Morgan Lewis

THE EVOLUTION OF ADVICE:
DIGITAL INVESTMENT ADVISERS AS FIDUCIARIES

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The Evolution of Advice: Digital Investment Advisers as Fiduciaries

The landscape for investment advice is shifting, and an innovative model has emerged that combines technology and investment expertise to deliver high-quality advice at a lower cost than traditional investment advisory services. Digital or so-called "robo" advisers that use algorithms and technology to offer discretionary investment advice through managed accounts are growing in popularity.[1] The emergence of digital advice is particularly significant for investors who were not previously able to access any advice because of the minimum balances required by other service models, but investors at every level of wealth have been drawn to the value, accessibility and transparency offered by digital advice.

Many industry participants have commented on the transformative potential of digital investment advice. Of particular note, the Chair of the US Securities and Exchange Commission ("SEC" or "Commission") observed that digital investment advice holds the "positive potential to give retail investors broader, and more affordable, access to our markets."[2] Other commentators have questioned whether digital advisers can meet the standards to which they are subject as fiduciaries under the Investment Advisers Act of 1940, as amended ("Advisers Act"), or whether it is necessary to consider new standards.[3] Although such questions are fair given the rapid growth of digital advice and the importance of ensuring that retail investors have access to high-quality investment advice, these critics tend to proceed from misconceptions about the application of fiduciary standards, the current regulatory framework for investment advisers, and the actual services provided by digital advisers.

This White Paper explores the application of fiduciary standards to digital advisers. It concludes that fiduciary standards, such as those incorporated into the Advisers Act, are flexible principles that

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1 A recent survey of the industry found that the top five digital advisers were currently providing investment management services in the United States to nearly $45 billion in combined assets under management. Alessandra Malito and Ellie Zhu, "Top 5 Robo-Advisers by AUM," InvestmentNews (Feb. 25, 2016), *available at* http://www.investmentnews.com/article/20160225/FREE/160229960/top-5-robo-advisers-by-aum; *see also* A.T. Kearney, *Robo-Advisory Services Study* (June 2015), *available at* https://www.atkearney.com/financial-institutions/robo-advisory-services-study (projecting that digital advisers' market share will rise to more than $2 trillion in assets under management by 2020).

2 Mary Jo White, Chair, US Securities and Exchange Commission, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), *available at* https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html.

3 *See* Massachusetts Securities Division, Policy Statement: Robo-Advisers and State Investment Adviser Registration (Apr. 1, 2016), *available at* https://www.sec.state.ma.us/sct/sctpdf/Policy-Statement--Robo-Advisers-and-State-Investment-Adviser-Registration.pdf; Massachusetts Securities Division, Policy Statement: State-Registered Investment Advisers' Use of Third-Party Robo-Advisers (July 14, 2016), *available at* https://www.sec.state.ma.us/sct/sctpdf/Policy-Statement-State-Registered-Investment-Advisers-Use-of-Third-Party-Robo-Advisers.pdf; Melanie L. Fein, *Robo-Advisors: A Closer Look* (June 30, 2015), pp. 22-23, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2658701; Melanie L. Fein, *FINRA's Report on Robo-Advisors: Fiduciary Implications* (Apr. 1, 2016), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2768295.

digital advisers and their nondigital counterparts (traditional advisers) are equally capable of satisfying. Investors benefit from this regulatory flexibility, which encourages innovation and permits the development of more varied services. Indeed, the Advisers Act already accommodates investment advisers with a wide variety of business models, investment strategies, and services. This White Paper also explains that the products and services offered by digital advisers are not unique, but instead are technologically enhanced versions of advisory programs and services that have long been subject to this flexible regulatory framework. Finally, this White Paper discusses the innovative and powerful ways that digital advisers can more effectively serve their clients, including by harnessing the efficiencies of technology and insights from behavioral finance.

DRIVERS BEHIND THE GROWTH OF DIGITAL ADVICE

Americans find themselves in the midst of what commentators have termed a "retirement savings crisis."[4] On the one hand, they are increasingly responsible for managing their own retirement savings because of the disappearance of defined benefit plans, deteriorating confidence in the long-term viability of the Social Security system, and concern that Social Security payments will provide insufficient retirement income.[5] Only 21% of American workers today reportedly are confident that they will have enough money for a comfortable retirement,[6] and participation in employee savings plans is at historic lows.[7] Moreover, more than half of current households approaching retirement have no savings, and a large proportion of those with savings do not have enough to maintain their standard of living in retirement.[8] On the other hand, many investors who would benefit from professional advice are not able to meet the high account minimums that often accompany access to financial advisors.[9]

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4 "America's Coming Retirement Crisis," Bloomberg News (May 13, 2015), *available at* http://www.bloomberg.com/view/articles/2015-05-13/providing-for-a-secure-retirement.

5 In 1998, more than half of the Fortune 500 offered new hires a defined benefit plan for retirement; in 2013, only 7% of those companies offered such plans. Brendan McFarland, *Retirement in Transition for the Fortune 500: 1998 to 2013*, Willis Towers Watson (Sept. 3, 2014), *available at* https://www.towerswatson.com/en/Insights/Newsletters/Americas/Insider/2014/retirement-in-transition-for-the-fortune-500-1998-to-2013.

6 Twenty-six percent of such workers report having saved less than $1,000 for retirement, and a further 38% have saved less than $50,000. Ruth Helman et al., *The 2016 Retirement Confidence Survey: Worker Confidence Stable, Retiree Confidence Continues to Increase*, Employee Benefit Research Institute Issue Brief No. 422 (Mar. 2016), *available at* https://www.ebri.org/pdf/briefspdf/EBRI_IB_422.Mar16.RCS.pdf.

7 The Bureau of Labor Statistics has found that close to 20% of low-wage or part-time workers with access to defined benefit pension plans and defined contribution retirement plans elect to participate in such plans; in companies with less than 50 workers, the participation rate is 34%. US Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in the United States*, *March 2016* (July 2016), *available at* http://www.bls.gov/news.release/archives/ebs2_07222016.pdf.

8 US Government Accountability Office, *Most Households Approaching Retirement Have Low Savings* (pub. avail. June 2, 2015), *available at* http://www.gao.gov/assets/680/670153.pdf.

