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‘First-ever’ enforcement cases against robo-advisers illustrate continued focus on model

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For the first time in two years, OCIE’s 2019 exam priorities letter didn’t call out robo-advisers as a key focus (**IA Watch**, Jan. 2, 2019). But does that mean the ever-increasing automated model will escape the scrutiny of examiners’ going forward? The SEC’s first-ever charges against two robo-advisers for false disclosures suggest otherwise.

Just one day before the government shutdown—and perhaps lost in the holidays' shuffle—was the late December announcement that the Commission had settled enforcement actions against the two robo-advisers for making false statements about their investment products. The firms were also charged with publishing misleading advertising.

Testing trading

The cases were preceded by the statement by an official in the **SEC**’s San Francisco office that robo-advisers would continue to be a focus. **Alice Schulman**, an assistant director of exams in San Francisco, signaled at an **IA Watch** event last November that the office would be examining robo-advisers to see how often their trading algorithms are tested and whether they work as intended (**IA Watch**, Nov. 21, 2018).

And there were the 2017 (**IA Watch**, Jan. 12, 2017) and 2018 (**IA Watch**, Feb. 7, 2018) exam priorities’ letters flagging robo-advisers as a focus. At the time, OCIE stated that examiners would likely focus on firms’ compliance programs, formulation of investment recommendations, data protection, disclosures and marketing.

It was false disclosures and improper marketing that tripped up **Wealthfront Advisers**. The Redwood City, Calif.-based robo-adviser, which has been registered with the SEC since 2008, was found by the Commission to have made false statements about a tax-loss harvesting strategy offered to clients. The Commission found that Wealthfront disclosed to clients that it would monitor all client accounts for any transactions that might trigger a wash sale. The problem: The firm failed to do so over a more than three-year period when wash sales occurred in at least 31% of accounts enrolled in the strategy.

Troubling testimonials

Testimonials and referrals were another trouble area. The SEC determined that Wealthfront, which had over $11 billion in AUM, improperly retweeted on its **Twitter** account prohibited client testimonials. The firm was charged with failing to adopt written P&Ps for reviewing marketing materials and communications for testimonials and misleading advertisements. The SEC discovered that not all retweets were assessed by compliance to determine if they were accurate and complete or contained testimonials before Wealthfront posted them on its Twitter feed.

Wealthfront further paid $97,000 to bloggers for client referrals under an “affiliate program” and received tens of millions in AUM under that program. The firm’s P&Ps required its CCO to both review agreements with solicitors for compliance with the applicable rules, and approve any such rules. Those P&Ps weren't implemented and the SEC stated that Wealthfront wasn’t complying with the cash solicitation rule.

“Technology is rapidly changing the way investment advisers are able to advertise and deliver their services to clients,” said **Dabney O’ Riordan**, chief of the SEC Enforcement Division’s Asset Management Unit. “Regardless of their format, however, all advisers must take seriously their obligations to comply with the securities laws, which were put in place to protect investors,” she added.

Under its settlement, Wealthfront will pay a $250,000 penalty.

Misleading statements

The penalty for **Hedgeable Inc.**, a robo-adviser charged with making a series of misleading statements about its investment performance, will be $80,000. The SEC found that from 2016 until April 2017, the New York City firm posted on its website and social media a “purported” comparison—dubbed a “Robo-Index”—of the investment performance of Hedgeable’s clients with two of its robo-adviser competitors.

The performance comparisons were determined to be misleading because Hedgeable only included less than 4% of its client accounts. Not surprisingly, those accounts had higher-than-average returns. Hedgeable compared this with rates of return that were not based on competitors’ actual trading models.

Winding down

Hedgeable had been registered as an Internet investment adviser since 2009. Last March, the firm reported $81 million in AUM. The SEC noted in the settlement that Hedgeable is winding down its investment advisory business and stated that last September the firm claimed that it no longer has AUM, and is no longer eligible to be registered with the Commission.

In 2017, the SEC’s Division of Investment Management issued guidance for robo-advisers suggesting compliance steps they should consider implementing (**IA Watch**, Feb. 23, 2017). Among the guidance was disclosure tips, including a warning to robo-advisers to “be careful not to mislead clients” and that disclosures should be “in plain English.”

The information contained herein was current as of the publication date.

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