ROBO-ADVISORS: A CLOSER LOOK

BY

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Robo-advisors have been touted by the Department of Labor as a source of investment advice that can benefit retirement investors by minimizing costs and avoiding conflicts of interest. On the other hand, they have been labelled as gimmicky and overly simplistic by some critics who have used them. The Securities and Exchange Commission has cautioned that robo-advisors may result in investment recommendations that are based on incorrect assumptions, incomplete information, or circumstances not relevant to an individual investor.

This paper examines whether robo-advisors in fact provide personal investment advice, minimize costs, and are free from conflicts of interest. It also evaluates whether robo-advisors meet a high fiduciary standard of care and act in the client's best interest. Based on a detailed review of user agreements for three leading robo-advisors, this paper concludes that robo-advisors do not live up to the DOL's acclaim. They are not designed for retirement accounts subject to ERISA and should be approached with caution by retail and retirement investors looking for personal investment advice.

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I. INTRODUCTION

The technology revolution has transformed the marketplace for investment products and services in significant ways. New Internet tools have made it possible for individual investors to buy and sell securities directly in the stock market without the advice of a broker, investment adviser, or other intermediary. Many individual investors have acquired the expertise and self-confidence to conduct their own investment programs online. Some devote hours each day to managing their investment portfolios. Some have done well for themselves in the stock market. Many have not. Some view the stock market as little more than a casino. Most understand that investing in the market is not for amateurs or the faint of heart. Certainly when it comes to investing one's retirement nest egg, caution is advisable.

Robo-advisors have emerged in the marketplace as an alternative for small investors who are comfortable using Internet technology but want the reassurance of an investment adviser to guide them. They offer investment advice and discretionary investment management services without the intervention of a human adviser, using algorithms and asset allocation models that are advertised as being tailored to each individual's investment needs.

Whether robo-advisors are a suitable investment vehicle for retail or retirement investors, however, has been questioned. The Securities and Exchange Commission ("SEC") and Financial Industry Regulatory Authority ("FINRA") have cautioned that robo-advisors may rely on assumptions that are incorrect or inapplicable to an individual's financial situation. As a result, the robo-advisor may recommend investments that are not appropriate for an individual investor.¹

Nevertheless, the Department of Labor ("DOL") has touted roboadvisors as potentially useful tools that can benefit retirement investors by minimizing costs and avoiding conflicts of interest.² The DOL has given robo-advisors regulatory latitude in order to facilitate development of the robo-advisor marketplace. In a recently proposed "best interest contract"

¹ Securities and Exchange Commission Office of Investor Advocacy and Financial Industry Regulatory Authority, Joint Investor Alert, Automated Investment Tools, updated May 8, 2015.

² See, e.g., "DOL Secretary Perez touts [robo-advisor] as paragon of low-cost, fiduciary advice," Investment News, June 19, 2015.

exemption from ERISA, for example, the DOL decided not to subject roboadvisors to cumbersome regulatory requirements that would govern other investment advisers. Curiously, however, the leading robo-advisors do not offer their services to ERISA accounts.

This paper examines the general attributes of robo-advisors along with recent criticism of these new investment vehicles. It then takes a closer look to assess whether robo-advisors are worthy of the DOL's praise or whether investors should be wary of them as the SEC and FINRA have advised. Based on a review of customer agreements for the leading robo-advisors, this paper shows that the DOL's endorsement of them is based on faulty assumptions. On the other hand, the cautionary guidance of the SEC and FINRA appears well-grounded.

This paper shows that robo-advisors do not provide investment advice that is necessarily in the customer's best interest, are not free from conflicts of interest, do not necessarily minimize investment costs, and do not comply with the fiduciary standard of care under well-established fiduciary principles.

II. OVERVIEW OF ROBO-ADVISORS

A. General Attributes

The term "robo-advisor" refers to any of a growing number of Internet-based investment advisory services aimed at retail investors that have emerged in the financial marketplace in recent months. About a dozen or so of such services currently exist with any significant customer base. More robo-advisors are expected to appear in the future.

Robo-advisors offer on-line investment advice based on the user's responses to a questionnaire filled out online. The questionnaire is designed to elicit information to establish basic risk parameters and investment preferences for the user, but does not necessarily elicit complete information about the user's financial situation. Based on the user's answers, the robo-advisor formulates an asset allocation program for the user and makes specific investment recommendations. Clients with similar investment objectives generally receive the same investment advice and may hold the same or substantially the same investments in their accounts.

Robo-advisors offer their services through an Internet interface or platform. A key characteristic of a robo-advisor is the absence of any human contact between the advisor and investors. Robo-advisors are designed to avoid the necessity of a personal advisory relationship with the client.

The leading robo-advisors offer discretionary investment services with the capacity to effect securities transactions and conduct an investment program for a user. The user must transfer money to the robo-advisor or its affiliates to be invested in accordance with the recommended investment program. The account can be structured to automatically reallocate investments or rebalance according to information inputs. Securities transactions typically are effected through the robo-advisor's affiliated broker-dealer and/or custodian. Less comprehensive robo-advisors provide asset allocation and rebalancing recommendations only, which the investor must implement elsewhere.

The investment vehicles recommended or used by robo-advisors in their investment programs typically include mutual funds and exchange traded funds ("ETFs"). ETFs and mutual funds are not limited to passively managed funds but also may include actively managed funds, and also may include ETFs and mutual funds sponsored and administered by affiliates. Some robo-advisors also recommend investments in individual stocks and offer "tax harvesting" services. A single ETF may be used for each asset category.

The minimum balance required to open a robo-advisor account typically is small—\$1,000-10,000. Some robo-advisors accept accounts with no minimum balance required. Robo-advisors charge fees ranging from zero to 50 basis points or more. They may earn additional compensation through affiliated and nonaffiliated intermediaries that provide investment services to the robo-advisor's user, for which the user pays a fee, and/or from revenue sharing arrangements with mutual funds. Robo-advisor users also pay fees directly to mutual funds and ETFs in which they invest through the robo-advisor's program.

Robo-advisors are required to register as investment advisers under the Investment Advisers Act of 1940 or applicable state law. As discussed *infra*, Robo-advisors also may be required to register as investment companies under the Investment Company Act of 1940, although none appear to be so registered at present.