9 A recent report by Cerulli Associates noted that only 8% of advisers will accept clients with less than $100,000 in assets and that only 29% of advisers target investors with assets in the $100,000 to $500,000 range. *See* Michael S. Fischer, "Can Digital Advice Fill Advisor Gap for Small Investors?" ThinkAdvisor (June 20, 2016), *available at* http://www.thinkadvisor.com/2016/06/20/can-digital-advice-fill-advisor-gap-for-small-inve.

Against this backdrop it is not surprising that there is tremendous hunger among the investing public for accessible, low-cost, and reliable advice. While some investors may still seek the services of a traditional adviser – and have sufficient assets to qualify for those services – others seek a different sort of advisory experience, at a different price point, to help them navigate the complexity of saving for retirement and other financial milestones. The availability of digital advice promotes the important policy objective of expanding access to retirement advice to a growing segment of underserved and undersaved Americans.

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At the same time, the growing awareness of the importance of fees in driving investment outcomes has led both investors and digital advisers to focus on the benefits of exchange-traded funds ("ETFs").[10] The maturation and growth of the ETF market over the last two decades has produced a broad range of products covering different asset classes, markets, styles, and geographies.[11] ETFs, which are traded intraday and are offered without the sales loads and internal distribution costs that can drive up expense ratios in other investment products, are a transparent, low-cost, and tax-efficient investment option. In addition, the passive index bias that is prevalent in the ETF market fits well with the diversification tenets of Modern Portfolio Theory. The use of passive ETFs allows digital advisers to create and manage inexpensive, broadly diversified global portfolios correlated to particular risk and return characteristics.

The growth of digital advice has also been accelerated by advances in technology that allow for a more personalized, efficient and seamless user experience. This appeals to the growing number of consumers who expect their financial providers to keep pace with the user experiences offered by other consumer services and who are comfortable relying on digital solutions to help manage their financial lives.[12] Banks and financial services firms are capitalizing on this trend by developing

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[10] *See* Tom Anderson, "Millennials prefer ETFs, and it's all about cost," CNBC (Sept. 15, 2016), *available at* http://www.cnbc.com/2016/09/15/a-millennial-money-move-boomers-would-be-wise-to-adopt.html (citing to Schwab's 2016 ETF Investor Survey (*available at* https://aboutschwab.com/images/uploads/inline/2016_ETF_Investor_Study_deck_0916-L9TS.pdf), which noted that both individual investors and registered investment advisers prioritize low expense ratios and total cost when choosing an ETF).

[11] Investment Company Institute, *2016 Investment Company Fact Book*, at 61 (May 4, 2016), *available at* https://www.ici.org/pdf/2016_factbook.pdf.

[12] A recent survey found that among affluent and high net worth investors, 64% expect their future wealth management relationships to be digital, and for those under the age of 40, 82% expect a digital relationship. A further 69% would be inclined to leave a wealth management firm if a digital component was not integrated into a wealth manager's offering. Taj Vakta and Sumit Chugh, *Self-Service in Wealth Management: Remaining Competitive in a Fast-Changing World*, Capgemini (2014), *available at* https://www.capgemini.com/resource-file-access/resource/pdf/self-service_in_wealth_management_whitepaper_2014.pdf. A separate survey by Wells Fargo/Gallup in May 2016 found that 54% of investors would trust advice from an adviser that has "good" applications and digital investing tools more than advice delivered by a less technologically savvy adviser. Wells Fargo/Gallup, *Investor and Retirement Optimism Index Q2 2016* (July 19, 2006), *available at* http://mms.businesswire.com/media/20160719005353/en/535372/5/3571706cInfographics_WF-Gallup_Investor_and_Retirement_Optimism_Index_2Q_2016_en+%281%29.jpg?download=1.

digital advice solutions designed to attract new clients and provide a broader range of services to existing clients.[13] Like digital advisers, these traditional advisers also recognize that such solutions appeal to the investing needs and expectations of a previously underserved segment of the investing public.[14]

DIGITAL ADVICE IS FIDUCIARY ADVICE

Critics of digital advice often focus on the fact that digital advisers differ from traditional advisers because there is no (or limited) human interaction.[15] However, the fact that digital advisers do not interface with their clients in the same way as traditional advisers does not mean that they are not fiduciaries to their clients, or that they cannot fulfill the fiduciary standards that govern an investment advisory relationship. Critics who suggest otherwise often misunderstand the source – and thus the contours – of an investment adviser's fiduciary duties.[16]

Fiduciary duties are imposed on investment advisers "by operation of law because of the nature of the relationship between the two parties."[17] This is made enforceable by Section 206 of the Advisers Act, which applies to all firms meeting the Advisers Act's "definition of investment adviser, whether registered with the Commission, a state securities authority, *or not at all*."[18] Investment

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[13] *See* Falguni Desai, "The Great FinTech Robo Advisor Race," Forbes (July 31, 2016), *available at* http://www.forbes.com/sites/falgunidesai/2016/07/31/the-great-fintech-robo-adviser-race/#267c5eee3812 (noting that "perhaps no other sub-sector of the fintech arena has received as much institutional and retail interest" as digital advisers, resulting in a number of strategic acquisitions or product launches by large financial services incumbents); *see also* Chris Flood, "Industry heavyweights put faith in robo-advisers," Financial Times (Sept. 11, 2016), *available at* http://www.ft.com/cms/s/0/ba0ea8e4-652a-11e6-8310-ecf0bddad227.html#axzz4KBEp73mY.

[14] Julie Verhage, "Morgan Stanley Analyst Says Robo Advisers Are One of the Major Threats to the Industry," BloombergMarkets (July 13, 2016), *available at* http://www.bloomberg.com/news/articles/2016-07-13/morgan-stanley-analyst-says-robo-advisers-are-one-of-the-major-threats-to-the-industry (noting that the wealth management industry has sought to meet the growing digital expectations of the investing public through strategic acquisitions, partnerships, or the pairing of human and digital capabilities).

[15] *See* Massachusetts Securities Division, Policy Statement: Robo-Advisers and State Investment Adviser Registration, and Fein, *Robo-Advisors: A Closer Look, supra* note 3.

[16] *See, e.g.*, Fein, *Robo-Advisors: A Closer Look supra* note 3, at 16 (implying that the "prevailing standard of care" for a registered investment adviser fiduciary is the Uniform Prudent Investor Act).

