Robo-advice settlement costs Schwab $185 million

By Editorial Staff *Wed, Jun 15, 2022*

'We are proud to have built a product that allows investors to elect not to pay an advisory fee in return for allowing us to hold a portion of the proceeds in cash, and we do not hide the fact that our firm generates revenue for the services we provide,' a Schwab statement said.

The Securities and Exchange Commission (SEC) this week charged three Charles Schwab investment adviser subsidiaries for not disclosing that they were allocating client funds in a manner that their own internal analyses showed would be less profitable for their clients under most market conditions. The subsidiaries agreed to pay $187 million to harmed clients to settle the charges.

Without admitting or denying the SEC's findings, Charles Schwab & Co., Inc., Charles Schwab Investment Advisory, Inc., and Schwab Wealth Investment Advisory, Inc., agreed to a cease-and-desist order prohibiting them from violating the antifraud provisions of the Investment Advisers Act of 1940, censuring them, and requiring them to pay approximately $52 million in disgorgement and prejudgment interest, and a $135 million civil penalty.

The subsidiaries also agreed to retain an independent consultant to review their policies and procedures relating to their robo-adviser's disclosures, advertising, and marketing, and to ensure that they are effectively following those policies and procedures.

According to the SEC's order, from March 2015 through November 2018, Schwab's mandated disclosures for its robo-adviser product, Schwab Intelligent Portfolios, stated that the amount of cash in the robo-adviser portfolios was determined through a "disciplined portfolio construction methodology," and that the robo-adviser would seek "optimal return[s]."

In reality, Schwab's own data showed that under most market conditions, the cash in the portfolios would cause clients to make less money even while taking on the same amount of risk. Schwab advertised the robo-adviser as having neither advisory nor hidden fees, but didn't tell clients about this cash drag on their investment.

Schwab swept money from the cash allocations in the robo-adviser portfolios to its affiliate bank, loaned it out, and then kept the difference between the interest it earned on the loans and what it paid in interest to the robo-adviser clients, the SEC said.

“Schwab claimed that the amount of cash in its robo-adviser portfolios was decided by sophisticated economic algorithms meant to optimize its clients’ returns when in reality it was decided by how much money the company wanted to make,” said Gurbir S. Grewal, Director of the SEC’s Division of Enforcement.

According to a release from Schwab:

The Charles Schwab Corporation reached a settlement with the US Securities and Exchange Commission to resolve an investigation into historical disclosures related to the Schwab Intelligent Portfolios (SIP) advisory solution, according to a release this week.

Under the terms of the settlement, Schwab will deposit $186.5 million into a Fair Fund account for distribution to affected investors. Schwab will also retain an Independent Compliance Consultant to review its current supervisory, compliance, and other policies and procedures concerning SIP-related disclosures, advertising, and marketing communications with clients or potential clients.

As disclosed in a Form 8-K filing dated July 1, 2021, Schwab’s second quarter 2021 financial results included a liability and related non-deductible charge of $200 million in connection with the settlement.

Excerpts from the company’s official statement include:

> Schwab has resolved a matter with the SEC regarding certain historic disclosures and advertising related to Schwab Intelligent Portfolios between 2015-2018, and we are pleased to put this behind us. The SEC Order acknowledges that Schwab addressed these matters years ago.
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> In entering the settlement, Schwab neither admits nor denies the allegations in the SEC’s Order. SIP was designed to provide clients competitive returns across different market environments, and the ability to help weather volatility or challenging market conditions over time. The service recommends a diversified portfolio based on a client’s goals, time horizon and risk profile, and keeps the allocation consistent through automated rebalancing as markets.

> We are proud to have built a product that allows investors to elect not to pay an advisory fee in return for allowing us to hold a portion of the proceeds in cash, and we do not hide the fact that our firm generates revenue for the services we provide. We believe that cash is a key component of any sound investment strategy through different market cycles.

The settlement with the SEC involves Schwab Wealth Investment Advisory, Inc., Charles Schwab Investment Advisory, Inc. and Charles Schwab & Co., Inc.

The Charles Schwab Corporation (NYSE: SCHW) provides 33.8 million active brokerage accounts, 2.3 million corporate retirement plan participants, 1.7 million banking accounts, and approximately $7.28 trillion in client assets. Its operating subsidiaries provide wealth management, securities brokerage, banking, asset management, custody, and financial advisory services to individual investors and independent investment advisors.