ROBO-ADVISERS AND THE SUITABILITY REQUIREMENT: HOW THEY FIT IN THE REGULATORY FRAMEWORK

Caelainn Carney*

Robo-advisers, which provide algorithmic investment advice, are becoming increasingly prevalent players in the financial services industry. As their prominence grows, regulators are working to determine where they fit in the current framework. Specifically, the Securities and Exchange Commission has been working toward setting standards for robo-advisers as they seek to provide suitable advice to investors. In November 2016, the Securities and Exchange Commission held its Fintech Forum, where regulators and industry leaders commented on the suitability requirement and how robo-advisers can meet it. This Note analyzes the current regulatory framework for robo-advisers and proposes ways that regulators can tailor the suitability requirement to digital investment advice.

* J.D. Candidate 2019, Columbia Law School; B.A. 2016, University of Virginia. Many thanks to Professor Kathryn Judge for her invaluable guidance and feedback on this Note. Additional thanks to Elizabeth Brandt, Norian Watson, and the staff of the *Columbia Business Law Review* for their outstanding editing and assistance in preparing this Note for publication. Lastly, special thanks to my family and friends for their love and support.

I. INTRODUCTION

Financial investing has existed for years, with merchant banks financing foreign trade and overseas investments in the 1600s, the New York Stock Exchange opening in 1792, and the rise of major investment banks in the 1800s.[1] Those who provide such services, investment advisers, are governed by the Investment Advisers Act of 1940 and are subject to regulation by the Securities and Exchange Commission ("SEC").[2] Providing wealth management services to clients has been a widespread practice for decades, but in recent years automated advisers powered by algorithms have provided these services.[3] These "robo-advisers," as the media have called them, are popular across segments of the population, from millennials to retirees. Robo-advisers give cheaper advice than human advisors.[4] As of mid-2017, robo-advisers collectively managed approximately $200 billion, but experts expect that figure to

---

1 *The History of Investing*, ACCUPLAN BENEFITS SERVICES, https://www.accuplan.net/investment-history.htm [https://perma.cc/D5NY-U533]; *see also* J. Woodrow Thomas, *The Investment Company Act of 1940*, 9 GEO. WASH. L. REV. 918, 919 (1941).

2 *See* Investment Advisers Act of 1940, 15 U.S.C. § 80b-3 (2012).

3 *See infra* Section I.D.

4 Andrew Meola, *Is Robo Investing Right for You? Here Are the 5 People Who Are Likely to Use Them*, BUSINESS INSIDER, (Jan. 13, 2017, 1:11 PM), http://www.businessinsider.com/5-types-of-people-who-use-robo-advisors-2017-1 [https://perma.cc/GM2N-3DZV].

balloon to $2.2 trillion by 2020.[5] While robo-advisers have grown rapidly in recent years, their business model poses challenges for regulators in terms of ensuring that robo-advisers adequately get to know their clients' needs.[6] This Note will argue that the SEC should leverage the infrastructure of its National Exam Program to create a collaborative, experimental space where SEC staff can work with robo-advisers to see how industry practices fit into the regulatory framework. Part I will lay out the landscape of investment advisory services and their history. Part II will explain the current regulations governing robo-advisers and where robo-advisers face confusion. Finally, Part III will argue that the SEC should follow the lead of other countries in engaging with robo-advisers one-on-one to determine how their client data collection practices fit into the regulatory framework and where the regulatory framework might merit change.

A. The History Behind the Investment Advisers Act of 1940

Following the stock market crash of 1929, Congress sought to eradicate abuses in the securities industry.[7] After the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, there remained no infrastructure for regulating advice on securities.[8] With that goal in mind, Congress tasked the SEC with researching the investment advisory industry

[5] *Bank Customers Overwhelmingly Reject Robo-Advisers: Survey*, REUTERS (May 30, 2017, 8:06 PM), https://www.reuters.com/article/us-robo-adviser-survey/bank-customers-overwhelmingly-reject-robo-advisers-survey-idUSKBN18R008?il=0 [https://perma.cc/4T8P-X693].

[6] *See generally* U.S. SEC. & EXCH. COMM'N, FINTECH FORUM (Nov. 14, 2016), https://www.sec.gov/spotlight/fintech/transcript-111416.pdf [https://perma.cc/WTU2-KW8Z].

[7] U.S. SEC. & EXCH. COMM'N, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION 1 (2013) [hereinafter REGULATION OF INVESTMENT ADVISERS], https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf [https://perma.cc/NEJ4-2KSM].

[8] *See* W.T. Jr. Mallison, *The Investment Advisers Act of 1940*, 1 VAND. L. REV. 68, 69–70 (1947).

in order to determine how it operated.[9] The project culminated in a 1939 report by the SEC, detailing the growing business of providing investment advice.[10] The report centrally focused on individuals and firms whose primary business was providing investment advice, rather than those who gave investment advice only incidentally, such as accountants and lawyers.[11]

Investment advisers rose to professional prominence after World War I.[12] The SEC report notes that "[o]f the 394 firms covered in the study, only 10 firms were organized prior to 1919."[13] In fact, World War I itself contributed to the rise of investment advisers.[14] The boom in stocks following World War I also spurred private individuals to invest in the market, while they had previously only deposited their money with a local bank or invested it in local projects.[15]

Later, the Great Depression changed people's mindsets about how to manage their money in the capital markets.[16] "Those people . . . found out through the depression that [investing] is not a question of buying one security and keeping it but that it is constant supervision of the securities that they own."[17] Essentially, the rise to prominence of investment advisers happened quickly after World War I and represented a new model of investing.[18]

---

9 *See generally* U.S. SEC. & EXCH. COMM'N, INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1939) [hereinafter INVESTMENT TRUSTS].

10 *Id.*

11 *Id.* at 1 n.1.

12 *Id.* at 3. For a discussion of World War I's effect on the New York Stock Exchange, see Bryan Taylor, *Desperate Traders Managed to Keep Trading During the World War I Stock Market Shutdown*, BUSINESS INSIDER (Aug. 1, 2014, 11:15 AM), http://www.businessinsider.com/world-war-i-impact-on-markets-2014-8 [https://perma.cc/P4XF-CKYB].

13 INVESTMENT TRUSTS, *supra* note 9, at 3.

14 *Id.* at 4. For a discussion of the rise of Liberty Bonds during WWI, see Richard Sutch, *Liberty Bonds*, FED. RESERVE (Dec. 4, 2015), https://www.federalreservehistory.org/essays/liberty_bonds [https://perma.cc/H2U3-DWDE].

15 INVESTMENT TRUSTS, *supra* note 9, at 4.

16 *Id.* at 5.

17 *Id.*

18 *Id.* at 4.

