FINRA’s Report on Robo-Advisors: Fiduciary Implications

April 2016

by

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ABSTRACT

The Financial Industry Regulatory Authority (“FINRA”) recently issued a report on robo-advisors entitled “Report on Digital Investment Advice.” The report addresses the various features of robo-advisors and highlights investor protection concerns and regulatory issues that may arise from their use by investment professionals and individual investors.

The report implicitly raises the question of whether robo-advisors meet the fiduciary standard of care applicable to broker-dealers and investment advisers when they give investment advice. The report suggests that, on a stand-alone basis, robo-advisors do not meet a fiduciary standard of care when they advise individual investors. The report supports the view that human judgment by a trained financial professional is a necessary element of the fiduciary standard.

This paper analyzes the findings and implications of the FINRA report in light of the fiduciary standard of care and poses questions that need to be answered by regulators concerning the fiduciary standard to which robo-advisors—as well as investment advisers and broker-dealers—will be held in the future.
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FINRA’s Report on Robo-Advisors: Fiduciary Implications

I. INTRODUCTION

The Financial Industry Regulatory Authority (“FINRA”) recently issued a report on robo-advisors entitled “Report on Digital Investment Advice.” The report addresses various features of robo-advisors—which it refers to as “digital investment advice tools”—and highlights investor protection concerns and regulatory issues that may arise from their use by investment professionals and individual investors.

The FINRA report suggests best practices for broker-dealers in the use of robo-advice and is not meant to create any new legal requirements or change any existing broker-dealer regulatory obligations.

However, the report implicitly raises the question of whether robo-advisors meet the fiduciary standard of care that applies to broker-dealers and investment advisers under federal securities laws with respect to the investment advice they give individual clients. The report suggests that, on a stand-alone basis, robo-advisors do not meet the fiduciary standard of care. The report supports the view that human judgment by a trained financial professional is a necessary element of the fiduciary standard governing investment advice given to individual investors.

This paper analyzes the findings and implications of the FINRA report in light of the fiduciary standard of care applicable under the securities laws and poses questions that need to be answered by regulators concerning the standard to which robo-advisors—as well as investment advisers and broker-dealers—will be held in the future when advising individual investors. This paper also highlights the

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3 FINRA Report at 1.
4 The report does not use the word “fiduciary” but rather addresses robo-advisors in a regulatory context that embodies fiduciary concepts. The report does not distinguish between retail and retirement investors or discuss the fiduciary standard applicable to retirement accounts under ERISA.
5 This paper does not address the fiduciary standard that applies to advice given to IRA accounts or 401(k) plans, which is subject to a new fiduciary regime adopted by the
report’s cautionary message for both financial professionals and investors who use robo-advisors.

II. **KEY FINDINGS AND IMPLICATIONS**

A. **Robo-Advisors Do Not Provide Portfolio Analysis—a Key Fiduciary Function**

The FINRA report discusses robo-advisory tools used by financial professionals for their clients and such tools used directly by investors. As described by the report, both tools provide customer profiling, asset allocation, portfolio selection, trade execution, portfolio rebalancing, and tax-loss harvesting.

However, according to the report, robo-advisors do not provide portfolio analysis, except when used as a tool by financial professionals in providing investment advice to their clients. This distinction is important in considering whether the investment advice generated by a robo-advisor meets the fiduciary standard of care applicable to an investment adviser when advising individual clients.

Investment advisers are deemed to be fiduciaries under the Investment Advisers Act of 1940 and equivalent state statutes. The SEC has never specifically defined the contours of the fiduciary duty of investment advisers under the Act, but the duty generally requires an investment adviser to provide investment advice that is in the best interest of the client. The best interest of the client requires the adviser to conduct some degree of portfolio analysis when providing investment recommendations. Without portfolio analysis, the adviser cannot be confident that the investment advice is appropriate for an individual client.

Portfolio analysis in a fiduciary context requires the application of well-accepted principles of modern portfolio theory. Those principles require an analysis of the risk and reward features of an investment not in isolation but in the context of the portfolio as a whole and as a part of an overall investment strategy for a particular client or account. Modern portfolio theory is contingent on portfolio analysis. Portfolio analysis is the only means by which the principles of modern portfolio theory can be implemented for an individual client.

The fiduciary standard of care incorporates modern portfolio theory. The Uniform Prudent Investor Act was drafted specifically to reflect modern portfolio theory.

