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## Rise of the Machines: The Legal Implications for Investor Protection with the Rise of Robo-Advisors

Bret E. Strzelczyk  
*DePaul University College of Law*

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## Rise of the Machines: The Legal Implications for Investor Protection with the Rise of Robo-Advisors

### Cover Page Footnote

Bret E. Strzelczyk is a Class of 2018 Juris Doctor Candidate at DePaul University College of Law and Executive Editor of the DePaul Business and Commercial Law Journal. Having previously served as Honors Intern with the United States Securities and Exchange Commission, he is fascinated with financial markets and the regulatory environment. He earned a B.A., cum laude, in Political Science with a concentration in Political Economy from Illinois Wesleyan University in 2014. He would like to thank his parents, John and Kim Strzelczyk, for their continued support throughout his academic career.

# **Rise of the Machines: The Legal Implications for Investor Protection with the Rise of Robo-Advisors**

*By: Bret E. Strzelczyk\**

## **ABSTRACT**

This note examines the complex state of financial innovation and preexisting investor protection regimes, mainly the Investment Advisers Act of 1940, which do not properly address the question of whether a robo-advisor platform serving as registered investment advisers satisfies the fiduciary standard elements laid out in the Act. This article examines the current regulation from the Department of Labor, the Financial Industry Regulatory Authority, and the Securities and Exchange Commission and addresses the inadequacies in each regulatory entity's policy prescription. This article contends that robo-advisors can not act as a fiduciary for several reasons – primarily because these platforms do not provide the type of individualized portfolio analysis that traditional fiduciary agents provide.

**I. GLOBAL FINANCIAL MARKETS ARE NOT IMMUNE TO THE DISRUPTIVE FORCES OF TECHNOLOGY AND ROBO-ADVISORS HAVE ENTERED THIS MARKET DISRUPTING THE MARKET SHARE OF INDUSTRY BEHEMOTHS SUCH AS JPMORGAN, CITIBANK, AND OTHERS.**

The business environment in the United States, and across the globe, has faced continued automation in all aspects of industry. Technology has become a disruptive force as seen by companies like Uber who disrupt monopolistic cab services in urban centers, or Airbnb which challenges global hotel chains.<sup>1</sup> While most commentary has been related to the impact of automation on manufacturing, attention is shifting to the financial services industry as robo-advisors steadily begin

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<sup>1</sup> Seth Archer, *EL ERIAN: Airbnb and Uber Used the Same 3 Factors to Disrupt Huge Industries*, BUSINESS INSIDER (June 21, 2016, 9:18 AM), <http://www.businessinsider.com/el-erian-airbnb-uber-used-same-factors-disrupt-huge-industries-2016-6>.

to manage increasing sums of investors' money.<sup>2</sup> In 2010, the robo-advisor platform, Betterment, burst onto the scene offering low cost financial advice without a human element.<sup>3</sup> As of 2017, more than ten other "robotlike" platforms have been opened by the more traditional financial services firms like Charles Schwab, Fidelity Investments, and Bank of America.<sup>4</sup> This technological explosion has coincided with one of the longest "bull markets" in American history.<sup>5</sup> A bull market is a financial market where the prices of securities is expected to rise overall while a bear market is indicative of a downward trend.<sup>6</sup> On March 9<sup>th</sup>, 2017, the market celebrated its eighth birthday with the S&P 500 posting a gain of 249%.<sup>7</sup> The S&P 500 is "an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists."<sup>8</sup> These positive returns have prompted passive investing to grow its market share against more active managers. Passive investing is where managers attempt to match the return and risk of an appropriate benchmark such as the S&P 500 or the FTSE 100. The FTSE is often regarded as an indicator of prosperity among qualifying United Kingdom companies and the global economy in general.<sup>9</sup> Active managers take more "active" steps to outperform a benchmark.<sup>10</sup> Active management incurs more costs which are passed on to the investors through the manager's fee structure. Therefore, retail investors and institutional investors alike have shifted their investments into these low-cost, passive managers as the market has given them no reason to incur the high costs of active managers. A retail investor is an individual investor with usually much lower investable assets that buys and sells securities for a

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<sup>2</sup> *Robo Advisors v. Human Financial Advisors: Why Not Both?*, BUSINESS INSIDER: MYPRIVATEBANKING (Aug. 24, 2016, 6:32 PM), <http://www.businessinsider.com/hybrid-robo-advisors-will-manage-10-of-all-investable-assets-by-2025-2016-8>.

<sup>3</sup> *The History of Betterment: How We Started a Company That Changed an Industry*, BETTERMENT, <https://www.betterment.com/resources/inside-betterment/our-story/the-history-of-betterment/>, (last visited July 27, 2017).

<sup>4</sup> Alex Eule, *Rating the Robo-Advisors*, BARRON'S (July 29, 2017), <http://www.barrons.com/articles/rating-the-robo-advisors-1501303316>.

<sup>5</sup> Jen Wiczner, *Happy Birthday, Bull Market! It May Be Your Last*, FORTUNE, (Mar. 9, 2017), <http://fortune.com/2017/03/09/stock-market-bull-market-longest>.

<sup>6</sup> *Bull market*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/bullmarket.asp> (last visited Sept. 15, 2017).

<sup>7</sup> Wiczner, *supra* note 4

<sup>8</sup> *S&P 500*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/sp500.asp> (last visited Sept. 15, 2017).

<sup>9</sup> *FTSE 100*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/ftse.asp> (last visited Sept. 15, 2017).

<sup>10</sup> *Lessons in Clarity: Active vs. Passive Management*, CFA INSTITUTE, [https://www.cfainstitute.org/programs/investmentfoundations/courseofstudy/Pages/lessons\\_in\\_clarity\\_active\\_vs\\_passive.aspx](https://www.cfainstitute.org/programs/investmentfoundations/courseofstudy/Pages/lessons_in_clarity_active_vs_passive.aspx) (last visited Jan. 15, 2017)

personal account.<sup>11</sup> An institutional investor is an organization that invests its assets under management on behalf of its members.<sup>12</sup> These types of entities include pension funds, commercial banks, mutual funds, and other private funds.<sup>13</sup> Due to this shift to passive management, the robo-advisor has emerged as one of the prominent financial platforms of the 21<sup>st</sup> century and the longest bull market in history. The law surrounding this financial platform has faced an uncertain and often contradictory path.

*A. There Are Several Different Types Of Investment Models That Have Spawned From This Shift To Passive Investing.*

A pure robo-advisor is an entirely online financial product that provides automated, algorithm-based wealth management services without human assistance.<sup>14</sup> The use of the term “robo-advisor” in this article refers to these types of pure models without any human element. A hybrid robo-advisor combines both the automated, algorithm-based method with dedicated human oversight.<sup>15</sup> This article will refer to this type of advisor as a “hybrid advisor.” As the market for low cost investment services grow, so too do the types of offerings provided.<sup>16</sup> Currently, models based on varying levels of robo to human interaction are used including pure robo-advisors, hybrid robo-advisors, and many other mixed models.<sup>17</sup>

American financial markets are regulated under a variety of complicated and extensive legislation that attempt to provide investor protection and protect against systemic risk. Numerous agencies are empowered to create and enforce specific rules relative to their regulatory mission. The controlling legislation regarding robo-advisors is the Investment Advisers Act of 1940 (“IAA”). The purpose of this legislation was to protect investors by creating a fiduciary duty between the investor and their registered investment adviser (“RIA”). By creating

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<sup>11</sup> *Retail Investor*, INVESTOPEDIA, <http://www.investopedia.com/terms/r/retailinvestor.asp> (last visited Sept. 15, 2017).

<sup>12</sup> *Institutional Investor*, INVESTOPEDIA, <http://www.investopedia.com/terms/i/institutionalinvestor.asp> (last visited Sept. 15, 2017).

<sup>13</sup> *Id.*

<sup>14</sup> *Robo-advisor*, INVESTOPEDIA, <http://www.investopedia.com/terms/r/roboadvisor-roboadviser.asp> (last visited Sept. 15, 2017).

<sup>15</sup> Barbara A. Friedberg, *Growth of Hybrid Robo-Advisors to Outpace Pure Robos*, INVESTOPEDIA (Feb. 23, 2017, 06:00 AM EST), <http://www.investopedia.com/articles/financial-advisor/100616/growth-hybrid-roboadvisors-outpace-pure-robos.asp>.

<sup>16</sup> *Id.*

<sup>17</sup> Within the industry, human advisers are spelled with an “e” rather than “o” which is more commonly used to describe robo-advisors.

this fiduciary duty, a higher level of protection was afforded to the average investor. This is because the average investor relied upon the expertise and professionalism of their financial advisor for their long-term wealth management. While the IAA had been amended several times since 1940, its current state is lacking in its ability to regulate the current financial services environment. The United States Congress and the relevant regulatory agencies have not adapted to the current technological disruption within the industry. These government actors have moved slowly, and often contradicting one another, in defining the terms and responsibilities that robo-advisors are held to as they begin to control a larger market share.

There are two dominant regulatory agencies that are heavily involved in the issue of robo-advisors. The first of these agencies is the Securities and Exchange Commission (the “SEC”) which is a public organization funded the federal government to regulate and police the securities market. The other is the Financial Industry Regulatory Authority (“FINRA”) which is a self-regulating organization (an “SRO”) tasked with regulating broker-dealers. An SRO is a non-governmental entity that is created by industry participants to self-police the industry by establishing best practices and other rules.

The SEC has stated “[a]dvisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client’s financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client’s situation, experience and objectives.”<sup>18</sup> SEC guidance has focused on three main areas: (1) substance and presentation of disclosures required by the IAA related to adviser’s business model, scope of services, and how these disclosures are disseminated to the client, (2) how investment advice is researched, chosen, and explained to the client, especially in those firms without any human element, and (3) the effectiveness of robo-advisory compliance programs mandated by Rule 206(4)-7 of the IAA which mandates cybersecurity policies and oversight of the robo-advisor algorithm in terms of periodic testing. Some industry commentators have called for robo-advisors to be regulated as investment companies under the Investment Company Act (“ICA”), specifically citing Rule 3a-4 which contains an exception for companies that provide advisory services

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<sup>18</sup> Russel D. Sacks et al., *Shearman & Sterling Examines the Changing Fiduciary Duty Landscape in a Trump Presidency*, THE CLS BLUE SKY BLOG. (Dec. 14, 2016), <http://clsbluesky.law.columbia.edu/2016/12/14/shearman-sterling-examines-the-changing-fiduciary-duty-landscape-in-a-trump-presidency/>.

to many clients with low investment amounts. Robo-advisors market themselves as offering this exact service to young people.