[17] Staff of the Investment Adviser Regulation Office, Division of Investment Management, US Securities and Exchange Commission, *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission* at 23 (Mar. 2013), *available at* https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf (citing *Arleen W. Hughes*, Exchange Act Rel. No. 4048 (Feb. 18, 1948), *affd sub nom. Hughes v. SEC*, 174 F.2d 969 (May 9, 1949)). The Department of Labor's ("DOL") new Fiduciary Rule explicitly recognizes that digital advisers are fiduciaries, and holds them responsible for providing investment advice to retirement plans and retirement plan participants consistent with the obligations of a "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA"). *See Best Interest Contract Exemption,* 81 Fed. Reg. 21,002, 21,012 (Apr. 8, 2016). We describe the DOL's Fiduciary Rule, and its treatment of digital advisers, in greater detail later in this White Paper.

[18] Division of Investment Management, US Securities and Exchange Commission, "General Information on the Regulation of Investment Advisers," *available at* https://www.sec.gov/divisions/investment/iaregulation/memoia.htm (last accessed Oct. 5, 2016) (emphasis

advisers, including digital advisers, have an affirmative duty to act with the utmost good faith, to make full and fair disclosure of all material facts, and to employ reasonable care to avoid misleading clients.[19] Sections 206(1) and (2) of the Advisers Act make it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client" or to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[20]

The concepts of fraud in Sections 206(1) and (2) are based on common law principles[21] and include a duty of loyalty and a duty of care. The duty of loyalty refers to the obligation to act loyally for the client's benefit, which requires that the adviser place the client's interests ahead of its own.[22] The duty of care refers to the obligation to act with the care, competence, and diligence that would normally be exercised by a fiduciary in similar circumstances.[23]

As noted above, the Supreme Court has interpreted Sections 206(1) and (2) as establishing a federal fiduciary standard for investment advisers.[24] Accordingly, it is an accepted legal principle that investment advisers, particularly advisers that are managing client assets on a discretionary basis, are fiduciaries.[25] Below we explain the source and parameters of an investment adviser's fiduciary duties, and discuss how these duties – the duty of care and the duty of loyalty – apply to the contours of the digital advisory relationship.

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added).

[19] *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 194-95 (1963). *See also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977) (noting that "Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers").

[20] Advisers Act § 206(1) and (2).

[21] *See, e.g., In re Brandt, Kelly & Simmons, LLC & Kenneth G. Brandt*, SEC Administrative Proceeding File No. 3-11672 (Sept. 21, 2004) (alleging that respondent "willfully violated Sections 206(1) and 206(2) of the Advisers Act, *which incorporate common law principles of fiduciary duties*" (emphasis added)).

[22] *See* Restatement (Third) of Agency § 8.01 (2006) ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."); § 8.01, cmt. b ("Although an agent's interests are often concurrent with those of the principal, the general fiduciary principle requires that the agent subordinate the agent's interest to those of the principal and place the principal's interests first as to matters connected with the agency relationship."); *see also* Restatement (Third) of Trusts § 78(1) (2007) ("Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purposes.")

[23] *See* Restatement (Third) of Agency § 8.08 ("[A]n agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances."); *see also* Restatement (Third) of Trusts § 77 (noting that a trustee has a duty to act with the exercise of "reasonable care, skill, and caution").

[24] *Capital Gains Research Bureau*, 375 U.S. 180 at 191–92; *see also Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers. Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations." (citations omitted)).

[25] Staff of the US Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers, at 22 (Jan. 2011), *available at* https://www.sec.gov/news/studies/2011/913studyfinal.pdf (noting that "[u]nder the Advisers Act, an adviser is a fiduciary").

THE FIDUCIARY STANDARD OF CARE IS DEFINED BY THE SCOPE OF THE RELATIONSHIP

Commentators who assert that digital advisers cannot meet the standard of care required of an investment adviser proceed from a fundamental misconception that there is a single standard of care that applies to all investment advisory relationships. In fact, the opposite is true. Under both common law and the Advisers Act, the applicable standard of care may be defined by contract, and the concepts of reasonable care and skill that are at the heart of any standard of care necessarily must be judged in relation to the scope of services agreed to by the client.[26]

Under common law, the standard of care an agent owes to a principal varies depending on the parties' agreement and the scope of their relationship.[27] An agent also owes to the principal a duty of care, which requires the agent to act with the care, competence, and diligence agents would normally exercise under similar circumstances.[28] However, the agent and principal may agree to raise or lower the duty of care by contract.[29] Even under trust law, which imposes higher obligations on trustees than exist under agency law, the scope of fiduciary duties is subject to the terms of the trust. A principal component of the common law duty of care is the requirement that a trustee act prudently in light of the purposes, terms, and other circumstances of the trust.[30] The duty of prudence encompasses the duty to exercise reasonable care and skill and to "act with a degree of caution suitable to the particular trust and its objectives, circumstances, and overall plan of administration."[31] While the trustee and beneficiary cannot agree to waive the trustee's fiduciary obligations under the duties of loyalty and care in their entirety,[32] trust law, especially trust fiduciary law, is default law that can be modified by the terms of the trust.[33] Thus, the trustee and

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[26] *See* Tamar Frankel, Arthur Laby & Ann Taylor Schwing, *Regulation of Money Managers: Mutual Funds and Advisers* § 16.02 (Dec. 2015) ("There is no single standard of care by which all transactions and relationships are measured. The relevant standard of care depends on multiple factors depending on the personal characteristics of the individuals, the terms of their arrangements, and the reasonable expectations of the clients, as well as the SEC Rules concerned among others with the impact of advisers on the markets.")

[27] *See* Restatement (Third) of Agency § 8.01 cmt. c ("Fiduciary obligation, although a general concept, is not monolithic in its operation. In particular, an agent's fiduciary duties to the principal vary depending on the parties' agreement and the scope of the parties' relationship.")

[28] *See id.* at § 8.08, *supra* note 23.

[29] *Id*. at cmt. b ("A contract may also, in appropriate circumstances, raise or lower the standard of performance to be expected of an agent . . . .").

[30] Restatement (Third) of Trusts § 90; *see also* Uniform Trust Code § 804 (Jan. 2013) ("A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.")

[31] *See* Restatement (Third) of Trusts § 77, cmt. b.

