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FINRA Digital Advice and the Robo-World

BY HARRIET BRITT

You may have either done business with a robo, or worked for one of the robo-advisors that have become household names. When the CBS Evening News financial reporter refers to Betterment and Wealthfront in connection with the DOL Fiduciary Rule, robo-advisors almost become mainstream.

As it is generally referred to, the robo-advisor is developed to reach the "millennial" investor – individuals who want to receive as many services as possible via the internet. In fact, the services must be accessible via mobile device. Much of the target client base doesn't even have a traditional bank account, and investing with Bank of America/Merrill Lynch or even Charles Schwab is not in their game plan. Robo-advisors – and their affiliated broker-dealers – attract young investors and the young adult children of the clients of the traditional broker-dealers. Traditional broker-dealers are also offering digital investment services, in a variety of flavors. And let's be honest – these models may also lower costs for the traditional broker-dealer or advisory firm.

With some firms, investors may open an account, deposit and authorize the investment of the funds in a simple, do it and forget method on their smart phones. Other firms provide tools that offer a more detailed question and answer process that leads to a more tailored portfolio. These tools may be used by the financial professional and investor together, or operated only by the investor. An investor may search for and find firms offering portfolios that are limited to a handful of ETFs with differing concentrations depending on objectives and risk, or portfolios that try to mirror various indexes using stocks. Obviously, the size of the investment wallet does make a difference about the type of platform that investors may elect to use.

FINRA published its "Report on Digital Investment Advice" in March, and indicated that the report is focused on the use of what it calls "digital investment advice tools" by the entire investment community. The rules cited are specific to the broker-dealer segment. The report also appears to focus on the larger, traditional firm, but not the newer start-ups. Digital investment advice tools are defined in the report as a platform/service that supports one or more of the following: customer profiling, asset allocation, portfolio selection, trade execution, portfolio rebalancing, tax-loss harvesting and portfolio analysis. FINRA also divides these tools into two groups: digital advice tools used by financial professionals, and tools used by clients. Generally, digital advice tools used by clients include all of these functions except portfolio analysis. The robo-advisors that have been recently formed generally provide all but tax-loss harvesting and portfolio analysis.

FINRA's report seems to focus on the adoption by a firm of a third party software solution. These have been in use for a number of years, especially by financial planners either in a broker-dealer or investment advisor setting. The report does not specifically address broker-dealers that developed their own software solution nor does it discuss the strong trend that has firms working to deliver services entirely though a mobile device.

The issues identified and observations made by FINRA in the report are very fair – these are issues and concerns for both broker-dealers and investment advisors to address.

The Report covers the following topics, among others:

- Governance and Supervision
- Investor Profiling
- Rebalancing
- Training

Governance and Supervision

Testing Algos and Tools

FINRA strongly advocates testing of algorithms used by digital investment advice tools, record-keeping of the testing, and surveillance to verify that the tool continues to work as implemented. These recommendations are in keeping with FINRA's existing requirements for any technology, especially any involving algorithmic portfolio or trading model. The Report advocates process that involves

- An initial review of the tool, including,
  - its methodology,
  - data inputs and
  - output testing
- Ongoing reviews assessing
  - the models used as market/economic conditions change
  - testing the output of the tool regularly to ensure expected performance
  - identifying the supervisors of the tool

Broker-dealers that either develop their own digital tool or adopt a third party system should essentially plan to select, test, operate, supervise and conduct surveillance as if the tool was a trading algo

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used on its institutional desk. Not discussed, but also important to consider, are the additional costs related to supervision of such a system in either their internal development costs or the costs to adopt a third party vendor's tool. Firms need to remember that costs include more than the IT development or third party vendor subscription costs of a tool. There will be costs related to the time to identify and onboard the tool, salaries of supervisors, IT development staff and costs related to information/cyber security.

Conflicts – Proprietary Products and Fees

The FINRA report also addresses the issue of conflicts related to both the use of proprietary products and of fees in general. Some firms take the position of excluding any affiliated investment products in the security selection, but clearly additional disclosures would be required if affiliated products are used. The other major issue for firms to resolve is that of fees and expenses. Since many of the investment selections are mutual funds and/or ETFs, identifying the conflicts related to trailing fees, trading rebates or other issues is very critical. Once identified, firms must mitigate those issues or otherwise resolve potential conflicts of interest.

