
Morgan Lewis
INVESTMENT ADVISER PERSPECTIVES:
DIGITAL ADVICE ROUNDTABLE
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Overview

- Evolution of the Business Model
  - Hybrid offerings
  - Proprietary products
  - Account aggregation
- Client Acquisition
  - Impact of the DOL Fiduciary Rule
  - Internal and External Referral Arrangements
- Current Regulatory Climate
- Data Protection and Cybersecurity
- Governance, Compliance, and Internal Controls

EVOLUTION OF THE BUSINESS MODEL

Evolution of the Business Model

- Hybrid human-robo advisers
- Proprietary funds
- Account aggregation
- Artificial intelligence
- Expanded models (ESG portfolios, Smart Beta strategies)
- Increased government regulation/focus
- Others?

Hybrid Human-Robo Advisers

- Scope of services provided by humans
- Product differentiation (within robo-adviser product and among other managed account offerings)
- Pricing for additional (premium) services
- Call centers
  - State IAR licensing and registration
  - Brochure supplement (Form ADV, Part 2B) delivery

Proprietary Products

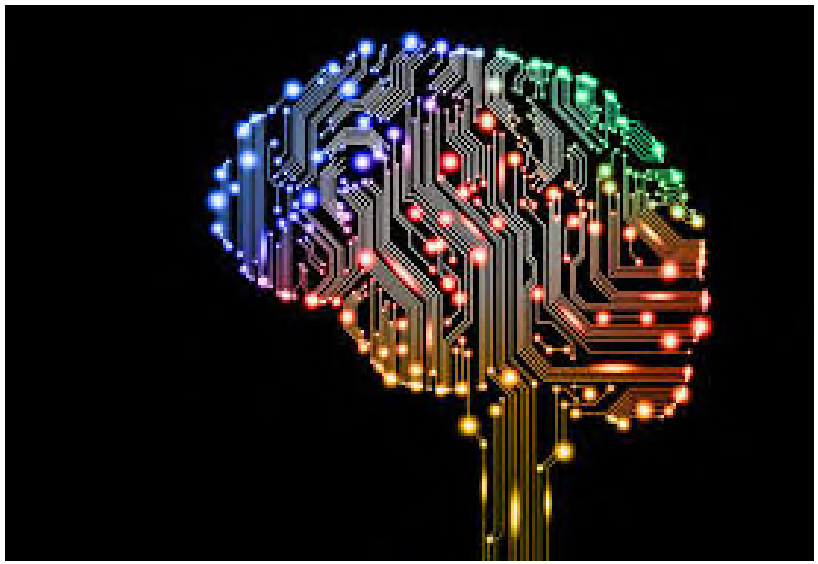
- Digital advisory programs that use proprietary products (e.g., affiliated managers or mutual funds) in retirement accounts must avoid variable compensation, or satisfy an exemption
- Options
  - Offset, credit or waive all additional compensation to client accounts
  - Level compensation
  - Exemption for Investment Advice (ERISA section 408(g))
    - Level-fee model
    - Computer model
  - Prohibited Transaction Exemption 77-4 (for investments in affiliated mutual funds)
    - Now subject to impartial conduct standards

Account Aggregation

- Aggregation raises the data breach stakes
- Sharing of financial or other personal information in violation of federal or state privacy laws
- Data transfer concerns
- Harmful scraping or other data-gathering techniques
- Distorted investment advice if aggregated data is incorrect
- Inaccurate or unavailable data
- Failure to properly consider aggregated information

Artificial Intelligence (AI)

- AI – The use of computational tools to perform tasks that would ordinarily require human intelligence
- Machine learning – A method of designing computational processes (e.g., algorithms) that have the ability to learn and optimize performance of specific tasks with limited or no human intervention
- Office of Compliance Inspections and Examinations (OCIE) request – Indicate whether the platform used by the adviser to provide electronic investment advice "employs cogitative computing (e.g., artificial intelligence, machine learning)"
- Potential-use cases for digital advice



