



Morgan Lewis

INVESTMENT ADVISER PERSPECTIVES:
DIGITAL ADVICE
ROUNDTABLE

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Speakers



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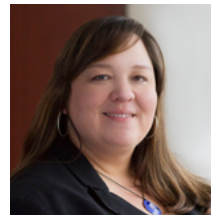
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Overview

- Super Robos: Key Trends in the Evolution from Digital Advice to Comprehensive Financial Wellness
- Artificial Intelligence and Machine Learning
- Current US Regulatory Climate for Digital Advice
- Proprietary Products and Other Tricky ERISA and IRA Issues
- ETF Fund Innovation
- Trading and Fractional Shares
- Transactions in FinTech
- Advertising, Social Media and Online Referral Arrangements
- Risk Management, Compliance and Internal Controls for Emerging Technologies

SUPER ROBOS: KEY TRENDS IN THE EVOLUTION FROM DIGITAL ADVICE TO COMPREHENSIVE FINANCIAL WELLNESS

JEN KLASS

Evolution of the Business Model

- Hybrid human-robo advisers
- Financial planning, financial literacy and wellness
- Incremental client profiling
- Integrated product offerings
- Product differentiation
- Proprietary funds
- Account aggregation
- Artificial intelligence

ARTIFICIAL INTELLIGENCE AND MACHINE LEARNING

ANDY RAY

Artificial Intelligence and Machine Learning

- Onboarding
- Natural language processing
- Natural language understanding
- Portfolio analysis & recommendations
- Overall user interface & modalities

CURRENT US REGULATORY CLIMATE FOR DIGITAL ADVICE

JEN KLASS
CHRISTINE LOMBARDO
CHARLES HORN

Regulatory Climate – SEC

- OCIE –2018 Examination Priorities
 - Electronic Investment Advice
 - Continue to examine investment advisers and broker-dealers that offer investment advice through automated or digital platforms
 - This includes “robo-advisers” and other firms that interact primarily with clients online
 - Examinations to focus on:
 - Compliance programs and oversight of algorithms that generate recommendations
 - Marketing materials
 - Data protection
 - Disclosure of conflicts of interest
 - Wrap Fee Programs
 - Areas of interest include whether the recommendations to invest in a wrap fee program and to continue in the program are reasonable

Banking Organizations and Digital Advice

- Fiduciary and Agency Considerations
 - Federal banking agencies have not said much about the financial regulatory aspects of digital advice, although they recognize its presence in the market.
 - Digital advice presumptively would be treated as investment advice for all regulatory purposes, and if provided to bank clients for a fee, would result in the bank being deemed to act in a fiduciary capacity.
 - If the advice in question is investment modeling prepared by a third party, the bank presumably would still be deemed to be providing the advice to its clients.
 - Offering of digital advice to clients would subject the bank to usual and customary regulatory and fiduciary requirements of care/prudence, loyalty and the like.
 - Suitability of advice/modeling for particular clients and client classes would have to be assessed and documented.
 - These considerations apply regardless of whether the digital advice application or platform is developed in-house or acquired from a third party.

Banking Organizations and Digital Advice

- Digital Advice Procurement Considerations
 - A banking organization that acquires digital advisory programs and applications from a third-party provider would be expected to treat the acquisition as a form of technology services contract.
 - In turn, banking agency guidance (especially that of the Office of the Comptroller of the Currency (“OCC”)) establishes the supervisory that banking organizations will appropriately identify, manage and oversee the risks associated with their third-party technology services relationships. *See, e.g.,* OCC, Bulletin 2013-29 (2013).
 - Risks to be managed include strategic, transaction, reputational, operational, legal/compliance, credit and others.
 - Areas of risk management focus should include proper risk-based identification of technology services needs and requirements; appropriate due diligence of potential services providers; adequate contractual documentation of the relationship with a view to protecting the banking organization’s interests; and monitoring of the relationship on an ongoing basis.
 - Regulators will scrutinize bank acquisitions of digital advisory products through this risk management “lens” with a focus on whether it promotes the bank’s satisfaction of its fiduciary obligations to its clients.

Broader FinTech Initiatives

- March 2018 GAO report: “Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight”
- July 2018 Treasury Report on Nonbank Financials, Fintech, and Innovation
- 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

Broader FinTech Initiatives

- Regulatory Sandboxes
 - Arizona passed first regulatory sandbox law (sandbox went live on August 3, 2018)
 - Illinois proposed law
 - New York – Not so much
 - “The New York State Department of Financial Services fiercely opposes the Department of Treasury’s endorsement of regulatory ‘sandboxes’ for financial technology companies. The idea that innovation will flourish only by allowing companies to evade laws that protect consumers, and which also safeguard markets and mitigate risk for the financial services industry, is preposterous. Toddlers play in sandboxes. Adults play by the rules. Companies that truly want to create change and thrive over the long-term appreciate the importance of developing their ideas and protecting their customers within a strong state regulatory framework.”