B. General Criticism of Robo-Advisors

Robo-advisors have been criticized for various shortcomings. Among other things, they have been labelled as gimmicky and overly simplistic. A leading robo-advisor, for example, has been accused of offering a "canned" asset allocation generated from a risk tolerance "personality quiz" that forces the user into a one-size-fits-all rebalancing algorithm.³

In this regard, the typical robo-advisor questionnaire allows investors to provide only limited information about their investment needs and risk tolerance. According to one user, typical questions are along the lines of the following:

- Are you saving (i) for retirement, (ii) to build an emergency fund, or (iii) to maintain my standard of living?
- Do you understand stocks, bonds and ETFs (i) a lot, (ii) somewhat, or (iii) not at all?
- When you hear "risk" related to your finances, do you (i) become worried, (ii) remain indifferent, or (iii) see opportunity?
- Have you ever lost 20% or more of your investments in one year?
- If you ever were to lose 20% or more of your investments in one year, would you (i) sell everything, (ii) do nothing, or (iii) buy more?
- When it comes to making important financial decisions, do you (i) avoid them, or (ii) make them?
- How much fluctuation are you confident your investment will encounter in the next year — (i) a lot, or (ii) not much?

³ See

http://www.forbes.com/sites/davidmarotta/2015/04/12/schwab-intelligent-portfolios-services-not-provided/.

 How long do you expect to keep your money invested?⁴

Critics argue that these questions elicit only superficial information that can result in no more than superficial asset allocation and investment recommendations.⁵

Robo-advisors also have been criticized for ignoring key information relevant to a user's investment needs, such as the user's contribution and withdrawal schedule, dependents, other sources of wealth, monthly expenses, tax situation, anticipated expenditures (such as college tuition), and the like.

Another key complaint is the absence of person-to-person contact with a human adviser who can more carefully evaluate an investor's investment needs and circumstances. A human adviser can offer personalized investment guidance, and encourage investors to save more, diversify, and engage in less speculative trading. A human adviser can be available to the investor at crucial times such as during market volatility when investors are most likely to panic and make investment mistakes.⁶

Other commenters have pointed out that robo-advisors have been in existence only during a bull market and are untested in how they would perform in a downturn.⁷

⁴ See

http://www.forbes.com/sites/davidmarotta/2015/03/22/schwab-intelligent-portfolios-built-on-a-faulty-premise.

⁵ Id.

⁶ See, e.g., Robert Litan and Hal Singer, "Good Intentions Gone Wrong: The Yet-To-Be-Recognized Costs of the Department Of Labor's Proposed Fiduciary Rule," ("[T]he decision to stay invested (or not) during times of market stress swamps the impact of all other investment factors affecting long-term retirement savings, including modest differences in advisory fees or investment strategies. "Robo-advice," which the DOL assumes will over time replace human advisors who find it uneconomic to serve small savers under the new rule, cannot effectively perform this critical role. (An email or text message in the fall of 2008, for example, would not have sufficed to keep millions of panicked savers from selling, with devastating consequences for their nest eggs).").

⁷ Letter dated July 21, 2015, from The American Council of Life Insurers to the U.S. Department of Labor, http://www.dol.gov/ebsa/pdf/1210-AB32-2-00621.pdf ("Depending on how many people utilize such a resource, there could

C. SEC FINRA Cautionary Alert

The Securities and Exchange Commission ("SEC") and Financial Industry Regulatory Authority ("FINRA") in May of 2015 issued a joint investor alert cautioning investors to be wary of robo-advisors.⁸ Among other things, the Joint Alert warns investors to be aware that a robo-advisor may give advice based on incorrect assumptions, incomplete information, or circumstances not relevant to the user:

Be aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation...An automated investment tool may not assess all of your particular circumstances, such as your age, financial situation and needs, investment experience, other holdings, tax situation, willingness to risk losing your investment money for potentially higher investment returns, time horizon for investing, need for cash, and investment goals. Consequently, some tools may suggest investments (including asset-allocation models) that may not be right for you.

For example, an automated investment tool may estimate a time horizon for your investments based only on your age, but not take into account that you need some of your investment money back in a few years to buy a new home. In addition, automated tools typically do not take into account that your financial goals may change. ⁹

The SEC/FINRA Joint Alert warns that the questionnaires used by some robo-advisors may be misleading and programmed to generate preset options, and that investors need to be prepared to make their own investment decisions:

Be aware that a tool may ask questions that are overgeneralized, ambiguous, misleading, or designed to fit you into the tool's predetermined options. In addition, be

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be systemic implications which would be particularly devastating to retirees and pre-retirees, as well as the economy as a whole.").

⁸ Securities and Exchange Commission Office of Investor Advocacy and Financial Industry Regulatory Authority, Joint Investor Alert, Automated Investment Tools, updated May 8, 2015.

⁹ Id.

very careful when inputting your answers or information. If you make a mistake, the resulting output may not be right for you....While automated investment tools are programmed to generate outputs based on preset options, it is up to you to decide whether and when to rely on these tools in making your investment decisions.¹⁰

The Joint Alert also cautions that robo-advisors do not offer the benefits of human judgment and oversight or access to value-added personalized service:

If the automated investment tool does not allow you to interact with an actual person, consider that you may lose the value that human judgment and oversight, or more personalized service, may add to the process.¹¹

The Joint Alert also points out that an automated investment tool may be programmed to use economic assumptions that will not react to shifts in the market. For example if the automated tool assumes that interest rates will remain low but interest rates rise instead, the tool's output will be flawed.¹²

The Joint Alert further warns that robo-advisors may be programmed to consider only limited investment options, such as only investments offered by an affiliate of the robo-advisor.

A closer look at robo-advisors indicates that the warnings in the SEC/FINRA Joint Alert are justified.

III. A CLOSER LOOK AT ROBO-ADVISORS

To better assess the services offered by robo-advisors, the author examined the user agreements and/or disclosure brochures of three leading robo-advisors. The user contracts and related agreements are available on the robo-advisors' websites. The contracts describe the services to be provided, fees charged, investment risks, potential conflicts

¹⁰ Id.