[32] *See* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 Buff. L. Rev. 99, 119 (2008) (discussing the concept of waiver under trust law); *see also* Restatement (Third) of Trusts § 70 cmt. d ("Although a trustee's duties, like trustee powers, may be affected by the terms of the trust, the fiduciary duties of trusteeship are subject to minimum standards that require the trustee to act in good faith and in a manner consistent with the purposes of the trust and the interest of the beneficiaries.")

[33] *See* Restatement (Third) of Trusts § 76 cmt. b(1) ("Briefly stated, much of trust law, especially trust fiduciary law, is default law—but some is not.") The "Prudent Investor Rule," as described in the Restatement (Third) of Trusts, is a perfect example of default trust law. It requires that each investment of a trust account

beneficiary may agree to modify or relax the default obligations of prudence through the terms of the trust[34] so long as they do not "altogether dispense with the fundamental requirement that trustees not behave recklessly but act in good faith, with some suitable degree of care, and in a manner consistent with the terms and purposes of the trust and the interests of the beneficiaries."[35]

Consistent with the common law, an investment adviser may limit the scope of its relationship with a client. In fact, it is not uncommon for investment advisers of all types to limit the scope of their services and authority based on the nature of the advisory relationship with their clients. For example, many traditional advisers provide the following types of limited service offerings:

- Prepare financial plans that speak to clients' overall investment objectives and financial circumstances at a particular point in time, thus disclaiming the responsibility to update the information on an ongoing basis;
- Provide asset allocation services or recommend investment strategies by researching and monitoring managers or funds, yet disclaim responsibility for making the underlying investment decisions with respect to those investment strategies or funds;
- Provide advice in connection with particular transactions by providing transition assistance to institutional investors transferring assets from one investment manager to another, yet disclaim responsibility for selecting individual securities to be bought or sold;
- Provide discretionary investment management services for one segment of a client's overall investment portfolio, and simultaneously disclaim responsibility for the management of the client's remaining assets;
- Provide nondiscretionary investment advice that cannot be implemented without the prior consent of a client; or

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be the result of the exercise of reasonable care, skill, and caution in the context of the trust portfolio as a whole and as part of an overall investment strategy that incorporates risk and return objectives reasonably suitable to the trust. It also requires the trustee to diversify investments unless, under the circumstances, it is prudent not to do so, and to conform to fiduciary standards, act with prudence in deciding whether to delegate its authority, and incur costs that are reasonable and appropriate. The overall duty of care applies not only in making investments but also in monitoring and reviewing investments. *See id.* at § 90, *supra* note 30. The Prudent Investor Rule is one of many default laws governing a trustee's duties at common law that may be modified by the terms of the trust. *See* Uniform Prudent Investor Act § 1(b) (1995) ("The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust."); *see also* § 1 cmt. on Variation (noting that "[a]lmost all of the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. Subsection (b) carries forward this traditional attribute of trust law"). Consequently, the broad articulations of the default trust law, which includes the Prudent Investor Rule, would not apply or would be modified where the parties have made other arrangements.

[34] *See* Restatement (Third) of Trusts § 76 cmt. b(1) ("A trustee has both (i) a duty generally to comply with the terms of the trust and (ii) a duty to comply with the mandates of trust law except as permissibly modified by the terms of the trust. Because of this combination of duties, the fiduciary duties of trusteeship sometimes override or limit the effect of a trustee's duty to comply with trust provisions; conversely, the normal standards of trustee conduct prescribed by trust fiduciary law may, at least to some extent, be modified by the terms of the trust.")

[35] *Id.* at § 77 cmt. d(3).

- Provide pricing or evaluation services that are limited to judging the appropriate price of a particular security or basket of securities.

The SEC has long recognized that investment advisers come in many shapes and sizes.[36] Rather than creating a prescriptive regulatory regime based on each discrete business model, the SEC has created a flexible, principles-based regulatory regime focused on an investment adviser's fiduciary duty to "make full and fair disclosure" of all material facts, including conflicts of interest between the adviser and its clients and "any other material information that could affect the advisory relationship."[37] The SEC has generally viewed the negotiation of the terms of an advisory relationship to occur at arm's length, provided that the investment adviser has satisfied its disclosure obligations, including disclosure about the adviser's business, material conflicts of interest, disciplinary information, and other information, so that prospective clients can decide whether to enter into an advisory agreement with the adviser.[38]

DIGITAL ADVISERS SHOULD HAVE A REASONABLE BASIS FOR THEIR ADVICE

Although there is no comprehensive list of the obligations that flow from fiduciary duty under the Advisers Act, it seems clear that part of that duty is to ensure that an adviser has a reasonable basis for its advice.[39] One of the central themes advanced by critics of digital advisers is that they do not

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[36] Staff of the US Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers,at 5 (Jan. 2011), *available at* https://www.sec.gov/news/studies/2011/913studyfinal.pdf (stating that "[i]nvestment advisers. . . offer a variety of services and products to their retail clients and customers, with the scope and terms of the relationship and the associated compensation reflecting the services and products offered"). *See also Investment Adviser Codes of Ethics*, Investment Advisers Act Rel. No. 2256 (July 9, 2004) (stating that "proposal left advisers with substantial flexibility to design individualized codes that would best fit the structure, size and nature of their advisory businesses"); *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Rel. No. 2204 (Dec. 17, 2003) ("Commenters agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements"); *Proxy Voting by Investment Advisers*, Investment Advisers Act Rel. No. 2106 (Jan. 31, 2003) ("Investment advisers registered with us are so varied that a 'one-size-fits-all' approach is unworkable").

[37] *See Amendments to Form ADV*, Investment Advisers Act Rel. No. 2711 (Mar. 3, 2008) (Mar. 14, 2008) [hereinafter, "Form ADV Proposing Release"] (*see* General Instruction No. 3 & n.148); *Amendments to Form ADV*, Investment Advisers Act Rel. No. 3060 (July 28, 2010) [hereinafter, "Form ADV Adopting Release"]. The Form ADV Proposing Release reflects the SEC's view that investment advisers should do more than simply identify a potential conflict of interest and should also explain generally how they address that conflict.

[38] The Advisers Act recognizes the arm's-length nature of the negotiation of an advisory relationship in not requiring that an investment advisory contract be in writing, or otherwise prescribing its terms, other than with respect to the receipt of performance compensation, assignment of the contract, and change in ownership where the adviser is a partnership. *See* Advisers Act § 205, 15 U.S.C. § 80b-5; *see also* Form ADV Adopting Release, *supra* note 37 ("[I]nvestors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts.")

