algorithm used to manage client accounts (e.g., that the robo-adviser might halt trading or take other temporary defensive measures in stressed market conditions).

6. 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).

7. A description of how the robo-adviser uses the information gathered from a client to generate a recommended portfolio and any limitations (e.g., if a questionnaire is used, that the responses to the questionnaire may be the sole basis for the robo-adviser's advice; if the robo-adviser has access to other client information or accounts, whether and, if so, how that information is used in generating investment advice).

a. This disclosure is also significant from a suitability perspective, in that this information will form the basis on which the robo-adviser is determining that a particular portfolio is suitable for the client.

8. An explanation of how and when a client should update information he or she has provided to the robo-adviser.

ii. Scope of Advisory Services Offered: In the IM Release, the SEC further specified that robo-advisers should consider the clarity of the descriptions of the investment advisory services they offer and use reasonable care to avoid creating a false implication or sense about the scope of those services which may materially mislead clients.

1. The SEC specifically referenced In the Matter of T. Rowe Price and Associates, Inc., Advisers Act Release No. 658 (Jan. 16, 1979) (settled action) in which the SEC found that a registered investment adviser was in violation of the Advisers Act by virtue of failing to disclose to clients "the amounts of individualized treatment provided to each … account and the extent to which investment decisions would be made and implemented based upon 'model portfolios'."

2. The SEC specified, by way of example, that robo-advisers should avoid misleading their clients by implying that the robo-adviser is:

    a. Providing a comprehensive financial plan when it is not in fact doing so.

    b. Providing comprehensive tax advice when it is in fact just providing a tax-loss harvesting service.

    c. Collecting information other than it does through its questionnaire when it is not in fact doing so.

iii. <u>Conflicts of Interest</u>. The FINRA Report goes into greater detail with respect to the governance and supervisory procedures that should be put into place to mitigate conflicts of interest; however, the IM Guidance specifically touches upon disclosures that need to made with respect to conflicts of interest. The IM Guidance specifically notes the need to disclose:

1. 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 robo-adviser at a discount, but the algorithm directs clients into products from which the third party earns a fee).

2. An explanation of any fees the client will be charged directly by the robo-adviser, and of any other costs that the client may bear either directly or indirectly (e.g., fees or expenses clients may pay in connection with the advisory services provided, such as custodian or mutual fund expenses; brokerage and other transaction costs).

    a. Note this disclosure is already expressly required under Form ADV.

2. <u>Presentation of Disclosure</u>. Given the particular limitations of presenting information to clients online, the SEC stressed that robo-advisers should

carefully consider whether their written disclosures are designed to be effective (i.e., are not buried or not in plain english). The SEC particularly highlighted that in other contexts it has stated that a relevant factor to consider when reviewing disclosures is whether such disclosures are individually highlighted and explained during an in-person meeting with the client. Accordingly, as mentioned above, the SEC seems to indicate that the pressure on the analysis increases in the pure robo-advisory context. The particular factors that the SEC noted robo-advisers may wish to consider are:

i. Whether key disclosures are presented prior to the sign-up process so that information necessary to make an informed investment decision is available to clients before they engage, and make any investment with, the robo-adviser.

ii. Whether key disclosures are specially emphasized (e.g., through design features such as pop-up boxes).

iii. Whether some disclosures should be accompanied by interactive text (e.g., through design features such as tooltips) or other means to provide additional details to clients who are seeking more information (e.g., through a "Frequently Asked Questions" section).

iv. Whether the presentation and formatting of disclosure made available on a mobile platform have been appropriately adapted for that platform.

C. Provision of Suitable Advice/Recommendation. The SEC's IM Guidance and the FINRA Report focused on suitability requirements for robo-advisors per Section 206 of the Adviser's Act and FINRA Rule 2111, respectively.

1. Soliciting Information from Client. Both the IM Guidance and FINRA Report emphasized the importance of effectively soliciting information from clients in the robo-advisory context towards providing suitable advice.

   i. IM Guidance. The SEC highlighted that given robo-advisers typically provide advice based primarily, if not solely, on client responses to online questionnaires, formulation of such online questionnaire is of particular importance in the robo-advisory context. The SEC specifically noted that robo-advisers may wish to take into account factors such as:

      1. Whether the questions elicit sufficient information to allow the robo-adviser 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.

2. Whether the questions in the questionnaire are sufficiently clear and/or whether the questionnaire is designed to provide additional clarification or examples to clients when necessary (*e.g.*, through the use of design features, such as tool-tips or pop-up boxes).

