

Morgan Lewis

INVESTMENT ADVISER PERSPECTIVES: DIGITAL ADVICE

Speakers: Jen Klass, Christine Lombardo, Eric Perelman

Evolution of the Business Model

- Consumer demand for digital solutions to manage personal and financial lives
- Sophistication of technology-based solutions to enhance client experience
- Reliance on passive management
- Fee sensitivity and increasing focus of impact of fees on investment returns
- Scalability of technology to automate repetitive investment management and operational tasks

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

Regulatory Climate

- SEC Strategic Hub for Innovation and Financial Technology (“FinHub”)
 - Launched in October 2018
 - Resource for public engagement on FinTech-related issues and initiatives before the SEC
 - Areas of focus: distributed ledger technology (including digital assets), automated investment advice, digital marketplace financing, and artificial intelligence/machine learning
- FINRA Office of Financial Innovation
 - Launched in April 2019
 - Central point of coordination for significant financial innovations by FINRA member firms, particularly new uses of FinTech
 - Areas of focus: RegTech, artificial intelligence, social media sentiment investing, and digital assets

Regulatory Climate

- March 2018 GAO report: “Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight”
- OCC National Bank Charters for FinTech Companies
 - July 2018 OCC begins considering applications for special purpose national bank charters from FinTech companies that are engaged in the business of banking but do not take deposits
- 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.

Regulatory Climate

- Regulatory Sandboxes
 - Arizona passed first regulatory sandbox law; initial participants announced May 19, 2019
 - Wyoming signed into law February 2019 authorizing waivers to certain regulatory requirements to promote financial technology innovation
 - Illinois and Georgia have each introduced proposed bills easing the application of certain laws for qualifying FinTech companies
 - New York has emphasized strident opposition

Selected Topics: 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

Selected Topics: Model/Algorithm Governance

- SEC Enforcement Action (Aug. 27, 2018)
 - 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

Selected Topics: Model/Algorithm Governance

- 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

Selected Topics: Affiliated Products

- SEC focus on affiliated service providers and funds (OCIE 2019)
- Reminder about mutual fund share class selection
- Disclosure of conflicts of interest and financial incentives
- Open vs. closed architecture fund design

Selected Topics: White-Label and Other Partnership Solutions

- Growth in the market for digital advice has been strongly impacted by the development of strategic partnerships among digital advice platform providers and traditional financial services firms
- Digital advice firms may offer a turn-key solution in the form of a white-labeled advisory program, discrete sub-advisory services such as model portfolio development and monitoring, or access to a platform powering key aspects of the delivery of advice (e.g., ongoing rebalancing, or trade processing and execution)
- Clear division of authority for investment advisory functions, and allocation of investment and trade discretion, are key in advisory agreements and operating procedures
- Governance structure and service provider oversight

Selected Topics: 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)
- Social media in the digital advice context is a focus
 - Adviser published testimonials and selectively re-tweeted positive posts by Twitter users it had reason to know had an economic interest in promoting its services

Selected Topics: Social Media and Advertising

- Social media remains a key SEC Enforcement priority outside of the digital advice context
- In a suite of five separate settled actions from July 2018, the SEC alleged that investment advisers, their representatives and related marketing consultants violated the Testimonial Rule by:
 - Actively soliciting testimonials from advisory clients (including videos) and posting them to various social media platforms
 - Publishing testimonials that specifically related to the investment advice and services provided by the advisers, including positive investment returns
 - Responding directly to favorable client comments on social media pages

Selected Topics: Social Media and Advertising

- Performance advertising is a pressure point for digital and traditional advisers alike
 - In the second December 2018 action against a digital adviser, SEC accepted an offer of settlement from now-defunct digital adviser in connection with misleading website disclosures
 - The adviser had published on its website a “Robo-Index” purporting to compare its performance with those of digital adviser peers
 - SEC found a number of misleading aspects of the Robo-Index, including extent to which the adviser’s clients were included in the composites, the performance calculation methodology, and the accuracy of advertised returns.
- Back-tested performance and the use of hypothetical “paper” models to demonstrate the viability of a strategy also remain a focus
 - In August 2018, SEC brought an action against an RIA in connection with misleading performance data around hypothetical returns for the adviser’s proprietary blended research stock rating system.
 - Extent to which Compliance understood the nature of the performance information subject to review, including that it was back-tested, in question.

Selected Topics: Online Referral Arrangements

- Compliance with Rule 206(4)-3 for online referral arrangements has been a focus of recent OCIE exams, even as the SEC is actively considering changes to the rule
 - OCIE Risk Alert – Investment Adviser Compliance Issues Related to the Cash Solicitation Rule
- In one of the December 2018 actions against a digital adviser, the SEC alleged the adviser made referral payments to third-party bloggers that constituted a cash solicitation arrangement under Rule 206(4)-3
- 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
 - Consider state licensing and registration requirements for solicitors
- 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

Selected Topics: Online Referral Arrangements



- 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

SEC Examination Priorities

2018 Focus

- OCIE said it would “continue to examine investment advisers and broker-dealers that offer investment advice through automated or digital platforms.”
- Focus on:
 - Compliance programs and oversight of algorithms that generate recommendations
 - Marketing materials
 - Data protection
 - Disclosure of conflicts of interest

2019 Focus

- OCIE remains focused on advisers participating in wrap fee programs, including the adequacy of disclosures and brokerage practices.
- Priorities relevant in the digital advice context include:
 - Affiliated service providers and products
 - Retirement accounts and products
 - Suitability of portfolio recommendations and related disclosure
 - Cybersecurity

Jennifer Klass



Jennifer L. Klass is a regulatory counseling lawyer with a broad background in investment management regulation. She advises clients on a wide range of investment advisory matters, including investment adviser registration and interpretive guidance, disclosure and internal controls, regulatory examinations, and enforcement actions. Her clients include major investment banks, investment advisers, broker-dealers, and the sponsors of private investment funds and mutual funds. Previously vice president and associate general counsel at Goldman, Sachs & Co., Jen's practice focuses on the convergence of investment advisory and brokerage services.

