

**Baker  
McKenzie.**

# **Digital Advice Roundtable**

Financial Regulation and Enforcement Practice | November 18, 2019



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# Evolution of Digital Advice

# Evolution of Digital Advice

The business drivers for digital advice continue to be relevant

- 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 on impact of fees on investment returns
- Scalability of technology to automate portfolio management and operational tasks

# Evolution of Digital Advice

Digital advice offerings continue to evolve and mature

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

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# **SEC Trends and Recent Developments**

# SEC Trends and Recent Developments

## Rulemaking and OCIE Priorities & Risk Alerts Maintain Wide Scope

- **Protecting Retail Investors and those Saving for Retirement**
  - Every enforcement matter, every examination, every public statement has some relation to this overarching focus
- **Regulation Best Interest (Reg BI) and Related Rules and Interpretations**
  - Raising the standards of conduct for broker dealers, and harmonizing them with the fiduciary duty to which investment advisers are held
  - Continues to be a focus for SEC staff at the implementation stage
- **Continuing Focus on Financial Conflicts of Interest**
  - Can disclosure ever be adequate?
  - Regulation by enforcement

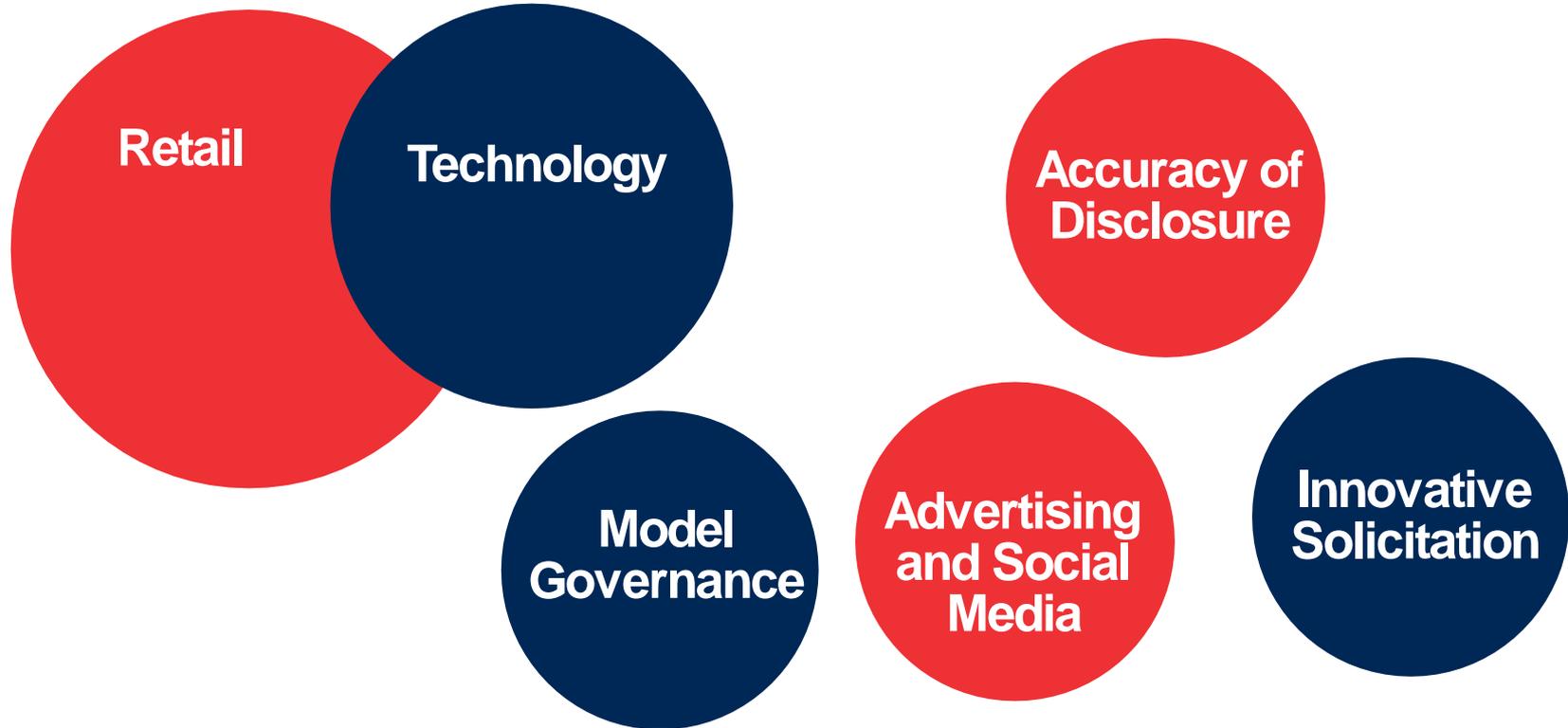
# SEC Trends and Recent Developments

## Rulemaking and OCIE Priorities & Risk Alerts Maintain Wide Scope

- **Recent/Current “Sweeps”: 403(b) Accounts, Cash Sweep Products**
  - Demonstrative of the SEC’s continuing evaluation of income streams throughout the financial services business
  - SEC data analytics, and ability to obtain data from throughout the marketplace, assists in identifying key issues and risks
- **Cybersecurity and Data Privacy**
  - Continued area of focus
- **Rulemaking**
  - Proposed modernization and overhaul investment adviser advertising and cash referral fee rules
  - Recent guidance on investment adviser proxy voting

# SEC Trends and Recent Developments

## Regulatory Profile for Digital Advisers



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# **Focus: Advertising Rule Amendments**

# The Advertising Rule: Proposed Amendments

## Modernized, Media Neutral Rule would Incorporate Decades of Guidance

- **Principles-Based Approach:** Redefines advertisement as any communication:
  - Disseminated by any means – Media neutral, extends to all electronic communications
  - By or on behalf of the adviser – Extends to communications distributed by the adviser, intermediaries and affiliates. Also covers communications distributed by third parties on behalf of the adviser if the adviser: (i) involves itself in the preparation of the communication; (ii) explicitly or implicitly endorses or approves the communication; or (iii) pays for the communication
  - That offers or promotes the advisory services, or that seeks to obtain or retain one or more investment advisory clients or investors – Does not regulate communications directed to existing clients that are designed to communicate information about their account
- **New Review and Approval Process:** Designated personnel, but not SEC or FINRA staff approval
- **Form ADV and Books and Records Rule Amendments:** Form ADV addresses additional information about adviser's use of advertisements; enhancements to books and records required to retain copies of all advertisements and records necessary to substantiate performance