Since robo-advisors represent such a dramatic shift from traditional wealth management practices, the SEC is not the only entity stepping into the regulatory fray. FINRA published a report stating that robo-advisors likely fail the qualifications necessary to establish a fiduciary duty, namely issues related to customer-specific suitability and supervision of the algorithms.<sup>19</sup> FINRA's decision focused on whether the users of these robo-advisors could rely on the software being used and whether the systems, and the advisers operating those systems, were advanced enough to provide fiduciary advice to their clients.<sup>20</sup> Presently, the lower "suitability" standard serves as the only protection for robo-advisor investors at the present time.<sup>21</sup> FINRA Rule 2111 requires, "[i]n part, that a broker-dealer or associated person have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."<sup>22</sup> FINRA does not believe that robo-advisors can act beyond this suitability standard.<sup>23</sup> The suitability standard may stay in place until the United States Department of Labor's new fiduciary standard is implemented. However, the Trump administration has already issued an executive order requiring further review for full compliance by July 1, 2019.<sup>24</sup> However, there is no consensus that the Department of Labor rule automatically applies to robo-advisors, especially as clients use these services for specific savings goal such as a large purchase in addition to robo-advisors services for retirement accounts.<sup>25</sup>

As it stands now, the Trump administration and Secretary of Labor Acosta appear to be in favor of the rule, albeit a watered-down version of the rule, as created by the Obama administration.<sup>26</sup> There is a growing

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<sup>19</sup> Fin. Industry Reg. Authority, *Report on Digital Investment Advice*, (Mar. 2016).

<sup>20</sup> *Id.*

<sup>21</sup> Fin. Industry Reg. Authority, *FINRA Rule 2111 (Suitability) FAQ*, <http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>. (last visited Jan. 15, 2017). (By default, the lack of any additional regulation returns the investor to the suitability standard)

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> Alexander Acosta, *Deregulators Must Follow the Law, So Regulators Will Too*, WALL STREET JOURNAL, (May 22, 2017 7:00 p.m. ET) <https://www.wsj.com/articles/deregulators-must-follow-the-law-so-regulators-will-too-1495494029>. See also, *U.S. Department of Labor Extends Transition Period for Fiduciary Rule Exemptions*, DEPT. OF LABOR, (Nov. 27, 2017).

<sup>25</sup> Anna Irrera & Elizabeth Dilts, *Robo-advisors shrug off U.S. fiduciary rule bubblub*, REUTERS, (last visited Feb. 2, 2018).

<sup>26</sup> Acosta, *supra* note 24.

consensus that the specter of the Department of Labor rule has already inspired a shift in the investment industry towards a more client-based advisory approach and for spurring higher compliance costs for advisers within the Department of Labor's crosshairs.<sup>27</sup> Anton Honikman, the CEO of MyVest, a digital investment advice firm, stated that "We think that the wealth management industry is already in the middle of a massive shift from a product-centric to a client-centric approach, and the DOL Fiduciary Rule has already accelerated that trend."<sup>28</sup> The Labor Department's rule and the industry's reaction to how the rule will impact their business in these areas is likely to be recycled by robo-advisory firms if more stringent regulation is passed targeting robo-advisors.

To better address the question of robo-advisor's status as a RIA, a detailed discussion of the Department of Labor rule is not sufficient as the rule is still under review and is likely to face numerous revisions before implementation. Instead, this note approaches this question of robo-advisors by examining the differing counteractive regulations, laws, policy papers, and other forms of guidance to illustrate the industry's inability to handle the regulation of robo-advisors, especially at a time when robo-advisor assets under management are relatively low compared to active managers. Particularly, this article supports the assumptions put forth by FINRA in that robo-advisors do not rise to the level of a fiduciary. The FINRA report illustrates certain considerations that should be promoted in future regulation of these robo-advisors. By further developing the criteria FINRA used, this note will establish a more thorough understanding of the regulatory and legal ramifications of robo-advisory services. Most importantly, the article examines the inadequate investor protection currently being provided to investors using robo-advisors like Wealthfront and Betterment. The inadequate system means that systemic risk increases with each additional dollar invested with a robo-advisor.

By examining current case law dealing with traditional human advisors, this article will set out an existing legal foundation for which the judicial system can apply litigation solutions to matters involving robo-advisors. In addition, this article will discuss the inadequacies of the current regulatory system, primarily the bureaucratic turf battle between the agencies that police the financial markets, namely the SEC, FINRA, and the United States Department of Labor ("DOL"). The interconnected conflicts between these agencies often means they are

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<sup>27</sup> Eugene Grygo, *Has the Fiduciary Rule Already Done Some Good?*, FTF NEWS, (last visited Jan. 12, 2018).

<sup>28</sup> *Id.*



unable to work together because of bureaucratic turf battles.<sup>29</sup> When the agencies do work together, they are able to guide the process forward as seen in the dual-agency 2015 report.<sup>30</sup> In their key report, the SEC and FINRA stated:

[A]n automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation ... An automated investment tool may not assess all of your particular circumstances, such as your age, financial situation and needs, investment experience, other holdings, tax situation, willingness to risk losing your investment money for potentially higher investment returns, time horizon for investing, need for cash, and investment goals. Consequently, some tools may suggest investments (including asset-allocation models) that may not be right for you.<sup>31</sup>

This dual-agency report, while severe in its outlook of robo-advisors, is not the most comprehensive and does not provide investors with the necessary knowledge of their rights or the standard to which robo-advisors are held. The inability to observe market trends towards a more automated investment method and the lack of political will to define the fiduciary duties of robo-advisors causes confusion for market innovators and leaves investors with questions.<sup>32</sup> Despite some analysts forecasting \$2 trillion dollars to be managed by robo-advisors within the next five years, there are still major concerns for investor protection and systemic risk looming.<sup>33</sup>

This article will dedicate individual sections to the attempts by the SEC, FINRA, and DOL by highlighting their successes and failures in addressing the robo-advisor question. The article will then offer suggestions to remedy the inadequacies of the present regulatory system through the application of existing case law involving human financial advisors. By incorporating the lessons learned from the courtroom at substantial hardship to investors and asset managers alike, the void left by the regulatory agencies can be filled with a more coherent strategy to better protect investors and institute measures to combat systemic risk.

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<sup>29</sup> Joseph A. Giannone, *Investment Advisers to SEC: we don't need new cops*, REUTERS, (last visited Jan. 12, 2018).

<sup>30</sup> U.S. SEC. AND EXCH. COMM'N, *Investor Alert: Automated Investment tools* (May 8, 2015), <https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html>.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> Michael P. Regan, *Robo Advisers to Run \$2 Trillion by 2020 if This Model Is Right*, BLOOMBERG (June 18, 2015), <http://www.bloomberg.com/news/articles/2015-06-18/robo-advisers-to-run-2-trillion-by-2020-if-this-model-is-right>

II. THE “FINTECH” REVOLUTION HAS CHANGED THE FACE OF INVESTING AND ROBO-ADVISORS CAN FULFILL MOST OF THE ROLES PLAYED BY TRADITIONAL HUMAN ADVISERS EXCEPT FOR SOME VERY IMPORTANT DEFICIENCIES IN THE ROBO-ADVISORY MODEL.

The term “fintech” has become extremely popular to describe the disruptive nature of start-ups and other market actors using technological innovation in the financial sector.<sup>34</sup> Fintech describes a business that is aimed towards providing financial services through modern technology.<sup>35</sup> This move towards more electronic, less “hands-on” style of investing began with the invention of exchange traded funds (ETF) due to their liquidity, diversification, and tax efficiency.<sup>36</sup> An ETF is an investment fund traded on stock exchanges, much like stocks.<sup>37</sup> The investment strategy of an ETF holds assets such as stocks, commodities, or bonds, and trades close to its net asset value over the course of the trading day.<sup>38</sup> The growth of ETF funds is indicative of the growth of passive investment strategies discussed earlier. Robo-advisors invest heavily in low-cost, highly liquid, index-tracking ETF’s to capitalize on this passive investment strategy.<sup>39</sup>

Robo-advisors have taken this new passive investment strategy a step further and have gained popularity with low net worth and high net worth investors alike. Investors seeking to begin saving for retirement, set aside for college savings, or other investment goals fill out brief questionnaires. These questionnaires ask for information such as age, annual income, target retirement age, risk appetite, and other questions necessary to formulate an investment strategy. Robo-advisors continue to gain a larger market share of the investment and financial services industry. By 2020, pure-robo advisers are predicted to actively manage nearly \$2 trillion in assets, an astronomical number.<sup>40</sup> This number means that robo-advisors rise to the level where a computer error,

<sup>34</sup> *FinTech*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fintech.asp> (last visited Jan. 15, 2018).

<sup>35</sup> *FinTech Definition*, FINTECH WEEKLY, <https://fintechweekly.com/fintech-definition> (last visited Jan. 12, 2018).

<sup>36</sup> Mark P. Cussen, *Why ETFs Are So Popular with Financial Advisors*, INVESTOPEDIA (April 19, 2016 9:00 AM EDT), <http://www.investopedia.com/articles/investing/041916/why-etfs-are-so-popular-financial-advisors.asp>.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> Dan Egan, *Get All the Returns You Deserve*, BETTERMENT, <https://www.betterment.com/resources/investment-strategy/investor-returns/>, (last visited Jan. 15, 2018).

