Can a Robot Be a Fiduciary?

By Scott MacKillop, JD

The question of whether a robo-advisor can be a fiduciary has become a hot topic, and heavy hitters have been weighing in on each side of the controversy. They include then-Securities and Exchange Commission (SEC) Chairwoman Mary Jo White, then-Department of Labor (DOL) Secretary Thomas Perez, Secretary of the Commonwealth of Massachusetts William Galvin, two prestigious law firms, and two professors. A lot is at stake for robos, but there is little agreement on the answer.

A related question is whether robo-advisors are operating as unregistered mutual funds in violation of the Investment Company Act of 1940 (the '40 Act). This is an important question for robos, because the costs and burdens attendant to registration would cripple the robo-advisor business model. Again, there is little agreement on the answer.

Let's examine these two questions and see if we can come up with some answers. Before we do, let's agree on what we mean by the term "robo-advisor."

For our purpose, robo-advisors are firms that provide portfolio management services directly to consumers through the Internet without the involvement of a human investment advisor. Wealthfront is an example. We are not talking about hybrid firms such as Vanguard or Personal Capital that combine robo-technology with human advice. Neither are we talking about firms such as Jemstep that provide robo-technology to advisors for use in their firms.

HOW IT BEGAN

The fun started in May 2015, when the SEC's Office of Investor Education and Advocacy and the Financial Industry Regulatory Authority (FINRA) issued a joint Investor Alert discussing the "risks and limitations" of "automated investment tools."[1] These included the risk that the automated tools may rely on assumptions that are "incorrect" or "do not apply to your individual situation." The alert warned of questions that may be "over-generalized, ambiguous, misleading or designed to fit you into the tool's predetermined options." It cautioned that "an automated tool's output may not be right for your financial needs or goals."

The following month, Melanie Fein, a Washington, DC, attorney who specializes in banking and securities law, issued a white paper entitled "Robo-Advisors: A Closer Look," which was prepared for Federated Investors, a non-robo firm. Fein (2015) questioned the fiduciary status of robos and argued that they were really unregistered mutual funds. The article leveled other criticisms as well, including alleged conflicts of interest and questions about the perception that robos charge low fees.

Fein's broadside was followed in April 2016 by a policy statement issued by the Massachusetts Securities Division (the Division) that openly questioned whether robos were fiduciaries.[2] The Division stated that robos "cannot fully satisfy their fiduciary obligations if they fail to perform the initial and ongoing due diligence necessary to act in the best interests of their clients." The Division's statement expressed concern that this failure "may render them unable to provide adequately personalized investment advice and make appropriate investment decisions."

Feeling the heat, robos issued a white paper of their own in October 2016. It was penned by two attorneys from the global law firm Morgan Lewis & Bockius, which represents the robo Betterment. Klass and Perelman (2016), "The Evolution of Advice: Digital Investment Advisers as Fiduciaries," mounted a comprehensive defense of robos, arguing that they met applicable fiduciary standards and were not unregistered mutual funds.

Further contributing to this conversation were White and Perez, both of whom made public comments in support of the robos. White said that robos offer retail investors "broader and more affordable access to our markets" and that the SEC has "been considering how these so-called robo advisors … meet their fiduciary and other obligations under the Advisers Act."[3] Perez was even more supportive, saying that robo Wealthfront has "a platform that enables them to lower fees, operate as a fiduciary and do well by doing good."[4]

White and Perez also made general policy statements supporting the use of technology to expand the availability of advice. "Regulators have an obligation to understand, monitor and, where appropriate, encourage such developments," White said.[5] Perez echoed that sentiment when he said, "Technology is, I think, a linchpin to the innovation that's enabling more people to get access to advice."[6]

In May 2017 Tom Baker, a professor at the University of Pennsylvania Law School, and Benedict G. C. Dellaert, a professor at Erasmus University of Rotterdam, joined the conversation. Baker and Dellaert (2017), "Regulating Robo Advice Across the Financial Services Industry," stated that "automated advice poses significant challenges for regulators seeking to preserve the integrity of financial markets." The authors identified a number of these challenges and recommended possible approaches to addressing them.

