



November 9, 2021

Observations from Examinations of Advisers that Provide Electronic Investment Advice*

I. Introduction

Advisers have been providing automated digital investment advisory services to retirement plan participants and retail investors for more than two decades; however, the Division of Examinations (“Division”) has recently observed a significant increase in the number of investment advisers choosing to provide automated digital investment advisory services to their clients. These advisers either exclusively provide online services or supplement their traditional investment advisory services by using proprietary software, third party software, or a combination thereof. Millions of investors, individually and through their employer-sponsored retirement plans, now entrust their savings to advisers that provide their investment advisory services online, via mobile applications, or both (also known as robo-advisers).

The use of automated digital investment advisory services (“robo-advisory services”) can have important investor protection implications. On the one hand, automation can offer significant benefits, including providing convenient, accessible, and lower cost services for investors and enhancing operational efficiency for advisers. When robo-advisers fail to comply with their regulatory obligations, however, investors may experience poor outcomes. If, for example, a robo-adviser’s client survey process does not appropriately capture a client’s risk tolerance, it could result in advice to invest in securities that are not aligned with the client’s best interest. Similarly, if a robo-adviser is programmed to act on conflicts of interest that raise the costs or decrease the quality of the services provided, the client may be harmed as a result of the adviser’s putting its own interests ahead of its clients.

The Division conducted a series of examinations to assess the practices of advisers providing robo-advisory services.¹ Under its Electronic Investment Advice Initiative (the “Initiative” or “eIA

* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the “Division”). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the “SEC” or the “Commission”). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

¹ The Division previously focused on examining advisers that provide advisory services through the Internet, including prior to the adoption of the exemption from the prohibition on Commission registration for Internet advisers pursuant to Advisers Act Rule 203A-2(e) (the “Internet adviser exemption”) (See [Exemption for Certain Investment Advisers Operating Through the Internet](#), Advisers Act Rel. No. 2091 (Dec. 12, 2002) (“[IA-2091](#)”). There is no standard industry nomenclature to describe advisers that provide electronic advisory services. The term “Internet adviser” herein refers to robo-advisers that registered with the Commission in reliance on this exemption. In addition, the Division’s observations from multiple robo-adviser examinations were considered when drafting the guidance published by the SEC’s Division of Investment Management (“Investment Management”) on robo-advisers and informed the development of the Initiative’s scope (See Investment Management, [Guidance Update: Robo-Advisers](#) (Feb. 23, 2017)

Initiative”), the staff sought to obtain a better understanding of how robo-advisers were operating their firms, providing advisory services to retail and institutional clients, and satisfying their regulatory obligations under the Investment Advisers Act of 1940 (“Advisers Act”). In particular, the staff focused on how robo-advisers were upholding their fiduciary duty to: (1) provide clear and adequate disclosure regarding the nature of the advisers’ services and performance history; and (2) act in their clients’ best interests.

The purpose of this Risk Alert is to raise awareness of certain compliance issues the Division observed while conducting examinations of advisers providing, or claiming to provide, robo-advisory services, including advisers that operate, recommend, or sponsor discretionary investment advisory programs.²

In order to gain a broad understanding of the industry, the Division selected advisers to examine under the eIA Initiative that had different business models, client types, investment practices, assets under management, and bases for SEC-registration. The examined advisers: (1) provided robo-advisory services to employer-sponsored retirement plans (“retirement plans”) and/or retail investors, including retirement plan participants; (2) sold, licensed, or otherwise granted interactive, digital platform access to third parties, such as advisers, broker-dealers, and banks; and/or (3) provided advisory or sub-advisory services to an interactive, digital investment platform.

II. Examination Focus and Relevant Regulations

A. Provision of Electronic Investment Advice

Examinations focused on the advisers’ robo-advisory practices in several areas. In addition to a broader review of these advisers’ adherence to their fiduciary duty,³ the staff specifically examined the advisers’:

- *Compliance programs* to assess whether compliance policies and procedures, particularly those related to the provision of robo-advisory services, were adopted, implemented, reasonably designed, and tested at least annually.⁴

(“[Guidance](#)”) for additional information). The eIA Initiative included Internet advisers as well as other advisers that provided electronic investment advice either exclusively or in addition to traditional investment advisory services (together, “advisers”).

