Rules, Regs and Robos
Mutual Fund Directors Forum
The Road Ahead – Disruption and Innovation in the Fund Industry

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Speakers

Catherine “Katy” Gordon  
VP, Corporate Counsel, US Customer Officer  
Prudential Financial

[DAdd Contact Information]

Derek Newman  
Senior Regulatory Counsel  
Motley Fool Wealth Management

Alexandria, VA

derekn@fool.com
+1 202 236 0782

Michael L. Sherman  
Partner  
Dechert LLP

Washington, D.C.

michael.sherman@dechert.com
+1 202 261 3449
Agenda

- Defining Robo-Advisers
- Regulating Advisers and Robo-Advisers
- Pros, Cons and Questions to Consider
- Future of Robo-Advice
Defining Robo-Advisers
Robo-Advisers

- Primarily refers to the Internet-based delivery of “digital investment advice” and “automated investment tools”
  - The term “robo-adviser” is used to refer both to firms (advisers and broker-dealers) and to the automated investment advisory programs they offer
- Robo-advisers seek to use the information provided through data collection to create an investment strategy with a suitable risk/reward profile
- Variations among current business models
  - Data collection methods
    - Online only and questionnaire-driven
    - Preliminary or additional information gathered by client or by personnel
  - Investment strategy selection and underlying investments
    - Non-discretionary to discretionary
    - Investments vary from mutual funds to ETFs to individual “names”
  - Scope of advisory services
    - Tool used by the client (self-directed) or by personnel
    - Used to meet a specific goal or to provide a comprehensive financial plan
Disruption?

- Robo-advice has been seen as disrupting traditional advisers modes of formulating and delivering investment advice
  - Formulation: increasing to near total reliance on data and algorithms, which is theoretically completely replicable and scalable
  - Delivery: online and through mobile devices, which may substantially or wholly replace human interaction
- These differences impact an adviser’s compliance with the Investment Advisers Act of 1940 (Advisers Act) in subtle but important ways, for example
  - Suitability: how well do robo-adviser’s know their client in order to believe the advice is appropriate
  - Records: the advice and its delivery may create more records and necessitate different storage mechanisms
Market

- Well-known institutions predict a continuing shift in AUM to robo-advisers
  - “Between shifts from traditional advisors and ‘new investors,’ ~ $2 trillion will be managed under robo-advisors by [December 31] 2020”
  - “Based on a 2016 study of ‘Future of wealth in United States’ by the Deloitte Center for Financial Services, Deloitte estimates that the $2 billion in assets under automated management today may grow to $5 trillion to $7 trillion by the year 2025. While this won’t approach the $18 trillion currently managed by traditional advisers, robo-advising will clearly no longer be a fringe or experimental part of the market”
  - “Robo-advisors will likely continue to see double-digit growth in assets under management (AUM) in coming years, albeit from a low base of less than $100 billion in 2016”
Evolving service models for robo-advice

1\textsuperscript{st} generation (static and client directed)
- Internet-based suitability questionnaire
- Robo-adviser develops portfolio allocation
- Client invests for their own account in stocks, bonds, ETFs
- Client manages future adjustments

2\textsuperscript{nd} generation (semi-automated)
- Internet-based suitability questionnaire
- Robo-adviser allocates to pre-defined risk-allocated portfolios
- Robo-adviser’s platform allows for buys, sells and holds in accounts
- Robo-adviser’s investment managers adjust asset allocation of portfolios

3\textsuperscript{rd} & beyond (> automated)
- Internet-based sophisticated suitability + risk questionnaires
- Robo-adviser’s invest assets on an individualized basis
- Robo-adviser rebalances
- Robo-adviser’s investment managers provide oversight
- Client may direct some investments

Increasingly automated investments and re-balancing; robo-adviser’s algorithms are self-learning and shifting with the market, increasing use of artificial intelligence
Questions: current generation robo-advice