PROPRIETARY PRODUCTS AND OTHER TRICKY ERISA AND IRA ISSUES

DAN KLEINMAN
LINDSAY JACKSON

Hot Topics for Retirement Accounts

- DOL Fiduciary Rule is “dead,” or is it?
- Digital acquisition and rollovers
- Proprietary products
- Cash sweep
- Home Depot litigation
- Open MEPs
- ESG investing guidance

ETF FUND INNOVATION

LAURA FLORES

Overview – Registered Funds and Cryptocurrency Strategies

- Status of and Prospects for 1940 Act Registered Funds (Mutual Funds and ETFs)
 - Timeline of Activity to Date
 - Dalia Blass Letter Articulating the Staff's Questions and Concerns
 - Significant Obstacles
- Status of and Prospects for 1933 Act Registered Funds (ETPs)
 - Timeline of Activity to Date
 - Areas of SEC Focus
 - Significant Obstacles
- What's the likelihood these Funds will make it to market?

TRADING FRACTIONAL SHARES

STEVE STONE

Trading Fractional Shares

- Section 206(3) principal trading issues
 - Implicated where adviser (or other affiliated adviser or broker-dealer) purchases from or sells fractional shares to clients
 - J.P. Morgan Securities LLC No-Action Letter
- Alternative approach is to “trade along” with clients in agency capacity
- Securities Act implications
- Form ADV disclosure

TRANSACTIONS IN FINTECH

ANDY RAY
SHERYL ORR

Overview

- Types of Fintech Transactions
- Trends in Fintech Transactions
- Key Considerations in Fintech Transactions

Types of Fintech Transactions

- Equity Investments (Venture Capital/Private Equity)
- Debt Financing
- Structured Finance Transactions
- M&A Transactions (mergers, acquisitions, leverage buy-outs, consortium transactions)
- IPOs
- Commercial/Outsourcing Transactions

Fintech Sector Transaction Activity and Related Trends

SECURITIES / INVESTMENT MANAGEMENT (IM)

- Back-Middle Office Technology
- Infrastructure & Trading Technology
- Asset Management Technology
- Wealth Management
- Liquidity Pools
- Data / Analytics / Research
- Robo Advisors
- Online Brokers / Trading / Custodians

BANKING

- Enterprise Banking Tech
- Peer-to-Peer Lending
- Consumer-Oriented Financial Services
- Real Estate Tech
- Bank Payment Solutions
- Alternative Lending
 - Consumer, SME, Real Estate

BLOCKCHAIN / CRYPTOCURRENCY

- Wallets
- ITOs (Initial Token Offerings)
- Sidechains
- Securities ledgers
- ETFs
- Miners
- Exchanges



PAYMENTS

- Merchant Services
- Carrier Billing and NFC Infrastructure (Telcos)
- Transactions Security
- Card-Based Payment Products
- Online / Mobile Payments
- E-Rewards / Loyalty
- International Money Transfer
- Financial Institutions
- Networks / Associations

INSURTECH

- Core Software (e.g. Claims Management)
- Data and Analytics
- Sales and Distribution