3. Whether steps have been taken to address inconsistent client responses, such as:

    a. Incorporating into the questionnaire design features to alert a client when his or her responses appear internally inconsistent and suggest that the client may wish to reconsider such responses.

    b. Implementing systems to automatically flag apparently inconsistent information provided by a client for review or follow-up by the robo-adviser.

        i. A particular example the SEC gives in this context is if an investor categorizes himself or herself as low-risk and picks high-yield bond investments or if an elderly client chooses a long-term investment horizon.

ii. FINRA Report. FINRA highlighted that, per the requirements of FINRA Rule 2111, a FINRA-registered broker-dealer and robo-adviser must use reasonable diligence to obtain and analyze a customer's investment profile, which includes, but is not limited to "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."

1. Pure versus Hybrid Models. FINRA drew a distinction between business models employing client-facing digital tools (i.e. in a pure robo-advisory model) and professional-facing digital tools (i.e. in a hybrid robo-advisory model where initial client intake is done by an investment professional) and stated that whereas the professional-facing model allows for the investment professional to complete the suitability analysis by gathering supplementary information, the client-facing model relies on a discrete set of questions to develop a customer profile.

2. Risk Tolerance. FINRA stated that risk tolerance is an important consideration in developing a customer profile and broke risk tolerance for a given customer into two components each of which should be discerned: risk capacity

(the financial capability to withstand risk) and risk willingness (risk appetite).

3. Contradictory or Inconsistent Answers. Like the SEC, FINRA emphasized the importance of reconciling inconsistent answers. FINRA further stated that it has observed that some firm's average the contradictory responses, others adopt the more conservative of the contradictory responses, while still others make the customer aware of the inconsistency and ask further questions towards accurately reconciling the consistency. Of these approaches, FINRA stated that averaging is a poor practice, as it can result in a customer being placed in a portfolio that exceeds his or her risk tolerance. FINRA stated that taking the more conservative of the two contradictory responses is a better approach but it is inferior to accurately reconciling the contradiction through follow-up questions since it can result in the selection of a portfolio that does not reflect the client's desired risk level.

4. Obtaining Necessary Information. FINRA drew attention to the importance of whether the customer profile questionnaire seeks to obtain all of the required investment profile factors in order to make a suitability determination. It should be noted that unlike in the investment adviser context, FINRA Rule 2111 offers a discrete list of factors that a customer's "investment profile" includes, but is not limited to: "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance."

5. FINRA Rule 2090. FINRA also highlighted the applicability of the requirement that broker-dealers collect the minimum body of information from each customer necessary to meet its Know Your Customer ("KYC") obligations under FINRA Rule 2090 in addition to FINRA Rule 2111 suitability requirements.

iii. MA Policy Statement. In the MA Policy Statement, the MA Securities Division stated that there may be regulatory concerns that robo-advisers are "unable to independently identify of the user (at the outset or any time after) [including] whether that user is a senior citizen, a person with diminished capacity, a child or otherwise". The MA Securities Division also stated that robo-advisers typically do not take steps to verify that the information provided by clients is accurate. As noted above, the obligations to perform KYC checks

on and verify a client's identity are independently imposed on broker-dealers by FINRA Rule 2090.

2. Making Suitable Investments. In addition to describing the information that needs to be solicited from the client towards determining suitability, the SEC and FINRA both touched upon measures that can be taken to ensure that a suitable portfolio is selected for the client.

   i. IM Guidance. The SEC highlighted in the IM Guidance that many robo-advisers give clients the opportunity to select portfolios other than those that the robo-adviser recommends but that some robo-advisers do not give the client an opportunity to consult with investment advisory personnel about how the client-selected portfolio relates to the client's stated investment objectives and risk profile and its suitability for the client. The SEC noted that this may result in a client selecting a portfolio that the robo-adviser believes is not suitable for the investment objectives and risk profile the robo-adviser generated for the client based on his or her questionnaire responses and that the robo-adviser should consider providing commentary to the client as to why it believes particular choices are more suitable.

   ii. FINRA Report. FINRA went further than the SEC in additionally focusing on the question of whether the recommendations made on the basis of input provided by the client are suitable by suggesting that robo-advisers pay attention to:

      1. What the criteria, assumptions and limitations are for determining that a security or investment strategy is suitable for a customer.

      2. Whether the tool favors any particular securities, and if so what the basis is for such treatment.

      3. Whether the tool considers concentration levels and if so, at what levels (i.e., particular securities, class of securities, industry sector).