- Does the regulators’ understanding of “robo-advice” match the vernacular and the industry’s view?
- Is there a typical robo-adviser?
  - What are its characteristics?
  - Is the typical robo-adviser using asset allocation models?
  - Is the “hybrid” model (mix of online and human touch) becoming more common?
  - What fee structures are common?
- What are the economic drivers? Do we see any evolution here?
- Are mutual funds popular on these platforms? If not, what is? Where is the industry headed?
- How are traditional asset managers faring in this space (either through entry or acquisition)? What are the pros and cons for traditional advisers?
- What are the biggest disruptions to robo-advice?
Regulating Robo-Advisers

“As technology continues to improve and make profound changes to the financial services industry, it’s important for regulators to assess its impact on U.S. markets and give thoughtful guidance to market participants. . . This information is designed to help investors tap into the opportunities that fintech innovation can provide while ensuring fairness and investor protection.”

SEC Acting Chairman Michael Piwowar in Press Release accompanying Guidance and Investor Bulletin
Applicable Laws & Regulations

- Advisers Act and related rules are a dated regulatory framework
  - Disclosure process anticipates a printed/paper model;
  - Advisory service and client relationship is interpersonal
- Like all SEC-registered investment advisers, robo-advisers are subject to other federal securities laws
- Rulemaking by the SEC and (for dual-registrants) FINRA
- SEC views itself as the primary regulator of robo-advisers
Notable Advisers Act Considerations

- Registration with the SEC
- Anti-fraud provisions
- **Fiduciary duties**
- Suitability
- Supervision and compliance programs
- Disclosure obligations
- Advertising rules
- Advisory contracts and fee arrangements
- Recordkeeping
Regulating Robo-Advisers

- November 14, 2016: SEC hosted a FinTech Forum to discuss recent innovations including automated investment advice and robo-advisers.

- February 23, 2017:
  - IM Guidance Update on Robo-Advisers discussing the issues presented by and potential considerations for robo-advisers.
  - Investor Bulletin describing considerations for investors, including:
    - Who is providing the advice, specifically, the level(s) of human interaction.
    - What investor information is utilized to formulate recommendations.
    - How the robo-adviser approaches investing.
    - How much in fees are charged for the service.
IM Guidance

- Broad applicability, including:
  - Any “automated” advisory program
  - Traditional advisers that are highly reliant on automation and/or technology
  - Quantitative advisers

- Guidance focuses on three distinct areas
  - **Disclosure** of the investment advisory services offered
    - Is the disclosure sufficiently specific and presented in a manner likely to be read and understood?
  - **Suitability of advice**, including the obligation to obtain information from clients
    - Is the questionnaire designed to elicit sufficient information to determine initial and ongoing suitability of investments?
  - **Compliance programs** that are designed to address concerns specific to automated advice
    - Has the firm designed and implemented an effective and tailored compliance program? What is the role of compliance in supervision of the investment process, advice rendered and data collected?
Lessons from Recent SEC Enforcement Actions

- Automation creates documentation, allowing for audit trails, including:
  - Client responses to questionnaires and other communications between the adviser and clients
  - Formulation of advice
  - Delivery of advice

- When marketing model and hypothetical performance, advisers must include clear and complete disclosures
  - Presentation must clearly indicate whether performance is model, hypothetical or actual
  - Extra care must be taken with backtested performance
  - Disclosure responsibility is heightened where the client base is retail and there is less personal contact
Regulatory Developments

▪ OCIE reviewed robo-advisers through recent compliance sweep examinations

▪ Department of Labor’s fiduciary rule and its status

▪ SEC proposes rules and interpretations addressing firms (advisers and broker-dealer) standards of conduct on April 18, 2018, including
  • Regulation Best Interest
  • New Disclosure Requirements for Firms and Financial Professionals
  • Interpretive Guidance Regarding the Standard of Conduct for Investment Advisers (Proposed IA Interpretation)

The proposals are expected and intended to supplant the Department of Labor’s fiduciary rule, as well as similar state initiatives. The SEC consulted with the DOL, state regulators and FINRA in developing the proposals.
The proposed standard for advisers “is similar to, but not the same as, the proposed obligations of broker-dealers” in Proposed Regulation Best Interest.

