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UPCOMING SEMINARS:

Artificial Intelligence (AI) Boot Camp

- January 12 Computer-Implemented Inventions in Biotechnology and Healthcare, Patentability from European and US Perspective
- January 13 M&A and Investment into AI Companies
- January 19 Software As a Medical Device: US FDA Regulatory and Legal Framework
- January 20 Patent and Trade Secret Protection for Inventions That Use AI
- January 21 AI in Hiring and Recruiting
- January 28 AI and Copyright



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Artificial Intelligence (AI) Boot Camp

- February 2 The Ethics of Artificial Intelligence for the Legal Profession
- February 3 AI and Data Privacy
- February 4 Patents for MedTech AI: Opportunities and Pitfalls
- February 9 IP Landscape of AI Hardware Startups
- February 11 AI in Digital Advisory Offerings: Regulatory Considerations
- February 16 Bias Issues and AI
- February 25 The Risks of Bias and Errors in AI-Enabled Decision-Making

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AI IN DIGITAL ADVISORY OFFERINGS: REGULATORY CONSIDERATIONS

Christine M. Lombardo, G. Jeffrey Boujoukos,
and Andrew J. Gray IV

February 11, 2021

Presenters



Christine M. Lombardo



G. Jeffrey Boujoukos



Andrew J. Gray IV

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Agenda

- Digital Advise – Business Model Evolution
- Regulatory Climate
 - Rulemaking/Requests for Comment
 - Guidance Statements
 - Cases
- The Rise of Data Analytics
- What's to Come?

Evolution of the Business Model

- Hybrid human-robo advisers
- Migration toward comprehensive financial planning
 - Financial planning, financial literacy and wellness
 - Account aggregation
- Incremental client profiling
- Integrated product offerings – combination of investment and banking features
 - Checking accounts, debit cards, loans, direct deposit, bill pay
- Product differentiation
 - Cash management solutions
 - Use of advanced analytics and risk management capabilities to move beyond “model portfolios” and provide more customized advice

Use of AI in Digital Advisory Offerings

- Client Acquisition
- Intake and suitability assessment
- Model recommendations
- Strategy creation/implementation
- Trading
- Client Communications

Regulatory Climate: Rulemaking/Guidance

- June 2017 Speech: *The Role of Big Data, Machine Learning, and AI in Assessing Risks: A Regulatory Perspective*
- March 2018 GAO report: “Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight”
- U.S. Department of the Treasury released a report on non-bank financials, FinTech and innovation (July 2018)
 - Identifies “digital financial planning” tools and services as promoting expanded access to advice for retail investors and those with small balances to invest.
- SEC Launches Strategic Hub for Innovation and Financial Technology (FinHub) (October 2018)
- Custody
 - SEC Staff issued statement inviting feedback from investment advisers, custodians, and other market participants on application of the SEC Custody Rule to digital assets (November 2020)
 - Requests Comment Regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers (December 2020)
- New SEC Marketing Rule (December 2020)

Regulatory Climate: Social Media and Advertising

- SEC brought an action against digital advisers for the first time in December 2018.
- Cases predominantly relate to unique marketing issues presenting under Advisers Act Rule 206(4)-1
- In the first action, the SEC brought an action against a digital adviser in connection with allegedly misleading disclosures to clients and the public in a marketing white paper
- Content specifically related to disclosures around automated program features (tax-loss harvesting)

Regulatory Climate: Model/Algorithm Governance

- SEC Enforcement Action (Aug. 27, 2018) – Model/Algorithm Governance
 - A group of related investment advisory entities settled an enforcement proceeding for \$97 million in disgorgement and civil penalties in connection with the offer, sale, and management of registered funds, variable life insurance products, and SMA strategies that used a proprietary quantitative investment model.
 - The strategies were marketed as “emotionless” and quantitatively-driven, but the SEC alleged the following:
 - Models were launched without adequate steps to confirm they worked as intended; no model validation policy for three initial years.
 - Discovery of errors in the models did not lead to reconciliation/correction of material errors
 - Failure to publicly disclose discovery of errors (including to fund boards/clients), or disclose the risks inherent in the models
 - An inexperienced, fresh-out-of MBA quant analyst “with no portfolio management experience” served as sole daily manager of the model on which the products were based; disclosure falsely indicated the opposite.
 - Prospectuses for ICs were drafted using templates from a “library” and therefore did not reference the use of the quant models or include relevant risks

Regulatory Climate

- Algorithm Governance
 - Internal Controls
 - Algorithm development, testing, maintenance, and monitoring
 - Change management – approval process, audit trails, pre- and post implementation testing
 - Compliance’s role in algorithm governance and testing
 - Disclosure of methodology, assumptions, and limitations
 - Disclosure of material changes in algorithms
 - Testing to consider whether inputs are resulting in appropriate outputs

The Rise of Data Analytics

- SEC
 - Peer to peer comparison
 - Product tracing analysis
 - Insider trading cases triggered by events other than M&A
 - Scraping of disclosure documents and other public filings

What's to Come?