² Discretionary investment advisory programs may raise implications under the Investment Company Act of 1940 (“Company Act”). See [Final Rule: Status of Investment Advisory Programs under the Investment Company Act of 1940 \(“Adopting Release”\)](#), Company Act Release No. 22579 (Mar. 24, 1997) (although investment advisory programs are typically sponsored by investment advisers, Rule 3a-4 is available to any investment advisory program, regardless of whether the sponsor, for example, is excepted from the definition of investment adviser, such as a bank, or is required or permitted to be registered under the Advisers Act). For this Risk Alert, the use of “operate” or “operating” includes advisers that operate a discretionary investment advisory program, recommend such a program, or both.

³ See, e.g., [Commission Interpretation Regarding Standard of Conduct for Investment Advisers](#), Advisers Act Rel. No. 5248 (Jun. 5, 2019) (“[Fiduciary Release](#)”) (“[T]he duty of care requires an investment adviser to provide investment advice in the best interest of its client, based on the client’s objectives... The duty of loyalty requires that an adviser not subordinate its clients’ interests to its own. In other words, an... adviser must not place its own interest ahead of its client’s interests.”). The Commission has recently brought an action against a robo-adviser that did not uphold its duties of loyalty and care. See [In re SoFi Wealth, LLC](#), Advisers Act Rel. No. 5826 (Aug. 19, 2021) (settled) (alleging that the adviser harmed clients by investing in certain affiliated securities and lacked written policies and procedures designed to prevent such harm).

⁴ Advisers Act Rule 206(4)-7 (“the Compliance Rule”) requires SEC-registered advisers to adopt, implement, and annually review written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and rules thereunder by advisers and their supervised persons. See also [Compliance Programs of Investment Companies and Investment](#)

- *Formulation of investment advice* to evaluate whether advisers gathered sufficient information from clients to form a reasonable belief that clients were receiving investment advice that was in their best interest based on each client’s financial situation and investment objectives.⁵ Where applicable, the staff also reviewed conflicts of interest disclosures and “customization” representations for adequacy and accuracy.⁶
- *Marketing and performance advertising practices* for compliance with the “Advertising Rule.”⁷ Also, if relevant, the staff reviewed whether the advertised securities selection and portfolio management techniques were used when managing client accounts.
- *Data protection practices* to understand the firms’ policies and procedures regarding client data protection, including cybersecurity practices.⁸
- *Registration information* to determine whether the advisers were eligible for SEC registration as investment advisers.

B. Use of Discretionary Investment Advisory Programs

Advisers that provide electronic investment advice may also sponsor or operate investment advisory programs, including for example, wrap fee programs and asset allocation programs that allocate client assets among mutual funds or exchange-traded funds. These programs are designed to provide the same or substantially similar professional portfolio management services to a large number of individual clients (“retail clients”) and are commonly used to manage retail clients’

[Advisers](#), Advisers Act Rel. No. 2204 (Dec. 17, 2003) (“[IA-2204](#)”) (“Where appropriate, advisers’ policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns.”). In the context of this Initiative, staff reviewed advisers’ practices, policies, and procedures addressing, among other things, advisers’ fiduciary duty to: (1) act in their clients’ best interest; (2) not place their interests ahead of their clients’ interests; and (3) make adequate and accurate disclosures.

⁵ See Advisers Act Section 206 (anti-fraud provision that imposes a fiduciary duty on advisers). See also supra [Fiduciary Release](#) at note 3 (“[I]n order to avoid liability under this antifraud provision, an investment adviser should have sufficient information about the prospective client and its objectives to form a reasonable basis for advice before providing any advice about these matters.”).

⁶ See supra [Guidance](#) at note 1 (information must be presented in a manner that clients are likely to read, if in writing, and understand).

⁷ Advisers Act Rule 206(4)-1 (“Advertising Rule”) prohibits any adviser that is registered or required to be registered under the Advisers Act from, among other things, using any advertisement that contains any untrue statement of material fact or that is otherwise false or misleading. The Commission recently adopted amendments to the Advertisements Rule, creating a merged rule (the “Marketing Rule”) that will replace the existing Advertising Rule and Rule 206(4)-3 (addresses cash solicitations). The Marketing Rule became effective on May 4, 2021, and has a compliance date of November 4, 2022. The staff anticipates that some advisers may seek to comply with the new marketing rule in advance of the compliance date. In conjunction with these amendments, the Commission adopted amendments to Form ADV, to provide the Commission with additional information about advisers’ marketing practices, and Rule 204-2 (requires advisers to make and keep certain books and records). See [Investment Adviser Marketing](#), Advisers Act Rel. No. 5653 (Dec. 22, 2020) (“[IA-5653](#)”).