[39] *See* Thomas P. Lemke & Gerald T. Lins, *Regulation of Investment Advisers* § 2.33 (Feb. 2016); *see also Regulation of Investment Advisers by the U.S. Securities and Exchange Commission, supra* note 17 at 23 (noting that one of the obligations that flow from an adviser's fiduciary duty is the duty to "have a reasonable, independent basis" for recommendations); *In re Alfred C. Rizzo*, Investment Advisers Act Rel. No. 897 (Jan. 11, 1984) ("As a registered investment adviser, Rizzo was required to have a reasonable basis for his investment advice.")

collect sufficient information to provide personalized investment advice and thus are not meeting their fiduciary obligations. We disagree. As discussed below, under established regulatory principles the information captured in the client-profiling process must be evaluated in relation to the nature of the advice that is provided. Accordingly, the critics' position appears to miss the mark in a number of ways.

The Advisers Act does not dictate the minimum amount of information that must be collected to make a reasonable determination that investment advice is appropriate for a client. In fact, unlike FINRA Rule 2111, the Advisers Act does not prescribe the amount or types of client profile information that are required to be collected in any respect. In 1994 the SEC proposed, but did not adopt, a suitability rule[40] that would have required investment advisers to conduct a reasonable inquiry into a client's financial situation, investment experience, and investment objectives before providing advice.[41] However, the proposing release makes clear that "the extent of the inquiry would turn on what is reasonable under the circumstances."[42] For instance, a "comprehensive financial plan" may, according to the proposing release, require extensive personal and financial information about a client, including current income, investments, assets and debts, marital status, insurance policies and financial goals. The implication is that an advisory program that is not offering comprehensive financial planning would not require the collection of such extensive information.

What is required to make a reasonable determination is a qualitative, rather than a quantitative, inquiry, and the type or amount of information relied upon by an adviser to make a recommendation may vary without compromising the advice. SEC Chair Mary Jo White, in public remarks addressing digital advisers, has acknowledged that "[j]ust like a conversation with a 'real person' about a client's financial goals, risk tolerances, and sophistication may be more or less robust, so too there is variation in the content and flexibility of information gathered by robo-advisors before advice is given."[43] Even the more prescriptive FINRA suitability rules provide broker-dealers with the flexibility to omit certain information from a customer profile if the broker-dealer determines that information would not be relevant to making a suitability determination in light of the applicable facts and circumstances.[44]

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[40] *Suitability of Investment Advice Provided by Investment Advisers,* Investment Advisers Act Rel. No. 1406 (Mar. 16, 1994).

[41] Although the SEC did not adopt the proposed rule, the Staff of the Division of Investment Management has taken the position that "the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the [Advisers] Act." *See Regulation of Investment Advisers by the U.S. Securities and Exchange Commission*, *supra* note 17 at 23 n.134.

[42] *Supra* note 40.

[43] Chair Mary Jo White, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative, *supra* note 2.

[44] FINRA Rule 2111.04 ("The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) *unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case*." (emphasis

The appropriate question is therefore not how *much* information an adviser is collecting, but rather whether the information the adviser decides to collect is appropriate in relation to the nature of the advice that is provided.[45] It follows that where advisers, digital or otherwise, provide assistance with specific and identifiable investment goals such as college or retirement savings, they need not collect the same degree of information, or conduct comparable due diligence, to that which may be required for a more expansive investment strategy.

Further, digital advice must be understood in relation to its place in the market. Many clients who choose a digital adviser have affirmatively chosen *not* to enroll in a comprehensive financial planning or investment management service. Instead, these investors have opted for goal-based wealth management (e.g., accumulating for retirement, planning for college education, saving for a vacation home). Rather than lumping all assets together and managing them in relation to a particular benchmark, goal-based wealth management allows clients to create a separate "bucket" of assets for each goal and define an investment strategy that is unique to that particular goal. Investors continue to have the option of working with an investment adviser that will provide a more comprehensive solution that considers outside resources, debt, financial history, career, anticipated medical expenses and a myriad of other factors that could potentially influence the advice provided to an investor. But, they have to pay for those services. Critics who make the blanket assertion that digital advice is *per se* insufficient attempt to impose their own judgment about what is best for investors, rather than accepting the investing public's judgment of the services it wants, needs, and is willing to pay for. Such critics also presume – in the absence of any data - that traditional advisers always provide a full suite of services to these investors, although that is not necessarily the case. It cannot be good public policy to force investors to choose between no advice and expensive, bespoke advice.

Critics who make the blanket assertion that digital advice is per se insufficient attempt to impose their own judgment about what is best for investors, rather than accepting the investing public's judgment of the services it wants, needs, and is willing to pay for.

DIGITAL ADVISERS PRESENT COMPARATIVELY FEWER CONFLICTS OF INTEREST

One of the positive features of digital advisers from a fiduciary perspective is that they typically present fewer conflicts of interest. As fiduciaries, all advisers owe their clients a duty of loyalty.[46] At common law, this involves refraining from acting adversely or in competition with the interests of clients, and not using clients' property for the adviser's benefit or for that of a third party.[47] The duty of loyalty consists of the principles that advisers deal fairly with clients and prospective clients,

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added).)

[45] *See* FINRA, *Report on Digital Investment Advice* (Mar. 2016), *available at* https://www.finra.org/sites/default/files/digital-investment-advice-report.pdf ("A key question in developing a customer profile is: What information is necessary to build a customer profile with sufficient information to make a sound investment recommendation?")

[46] *See* Restatement (Third) of Agency § 8.01 and Restatement (Third) of Trusts § 78(1), *supra* note 22.