Investor Profiles

The report also offers insight into the regulatory view of establishing investment objectives and especially risk tolerance – the investor profile - only through a questionnaire. There are clear concerns with this practice, especially when contradictory or incomplete responses are provided. While we all agree that a live, interactive dialog is always preferred, in a true "robo-advisor" model, the entire model is built on the idea that there is no human to human contact. FINRA did not really leave a door open to any other form of developing the investor profile. This may be very problematic for broker-dealers or dual registrant firms adopting this model.

One other issue on the topic of investor profiles: The Department of Labor has finally released the regulation defining "fiduciary". We are all digesting the rule and the interpretations from appropriate counsel. It does appear as if the DOL accepts the concept of an electronic form of profile, without any interaction with a financial professional, as an appropriate part of rendering investment advice in a fiduciary setting. If that is actually the case, it will lead to more discussion. While robo forms of investment activities are not generally offered to IRA or other forms of ERISA plans, that may not always be the case. Firms electing to offer robo or forms of digital investment advice tools should consider the apparently differing views of the regulators.

Rebalancing

FINRA's report strongly advocates for rebalancing an investment portfolio over time, in order to maintain a stated target asset allocation plan. The types of financial planning systems that both advisors and broker-dealers have traditionally used allow for rebalancing. However, there are robo-advisors that utilize ETFs or mutual funds to build a portfolio that do not rebalance.

Establishing the practices, or procedures, for rebalancing requires several actions which may not be readily apparent. They include:

1. explicit customer agreement to automatic rebalancing
2. disclosing potential cost and tax implications
3. defining the parameters, such as drift and the frequency of rebalancing
4. policies and procedures for major market moves
5. methods for minimizing tax impact

There are other considerations. The triggers for rebalancing should be determined and disclosed to clients, and then surveillance must be conducted to verify that the tool performs as designed. Cash flows need to be considered, and then actions determined based on funds added or withdrawn.

Thoughts for the New Robo

For the Compliance Officer, what are our concerns with a robo-advisor? First, many of the true robo-advisors are started by innovators who have not worked in the traditional financial services world. It is possible that the capital raised to fund the start-up business may not have been raised in accordance with SEC regulation. The actual structure of the raise or the number or quality of the investors may pose a problem during a FINRA NMA, should the robo-advisor elect to start an affiliate broker-dealer.

While many of the traditional physical needs of an advisor or brokerage business "go away" in a web or mobile based business, the regulatory requirements do not, and many innovators are unaware of the requirements. It is important that the programs and applications that solicit customers, maintain customer suitability and account information, transmit orders, reconcile purchases and sales, render statements/confirms and provide performance reports are all tested thoroughly. Records of testing must be maintained. The need for testing of all processes and the retention of those records is significant.

Many robo-firms choose to develop their own systems and processes, rather than utilize existing vendors. Some of the robo-advisors have elected to create an affiliate broker-dealer that is an omnibus clearing firm, which is layered on one of the long established clearing firms. It is important that developers of the technology of the "new omnibus" firm have the input of experienced operations and compliance officers in order to make the new processes connect to the back-end clearing firm. Operations and compliance must ensure that appropriate reports related to customer account activities, supervision and surveillance are developed. It is far too easy for developers to believe that their processes and systems alleviate the need for the traditional type of reconciliation that has occurred throughout the industry. While it may be possible to streamline much of the process, at the end of the day, however, it still must be possible to identify a transaction that is specific to an individual account, and follow it through the process.

Businesses that are conducted on mobile apps and that are, from the customer perspective, entirely web based may streamline the front end of the investment process. However, behind that streamlined customer onboarding and investment process, care must be taken to ensure that the operational processes and reports that are needed to exert proper controls and conduct supervision and surveillance are in place. Business creators and technology developers must work closely with compliance and operations in order to ensure that the business is not put at risk due to inadequate operational controls or compliance supervision and surveillance.

Finally, a thought about the actual investment advice and portfolio construction. A sampling of the websites of a number of these new innovators will often present an investment philosophy that seems very simple, many featuring noted professors of economics or finance discussing asset diversification. Many, especially the models that are tailored to attract small investors, feature portfolios made up of a small number of ETFs used to create a diversified portfolio. Does this develop long term, "sticky" client relationships? Is the business going to have to develop a new offering in order to retain this client and these assets over the investing life of the client? If so, will this model provide that flexibility? These are not questions that are generally part of the compliance officer's responsibilities. However, unless we help the business change in a way that serves the immediate and long term needs of the client, that business is unlikely to survive in the long term. ★