⁸ See [Privacy of Consumer Financial Information \(Regulation S-P\)](#), Advisers Act Rel. No. 1883 (Jun. 22, 2000) (adopting rules implementing the privacy provisions of Subtitle A of Title V of the Gramm-Leach-Bliley Act with respect to financial institutions regulated by the SEC) (“[Regulation S-P Release](#)”) and [Identity Theft Red Flags Rules](#), Advisers Act Rel. No. 3582 (Apr. 10, 2013) (“[Regulation S-ID Release](#)”) (adopting rules and guidelines to require certain regulated entities to establish programs to address risks of identity theft). See also Division (published as OCIE) [Report on Cybersecurity and Resiliency Observations](#) (Jan. 27, 2020).

individual accounts and retirement plans (*e.g.*, 401(k) plans) on a discretionary or nondiscretionary basis.

Certain discretionary investment advisory programs may meet the definition of an “investment company” under the Company Act.⁹ To address this concern, the Commission adopted Company Act Rule 3a-4 as a nonexclusive safe harbor.¹⁰ An investment adviser that sponsors or operates a discretionary investment advisory program should consider the program’s status under the Company Act. Furthermore, if the program intends to rely on the Rule 3a-4 safe harbor, then the program’s sponsor or operating adviser should consider whether the program is in compliance with the Rule’s conditions.¹¹

Where advisers recommended discretionary investment advisory programs, the staff reviewed whether such programs could be considered investment companies pursuant to the Company Act. More specifically, the staff inquired as to whether the advisers were aware of how these programs were organized and whether they were being operated in accordance with the nonexclusive safe harbor provided by Rule 3a-4.

III. Staff Observations

Nearly all of the examined advisers received a deficiency letter, with observations most often noted in the areas of: (1) compliance programs, including policies, procedures, and testing; (2) portfolio management, including, but not limited to, an adviser’s fiduciary obligation to provide advice that is in each client’s best interest; and (3) marketing/performance advertising, including misleading statements and missing or inadequate disclosure. The staff also observed, among other things,

⁹ The Commission has indicated that discretionary investment advisory programs that provide each client with individualized treatment and the ability to maintain indicia of ownership of the securities in their accounts are not investment companies. *See* [Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches: Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice](#), Advisers Act Rel. No. 5833 (Aug. 27, 2021). *See also* *supra* [Guidance](#) at note 1 (“[R]oboadvisers should consider whether the organization and operation of their programs raise any issues under the other federal securities laws... in particular Rule 3a-4 under the... Company Act”). Company Act Section 3(a)(1) defines the term investment company generally to include any “issuer” that is engaged primarily in the business of investing, reinvesting, or trading in securities. The definition of “issuer” includes any organized group of persons, whether or not incorporated, that issues or proposes to issue any security. For a detailed discussion of why a discretionary investment advisory program may meet the definition of investment company and may be deemed to be issuing securities, *see* [Status of Investment Advisory Programs under the Investment Company Act of 1940](#), Company Act Rel. No. 21260 (Jul. 27, 1995) (revised proposal of Rule 3a-4).

¹⁰ Rule 3a-4 only applies to discretionary investment advisory programs. *See* *supra* [Adopting Release](#) at note 2. (“A nondiscretionary program (*i.e.*, one in which the investor has the authority to accept or reject each recommendation to purchase or sell a security made by the portfolio manager, and exercises judgment with respect to such recommendations), generally will not meet the definition of investment company under the Investment Company Act or issue securities that are required to be registered under Section 5 of the Securities Act, regardless of whether the program is operated in accordance with the provisions of [R]ule 3a-4.”).

¹¹ *See* *supra* [Adopting Release](#) at note 2 (“Whether a program that operates outside of [R]ule 3a-4 is an investment company is a factual determination and depends on whether the program is an issuer of securities under the... Company Act and the Securities Act [of 1933]... [Rule 3a-4] is not intended... to create any presumption about a program that is not organized and operated in the manner contemplated by the [Rule]... Investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice, whether or not the advice is provided to clients through an investment advisory program.”). Rule 3a-4 is designed to address only the status of the program under the Company Act, not the obligations of any investment adviser under the Advisers Act. Accordingly, the steps required to meet the conditions to Rule 3a-4 may not satisfy an adviser’s obligations under the Advisers Act, including its fiduciary obligations to clients participating in an investment advisory program. *See* *supra* [Fiduciary Release](#) at note 3.

advisers that were relying on, but not acting in accordance with, the Internet adviser exemption and Company Act Rule 3a-4. Additional details regarding these observations are described below.