# The Advertising Rule: Content Prohibitions

## Proposed Amendments Shares Similarities with FINRA Rule 2210

- **General Prohibitions:** False or misleading advertisements (existing rule's catch-all), unsubstantiated claims, untrue or misleading implications about material facts, discussions of potential benefits without clearly and prominently disclosing material risks or other limitations, unfair and unbalanced references to advice, and unfair and unbalanced performance results and time periods
- **Testimonials and Endorsements:** Permitted, subject to disclosure as to whether the speaker is a current or former client and whether the speaker is compensated
- **Third-party Ratings:** Permitted, so long as the questionnaire or survey used in the preparation of the third-party rating makes it equally easy to provide both favorable and unfavorable responses, is not designed to produce any predetermined result, and is accompanied by certain specified disclosures

# The Advertising Rule: Performance Presentations

## Subject to General Prohibitions, with Additional Requirements Governing Use and Presentation of Performance

- **Express Distinction between Non-Retail Advertisements and Retail Advertisements:** Non-Retail Advertisements includes qualified purchasers and knowledgeable employees; Retail Advertisements includes everything else
- **Gross and Net Performance:** Must be shown with equal prominence in Retail Advertisements, calculated over same time period, and using same type of return methodology
- **Performance Periods:** Retail Advertisements would have to include performance for 1, 5, 10 year periods or since inception — presented with equal prominence
- **Hypothetical Performance:** Covers backtested performance, representative (or model) performance, and targets and projections
  - Subject to conditions to ensure relevancy, disclosure of calculation methodology, and explanations of risks and limitations
  - SEC questions whether hypothetical performance would ever be appropriate for retail investors

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# Focus: Solicitation Rule Amendments

# The Solicitation Rule: Proposed Amendments

## Similar Modernization Goal as Advertising Rule Amendments

- Solicitation Rule Amendments rest on the same underlying policy rationale as the current Solicitation Rule: *perceived* risk of solicitor compensation
- Both in 1979 and 2019, the SEC notes investors could mistakenly view solicitor recommendations as unbiased if the existence of compensation remains undisclosed
- Expansiveness of proposed amendments only somewhat balanced by changes that streamline and improve compliance workability

# The Solicitation Rule: Expansive Changes

## Proposed Changes Include All Compensation and Material Conflicts Disclosure

- **All Compensation:** Both cash and non-cash compensation requires compliance with the proposed amendments to the Solicitation Rule (non-cash compensation includes directed brokerage, sales awards, free or discounted advisory services)
- **Solicitor Disclosures Expanded:** Requires disclosure of material conflicts
  - Due to receipt of compensation, including contingent or deferred arrangements, any non-cash compensation and its value, and relationship with adviser
  - The amount of any additional cost to the investor as a result of the solicitation arrangement