¹¹ Id.

¹² Id.

¹³ For purposes of this paper, the robo-advisors will be referred to as Robo-advisors A, B, and C.

of interest, and other matters a user should know about the service and service providers.

Users are required to agree to an online contract. Some contracts are lengthy. In one case, the user must read, understand, and sign a 140-page online document that includes myriad disclosures, disclaimers and indemnification clauses. It is doubtful that most users actually read and understand the agreements or print them out for their records.

A review of the leading robo-advisor customer agreements shows that they generally:

- Do not provide personal investment advice
- Are not free from conflicts of interest
- Do not necessarily minimize costs
- Do not act in the best interest of the client
- Do not meet the standard of care for fiduciary investments
- Are not designed for ERISA retirement accounts and would not meet the DOL's proposed "best interest" contract exemption.

These conclusions are discussed below.

A. Robo-Advisors Do Not Provide Personal Investment Advice

The leading robo-advisors provide discretionary investment management services whereby they manage money for investors. Nevertheless, it would be inaccurate to characterize these robo-advisors as providing personal investment advice.

As one robo-advisor agreement provides, the robo-advisor will manage the client's account not in accordance with the client's financial situation or needs but "in accordance with the Plan":

Client appoints [Robo-advisor] to manage the Account on a discretionary basis and act as Client's attorney-in-fact with limited power and authority for Client and on Client's behalf to buy, sell, and otherwise effect investment transactions in the name of the Account *in accordance with the Plan*.¹⁴

The "Plan" is based on the robo-advisor's investment methodology regarding asset allocation strategies for investors with the client's risk profile and investment preferences based on information provided by the client in response to the questionnaire. However, as the SEC and FINRA have cautioned, the resulting advice may be based on incorrect assumptions, incomplete information, or circumstances not relevant to the user. 15

Moreover, the "Plan" does not purport to meet the individual client's investment needs based on an assessment of the client's complete individual financial situation. As one robo-advisor provides:

Client understands and agrees that [Robo-advisor's] only obligation is to manage the Account in accordance with the IPS [investment policy statement], and that Client has not engaged [Robo-advisor] to provide any individual financial planning services beyond what is provided via the Interface.¹⁶

Another robo-advisor similarly provides:

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....¹⁷

The customer agreement specifically states that the *client*—not the advisor—is responsible for determining that Plan investments are in the client's best interests:

Client is responsible for determining that investments are in the best interests of Client's financial needs.¹⁸

¹⁴ Robo-advisor B customer agreement at 26.

¹⁵ Securities and Exchange Commission Office of Investor Advocacy and Financial Industry Regulatory Authority, Joint Investor Alert, Automated Investment Tools, updated May 8, 2015.

¹⁶ Robo-advisor B customer agreement at 24 (emphasis added).

¹⁷ Robo-advisor C customer agreement at 4 (emphasis added).

¹⁸ Robo-advisor B customer agreement at 26.

Another robo-advisor agreement similarly provides:

Clients use a web or mobile application to determine whether the Program is appropriate for them and, if so, to select an investment strategy. Clients complete their assessment online and therefore clients should carefully consider whether their participation in the Program is appropriate for their investment needs and goals.¹⁹

Another robo-advisor's agreement provides:

Services of the Program shall include provision of Products and provision of online tools and functionality to aid *Client* in determining Client's investment preferences.²⁰

[Robo-advisor's] online platform enables *clients*...to finetune their allocation to match to their individual needs.²¹

Robo-advisors do not afford an opportunity for a client to have a personal advisory relationship with a human adviser. As one robo-advisor's agreement provides:

Services shall *not* include in person, telephonic, or other written consultation to determine the Client's financial situation and investment objectives.²²

The primary, if only, means of communication with the roboadvisor is through postings on the Internet. As one robo-advisory agreement describes:

Method of Communication. Client agrees that the primary method of [Robo-advisor's] communication with Client will be by posting information on servers accessible from the Website and, to the extent required by law, sending Client a notice that directs Client to the Website from which the information can be read and printed. Client understands that [Robo-advisor] reserves the right,

²⁰ Robo-advisor B customer agreement at 25.

¹⁹ Robo-advisor A at 1.

²¹ Robo-advisor customer agreement at 7.

²² Robo-advisor customer agreement at p. 24.

however, to post Account Communications on the Website without providing notice to Client, send Account Communications to Client's postal or electronic mail address of record or to another Access Device Client has registered with [Robo-advisor] or [Robo-advisor] Securities. Client agrees to check the Interface regularly as Client may have no other means of knowing that information and Account Communications have been delivered to Client. Client agrees that all Account Communications provided to Client in any of the ways described above will be deemed to have been good and effective delivery to Client when sent or posted by [Roboadvisor], by [Robo-advisor] Securities, or by [Roboadvisor[on behalf of [Robo-advisor[Securities, regardless of whether Client actually or timely receives or accesses the Account Communication.²³

One robo-advisor affords wealthier clients access to a one-time personal consultation with its financial planning experts:

Customers with an account balance of \$500k or greater can schedule a one-time personal consultation with one of our financial planning experts. This is in addition to being able to talk 7 days a week with our excellent customer support team, which is available to all customers.²⁴

This robo-advisor does not indicate whether its "customer support" team includes trained investment advisers or qualified representatives.

Robo-advisor clients are essentially left on their own to determine whether the robo-advisor's investment strategies are appropriate for their needs. Moreover, robo-advisor clients also get no help in understanding the contract they are required to sign in order to obtain services. As one robo-advisor agreement provides:

Client is solely responsible for reviewing and understanding all of the terms and conditions of these documents.²⁵

²³ Robo-advisor B customer agreement at 21.

²⁴ Robo-advisor A customer agreement.

²⁵ Robo-advisor B customer agreement at 35.

The robo-advisor typically reserves the right to change the advisory agreement without notice to the investor, who must consult the robo-advisor's website for the most up-to-date agreement:

Client acknowledges and agrees that [Robo-advisor] may modify the Advisory Agreement from time to time and Client agrees to consult the Interface from time to time for the most up-to-date Advisory Agreement.²⁶

Robo-advisor users who wish to allocate their assets themselves generally may do so only among the assets made available by the roboadvisor and only in accordance with the recommended plan.