A. Electronic Investment Advice

- *Compliance programs.* Most advisers had inadequate compliance programs, typically as a result of either a lack of written policies and procedures or having ones that were insufficient for their operations, unimplemented, or untested.¹² Specifically, the staff observed advisers that did not:
 - Include elements in their policies and procedures specific to their use of an online platform and/or other digital tools for the provision of investment advice, such as assessing whether the advisers’: (1) algorithms were performing as intended; (2) asset allocation and/or rebalancing services were occurring as disclosed; and/or (3) data aggregation services did not impair the safety of clients’ assets as a result of the adviser having direct or indirect access to clients’ credentials (*e.g.*, pins and passwords).¹³ Additionally, advisers using business-to-business platforms (*e.g.*, “white-label platforms”) lacked policies and procedures that addressed the platform providers’ attention to these matters.
 - Undertake a sufficient review of their policies and procedures at least annually to determine their adequacy, the effectiveness of their implementation, or both. For example, in addition to not addressing the above practices, many advisers did not detect inadequacies or non-compliance with their marketing and performance advertising practices, and several failed to recognize that certain practices constituted custody, causing the adviser to violate the “Custody Rule.”¹⁴
 - Comply with the “Code of Ethics Rule.”¹⁵ For example, some advisers did not: (1) receive the required holdings and/or transaction reports from all access persons, typically because not all access persons had been identified; (2) obtain or maintain the required written acknowledgements from all supervised persons confirming receipt of the advisers’ codes; and/or (3) include in their codes all required provisions.

¹² See supra [IA-2204](#) at note 4 (“[A]n adviser should identify... factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks.”) See also supra [Guidance](#) at note 1 (“In developing its compliance program, a robo-adviser should be mindful of the unique aspects of its business model.”).

¹³ Some robo-advisers offer data aggregation services, through which a client can view all or a portion of their personal financial information on the adviser’s platform, such as outside bank and brokerage account information (*e.g.*, assets, debt, transaction activity).

¹⁴ Advisers Act Rule 206(4)-2 requires advisers that are registered or required to be registered under the Advisers Act, and that have custody of their clients’ funds or securities, to take several steps that are designed to safeguard those clients’ assets against theft, loss, misappropriation, or financial reverses of the adviser. Advisers have custody if they hold, directly or indirectly, client funds or securities, or have the authority to obtain possession of them. Examples of an adviser that has indirect access or the authority to obtain possession of clients’ funds or securities include a firm that has access to a client’s log-in credentials, has personnel who serve as a trustee to a firm client, or accepts client checks for investment that are made payable to the adviser.

¹⁵ Advisers Act Rule 204A-1 requires any adviser that is registered or required to be registered under the Advisers Act to establish, maintain and enforce a code of ethics that, at a minimum, includes certain provisions. Among these are provisions requiring the adviser’s access persons to: (1) report, and the adviser to review, their personal securities holdings and transactions; and (2) obtain pre-approval of certain investments from the adviser.

- *Portfolio management – oversight.*¹⁶ Many advisers were not testing the investment advice generated by their platforms to clients’ stated or platform-determined investment objectives or otherwise satisfying their duty of care. The staff observed advisers that:
 - Either lacked written policies and procedures that would allow the firms to develop a reasonable belief that the investment advice being provided to clients was in each client’s best interest based on the client’s objective, or adopted policies and procedures that were inadequate or not followed. A review of practices revealed that, while advisers commonly used questionnaires to collect client data, some firms relied on just a few data points to formulate investment advice. This raised the concern that the questions did not elicit sufficient information to allow the adviser to conclude that its initial and ongoing advice were suitable and appropriate for that client based on the client’s financial situation and investment objectives.¹⁷ In addition, many advisers did not periodically evaluate whether accounts were still being managed in accordance with the clients’ needs, such as by inquiring about any changes in their financial situation or investment objectives or having clients update or retake their questionnaires.¹⁸
 - Lacked written policies and procedures related to the operation and supervision of their automated platforms, increasing the risk of algorithms producing unintended and inconsistent results (*e.g.*, due to coding errors or coding insufficient to address unforeseen or unusual market conditions, such as those caused by geo-political events, substantial oil price movements, or interest rate changes). The staff observed, among other things, rebalancing errors and other trade errors at firms that lacked adequate oversight of their automated platforms.
 - Lacked written policies and procedures to prevent violations of legal requirements related to their duty to seek best execution. For example, some advisers did not conduct, or document the details of, a best execution review, while others did not appear to be aware of their best execution obligations at all.
- *Portfolio management – disclosures and conflicts.*¹⁹ The staff observed inaccurate or incomplete disclosures in many advisers’ Form ADV filings, including those related to conflicts

¹⁶ See supra [Fiduciary Release](#) at note 3 (stating that an adviser has a fiduciary duty to: (1) provide advice that is in the best interest of its client, which requires the adviser to make a reasonable inquiry into the client’s investment objectives and have a reasonable belief that the advice is in the client’s best interest; (2) seek best execution; and (3) provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship). See also supra [IA-2204](#) at note 4 (“The [Compliance Rule] requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.”).