<sup>40</sup> Michael P. Regan, *Robo Advisers to Run \$2 Trillion by 2020 if This Model Is Right*, BLOOMBERG (June 18, 2015), <http://www.bloomberg.com/news/articles/2015-06-18/robo-advisers-to-run-2-trillion-by-2020-if-this-model-is-right>.

unchecked by human oversight, could lead to massive changes in financial markets. Even more so, not all robo-advisors offer the ability for an investor to quickly change their risk appetite as market conditions change or their own personal situation changes.<sup>41</sup> This should worry some investors, particularly younger and more active investors who may wish to trade more aggressively but end up being drawn to the robo-advisor over its low fees.

A robo-advisor is different – you cannot technically “call up” the robo-advisor for financial advice, or to discuss your investment strategy. In a frantic market sell-off, a human adviser can calm down her client in a way that a robo-advisor simply cannot. Investing, while technical, is still wrought with emotion that a human adviser fills in a way that a robo-advisor cannot. Furthermore, volatility offers unique opportunities for profits that may not be applicable to investors using robo-advisors. Instead, a robo-advisor engages in simple investing across a wide range of securities. A robo-advisor can also engage in tax harvesting where a security that has experienced a loss is sold and replaced with another security so that the investor offsets taxes on gains and income.<sup>42</sup> However, the services offered by a robo-advisor are different than that of a traditional financial advisor who can discuss strategy and long-term options with their client. A robo-advisor offers limited investment options based on user inputs, such as target retirement date and risk appetite. This is hardly a full service advisory plan. These robo-advisors mostly fit into what is known as the Level Fee Fiduciary Rules where they charge a flat AUM fee regardless of the investment strategy chosen by the investor.<sup>43</sup> These types of reasonable compensation questions have not been fully explored to date as most attention has been paid to issues of fiduciary status rather than an investigation into the fees and compensation structure of robo-advisors. Concerns of whether robo-advisors will face certain economy of scale questions as it relates to their reasonable compensation will be addressed at a more in-depth level in Section V.

Some of the most well-known robo-advisors are Betterment and Wealthfront, but more traditional financial industry behemoths such as J.P. Morgan, Goldman Sachs, and Charles Schwab have planned to roll

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<sup>41</sup> Victor Reklaitis, *Why investors should approach robo advisers with caution*, MARKETWATCH (Nov. 27, 2015 9:20 a.m. ET), <http://www.marketwatch.com/story/why-investors-should-approach-robo-advisers-with-caution-2015-11-27>.

<sup>42</sup> *Experience the Next Generation of Tax Loss Harvesting*, BETTERMENT, <https://www.betterment.com/tax-loss-harvesting/>, (last visited Sept. 15, 2017).

<sup>43</sup> Michael Kitces, *How DoL Fiduciary Will Disrupt The Blackrock And Schwab Robo-Advisors*, KITCES (May 12, 2016 11:53 AM), <https://www.kitces.com/blog/schwab-intelligent-portfolio-and-blackrock-futureadvisor-under-dol-level-fee-fiduciary-rules/>.

out their own robo-advisors.<sup>44</sup> The fintech revolution was once dominated by smaller more nimble firms but is now facing competition from those larger firms with a higher market capitalization, more resources to spend on developing these platforms, and the ability to even purchase these robo-advisor firms. This was done recently where LearnVest was acquired by Northwestern Mutual in 2015 for at least \$250 million; FutureAdvisor was acquired by Blackrock in the same year for \$150 million.<sup>45</sup>

### III. THE FIDUCIARY STANDARD FOR ROBO-ADVISORY FIRMS IS UNCLEAR WHICH HARMS THE MARKET, INDUSTRY INNOVATORS, OR INVESTORS.

Within the global and electronic markets that now dominate finance, investors increasingly rely upon their brokers and advisors to navigate the complicated scene of modern investing. Investors have benefitted from positive returns as a result of this prolonged bull market – stock prices are rising – and have not had to deal with immense losses. Those watching robo-advisors with suspicion point to the nearly decade long bull market as evidence that investor confidence in these robo-advisors may be misplaced.<sup>46</sup>

The Advisers Act is unequipped to protect investors from these robo-advisors.<sup>47</sup> This lack of protection will negatively impact on the industry's innovative solutions for providing services to lower income clients and other fixed income trading.<sup>48</sup> There has been no effort to include an amendment that would distinguish between robo-advisors as opposed to the more traditional adviser. The firms that are providing these robo-advisor services are liable under the Investment Adviser's

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<sup>44</sup> Jon Marino, *Big Banks are Fighting Robo-Advisors Head On*, CNBC: FINANCE (June 26, 2016 3:01 PM ET), <http://www.cnbc.com/2016/06/25/big-banks-are-fighting-robo-advisors-head-on.html>.

<sup>45</sup> Michael Kitces, *Blackrock Acquires FutureAdvisor For \$150M As Yet Another Robo-Advisor Pivots To Become An Advisor #FinTech Solution*, NERD'S EYE VIEW (Aug. 27, 2016), <https://www.kitces.com/blog/blackrock-acquires-futureadvisor-for-150m-as-yet-another-robo-advisor-pivots-to-become-an-advisor-fintech-solution/>.

<sup>46</sup> Jule Verhage, *For Robo-Advisors, the Next Bear Market Is Make or Break*, BLOOMBERG, (April 20, 2016) <https://www.bloomberg.com/news/articles/2016-04-20/for-robo-advisors-the-next-bear-market-is-make-or-break>

<sup>47</sup> U.S. SEC. AND EXCH. COMM'N. *Investor Bulletin: Robo-Advisors*, <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-robo-advisors>, (Feb. 23, 2017).

<sup>48</sup> *Id.* See also, *Fixed Income Trading*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fixedincome.asp> (last visited Feb. 2, 2018), (“Fixed income refers to a type of investing or budgeting style for which real return rates or periodic income is received at regular intervals at reasonably predictable levels.”)

Act, yet their use of either a third-party developed algorithm or even an internally developed algorithm have sparked a discussion on what types of protections should be afforded to the twenty-first century investor.

While a contracting organization can obtain indemnity from a service provider, this does not impact their initial exposure to harmed investors or the far-reaching power of government regulatory agencies. The financial services industry, Congress, and the relevant regulatory agencies have been unable to deliver an actionable definition as to whether a robo-advisor has a fiduciary duty to an investor, despite their official label as an advisor. Is the robo-advisor simply software or is this investment platform an advisor within the meaning of the Advisers Act. This distinction ultimately decides whether a fiduciary duty has been created to protect investors.

From a practical litigation standpoint, an aggrieved investor would sue the firm offering the service, the software or algorithm developer, and other relevant third parties. There is no investment without the risk of loss; when the market begins to experience negative returns, there stands to be excessive litigation in this area as more firms turn to robo-advisors to meet market demands and changing investor appetites for risk or cost. Since robo-advisors have grown with the bull market, case law in this area is non-existent and this article incorporates case law involving traditional advisors. Therefore, the judicial overwatch of robo-advisors will require a hybrid approach to addressing the complex issues impacting investors, industry providers, and government regulatory agencies. Without a clear fiduciary duty, aggrieved investors must turn to more complex and difficult claims. Robo-advisors will be able to hide behind the suitability standard and investors will be left to pursue claims such as fraud and breach of contract in hopes of securing a remedy.

#### IV. ROBO-ADVISORS REPRESENT UNIQUE INVESTOR PROTECTION CONCERNS AND POSE SYSTEMIC RISK FEARS.

Investor protection is at the heart of efforts to regulate the securities industry.<sup>49</sup> The fiduciary standard was put in place to elevate the level of investment advice given to clients to be in the best interest of the client. An implied private cause of action against an RIA rests on two purposes established by the Second Circuit where the cause of action was for the “protect[ion] [of] the public and investors against malpractice by persons paid for advising others about securities”, and whether there was

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<sup>49</sup> U.S. SEC. AND EXCH. COMM’N, *What We Do*, <https://www.sec.gov/Article/whatwedo.html> (last visited Jan. 15, 2018).

“effective federal regulation of an important segment of the securities industry.”<sup>50</sup> The American Bar Association has developed further guidance on the elements necessary for a private cause of action: (1) the existence of a fiduciary duty, specifically the scope of that duty, (2) whether a breach occurred, and (3) the damages caused by that breach.<sup>51</sup> Outside of investor protection, robo-advisors pose unique systemic risks to the global financial markets. Systemic risk has many definitions. This article will examine the systemic risk posed by robo-advisors through a definition put forth by former SEC Commissioner, Andrew Lo.<sup>52</sup> Mr. Lo’s approach focuses on six elements: (1) leverage, (2) liquidity, (3) correlation, (4) concentration, (5) sensitivities, and (6) connectedness which together through a series of small market movements create a ‘death spiral.’<sup>53</sup> Robo-advisors, as shown with the halt in trading on the Betterment platform after Brexit, are vulnerable to dramatic trading frenzies.<sup>54</sup> Many industry professionals looked at Betterment’s decision to halt trading after a 2% market drop as a sign of Betterment’s “immaturity” and inability to adapt to changing market conditions.<sup>55</sup> While Betterment’s allies in the industry voiced their support for Betterment’s decision to suspend trading in order to protect client accounts, others found the length of the suspension and the lack of communication to clients as troubling.<sup>56</sup> The result was that investors were locked out of their accounts, and essentially lost money if they attempted to buy at a discount because of a management decision made by Betterment without input from its clients.<sup>57</sup> While this trading halt

<sup>50</sup> *Abrahamson v. Fleshchner*, 568 F.2d 862 (2d Cir. 1977).

<sup>51</sup> Robert A. Kutcher, *Breach of Fiduciary Duties*, AMERICAN BAR ASSOCIATION, discussing *Green v. Freeman*, 749 S.E.2d 262, 268 (2013).

<sup>52</sup> Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Hearing on Hedge Funds Before H. Comm. on Oversight and Gov’t Reform, 1 (November 13, 2008) (statement of Andrew W. Lo, Professor, MIT Sloan School of Management), <https://ssrn.com/abstract=1301217>.