The largest concern for the SEC did not necessarily come from the different sizes and organizational structures of investment advisers, but rather from the complete absence of industry standards for how such businesses should be run.[19] As the SEC noted in the report, "[a]pparently no uniformity of standards prevails in the selection of the personnel of investment counsel organizations."[20] For instance, the SEC worried about how investment advisers would deal with the potential for a conflict of interest when prioritizing order execution client transactions.[21] The SEC report noted, "[in] those cases where investment counsel firms had more than one client, a possible conflict of interest exists with respect to the priority of security transactions for these clients."[22] Additionally, there were ambiguities regarding who qualiied as affiliates of investment advisers and how they were paid.[23] While many of the investment advisory experts quoted in the SEC's report lauded such services as a boon to the capital markets, one expert admitted that "many investment counsel have 'strayed a great distance from that professed function' of furnishing disinterested, personalized, continuous supervision of investments."[24] Recognizing that no federal laws imposed capital requirements or required periodic audits of the advisers' books, the SEC's report highlighted the problematic, unfettered growth of investment advisory services.[25] Concerns such as this were likely a driving force behind the enactment of the Investment Advisers Act of 1940.[26] This set the stage for Congress' next major enactment in the securities law field, the Investment Advisers Act of 1940.

19 *See id.* at 16.
20 *Id.*
21 *Id.* at 17.
22 *Id.*
23 *Id.* at 19–20.
24 *Id.* at 25.
25 *Id.* at 30.
26 *See* Mallison, *supra* note 8, at 69–70.

B. Regulation Under the Investment Advisers Act of 1940

The Investment Advisers Act of 1940 regulates both human and algorithmic investment advisers.[27] Section 202(a)(11) defines an investment adviser as any person or firm that is engaged in the business of providing advice or issuing reports on securities for compensation.[28] The SEC has issued guidance on the various components of the statute and has suggested that the elements are meant to be given broad scope.[29] The SEC has stated that any kind of "economic benefit" meets the compensation component of section 202(a)(11) and that providing advice to investors "does not have to be the sole or even primary activity of the person."[30] In determining whether the advice offered is about securities, the SEC has said that even "advice about market trends is advice about securities."[31] In addition, when the SEC staff determines whether an investment adviser is advising third parties, it looks to the realities of the relationship rather than focusing on formalities.[32] For example, the SEC has said "[a] general partner of a limited partnership that provides advice with respect to the investments of partnership assets is advising others (the limited partners) even where the general partner may have legal title to these assets."[33] Essentially, the SEC has

---

27 *See generally*, U.S. SEC. & EXCH. COMM'N, NO. 2017-02, IM GUIDANCE UPDATE (2017), https://www.sec.gov/investment/im-guidance-2017-02.pdf [https://perma.cc/JX2Q-4W4Q] [hereinafter IM GUIDANCE].

28 Investment Advisers Act of 1940, Pub. L. No. 86-80 § 202, 54 Stat. 847 (1940) (codified as amended at 15 U.S.C. § 80b-2(11) (2017)) ("'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . .").

29 REGULATION OF INVESTMENT ADVISERS, *supra* note 7, at 2–3.

30 *Id.* at 2.

31 *Id.* at 3.

32 *Id.*

33 *Id.*

interpreted the Investment Advisers Act of 1940 as a broad measure to regulate the dispensation of advice about securities.[34]

Those who meet the definition set forth in section 202(a)(11) must register with the SEC unless they meet one of the exemptions or the Advisers Act bars them from such registration.[35] Section 203A of the Advisers Act bars registration with the SEC for "small advisers"—those who have less than $25 million of assets under management and are regulated by at least one state.[36] "Mid-sized advisers"—those that have between $25 million to $100 million of assets under management are often regulated by one or more states, and are subject to regular examinations by state agencies.[37] Investment advisers managing over $100 million must register with the SEC.[38] All foreign investment advisers, regardless of the value of total assets they manage, must register with the SEC unless they meet an exemption.[39] When registration is required for an investment adviser, generally only the firm must register and its employees fall under the firm's registration.[40]

Notably, the SEC does not impose any substantive prerequisites on applicants seeking to become registered investment advisers.[41] The SEC merely requires robust disclosure of the adviser's background to clients.[42] Once an adviser has registered with the SEC, it must meet "(i) fiduciary duties to clients; (ii) substantive prohibitions and requirements; (iii) contractual requirements; (iv) recordkeeping requirements; and

[34] *See generally id.*

[35] Brian Carroll, *Observations on Judicial Approaches to Discerning Investment Adviser Status Under the Investment Advisers Act of 1940*, 1/2015 AUSTRIAN L.J. 100, 101–04 (2015).

[36] REGULATION OF INVESTMENT ADVISERS, *supra* note 7, at 9.

[37] *Id.*

[38] *Id.* at 9 n.45.

[39] *Id.* at 9–10.

[40] *Id.* at 17.

[41] *Id.* at 22 (quoting Amendments to Form ADV, Investment Advisers Act Release No. 2711 (Mar. 3, 2008)).

[42] *Id.* at 20.

(v) administrative oversight by the SEC, primarily by inspection."[43] Of particular importance for this Note are the fiduciary requirements imposed upon investment advisers, among which is the duty to provide suitable advice.

C. Suitability as a Fiduciary Duty

The SEC has stated that the general notion of an investment adviser as a fiduciary requires advisers to "avoid conflicts of interest with clients and [prohibits them] from overreaching or taking unfair advantage of a client's trust."[44] The SEC stresses that this is a high professional standard: "A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss."[45] Though the fiduciary duties arise from the nature of the relationship between the adviser and its client and do not explicitly appear in the Investment Advisers Act of 1940, section 206 of the Act serves as the basis of the SEC's regulatory power when it comes to ensuring that advisers provide personalized advice to their clients, namely, suitable advice.[46]

To fulfill their fiduciary duty to provide suitable advice, advisers must "make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and . . . make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives."[47] In 1994, the SEC proposed a new rule that

[43] *Id.* at 22; *see also* Daniel K. Liffmann, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, 38 LOY. L.A. L. REV. 2147, 2156–57 (2005).

[44] *Id.* at 22.

[45] *Id.*

[46] *See* Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 RUTGERS L.J. 627, 629–31 (2008).

[47] REGULATION OF INVESTMENT ADVISERS, *supra* note 7, at 24; *see also* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1557–58 (1999).

would have clarified the suitability requirement.[48] Though it never formally adopted the rule, the release detailing the proposal offers insight into the suitability requirement.[49] The proposed rule explained that satisfying the "duty to inquire," which requires the investment adviser to make reasonable inquiry into the client's background, depends on the "circumstances" and might involve learning both personal and financial information about the client.[50] Such information might include a client's "current income, investments, assets and debts, marital status, insurance policies, and financial goals."[51] The release also explained that for the advice to be suitable, it must consider the risk profile of the client.[52] The release states that "[a] reasonable determination of an investment's suitability for a client would require, for example, that certain kinds of particularly risky investment products be recommended only to those clients who can and are willing to tolerate the risks and for whom the potential benefits justify the risks."[53] However, the presence of risky investment products in a risk-averse client's portfolio would not automatically classify the adviser's advice as unsuitable.[54] For instance, if the adviser incorporated risky products into such client's portfolio

48 *See* Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, 59 Fed. Reg. 13464 (proposed Mar. 22, 1994).