¹⁷ See supra [Guidance](#) at note 1 (suggesting written policies and procedures a robo-adviser should consider adopting and implementing).

¹⁸ While the duty of care applies to all advisers, this observation generally was noted in the context of advisers operating investment advisory programs. See Section III.B. of this Risk Alert for additional information regarding sponsor and operator reliance on Rule 3a-4.

¹⁹ See supra [Fiduciary Release](#) at note 3 (“[t]o meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship... In addition, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser-consciously or unconsciously-to render advice which was not disinterested... In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent... Whether the disclosure is full and fair will depend upon, among other things, the nature of the client, the scope of the services, and the

of interest, advisory fees, investment practices, and ownership structure. In addition, more than half of the advisers included hedge clauses and/or other exculpatory language in their advisory agreements, “terms of use and conditions,” or other documents that may not align with their fiduciary duty.²⁰ Examples of omitted, inaccurate, or incomplete disclosures include instances where the advisers:

- Had purported third-parties recommend the advisers or provide execution services for advisory clients, but did not disclose that these parties were, in fact, affiliated with, and received compensation from, the advisers for the referrals, trades executed, or both.
- Omitted or had insufficient disclosure regarding how the adviser collects and uses information gathered from a client to generate a recommended portfolio, or how and when rebalancing occurs.²¹
- Omitted disclosures regarding processes for addressing profits and losses from trade errors.
- Provided inconsistent disclosures in various documents regarding advisory fee calculations.
- *Performance advertising and marketing.* More than one-half of the advisers had advertisement-related deficiencies.²² For example, the staff observed advisers that:
 - Made misleading or prohibited statements on their websites, such as: (1) using vague or unsubstantiated claims that could cause an untrue or misleading implication or inference to be drawn regarding the advisory services provided, investment options available, performance expectations, and costs incurred in investing (*e.g.*, a comparative analysis of adviser-offered versus other products and services); (2) misrepresenting SIPC protections by implying that client accounts would be protected from market declines;²³ (3) using press logos (*e.g.*, ABC, CNN, Forbes) without links or disclosure that would explain their relevance; and (4) referring to, or providing links to, positive third party commentary, without disclosing the relevance, any conflict of interest (*e.g.*, adviser compensation), or both.²⁴

material fact or conflict”). *See also* supra [IA-2204](#) at note 4 (“Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks.”).

²⁰ *Id* (stating the Commission’s view an adviser’s federal fiduciary duty may not be waived, though its application may be shaped by the agreed-upon scope of its advisory relationship, and, “[a] contract provision purporting to waive the adviser’s federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act...”).

²¹ *See* supra [Guidance](#) at note 1 (providing examples of information a robo-adviser should consider disclosing).

²² The Commission has brought actions against advisers that provided electronic investment advice and made false or misleading statements in their advertisements. *See, e.g., In re Hedgeable, Inc.*, Advisers Act Rel. No. 5087 (Dec. 21, 2018) (settled) (alleging that the adviser disseminated false and misleading marketing materials and performance data) and [In re Wealthfront, LLC](#), Advisers Act Rel. No. 5086 (Dec. 21, 2018) (“[Wealthfront](#)”) (settled) (alleging that the adviser falsely stated that it monitored client accounts to avoid making wash sale transactions).

²³ SIPC does not protect against investment losses. SIPC protects the custody function of a broker-dealer in the event the broker-dealer should fail. The limit of its protection is \$500,000, which includes a \$250,000 limit for cash.

²⁴ The Commission has brought actions against advisers that published advertisements that omitted material information, including robo-advisers. *See* supra [Wealthfront](#) at note 22 (adviser allegedly selectively republished certain social media posts that made