CLIENT ACQUISITION

Client Acquisition – DOL Fiduciary Rule

- Rule became applicable June 9, 2017
  - Expanded definition of "fiduciary" applies to investment advice to retirement investors
  - Impartial conduct standards apply under exemptions, including Best Interest Contract exemption
- Extension of "transition period"
  - Delays applicability of other conditions of exemptions (e.g., contract, warranties, policies and procedures, disclosures)
  - Compliance subject to DOL/IRS nonenforcement policy
- DOL is studying the Rule per President's direction
  - Coordinating with the SEC
  - Considering changes, including "streamlined" exemptions (such as for "clean" shares), changes to address private right of action, other issues
- Meanwhile . . .
  - Litigation to overturn the Rule is ongoing
  - Protecting Advice for Small Savers Act would repeal Rule and give jurisdiction to SEC (unlikely to pass Senate)

Client Acquisition – DOL Fiduciary Rule

Other regulators stepping in . . .

- SEC Uniform Fiduciary Standard of Conduct
  - SEC requested information on its fiduciary standard
  - Staff is working on a draft rulemaking
  - Timing and framework remain unclear
- State fiduciary laws—developments
  - Nevada—Applies fiduciary duties and disclosure requirements to broker-dealers and investment advisers
  - Other initiatives in Connecticut, Massachusetts, New Jersey, New York, and California
  - Question as to preemption under federal law
  - Risk of inconsistent standards among the 50 states

Client Acquisition – DOL Fiduciary Rule

- Rule broadens the types of relationships and communications that may result in fiduciary status to plans and IRAs
  - Fiduciaries are subject to strict prohibited transaction rules, including prohibitions against receiving variable, transaction-based compensation in connection with advice
  - ERISA plan fiduciaries subject to "prudent expert" standard of care
- Advice provided when acquiring client assets can result in fiduciary status
  - Rollover, transfer, and distribution recommendations
  - Recommendations to use digital advisory program vs. traditional advisory program vs. brokerage
  - Recommendations to buy, hold, or sell securities
  - Strategy recommendations
  - Recommendations of third-party managers and advisers
- May need a prohibited transaction exemption if fiduciary advice can affect compensation

Client Acquisition – DOL Fiduciary Rule

- Digital advisers have two primary options for client acquisition
  - "Hire me"/education-only
    - Can tout your advisory services and "recommend" that the client hire you
    - Can provide general information and education about services and options
    - Cannot recommend that the client roll money out of a plan or IRA
    - Cannot recommend among different advisory programs with different fees (e.g., digital vs. traditional)
  - Best Interest Contract Exemption for "Level Fee" Fiduciaries
    - May only receive a level asset-based or flat fee that is paid by the client
    - Must:
      - Comply with the impartial conduct standards
      - Acknowledge fiduciary status (requirement delayed during transition period)
      - Document the specific reasons the recommendation was in the client's best interest (requirement delayed during transition period)

Client Acquisition – Referral Fees

Passive Advertising Agreement → Lead Generation → Solicitation Arrangement

- Nature of compensation – Fees paid based on traffic (CPI/CPM), flat fees per user action, additional incentive payments, asset-based fees
- Compensation triggers – Clicks, creation of log-in credentials, portfolio recommendation, linking of external accounts, opening of advisory account, funding of advisory account
- Content leading to referral – Impartial (neutral content), list of providers, discussion of pros and cons, targeted review, personalized recommendation
- Terms of agreement – Description of services provided

Client Acquisition – Referral Fees

- Compliance with Rule 206(4)-3 for online referral arrangements has been a focus of recent OCIE exams
- Advisers should review their agreements with portals and personal finance websites to evaluate whether they are subject to Rule 206(4)-3
  - Agreements need to comply with terms of rule
  - Operationalize online delivery of Form ADV Part 2A and Separate Disclosure Statement
- Internal referrals from affiliates
  - "Affiliated" referrals do not require delivery of disclosures under Rule 206(4)-3
  - But, if the individuals referring clients are not "supervised persons," they are subject to state investment adviser representative licensing and registration requirements

CURRENT REGULATORY CLIMATE

Regulatory Climate – SEC

- IM Guidance Update: Robo-Advisers (February 2017)
  - Robo advisers are subject to fiduciary obligations and substantive provisions of the Advisers Act
  - Acknowledged wide variety of business models and "variety of means" to meet regulatory obligations:
    - Range of methods to collect client information
    - Limited information may be considered
    - Varying levels of human interaction
  - Ability of clients to contract for narrowed scope of services
  - Reference to compliance with Rule 3a-4
  - Heavy emphasis on disclosure
  - Accompanied by an "Investor Bulletin"