Rather than characterize robo-advisors as providing personal investment advice, it is more accurate to describe them providing online tools for a client to use in determining the client's own risk tolerance and investment preferences and then enabling the client to subscribe to an investment strategy based on asset allocation formulas recommended for investors with similar preferences. In this regard, robo-advisors are similar to mutual funds.²⁷

For the foregoing reasons, it would be a mistake for retail or retirement investors to view robo-advisors as providing comprehensive personal investment advice designed to meet their individual needs.

B. Robo-Advisors Do Not Minimize Investment Costs

Some robo-advisors advertise that they offer their services for "free." The DOL has touted robo-advisors as a benefit to retirement investors for that reason.²⁸ The claim that robo-advisor services are "free" or "low-cost," however, is misleading if not completely false.

While some robo-advisors may not charge a fee to users, they do not offer their services without compensation. The compensation they receive ultimately is paid for by their customers in the form of higher fees embedded in investment products and services. Robo-advisors receive compensation from affiliated and non-affiliated broker-dealers,

 27 As discussed *infra*, some robo-advisors may be operating as unregistered investment companies.

²⁶ Robo-advisor B customer agreement at 36.

²⁸ See, e.g., "DOL Secretary Perez touts [robo-advisor] as paragon of low-cost, fiduciary advice," Investment News, June 19, 2015.

custodians, and clearing firms that handle their customer's securities transactions, and who similarly do not act without compensation. Roboadvisor users typically bear the cost of brokerage, transaction, and other transaction fees and expenses, whether directly or indirectly, and thus contribute to the robo-advisor's compensation. Accordingly, it is misleading to say that robo-advisory services are "free" or even "low-cost" to the user.

Robo-advisors disclose their compensation arrangements with service providers in their customer agreements. Some robo-advisors charge a single "all-inclusive" fee or "wrap fee" and the client may not pay a separate charge for securities transactions. Nevertheless, the robo-advisor may receive revenue sharing payments from products in which clients are invested. A leading "low-cost" robo-advisor, for example, discloses:

Client understands and agrees that [Robo-advisor], [Robo-advisor] Securities, their affiliates, and their representatives, consultants, or other agents in connection with the performance of their respective services, shall be entitled to and may share in the Fee or revenues derived from the Program.²⁹

In addition, users who invest through a robo-advisor are charged fees embedded in the investment products purchased for the user's account:

The only other fees Client will incur are the fees embedded in the Products purchased on Client's behalf.³⁰

Such embedded fees can be significant and include mutual fund advisory fees, brokerage, and other fees and expenses. One robo-advisor discloses:

[Robo-advisor] charges no advisory fees. [Robo-advisor] affiliates do earn revenue from the underlying assets in [Robo-advisor] accounts. This revenue comes from managing [Robo-advisor] ETFsTM and providing services relating to certain third-party ETFs that can be selected for the portfolio, and from the cash feature on the accounts.

³⁰ Robo-advisor B customer agreement at 27.

²⁹ Robo-advisor B customer agreement at 27.

Revenue may also be received from the market centers where ETF trade orders are routed for execution.³¹

All fees paid to [Robo-advisor] for investment advisory services are separate and distinct from the fees and expenses charged by Funds to their shareholders. These fees and expenses are described in each Fund's prospectus. These fees are generally composed of a management fee and other Fund expenses.³²

Moreover, robo-advisors typically reserve the right to charge or change a fee at any time:

Client understands and agrees that [Robo-advisor] may change the Fee or amend the Fee Schedule at any time by giving 30 days prior written notice.³³

Moreover, robo-advisors do not appear to offer their services at less cost than many mutual funds that are available online and provide simple asset allocation tools that enable investors to invest directly without the need for an intermediary.

Similarly, robo-advisors do not appear to be less costly to the investor than ERISA 401(k) plans and similar plans that offer mutual fund "C" shares with no fee at the account level.

It is unclear what benchmark the DOL is using, but its assumption that retirement investors can obtain investment advice from a roboadvisor for "free" or at "low cost" is not well-founded.

In any event, while fees can have a significant impact on investment returns, it is well-established that the least cost investment is not necessarily the best investment. The DOL itself has rejected the idea that the least cost investment is required by ERISA or is necessarily in the best interests of plan beneficiaries.

³¹ Robo-advisor A customer agreement.

³² Robo-advisor B customer agreement at 10.

³³ Robo-advisor B customer agreement at 27.

C. Robo-Advisors Are Not Free from Conflicts of Interest

Robo-advisors are affected with a number of conflicts of interest that enable them to engage in self-dealing transactions. Among other things, as noted, in providing services to customers, robo-advisors use affiliated brokers, custodians, clearing firms or other firms from which they receive compensation. They also use their own investment products.

To effect securities transactions for users, robo-advisors typically use an affiliated broker-dealer or a broker of their choice, which may not always obtain a favorable price for the user. As one leading robo-advisor discloses:

All brokerage transactions for securities in [the] Program accounts will be routed to [Robo-advisor's brokerage affiliate] for execution, which may not always obtain as favorable a price as another broker-dealer.³⁴

Another robo-advisor agreement similarly discloses that the client may not obtain rates as low as it might otherwise get if the robo-advisor selected a non-affiliated broker:

All transactions shall be executed by Broker [which may be an affiliate] as the custodian of the Account. Client represents and warrants that Client is satisfied with the terms and conditions relating to all services to be provided by Broker. [Robo-advisor] shall not have any responsibility for obtaining for the Account the best prices or any particular commission rates. Client recognizes that Client may not obtain rates as low as it might otherwise obtain if [Robo-advisor] had discretion to select broker-dealers other than Broker.³⁵

The customer agreement also discloses that the robo-advisor engages in agency cross-trades that have resulting conflicts of interest. The client is required to consent to such conflicts:

Client agrees that [Robo-advisor], or any person controlling, controlled by or under common control with [Robo-advisor], may act as broker for both Client and for

³⁴ Robo-advisor A customer agreement at 5.