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6 FINRA Report at 2.

7 See Uniform Prudent Investor Act § 2.
theory and requires trustees to employ its basic principles. The Act requires trustee, in making investment decisions for a trust, to consider all relevant aspects of the trust beneficiaries, including other investments, assets, sources of income, and resources of the beneficiaries, among other factors.

B. Can Robo-Advisors Fulfill the Role of Fiduciary Without Portfolio Analysis?

The failure of robo-advisors to provide portfolio analysis, as found in the FINRA report, raises the question of whether robo-advisors can fulfil the role of a fiduciary in giving prudent investment advice to individual clients. The implication of the FINRA report is that they cannot—if a robo-advisor cannot perform overall portfolio analysis, it cannot perform a critical function of an investment fiduciary.

The report thus raises the corresponding question of whether robo-advisors, which are required to be registered as investment advisers (because they give investment advice), can comply with the fiduciary obligations applicable to investment advisers, and whether they are entitled to be registered under the Investment Advisers Act of 1940.

The overriding question that needs to be answered is: Does a registered investment adviser, which has the status of a “fiduciary” under the Investment Advisers Act of 1940, comply with its fiduciary obligations if it provides investment advice in all respects except the one key function necessary to provide prudent advice based on modern portfolio theory—i.e., portfolio analysis? In other words, what is the scope of an investment adviser’s fiduciary duty and does it include portfolio analysis?

The FINRA report does not answer this question. The agency with clear authority to address the question—the Securities and Exchange Commission—has

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8 Pertinent provisions of section 2 of the Uniform Prudent Investor Act—captioned “Standard of Care; Portfolio Strategy; Risk and Return Objectives,” are included in the appendix hereto. See also John H. Langbein, Sterling Professor of Law, Yale Law School, “The Uniform Prudent Investor Act and the Future of Trust Investing,” 81 Iowa L. Rev 641 (1995-1996) (“The Uniform Prudent Investor Act implements a tightly interconnected set of reforms. These adjustments to the legal regime were driven by profound changes that have occurred across the past generation in our understanding of the investment function. This new learning about the investment process is called the theory of efficient markets, or more broadly, Modern Portfolio Theory (MPT).”). Professor Langbein was the official reporter and draftsman for the Uniform Prudent Investor Act, which was approved in 1994 by the National Conference of Commissioners on Uniform State Laws for adoption by the states, nearly all of which have incorporated the UPIA into state trust law.

9 See appendix hereto.
never addressed this issue. 10 If the duty of an investment adviser does not encompass a duty to provide overall portfolio analysis, the SEC needs to say so.

The Massachusetts Securities Division recently set forth its position on the question. In a policy statement issued on April 1, 2016, the Division declared that robo-advisors may not be able to register as investment advisers in Massachusetts due to their deficiencies as fiduciaries: “robo-advisers, as currently structured, may be inherently unable to carry out the fiduciary obligations of a state-registered investment adviser.”11 Among its reasons, the Securities Division stated that robo-advisors do not perform comprehensive portfolio analysis necessary to act in the best interests of their clients:

Robo-advisers in the Commonwealth 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. Specifically, robo-advisers’ failure to conduct due diligence, as well as robo-advisers’ depersonalized structure, may render them unable to provide adequately personalized investment advice and make appropriate investment decisions…. [R]obo-advisers typically do not conduct due diligence on assets held outside of a client’s account or inquire about this information from clients. Rather, the robo-advisers will require the client to agree that he or she is responsible for any assets outside the account. Robo-advisers attempt to disclaim this due diligence duty by stating that they do not provide financial planning or wealth management services. However, assets held outside of a client’s account directly impact the client’s total financial picture and, accordingly, the investment adviser’s ability to personalize advice and make appropriate investment decisions.12

10 SEC Commissioner Stein has indicated that the SEC is considering this question: “The Commission is now challenged with thinking through what it means to regulate a robo advisor….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.” Kira Stein, Commissioner, Securities and Exchange Commission, “Surfing the Wave: Technology, Innovation, and Competition – Remarks at Harvard Law School’s Fidelity Guest Lecture Series,” Nov. 15, 2015.


12 Id. at 4-5.
Other states may be considering similar policies. Guidance on this issue from the SEC obviously will be important as robo-advisors expand their presence in the marketplace.