      4. Monitoring pre-packaged portfolios to assess whether their performance and risk characteristics are appropriate for the type of investors to which they are offered.

      Finally, FINRA highlighted that a registered representative that uses a digital advice tool to help develop a recommendation must comply with the requirements of the suitability rule and cannot rely on the tool as a substitute for the requisite knowledge about the securities or customer necessary to make a suitable recommendation.

D. Effective Compliance Programs. Both the SEC and FINRA highlighted the importance of the implementation of an internal compliance program including written policies and procedures that take into account the particular dynamics of the robo-advisers operations including its reliance on algorithms, the lack of human interactions and the risks that come with such dynamics.

1. IM Guidance: Particular areas that the SEC noted robo-advisers should consider whether to adopt and implement written policies and procedures are:

    i. The development, testing, and back-testing of the algorithmic code and the post-implementation monitoring of its performance (e.g., to ensure that the code is adequately tested before, and periodically after, it is integrated into the robo-advisers' platform; the code performs as represented; and any modifications to the code would not adversely affect client accounts).

    ii. The development and use of the questionnaire eliciting sufficient information to allow the robo-adviser 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.

    iii. The disclosure to clients of changes to the algorithmic code that may materially affect their portfolios.

    iv. The appropriate oversight of any third party that develops, owns, or manages the algorithmic code or software modules utilized by the robo-adviser.

    v. The prevention and detection of, and response to, cybersecurity threats.

    vi. The use of social and other forms of electronic media in connection with the marketing of advisory services (e.g., websites; Twitter; compensation of bloggers to publicize services; "refer-a-friend" programs).

    vii. The protection of client accounts and key advisory systems.

2. FINRA Report. Governance and supervision was a central area of the FINRA Report and FINRA particularly focused on the following areas:

    i. Algorithms. FINRA stated that an effective governance and supervisory framework surrounding the algorithms used can be important given that these algorithms play a central role in the digital advice business model.

1. In particular FINRA suggested that such a governance and supervisory review could include:

    a. Initial reviews (i) assessing whether the methodology a tool uses, including any related assumptions, is well suited to the task, (ii) understanding the data inputs that will be used and (iii) testing the output to assess whether it conforms with a firm's expectations.

    b. Ongoing reviews (i) assessing whether the models a tool uses remain appropriate as market and other conditions evolve, (ii) testing the output of the tool on a regular basis to ensure that it is performing as intended and (iii) identifying individuals who are responsible for supervising the tool.

2. FINRA further specified that some firms use some form of an investment policy committee to (a) oversee the development and implementation of algorithms, (b) participate in the due diligence on third-party tools and (c) evaluate scenarios used in the firm's portfolio analysis tools.

3. Finally FINRA noted that in the context of professional facing digital advice tools they have observed that some firms do not vet digital investment advice tools used by their employees and that the absence of a process to review such tools raises a concern about a firm's ability to adequately supervise the activities of registered representatives who use these tools and is not consistent with effective governance practices expected with respect to algorithms in these contexts.

ii. <u>Conflicts of Interest.</u> FINRA distinguished between employee versus client conflicts (i.e., commission payments and other incentives for registered representatives) and firm versus client conflicts (i.e., revenue sharing or sale of proprietary or affiliated products) and clarified that the risk for employee versus client conflicts does not exist in a pure robo advisory model, and noted that some firms seek to avoid firm versus client conflicts by not offering proprietary or affiliated funds or funds that provide revenue-sharing payments.

iii. <u>Rebalancing</u>. FINRA stated that effective practices with respect to rebalancing of customer portfolios include developing policies and procedures around monitoring portfolio drift, defining how the tool will act in the event of a major market movement and developing methods that minimize the tax impact of rebalancing.

iv. Training. FINRA emphasized the importance of training especially in the case of financial professionals using digital tools and highlighted that training can often be given by the third-parties that designed these tools.