49 *Id.*; REGULATION OF INVESTMENT ADVISERS, *supra* note 7 at 24 n.134. Most lawyers rely on these proposed rules as primary authority on the Investment Advisers Act of 1940, because the proposed rules only clarified the meaning of the existing requirement and did not change any substantive rules. *See* Megan Ji, Note, *Are Robots Good Fiduciaries? Regulating Robo-Advisors Under the Investment Advisers Act of 1940*, 117 COLUM. L. REV. 1543, 1552 (2017).

50 Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, 59 Fed. Reg. at 13465–13467.

51 *Id.*

52 *Id.* For more on suitability, see also Gary Douglas Rubin, *Advisers and the Fiduciary Duty Debate*, 120 BUS. & SOC'Y REV. 519, 520–21 (2015).

53 Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, 59 Fed. Reg. at 13465–13467.

54 *Id.*

for a hedging function, the SEC would analyze suitability in light of that function.[55]

Though the SEC never adopted the 1994 proposed rules on suitability, the Commission still believes that the text of the Act itself gives rise to the requirement.[56] In fact, the SEC initiated two notable enforcement actions against investment advisers for violating the suitability requirement.[57] In the enforcement action *In the Matter of George E. Brooks and Associates*, an SEC administrative law judge found an investment adviser liable for keeping risky investments in an elderly client's portfolio.[58] The client had repeatedly asked the adviser to sell the risky investments and the adviser repeatedly ignored the instructions.[59] The adviser also generally "effected unsuitable trades for his clients with conservative investment objectives without informing them of the risks involved in the transactions."[60] In another enforcement action, *In the Matter of Philip A. Lehman*, the SEC brought an action against an adviser for recommending an investment opportunity as "a suitable investment for his individual retirement account (IRA) when, in fact, it was not suitable in light of the conservative nature of the investor's IRA account[.]"[61] Though not explicit in the Investment Advisers Act of 1940, the SEC's releases and guidance on suitability make clear that the requirement is central to the relationship between an investment adviser and its client.[62]

---

[55] *Id.*

[56] *See supra* notes 50–55.50

[57] George E. Brooks & Assocs., Inc., 67 S.E.C. Docket 50, (1998) [hereinafter Brooks]; Philip A. Lehman, 70 S.E.C. Docket 1342 (1999) [hereinafter Lehman].

[58] Brooks, *supra* note 57, at 4–5.

[59] *Id.* at 5.

[60] *Id.* at 4.

[61] Lehman, *supra* note 57, at 3.

[62] *See generally* REGULATION OF INVESTMENT ADVISERS, *supra* note 7; Brooks, *supra* note 57; Lehman, *supra* note 57.

D. The Rise of Robo Advisers

The first major robo-advisers first made their grand entrance to the market in 2010.[63] Robo-advisers often differ in the specific kinds of services they provide and whether they have supplemental human advisers available to their clients to answer questions or personally monitor their portfolios.[64] For instance, the largest robo-adviser currently in the market, Betterment, has ten billion dollars under management.[65] While Betterment does not have a minimum investment requirement for clients to sign up for its services, it only gives clients access to human advisers if they have accounts containing more than $500,000.[66] Vanguard (VPAS), on the other hand, has a minimum investment requirement of $50,000, but gives its clients access to a human adviser via email, phone, or video chat.[67] Vanguard also has a human adviser periodically review client portfolios.[68] Other popular robo-advisers

---

63 *See* Ji, *supra* note 49, at 1544.

64 Andrew Meola, *Here Are the Top 15 Robo Advisors Making Stock Portfolio Management Easy in 2017*, BUSINESS INSIDER (Jan. 3, 2017, 1:49 PM), http://www.businessinsider.com/best-robo-advisors-2017-1 [https://perma.cc/4FD6-7PLM].

65 *Betterment Becomes the First Independent Online Financial Advisor to Exceed $10B in Assets Under Management*, BETTERMENT (Jul. 31, 2017), https://www.betterment.com/press/newsroom/betterment-becomes-first-independent-online-financial-advisor-exceed-10b-assets-management/ [https://perma.cc/P4Z5-EMWM].

66 Andrew Meola, *Betterment Review 2017: Fees, Returns, Investing Services, & Competitors*, BUSINESS INSIDER (Jan. 25, 2017, 12:44 PM), http://www.businessinsider.com/betterment-review [https://perma.cc/5TBC-RE93] [hereinafter *Betterment Review*].

67 *Partner with a Vanguard Adviser*, VANGUARD, https://investor.vanguard.com/financial-advisor/financial-planner [https://perma.cc/SG7B-QAVW].

68 Andrew Meola, *Vanguard Personal Adviser Services Review 2017: Fees, Returns, Investing Services, & Competitors*, BUSINESS INSIDER (Feb. 22, 2017, 4:31 PM), http://www.businessinsider.com/vanguard-personal-advisor-services-review [https://perma.cc/LE5W-X68X] [hereinafter Vanguard Review].

such as Hedgeable and Wealthfront do not have human advisers review client portfolios and instead solely rely on their algorithms.[69]

Despite these different business models, all of the above robo-advisers have over $25 million in assets under management (AUM) and therefore have registered as investment advisers with the SEC and are subject to the Investment Advisers Act of 1940.[70] In addition to meeting disclosure and custody requirements, the advisers must make sure that the advice they provide is suitable for their clients.[71] This means that the adviser must know enough about each of its clients in order to provide personalized investment advice that is in the best interest of that individual client.[72] There are a multitude of factors that investment advisers should consider as they try to provide suitable investment advice. As explained above, they must take into consideration "the client's financial situation and investment objectives."[73] As fiduciaries, investment advisers must affirmatively make a reasonable inquiry into a client's financial situation.[74] This inquiry is critical in light of investment advisers' duty to provide advice in their clients'

---

69 Andrew Meola, *Wealthfront Review 2017: Fees, Returns, Investing Services & Competitors*, BUSINESS INSIDER, (Feb. 9, 2017, 1:23 PM), http://www.businessinsider.com/wealthfront-review [https://perma.cc/UWS6-KZX9] [hereinafter *Wealthfront Review*]; Andrew Meola, *Hedgeable Review 2017: Fees, Returns, Investing Services & Competitors*, BUSINESS INSIDER, (Jan. 30, 2017, 3:13 PM), http://www.businessinsider.com/hedgeable-review [https://perma.cc/9L3Y-VVEY] [hereinafter *Hedgeable Review*].

70 U.S. SEC. & EXCH. COMM'N, GENERAL INFORMATION ON THE REGULATION OF INVESTMENT ADVISERS (2011), https://www.sec.gov/divisions/investment/iaregulation/memoia.htm [https://perma.cc/P595-5QYB] [hereinafter GENERAL INFORMATION]; *see also Vanguard Review*, *supra* note 68; *Betterment Review*, *supra* note 66; *Wealthfront Review*, *supra* note 69; *Hedgeable Review*, *supra* note 69.

71 REGULATION OF INVESTMENT ADVISORS, *supra* note 7, at 24.

72 IM GUIDANCE, *supra* note 27, at 6.

73 *Id.*; *see generally* REGULATION OF INVESTMENT ADVISERS, *supra* note 7.

74 *See* Melanie L. Fein., How Are Robo-Advisers Regulated? 8–9 (Sept. 12, 2017) (unpublished manuscript), https://ssrn.com/abstract=3028232 [https://perma.cc/328G-E8R8].