SORTING IT OUT

No one can argue with the policy of making advice available more generally to those who need it. Nor can one quibble with the other policy arguments made in Klass and Perelman (2016): Robos give consumers more choice in how they access advice, they tend to have lower fees, and they use low-cost exchange-traded funds (ETFs), which further keep costs down for consumers of advice. These are all good things that are associated with robo-advisors as we know them today.

But we should not look the other way and give robos a pass on legal requirements that apply to everyone else. Sure, everyone loves a disruptor and robos of today seem harmless enough. Jon Stein, chief executive officer of Betterment, looks more like a choirboy than a portfolio manager, and his hoodie-wearing robo contemporaries have that Silicon Valley panache we associate with an inclusive, power-to-the-people worldview. There's not a whiff of Wall Street.

But what about tomorrow? Robos are getting gobbled up by the familiar faces of the financial services industry faster than you can fill out an online risk tolerance questionnaire. If you held a robo conference three years from now there wouldn't be a hoodie in sight—just pinstripes. Any of the original robo firms that might be left will be under such pressure from the venture capitalists who backed them that they won't have time to be concerned about the little guy.

And as Fein (2015) points out, current robo practices aren't nearly as praiseworthy as the robos' squeaky-clean public image would suggest. Conflicts of interest exist. Fees aren't always low. Investment options often are limited and may include proprietary products. Although today's robo portfolios are relatively benign, focusing on buy-and-hold ETF strategies, tomorrow's robo portfolios may—and probably will—include all manner of high-fee products and could even utilize hair-trigger market timing strategies.

For now, we should put aside the sweeping policy considerations and forget about how the robo world looks today. Whatever rules we settle on now we should be willing to live with for years to come. They should be based on sound legal principles applicable to all advisors.

So, let's take a quick look at some sticky legal issues that will help us answer these two important questions: Can robos satisfy the fiduciary standards applicable to human advisors and are they operating unregistered mutual funds in violation of the Investment Company Act of 1940 ('40 Act)?

THE FIDUCIARY QUESTION

Investment advisors who are registered under the Investment Advisers Act of 1940 (the Advisers Act) owe a fiduciary duty to their clients. This fiduciary obligation is not actually spelled out in the Advisers Act itself; it was breathed into the statute in 1963 by the U.S. Supreme Court in *SEC vs. Capital Gains Research Bureau*.[7]

An advisor's fiduciary obligation has two parts. The first is the duty of loyalty, which is the obligation of the advisor to act for the client's benefit and to place the client's interests ahead of its own. The second is the duty of care, which is the advisor's obligation to act with the care, competence, and diligence that normally would be exercised by a fiduciary in similar circumstances. The key to satisfying these obligations is knowing the client.

Robos collect basic data about the client, such as name, age, and address, and then run the client through what is essentially a brief risk tolerance questionnaire. Astronomer and computer scientist Clifford Stoll said, "Data is not information, information is not knowledge, knowledge is not understanding and understanding is not wisdom." Robos collect data, but they have very little knowledge about, and certainly no understanding of, the client's needs or interests. How can you meet your fiduciary obligations to someone you don't know?

MacKillop (2016) discusses the challenges of using conventional risk tolerance questionnaires to gain an understanding of a client's investment needs. On a stand-alone basis these questionnaires are essentially worthless. Only in the hands of a skilled advisor do they become valuable tools.

It is simply not possible to understand the goals, experiences, preferences, risk profiles, and other relevant information about clients without talking to them. Anyone who has worked with clients knows this. The answers to a 10- or 15-question questionnaire provided in an online environment cannot even begin to scratch the surface. There may come a day when artificial intelligence has advanced to such a state that a human advisor does not need to be a party to that conversation, but that day is far in the future.