- Used materially misleading performance advertisements on their websites, including hypothetical performance results of an investment model applied retroactively without including disclosures that would make the presentation not misleading.²⁵
- Provided inadequate or insufficient disclosure about “human” services (*e.g.*, whether interactions with live individuals are available, mandatory, or restricted; whether they cost extra; or whether the client is assigned a financial professional).²⁶
- *Cybersecurity and protection of client information.* The staff observed that while all of the advisers had business continuity plans, and the vast majority had implemented written policies and procedures regarding identifying and recovering from cybersecurity events, fewer advisers had policies and procedures that addressed protecting the firm’s systems and responding to such events. The staff also observed advisers that were not in compliance with Regulation S-ID, Regulation S-P, or both because they: (1) had “covered accounts,” but lacked written policies and procedures designed to detect, prevent, and mitigate identity theft; (2) lacked or did not implement written policies and procedures addressing compliance with certain elements of Regulation S-P; and/or (3) did not deliver initial and/or annual privacy notices to all clients when required to do so.²⁷
- *Registration matters.* Nearly half of the advisers claiming reliance on the Internet adviser exemption were ineligible to rely on the exemption, and many were not otherwise eligible for SEC-registration. This has been a common finding for many years.²⁸ The staff observed advisers that: (1) did not have an interactive website; or (2) provided advisory personnel who could expand upon the investment advice provided by the adviser’s interactive website or otherwise provide investment advice to clients, such as financial planning.²⁹ The staff also

positive statements about its services, including ones made by individuals that it knew or should have known had an economic interest in promoting the adviser, without disclosing this conflict of interest).

- ²⁵ Newly adopted amendments to Rule 206(4)-1 generally limit an adviser’s use of hypothetical performance in advertisements provided to investors who have access to the resources to independently analyze such information and have the financial expertise to understand the risks and limitations of such performance presentations. *See supra* [IA-5653](#) at note 7.
- ²⁶ Advisers that provide electronic investment advice should disclose their use of algorithms and explain the degree of human involvement in the oversight and management of individual client accounts. *See supra* [Guidance](#) at note 1.
- ²⁷ *See supra* [Regulation S-P Release](#) and [Regulation S-ID Release](#) at note 8. *See also* Division (published as OCIE), [Risk Alert: Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P - Privacy Notices and Safeguard Policies](#) (Apr. 16, 2019) (highlighting the requirements of Regulation S-P and common areas of non-compliance observed by the staff).
- ²⁸ The Commission has cancelled the registration of advisers claiming reliance on the Internet adviser exemption for not satisfying the requisite conditions and also brought actions against them. *See, e.g.,* [Ajenifuja Investments, LLC; Order Cancelling Registration Pursuant to Section 203\(h\) of the Investment Advisers Act of 1940](#), Advisers Act Rel. No. 5110 (Feb. 12, 2019) (finding that adviser was registered as an Internet adviser for over three years and in that time period did not have an interactive website and did not demonstrate any other basis for registration eligibility). *See also* [In re RetireHub, Inc.](#), Advisers Act Rel. No. 3337 (Dec. 15, 2011) (settled) (alleging that the adviser was never an Internet adviser because, over the course of its registration, it did not provide investment advice exclusively through an interactive website, advised more clients than permitted through personal contact, or both).
- ²⁹ *See supra* [IA-2091](#) at note 1 and Advisers Act Rule 203A-2(e)(1)(i) (stating that the Internet adviser exemption is available only to an adviser that provides investment advice to clients *exclusively* through an “interactive website,” except as permitted by the *de minimis* exception). The *de minimis* exception permits an adviser relying on the rule to advise clients through means other than its interactive website, so long as the adviser had fewer than 15 of these non-Internet-based clients during the preceding 12 months. Thus, an adviser relying on this exemption for SEC registration generally cannot offer non-interactive website based services to its clients.

observed that some advisers' affiliates were operating as unregistered investment advisers because they were operationally integrated with the respective advisers. Such affiliates could not rely on the Internet adviser's registration as a basis for their own registration, as such reliance is prohibited under Advisers Act Rule 203A-2(e)(iii).³⁰

B. Discretionary Investment Advisory Programs

The staff reviewed the use of discretionary investment advisory programs ("programs") by more than two dozen advisers under the eIA Initiative. During these examinations, the staff assessed whether the programs provided each retail client with individualized treatment and enabled clients to maintain certain indicia of ownership of the securities in their accounts as required for reliance on Company Act Rule 3a-4. Where compliance with Rule 3a-4 was not specified or observed, the staff reviewed whether alternative measures that addressed their status under the Company Act were being employed. The staff also examined whether advisers had adequate disclosures about the programs that addressed implications under the Company Act and had adopted and implemented effective written policies and procedures to address the provisions of Rule 3a-4 or any alternative measures employed to address Company Act status questions.

