Voices How Robos Fall Short of Fiduciary Law

By Melanie L. Fein October 07, 2015, 6:52 a.m. EDT 4 Min Read

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Robo advisors are new in the financial marketplace. They serve investors who are comfortable investing through the Internet but still feel the need for investment guidance. Robo advisors design online investment programs for their clients using algorithms and asset allocation models — and even manage client assets —without any human interaction with the client.

The Department of Labor has touted robo advisors or as a source of low-cost personal investment services for retirement investors that pose minimal conflicts of interest. But do they live up to the department's acclaim? A review of user agreements for the leading robo advisors suggests they do not.

Robo advisors do not provide personalized investment advice. Their advice is generated programmatically by computers based on client responses to online questionnaires, but the questionnaires do not elicit all relevant information and may ignore key facts, such as a user's contribution and withdrawal schedule, dependents, other sources of wealth, monthly expenses, tax situation, and anticipated expenditures (such as college tuition). Robo advisor agreements provide that the *client*, not the robo advisor, is responsible for ensuring that the robo advisor's recommendations are in the client's best interest. Clients are left on their own to assess whether recommended investments are appropriate for their needs.

ROBO CONFLICTS

The claim that robo advisors are "free" or "low-cost" is misleading. Robo advisors do not offer their services without compensation. In addition to any fees from the customer, they receive fees and revenue sharing from affiliated and non-affiliated broker-dealers, custodians, and clearing firms that handle the customer's securities transactions, the cost of which is embedded in the price of products sold to clients. They do not cost less than many mutual funds, particularly those that offer "C" shares.

The claim that robo advisors "minimize conflicts of interest" also is misleading. Robo advisors are affected with myriad conflicts of interest. They engage in self-dealing transactions, invest client assets in proprietary investment products, receive payments for order flow, use affiliated banks for cash sweeps, and use affiliated brokers, custodians, clearing firms or other firms. Clients must consent to these conflicts as a condition of use.

Robo advisors do not adhere to the high standard of care under fiduciary investment law, particularly the Uniform Prudent Investor Act. They do not evaluate an investor's total financial circumstances in light of all relevant factors and do not reasonably verify all facts relevant to a client as required by the Act.

The Act requires a fiduciary to make investment decisions “not in isolation” but in the context of the portfolio “as a whole” and as a part of an overall investment strategy having risk and return objectives suited to the trust. Robo advisors do just the opposite — they make isolated investment decisions that do not necessarily consider the investor’s total portfolio. Robo advisors also do not monitor client investments for suitability on an ongoing basis.

INCORRECT ASSUMPTIONS

Robo advisors offer their services to IRA accounts but the leading robo advisors specifically exclude 401(k) and other accounts subject to the Employee Retirement Income Security Act. Robo advisor agreements seek to limit the adviser’s fiduciary duty and would not meet the Labor Department’s proposed “best interest” contract exemption that requires investment advisers to acknowledge their fiduciary status, commit to give only advice that is in the customer’s best interest, and agree to receive no more than reasonable compensation.

In May the Securities and Exchange Commission and Financial Industry Regulatory Authority issued aninvestor alertcautioning that robo advisors may give advice based on incorrect assumptions, incomplete information, or circumstances not relevant to the user, and may use questionnaires that are ambiguous, misleading and programmed to generate preset options. The regulators warned that robo advisors may use economic assumptions that will not react to market shifts, and may be programmed to consider only limited investment options — such as only investments of an affiliate.

These agencies also noted that robo advisors do not offer the benefits of human judgment and oversight or access to value-added personalized service, and cautioned users to be prepared to make their own investment decisions.

These warnings by investor protection agencies appear justified whereas the Labor Department’s endorsement of robo advisors seems curious and misplaced.

Melanie L. Fein is an attorney who advises clients on matters of banking, securities, and trust law and has served on the adjunct faculty of Yale Law School. This article is adapted from her paper, "Robo-Advisors: A Closer Look," which was commissioned by Federated Investors.