"best interest."[75] Fein notes that while the "best interest" duty, a corollary of suitability, is not well defined, it encompasses a duty of loyalty and a duty of care.[76] For traditional investment advisers who have face time with their clients, it may not be difficult to gather the information necessary to meet the suitability and the best interest requirements. However, things become more complicated in the case of robo-advisers. Fein notes that "the standard can be read to require a [robo-adviser] to provide personalized advice in the best interest of each customer individually rather than its customers collectively . . . it is not clear that the typical [robo-adviser] business model could meet this standard."[77]

II. THE CURRENT REGULATORY FRAMEWORK AND WHERE INDUSTRY MEMBERS WANT IMPROVEMENT

"As is obvious to any market participant or observer, our financial regulatory structure is a fragmented, sometimes contradictory, alphabet soup."[78] SEC senior adviser, Ryan Van Grack, uttered these words at the Commission's Fintech Forum in November 2016. The entire event, where leaders and regulators in the fintech field came together to discuss business and regulatory concerns, sought to address the sentiment reflected in the above remark.[79] Indeed, in the face of financial innovation, regulators need to continually evaluate their policies to ensure they are still best serving investor interests.[80] In this section, this Note explores the current state of regulation around robo-advisers and areas where confusion still exists.

---

75 *Id.* at 12.

76 *Id.* at 12–13.

77 *Id.* at 14.

78 Ryan Van Grack, Senior Adviser, U.S. Sec. & Exch. Comm'n, Opening Comments at the FinTech Forum: The Evolving Financial Marketplace, at 15 (Nov. 14, 2016), https://www.sec.gov/spotlight/fintech/transcript-111416.pdf [https://perma.cc/6Y32-8S45].

79 *See generally id.*

80 *See generally id.*

A. The Traditional Investment Adviser and Its Business

Investment advisory services provided by humans rather than algorithms represent the traditional form of investment advising. Generally speaking, "an investment adviser is an individual or a firm that is in the business of giving advice about securities to clients."[81] They receive compensation for their advice and some even manage portfolios of securities.[82] Firms and individuals who call themselves financial planners are usually investment advisers. Some financial planners take a holistic view of a client's financial life in order to "develop a detailed strategy or financial plan for meeting all [of the client's] financial goals."[83] Other financial planners may only be able to recommend a narrow range of products to clients.[84] According to the U.S. Bureau of Labor Statistics' Occupational Outlook Handbook, personal financial advisers often meet with clients in person to discuss their financial goals, explain their services to clients, and educate clients about investment options and risk.[85] They also monitor clients' accounts and make changes to the investment strategy as needed to improve performance.[86] All investment advisers need to gather personal and financial data about clients, including their risk tolerance.[87]

It is key for investment advisers looking into a client's risk tolerance to consider both a client's ability and willingness to

81 *Investment Advisers: What You Need to Know Before Choosing One*, SEC: INVESTOR PUB'NS, (Aug. 7, 2012), https://www.sec.gov/reportspubs/investor-publications/investorpubsinvadvisershtm.html [https://perma.cc/7ZKB-ASBS].

82 *Id.*

83 *Id.*

84 *Id.*

85 *Personal Financial Advisors*, BLS: OCCUPATIONAL OUTLOOK HANDBOOK (Apr. 13, 2018), https://www.bls.gov/ooh/business-and-financial/personal-financial-advisors.htm [https://perma.cc/G47R-Z9Y9].

86 *Id.*

87 Dana Anspach, *What Will a GoodInvestment Adviser Do for Me?*, THE BALANCE (Apr. 3, 2018), https://www.thebalance.com/what-will-a-good-investment-adviser-do-for-me-2388443 [https://perma.cc/BLM4-S9QE].

take on risk. An investment adviser can measure ability "primarily through [the client's] net worth or [the client's] wealth relative to [the client's] debt. Other factors that are considered in determining [the client's] ability to take on risks are [the client's] time horizon, human capital, and expected income from investing."[88] On the other hand, "willingness refers to the degree of investment risk one is comfortable taking."[89] It essentially refers to one's ability to "sleep soundly" at night after making an investment decision.[90] Both components of how a client can manage risk are key for an investment adviser to know as they put together a plan.

B. How Robo-Advisers Collect Information

Robo-advisers generally learn about their clients through an online questionnaire.[91] In its guidance update, the SEC stated that the questionnaires often only offer a limited interaction.[92] Indeed, Wealthfront's risk assessment questionnaire only contains a mix of approximately ten multiple choice, fill-in-the-blank, and check the box questions before it delivers a risk assessment analysis and invites the user to sign up as a client.[93] Betterment asks even fewer questions, all multiple choice, before inviting the user to sign up online with his or her Social Security number and other information.[94]

Even between these two automated investment advice giants, the actual questions they ask are quite different. In addition to having a longer pre-sign-up questionnaire than Betterment, Wealthfront tries to gauge how much money a potential client can invest by asking about his or her income

88 Kirl Nikolaev, *Ability Vs. Willingness to Take Risks in Investing*, INVESTOR ACADEMY (Apr. 7, 2016), http://investoracademy.org/ability-vs-willingness-to-take-risks-investing/ [https://perma.cc/3HUT-SXMT].

89 *Id.*

90 *Id.*

91 IM GUIDANCE, *supra* note 27, at 6.

92 *Id.*

93 *Assess Your Risk Tolerance*, WEALTHFRONT, www.wealthfront.com/questions [https://perma.cc/295N-6RMV].

94 *Guide to Betterment*, BETTERMENT, https://wwws.betterment.com/app/guidance/investable_assets/new (last visited Feb. 19, 2018).

and the kind of household in which he or she lives.[95] Betterment, on the other hand, asks what the potential client's investable assets are.[96] Wealthfront also tries to garner a sense of the user's risk tolerance by presenting a market downturn scenario and asking how the user would respond in terms of keeping or selling stock. The user, though, can only respond by saying he would buy more, keep them all, sell some, or sell them all; there is no intermediate option such as sell less than a third or more than seventy-percent.[97] These questions, while quick to answer, do not leave much room for the investor to flesh out the nuances of his or her risk tolerance, which gives some credence to the SEC's concerns.[98]

In its March 2016 Report on Digital Investment Advice, the Financial Industry Regulatory Authority ("FINRA") sought to take a broader look at how robo-advisers in general try to collect client risk tolerance information. The robo-advisers that FINRA reviewed used four to twelve questions in categories like personal information and investment objective to learn about potential clients.[99] A main disparity that FINRA found among the robo-advisers it reviewed was whether they framed their questionnaires around a potential client's risk willingness or risk tolerance, two potentially very different indicators.[100] FINRA noted that when clients provided contradictory answers, some firms averaged their responses or made recommendations based on the more conservative response.[101] While averaging could put a client in a portfolio that exceeds his or her risk tolerance, choosing the more conservative response could leave the customer "with a portfolio that does not

95 WEALTHFRONT, *supra* note 93.

96 BETTERMENT, *supra* note 94.

97 WEALTHFRONT, *supra* note 93.

98 FIN. INDUS. REGULATORY AUTH., REPORT ON DIGITAL INVESTMENT ADVICE 14–16 (2016), https://www.finra.org/sites/default/files/digital-investment-advice-report.pdf [https://perma.cc/P46K-MWNQ].