[47] Restatement (Third) of Agency § 8.01–8.05.

seek to avoid conflicts of interest, disclose all material facts for any actual or potential conflicts of interest that may affect the adviser's impartiality,[48] and not subrogate client interests to their own.[49] Consistent with the common law, the federal regulatory framework governing investment advisers is a disclosure-based regime that does not preclude an adviser from acting where there is an actual or potential conflict of interest, provided that full and fair disclosure is made to clients.[50]

By emphasizing transparent and straightforward fee structures, prevailing digital advice business models inherently minimize conflicts of interest associated with traditional investment advisers. Digital advisory offerings are typically comprised of ETFs that, in comparison to mutual funds, offer little room for revenue streams and payment shares that would otherwise create a conflict of interest for investment advisers (e.g., 12b-1 fees, subtransfer agent fees). The absence of such compensation factors means that comparatively fewer conflicts of interest are present even where digital advisers are affiliated with some of the ETFs that they recommend, and independent digital advisers reduce such conflicts even further. Moreover, digital advisory solutions eliminate the representative-level conflicts of interest typically present in the nondigital advisory context because there is little or no role for financial advisors who receive incentive-based compensation in an online offering. Accordingly, digital advisory solutions are less susceptible to the financial incentives that create conflicts of interest, disclosure, and sales practice and supervisory issues resulting from the compensation paid on accounts recommended and managed by financial advisors.[51]

Regulators have endorsed the position that the digital investment advice model eliminates many of the conflicts of interest presented by traditional advisers. DOL Secretary Thomas E. Perez has publicly remarked that digital investment advice platforms are able to provide fiduciary investment advice to lower balance investors, consistent with their best interests, at "significantly lower" fees than traditional advisers.[52] Moreover, the DOL itself, in its highly anticipated final regulations (the "Fiduciary Rule") expanding the definition of a fiduciary under ERISA, noted that "the marketplace

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[48] *See* Form ADV Adopting Release, *supra* note 37 ("An investment adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict." (citations omitted))

[49] *Proxy Voting by Investment Advisers*, *supra* note 36 ("Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting…. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.")

[50] *See* Form ADV Adopting Release, *supra* note 48.

[51] FINRA, *Report on Digital Investment Advice*, *supra* note 45 (noting that purely digital client-facing tools eliminate conflicts between employees and clients because financial professionals are not involved in the advice process). The SEC and wealth-management industry have long recognized that sales-related incentives pose potential conflicts of interest for brokerage and advisory relationships. In 1995, then SEC Chairman Arthur Levitt convened a committee comprised of representatives from across the financial services industry to review compensation practices. In its report, the committee found that sales and other financial incentives relating to an investment adviser or representative's compensation present a key conflict of interest for brokers and investment managers. Daniel P. Tully, Thomas E. O'Hara, Warren E. Buffet, Raymond A. Mason, and Samuel L. Hayes III, *Report of the Committee on Compensation Practices* (Apr. 10, 1995), *available at* https://www.sec.gov/news/studies/bkrcomp.txt.

[52] Thomas E. Perez, Secretary of Labor, Statement Before the Health, Employment, Labor and Pensions Subcommittee, Committee on Education and the Workforce, U.S. House of Representatives (June 17, 2015).

for robo-advice is still evolving in ways that both appear to avoid conflicts of interest that would violate the prohibited transaction rules and minimize cost."[53]

The Fiduciary Rule broadly treats advice to retirement plans (including individual retirement accounts) and retirement plan participants on investments, the management of investments, and rollovers, transfers, or distributions as fiduciary investment advice subject to the ERISA prohibited transaction rules, which are designed to prohibit a fiduciary from using its fiduciary authority or responsibility to cause itself to be paid an additional fee.[54]

As a companion to the Fiduciary Rule, the DOL adopted the Best Interest Contract Exemption ("BICE").[55] The BICE permits advisers that provide fiduciary advice to continue to market and sell investments and investment programs for which they receive compensation, provided that certain conditions are met. These conditions generally require an adviser to, among other things, only give advice that is in the retirement investor's best interest, acknowledge to investors that it is acting as a fiduciary, and disclose important information relating to fees, compensation, and material conflicts of interest.[56]

A streamlined, or "light" version of the BICE ("BICE-Lite") is available to fiduciaries who are compensated only through fees that are a fixed percentage of a retirement investor's assets under management or that otherwise do not vary based on particular recommended investments ("level fee fiduciaries"). The DOL explicitly stated that digital advisers could qualify as level-fee fiduciaries. Digital advisers that receive nonlevel compensation, on the other hand, are excluded from the BICE altogether. The DOL reasoned that to provide an exemption for robo-advice providers that permits nonlevel compensation would "adversely affect the incentives currently shaping the market for robo-advice."[57]

DIGITAL ADVICE HAS LONG BEEN GOVERNED BY THE EXISTING REGULATORY FRAMEWORK

Digital advisers are a disruptive and competitive alternative to traditional advisers, but the advisory services they offer build upon the traditional advisory framework and its regulatory structure, rather than depart from it. The range of advisory services offered by digital advisers – from online asset allocation recommendations to discretionary managed accounts comprised of diversified portfolios of ETFs – follow well-worn regulatory paths governing the use of electronic media, the use of interactive websites to deliver advice, and the governance of separately managed account and wrap fee programs. Further, the history of these services underscore that the Advisers Act is a flexible and technologically neutral regulatory regime that has accommodated technological change, innovation in products and services, and evolving business models.

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53 *Best Interest Contract Exemption, supra* note 17 at 21,058.

54 *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice*, 81 Fed. Reg. 20,946 (Apr. 8, 2016), codified at 29 C.F.R. § 2510.3-21.

55 *Best Interest Contract Exemption, supra* note 17 at 21,058*,* §I(c)(3).

56 *Id.* at 21,020.

57 *Supra* note 53.

In 1995, the SEC published its first interpretation on the use of electronic media to deliver regulatory communications. This release and the others that followed recognized the power of technology and, specifically, the electronic distribution of information, to "enhance the efficiency of the securities markets by allowing for the rapid dissemination of information to investors and financial markets in a more cost-efficient, widespread, and equitable manner than traditional paper-based methods."[58] In providing this guidance, however, the SEC also clearly established the principle that the securities laws are technologically neutral. The use of electronic media did not change the substantive provisions of the federal securities laws. In fact, the SEC specifically stated that the guidance set forth in the 1995 release "addresses only the procedural aspects under the federal securities laws of electronic delivery, and does not affect the rights and responsibilities of any party under the federal securities laws."[59] In the 1995 release and in a subsequent release in 1996 extending the same principles to the delivery of required communications under the Advisers Act, the SEC was clear that the "liability provisions of the federal securities laws apply equally to electronic and paper-based media."[60]

The Advisers Act is a flexible and technologically neutral regulatory regime that has accommodated technological change, innovation in products and services, and evolving business models.