FINANCIAL MANAGEMENT SOLUTIONS

- Enterprise Resource Planning
- Financial Planning
- Accounting Support

HEALTHCARE

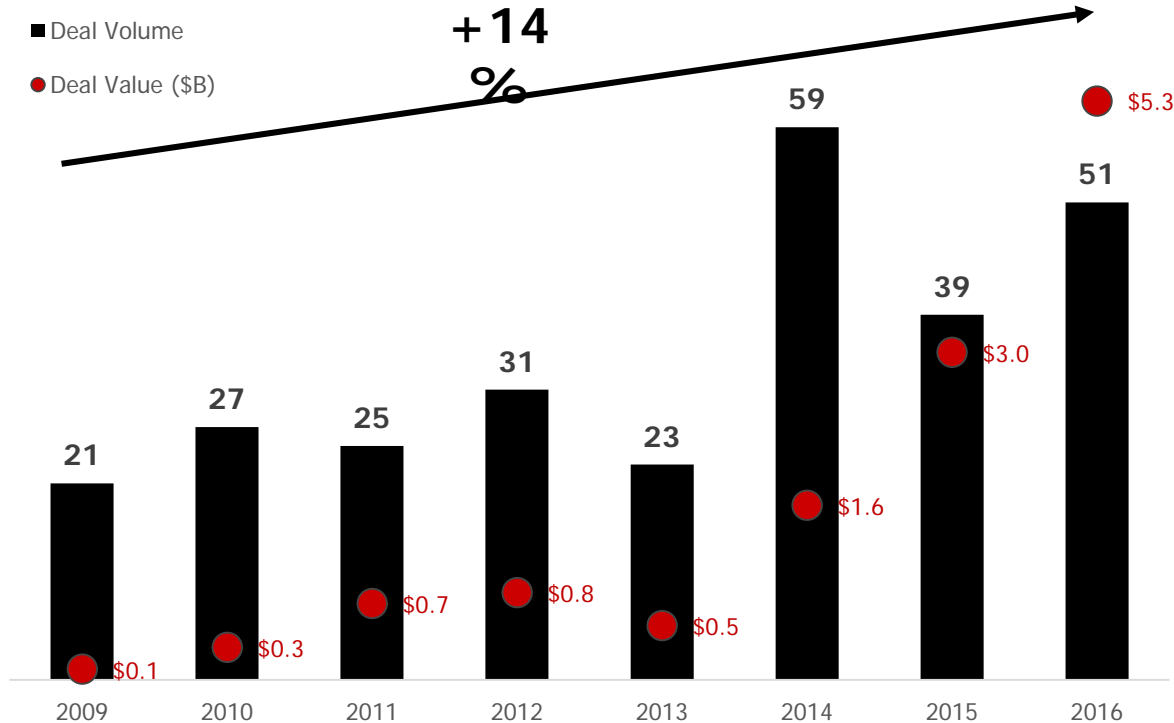
- Patient Care Administration (e.g. RCM)
- Benefits Procurement and Management
- Health Insurance Sales & Distribution

Sources

Financial Technology Partners; CB Insights; Morgan Lewis

Wave of M&A is Transforming the Payments Industry

Payments M&A Deals (Europe)



Source
McKinsey & Co. "How Value Creation Is Reshaping the Payments Industry"

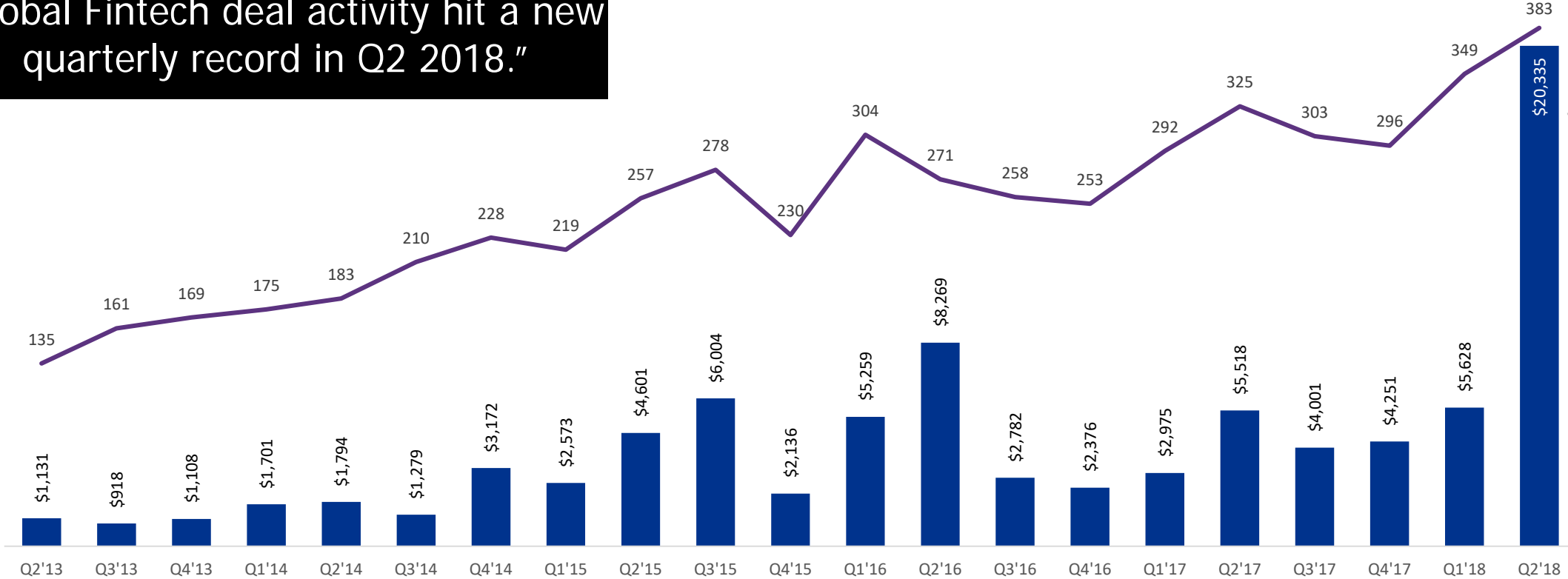
Top 10 Global Fintech VC, PE and M&A Deals (H1'18)