Regulatory Climate – SEC

- IM Guidance Update: Robo-Advisers (February 2017)
  - Substance and presentation of disclosures
    - Explanation of business model
    - Scope of advisory services
    - Presentation of disclosures
  - Provision of suitable advice
    - Reliance on questionnaires to gather client information
    - Client-directed changes in investment strategy
  - Effective compliance programs
    - Testing
    - Suitability
    - Algorithm Modifications
    - Oversight

Regulatory Climate – SEC

- OCIE – Examination Priorities for 2017 (January 12, 2017)
  - Electronic Investment Advice
    - Focus on advisers and brokers that offer automated or digital platforms, including robo advisers that primarily interact with clients online AND firms that use both automation and humans as components of their services
  - Examinations to focus on:
    - Compliance programs
    - Marketing
    - Formulation of investment recommendations
    - Data protection
    - Disclosures relating to conflicts of interest
    - Oversight of algorithms

Regulatory Climate – SEC

- OCIE – Examination of "Robo-Advisory Services" (September 2017)
  - Suitability
    - Account conversions from digital advisory accounts to traditional/non-automated advisory accounts
    - Clients with traditional/non-automated advisory accounts and digital advisory accounts
    - Policies and procedures addressing how compliance evaluates the suitability of specific investments or allocations relative to information provided by the client
  - Compliance oversight
    - Algorithm governance and related controls
    - Explanation of the role of compliance in connection with testing and monitoring of risk assessment models and investment and asset allocation algorithms
    - Log and description of any stress tests – how systems would have performed under various conditions (market volatility, high volumes of client-driven activity)
    - Trading suspensions
    - Trading, portfolio management, or algorithmic-based errors

Regulatory Climate – SEC

- OCIE – Examination of "Robo-Advisory Services" (September 2017)
  - Portfolio Management and Brokerage Services
    - Proprietary products and related compensation
    - List of models offered by adviser and related research or analysis to determine type of client (based on risk tolerance, investment objective, etc.) that is best suited for the model
    - List of data fields completed during the onboarding process, including any changes to the data fields and compliance's involvement in such changes
    - Formula used to determine the risk rating/tolerance for client accounts (mapping methodology)
    - Ability of clients to impose account restrictions or maintain legacy positions, and types of transfers or restrictions permitted
    - Data fields that a client might update that could result in changes to investment recommendations
    - Exception reports, communication and correction process for inconsistent responses
    - Policies and procedures for tax-loss harvesting and rebalancing

Regulatory Climate – SEC

- OCIE – Examination of "Robo-Advisory Services" (September 2017)
  - Advertising
    - All advertising mechanisms used to solicit or inform users or clients – websites, mobile applications, podcasts, search engine advertisements, mainstream media, blogs and social media sites
    - Any marketing programs in place that compensate individuals or entities for client referrals – clients, users, solicitors, bloggers, and other entities
    - All pitch books, pamphlets, brochures, videos, or other promotional and/or marketing materials – not available through the website/mobile application – furnished to clients and/or users regarding the digital advisory services
    - Access to any password-protected section of website (e.g., for users, clients, investors or advisory representatives)

Regulatory Climate – New York State

- New York State, Office of the Attorney General (NYS OAG) (Investor Protection Bureau) – RFI on Robo-Advisory Products (September 2017)
  - The NYS OAG Investor Protection Bureau has issued a request to meet with selected firms offering digital investment advisory products
  - Topics for discussion:
    - Overview of the digital advisory services generally (e.g., development and size, products and services, fees, internal controls and monitoring)
    - Extent of human involvement
    - Controls to identify investors for whom the digital advisory services may not be appropriate
    - Payments and/or gifts to or from third parties (including revenue sharing)
    - How investments are evaluated for the program, including the frequency of changes to funds
    - Use of digital advisory services by third-party investment advisers