The SEC recognized the presence of digital advice and its compatibility with the framework of the Advisers Act when it adopted the so-called "Internet Investment Advisers Exemption" in 2002.[61] This exemption permits advisers that provide personalized investment advice exclusively through interactive websites[62] to register as investment advisers at the federal level without necessarily meeting the regulatory assets under management threshold that is typically required of an SEC registered adviser. In adopting the exemption, the SEC acknowledged that it had to create a new basis for registration that captured investment advisers that did not technically have regulatory assets under management (the exemption assumed a business model under which advisers were not providing continuous and regular supervisory services). However, the SEC never considered changing the substantive provisions of the Advisers Act to address internet advisers solely because they provide advice through an interactive website.

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[58] *Use of Electronic Media for Delivery Purposes*, Securities Act Rel. No. 7233 (Oct. 6, 1995). It is interesting to note that many of these same sentiments regarding the promise of electronic delivery and the democratization of access to online information are today used to describe the benefits of digital investment advice.

[59] *Id*. at 4.

[60] *Id*.; *see also Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information,* Investment Advisers Act Rel. No. 1562 (May 9, 1996).

[61] *Exemption for Certain Investment Advisers Operating Through the Internet*, Investment Advisers Act Rel. No. 2091 (Dec 12. 2002) (noting that internet advisers offer advisory programs in which "[c]lients visit these websites and answer online questions concerning their personal finances and investment goals. Thereafter, the adviser's computer-based application or algorithm processes and analyzes each client's response, and then transmits investment advice back to each client through the interactive website.")

[62] Under the Internet Investment Advisers Exemption, internet advisers are permitted to provide advice through other means to a *de minimis* number of clients (less than 15 within a 12-month period). *See* Advisers Act Rule 203A-2(e)(1)(i).

Digital advisers generally manage client assets on a discretionary basis through separately managed account and wrap programs,[63] which are subject to a longstanding regulatory regime under Rule 3a-4 of the Investment Company Act of 1940 ("Company Act"). Rule 3a-4 provides advisers that manage discretionary investment advisory programs with a nonexclusive safe harbor from being classified as operating an investment company (or mutual fund), which therefore requires the advisers to comply with extensive compliance and reporting requirements under the Company Act.[64] Rule 3a-4 was designed to address programs where advisers seek "to provide the same or similar professional portfolio management services on a discretionary basis to a large number of advisory clients having relatively small amounts to invest."[65] Advisory programs that are organized and operated in accordance with the rule are not deemed to be *de facto* investment companies so long as they comply with a number of conditions designed to ensure that clients receive individualized treatment and there is no pooling of assets.

In a typical discretionary digital advice program, investors establish individual brokerage accounts to custody their assets, and the digital adviser selects and manages a portfolio of ETFs based on an asset allocation recommended by the adviser and selected by the client. Although many digital advisory services give clients the flexibility to change their asset allocation on a regular basis through a website or mobile application, the digital adviser retains the authority to manage the account based on the asset allocation parameters the client designates. This type of digital advisory service is not a radical departure from the norm. To the contrary, the wealth-management industry, which includes separately managed account and wrap fee programs, today accounts for $4.2 trillion in assets under management.[66]

Critics argue that digital advisers may be operating as unregistered investment companies because they do not meet two key provisions of the Rule 3a-4 safe harbor.[67] The first is 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

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63 A wrap fee program, as defined by the SEC's Glossary of Terms to Form ADV, is "any advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions."

64 *Status of Investment Advisory Programs Under the Investment Company Act of 1940*, Investment Company Act Rel. No. 22579 [hereinafter, "Rule 3a-4 Adopting Release"] (Mar. 24, 1997). Note that Rule 3a-4 formalized a long line of no-action letters that went back to 1980 that included conditions on which the rule was ultimately based.

65 *Id.*

66 Money Management Institute, *MMI Reports Investment Advisory Solutions Assets Rose 1.6% to $4.2 Trillion in First Quarter* (June 20, 2016), *available at* http://www.mminst.org/press-releases/mmi-reports-investment-advisory-solutions-assets-rose-16-42-trillion-first-quarter.

67 *See, e.g.*, Fein, *Robo-Advisors: A Closer Look, supra* note 3, at 16 (stating that "[r]obo-advisors may be acting as unregistered investment companies in violation of the Investment Company Act of 1940 and SEC regulations thereunder" and questioning whether they meet the requirements of Rule 3a-4 "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").

management of the account."[68] The second is that 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."[69] Leaving aside the question of whether any particular digital adviser needs to take advantage of the safe harbor provided by Rule 3a-4 based on the particular characteristics of its advisory programs – these critics tend to take a narrow view of the rule's conditions.

With respect to the first provision relating to individualized advice, it is important to understand that this requirement of Rule 3a-4 is not a suitability rule that requires advisers to collect specific information concerning the financial situation and investment objectives of each client, nor does the rule dictate the quantity of information that must be collected. Rather, the intent of this provision is to negate the inference that the discretionary managed account program is operating as a pooled investment company. In most cases, digital advisers do far more than simply provide online tools that allow self-directed investors to determine their own risk tolerance and investment preferences and then subscribe to a model portfolio designed for investors with similar preferences.[70] Moreover, in many respects, digital advisers permit far more customization than the traditional approach of simply giving clients the ability to impose reasonable restrictions on the management of their accounts by designating certain ticker or security limitations. Digital advisers offer many features and tools that a client or adviser may use to personalize portfolios, including financial planning tools to inform portfolio selection; portfolio allocations that clients may customize to their desired asset class mix; the ability to retain legacy positions; sophisticated, technology-driven portfolio rebalancing based on market changes, cash in-flows and out-flows, and risk parameters; and asset placement and tax-loss harvesting services. The result is that clients receive investment advice that is customized to their particular investment goals and needs.

Moreover, digital advisers are "reasonably available" to clients consistent with Rule 3a-4. In fact, they are arguably more available than traditional advisers. The requirement that the manager of the account be reasonably available for consultation is one of many factors that distinguish a separate account holder from a mutual fund investor. A mutual fund investor generally would not have access to the portfolio manager of the fund. But, Rule 3a-4 does not dictate how that access needs to be accomplished. Digital advisers typically provide their clients with around-the-clock access to a great deal of interactive real-time information about the holdings, performance and attributes of their accounts. In addition, this business model puts a premium on transparency – frankly, in a way that more traditional (nondigital) investment solutions do not. Digital advisers generally make a great deal of information about their investment philosophy and approach available to investors through articles, blogs and social media posts. Further, many digital advisers 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.