C. Only Financial Professionals Can Provide Portfolio Analysis

The FINRA report suggests that only a financial professional can provide portfolio analysis in light of all the relevant factors a fiduciary must consider. The report acknowledges that sound investment advice requires, among other things, an understanding of the facts and circumstances of each customer’s investment situation. While digital investment tools can assist a financial professional in determining the client’s profile, the report indicates that prudent investment advice requires human judgment beyond such tools (although human judgment still depends on the skill of the professional):

Most fundamentally,…financial professionals can ask the client questions to gather supplementary information and develop a nuanced understanding of the client’s needs. The effectiveness is, of course, driven significantly by the skill of the financial professional.13

The FINRA report strongly suggests that, absent intervention by a trained professional, the investment advice given by a robo-advisor is likely to be deficient. Among other things, the report says, robo-advisor questionnaires alone do not adequately profile investors and may elicit contradictory responses:

In the course of answering customer profiling questions, a customer may provide contradictory responses, which firms should seek to reconcile. This can be done through discussions with the customer or, in a purely digital environment, by making a customer aware of contradictory responses and asking additional questions to resolve the inconsistency. FINRA observed firms that averaged contradictory responses or that used the more conservative of the contradictory responses. Averaging is a poor practice, as it can result in a customer being placed in a portfolio that exceeds his or her risk tolerance. If a firm does not reconcile the customer response, taking the more conservative response is a better approach than averaging because it reduces the chance of unacceptable losses. However, even with this approach, the customer could end up with a portfolio that does not reflect their desired risk.14

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13 FINRA Report at 8.
14 FINRA Report at 10.
Financial professionals can help ensure that the customer’s investment profile results in appropriate recommendations based on an analysis of the customer’s complete profile, entire investment portfolio, and other relevant factors a prudent fiduciary must consider in making investment recommendations.

The FINRA report notes that wide disparities exist in the asset allocations recommended by different robo-advisors:

Even when client-facing digital advice tools take a similar approach to investing, implementation of methods for specific investing tasks, for example asset allocation, may produce very different results. Cerulli Associates compared the asset allocation for a notional 27-year-old investing for retirement across seven client-facing digital advice tools. Equity allocations ranged as high as 90 percent and as low as 51 percent; fixed income allocations ranged from 10 percent to 40 percent.15

According to the report, a financial professional can help ensure that the resulting investment recommendations are appropriate for the investor whereas a robo-advisor lacks the ability to go beyond its algorithms.

D. Robo-Advisors Are Not a Substitute for Suitability Analysis

The report emphasizes that robo-advisors are not a substitute for human judgment in determining the suitability of investment advice for a particular client:

FINRA reinforces that a registered representative using a digital advice tool to help develop a recommendation must comply with 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.16

The suitability rule requires a broker to have a reasonable basis to believe that investment advice is suitable for an individual client based on a reasonably diligent inquiry into a number of different factors:

A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the

15 FINRA Report at 3.
16 FINRA Report at 5.
reasonable diligence of the member or associated person to ascertain the customer’s investment profile, including, but 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.17

In other words, the suitability analysis effectively requires a broker to conduct a portfolio analysis of the client’s portfolio as a whole. The report suggests that a robo-advisor may not be able to ascertain all of the information required for a suitability analysis, especially the customer’s other investments and individual financial situation and needs.

E. The Use of Robo-Advisors Requires Training and Education

The report emphasizes that robo-advisors should not be used by financial professionals without training and education:

Training and education are crucial for individuals who use digital investment advice tools. Some of the financial professional-facing tools FINRA observed can deliver sophisticated analytics, but using them effectively and communicating with clients about their output is dependent on the financial professional understanding the assumptions that go into the analytics and the potential limitations on the results.18

The report notes that third-party vendors of digital investment advice tools often play a role in training staff on their tools.

F. Robo-Advisors Should Not be Used by Investors on Their Own

The logical conclusion to be drawn from the report is that, like financial professionals, individual investors should not use digital investment tools on their own without education and training.

The report constitutes a significant warning to investors. Because of the complex algorithms, wide disparities in advice, and conflicts of interest, the report

17 FINRA Rule 2111(a). In addition, FINRA Rule 2090 (the “Know Your Customer” rule) requires broker-dealers to use reasonable diligence to know the essential facts concerning a customer at account opening and thereafter.