5 out of Top 10 Deals were in Payments

- \$12.9B acquisition of **WorldPay** by Vantiv
- \$5.3B acquisition of **Nets** by Hellman & Friedman
- \$3.5B acquisition of **Blackhawk Network Holdings** by Silver Lake and P2 Capital Partners
- \$2.2B acquisition of **iZettle** by Paypal
- \$1.05B acquisition of **Cayan** by TSYS

Global Fintech VC-Backed Deals

"Global Fintech deal activity hit a new quarterly record in Q2 2018."

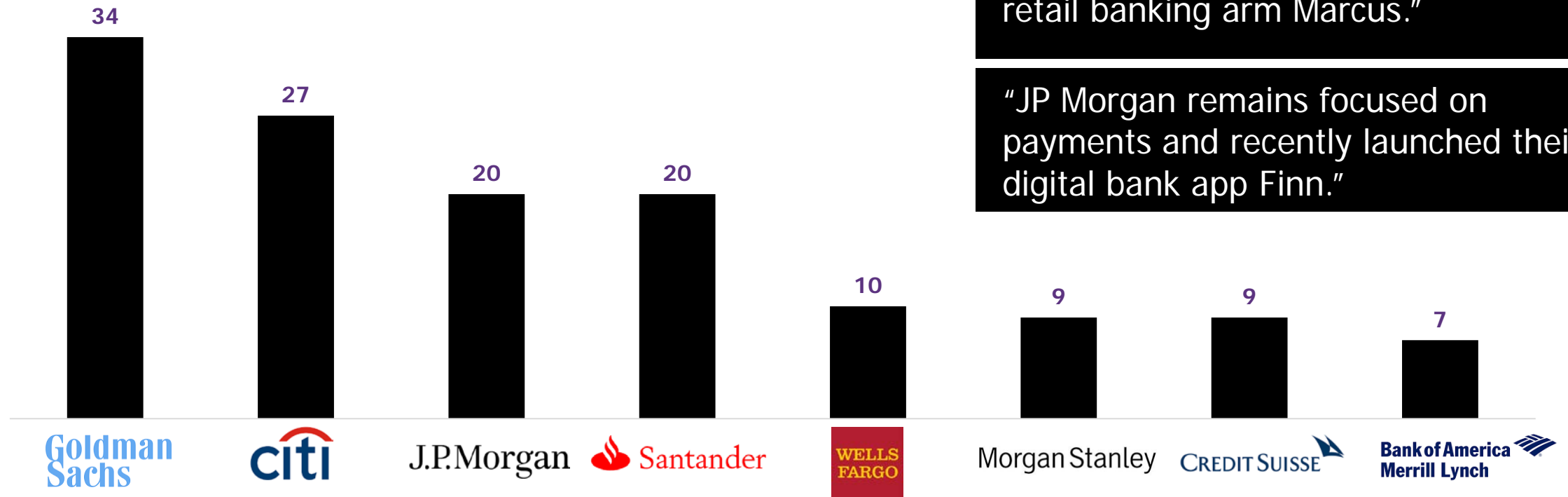


Source: CB Insights Global Fintech Report Q2 2018

Value (US\$ mil.) Volume

Incumbents Make Strategic Bets in Fintech

Number of Fintech Portfolio Companies (Equity Financing 2012 – Q2 2018)