DATA PROTECTION AND CYBERSECURITY

Data Breach Tsunami

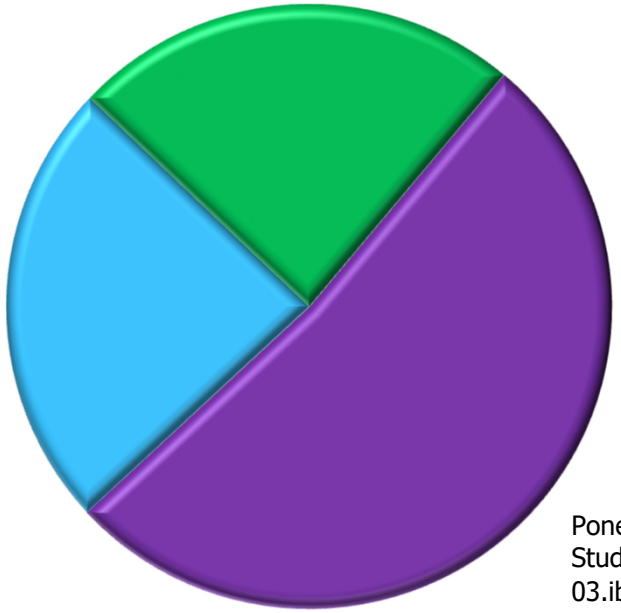
- Record numbers of data breaches
  - 1,093 reported data breaches last year; up 40% from 2015
  - 52 data breaches in financial services

    ITRC Data Breach Report, Jan. 18, 2017, www.idtheftcenter.org/images/breach/DataBreachReports_2016.pdf
- OCIE found that 78% of advisers reported a breach directly or through a vendor

  Examination Sweep Summary (Feb. 3, 2015)
- Rising data breach costs
  - Average total cost in 2016 was $7.35 million, a 5% increase from 2015
  - $225 average cost per record; $336 for financial services

    Ponemon Institute, 2017 Cost of Data Breach Study, June 2017, http://www-03.ibm.com/security/data-breach/
- Continue to grab headlines
  - SEC
  - WannaCry
  - Verizon/Yahoo
  - Equifax

Sources of Data Breaches



Ponemon Institute, 2017 Cost of Data Breach Study, June 2017, http://www-03.ibm.com/security/data-breach/

Cyber Risks for Digital Advisors

- Loss of investor information (e.g., names, Social Security and bank account numbers)
- Loss of intellectual property (e.g., proprietary trading algorithms, strategies, source code)
- System disruptions
- Fraudulent trading and transfer activity
- Penalties and fines
- Reputational harm

US Privacy Law – Sector Specific

Money	Health	Kids
• Gramm-Leach-Bliley Act; Regulation S-P • Fair Credit Reporting Act (FCRA) • State Laws	• Health Insurance Portability & Accountability Act (HIPAA)	• Family Educational Rights & Privacy Act (FERPA) • Children's Online Privacy Protection Act (COPPA) • State Laws

- Consumer Marketing! Telephone Consumer Protection Act (TCPA), CAN-SPAM, and Do Not Call regulations

Regulation S-P (2000)

- Privacy Rule: Notice and opt-out requirements for "nonpublic personal information." 17 C.F.R. 248.1 et seq.
- Safeguards Rule: Requires (a) adoption of written policies and procedures for the protection of customer information and records, including administrative, technical, and physical aspects; and (b) protection against anticipated threats or hazards to the security or integrity of customer records and information, and against unauthorized access to or use of customer records or information. 17 C.F.R. § 248.30.

State Laws

- Data breach notification laws (48 states and DC)
- State laws on financial privacy and biometrics, broader than federal requirements (e.g., CA, IL, TX)
- State laws on security of personal information, stricter federal requirements (e.g., CA, MA)

Regulatory Focus

- SEC Cybersecurity Guidance (April 2015)
  - Highlighted that "[c]yber attacks on a wide range of financial services firms highlight the need for firms to review their cybersecurity measures."
  - Recommended that funds and advisers:
    - conduct a periodic risk assessment regarding cybersecurity risk
    - create a strategy designed to prevent, detect, and respond to threats identified through the assessment
    - implement the strategy through written policies and training, including a system for monitoring compliance

Regulatory Focus

- SEC 's Robo Guidance (February 2017)
  - Highlighted privacy and cyber-related risks associated with digital advisers
  - "A client that wishes to utilize a robo-adviser enters *personal information* and other data into an interactive, digital platform (e.g., a website and/or mobile application)." (Emphasis added.)
  - "[P]olicies and procedures should cover at a minimum . . . privacy concerns."
  - "[R]obo-advisers should consider whether to adopt and implement written policies and procedures that address areas such as: . . .
    - The appropriate oversight of any third party that develops, owns, or manages the algorithmic code or software modules utilized by the robo-adviser;
    - The prevention and detection of, and response to, cybersecurity threats; . . . and
    - The protection of client accounts and key advisory systems."