The Proposed IA Interpretation indicates there is a federal, common-law fiduciary standard, including a duty of care and a duty of loyalty, which advisers owe to their clients and that such standard arises from the Advisers Act and is enforced through the antifraud provisions of rules under the Advisers Act.

- This federal fiduciary duty would apply to all clients and all aspects of the advisory relationship.
- It is unclear how the scope and contours of the duty can be modified by contract and disclosure.

The SEC also requested comment on whether certain compliance obligations of broker-dealers should apply to advisers, including:

- Licensing and continuing education requirements for personnel;
- Account statement delivery requirements for advisory accounts; and
- Financial responsibility (net capital and fidelity bond) requirements.
Questions: Meeting Existing and Emerging Regulatory Challenges

- What are the biggest challenges in the real world to implementing this regulatory regime?
  - What does a robo-adviser do if they have conflicting responses from a client (e.g., age and risk tolerance)?

- What is the effect on robo-advisers of the recently proposed standard of conduct rules?

- What do we see as the big ticket risks and conflicts for a stand-alone robo-adviser? For a robo-adviser who is part of a broader organization?
Pros, Cons and Questions to Consider
Considerations for Directors

▪ When considering whether to add funds to a robo-adviser’s platform, directors may wish to consider
  • Who is the robo-adviser and what advisory services do they offer their clients?
    – Any unique risks (e.g., is the robo-adviser a start-up)?
  • Is this a new platform being added to an existing distribution relationship?
  • What is the business plan for this platform?
▪ When considering whether to begin a robo-platform, is the adviser prepared? What costs/benefits?
▪ Fractional shares?
Considerations for Directors

- If considering joining an existing platform, what is the business plan for this platform?
  - Funds/products ripe for platform;
  - Sales channel permanency;
  - Share class needs;
  - Round trips (for allocation and tax planning);
  - Fee waivers;
  - Who asset allocator; and
  - Conflicts if platform is affiliated with the fund complex
Considerations for Directors

- If the fund’s adviser or a related adviser is beginning a robo-platform, is it prepared and what costs/benefits?
  - Will it distract or cannibalize;
  - How service in real-time (e.g., chat, skype, phone);
  - Compliance needs;
  - Marketing and impact on brand;
  - How much anticipate selling;
  - Who new shareholders are likely to be; and
  - Will be more like a marketplace, if so, how manage conflicts
Considerations for Directors

- Fractional shares?
  - Regulatory issues;
  - Conflicts;
  - Operational issues; and
  - Shareholder issues
Questions: Today’s opportunity or competition

- How are robo-advisers competing with mutual funds today?
- Why do some clients prefer robo-advice? What is the typical client profile?
- How does this market differ from the traditional (or other) distribution channels?
  - Which share classes are typically utilized by robo-advisers?
  - What fees and expenses to get on a robo-adviser’s platform? And who (the client or the fund) is paying?
- How are existing shops handling their affiliated products?
- How can a strong robo-adviser benefit the affiliated complex and vice versa?
Future of Robo-Advice
Questions: Future of robo-advice

- How have the SEC and FINRA historically responded to technological change?
- Is considering the growth of ETFs instructive to considering the potential impact of robo-advisers? If so, what lessons?
- How will robo-advisers serve various generations (greatest generation, baby boomers, Generation X and millennials)?
- What about the 3rd and 4th generations of robo-advice?
  - What role will artificial intelligence play in the future?
  - Will a robo-adviser be able to see all of my accounts (e.g., linking)?
Recent Actions by Other Regulators

- GAO, Financial Technology: Information on Subsectors and Regulatory Oversight (April 2017)
- Department of Labor, Final “Fiduciary” Rule, Department Position on Advice through Unbiased Computer Model (April 2016)
- Massachusetts, Policy Statement: Robo-Advisers and State Investment Adviser Registration (April 2016)
- FINRA, Report on Digital Investment Advice (March 2016)
Final Thoughts & Questions
For further information, visit our website at dechert.com.
Dechert practices as a limited liability partnership or limited liability company other than in Dublin and Hong Kong.