³⁵ Robo-advisor C customer agreement at 6.

another person on the other side of any transaction involving funds or Securities in the Account ("Agency Cross Transaction"). 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....³⁶

Robo-advisors may have an interest or position in securities that are recommended to clients:

[Robo-advisor] or individuals associated with [Robo-advisor] may buy or sell securities identical to or different than those recommended to clients for their personal accounts. In addition, any related person(s) may have an interest or position in certain securities which may also be recommended to a client.³⁷

Robo-advisors may require customers to consent to allow the roboadvisor to engage in principal transactions with itself in connection with the sale or purchase of securities for the client's account:

Client expressly authorizes [Robo-advisor] Securities with [Robo-advisor's] cooperation to arrange "agency cross" transactions (i.e., transactions for which [Robo-advisor] Securities or an affiliate acts as a broker for both parties in a transaction) and transactions between Client and [Robo-advisor's] own account, which may result in conflicting loyalties.³⁸

Another robo-advisor agreement discloses similar conflicts of interest in the handling of client orders:

Order Handling. [Robo-advisor] Securities may, but is not required to, aggregate orders for the sale or purchase of securities for the Account with orders for the same security for other [Robo-advisor] Securities customers, including its employees and their related persons, and for [Robo-advisor's] own account with [Robo-advisor]

³⁶ Robo-advisor C customer agreement at 6.

³⁷ Robo-advisor B customer agreement at 9.

³⁸ Robo-advisor B customer agreement at 64.

Securities. In such cases, each Account will be charged or credited with the average price per unit.

Client expressly authorizes [Robo-advisor] and [Robo-advisor] Securities to arrange "agency cross" transactions (i.e., transactions for which [Robo-advisor] Securities or an affiliate acts as a broker for both parties in a transaction) and transactions between Client's Account and [Robo-advisor's] own account with [Robo-advisor] Securities. These types of transactions may result in conflicting loyalties. In instances of agency cross transactions and transactions with [Robo-advisor's] account no mark down, mark up, or other compensation will be charged.³⁹

Robo-advisors may receive payments for order flow in exchange for routing trades to a clearing firm. For example, one robo-advisor agreement discloses:

[Robo-advisor] routes your trades to our brokerage partner, Apex Clearing, for execution. In exchange for routing trades, we may receive monetary rebates that offset our commission cost.⁴⁰

Apex or [Robo-advisor] may receive compensation or other consideration for the placing of orders with market centers for execution. The amount of the compensation depends on the agreement reached with each venue. The source and nature of compensation relating to the undersigned's transactions will be furnished upon written request.⁴¹

[Robo-advisor] Securities reserves the right to receive remuneration (generally in the form of per-share cash payments or through profit sharing arrangements) for directing orders in securities to particular broker-dealers and market centers for execution. Client understand that this remuneration, known as "payment for order flow," is considered compensation to [Robo-advisor] Securities and

³⁹ Robo-advisor B customer agreement at 26.

⁴⁰ Robo-advisor C customer agreement at 16.

⁴¹ Robo-advisor C customer agreement at 20.

the source and amount of any compensation received by [Robo-advisor] Securities in connection with Client's transaction will be disclosed on written request.⁴²

One leading robo-advisor uses deposits of an affiliated bank for the cash sweep allocation of its investment program. The robo-advisor discloses that this arrangement creates a conflict of interest:

[Robo-advisor] Bank ("Robo Bank") earns income on the Sweep Allocation for each investment strategy. The higher the Sweep Allocation and the lower the interest rate paid the more Robo Bank earns, thereby creating a potential conflict of interest for [Robo-advisor]. The cash allocation can affect both the risk profile and performance of a portfolio.⁴³

To mitigate the conflict, the robo-advisor, states that its investment strategies are constructed "pursuant to modern portfolio theory and behavioral factors seeking an optimal return goal for a portfolio based on the level of risk an investor is willing to take." ⁴⁴ It is unclear, however, how this "mitigation" relates to the actual conflict.

As noted above, the SEC/FINRA Joint Alert cautions investors that robo-advisors may be programmed to consider only limited investment options, such as only investments offered by an affiliated firm. A review of robo advisory programs indicates that this warning is justified and that robo-advisors are structured to invest in products sponsored by affiliates or from which they and/or their affiliates receive fees. One leading robo-advisor discloses:

Eligible ETFs include [affiliated] ETFsTM, which are managed by [investment manager], which is an affiliate of [Robo-advisor]. [Robo-advisor's] ETFs pay fees to [another affiliate, which] has discretion to allocate any portion, from none up to 100%, of an investment strategy into [Robo-advisor] ETFs....**** Each ETF, including a [Robo-advisor] ETF, pays investment advisory, administrative, distribution, transfer agent, custodial, legal, audit, and

⁴² Robo-advisor B customer agreement at 67.

⁴³ Robo-advisor A at 1.

⁴⁴ Robo-advisor A at 1.

other customary fees and expenses, as set forth in the ETF prospectus. An ETF pays these fees and expenses, which ultimately are borne by its shareholders. Therefore, [Roboadvisor affiliate] will earn fees from [Roboadvisor] ETFs that are held in [] Program accounts.

[Robo-advisor] has established the [Robo-advisor] ETF OneSourceTM program ("ETF OneSource") under which ETFs can be traded without a commission on buy and sell transactions. [Robo-advisor] Program accounts may include ETFs that participate in ETF OneSource. [Roboadvisor] receives payments from the third-party ETF sponsors or their affiliates participating in ETF OneSource for recordkeeping, shareholder services and other administrative services that [Robo-advisor] provides to participating ETFs. In addition, [Robo-advisor] promotes the ETF OneSource program to its customers, and a portion of the fees paid to [Robo-advisor] offsets some or all [Robo-advisor's] costs of promoting administering ETF OneSource. [Robo-advisor] does not receive payment to promote any particular ETF to its customers.

ETF sponsors or their affiliates pay a fixed program fee to [Robo-advisor] each year for each ETF participating in ETF OneSource. The program fees vary, but can range up to \$250,000 per year for each participating ETF. ETF sponsors or their affiliates also pay [Robo-advisor] an asset-based fee based on a percentage of total ETF assets purchased by [Robo-advisor] customers after the ETF was added to ETF OneSource. The amount of the asset-based fee can range up to 0.20% annually. [Robo-advisor] ETFsTM do not pay any program or asset-based fees to participate in ETF OneSource.