99 *Id.* at 9, 14–16.

100 *Id.* at 4, 9.

101 *Id.* at 10.

reflect [his or her] desired risk."[102] In a side-by-side comparison of the questionnaires of three robo-advisers, one did not ask the user's risk preferences and two did not ask about household composition.[103] While the robo-advisers may be choosing relevant questions given the assumptions made by their algorithms, they likely do not take into consideration the intricate needs of potential clients.[104] A twenty-five year old who is investing to save for retirement would have very different needs than a twenty-five year old investing to finance graduate school.[105] Perhaps even more foundational, these questionnaires have no way of taking into account a client's hesitation or confidence in asserting certain risk preferences: with mostly multiple choice questions, the adviser cannot see whether the client really vacillated between two options before selecting one or the other.[106] A human adviser collecting this information from a potential client in person might more readily be able to read hesitation on the potential client's face and come to a more holistic risk assessment.[107] The new challenge for robo-advisers attempting to meet their suitability requirement lies in finding a way to obtain more expansive client information to satisfy regulators without destroying the cost minimizing benefits of an online platform.

C. The SEC's New Guidelines

In an effort to help providers of automated investment advice meet this standard, the SEC's Division of Investment Management released new non-binding guidance for robo-advisers following its Fintech Forum on November 14, 2016 and

[102] *Id.*

[103] *Id.* at 14–16.

[104] *See id.* at 14–16.

[105] *Id.* at 9.

[106] *See id.* at 14–16.

[107] *See*, *e.g.*, Susan Krauss Whitbourne, *The Ultimate Guide to Body Language*, PSYCHOLOGY TODAY (June 30, 2012), https://www.psychologytoday.com/us/blog/fulfillment-any-age/201206/the-ultimate-guide-body-language [https://perma.cc/SL8L-JQQP] (discussing body language, which robo-advisers cannot detect, and its importance in human communication).

after gathering input from players in the industry.[108] The SEC focused on three areas in the guidance update:

> 1. [The] substance and presentation of disclosures to clients about the [robo-adviser] and the investment advisory services it offers;
> 2. The obligation to obtain information from clients to support the [robo-adviser's] duty to provide suitable advice; and
> 3. The adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated advice.[109]

While the release focused the lion's share of its discussion on the importance of proper disclosures and effective compliance mechanisms,[110] it raised some key concerns about how robo-advisers meet the suitability requirement.[111] Chief among the concerns was how robo-advisers generally collect client information through an online questionnaire.[112] The questionnaires often vary in depth and length.[113] In the guidance, the Com

mission noted that "some of these questionnaires are not designed to provide a client with the opportunity to give additional information or context."[114] Possible solutions proposed in the guidance included adding design features to the questionnaire that alert a client when responses seem internally inconsistent or implementing a system that flags inconsistent information for review or follow-up by the adviser.[115] While these solutions likely would elicit better client information, it

108 *See generally* IM GUIDANCE, *supra* note 27, at 2; Van Grack, *supra* note 78, at 19.

109 IM GUIDANCE, *supra* note 27, at 2.

110 *Id.* at 3–8.

111 *Id.* at 6–7.

112 *Id.* at 6.

113 *Id.*

114 *Id.* at 6–7.

115 *Id.* at 7.

makes sense that requiring follow up by the adviser—potentially a human adviser if the case were complicated enough—would add costs into the robo-adviser business model.[116]

Commentary from panelists at the SEC's Fintech Forum gives insight into the motivation behind the agency's new guidelines. The panel on robo-advisers began by recognizing how important they are to the economy, and how they enable the financial market to reach clients in a different manner than before. Bo Lu, the co-founder and CEO of Future Adviser, the digital advice arm at of BlackRock, framed the panel discussion around robo-advisers' ability to reach lower income individuals. He stated that two major value propositions for clients would be taking the workload off of human advisers so that they can add value elsewhere and generally improving the client experience.[117] Ben Alden, general counsel at Betterment, gave commentary that further explained why robo-advisers may be critical for economic health in general. Alden said that there is a "retirement savings crisis . . . [and] we have a generation of people who won't have access to defined benefits quite the same way that past generations have . . . ."[118] A recent article in Forbes put some numbers behinds Alden's statements:

> There's a national shortfall in retirement savings, estimated at $4.13 trillion for heads-of-households aged 25- to-64, by the Employee Benefit Research Institute, and at $6.8 trillion or more by the National Institute on Retirement Security; 29% of those aged 55-to-64 have no retirement savings and no pension, according to the General Accountability Office; 401(k) participation rates hover around 50% and, even among those

[116] *See, e.g.*, Jim Allen, Head, Capital Markets Policy Group, CFA Inst., Panel I at the FinTech Forum 40 (Nov. 14, 2016), https://www.sec.gov/spotlight/fintech/transcript-111416.pdf [https://perma.cc/Y6PE-YX3Z] (describing ATMs as more cost-effective than bank tellers).

[117] Bo Lu, CEO, Future Adviser, Panel I at the FinTech Forum 24 (Nov. 14, 2016), https://www.sec.gov/spotlight/fintech/transcript-111416.pdf [https://perma.cc/Y6PE-YX3Z].

[118] Ben Alden, General Counsel, Betterment L.L.C., Panel I at the FinTech Forum 25 (Nov. 14, 2016), https://www.sec.gov/spotlight/fintech/transcript-111416.pdf [https://perma.cc/Y6PE-YX3Z].

> using the plans, 39% have account balances of less than $10,000, EBRI says.[119]

In sum, panelists seemed to recognize that automated investment advice could be the way to cure the retirement savings crisis among lower income individuals. The SEC's Division of Investment Management sought to use these concerns as a basis for explaining the regulatory framework as applied to robo-advisers.[120]

Even as enthusiastic as the panelists were about the potential of robo-advisers to revolutionize wealth management, some expressed concern that the current regulatory framework was insufficient to guide robo-advisers as they become increasingly prevalent.[121] Mark Goines, Vice Chairman of Personal Capital, stated that regulators need to consider the differences between human and robo-advisers in putting together an oversight plan.[122] He stated, "the implementation of regulatory oversight needs to be different, there's no question, because they are very different business practices."[123] Jim Allen, a leader at the CFA Institute, noted that one of the biggest concerns among industry leaders was making sure that clients receive personalized advice.[124] He noted that with the "many and varied circumstances of investors . . . they may not receive this sort of appropriate, personalized advice that

---

119 Mary Josephs, *How to Solve America's Retirement Savings Crisis*, FORBES (Feb. 6, 2017, 12:33 PM), https://www.forbes.com/sites/maryjosephs/2017/02/06/how-to-solve-americas-retirement-savings-crisis/#4713ccba15ae [https://perma.cc/6WTR-CF3J].

120 *See* Alden, *supra* note 118, at 72 ("There's a large portion of the country that's not saving for retirement or who are saving, but it's too expensive, and something is going to fill the gap, and our hope is that it's high quality advice services that technology can make scalable and affordable, and so, we really see this to be a one-way thing.").