It is not surprising that the application of Rule 3a-4 looks different in the context of a digital offering, but that does not mean that digital advisers are operating unregistered investment companies. To the contrary, under digital offerings clients still receive the benefit of personalized advice and individualized treatment, and maintain all of the indicia of ownership of the ETFs and

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[68] 17 C.F.R. § 270.3a-4(a)(1).

[69] Id. at § 270.3a-4(a)(2)(iv).

[70] *Cf.* Fein, *Robo-Advisors: A Closer Look, supra* note 3 at 12.

other securities held in their accounts.

DIGITAL ADVICE IS HUMAN ADVICE, WITH CERTAIN UNIQUE ADVANTAGES

Digital advisers possess unique advantages that strengthen the fiduciary relationship and promote the delivery of sophisticated, consistent advice. Critics have sought to exaggerate the differences between traditional and digital advisers by characterizing digital advisers as "robots." As discussed below, this ignores the centrality of humans in providing digital advice, and the many advantages that digital advisers bring to the table that enable them to provide advisory services to clients in innovative and powerful ways.

Digital advice presents strong advantages with respect to the consistency, precision, and predictability of advice.

First, the algorithms used by digital advisers are developed by humans, and are monitored and overseen by investment and technology professionals. Rather than take human judgment out of the equation, the skill and investment expertise of these professionals is reflected in the algorithms used to manage client accounts. Digital advisers thus leverage technology to make the value provided by talented portfolio managers and investment professionals available to the broadest universe of clients. Further, digital advice presents strong advantages with respect to the consistency, precision, and predictability of advice.[71] Unlike advice delivered exclusively by individual human financial advisors, digital advice can mitigate instances of distraction, fatigue, or human bias that can lead to negative client investment outcomes or costly trade errors.

Additionally, digital advice tools can be used to rebalance portfolios, conduct daily portfolio reviews and apply new investment insights across many different client accounts in a way that would not be economically or operationally feasible for individual human financial advisors. This promotes faster, smarter and more effective investment decisions, which can help client portfolios stay on track and within applicable risk thresholds and efficiently allocate even the smallest cash flows across their investment portfolio. Moreover, automated investing enables digital advisers to more effectively implement their compliance programs and meet regulatory obligations. In contrast to advice delivered through individual human financial advisors, which may be offered *ad-hoc*, by phone, or conducted without reliable documentation, digital advice enables the consistent application of investment methodologies and strategies to client accounts, providing transparency, improved recordkeeping, and ease of audit.[72]

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[71] *See, e.g.*, Thomas Philippon, *The FinTech Opportunity* at 18 (July 2015) *available at* http://pages.stern.nyu.edu/~tphilipp/papers/FinTech.pdf (noting that digital advice is likely to perform better, on average, than human advice, as empirical studies reveal that human advice is subject to behavioral biases, misconduct, and returns-chasing patterns that statistically result in negative investment outcomes).

[72] *Id.* (noting that algorithmic advice promotes ease of monitoring and predictability of investment decisions as compared to human advisers).

Second, humans are operationally present, and in certain instances supplement, digital advice. A number of digital advisers offer live customer support to assist clients and answer service-related questions. Some digital advisers offer a so-called "hybrid model" where clients have the ability to speak with live investment adviser representatives. Digital advisers also have the capability to communicate instantaneously through email, mobile applications and their web interfaces to clients at a scale that far surpasses what an individual human financial advisor would be able to accomplish. Such communication features can be used to provide real-time account data or tailored portfolio analysis to clients at intervals of their choosing. Whereas an individual human financial advisor may be unable to reach even a small subset of its clients in a timely manner, a digital adviser may provide important and personalized account updates to its clients on a real-time basis.

Whereas an individual human financial advisor may be unable to reach even a small subset of its clients in a timely manner, a digital adviser may provide important and personalized account updates to its clients on a real-time basis.

Finally, digital investment advice platforms are able to leverage behavioral finance insights to offer innovative services and account features in a timely and consistent way. Digital advisers may collect data and observations based on a client's online behavior (either individually or in the aggregate) and use the information to enhance the client experience and promote positive investment outcomes.[73] For instance, digital advisers may observe that investors who look at their accounts frequently are more inclined to rebalance their portfolios in the event of minor losses that result from normal intraday market movements. In this way, digital advisers are able to focus on the actual behavioral patterns of clients, and this observed behavior tends to offer insights that clients are not aware of or may not voice to their financial advisors. Digital advisers may leverage such observations to guide investors away from missteps that could lead to negative investment outcomes. In response to actions involving contributions to or transfers from advisory accounts, for example, digital advisers can provide personalized recommendations and reminders that promote positive financial behaviors. These communications may take the form of reinforcement of savings and guidance around transfers that may have undesirable tax consequences.[74]

CONCLUSION

Under established principles of fiduciary law, digital advisers are capable of fulfilling fiduciary standards that are consistent with the scope and nature of the advisory services they provide to clients. Rather than a radical departure, digital advice reflects the technological evolution of traditional advisory services and thus fits entirely within the existing regulatory framework governing investment advisers.

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[73] Brad M. Barber & Terrance Odean, "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors," *The Journal of Finance*, Vol. LV, No. 2 (Apr. 2000), *available at* https://faculty.haas.berkeley.edu/odean/Papers%20current%20versions/Individual_Investor_Performance_Final.pdf.

[74] *See* Brad M. Barber & Terrance Odean, "The Behavior of Individual Investors" (Sept. 2011), *available at* http://www.umass.edu/preferen/You%20Must%20Read%20This/Barber-Odean%202011.pdf.

Moreover, any meaningful discussion of digital advice should acknowledge that it offers the investing public a high-quality, transparent advisory product that entails a different blend of services, at a lower cost, than traditional advisers. Digital advice can help achieve the important policy objective of addressing the retirement crisis by providing advice that is accessible to individual investors – both financially and technologically. That includes investors who do not qualify for, or may not be able to afford, traditional advice. For such investors, the choice is not between traditional advice and digital advice. The choice is between digital advice and no advice. Digital advice that is offered in a responsible manner, consistent with applicable fiduciary standards and the existing regulatory requirements imposed by the Advisers Act, is the far better option.

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