IV. RECENT SEC AND FINRA ENFORCEMENT AND DEVELOPMENTS

A. The SEC Transamerica Order (8-27-2018).[5]

1. Summary. On August 27, 2018, the SEC settled an enforcement action against four Transamerica entities regarding the offer and sale to investors by the Transamerica entities of various investment products and strategies that used faulty quantitative models that were designed by an inexperienced analyst with "no experience in portfolio management or any formal training in financial modeling" and that was not formally tested or validated before being offered to investors. The SEC found that the Transamerica entities misled investors by distributing marketing materials that "implied the models worked as intended" and failed to disclose that an inexperienced analyst was the day-to-day manager of the products. The SEC further found that the marketing materials specifically stated that the products and strategies were "managed using a proprietary quant model" and were "emotionless", "model-driven," and "model supported". Once the Transamerica entities became aware of the errors in the models, the SEC found that the Transamerica entities halted use of at least some of the models but failed to disclose publicly or to the fund boards the errors and the decision to halt use. The SEC also found that various Transamerica entities provided inaccurate disclosure on the relevant products to investors. As part of the settlement, without either admitting or denying the SEC's findings, the Transamerica entities agreed to cease and desist committing the violations, to a censure and to pay nearly $53.3 million in disgorgement, $8 million in interest, and a $36.3 million penalty. They also agreed to the creation of a fund to distribute the entire $97.6 million to investors.

2. Implication for Robo-Advisers.

   i. Policies and Procedures for Testing and Oversight of Algorithms. While the Transamerica products were not marketed as robo-advisor products, the order nonetheless highlights that robo-advisers should have established processes in place with respect to the testing of the algorithms or models underlying investment products. This is an area which FINRA focused on in the FINRA Report as described in Section III.D.2.i above.

   ii. Accurate and Adequate Disclosure of Models. Robo-advisers should carefully consider disclosures to investors with respect to

[5] In the Matter of Aegon Usa Inv. Mgmt., LLC, Transamerica Asset Mgmt., Inc., Transamerica Capital, Inc., & Transamerica Fin. Advisors, Inc., Respondents., SEC Release No. 4996 (Aug. 27, 2018).

how algorithmic models work. In the case of Transamerica, the SEC particularly took issue with what it found to be misleading disclosure by the Transamerica entities that the investment product was purely algorithmic and automated when, according to the SEC, in actuality, the underlying model and its underlying assumptions were being modified by an inexperienced analyst on a periodic basis. The SEC had also provided detailed guidelines on appropriate disclosure relating to the operation of models in the IM Guidance as described in Section III.B.1 above.

B. The SEC Wealthfront and Hedgeable Enforcement Orders (12-21-2018). On December 21, 2018, the SEC brought its first enforcement actions against robo-advisers by separately charging Wealthfront Advisers LLC ("Wealthfront") and Hedgeable Inc. ("Hedgeable") with false disclosure-related violations. The SEC announced the enforcement actions jointly with a press release, quoting C. Dabney O'Riordan, Chief of the SEC Enforcement Division's Asset Management Unit, acknowledging that "technology is rapidly changing the way investment advisers are able to advertise and deliver their services to clients" and stating that "regardless of their format … all advisers must take seriously their obligations to comply with the securities laws, which were put in place to protect investors."[6]

1. Wealthfront. The SEC charged Wealthfront with disclosure violations related to its tax-loss harvesting program, its posting of client testimonials on Twitter and its payments to bloggers for client referrals. Without either admitting or denying the SEC's findings, Wealthfront agreed to pay the SEC a fine of $250,000.[7]

   i. Tax Loss Harvesting Program. The SEC found that Wealthfront falsely stated in its whitepaper that it monitored all client accounts enrolled in its tax-loss harvesting program to avoid transactions that might trigger a wash sale when, in fact, it did not do so and at least 31% of these accounts experienced some wash sales over an approximately 4 year period.

   ii. Client Testimonials Posted on Twitter. The SEC found that Wealthfront "retweeted" positive statements made about it by Twitter users who had an economic interest in promoting Wealthfront without providing appropriate disclosure with respect to such persons' economic interests in "tweeting". According to the SEC, the Twitter users whose tweets Wealthfront retweeted included Wealthfront employees, investors in Wealthfront and individuals who were being provided with free services by

[6] SEC Charges Two Robo-Advisers for False Disclosures, SEC Press Release (2018-300) (published December 21, 2018).

[7] In the Matter of Wealthfront Advisers LLC, f/k/a Wealthfront, Inc., SEC Release No. 5086 (December 21, 2018).