- *Reliance on the nonexclusive safe harbor provisions of Rule 3a-4.* Advisers recommending programs commonly provided the same or similar investment advice on a discretionary basis to a large number of their advisory clients, frequently using asset allocation portfolios that they, an affiliate, or a third-party created. Often, these advisers:
 - Were unaware that the programs they sponsored or operated may be unregistered investment companies. Many had clients with similar investment objectives that received the exact same investment advice, were placed in the same model portfolio, and invested identically as other clients. Some advisers recognized these issues and claimed reliance on Rule 3a-4, but others neither specifically claimed reliance on Rule 3a-4 nor claimed to be employing any alternative measures.³¹
 - Claimed that programs they sponsored or operated were relying on Rule 3a-4, but the programs or adviser did not comply with all of the provisions of the safe harbor. Many advisers had compliance policies and procedures that were inadequate in addressing adherence with Rule 3a-4, were not implemented, or both. Advisers that sponsor or operate discretionary investment advisory programs that are relying on the safe harbor afforded under Rule 3a-4 should adopt compliance policies and procedures that are reasonably designed to validate that such programs are, in fact, consistent with the Rule's provisions.³²

³⁰ See [Investment Management No-Action Letter to Richard Ellis, Inc.](#) (Mar. 18, 1981) and [Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \\$150 Million in Assets Under Management, and Foreign Private Advisers](#), Advisers Act Rel. No. 3222 (Jun. 22, 2011) (discussing principles of adviser integration and applicability of Advisers Act Section 208(d)). See also [IA-2091](#) at note 1 (Internet advisers cannot rely on the Internet adviser exemption as their basis for registration with the Commission if another adviser in a control relationship with them relies on the Internet adviser's Internet adviser registration as the basis for its own registration under Advisers Act Rule 203A-2(b), the "related adviser" exemption).

³¹ See [Adopting Release](#) at note 2 (Rule 3a-4 does not create any presumption about a program that does not meet the rule's provisions).

³² See [Adopting Release](#) at note 2 ("Each person relying on [R]ule 3a-4 is responsible for demonstrating its compliance with the [R]ules' provisions... The Commission... strongly recommends that a sponsor of an advisory program seeking to rely on

- *Establishing client accounts.* To rely on Rule 3a-4, sponsors or another person designated by a sponsor (e.g., the adviser recommending the program) must obtain information from each client regarding the client’s financial situation and investment objectives and inquire as to whether the client wishes to impose any reasonable restrictions on the management of the client’s account. This information must be obtained at the opening of the account and updated periodically thereafter. Advisers observed not complying with these provisions:
 - Used questionnaires to gather information pertinent to providing individualized advice that included a very limited number of data points, potentially increasing the risk of not providing clients with individualized advice or acting in their clients’ best interests.³³
 - Did not allow clients to impose reasonable restrictions, or placed obstacles impeding their ability to do so. Many advisers engaged in practices that were inconsistent with this Rule 3a-4 requirement, which allows clients to designate particular securities or types of securities that should not be purchased or that should be sold if held. Some advisers expressly prohibited the imposition of any restrictions, while others appeared to impede clients from imposing reasonable restrictions. Examples include advisers that:
 - Required the selection of a different model portfolio if any restrictions were requested, established unduly restrictive requirements (e.g., investment thresholds that very few clients likely would attain, or only allowed specific securities), or warned of negative consequences that may result from applying restrictions (without further explanation).
 - Did not disclose to clients, or did not disclose adequately, that they could impose reasonable restrictions on the management of their accounts or provided inaccurate or insufficient information regarding the client’s ability to impose such restrictions.
- *Ongoing communications.* An adviser relying on the safe harbor must contact each client at least annually to: (1) update the client’s financial situation or investment objectives; and (2) determine if the client wishes to impose any reasonable restrictions on the management of the client’s account or reasonably modify existing restrictions. In addition, at least quarterly, an adviser must provide its clients with written notification to contact the adviser with any changes to such information. The adviser (or sponsor) also is required to make a person sufficiently knowledgeable about the account and its management reasonably available to the client for consultation. The staff observed issues with advisers meeting these requirements, including instances where advisers:
 - Did not request with the required frequency information regarding clients’ financial situations and investment objectives. Many advisers did not satisfy the Rule’s quarterly notification provision, as they contacted clients only once or twice per year. Nevertheless,

[R]ule 3a-4 establish and implement written policies and procedures, and a system for applying such procedures, that are reasonably designed to ensure that the program operates in the manner contemplated by the rule.”).

³³ Questionnaires varied greatly in the quantity and quality of information requested. Such advisers generally offered a very small set of responses from which a client could choose. Commonly requested investment profile data points include items such as age, income, retirement status, and investment goals. See also Section III.A. *Portfolio management – oversight* observations.

most of the communications were in writing and indicated how clients should convey changes to the adviser.