121 *See, e.g.,* Mark Goines, Vice Chairman, Personal Capital Corp., Panel I at the FinTech Forum 64 (Nov. 14, 2016), https://www.sec.gov/spotlight/fintech/transcript-111416.pdf [https://perma.cc/Y6PE-YX3Z].

122 *Id.*

123 *Id.*

124 Jim Allen, Head, Capital Markets Policy, CFA Inst., Panel I at the FinTech Forum 59 (Nov. 14, 2016), https://www.sec.gov/spotlight/fintech/transcript-111416.pdf [https://perma.cc/Y6PE-YX3Z].

you would hope that they would have."[125] Goines suggested that guidance from regulators may help alleviate this concern and ensure that robo-advisers are in compliance with the Investment Advisers Act of 1940.[126] Essentially, regulators could help robo-advisers determine what personal information their algorithms need in order to provide their clients with suitable advice.[127] Goines said that the appropriate "inputs" for client information are critical for understanding a client and that this is "the area of regulation that has not been fully developed."[128] The goal is to ensure that "the algorithm [is] actually collecting enough data to actually apply its applied rules effectively."[129]

The industry experts did not imply, however, that the current regulatory framework was completely irrelevant to robo-advisers.[130] Goines stated, "we really like the SEC's regulatory models, and . . . we chose to be specifically a registered investment adviser, because we felt that it fit best with the model that we have."[131] He admitted, though, that the SEC's current examination practices did not work well with the robo-adviser business model.[132] He stated that "examination methodologies" need some "modernization" to be "capable of keeping up with what's happening with digital delivery of information."[133] In the SEC's current examination methodology, the Office of Compliance Inspections and Examinations conducts examinations of robo-advisers as they have done with

125 *Id.*

126 *See* Goines, *supra* note 121, at 64. The SEC currently has broad supervisory powers that would allow them to interact directly with registrants. *See* John H. Walsh, *Regulatory Supervision by the Securities and Exchange Commission: Examinations in a Disclosure-Enforcement Agency*, 51 ADMIN. L. REV. 1229, 1231 (1999).

127 Goines, *supra* note 121, at 65.

128 *Id.*

129 *Id.*

130 *Id.* at 69.

131 *Id.* at 68.

132 *Id.* at 69; *see* Alex Padalka, *Robo-Advisers Call for SEC Rule Changes*, FIN. ADVISER IQ (November 16, 2016), https://financialadvisoriq.com/c/1500453/172143 [https://perma.cc/6S9D-QRDY].

133 Goines, *supra* note 121, at 69.

human investment advisers for years through its National Exam Program.[134] The SEC examines about ten percent of investment advisers annually through the program.[135] Usually, an examination begins with SEC examiners asking the investment adviser for a "Core Initial Request for Information."[136] As part of that request, examiners ask for information on the adviser's organizational structure, clients, and compliance programs.[137] In trying to learn about how the robo-adviser advises its clients, the SEC examiners often request information about investment strategy and management discretion for different clients.[138] Though Goines liked the general regulatory structure put in place for investment advisers, he stated that more transparency as to the examination rules would help robo-advisers.[139]

III. A WAY FORWARD: COLLABORATION BETWEEN THE SEC AND THE INDUSTRY

Going forward, the SEC should build on its existing framework for regulating investment advisers under the Advisers Act as it seeks to develop proper standards for regulating robo-advisers. The key, as suggested at the November 2016 Fintech Forum, would be updating examination procedures and making them more transparent for robo-advisers. One potential way to find the right examination criteria and standardize the client data that robo-advisers should collect in order to provide

---

[134] *See About the Office of Compliance Inspections and Examinations*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/ocie/Article/ocie-about.html [https://perma.cc/4B82-44F2] [hereinafter *OCIE*].

[135] Liz Skinner, *What Advisers Can Expect from an SEC Exam*, INVESTMENT NEWS (Mar. 13, 2016, 12:01 AM), http://www.investmentnews.com/article/20160313/FREE/160319981/what-advisers-can-expect-from-an-sec-exam [https://perma.cc/U3XS-R2NQ].

[136] *Office of Compliance Inspections and Examinations, Investment Adviser Examinations: Core Initial Request for Information*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/info/cco/requestlistcore1108.htm [https://perma.cc/S29T-UFFH].

[137] *Id.*

[138] *Id.*

[139] Goines, *supra*, note 121, at 70.

more suitable advice is to create collaborative forums where robo-advisers and regulators work together to test innovative financial products.[140] Another is for the SEC to allow different sources of client data to be aggregated and inform the robo-adviser algorithm about the personal information of a particular client.[141] In this section, the Note draws on the background of Parts I and II and argues that one-on-one collaboration between SEC staff and robo-advisers in a controlled environment would be the best way to determine how robo-advisers can meet the suitability requirement and if new regulations are necessary.

The regulatory practices in the United Kingdom offer a model for a collaborative forum that the SEC may wish to emulate.[142] In the last two years, the United Kingdom's Financial Conduct Authority ("FCA") has made robust use of an experiment it calls the "regulatory sandbox."[143] The experiment allows financial service providers to test new products on consumers in a controlled environment.[144] As part of the experiment, innovators work with regulators to bring new products to market in a way that minimizes risk to consumers.[145] In the United Kingdom, the FCA pairs a participating firm with "a dedicated case officer who supports the design and implementation of the test."[146] The case officer works with the firm

---

140 *See generally* FIN. CONDUCT AUTH., REGULATORY SANDBOX LESSONS LEARNED REPORT 5 (2017), https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf [https://perma.cc/7QSW-4PFB].

141 *See* BLACKROCK, DIGITAL INVESTMENT ADVICE ROBO ADVISORS COME OF AGE 8 (2016), https://www.blackrock.com/corporate/en-at/literature/whitepaper/viewpoint-digital-investment-advice-september-2016.pdf [https://perma.cc/6DLP-RLKC].

142 *See generally* FIN. CONDUCT AUTH., *supra* note 140.

143 *Id.* at 3.

144 *Id.* at 3–4; *see* Fraser Tennant, *Innovation Via the Regulatory Sandbox*, FINANCIER WORLDWIDE (Feb. 2017), https://www.financierworldwide.com/innovation-via-the-regulatory-sandbox/#.WnYco1Q-cWo [https://perma.cc/32VG-4DG6].

145 *See* FIN. CONDUCT. AUTH., *supra* note 140 at 6.

146 *Id.* at 4.

to design safeguards that are specific for that firm's experiment.[147] Key to the program is the "direct feedback" given by case officers during and after the experiment so that the firms know "how the regulatory framework applies to them."[148] Some safeguards implemented in the FCA's regulatory sandbox "include extra capital requirements, systems penetration testing and secondary review of robo-advice by a qualified financial adviser . . . ."[149] Robo-advisers participating in the experiment received extra safeguards, including the requirement that a qualified financial adviser check the robo-advisers' suggestions before making any changes to client accounts.[150]

One possible take on the regulatory sandbox would allow robo-advisers to determine how their current innovative practices fit within the regulatory framework and also allow them to test new products for regulatory compliance.[151] While the U.K. has designed its regulatory sandbox to help new firms or firms with new products, the regulatory sandbox could be adapted to study robo-advisers' current methods of client information collection. While the SEC's Guidance Update put forth ideas for meeting the suitability requirement, the suggestions were lacking given the size and importance of this new technology in the financial advisory industry. A more collaborative approach is warranted.[152] A regulatory sandbox would provide one-on-one advice. With this, robo-advisers would have less interpretation to do on their own. This, in turn, would minimize suitability issues *ex post* that otherwise would have called for corrective action.