18 FINRA Report at 12.
suggests it may be hazardous for individual investors to use these tools without the aid of a financial professional. The report says as much in “Lessons for Investors”:

The use of digital investment advice tools adds nuances to the questions investors should ask and information investors should obtain and understand in opening and maintaining an investment account. We elaborate on some of those considerations here. Sound investment advice rests on a robust understanding of an individual investor’s particular needs and circumstances. Investors should evaluate whether their financial services firm gathers sufficient information and asks sufficient questions to understand their needs and risk tolerance, and whether these factors are reflected in the advice they receive. If an investor believes that relevant information is not being taken into consideration, the investor should raise this with the financial services firm before making investment decisions.

Investors should be aware that the advice they receive about allocating assets and building a portfolio depends significantly on the investment approach embodied in the algorithms and underlying assumptions used by a digital advice tool. To the degree possible, investors should familiarize themselves with the investment approach and key assumptions so that they understand how recommendations for securities and asset allocations are derived. Since conflicts of interest may exist in the investment advice they receive, investors should evaluate whether those conflicts compromise the objectivity of that advice. Digital investment advice tools do not necessarily eliminate conflicts of interest. Conflicts could include, for example, commission payments and other incentives for a registered representative in a financial professional-facing context, and revenue sharing or sale of proprietary or affiliated products for a firm in a client-facing context.

As with any account, investors should understand the specific services they will receive and their cost. In this regard, investors should inquire about all costs associated with the services offered or provided, including costs generated from third parties, such as mutual fund management fees. Since some accounts offer features such as rebalancing and tax-loss harvesting, investors should understand how these services will be performed. If an investor’s account will be automatically rebalanced, investors should know whether this will occur based on a time schedule, e.g., quarterly; based on a trigger such as portfolio drift, e.g., if part of the account is more than five percent out of balance; or some other method. Investors should
be aware of what safeguards, if any, exist if there are sudden, sharp market movements such as those that occurred during the May 2010 Flash Crash. Rebalancing may also generate expenses or tax liabilities, so investors should inquire into the financial consequences of this activity.19

III. CONCLUSION

The FINRA report highlights a number of reasons why robo-advisors may have limited utility as a source of fiduciary investment advice for individual investors. The most prominent limitation noticed in the report is the failure of robo-advisors to provide overall portfolio analysis based on the facts and circumstances unique to each individual client, including the investor’s other investments and overall financial situation. The FINRA report implicitly raises the following questions:

- Are robo-advisors that do not provide overall portfolio analysis true fiduciaries?
- Do robo-advisors meet the standard of care applicable to an investment fiduciary?
- Do robo-advisors comply with the fiduciary duty of a registered investment adviser under the Investment Advisers Act of 1940?
- What is the fiduciary duty of a registered investment adviser with respect to individual clients?
- Does that duty require an investment adviser to provide overall portfolio analysis?
- Can an investment adviser provide prudent investment advice without providing portfolio analysis and without complying with the prudent investor standard of care?
- Are robo-advisors entitled to be registered as investment advisers under the Investment Advisers Act of 1940 or equivalent state laws?

The Massachusetts Securities Division has issued a policy statement stating that robo-advisors may be inherently incapable of meeting the fiduciary standard of care under its laws governing investment advisers. It remains to be seen what

position the Securities and Exchange Commission will take regarding robo-advisors. Whatever position it adopts, if any, will implicate the standard of care to which non-robo investment advisers and broker-dealers are held as well.

While the FINRA report does not preclude the use of robo-advisors by financial professionals in providing investment advice to their clients, the report emphasizes that robo-advisors are not a substitute for the suitability analysis required when broker-dealers provide investment recommendations. A corresponding implication is that robo-advisors are not a substitute for the portfolio analysis required of an investment fiduciary under the fiduciary standard of care.

The report stresses that financial professionals should not use robo-advisors without education and training. It also strongly suggests that individual investors should not rely on robo-advisors without the assistance of a trained financial professional.
APPENDIX

Pertinent provisions of the Uniform Prudent Investor Act, section 2:

SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;

(2) the possible effect of inflation or deflation;

(3) the expected tax consequences of investment decisions or strategies;

(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) the expected total return from income and the appreciation of capital;

(6) other resources of the beneficiaries;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(8) an asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets. ****