- Did not communicate with clients about their ability to impose new, or modify existing, reasonable restrictions. Many advisers did not provide written notice to their clients at least quarterly, or contact their clients at least annually, regarding the client's ability to add or change reasonable restrictions on their accounts.³⁴
- Provided clients with limited or no access to advisory personnel knowledgeable about the account and its management. Advisers sometimes limited client communication to technical support (*e.g.*, navigating the adviser's website) and general customer service support (*e.g.*, directing investors to educational materials). At firms where advisers made advisory personnel available to clients to address this Rule provision, there generally were access limitations or restrictions. For example, only clients who met certain account size thresholds were eligible for these services.
- *Account statements.* Rule 3a-4 requires the sponsor of a discretionary investment advisory program, or a person designated by the sponsor, to provide each client with a statement, at least quarterly, that contains certain information. The staff observed general compliance with this provision.
- *Client rights.* Rule 3a-4 provides for the retention by clients of certain indicia of ownership, to the same extent as if the clients held the securities and funds outside of the discretionary investment advisory program. However, the staff observed advisers that:
 - Restricted their clients' ability to withdraw cash or securities from their accounts. For example, some advisers limited the types of permitted withdrawals (*e.g.*, cash-only).
 - Did not allow clients to vote proxies or to delegate that right to a third-party for any or all securities, or required clients to request this right.
 - Appeared not to ensure that clients were being sent legally required documents (*e.g.*, trade confirmations and prospectuses).
 - Did not allow clients to have the legal right to proceed, directly as a security holder, against the issuer of any security in the client's account, as prescribed in Rule 3a-4.

III. Staff Observations on Ways to Improve Compliance

Due to the assorted advisers included in the eIA Initiative, the staff observed a wide range of compliance practices. As a result, while not all of the practices noted below may be universally applicable, they may assist advisers in developing and maintaining adequate and effective policies and procedures under the Compliance Rule.

- *Adopting, implementing, and following written policies and procedures that are tailored to the adviser's practices.* Advisers cited for compliance program-related deficiencies often had

³⁴ Compliant advisers contacted clients and also indicated how clients should convey their requests to the adviser.

multiple deficiencies across more than one category (*e.g.*, disclosure, marketing, or portfolio management). Conversely, advisers with compliance programs that appeared to be adequate and effective were not cited for deficiencies related to: (1) portfolio management (*e.g.*, best interest advice, best execution, and practices being inconsistent with disclosures); (2) custody; and (3) books and records. Such advisers also rarely had deficiencies related to marketing, performance advertising, or billing practices.

- *Testing algorithms periodically to ensure that they are operating as expected.* At advisers where algorithm-related testing was performed at least quarterly, the staff observed the following practices:
 - Testing frequently was performed by the advisers' algorithm designers/software developers, but rarely in isolation. Most included one or more other groups in their testing process, such as portfolio management, compliance, internal audit, and information technology ("IT") staff.
 - Where compliance was included in the process, compliance staff performed independent testing and also relied on work performed by others.
 - Exception reports or other reporting mechanisms commonly were used and frequently involved a combination of high-level and account-specific results. Reports often were reviewed by algorithm designers/software developers and compliance staff, but many firms also had portfolio management staff and/or IT staff review them.
- *Safeguarding algorithms.* Most advisers employed safeguards to prevent unauthorized algorithm changes, such as exclusively limiting code access to certain persons and providing compliance staff with advance notice of substantive algorithm changes or overrides (usually during the development process). Advisers using white-label platforms generally could not modify the platform's underlying code but reported that platform providers would notify them of changes.

IV. Conclusion

The examinations conducted within the scope of this review resulted in a range of actions. In response to the staff's observations, some advisers elected to amend disclosures and marketing materials, modify or eliminate performance advertisements, revise compliance policies and procedures, improve data protection practices, and/or change other practices.

The Division encourages advisers providing electronic investment advice to review their portfolio management practices and related disclosures; performance advertising and marketing materials; and written policies and procedures, including the implementation and testing of those policies and procedures, to ensure that they are consistent with the Advisers Act and the rules thereunder, as well as other federal securities laws, as applicable. Advisers relying on the Internet adviser exemption also are encouraged to review their registration eligibility.

The Division encourages advisers that recommend discretionary investment advisory programs to assess whether clients are being provided with individualized advice and whether sufficient policies,

procedures, and practices are being employed to prevent such programs from being deemed unregistered investment companies and securities.

This Risk Alert is intended to highlight for firms risks and issues that the Division's staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