Regulatory Focus

- OCIE Risk Alert, Observations from Cyber Examinations (August 2017)
  - Better preparedness than found in the 2014 exams
  - Less than 2/3 of advisers had breach response and notification plans
  - Written security policies were formulaic and not tailored
  - Spotty adherence to and enforcement of policies in place
  - Training required, but little follow-up or confirmation that it occurred
  - Stale security patches
  - Failure to remediate high-risk findings from penetration tests or vulnerability scans
  - Also recommended:
    - maintaining an inventory of data and information, classified by risk
    - enforced controls to access data and systems
    - mandatory employee training
    - engaged senior management

SEC Enforcement

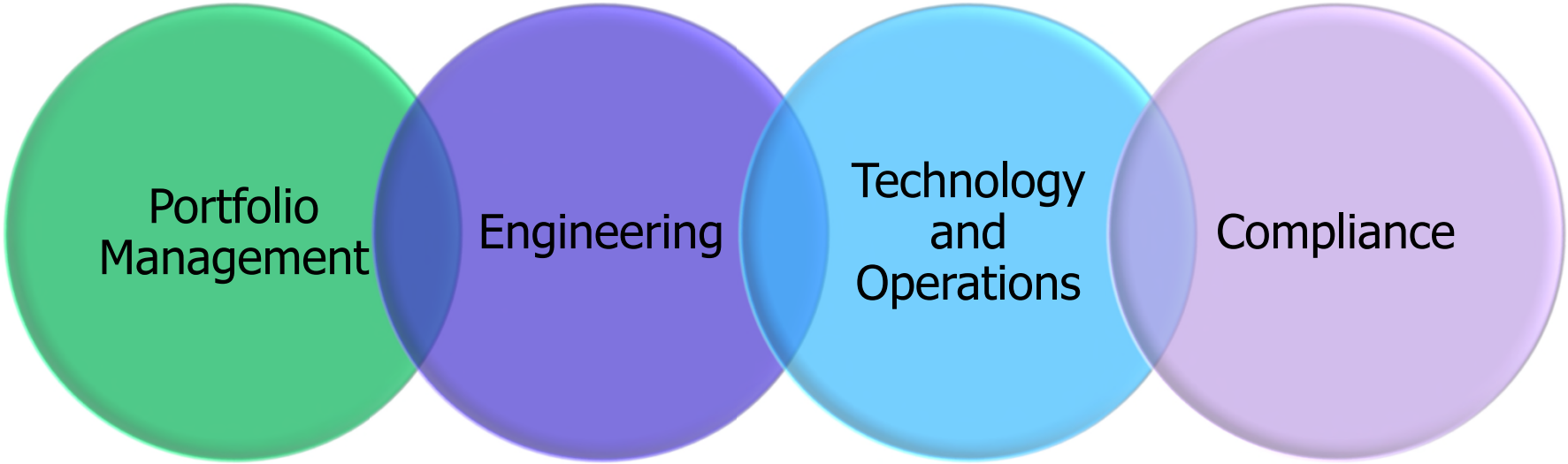
- A major bank agreed to pay $1 million to settle claims that it failed to safeguard customer data. SEC Press Release, 2016-112, June 8, 2016.
- Craig Scott Capital and its principals agreed to pay $150,000 to settle charges that they failed to protect confidential customer data. *See* https://www.sec.gov/litigation/admin/2016/34-77595.pdf.
- St. Louis Investment Adviser agrees to settle claims that it failed to adopt proper cybersecurity policies and procedures prior to a breach. SEC Press Release, 2015-202, Sept. 22, 2015.