- Change in leadership at SEC
 - Potential impact in focus of examinations and enforcement
 - Potential impact associated with use of AI within SEC
 - New rulemaking?
- Evolution of technology
- Comfort among industry participants and consumers?

Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

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To help keep you on top of developments as they unfold, we also have launched a resource page on our website at www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple “Stay Up to Date” button.



Biography



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Christine Lombardo advises investment managers and broker-dealers on financial regulatory matters. She concentrates her practice on securities regulation for a broad range of financial firms including retail asset managers, private fund managers, family offices, broker-dealers, other professional traders, and high-net-worth individuals. Christine also counsels legal, compliance, and business personnel on the structure, operation, and distribution of advisory programs, including digital advisory offerings, and investment products, including hedge funds, private equity funds, venture capital funds, real estate funds, and other alternative investment products.

Biography



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G. Jeffrey Boujoukos is the leader of our securities enforcement practice. The former regional director of the Philadelphia Regional Office of the US Securities and Exchange Commission (SEC), Jeff defends public companies, financial services clients, and their executives in SEC, self-regulatory organization (SRO), and state enforcement matters. Combining his government and private practice experience, Jeff advises clients in collaboration with Morgan Lewis's securities, white collar defense, and investment management practices. He is admitted in Pennsylvania and Massachusetts only, and his practice is supervised by DC Bar members.

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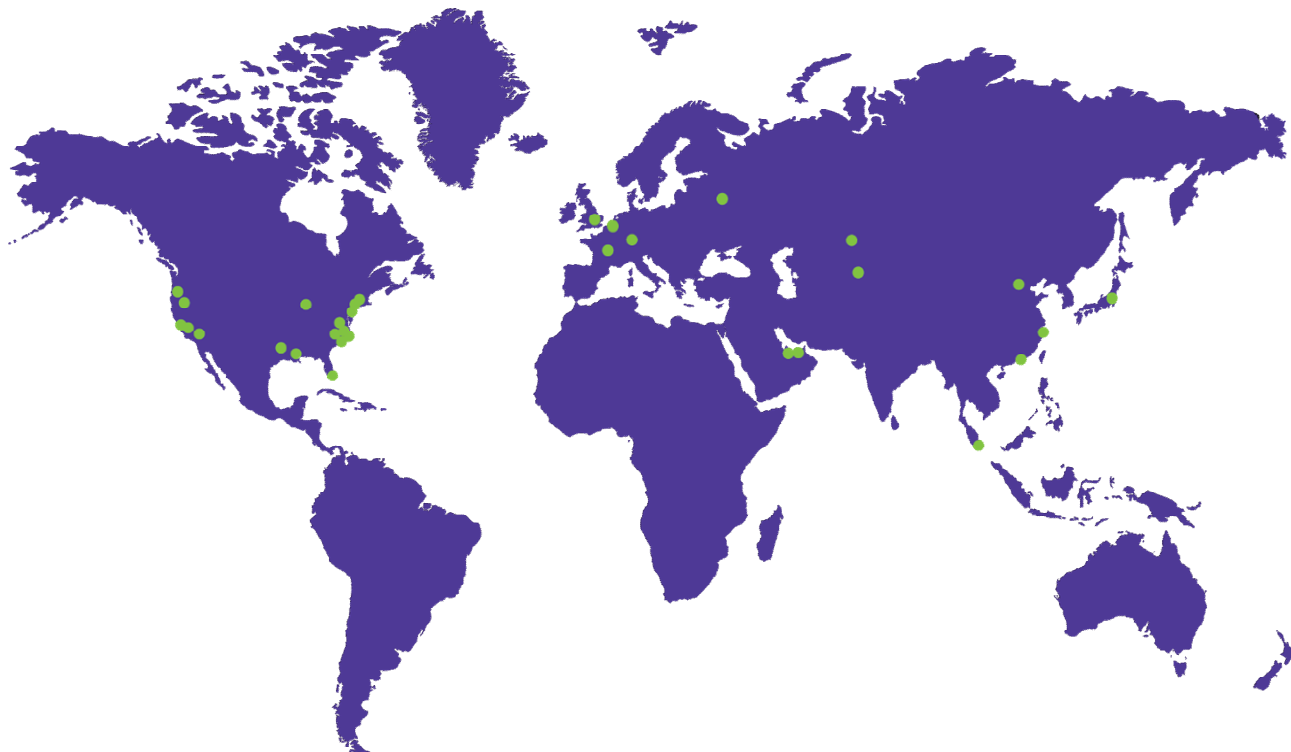
Serving as the leader of Morgan Lewis's semiconductor practice and as a member of the firm's fintech and technology practices, Andrew J. Gray IV concentrates his practice on intellectual property (IP) litigation and prosecution and on strategic IP counseling. Andrew advises both established companies and startups on Blockchain, cryptocurrency, computer, and Internet law issues, financing and transactional matters that involve technology firms, and the sale and licensing of technology. He represents clients in patent, trademark, copyright, and trade secret cases before state and federal trial and appellate courts throughout the United States, before the US Patent and Trademark Office's Patent Trial and Appeal Board, and before the US International Trade Commission.

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