Notably, the U.K.'s FCA is not the only financial regulatory agency that is taking a controlled, experimental approach to

147 *Id.*

148 *Id.* at 5.

149 *Id.* at 4.

150 *Id.*

151 *See id.* at 3–4.

152 *See* Mark Fenwick, et al., *Regulation Tomorrow: What Happens when Technology is Faster than the Law?* 2 (TILEC Discussion Paper No. 2016-024), http://ssrn.com/abstract=2834531 [https://perma.cc/2L8P-NZ2D].

determining where new technology fits with securities laws. Canada's Ontario Service Commission ("OSC") runs a program called "OSC Launchpad." The program is designed not only to help firms develop innovative projects, but also to "learn from them."[153] One of OSC's missions is to help online advisers determine what information they need to collect from their clients in order to form an accurate picture of them.[154] The OSC recognizes that traditional advisers previously accomplished this through "face-to-face conversations," but that online advisers often use different methods "to achieve the same results."[155] The OSC Launchpad allows firms to submit formal "request[s] for support," in order to receive personal guidance from the OSC staff.[156] While the program provides the most support for new businesses that have not launched

---

153 Dirk Zetzsche, et al., *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation* 8 (Univ. of Lux. L. Working Paper Series, No. 006/2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3018534 [https://perma.cc/AV8G-J774]; *see also* Ana Badour & Genevieve Pinto, *Canada's First Regulatory Sandbox for Fintech? OSC Announces Plans for "OSC LaunchPad" Innovation Hub*, MCCARTHY TETRAULT (Sep. 28, 2016), https://www.securitiesregulationcanada.com/2016/09/canadas-first-regulatory-sandbox-for-fintech-osc-announces-plans-for-osc-launchpad-innovation-hub/ [https://perma.cc/A7KB-8LAZ].

154 ONT. SEC. COMM., *Our Approach*, OCS LAUNCHPAD, https://www.osc.gov.on.ca/en/our-approach.htm [https://perma.cc/HEG7-Y3AP].

155 *Id.*

156 *Id.* For more examples of countries that have adopted a regulatory sandbox approach, see *Innovation Hub,* ASIC, http://asic.gov.au/for-business/your-business/innovation-hub/ [https://perma.cc/8C33-JGR7]; *About the FinTech Office*, AUTORITI MONETARI BRUNEI DARUSSALAM, http://www.ambd.gov.bn/fintech-office [https://perma.cc/VFY4-8MTS]; *FinTech Facilitation Office*, HONG KONG MONETARY AUTHORITY, http://www.hkma.gov.hk/eng/key-functions/international-financial-centre/fintech-facilitation-office-ffo.shtml [https://perma.cc/RUR3-NZC2]; *General Organisation,* COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER, http://www.cssf.lu/en/about-the-cssf/general-organisation/ [https://perma.cc/CA6U-ZQFE]; *Fintechs: Adressatengerechte Kommunikation – Umgang der BaFin mit innovativen Unternehmen,* BUNDESANSTALT FÜR FINANZDIENSTLEISTUNGSAUFSICHT, (Sept. 15, 2016), https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2016/fa_bj_1609_fintechs.html [https://perma.cc/7UHW-3L9B].

yet, the OSC Launchpad also supports existing firms with "a new innovation."[157] Robo-advisers already in the market likely fit into this category. The SEC similarly may wish to give existing robo-advisers similar support as the firms adjust how they collect client information and seek to determine how their methods fit within the regulatory framework. Though changing client questionnaires may not be grand enough to constitute a new innovation, their importance for the business model warrants interactive support from the SEC.

The existing framework for regulating robo advisers, pursuant to the Investment Advisers Act of 1940 may still be useful,[158] so adopting an approach like a regulatory sandbox may be appropriate. This model could help determine what kinds of questionnaires and data collection are sufficient for robo-advisers to know their clients and thus meet the suitability requirement. The SEC does not necessarily have to adopt the regulatory sandbox method wholesale, but may want to adopt features that would lend themselves particularly well to clarifying the kind of client data collection needed to meet the suitability requirement. Though robo-advisers have operated in the open market for some time, creating a limited, experimental space may be fruitful for fine tuning exactly what client information is necessary to provide personalized advice and what methods of data collection are acceptable to the SEC.

For instance, in a recent publication about the state of regulation for robo-advice, BlackRock noted that one way to get a more holistic view of a client's profile would be to aggregate his or her online data.[159] Because young consumers move homes and jobs more frequently than previous generations, they are likely to hold multiple financial accounts.[160] BlackRock noted that the aggregation of this information would likely be productive for providing suitable advice, but

---

[157] ONTARIO SEC. COMM., *Request Support*, OSC LAUNCHPAD , https://www.osc.gov.on.ca/en/request-support.htm [https://perma.cc/4ALT-PVW6].

[158] Goines, *supra* note 121, at 69.

[159] BLACKROCK, *supra* note 141, at 8.

[160] *Id.*

that it is challenging to consistently access all of this data together.[161] One possible solution considered in the European Union, involves creating a "Digital ID" for each consumer that would create "common standards for sharing account information between different financial services providers."[162] "A Digital ID would facilitate the development of digital account aggregation applications, especially if linked to a facility that would automatically update an individual's profile as their circumstances change."[163] Through a regulatory sandbox model, the SEC might be able to create a safe, controlled environment to test a tool like a Digital ID. Firms might be more comfortable implementing such a tool if they can use a collaborative regulatory sandbox with the SEC to determine litigation risks and how expensive compliance might be.

The SEC's National Exam Program currently has the infrastructure to support a regulatory sandbox experiment similar to the one conducted by the FCA in the U.K. and the OSC in Canada.[164] Currently, the "[National Exam Program] staff promote compliance with federal securities laws through exams, outreach, [and] publications[.]"[165] The SEC examiners can be seen as analogous to the "dedicated case officer[s]" from the FCA that work with firms who are testing new programs in the regulatory sandbox. Because SEC examiners already are accustomed to conducting in-depth one-on-one "exams" and "outreach" with individual robo-advisers, it may not be too difficult to have them function as "dedicated case officer[s]" in a regulatory sandbox experiment. Of course, not necessarily being experts in the technological field, examiners may face a steep learning curve in determining whether regulations work to accommodate fintech advancements.[166]

161 *Id.*

162 *Id.*

163 *Id.*

164 *See generally supra* notes 142–157.

165 *OCIE*, *supra* note 134.

166 *See*, *e.g.*, Gillian K. Hadfield, *Legal Barriers to Innovation*, 60 Stan. L. Rev. 1689 (2010) (discussing how the homogeneity in the training background of those in the legal field sometimes impedes their ability to innovate).