<sup>53</sup> *Id.* at 4-5. “Leverage has the effect of a magnifying glass, expanding small profit opportunities into larger ones, but also expanding small losses into larger losses. And when adverse changes in market prices reduce the market value of collateral, credit is withdrawn quickly and the subsequent forced liquidation of large positions over short periods of time can lead to widespread financial panic, as we have witnessed over the past several months. The more illiquid the portfolio, the larger the price impact of a forced liquidation, which erodes the investor’s risk capital that much more quickly. Now if many investors face the same “death spiral” at the same time, i.e., if they become more highly correlated during times of distress, and if those investors are obligors of a small number of major financial institutions, then small market movements can cascade quickly into a global financial crisis. This is systemic risk.”

<sup>54</sup> Anora Mahmudova, *Betterment halted trade amid Brexit panic – here’s why*, MARKETWATCH, (last visited Feb. 2, 2018).

<sup>55</sup> Suleman Din, *After trading halt, Betterment suffers its own Brexit stock*, FINANCIAL PLANNING (June 29, 2016, 12:03pm EDT) <http://www.financial-planning.com/news/after-trading-halt-betterment-suffers-its-own-brexit-shock>

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

primarily affected institutional investors who are given less protection because they are considered sophisticated enough to protect themselves, there is still cause for concern. No actions for breach of fiduciary duty were brought during this time but the Betterment example of what a potential case against a robo-advisor would look like. As robo-advisors grow their AUM, massive portions of the market stand to be frozen during market frenzies. The potential issues that could result from the total stoppage in all trading should trigger regulators, policy analysts, and investors as to the limitations of robo-advisors especially since clients have not been persuaded by the vague arguments put forth by Betterment to justify such a practice.<sup>58</sup>

#### V. THE ANALYSIS OF THE ROBO-ADVISOR QUESTION MEANS LOOKING ACROSS THE FINANCIAL SERVICES INDUSTRY TO THE SEC, TO FINRA, EXISTING CASE LAW DEALING WITH HUMAN ADVISERS, AND POLICY CONCERNS.

Since the courts have not addressed these issues yet, any legal argument must be drawn from: (1) litigation involving human advisers, and (2) examining policy perspectives put forth by industry regulatory bodies such as the SEC and FINRA. At the most basic level, investors and financial professionals alike are beginning to question whether these robo-advisors satisfy the fiduciary duty of care, which requires an analysis that goes beyond just a suitable recommendation.<sup>59</sup> Are these robo-advisors subject to the Advisers Act? The SEC has struggled with answering this question in a clear, definitive manner but has recently published a release declaring robo-advisors to be registered investment advisers.<sup>60</sup> Despite this, there is still no industry consensus as to the level of their fiduciary capacity. Are these modern methods of investing subject to the Investment Company Act of 1940 (“ICA”), which deals primarily with open end mutual funds? The contradicting regulations, laws, policy papers, executive orders, and other regulations complicate this question.

An argument can be made that companies like Betterment and Wealthfront operate as mutual funds because they pool investor money to

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<sup>58</sup> *Id.*

<sup>59</sup> Ryan C. Fuhrmann, *Choosing A Financial Advisor: Suitability Vs. Fiduciary Standards*, INVESTOPEDIA, <https://www.investopedia.com/articles/professionaleducation/11/suitability-fiduciary-standards.asp>, (last visited Feb. 2., 2018).

<sup>60</sup> U.S. SEC. AND EXCH. COMM’N. *Investor Bulletin: Robo-Advisers*, <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-robo-advisers>, (Feb. 23, 2017).

purchase shares across a wide range of securities. A mutual fund is an investment vehicle made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets.<sup>61</sup> Section 36(b) of the Investment Company Act, has been enacted in large part because Congress has recognized that as mutual funds grow more prevalent within the industry, it becomes less expensive for investment advisers to provide additional services. Thus, § 36(b) imposes a fiduciary duty upon investment advisers of mutual funds with respect to the receipt of compensation for services.<sup>62</sup> This section also provides for a private cause of action by a mutual fund investor against the investment advisor for breach of fiduciary duty in respect of such compensation.<sup>63 64</sup>

The current regulatory environment for mutual funds would stifle robo-advisors rather than allow them to provide benefits to the market as well as provide investment opportunities to investors. Therefore, this article does not address the mutual fund proposal as doing so would greatly expand the scope of the discussion. This article's analysis is separated into the following areas: (A) the inadequacies of the current legislation and the regulatory bodies inability to guide the process; and (B) potential solutions to this problem that will optimize the investment industry and better protect investors.

*A. There Are Major Inadequacies In The Investment Advisers Act, The Investment Company Act, And Other Statutes Designed To Protect Investors And Hedge Systemic Risk.*

The IAA is the paramount statute governing the investment industry in the United States. Section 202(a)(11) defines an investment adviser as any person or firm that satisfies two main elements: the person or firm is provided compensation in exchange for providing advice to others regarding securities.<sup>65</sup> Under this basic test, a robo-advisor satisfies those requirements. For example, Betterment charges an annual fee relative to the amount invested. In exchange for that fee, Betterment's published mission statement reads: "[t]he Betterment portfolio is designed to achieve optimal returns at every level of risk. Through diversification,

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<sup>61</sup> *Mutual Fund*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/mutualfund.asp> (last visited Jan. 15, 2018).

<sup>62</sup> 15 U.S.C. § 80a-35(b).

<sup>63</sup> *Id.*

<sup>64</sup> John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, *Conflict of Interest*, 26 *J. Corp. L.* 609 (2001).

<sup>65</sup> *Investors Advisers Acts of 1940*, 15 U.S.C. § 202(a)(11) (1940).



automated rebalancing, better behavior, and lower fees, Betterment customers can expect 2.66% higher returns than a typical do it yourself investor.”<sup>66</sup> Therefore, this question should be already answered as these robo-advisors satisfy the elements to serve as a registered investment adviser to their customers. However, that question is not answered. The fact that there is so much confusion around this fiduciary duty shows how complicated robo-advisor regulation is and shows how necessary an article on the intricacies of that regulation is in the current environment.

Under the IAA, the classification as a registered investment adviser imposes certain legal obligations. One of those obligations is the duty of disclosure regarding current portfolio holdings.<sup>67</sup> An adviser in compliance must have policies and procedures that are not shared by the traditional adviser.<sup>68</sup> Most notably, robo-advisors are subject to the twin duties of loyalty and care.<sup>69</sup> These algorithms represent various concerns on whether the IAA is equipped or capable to understand the fiduciary duty that must be considered when advice is delivered to the client, and these responsibilities fall on the human employees of the firm offering the service.<sup>70</sup> Robo-advisors appear to be registered investment advisers (RIAs) as defined under the IAA, yet the robo-advisors have not been given the tools necessary for self-regulation, nor have the appropriate governing bodies took the lead in developing substantial investor protections.<sup>71</sup> This has allowed for a significant gap to develop between these firms which hold themselves out as robo-advisor RIAs and other actors within the financial markets.

Firms that use robo-advisors charge less than traditional full-service brokerage firms or mutual funds.<sup>72</sup> While a large majority of firms use trading algorithms, robo-advisors are unique in that they solely use these algorithms completely outside of traditional active management styles. Firms like Betterment charge between 0.15% to 0.35%, while the more traditional firms like Vanguard charge on average 1.0% of assets under management from the individual investor.<sup>73</sup> Robo-advisors benefit from

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<sup>66</sup> *Why Betterment: Overview*, BETTERMENT, <https://www.betterment.com/why-betterment/> (last visited May 15, 2017)

<sup>67</sup> Investors Advisers Act of 1940, 15 U.S.C. § 206(4) (1940).

<sup>68</sup> Danielle Andrus, *SEC Issues Guidance for Robo-Advisors, Investors*, THINKADVISOR (Feb. 23, 2017), <http://www.thinkadvisor.com/2017/02/23/sec-issues-guidance-for-robo-advisors-investors>.

<sup>69</sup> IMCA International, March 2016 – Legislative Intelligence Update: Regulatory Focus on Robo-Advice (Mar. 2016).

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> Mason Braswell, *SEC to Robo-Advisors: We're Watching You*, ADVISOR HUB (Nov. 14, 2016), <https://advisorhub.com/sec-to-robo-advisors-were-watching-you/>

<sup>73</sup> *Id.*

the same economy of scale yet are not regulated in a similar fashion as traditional human advisers that benefit from economies of scale.<sup>74</sup> In fact, robo-advisor profit margins rely on growing their economies of scale as their investment advice does not require the active management fees incurred by other advisors.<sup>75</sup> The bull market returns and the low service costs being charged may be the reason that no private actions have been brought against these firms. The ambiguous, and at times contradictory, treatment of robo-advisors stands in stark contrast to the regulation of human financial advisers which has clear fiduciary standards. This dichotomy of regulation highlights the many issues that technology has brought to the financial industry.

*B. FINRA's Inability To Establish Appropriate Fiduciary Standards Pose A Risk To The American And Global Economies And Directly Contrasts The Sec Guidance.*

Given that stock markets have enjoyed unprecedented success over the past eight years, robo-advisors have enjoyed moderate gains and have left most customers happy.<sup>76</sup> While investors appear to increase their use of these investment vehicles, all investing comes with risk. Wealthfront's own website declares, "[a]ll securities involve risk and may result in loss," which serves as a notice to investors.<sup>77</sup> The primary regulatory body for broker-dealers operating with robo-advisors is FINRA. In a sign indicative of the complexity of the proper regulation, FINRA and the SEC have published conflicting reports declaring the fiduciary status of robo-advisors.<sup>78</sup> FINRA has published a report which declares robo-advisors have no fiduciary duty to investors.<sup>79</sup> This report states that robo-advisors do not meet the standards necessary to be held liable as a fiduciary.<sup>80</sup> FINRA came to this conclusion by focusing on the robo-advisor's inability to perform a critical and important task which human

<sup>74</sup> An economy of scale is the inverse relationship between production and the cost to do produce that item. This is the inverse relationship between the quantity produced and per-unit fixed costs.

<sup>75</sup> Larry Ludwig, *The Rise of Robo-Advisors – Should You Use One?*, INVESTOR JUNKIE (Apr. 11, 2017) <https://investorjunkie.com/35919/robo-advisors/>.