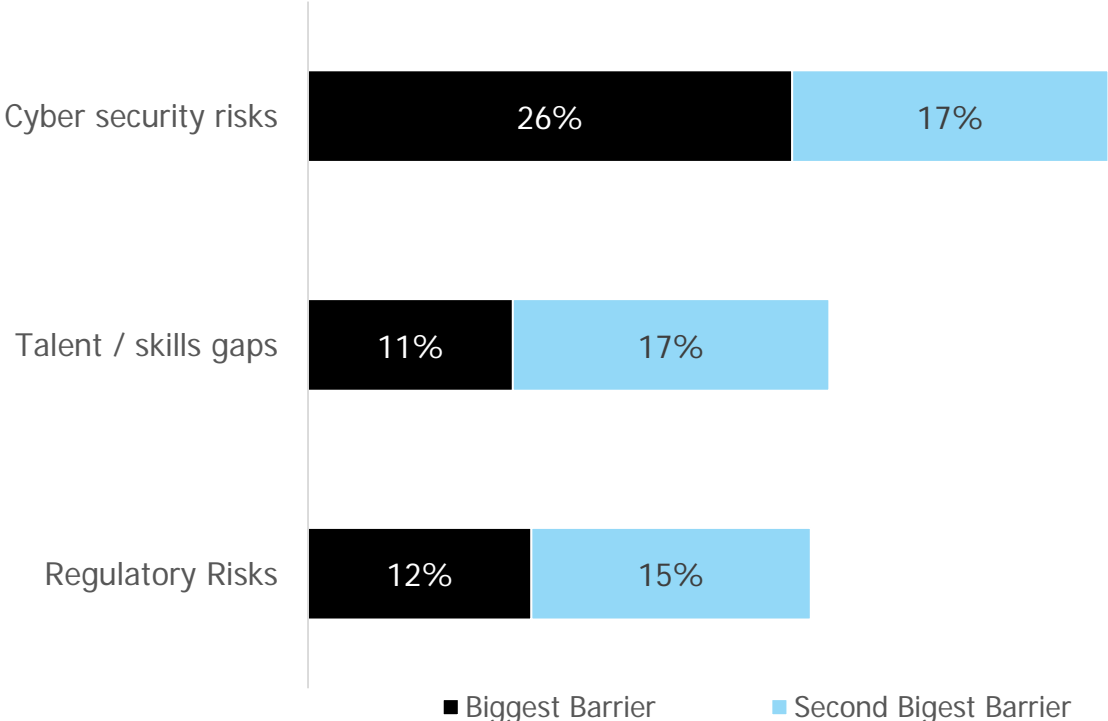
“Goldman focuses on building out retail banking arm Marcus.”

“JP Morgan remains focused on payments and recently launched their digital bank app Finn.”

Source
CB Insights Global Fintech Report Q2 2018

Cybersecurity as Drag on Digital Innovation

What are the biggest barriers to transforming digital innovation?
Survey of 200 senior-level respondents from large banks and asset management firms



Source
Simmons & Simmons October 2017 Survey

Key Considerations in Fintech Transaction

- Regulatory Approvals
- Diligence
 - Intellectual Property & Software
 - Privacy & GDPR
- Reps/Warranties
 - Regulatory/Compliance
 - Cybersecurity
 - #metoo
 - Intellectual Property/Software/Privacy & GDPR
- Regulatory Oversight and Compliance Structure

ADVERTISING, SOCIAL MEDIA AND ONLINE REFERRAL ARRANGEMENTS

JEN KLASS
ERIC PERELMAN

Referral Fees

- 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
- 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

Referral Fees



- 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

Advertising and Performance

- Advertisements directed to Retail Investors
 - Higher sensitivity as to whether advertisements will be considered false or misleading based on the (lack of) sophistication of the prospective client
 - Placement and content of disclosure
- Hypothetical Performance
 - Projections must be positioned as hypothetical, forward-looking statements that are provided for illustrative purposes
 - Disclose the methodology of the calculations and the limitations inherent in the projections
 - Distinction between Advisers Act and FINRA treatment of hypothetical performance
- Use of Graphs, Charts, and Formulas
 - Advisers may not represent, either directly or indirectly, that any graph, chart, formula or other device being offered can in and of itself be used to make trading decisions, unless the advertisement prominently discloses the limitations or difficulties in its use
 - Disclose limitations of algorithm and operation of advisory service

Advertising and Performance

- Claims of Free Services
 - Advisers may not publish or distribute any advertisements that contain any statement to the effect that a report, analysis, or service offered is free unless it actually is
- Social Media and Testimonials

RISK MANAGEMENT, COMPLIANCE, AND INTERNAL CONTROLS FOR EMERGING TECHNOLOGIES

JEN KLASS
CHRISTINE LOMBARDO

Compliance and Internal Controls

- Algorithm Governance
 - Lessons from recent SEC enforcement action
 - SEC examination requests
 - “All compliance policies and procedures that currently are in effect for the Adviser. In responding to this request, the Adviser also should include any procedures related to the development, testing, maintenance, and monitoring of any systems and algorithms.”
 - “An explanation of the role of compliance in connection with the testing and monitoring of risk assessment models and investment/asset allocation algorithms.”

Compliance and Internal Controls

- 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

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

- Advertising and Electronic Communications
- Referral and Solicitation Arrangements
- 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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