Klass and Perelman (2016) acknowledges that the fiduciary obligations under the Advisers Act require an advisor to have "a reasonable basis for its advice." The authors do not directly argue that the meager data collected by robos is sufficient to form a reasonable basis for the advice they provide. Instead, they argue that robos and their clients may agree to limit the scope of both the fiduciary duties owed to the client and the amount of information robos must collect. In effect, they are saying that by using a robo's services, the client is agreeing to the limited nature of the interaction between robo and client.

The implications of this argument are frightening, because it claims that an advisor can disclaim as much responsibility as the client will agree to. This is particularly distressing in light of the fact highlighted in Fein (2015) that at least one robo's client agreement is 140 pages long.

Fein (2015) shows that some robos have taken this approach to the extreme by stating in their client agreements that "Client is responsible for determining that investments are in the best interests of Client's financial needs." This turns the robo-advisor into a self-help platform for do-it-yourself investors.

Klass and Perelman (2016) argues that goal-based investors—those with specific investment objectives such as accumulating assets for retirement, college funding, or saving for a vacation house—do not want or need to engage in a comprehensive financial planning process. For them, collecting less information is perfectly appropriate because the Advisers Act does not dictate the quantity of information that must be collected.

This is absolutely true. But what about the quality of the information? First of all, there is little established science behind most risk tolerance questionnaires. Moreover, research has shown that a person's risk tolerance changes over time. Research also has shown that people are notoriously bad at assessing their own tolerance for risk.

Then there is the problem of properly identifying a client's goals. What if a client isn't really sure about his or her goals or has a problem articulating those goals? What if a client has multiple goals? What if the client has conflicting goals? What if there is a gap between an investor's tolerance for risk and the amount of risk needed to reach the stated goal?

What if the investor simply doesn't understand some of the 10 or 15 questions on the robo's questionnaire? What if the investor thinks he understands the questions but really doesn't?

These are problems experienced advisors deal with frequently. How do robos deal with them?

Being a fiduciary comes with important obligations and duties to the client. You cannot maintain that you are a fiduciary while disclaiming all the responsibilities that go along with that title. The weak link in robos' claim to fiduciary status is their lack of meaningful knowledge about clients and understanding of their needs.

THE UNREGISTERED MUTUAL FUND QUESTION

Mutual funds pool the investments of a large number of investors and manage them collectively for the benefit of all. They must be registered under the '40 Act.

The SEC has taken the position that an advisor who manages a large number of individual client accounts in a similar manner also may be subject to the registration requirements of the '40 Act. This position recognizes that a single pooled account and a series of individual accounts managed in the same way are functionally the same.

The SEC established Rule 3a-4 under the '40 Act to carve out a "safe harbor" for advisors who manage accounts in a parallel manner so they can avoid being characterized as de facto mutual funds. Robos maintain that they qualify for this safe harbor provided by Rule 3a-4.

A number of requirements must be met to qualify for safe harbor protection under the rule. Robos arguably fall short on two of them.

The rule requires each client's account to be "managed on the basis of the client's individual financial situation and investment objectives, which should be gathered upon opening the account." As discussed above, robos do not collect sufficient information to know a client's "individual financial situation and investment objectives."

Klass and Perelman (2016) argues that an advisor and client can agree to limit the duties owed to the client under the fiduciary standard, but clients cannot waive the rule's requirements. They argue instead that because robos provide risk tolerance questionnaires and online financial planning tools and allow clients to customize their own portfolios, the clients "receive investment advice that is customized to their particular investment goals and needs."

But in reality, they receive no investment advice at all. What Rule 3a-4 calls for is personalized advice from a qualified professional. What robos provide is a box full of self-help tools.

Rule 3a-4 also requires the following: "Some personnel of the investment adviser, who are knowledgeable about the account and its management, are reasonably available to the client for consultation." Of course, this is a difficult requirement for robos to meet because their basic value proposition is that you can do it all online without having to talk to anyone.

Not to be deterred, Klass and Perelman (2016) argues that the "reasonably available" requirement is met because robos provide clients with "around-the-clock access to a great deal of interactive real-time information about their accounts."

This is unconvincing because it amounts to no more than the typical information available to clients through a custodian.