<sup>76</sup> *Robo Advisors Gaining Popularity with High-Net-Worth Investors*, BUSINESS INSIDER: MYPRIVATEBANKING (Aug. 24, 2016 at 2:33 PM), <http://www.businessinsider.com/robo-advisors-are-gaining-popularity-with-high-net-worth-investors-2016-8>.

<sup>77</sup> *General Disclosures*, WEALTHFRONT, <https://www.wealthfront.com/legal/disclosure>, (Mar. 2016).

<sup>78</sup> U.S. SEC. AND EXCH. COMM'N. *Investor Bulletin: Robo-Advisers*, <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-robo-advisers>, (Feb. 23, 2017).

<sup>79</sup> Fin. Industry Reg. Authority, *Report on Digital Investment Advice*, (Mar. 2016).

<sup>80</sup> *Id.* at 2

advisors can perform, which is portfolio analysis.<sup>81</sup> Portfolio analysis in a fiduciary context requires the application of well-accepted principles involving risk and reward in relation to the overall investment strategy.<sup>82</sup>

As stated above, these robo-advisors are registered investment advisors yet FINRA refuses to declare these advisors have fiduciary duty to uphold when managing investors' money. The FINRA report has been bolstered by a separate report authored by Melanie L. Fein, a private sector attorney with substantial previous government sector as senior counsel to the Federal Reserve Board of Governors.<sup>83</sup> Fein reasons that FINRA has placed so much emphasis on this portfolio analysis is because this question is essential to compliance with the Advisors Act.<sup>84</sup> This is important because these robo-advisors pool investor monies to make investments based on specific risk appetites as determined by investors when they fill out the on-line questionnaires.<sup>85</sup> Fein has stated, "Without portfolio analysis, the advisor cannot be confident that the investment advice is appropriate for an individual client."<sup>86</sup> This leaves individual investors vulnerable and has prompted Fein to state, "If the duty of an investment advisor does not encompass a duty to provide overall portfolio analysis, the SEC needs to say so."<sup>87</sup> She has gone so far as to say that robo-advisors may be unregistered investment companies and therefore in violation of the Company Act and SEC regulation.<sup>88</sup>

Fein's report concludes that uneducated investors should stay away from these robo-advisors since they are ill-informed to properly apply the firm questionnaires to meet their investor goals.<sup>89</sup> Firms like Betterment have expressed strong condemnation with Fein's assessment as these robo-advisory services are marketed to less sophisticated investors.<sup>90</sup> Despite such strong rhetoric against robo-advisors by certain private sector actors, FINRA has largely left this question to the SEC, which has refused to address these contradictions.

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<sup>81</sup> *Id.* at 3

<sup>82</sup> *Id.*

<sup>83</sup> Andrew Shilling, *No, Robos Still Can't Act as Fiduciaries, Attorney Contends*, FINANCIAL PLANNING, Apr. 21, 2016. (<http://www.financial-planning.com/news/no-robos-still-cant-act-as-fiduciaries-attorney-contends>)

<sup>84</sup> *Id.*

<sup>85</sup> Falguni Desai, *The Great FinTech Robo Advisor Race*, FORBES, July 31, 2016. (<http://www.forbes.com/sites/falgunidesai/2016/07/31/the-great-fintech-robo-adviser-race/#7bab81403812>)

<sup>86</sup> Shilling, *supra* note 83.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

VI. THE MASSACHUSETTS SECURITIES DIVISION AND THEIR HANDLING OF ROBO-ADVISOR FIRMS IS AN EXAMPLE OF FEDERALISM AT WORK THAT COULD BE APPLIED AT A NATIONAL LEVEL BY THE SEC.

In keeping with the American federalist system where states serve as laboratories for innovation in certain areas, Fein has applauded the Massachusetts Securities Division (“MSD”) for its innovative regulation scheme which addresses robo-advisors on a case-by-case basis.<sup>91</sup> The MSD is tasked with investor protection in Massachusetts and has come out strongly against robo-advisors.<sup>92</sup> The MSD focused their assessment primarily on the robo-advisor firm’s attempts to shed their responsibilities to investors by utilizing disclaimers regarding the actual services being provided by the robo-advisor.<sup>93</sup> The MSD saw this as an automatic red flag.<sup>94</sup> The MSD paid particular attention to the inability of robo-advisors to perform overall wealth management services, as the breadth of their client information comes from a brief questionnaire which the client is responsible for creating and updating as investment needs change.<sup>95</sup> The robo-advisor’s lack of due diligence as it relates to the client’s overall financial picture is a major strike against holding them as a fiduciary.<sup>96</sup> The MSD identified several main areas of concern since the advisers: (1) do not meet with or conduct due diligence on a client, (2) provide minimally personalized investment advice, (3) may fail to meet the high standard of care for appropriateness of adviser decision making, and (4) how the advisers decline the obligation to act in client’s best interest.<sup>97</sup> The MSD undertakes a fact intensive inquiry as to each robo-advisor seeking to become a state registered investment advisory firm and whether the fiduciary standard will be applied.<sup>98</sup>

This author believes that the innovation shown by Massachusetts could serve as a guide to the SEC’s issue in establishing a bright line rule for the fiduciary obligations. Massachusetts could serve as “... a state may,

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<sup>91</sup> *Id.*

<sup>92</sup> SEC’Y OF THE COMMONWEALTH OF MASS., *Policy Statement, Robo-Advisers and State Investment Adviser Registration* 1 (April 1, 2016), <https://www.sec.state.ma.us/sct/sctpdf/policy-statement--robo-advisers-and-state-investment-adviser-registration.pdf>

<sup>93</sup> *Id.* at 6

<sup>94</sup> *Id.* at 7

<sup>95</sup> *Id.*

<sup>96</sup> *Id.* at 6

<sup>97</sup> C. Todd Gibson, *U.S. Regulatory Scrutiny of Robo-Advisers and other Providers of Digital Investment Advice*, K&L GATES: FINTECH L. WATCH (July 21, 2016), <https://www.fintechlawblog.com/tag/massachusetts-securities-division>

<sup>98</sup> SEC’Y OF THE COMMONWEALTH OF MASS., *Policy Statement, Robo-Advisers and State Investment Adviser Registration* 8 (April 1, 2016), <https://www.sec.state.ma.us/sct/sctpdf/policy-statement--robo-advisers-and-state-investment-adviser-registration.pdf>.

if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”<sup>99</sup> While efforts at the state level should be applauded, the regulation of securities is better done at the federal level given the manner in which securities are traded across state lines and across the world. The SEC should look to the MSD and create a new department to monitor and address the investor protection and systemic risk concerns posed by robo-advisors.

Unfortunately, such a suggestion faces numerous obstacles primarily due to budget concerns. The 2016 budget was \$1.605 billion and 2017 is scheduled to be \$1.781 billion.<sup>100</sup> Even with such a large budget, the SEC has lobbied Congress for more funds as resources are stretched thin.<sup>101</sup> Even more so, President Trump has signaled that the SEC may face budget restrictions during his administration.<sup>102</sup> While budget concerns may stop this suggestion in its tracks, the SEC could partner with the MSD to develop a best practices model for use in regulating the larger robo-advisors like Betterment and Wealthfront. Best practices are guidelines, ethics, or ideas put forth by a regulatory authority or industry experts that constitute the most efficient course of action.<sup>103</sup> Creating these best practices, along with examining the successes and failures of the MSD program, could fill the void in investor protection and systemic risk that currently exists in the robo-advisor market. Best practices could be the quickest and most cost-efficient solution to this problem until such time that Congress amends the Advisers’ Act to specifically address robo-advisors, or the SEC and FINRA establish a common understanding of the fiduciary obligations, or until the free market squeezes pure robo-advisors out in favor of hybrid robo-advisors.

*A. The SEC’s Attempts To Label This Fiduciary Standard For Robo-Advisors Is More Clear Than Guidance Put Forth By Other Agencies, However, It Directly Contradicts Other Government Agencies And Positions Put Forth By Those Actively Participating In The Market.*

<sup>99</sup> *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932).

<sup>100</sup> U.S. SEC. AND EXCH. COMM’N, *Budget History – BA vs. Actual Obligations*, <https://www.sec.gov/foia/docs/budgetact.htm>, (last visited Dec. 26, 2017)

<sup>101</sup> Carmen Germaine, *SEC & CFTC Heads Say Enforcement Justifies Bigger Budgets*, LAW360, (Apr. 12, 2016, 4:47 PM EDT), [https://www.law360.com/articles/783040/sec-cftc-heads-say-enforcement-justifies-bigger-budgets?article\\_related\\_content=1](https://www.law360.com/articles/783040/sec-cftc-heads-say-enforcement-justifies-bigger-budgets?article_related_content=1).

<sup>102</sup> Matt Robinson & Benjamin Bain, *Wall Street Cops Reined In as SEC Braces for Trump Budget Cuts*, BLOOMBERG, <https://www.bloomberg.com/news/articles/2017-03-06/wall-street-cops-reined-in-as-sec-braces-for-trump-budget-cuts>, (last updated Mar. 6, 2017, 8:00 AM CST)

<sup>103</sup> *Best Practices*, INVESTOPEDIA, [http://www.investopedia.com/terms/b/best\\_practices.asp](http://www.investopedia.com/terms/b/best_practices.asp), (last visited Jan. 15, 2018).