Key Takeaways

1. Importance of Cybersecurity Governance
   - Need to implement and enforce written cybersecurity procedures
   - Designate someone responsible for cybersecurity
   - Mandatory training for all personnel
   - Ensure that WSPs are tailored to the firm
2. Protecting Firm Networks and Customer Information
   - Need to encrypt nonpublic personal information
   - Fix inadequate antivirus software/firewalls; update security patches
   - Don’t forget about the little things
3. Vendor Management
   - Have contracts in place to require proper security, breach notification etc.
   - Monitor compliance through assessments
   - Require/obtain cybersecurity insurance

GOVERNANCE, COMPLIANCE, AND INTERNAL CONTROLS

Compliance and Internal Controls



Compliance and Internal Controls

- Portfolio Construction and Model Management
  - Rebalancing
  - Tax-Loss Harvesting
- Research and Due Diligence Processes for Fund Selection
- Suitability and Client Profiling
  - Development of RTQ – sufficiency of questions
  - Identification of factors that affect recommendations and mapping methodology
  - Client responses that are inconsistent with selected portfolio
  - Recommendations and account conversions between digital advisory and other managed account solutions
- Electronic Consent and Delivery Requirements

Compliance and Internal Controls

- Rule 3a-4
  - Approach to reasonable restrictions
    - Ability to restrict particular ETFs (limitations on number or types)
    - Create custom portfolios
    - Retention of legacy investments
    - Customization features
  - Process for considering requests for restrictions
  - Client communication mechanism (in response to reasonable restrictions, quarterly and annual communications)
  - Implementation of reasonable restrictions
- Use of Proprietary Products

Compliance and Internal Controls

- Algorithm Governance
  - 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
- Advertising and Electronic Communications
- Referral and Solicitation Arrangements

Compliance and Internal Controls

- Technology and Operational Governance
  - Process for testing technology and reviewing proposed code changes
  - Stress testing around adverse market conditions (e.g., market volatility, trading suspensions)
  - Trading suspensions due to market conditions or client activity
  - Evaluation of technological and operational glitches (identification, correction, and documentation of client impact)
  - Vendor management
- Information Security Plan
- Breach Response Plan

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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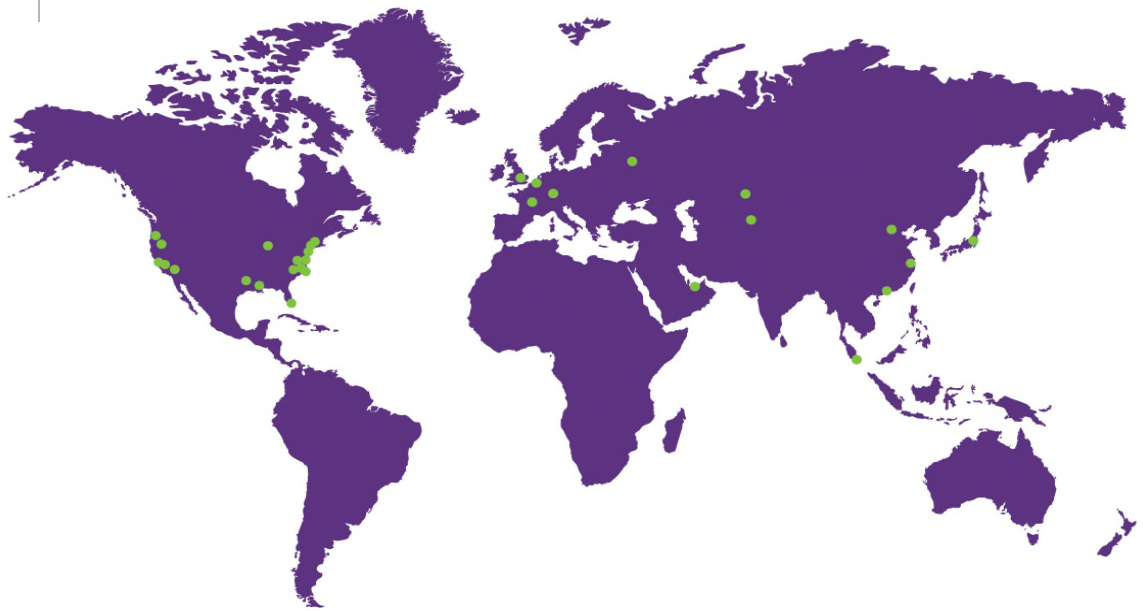
Astana
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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