Assets in [Robo-advisor] Program accounts are included in the calculation of the asset-based fee to be paid to [Robo-advisor] by an ETF sponsor or its affiliates. [Roboadvisor] may exclude other assets or other types of transactions from the asset-based fee paid by an ETF sponsor or its affiliates.⁴⁵

Robo-advisors that provide discretionary investment management services generally use only the products they select, which typically include mainly proprietary products or mutual funds and ETFs with which they have revenue sharing agreements. For example, one robo-advisor customer agreement provides:

Client understands that the Products available for inclusion in the Account are to be determined by [Roboadvisor] and that [Robo-advisor] may change the Products available for inclusion in the Account without notice to Client.⁴⁶

Client may direct [Robo-advisor] by means outside of the Interface to allocate assets in the Account in a manner determined by Client and other than as determined by [Robo-advisor]; provided however, that the Products available under such alternative asset allocation shall be limited to the Products determined by [Robo-advisor].⁴⁷

Robo-advisor agreements may impose requirements or restrictions that limit users' access to their funds. For example, one robo-advisor agreement reserves the right to impose a waiting period of longer than five days during which a user might not have access to his or her funds for trading or withdrawal:

Client understands and agrees that the deposit and withdrawal of funds to or from the Account will be conducted exclusively in cash via [sic]. Client understands and agrees that ACH transactions are subject to processing delays which may last up to five Business Days or longer and funds transferred may not be credited to the Account or otherwise available to Client during processing. [Robo-advisor]and [Robo-advisor]Securities, in their sole discretion, may impose a longer waiting

⁴⁵ Robo-advisor A at 1 and 4.

⁴⁶ Robo-advisor B customer agreement at 24.

⁴⁷ Robo-advisor B customer agreement at 25.

period during which funds may not be available for trading or withdrawal.⁴⁸

The agreement does not indicate what circumstances would warrant the robo-advisor, in its sole discretion, imposing an indeterminate longer waiting period during which the customer could not access his or her funds.

All of these conflicts of interest are not necessarily prohibited under federal securities law to the extent they are disclosed by the robo-advisor and the user consents by accepting the customer agreement. But they do indicate that robo-advisors are not free from conflicts of interest, contrary to the DOL's assertions otherwise.

D. Robo-Advisors Do Not Meet a High Standard of Care

Robo-advisors do not meet the high fiduciary standard of care that normally governs the provision of investment management services by a registered investment adviser or ERISA fiduciary.

The prevailing standard of care is that described in the Uniform Prudent Investor Act ("UPIA"). The UPIA requires a trustee to "invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust" and to "exercise reasonable care, skill, and caution" in doing so.⁴⁹

Among the factors the UPIA requires a trustee to consider when investing and managing trust assets are:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of investment decisions or strategies;

⁴⁸ Robo-advisor B customer agreement at 28.

⁴⁹ Uniform Prudent Investor Act § 2. The UPIA was approved for enactment in all the states by the National Conference of Commissioners on Uniform State Laws in 1994. Nearly all of the states have adopted the UPIA or a variation thereof.

- 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;
- the expected total return from income and the appreciation of capital;
- other resources of the beneficiaries;
- needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

None of the leading robo-advisor advisory services evaluate an investor's total financial circumstances in light of all these factors, and none of them meets the fiduciary standard of care set forth in the UPIA.

The UPIA states that "investment and management decisions respecting individual assets must be evaluated <u>not in isolation</u> but in the context of the trust portfolio <u>as a whole</u> and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." (emphasis added) Robo-advisors do just the opposite—they make isolated investment and management decisions that do not take into consideration the investor's portfolio as a whole. They generally disclaim that they offer an overall investment strategy for the investor. For example, a leading robo-advisor's agreement provides:

Client understands and agrees that [Robo-advisor's] investment plan will not be based on assets that Client may have outside of the Account or Client's preferences that [Robo-advisor] does not explicitly request via the Interface after Client logs into the Website, unless [Robo-advisor] specifically requests such information via the Interface after Client logs into the Website and Client provides the requested information via the Interface. Client understands and agrees that [Robo-advisor's] only obligation is to manage the Account in accordance with the IPS [investment policy statement], and that Client has

not engaged [Robo-advisor] to provide any individual financial planning services beyond what is provided via the Interface.⁵⁰

In addition, none of the leading robo-advisors appears to comply with the UPIA requirement that a trustee "make a reasonable effort to verify facts relevant to the investment and management of trust assets." A robo-advisor typically does not make any effort to verify such facts but relies solely on information provided by the client and requires the client to certify that the information provided to the robo-advisor is correct.

The UPIA requires a fiduciary to monitor investments to ensure that they continue to be in the best interests of the account. The Supreme Court has held that the fiduciary duty of an ERISA fiduciary similarly includes the duty to monitor investments for fiduciary accounts on an ongoing basis.⁵¹ Robo-advisors, however, do not monitor the appropriateness of investments for individual client accounts. They may adjust their asset allocations and rebalance customer accounts, but they do not monitor whether the client's account investments are in the best interests of the client on an ongoing basis.

One robo-advisor customer agreement emphasizes that it is the *client's* responsibility to monitor his or her own accounts and that robo-advisor personnel will conduct only limited, non-periodic reviews of customer accounts:

[Robo-advisor's] investment tools are intended for clients to utilize to review their account and better understand their holdings and performance. [Robo-advisor's] personnel conduct only limited, non-periodic individual reviews of client accounts when triggered by certain investment activity and account settings.⁵²

E. Robo-Advisors Do Not Act in the Client's Best Interest

Robo-advisors are not structured to act in the client's best interest. As one agreement states, the *client*—not the robo-advisor—is responsible for determining that investments are in the client's best interests:

⁵⁰ Robo-advisor B customer agreement at 24.

⁵¹ Tibble v. Edison Int'l, 135 S. Ct. 1823 (2015).

⁵² Robo-advisor B customer agreement at 10.