They also point to the fact that robos "make a great deal of information about their investment philosophy and approach available through articles, blogs, and social media posts." This is thin stuff. Mutual funds also do this and they still have to register under the '40 Act.

Klass and Perelman valiantly continue, pointing out that robos "supplement their online offerings with telephone, email and chat features that allow clients to ask more specific questions about the management of their accounts in real time." Certainly the fact that this all happens "in real time" makes it very compelling, but who does the client talk to when they initiate the "chat feature?" Probably not someone who is "knowledgeable about the account and its management" and definitely not someone who is familiar with the client's "individual financial situation and investment objectives" because the robo never collected any of that information.

The personalized interaction that the SEC was looking for in Rule 3a-4 is missing. Robos aspire to use algorithms to weave data into personalized recommendations. Their technology is brilliant, but it falls far short of replicating the interaction between a human advisor and a client.

A skilled advisor can take a conversation in an infinite number of directions depending on the information a client provides and the sense the advisor gets of the client's knowledge, sophistication, and emotional state. There are limited pathways through a risk tolerance questionnaire and no way to look a client in the eye online or hear that client's tone of voice.

WHAT TO DO ABOUT THIS MESS

Why hasn't the SEC taken action against robos for failure to meet their fiduciary duties under the Advisers Act or for failure to register their de facto mutual funds under the '40 Act? Mary Jo White told us why when, speaking about robos, she said, "Regulators have an obligation to understand, monitor and, where appropriate, encourage such developments."

And she is absolutely right in taking a hands-off position up to this point. Robo-technology has been and will continue to be a powerful positive force in our industry. It is transformative and will be a part of every financial advisor's practice in the years to come. Shutting down robo-advisors because they don't fit well into our existing regulatory structure would be a mistake.

But bending existing law to try to fit them in also would be a mistake and would have unintended negative consequences. If we allow robos to be considered fiduciaries, we will dilute the fiduciary standards that have served us so well and we'll be opening the gates to allow other less lovable players under the fiduciary umbrella.

By twisting the language and intent of Rule 3a-4 to allow robos to operate as they do, we render the rule meaningless. Firms that want to run thousands of parallel accounts without knowing the needs, goals, and objectives of their clients will have license to do so.

Robos are here to stay and will continue to make contributions that benefit both advisors and clients. Now that we have some familiarity with the characteristics of this new set of players, regulators need to get to work modifying the existing regulatory structure to accommodate them. The robo foot simply doesn't fit into the fiduciary glass slipper.

Perhaps a new regulatory category is the answer. Advisors assume a position of trust when they become fiduciaries. They enter into a relationship that may be limited in scope but is complex in nature. Computers can follow logic, but they can't exercise judgment. At least for now, robo-advisors are unable to honor the duties that flow from a fiduciary relationship, so they should not fall under the same regulatory scheme applicable to fiduciary advisors.

But robos already have proven that technology can provide do-it-yourself investors with a valuable, low-cost way of accessing diversified, long-term portfolios. Instead of registering as advisors, what if they registered as product platforms that were available to those who did not need or want the services of a fiduciary advisor?

The regulations applicable to robo platforms could parallel those applicable to mutual funds. That is, they would describe certain practices that are permitted and certain practices that are forbidden, and prescribe standardized disclosure to inform platform users.

The regulations could outline acceptable portfolio management practices. They might set restrictions on fees. They might set standards for the self-help tools offered by the platforms to ensure that there is some science in them. They might restrict the use of client data captured online so it is not sold to other firms or used for the purpose of later cross-selling.

The disclosure requirements could be targeted to highlight conflicts of interest and prevent fraudulent or deceptive practices. They might describe the limitations of the robo self-help tools, much as the SEC/FINRA joint Investor Alert did. They also might require information about the backgrounds and qualifications of those building and managing the portfolios.

How should the other robos be regulated—the ones that combine technology with human advice, as well as those that sell their technology to advisors for use in their practices? Hybrid robos such as Vanguard and Personal Capital, which combine technology with human advice, should be regulated as investment advisors under the Advisers Act. That is how they are currently regulated. The regulators should make sure, however, that these firms are truly giving clients access to qualified advisors and not simply to customer service representatives or salespeople who don't have the training or credentials to provide personalized advice.