Wealthfront in return for having others enroll in Wealthfront through their tweets.

iii. Payments for Client Referrals. The SEC found that Wealthfront paid certain bloggers for successfully soliciting new clients to open Wealthfront accounts through their blog posts. According to the SEC, Wealthfront paid various bloggers a total of $97,000 based on the amount of assets a newly-referred client initially invested with Wealthfront and received tens of millions of dollars of new assets under management through the program. The SEC found that Wealthfront violated Rule 206(4)-3 of the Advisers Act (the "Cash Solicitation Rule") by virtue of not entering into a written solicitation agreement with the bloggers and not providing the necessary disclosures to, and receiving written acknowledgment from, the solicited clients. Furthermore, the SEC found that Wealthfront's disclosure in its Form ADV that it would comply with the Cash Solicitation Rule was false because it was engaging in this activity.

2. Hedgeable. The SEC charged Hedgeable with publishing misleading marketing materials on its website and social media platforms, specifically with respect to the performance of its clients' accounts compared to accounts at other robo-advisors.[8] According to the SEC, the data presented in the marketing materials misleadingly used only small subset of Hedgeable's clients in calculating Hedgeable's performance. It also incorrectly approximated the performance of Hedgeable's competitors based on information available on their websites. Finally, there was insufficient disclosure in the marketing materials with respect to the calculation methodology and, as a general matter, Hedgeable failed to maintain sufficient documentation to substantiate the figures it presented in its marketing materials. The SEC stated that such false and misleading marketing materials were produced, at least in part, as a result of Hedgeable's ineffective compliance program which did not require any officer of Hedgeable to review or approve marketing materials or performance data. Without either admitting or denying the SEC's finding, Hedgeable agreed to pay the SEC a fine of $40,000.

3. Implication for Robo-Advisers. By instituting the proceedings against Wealthfront and Hedgeable on the same day and by jointly announcing the proceedings, the SEC sent a message that it is keeping a close eye on the activities of robo-advisers. Although the alleged violations in Wealthfront and Hedgeable are not specific to robo-advisers, they are centered around the use of online advertising and social media and the proceedings serve as a reminder that all such activities must be done in compliance with relevant securities laws, rules and regulations. Furthermore, the emphasis in the enforcement actions on disclosure is in

8 In the matter of Hedgeable, Inc., SEC Release No. 5087 (December 21, 2018).

line with the SEC's IM Guidance in which the SEC took the position that disclosure is particularly important in the pure robo-advisory context because there is no opportunity for relevant information and disclosures to be communicated to the client in person.

C. The FINRA Betterment Acceptance, Waiver and Consent ("AWC") (6-20-2018).[9] FINRA entered into an AWC with Betterment LLC ("Betterment") on June 21, 2018 with respect to Betterment's practice of "window dressing" by altering its practices on days when its broker-dealer entity was computing its customer reserve account, which had the effect of reducing its reserve requirement from October 2013 through January 2015. The AWC stated that during this period, Betterment had a practice of providing pre-settlement payments to its customers selling securities and that it funded these payments through customer free credit balances, which it transferred from its sweep account to its omnibus account. Customer deposits in the omnibus account should have been reserved for in the customer reserve account. However, Betterment avoided transferring deposits from the sweep account to its omnibus account on days on which its reserve requirements were to be calculated such as to evade the reserve requirement. As part of the AWC, without either admitting or denying the SEC's findings, Betterment consented to a censure and a $400,000 fine. In a corrective action statement appended to the AWC, Betterment clarified that it has since discontinued its pre-settlement cash withdrawal program.

D. SEC Office of Compliance Inspections and Examinations ("OCIE"): 2019 Examination Priorities.[10] On December 20, 2018 the OCIE published its annual examination priorities letter for 2019. While the letter did not specifically mention robo-advisers as an area where the OCIE will focus its examinations in 2019, it did state that it will examine investment adviser portfolio recommendations to assess, among other things, whether investment or trading strategies of advisers are: (1) suitable for and in the best interests of investors based on their investment objectives and risk tolerance, (2) contrary to, or have drifted from disclosure to investors, (3) venturing into new, risky investments or products without adequate risk disclosure; and (4) appropriately monitored. Due to, among other reasons, the novelty of various robo-advisor algorithmic approaches to investing and the lack of human interaction allowing for in-person suitability evaluation and disclosures, these areas of attention listed by the OCIE can be interpreted as particularly applicable to robo-advisors.

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Questions regarding this outline may be directed to Stephen P. Wink at Latham & Watkins LLP.

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9 Acceptance, Waiver and Consent No. 2015048047101 to: Department of Enforcement Financial Industry Regulatory Authority RE: MTG LLC d/b/a Betterment Securities, Respondent Member Firm No. 47788 (June 21, 2018).

10 2019 Examination Priorities, Office of Compliance Inspections and Examinations, SEC (December 20, 2018).