Client is responsible for determining that investments are in the best interests of Client's financial needs.⁵³

The customer agreement further provides:

In deciding to engage [Robo-advisor] and open the Account, Client represents that *Client has determined that the Program is appropriate for Client*, taking into account all factors that *Client* believes are relevant....⁵⁴

Nowhere in the agreement does the robo-advisor obligate itself to act in the customer's best interest.

Robo-advisors appear to aim to minimize their fiduciary duty to clients. Their agreements are designed to limit their fiduciary duty. One robo-advisor agreement expressly disclaims that it has any relationship with the client other than as an independent contractor:

[Robo-advisor] is and will hereafter act as an independent contractor and not as an employee of Client, and nothing in this Agreement may be interpreted or construed to create any employment, partnership, joint venture *or other relationship* between [Robo-advisor] and Client.⁵⁵

Another robo-advisor agreement all but disclaims any fiduciary duty to the client:

Client understands and agrees that Client is responsible for any trades placed in the Account and for all Losses arising from or related to the Account. Except for negligence or malfeasance or violation of applicable law, Client agrees that [Robo-advisor] and [Robo-advisor] Securities and their respective officers and employees shall not be liable hereunder for any action performed or omitted to be performed or for any errors of judgment in managing the Account. Federal and state securities laws impose liabilities under certain circumstances on persons who act in good faith and therefore nothing herein shall in any way constitute a waiver or limitation of any rights

⁵³ Robo-advisor B customer agreement at 26.

⁵⁴ Robo-advisor B customer agreement at 33 (emphasis added).

⁵⁵ Robo-advisor C customer agreement at 7.

which Client may have under federal or state securities laws. In addition, it is possible that Client or [Roboadvisor] itself may experience computer equipment failure, loss of internet access, viruses, or other events that may impair access to [Robo-advisor's] software based financial advisory service. [Robo-advisor] and its representatives are not responsible to any Client for losses unless caused by [Robo-advisor] breaching its fiduciary duty.⁵⁶

Another robo-advisor agreement actually requires the client to agree to indemnify the robo-advisor and its officers, directors, employees, shareholders, and affiliates for "all claims, losses, damages, liabilities, and expenses" that arise by reason of any act or omission of the client, broker, agent, or other third party selected by the robo-advisor:

Client...shall indemnify and defend [Robo-advisor] and [Robo-advisor's] directors, officers, shareholders, employees and affiliates and hold them harmless from and against any and all claims, losses, damages, liabilities and expenses, as they are incurred, by reason of any act or omission of Client or Broker or any custodian, broker, agent or other third party selected by [Robo-advisor] in a commercially reasonable manner or selected by Client, except such as arise from [Robo-advisor's] breach of fiduciary duty to Client.⁵⁷

Another robo-advisor agreement similarly limits its liability:

Client shall indemnify and hold harmless [Robo-advisor] Securities, its directors, employees, agents, and affiliates from and against any and all Losses, claims, or financial obligations that may arise from any act or omission of [Robo-advisor] with respect to the Account.⁵⁸

While a fiduciary generally is not responsible for losses in a client's account that are beyond its control, the extent to which robo-advisors seek

⁵⁶ Robo-advisor B customer agreement at 32.

⁵⁷ Robo-advisor C customer agreement at 6.

⁵⁸ Robo-advisor B customer agreement at 59.

to limit their liability suggests that they do not perceive themselves as under a fiduciary duty to act in the client's best interest.

The leading robo-advisor agreements provide for mandatory arbitration of disputes and require investors to waive their right to a court-ordered remedy:

The parties waive their rights to seek remedies in court, including any right to a jury trial.⁵⁹

All parties to this Advisory Agreement are giving up the right to sue each other in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed...Arbitration awards are generally final and binding; a party's ability to have a court reverse or modify an arbitration award is very limited...The ability of the parties to obtain documents, witness statements and other discovery is generally more limited in arbitration than in court proceedings...The arbitrators do not have to explain the reason(s) for their award unless, in an eligible case, a joint request for an explained decision has been submitted by all parties to the panel at least 20 days prior to the first scheduled hearing date...The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry....⁶⁰

Based on the foregoing, it cannot be said that robo-advisors act in the best interest of the client but rather leave it to the client to act in his or her own best interest.

F. Robo-Advisors Exclude ERISA Accounts

Robo-advisors avoid fiduciary status under ERISA by not offering their services to retirement accounts that are subject to ERISA. One leading robo-advisor's customer agreement explicitly states that ERISA accounts are "not eligible" to use its services:

Business entities, government entities and accounts that are subject to the Employee Retirement Income Security

⁵⁹ Robo-advisor C customer agreement at 7.

⁶⁰ Robo-advisor B customer agreement at 37.

Act of 1974 ("ERISA"), as amended, are not eligible for the SIP Program.⁶¹

Another leading robo-advisor's agreement similarly provides:

Client represents and warrants to [Robo-advisor] and agrees with [Robo-advisor] as follows: ...As of the Effective Date, and at all times during the term of this Agreement, none of the Account's assets are or will be assets of "employee benefit plans" within the meaning of the Federal Employee Retirement Income Security Act of 1974, as amended.

Robo-advisors may allow customers with individual retirement accounts (IRAs) to use their services, but generally avoid ERISA accounts. By refusing to serve ERISA accounts, they thereby avoid ERISA's strict fiduciary duties.

Accordingly, robo-advisor services do not appear to be available to retirement investors for their 401(k) plans, which are subject to ERISA, notwithstanding the DOL's encouragement of their use by such investors.

G. Robo-Advisors Do Not Meet DOL's Proposed "Best Interest Contract"

The DOL has proposed a new definition of "fiduciary" for purposes of ERISA under which investment advisers will be deemed to have "fiduciary" status under ERISA.⁶² In connection with the proposed rule, the DOL also proposed an exemption to allow such fiduciaries to receive compensation that otherwise would be prohibited under ERISA if the fiduciary enters into a "best interest" contract with each retirement investor.⁶³ Under the contract, the adviser must:

- contractually acknowledge its fiduciary status,
- commit to adhere to basic standards of impartial conduct,

63 80 Federal Register 21960 (April 20, 2015).

⁶¹ Robo-advisor A customer agreement at 1.