New York

+1.212.309.7105

jennifer.klass@morganlewis.com

Advertising and communications with the public, social media, and fiduciary duty and disclosure are among the securities regulatory areas in which Jen counsels clients. She also advises them on investment adviser registration, internal controls, compliance policies and procedures, separately managed (or wrap fee) programs, regulatory examinations and enforcement actions, interpretive guidance, and no-action requests.

Christine M. Lombardo



New York

+1.212.309.6629

Philadelphia

+1.215.963.5012

christine.lombardo@morganlewis.com

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. She is admitted in New York only, and her practice is supervised by PA Bar members.

Christine also counsels financial firms through examinations by industry regulators, as well as on enforcement related matters. Before joining Morgan Lewis, she was an associate at an international law firm in New York and worked for the Division of Enforcement at FINRA

Eric L. Perelman



Eric L. Perelman is a securities lawyer representing private fund managers and global financial institutions across a variety of regulatory and transactional matters, including structure and operations, regulatory guidance and interpretation, investment adviser compliance and controls, internal and regulatory investigations, and enforcement actions and examinations by the US Securities and Exchange Commission (SEC). Eric's practice also focuses on fintech in the asset management industry, with experience counseling a number of leading robo-advisers, venture capital fund managers, and emerging fintech companies on securities matters.

New York

+1.212.309.6735

eric.perelman@morganlewis.com

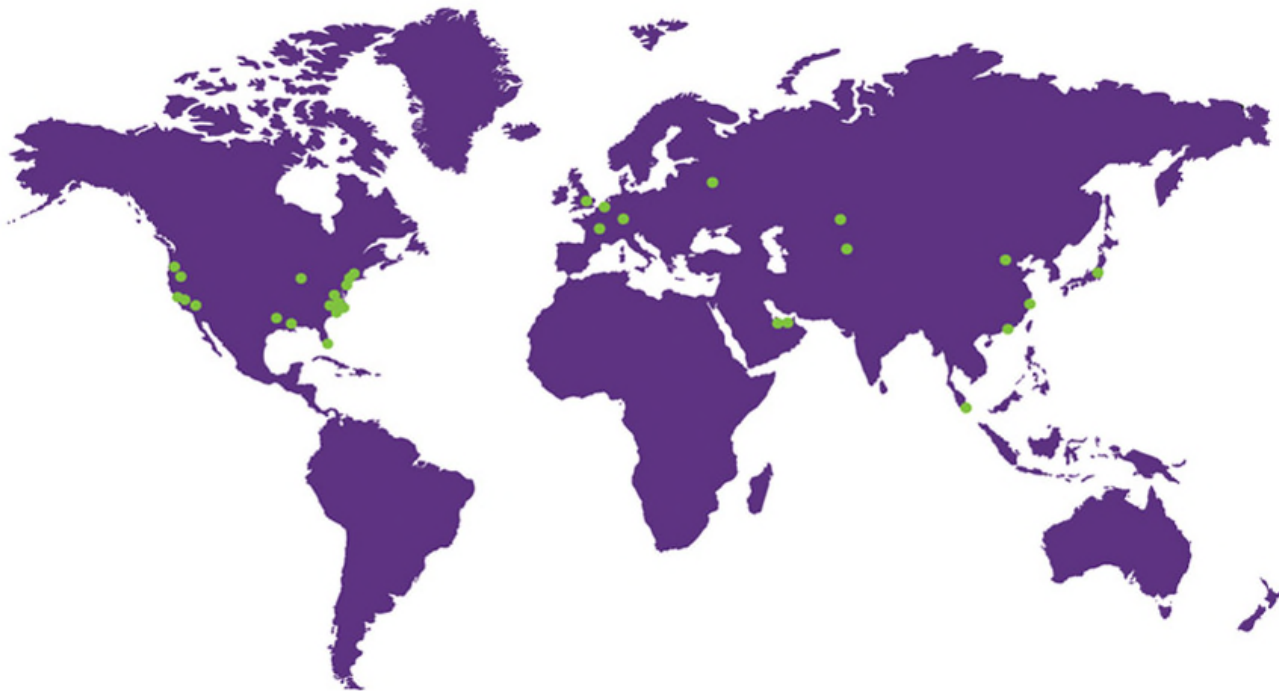
Eric counsels hedge funds, private equity funds, venture capital funds, and global financial institutions on securities regulatory matters, including the formation of private investment funds, investment adviser registration and disclosure, fiduciary duty, interpretive guidance, regulatory examinations and investigations, and enforcement actions. With respect to fintech, Eric represents robo-advisers and other emerging companies that focus on the application of disruptive technology to investment management services. He also counsels clients on mergers, acquisitions, and joint ventures involving asset managers and investment advisers. Eric served with the Division of Enforcement and the Division of Investment Management at the SEC while in law school.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

THANK YOU

© 2019 Morgan, Lewis & Bockius LLP

© 2019 Morgan Lewis Stamford LLC

© 2019 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.