The pure technology providers, such as Jemstep, do not purport to provide personalized advice directly to clients. Instead, they offer their technology to advisors who themselves provide advice to clients. Those advisors should be registered as investment advisors under the Advisers Act (or applicable state law), as they currently are. As long as the technology itself consists of calculators, account aggregations tools, functionality to streamline the account opening process, and the like, there is no reason the technology providers should register as investment advisors.

If, however, the technology offers portfolios created by robos or functionality that brings the firm within the definition of "investment adviser" under 202(a) 11 of the Advisers Act, then the technology provider also should be required to register, either as an investment advisor under the Advisers Act or as a robo platform under the new regulatory category I am proposing. In this situation, the robo providing technology to an advisor owes a fiduciary duty to the advisor's firm, but the contractual relationship between the robo and the advisor should place fiduciary responsibility to the client on the advisor.

CONCLUSION

The key here is to develop a regulatory scheme that recognizes the unique nature of robos. Robo-advisors did not exist when the Advisers Act and the '40 Act became law. The old regulatory schemes don't work for these new players. Trying to fit robos into the same categories as either human advisors or mutual funds will not work and will only pervert the existing regulatory structures. New thinking is required.

The world needs robos. They can provide a source of solid, low-cost portfolio management for individuals who otherwise cannot afford to, or don't want to, work with a human advisor. In a world where individuals are increasingly dependent on their own resources to secure their financial security, it is worth creating a workable regulatory niche for robos.

Scott MacKillop, JD, is chief executive officer of First Ascent Asset Management, a Denver-based firm that provides investment management services to financial advisors and their clients. He is a 40-year veteran of the financial services industry and spent the first 15 years of his career practicing securities and Employee Retirement Security Act of 1974 (ERISA) law in Washington, DC. Contact him at scott@firstascentam.com.

ENDNOTES

1. See SEC/FINRA, "Investor Alert: Automated Investment Tools" (May 8, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html.
2. See Massachusetts Securities Division, Policy Statement: Robo-Advisers and State Investment Adviser Registration (April 1, 2016), https://www.sec.state.ma.us/sct/sctpdf/policy-statement-robo-advisers-and-state-investment-adviser-registration.pdf.
3. See Suleman Din, "SEC's White: Robo Advice Has Broad Potential," *Financial Planning* (November 14, 2016), https://www.financial-planning.com/news/secs-white-robo-advice-has-broad-potential.
4. See Mark Schoeff, Jr., "DOL Secretary Perez Touts Wealthfront as Paragon Of Low-Cost, Fiduciary Advice," *Investment News* (June 17, 2015), http://www.investmentnews.com/article/20150619/FREE/150619892/dol-secretary-perez-touts-wealthfront-as-paragon-of-low-cost.
5. See endnote 3.
6. See endnote 4.
7. See https://www.sec.gov/divisions/investment/capitalgains1963.pdf/.

REFERENCES

Baker, Tom, and Benedict G. C. Dellaert. 2017. Regulating Robo Advice Across the Financial Services Industry. *Faculty Scholarship*. 1740. http://scholarship.law.upenn.edu/faculty_scholarship/1740.

Fein, Melanie L. 2015. Robo-Advisors: A Closer Look. Fein Law Offices (June 30). https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2658701.

Klass, Jennifer L., and Eric L. Perelman. 2016. The Evolution of Advice: Digital Investment Advisers as Fiduciaries. Morgan Lewis (October). https://www.morganlewis.com/pubs/the-evolution-of-advice-digital-investment-advisers-as-fiduciaries.

MacKillop, Scott. 2016. Are Risk Tolerance Questionnaires a Silly Waste of Time? *Advisor Perspectives* (June 7). https://www.advisorperspectives.com/articles/2016/06/07/are-risk-tolerance-questionnaires-a-silly-waste-of-time.