The Investment Advisers Act authorizes the SEC to bring suits to enforce the duties or obligations created by the Act.<sup>104</sup> The SEC has also stated that robo-advisors may be subject to the Investment Company Act of 1940 (the “ICA”) and Rule 3a-4.<sup>105</sup> This rule creates a safe harbor provision that allows an adviser which manages multiple accounts, like a Betterment or a Wealthfront, to not be registered as a mutual fund. Some market actors have drawn comparisons between robo-advisors and mutual funds, specifically whether regulation under the ICA could result in robo-advisors aligning more with mutual fund practices.<sup>106</sup> Registering as a mutual fund would mean much higher levels of disclosure due to ICA statutes and higher costs associated with those compliance measures. These higher costs which would effectively freeze out the target demographic for these robo-advisors. The SEC has yet to bring a suit against any of these robo-advisors due to positive market conditions. Ironically, an event that occurred outside the United States brought forward one of the more forceful statements from the SEC.<sup>107</sup> After the United Kingdom voted to leave the European Union, financial markets around the globe plummeted and trading was halted for nearly three hours.<sup>108</sup> Betterment was one of those firms who trading practices were halted, yet the customers were not notified about the disruption to the firm’s trading strategy.<sup>109</sup> Investors wishing to profit from the volatility were unable to do so. In response to Betterment’s algorithm being unable to conduct transactions during the frenzy and the lack of disclosure to Betterment investors, the head of the SEC under the Obama administration, Mary Jo White, said that this trading halt reinvigorated the SEC to continue their thorough examination of applicable regulations against these robo-advisors.<sup>110</sup> Commissioner White stated that, “In particular, we are looking at how advisers that provide investment advice with limited, if any, human interaction: (1) provide appropriate disclosures so that their clients understand their services; and (2) obtain information to support their duty to provide suitable advice.”<sup>111</sup> These comments point to the ongoing regulatory minefield faced by the SEC in

<sup>104</sup> *Transamerica Mortg. Advisors (tama) v. Lewis*, 444 U.S. 11, 14 (U.S. 1979).

<sup>105</sup> Danielle Andrus, *SEC Issues Guidance for Robo-Advisors*, THINKADVISOR, Feb. 23, 2017, (<http://www.thinkadvisor.com/2017/02/23/sec-issues-guidance-for-robo-advisors-investors>)

<sup>106</sup> Cullen Roche, *Robo Advisors Don’t Beat Traditional Index Funds*, SEEKING ALPHA, Aug. 18, 2017.

<sup>107</sup> Mason Braswell, *SEC to Robo Advisors: We’re Watching You*, ADVISOR HUB, Nov. 14, 2016, (<https://advisorhub.com/sec-to-robo-advisors-were-watching-you/>)

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

dealing with these firms. Even after declaring that robo-advisors are held to the fiduciary standard, the SEC needs to be more forceful in its outlook on robo-advisors. Since the SEC is empowered to bring civil enforcement actions against individuals and companies that violate securities laws, the entire market looks to the SEC to use enforcement actions as guidance<sup>112</sup>

The SEC has put forth very little guidance to the marketplace despite its status as the largest and most powerful regulatory body in American financial markets.<sup>113</sup> The SEC has the power to subpoena entities and individuals, an action against one of these robo-advisor actors would provide guidance to the marketplace. This means that SEC action The SEC has established five general guidelines for investors who use robo-advisors: (1) understand any terms and conditions, (2) consider the tool's limitations, including key assumptions, (3) recognize that the automated tool's output depends on your questionnaire answers, (4) those outputs may not be right for your financial goals, and (5) safeguard your personal information.<sup>114</sup> While a step in the right direction to address this new investment tool, these tips are not unique to investing with these robo-advisors because any investment opportunity represents these same risks.<sup>115</sup> This lack of more specific and extensive regulation and guidance is an obvious shortcoming that needs to be addressed in a quick and efficient manner. This lack of guidance at every level within government and among competing agencies has provided an uneasy environment for investors and financial institutions alike as markets reward stability. However, innovation and the markets will not wait for the regulatory bodies to catch up to the current level of innovation before moving further beyond the slow moving bureaucratic institutions. The SEC has stated these registered investment advisers are fiduciaries, yet the SEC has put forth no guidance as to how any suit would proceed against a robo-advisor. Nor has the SEC sought to address the conflicting guidance and regulations put forth by FINRA or the other industry professionals such as industry attorneys, investment advisers, and professors.

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<sup>112</sup> Suleman Din, *After trading halt, Betterment suffers its own Brexit stock*, FINANCIAL PLANNING, June 29, 2016. (<http://www.financial-planning.com/news/after-trading-halt-betterment-suffers-its-own-brexite-shock>)

<sup>113</sup> U.S. SEC. AND EXCH. COMM'N. *Investor Bulletin: Robo-Advisers*, <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-robo-advisers>, (Feb. 23, 2017).

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

*B. The U.S. Department Of Labor's Expansion Of Fiduciary Duty To All Advisers Handling Retirement Money May Serve As A Sign Of What Future Regulation May Look Like.*

The Department of Labor regulations put forth by the Obama administration, like much of the regulation levied against the financial industry after the 2008 market downturn, attempted to fill the massive void left by the above mentioned regulatory bodies but have yet to take affect as final implementation has been extensively litigated.<sup>116</sup> This rule is currently in the crosshairs of the Trump administration but may be indicative of where regulation is heading. The DOL has extended the more extensive duties and responsibilities of the “investment advice fiduciary” to all financial professionals providing services to retirement plans.<sup>117</sup> A qualified retirement plan is established by an employer such as a 401(k) or pension.<sup>118</sup> This new standard will replace the “suitability” standard which previously governed brokers, dealers, and other RIA.<sup>119</sup> Most important within the suitability standard is whether or not brokers are within their power to “recommend” certain investment contracts.<sup>120</sup> This “recommendation” definition is vague and relies on a facts and circumstances inquiry.<sup>121</sup> FINRA has established and the SEC have stated, for example, that brokers who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule.<sup>122</sup> Under this policy regime, robo-advisors are subject to the suitability rule and are subject to this standard for each investment made on a client's behalf. This new fiduciary rule requires all financial advisors to make the best investment at the lowest prices rather than in the adviser's interests.<sup>123</sup>

This expansion of the rule has been met with both criticism and acceptance from the industry.<sup>124</sup> The split in classifying these advisors is

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<sup>116</sup> Mark Schoeff Jr., *Court decision on DOL fiduciary rule expected in February*, INVESTMENTNEWS, (Jan. 10, 2018).

<sup>117</sup> *Id.*

<sup>118</sup> *Qualified Retirement Plan*, INVESTOPEDIA, <http://www.investopedia.com/terms/q/qrp.asp>, (last visited Feb. 2, 2018).

<sup>119</sup> Schoeff Jr., *supra* note 116.

<sup>120</sup> *FINRA Rule (Suitability) FAQ*, FINRA, <http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>, (last visited Feb. 2., 2018).

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> Liz Skinner, “Figuring Out Fiduciary”, INVESTMENT NEWS, (May 9, 2016), <http://www.investmentnews.com/article/20160509/FEATURE/160509939/the-dol-fiduciary-rule-will-forever-change-financial-advice-and-the>.

<sup>124</sup> *Id.*



evidence of the different interests and concerns present in various advisor-investor relationships.<sup>125</sup> While this new rule may seem to extend to robo-advisors, robo-advisors are already considered RIAs and are therefore subject to a fiduciary standard.<sup>126</sup> This DOL rule throws yet another wrinkle into a complicated and overlapping system of regulatory guidance as the DOL declared that robo-advisors would not be bound by this rule.<sup>127</sup> Three separate government organizations have been unable to agree on a clear answer to whether a fiduciary duty exists for robo-advisors. Each organization has created additional burdens and costs that are counteractive to ensuring the free flow of securities in our market-based economy.

The DOL has stated that this new rule does not apply to robo-advisors.<sup>128</sup> Betterment has commented on this new rule. The Betterment legal counsel addressed this DOL development: “It sounds like they generally like robos and like the way the robo advice market looks.”<sup>129</sup> Certain industry professionals that operate robo-advisors believe that this rule would make fiduciaries.<sup>130</sup> Blackrock, an industry titan, has published a report stating that: “Under the Fiduciary Rule, digital advisors will be considered fiduciaries under ERISA for advice provided to qualified retirement plans and individual retirement accounts.”<sup>131</sup> ERISA is the Employee Retirement Income Security Act which protects retirement assets by implementing higher standards for these accounts and their investors.<sup>132</sup> Like the disagreement between the SEC and FINRA, this DOL rule also faces competing interpretation from industry regulators and participants. These conflicts further complicate the myriad of regulations, laws, policy papers, and other guidance from the many agencies regulating the financial markets.<sup>133</sup>

In what may be a positive signal for the future, this rule now stands in the crosshairs of the Trump administration’s rollback of regulations.<sup>134</sup>

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<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> Suleman Din, *Fiduciary rule dictates asset manager robo adviser plans*, FINANCIAL PLANNING, Nov. 2, 2016.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> *Digital Investment Advice: Robo Advisors Come of Age*, Blackrock, <https://www.blackrock.com/corporate/en-at/literature/whitepaper/viewpoint-digital-investment-advice-september-2016.pdf>.

<sup>131</sup> *Id.* at 13.

<sup>132</sup> *ERISA*, INVESTOPEDIA, <http://www.investopedia.com/terms/e/erisa.asp>, (last visited Jan. 15, 2018).

<sup>133</sup> *Id.*

<sup>134</sup> Ashlea Ebling, *Trump Orders DOL To Review The Fiduciary Rule: The Official Memo*, FORBES, Feb. 3, 2017, (<https://www.forbes.com/sites/ashleaebeling/2017/02/03/trumps-official-memo-ordering-dol-to-review-the-fiduciary-rule-meant-to-protect-investors/#2e6ba7832c66>).

Rolling back this rule would eliminate one level of confusion as to the fiduciary obligations facing market actors and other participants. This DOL rule is important to this discussion because many investors are using these robo-advisors to plan for retirement but are not aware of the different implications of using these different investment platforms. The DOL rule, and its corresponding press releases and guidance from the department, are again indicative of the main problem with robo-advisors in that they can't provide individual portfolio analysis to investors.

VII. THERE ARE SEVERAL SOLUTIONS TO THE QUAGMIRE POSED BY ROBO-ADVISORS: NONE OF WHICH CAN BE SOLVED WITHOUT POLITICAL WILL, TRIAL AND ERROR, AND A DEDICATED EFFORT TO ADDRESS FINANCIAL REGULATION IN THE 21ST CENTURY.

The answer to the questions posed by robo-advisors are essential to the 21<sup>st</sup> century global economy. Investors, even those not choosing to invest with a robo-advisor, will be interacting with assets managed completely by robo-advisors. Investing is a fundamental aspect of the American economy. A fiduciary relationship exists in many industries outside the financial services industry. The first of many solutions is to review what courts have done when reviewing the fiduciary duty of human advisers.