⁶² DOL, "Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice," 80 Federal Register 21927-21960 (April 20, 2015).

- warrant that it has adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest,
- disclose basic information on its conflicts of interest and the cost of its advice,
- commit to fundamental obligations of fair dealing and fiduciary conduct,
- commit to give advice that is in the customer's best interest,
- commit to avoid misleading statements, and
- agree to receive no more than reasonable compensation.⁶⁴

As proposed, the DOL's best interest contract exemption does not apply to compensation received by a robo-advisor. The DOL in its Federal Register notice stated that such an exemption—and its stringent requirements—is not necessary because the marketplace for robo-advice is evolving in ways that "both appear to avoid conflicts of interest that would violate the prohibited transaction rules, and minimize cost." Indeed, the DOL's position seems to be that, because robo-advisors give investment advice without any personal interaction or advice from an individual adviser, they are not even ERISA fiduciaries. Furthermore, the DOL seems to say, there is no need to regulate them as fiduciaries under ERISA since they avoid conflicts of interest and minimize cost.

The DOL provides no basis for its assumption that robo-advisors are free from conflicts of interest or minimize costs. As this paper has shown, the leading robo-advisors do not meet these standards. Among other things, the robo-advisors do not acknowledge their fiduciary status and indeed some seek to contract it away. They do not commit to give advice that is in the customer's best interest, and are not structured to do so. They do not agree to receive no more than reasonable compensation. Accordingly, despite being touted by the DOL as providing beneficial "low-cost" investment advisory services to retirement investors, the leading robo-advisors do not meet the DOL's proposed fiduciary standards.

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⁶⁴ Id.

Moreover, the DOL seems surprisingly unconcerned about the minimal level of fiduciary responsibility assumed by robo-advisors. Robo-advisors are not structured to comply with the prudent investor standard of care or to act in the client's best interest. Rather, they rely on the client to act in his or her own best interest.

The DOL's endorsement of robo-advisors seems especially misplaced in light of the fact, as shown above, that the leading robo-advisors are structured to exclude ERISA retirement accounts for eligibility for their services.

H. Robo-Advisors May Be Unregistered Investment Companies

Robo-advisors may be acting as unregistered investment companies in violation of the Investment Company Act of 1940 and SEC regulations thereunder. The SEC has taken the position that investment advisory services that are provided on a discretionary basis to a large number of advisory clients having relatively small amounts to invest may be deemed "investment companies" unless they comply with a nonexclusive "safe harbor" under SEC Rule 3a-4 under the Investment Company Act.⁶⁵

⁶⁵ See Status of Investment Advisory Programs under the Investment Company Act, 62 Federal Register 15098 (March 31, 1997) (final rule); 60 Federal Register 39574 (Aug. 2, 1995) (proposed rule). The SEC said: "Under wrap fee and other investment advisory programs, a client's account typically is managed on a discretionary basis in accordance with pre-selected investment objectives. Clients with similar investment objectives often receive the same investment advice and may hold the same or substantially the same securities in their accounts. In light of this similarity of management, some of these investment advisory programs meet the definition of investment company under the Investment Company Act, and can be deemed to be issuing securities for purposes of the Securities Act of 1933 ("Securities Act"). Section 3(a)(1) of the Investment Company Act defines the term investment company generally to include any "issuer" which is engaged primarily in the business of investing, reinvesting, or trading in securities. The definition of issuer includes any organized group of persons, whether or not incorporated, that issues or proposes to issue any security. An investment advisory program could be considered to be an issuer because the client accounts in the program, taken together, could be considered to be an organized group of persons. Investors in the program could be viewed as purchasing securities in the form of investment contracts. If an investment advisory program is deemed to be an "issuer," it also would be deemed to be an investment company because it is engaged in the business of investing, reinvesting, or trading in securities." 60 Federal Register 39574.

To be eligible for the safe harbor, an investment advisory program must be organized and operated in accordance with certain requirements. Among these are that "each client's account in the program is managed on the basis of the client's financial situation and investment objectives and in accordance with any reasonable restrictions imposed by the client on the management of the account" and "the sponsor and personnel of the manager of the client's account who are knowledgeable about the account and its management are reasonably available to the client for consultation."

It may be questioned whether robo-advisors meet these requirements to the extent they do not manage client accounts on the basis of each client's financial situation and clients do not have reasonable access to personnel who are available to consult with the client. As discussed above, robo-advisor questionnaires do not necessarily elicit all of the relevant information about each client's financial situation. Thus, the robo-advisor may not be managing the client's account on the basis of the client's financial situation but rather on the basis of responses to the questionnaire, and the advisor's assumptions based thereon, which might not be accurate. Moreover, robo-advisors are designed to provide investment advice based on asset allocation formulas and strategies that result in the same investment recommendations to investors with broadly similar investment goals and thus may not be based on each client's individual financial situation.

Finally, to the extent robo-advisors limit communication with their clients to an Internet interface, clients may not be able to consult with the sponsor or personnel of the manager of the client's account who are knowledgeable about the account. Indeed, the reason robo-advisors are called "robo" is because they are designed to operate with no individual account manager or human personnel contact.

IV. CONCLUSION

The DOL has touted robo-advisors as investment alternatives for retirement investors based on ill-founded assumptions that robo-advisors are free or "low-cost" and seek to minimize conflicts of interest. This paper has examined several of the leading robo-advisors and shown that the DOL's assumptions are incorrect or misleading.

⁶⁶ SEC Rule 3a-4; 17 C.F.R. 270.3a-4.

Based on a review of robo-advisor customer agreements, this paper has shown that robo-advisors are not free from conflicts of interest and do not minimize investment costs to the extent the DOL assumes. Moreover, robo-advisors do not provide personal investment advice, do not meet a high standard of care for fiduciary investing, and do not act in the client's best interest. The robo-advisor agreements reviewed herein would not meet the DOL's proposed "best interest" contract exemption that requires investment advisers to acknowledge their fiduciary status, commit to give only advice that is in the customer's best interest, and agree to receive no more than reasonable compensation.

The SEC and FINRA have issued cautionary advice to investors regarding robo-advisors. Their concerns appear justified, based on the robo-advisor customer agreements reviewed herein.