Working closely with robo-advisers in an experimental setting, examiners may take a more collaborative, rather than authoritative, approach with registrants, which could help to surmount that curve quickly. By seeing how certain innovative ideas affect consumers in a controlled test environment, SEC examiners may be able to obtain a more organic sense of how a new product fits into the Investment Advisers Act of 1940 regulatory framework. Examinations of robo-advisers, thereafter, may benefit from these types of experiments and obtain the "modernization" that Mark Goines suggested was needed.[167] Learning about these products in a regulatory sandbox may teach the SEC examiners what kinds of questions they need to ask in an examination to determine if a robo-adviser is collecting enough information to provide suitable advice. The regulatory sandbox approach will give the SEC the information it needs to determine how robo-advisers can be compliant with existing regulations and if the SEC needs to promulgate new regulations. Additionally, determining which methods of data collection adequately protect client interests in a controlled environment would give robo-advisers predictability of suitability requirements as they design questionnaires going forward. Once robo-advisers are confident in terms of the inputs needed to meet the suitability requirements, they may be able to divert costs away from extraneous client data collection and toward lowering the costs of their services for retail consumers.[168]

In addition, although much of the examinations are currently accomplished through document requests, sometimes SEC examiners meet with employees of the investment advisory firms, particularly the firm's chief compliance officer.[169] These types of face-to-face meetings may be key to truly understanding how an innovative idea by a robo-adviser fits in the regulatory framework. The fact that the SEC already lists "improv[ing] compliance" and "inform[ing] policy" as goals of

---

167 *See* Goines, *supra* note 121, at 69.

168 Alden, *supra* note 118, at 72.

169 *SEC Surprise Examinations Are Back*, ACA COMPLIANCE GROUP , https://www.acacompliancegroup.com/news/compliance-alert/sec-surprise-examinations-are-back [https://perma.cc/U7K3-Z2S6].

its examinations suggests that the program already has the fundamental goal of industry members and SEC staff learning from one another.[170] A more collaborative regulatory sandbox approach would ideally have more transparency than current examinations and discontinue the practice of not sharing with the entity under examination the reasons the SEC is reviewing it.[171] Instead of notifying robo-advisers of compliance problems through a deficiency letter and then requiring a response indicating "steps [the robo adviser] has taken or will take to address the issues and to prevent their reoccurrence,"[172] SEC staff should continue to meet with robo-advisers as they try to fix potential issues. In this way, the SEC could garner a better sense of *how* robo-advisers could comply with current regulations and whether different standards are necessary. If the SEC were to adopt more of a regulatory sandbox model, it also might be helpful to interview more employees of the robo-advisory firm who are involved in more than just compliance activities. This potentially may give SEC staff a better understanding of how the robo-adviser's technology and business model work—something that is necessary to understand before deciding how robo-advisers may meet the suitability requirement. Specifically, it could allow the SEC to understand what client data a robo-adviser needs to collect through its questionnaire in order to provide suitable advice.

Indeed, with the rise of artificial intelligence and the rise of big data, robo-advisers may want to look to alternate avenues for collecting client information to meet the suitability requirement. Recently, companies who specialize in an area other than finance have tried to leverage the data they collect through their regular business to enter the financial services industry.[173] Chinese company Alibaba, an online commerce

[170] *See* U.S. SEC. & EXCH. COMM'N, *Examination Information for Entities Subject to Examination or Inspection by the Commission* 1 (2014), https://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf [https://perma.cc/Q7NM-ZLMX].

[171] *Id.* at 1.

[172] *Id.* at 4.

[173] Zetzsche et al., *supra* note 153 at 4.

company, seeks to use technology to get into the financial services arena.[174] Companies with household names, like Amazon, Google, and Microsoft, to name a few, offer some form of payment, lending, or financial services.[175] The companies have relationships with customers from non-financial settings that allow them to collect "massive amounts of data from those relationships."[176] They sometimes sell that data to other financial institutions and then transition to providing financial services themselves.[177] It is possible that robo-advisers may someday want to take advantage of this kind of technology and data in order to make their services accessible to people with a lower net worth.[178] Robo-advisers may be less reticent to do so if they have a secure way to test the business model with regulatory oversight. In turn, the SEC may feel more comfortable with the use of technology to collect client data, if it has the chance to review how it works in a controlled environment. If the SEC leverages the infrastructure of its examination program into a collaborative forum where robo-advisers and SEC staff review in-depth how client information is collected, both sides will be able to learn how robo-advisers' technology fits into the current regulatory framework and how robo-advisers can collect necessary information to meet the suitability requirement.

174 Marc Lajoie & Nick Shearman, *Defining Alibaba*, WALL ST. J., http://projects.wsj.com/alibaba/ [https://perma.cc/5K3N-Q3X3]; Zen Soo, *TechFin: Jack Ma Coins Term to Set Alipay's Goal to Give Emerging Markets Access to Capital*, SOUTH CHINA MORNING POST (Dec. 2, 2016, 9:38 PM), http://www.scmp.com/tech/article/2051249/techfin-jack-ma-coins-term-set-alipays-goal-give-emerging-markets-access [https://perma.cc/9A22-2RAG].

175 Zetzsche, *supra* note 153, at 4–7 n.21.

176 *Id*. at 9.

177 *Id*.

178 *See* Alden, supra note 118, at 72; *see also* John Lightbourne, *Algorithms & Fiduciaries: Existing and Proposed Regulatory Approaches to Artificially Intelligent Financial Planners*, 67 DUKE L.J. 651, 652–53 (2017); Iris H-Y Chiu, *Fintech and Disruptive Business Models in Financial Products, Intermediation and Markets– Policy Implications for Financial Regulators*, 21 J. TECH. L. & POL'Y 55, 60 (2016).

IV. CONCLUSION

Over the long run, the adoption of a modified regulatory sandbox model where SEC examiners work closely with robo-advisers in a controlled environment may be the safest road for getting innovative business ideas to market quickly. It may also be the best route for determining if more (or different) regulation is necessary for collection of client data. Suitability and collecting accurate client information will still be of paramount concern as robo-advisers and SEC staff figure out where new business ideas fit into the regulatory framework of the Investment Advisers Act of 1940. A provisional approach to new technology in the regulatory sandbox would allow robo-advisers and the SEC to determine if advisers can leverage technology in order to accurately learn more about clients.

For business practices that already exist in the market, but around which there exists some uncertainty, this experimental approach could teach industry members and regulators how regulations should apply. The question may not be whether an algorithm can obtain client information like a traditional investment adviser, but whether it can obtain the right kind of client information in order to deliver suitable advice. A regulatory sandbox model may allow for an organic discussion between regulators and industry members about where the business models of the traditional investment adviser and the robo-adviser are similar and where they diverge. Regulation around this industry needs to appreciate the valuable service that automated advice provides and frame requirements around responsible data collection and processing. The way for regulators to determine where the value lies in these services and where to draw regulatory lines is to engage with robo-advisers on a granular level. The concerns that led to the adoption of the Investment Advisers Act of 1940 are still relevant today. The task now is to determine how robo-advisers fit into this decades-old regime.