As it relates to the fiduciary attached to a human financial adviser, the judiciary has determined that a breach of fiduciary duty occurs when an investment adviser holds themselves out as an expert and then makes investment decisions outside the normal bounds of that role whether it be from negligence or a conflict of interest issue.<sup>135</sup> For example, when the president and vice president of an investment advisory and management firm "held themselves out as experienced in the field of investment management" then those advisers can be considered to have taken steps towards establishing a fiduciary duty with their client.<sup>136</sup> In that case, the defendants breached their fiduciary duty owed to investors by failing to advise the fund properly, overcharging commissions, and improperly retaining commissions.<sup>137</sup> Robo-advisors no doubt hold themselves out in such a manner and are compensated for their services. Investors of robo-advisory firms and other firms utilizing electronic trading platforms, like the plaintiff in *Sergeants Benevolent Ass'n Annuity Fund*, rely upon the purported expertise of the robo-advisers and the firm offering those

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<sup>135</sup> *Sergeants Benevolent Ass'n Annuity Fund v. Renck*, 796 N.Y.S.2d 77 (N.Y. App. Div. 1st Dep't 2005).

<sup>136</sup> *Id.* at 79.

<sup>137</sup> *Id.*

services.<sup>138</sup> The finds of this case support the SEC's contention that robo-advisors are RIAs and therefore subject to fiduciary standards. Yet FINRA has publicly declared that robo-advisor's investors are not offered fiduciary protections.<sup>139</sup> The conflict between these two points of view seems irreconcilable. The main answer sought by FINRA was whether robo-advisors could provide the type of portfolio analysis centered on continual communication, disclosure, and compliance with changing law.<sup>140</sup> FINRA decided that these robo-advisors cannot provide continual portfolio analysis in a manner similar to a human adviser<sup>141</sup>. Instead of developing a new portfolio analysis test, FINRA should instead look to jurisprudence and the SEC rather than adding instability to the investment community by breaking from established norms.

In *Goldenberg v. Indel, Inc.*, the court determined that fiduciary duty is owed to an investor when an advisor was:

- (1) providing individualized investment advice; (2) given pursuant to a mutual understanding; (3) on a regular basis; (4) that serves as a primary basis for investment decisions with respect to plan assets; (5) pertains to the value of the property or consists of recommendations as to the advisability of investing in certain property; and (6) is rendered for a fee.<sup>142</sup>

A robo-advisor would satisfy these six elements yet the inability for robo-advisors to develop an individualized and ongoing portfolio analysis complicates the characterization of the relationship. Even with such a defined test in which to analyze whether a fiduciary duty exists, the inability for the regulatory agencies to adopt a consensus on this issue is concerning.

Courts have dismissed breach of fiduciary duty claims when the investment advisor "makes discretionary investments consistent with its investment authority and investment agreements."<sup>143</sup> The problem here rests in that average investors are agreeing to these investment agreements online without ever speaking to a human advisor to discuss their questions. Is a "Frequently Asked Question" page enough to create a fiduciary duty between the robo-advisor and the investor? It is unlikely

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<sup>138</sup> U.S. SEC. AND EXCH. COMM'N, *Investor Alert: Automated Investment Tools* (May 8, 2015), <https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html>.

<sup>139</sup> Alessandra Malito, *Finra issues report on digital investment advice for financial firms and investors*, INVESTMENT NEWS, <http://www.investmentnews.com/article/20160315/FREE/160319963/finra-issues-report-on-digital-investment-advice-for-financial-firms>.

<sup>140</sup> *Id.*

<sup>141</sup> Fin. Industry Reg. Authority, *Report on Digital Investment Advice*, (Mar. 2016).

<sup>142</sup> *Goldenberg v. Indel, Inc.*, 741 F. Supp. 2d 618, 627 (D.N.J. 2010).

<sup>143</sup> *Vladimir v. Cowperthwait*, 839 N.Y.S.2d 761 (App. Div. 2007).

that this type of “catch all” page would withstand any judicial scrutiny. This is especially true considering these robo-advisors have been marketed as an alternative for the less informed or sophisticated investors. Often these investors are without the financial ability to pursue other options or retain counsel to review these agreements.

While these types of issues have not been as prominently litigated, one case does show how courts have looked to the duties assigned to these types of investment models where the reliance is on an algorithm rather than from human input.<sup>144</sup> In that case, the court determined that the investment advisers had breached their fiduciary duties when they failed to disclose and properly fix an error in the investment model which resulted in losses to the investors.<sup>145</sup> The error in their computer model affected more than 600 client portfolios and resulted in nearly \$217 million in losses.<sup>146</sup> Since losses can occur with these types of automated, computer-sourced investment schemes, this case highlights how investors can suffer damages. Losses among various investors are the exact type which pose systemic risk. This case is of importance to the question of robo-advisor regulation, since errors in investment models can affect the entire business model for firms like Betterment and Wealthfront.

A solid legal foundation exists for determining whether there is a fiduciary duty between robo-advisors and investors. In the event of a market downturn, the lack of active management means the potential for huge losses as shown by the above cases. When these types of issues are brought before the court in the coming years, the bench need only look to the above referenced cases and numerous other cases in establishing a new framework which incorporates the problems faced by losses suffered for robo-advisors. The fact that these cases and their clear applicability to the regulation of robo-advisors have not steered FINRA and the SEC to determine that a fiduciary duty exists is unnerving given their mandate to regulate this industry.

#### VIII. HYBRID ROBO-ADVISORS MAY OFFER THE MOST COST EFFECTIVE AND FREE MARKET SOLUTION TO THIS ISSUE AS

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<sup>144</sup> In the Matter of AXA Rosenberg Group, LLC, File No. 3-14224 (Feb. 3, 2011), <https://www.sec.gov/litigation/admin/2011/33-9181.pdf>.

<sup>145</sup> IM Guidance Update, SEC No. 2017-02 (Feb. 2017), <https://www.sec.gov/investment/im-guidance-2017-02.pdf>.

<sup>146</sup> “SEC Credits Former AXA Rosenberg Executive for Substantial Cooperation During Investigation,” SEC Litigation Release No. 22298 (March 19, 2012), <https://www.sec.gov/litigation/litreleases/2012/lr22298.htm>.

INVESTORS SEEM TO DESIRE THESE SERVICES AS SEEN BY THE NEW  
HYBRID OFFERINGS BY THE MAJOR ROBO-ADVISORY FIRMS.

If Congress or any of the appropriate regulatory bodies remain unwilling to establish a clear and effective fiduciary standard for robo-advisors beyond the present suitability standard, then robo-advisors should be eliminated. Instead, this business model should be replaced with hybrid robo-advisors which combine the low-cost algorithms employed by pure robo-advisors with the human element to monitor and provide overall portfolio analysis. Support for such an initiative need not look further than within the industry. Research suggests that this hybrid model will manage \$3.7 trillion in assets by 2020 and grow to \$16.3 trillion by 2025.<sup>147</sup> These numbers represent 10% of global investable assets.<sup>148</sup> Pure robo-advisors on the other hand will manage only 1.6% of worldwide assets by 2025.<sup>149</sup> While this figure is small, regulation should be addressed now because these firms still have an impact on investor protection and systemic risk. One of the leading firms, Betterment, has added human advisors to a new premium offering to more high net worth investors who may need “more hand holding.”<sup>150</sup> Betterment’s move to include this hybrid model shows that the consumer is actively searching for a human element in addition to low cost digital advisory services. Betterment Plus includes one consultation per year, will charge 0.40% on assets under management, and will require a minimum balance of \$100,000.<sup>151</sup> Betterment Premium includes access to investment professionals, will charge 0.50% on assets under management, and will require a minimum balance of \$250,000.<sup>152</sup> Betterment’s original investing plan, Betterment Digital, charges only 0.25% on assets under management and there is no minimum investment.<sup>153</sup> This growing selection of services is indicative of two market trends: (1) human advisers are able to supplement these

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<sup>147</sup> Barbara A. Friedberg, *Growth of Hybrid Robo-Advisors to Outpace Pure Robos*, INVESTOPEDIA (February 23, 2017), <http://www.investopedia.com/articles/financial-advisor/100616/growth-hybrid-roboadvisors-outpace-pure-robos.asp>.

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> Ainsley Harris, *Betterment Adds Human Advisors, Casting Doubt On Pure-Play “Robo” Investment Models*, FAST COMPANY (January 31, 2017), <https://www.fastcompany.com/3067717/betterment-adds-human-advisors-casting-doubt-on-pure-play-robo-investment-models>.

<sup>151</sup> Rob Berger, *Betterment Adds Human Touch and Raises Its Fees*, FORBES (January 31, 2017), <https://www.forbes.com/sites/robertberger/2017/01/31/betterment-adds-human-touch-and-raises-its-fees/#49be4575624d>.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

investment offerings in ways that algorithms cannot mimic, and (2) those seeking to invest are willing to take on the higher costs in order to have a human element involved in their investing.

Betterment's attempt to broaden its investment choices highlights two main concerns for the average investor using Betterment Digital or other pure robo-advisory services. First, the consultation services offered in these more expensive opportunities is evidence that human analysis is key to more substantial returns. Second, even Jon Stein, Betterment's founder and CEO, admits that he believes few Betterment users will upgrade to these hybrid models.<sup>154</sup> Thus, the primary investor of these robo-advisors and the primary target of robo-advisor marketing efforts are still left less protected under the suitability standard. The suitability standard, coupled with the regular investor's inability to consult with a human advisor for portfolio guidance means that a large majority of robo-advisor clients are not protected in such a manner that robo-advisor firms claim to be developing in order to cater to those needs. This sense of false security is negative for both investors and the market.

IX. THERE ARE NUMEROUS POLICY CONCERNS THAT RELATE TO A  
ROBO-ADVISOR'S ABILITY TO OFFER INEXPENSIVE INVESTMENT  
SERVICES TO OFTEN UNDERPRIVILEGED AND DIVERSE  
DEMOGRAPHIC GROUPS THAT ARE UNDEREXPOSED TO THE  
FINANCIAL MARKETS.

Robo-advisors have been heralded as an acceptable alternative for lower income investors as these firms charge lower management fees and have lower investment minimums. Certain institutions such as Betterment have no investment minimum. This strategy has proved so successful that Betterment passed the \$5 billion-dollar threshold for assets under management.<sup>155</sup> From a policy perspective, far too many Americans get no financial advice, especially those minority groups already suffering from income inequality.<sup>156</sup> There should be a proper middle ground. Robo-advisors like Betterment and Wealthfront believe "that everyone deserves fiduciary advice."<sup>157</sup> Wealthfront has come out strongly that every industry actor should be held to the full fiduciary

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<sup>154</sup> Ainsley Harris, *Betterment Adds Human Advisors, Casting Doubt On Pure-Play "Robo" Investment Models*, FAST COMPANY (Jan. 31, 2017).

<sup>155</sup> Julie Verhage, *Robo-Adviser Betterment Hits the \$5 Billion Mark*, BLOOMBERG (July 14, 2016).

<sup>156</sup> Andrew Biggs, *Are Half of American Approaching Retirement with No Savings*, FORBES (Jan. 18, 2017), <https://www.forbes.com/sites/andrewbiggs/2017/01/18/are-half-of-americans-approaching-retirement-with-no-savings/#15cdfa6540e5>.

<sup>157</sup> Adam Nash, *The Fight for a Fiduciary Standard*, WEALTHFRONT BLOG, Apr. 5, 2015.

standard of service.<sup>158</sup> This is good for firms like Wealthfront due to the competitive advantage of their low-cost business compared to the larger Wall Street firms that incur higher costs to implement systems necessary to satisfy fiduciary obligations.<sup>159</sup> This question has become a battle between these fintech startup firms against the established Wall Street behemoths who continue to lose market share to the fintech innovators. Wealthfront issued a public letter to the Department of Labor in 2015 calling for a uniform application of the fiduciary standard across the industry<sup>160</sup>, this article has shown there are still large differences in the standards applied to firms like Wealthfront as opposed to other broker-dealers.

Not only are these robo-advisors disrupting the way of investing but they are altering the demographics of investors.<sup>161</sup> These robo-advisors can be accessed online, and often through mobile devices, which means that non-typical investors in rural areas, minorities, and youthful investors now have access to investing and can better plan for retirement.<sup>162</sup> In addition, since these types of investments are more hands off and do not require as much active investment management, the costs are lower to the providers. Firms like Wealthfront do not believe this should mean that these asset managers cast away their traditional fiduciary duties to those with whom they are trusting their investments.<sup>163</sup> Certain industry professionals have stated that placing a fiduciary duty on these robo-advisors will mean a dramatic change in business procedures to satisfy the standards necessary to serve as fiduciary – the costs of which will be offset by higher fees to the investor.<sup>164</sup> Such hesitation to impose these high standards could in fact drive these types of services away from the very segment of the population who stand to benefit most from such an investment strategy.<sup>165</sup> In order to comply with this higher standard, firms and individual advisers will face higher compliance fees.<sup>166</sup>

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<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

<sup>161</sup> Zina Kumok, *3 Reasons Millennials Should Consider a Robo-Advisor*, U.S. NEWS (April 7, 2016), <http://money.usnews.com/money/personal-finance/articles/2016-04-07/3-reasons-millennials-should-consider-a-robot-advisor>.

<sup>162</sup> *Id.*

<sup>163</sup> Adam Nash, *The Fight for a Fiduciary Standard*, WEALTHFRONT BLOG, Apr. 5, 2015.

<sup>164</sup> Michael Kitces, *How DoL Fiduciary Will Disrupt The Blackrock And Schwab Robo-Advisors*, KITCES (May 12, 2016, 11:53 AM) <https://www.kitces.com/blog/schwab-intelligent-portfolio-and-blackrock-futureadvisor-under-dol-level-fee-fiduciary-rules>.

<sup>165</sup> *Id.*

<sup>166</sup> *DOL Fiduciary Rule Explained as of August 31, 2017*, INVESTOPEDIA (August 31, 2017, 10:00 AM), <http://www.investopedia.com/updates/dol-fiduciary-rule>.

Social Security continues to face uncertainties with some analysts predicting that the fund will be insolvent by 2034.<sup>167</sup> This fund, which most Americans depend on for their retirement savings, continues down an uncertain road.<sup>168</sup> Both political parties hold the system hostage for political theatre and fewer American companies offer pensions which means that more and more Americans face an uncertain retirement. Therefore, Congress and regulatory organizations should be incentivized to promote the use of robo-advisors by clearly establishing the fiduciary protections and legal remedies available to investors using these services. If Congress is unable to efficiently transfer the ERISA protections provided to retirement accounts to robo-advisors, then hybrid robo-advisors should be promoted. These hybrid models allow more Americans to take control of their own investments. The use of these robo-advisors also means that more money that may have stayed on the “sideline” is invested into the market which provides for a healthy and robust market economy.<sup>169</sup>

Our legislative and judicial systems should never stifle innovation but should instead promote the innovation of products and business methods that propel the world forward. By refusing to adopt a clear understanding of the fiduciary duty created between robo-advisors and their customers, the industry rests at a standstill. Industry actors and investors alike would benefit from clear direction as to whether this new investment strategy will have a place in the future. Firms like Betterment are still not profitable and rely on outside capital to continue their ventures, usually with investments from competitors like Vanguard and Fidelity.<sup>170</sup> Investments made in these types of robo-advisors may turn out to be poor investments if regulation or free market forces drive out robo-advisors. Markets react positively to stability in financial regulation as dramatic changes in regulation cut directly into profits as compliance costs increase. A clear, industry-wide declaration of the fiduciary standard would mean that market participants could move forward in the market.

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<sup>167</sup> Jeanne Sahadi, *Social Security Trust Fund Projected to Run Dry By 2034*, CNN MONEY, June 22, 2016, (<http://money.cnn.com/2016/06/22/pf/social-security-medicare/>) See also, <https://www.forbes.com/sites/andrewbiggs/2017/01/18/are-half-of-americans-approaching-retirement-with-no-savings/#15cdfa6540e5>.

<sup>168</sup> *Id.*

<sup>169</sup> Hillary Kramer, *Are Robo-Advisers the Future of Investing*, KRAMER CAPITAL RESEARCH (Nov. 17, 2015) <http://www.kramercapitalresearch.com/2015/11/are-robo-advisers-the-future-of-investing>.

<sup>170</sup> Julie Verhage, *Robo-Adviser Betterment Sees \$700 Million Valuation After New Round of Funding*, BLOOMBERG, (Mar. 29, 2016) <https://www.bloomberg.com/news/articles/2016-03-29/robo-adviser-betterment-sees-700-million-valuation-after-new-round-of-funding>.



X. ROBO-ADVISORS REPRESENT THE PINNACLE OF INNOVATION  
WITHIN THE FINANCIAL INDUSTRY AND THEIR CONTRIBUTION  
TOWARDS THE GLOBAL ECONOMY SHOULD BE REWARDED, BUT  
PROPERLY REGULATED IN A MANNER WHICH WILL PROTECT  
INVESTORS AND ELIMINATE SUBSTANTIAL SYSTEMIC RISK.

Robo-advisors The size and complexity of the financial industry along with its fierce competitiveness has always meant that regulatory and judiciary controls have lagged behind the devices and business methods used by industry players to beat their competition and provide a higher quality of service to their customers. Often, regulatory bodies have been unable to process new technologies or practices quickly enough to ensure that investors and the overall economy are properly protected. The present situation involving robo-advisors highlights technological innovation and the inability to properly guide the industry. FINRA, the SEC, the DOL, and the judiciary need only to look to their treatment of human advisors and their fiduciary duty to collaborate on a common understanding of the fiduciary obligations. Doing so would begin untangling the competing and often counteractive regulations, laws, policy papers, and other forms of guidance that have been given to attempt to answer the robo-advisor question. Innovation has never been allowed to sever the common law and statutory obligations that exist between advisor and investor – it should not do so now.

The inability to correctly define the relationship between investor and robo-advisor stands to complicate the existing global financial system with each passing day as more investors pursue economic advancement through these low-cost, automated options. Each day without additional regulation and legal guidance means further opportunity for dramatic losses and a lack of remedy for investors. As discussed in this note, the present inadequacies of current laws and the inability of financial regulatory bodies to use their expertise to guide both the legislative and judicial branches of our government towards a more equitable investment industry for all participants. The inability to define the fiduciary structure of the robo-advisor may be remedied by forcing robo-advisors out of the market and replacing them with hybrid robo-advisors which combine the positive elements of artificial intelligence and human portfolio analysis.

This note is unique because those following the rise of robo-advisors have not sought to compile the conflicting regulations, press releases, and guidance that the numerous agencies have distributed. No one has attempted to make sense of why a robo-advisor may comply with the elements necessary to invoke the fiduciary standard of care, but still the

final answer remains severed from existing case law involving human advisers and SEC declarations. This note has put forth several solutions to an extremely complicated and quickly evolving question. Those solutions range from free market initiatives, to allowing states to serve as the laboratories of democracy in regulating these types of firms, to heavy-handed federal government intervention to essentially push out pure robo-advisors in favor of hybrid models, to having Congress settle the question of fiduciary status once and for all by eliminating the differences between the various SEC, FINRA, and DOL interpretations through legislation. The author admits that none of these solutions are easy, but they represent solutions which have been used in the past to address market areas that have posed threats to investor protection and that have heightened systemic risk.

The regulatory questions and political issues involving robo-advisors have begun to take more precedent within the legal industry as retail investors and institutional investors have begun to invest more heavily in these areas. Those steps have fallen short in providing proper investor protection and creating appropriate safeguards against systemic risk. Several steps were proposed in this note to move forward as technology moves forward in a way that will not stifle innovation. If implemented, these steps can provide the proper protections for investors, investment platform developers, and financial institutions alike to take on the challenges of investing in the twenty-first century.