# The Solicitation Rule: Expanded Disqualifiers

## Proposed Changes Include Expanded Disqualification Provisions with a Grandfathering Provision

- **Disqualifying Events Include Expanded List of Regulators in Addition to U.S. Courts:** Disqualifying events would include finding, order or conviction by a U.S. Court, the SEC, or certain regulatory agencies that the person has engaged in certain acts or omissions. Additional regulators include:
  - Federal Agencies: The CFTC and federal banking agencies
  - State authorities: state securities commissioners, state insurance commissioners, state banking supervisors (includes oversight of savings association and credit unions)
  - SROs: FINRA, registered exchanges, other national securities associations
- **Reasonable Care Standard to Assess Solicitor Ineligibility:** SEC expects advisers to periodically inquire on the solicitor's status
- **10-Year Lookback:** Same lookback as the Regulation D Rule 506 disqualification provisions

# The Solicitation Rule: Some Streamlining

## Proposed Changes Include Some Welcome Common-Sense Changes

- **Adviser Can Fulfill Solicitor Disclosure:** Allowing the adviser to fulfill the solicitor disclosure requirement, on behalf of the solicitor and provided the written agreement makes designation, is a welcome shift
- **Variety of Media Allowed for Disclosures:** Media formats include audio, video or online, in addition to written
- **Elimination of Duplicate Form ADV Part 2A Delivery Requirement.** The proposed amendments would remove the requirement that solicitors provide a copy of the investment adviser's Form ADV Part 2A (the brochure) to clients
- **Narrowing the Undertaking Under the IAA:** The solicitor undertaking in the written agreement would narrow to Sections 206(1), (2) and (4)

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# **Focus: Regulation BI Rule Set – Check In**

# Reg BI & Related Rules and Interpretations

## Investment Adviser Interpretation Effective While Form CRS Becomes Mandatory On June 30, 2020

- **Form CRS *Filing* Requirement for Investment Advisers**
  - Form CRS/Form ADV Part 3 must be filed with the SEC by June 30, 2020
  - Filing can begin on May 1, 2020
- **Form CRS *Delivery* Requirement for *Existing* Clients of Investment Advisers**
  - Form CRS transition provisions set a requirement of July 30, 2020 (30 days after implementation deadline)
- **Form CRS *Delivery* Requirement for *New* Clients of Investment Advisers:** Before or at the time of entering into an advisory agreement. Note that dual registrants have to take into account whether a recommendation was provided to a retail investor prior to account opening

# Form CRS for Advisers and Dual Registrants

## Disclosure Requirements Focus on Costs, Fees and Conflicts

- **Form CRS Requires Disclosure of Material Fees and Costs**
  - Principal fees and costs (transaction-based fees, if applicable)
  - Other fees and costs, including custodian fees, account maintenance fees, mutual funds and variable annuity fees, and any other fees
- **Form CRS Requires Granularity in Disclosing Type and Scope of Services, including Client-Firm Relationships and Governing Legal Standards:**
  - Summary of principal services, accounts or investments
  - Explanation of client-firm relationship, including duty of care owed to the client
- **Form CRS Requires Disclosure of Legal or Disciplinary History of the Financial Professionals of the Firm**
- **Dual Registrants' Form CRS Includes a Comparison of Broker-Dealer and Investment Adviser Client Relationships**

# Investment Adviser Interpretation

Reaffirms and Clarifies Existing Fiduciary Duty Standard Advisers Owe Clients, Though Clarification Goes Beyond Restatement in Certain Areas

- **Consolidates Fiduciary Duty Caselaw and Investment Management Staff Positions in a Single SEC Guidance on Federal Fiduciary Duty**
  - Addresses both the duty of loyalty and duty of care
  - Notes the Interpretation covers all advice, to both retail and institutional clients
- **Interpretation Provides New Guidance, Including:**
  - Expanding conflicts of interest disclosure beyond material conflicts
  - Clarifying use of hedge clauses and that application of duty is determined by scope of the advisory relationship, as defined by contract
  - Noting applicability to all (SEC and state) advisers while acknowledging potential additional obligations (case law, ERISA, state law)
- **Interpretation Specifically Addresses Its Applicability to Digital Advisers:** Notes *IM Guidance Update No. 2017-02*

# Interpretation: Duties of Loyalty and Care

How the Interpretation Addresses the Duty of Loyalty and Duty of Care and How the SEC will Examine For and Enforce These Two Duties

- **Duty of Care Requirements Include:**

- Providing advice that is in the best interest of, and is suitable for, the client
- Seeking best execution when adviser responsible for broker-dealer selection
- Providing advice and monitoring over the course of the relationship

- **Duty of Loyalty Section of the Interpretation Includes:**

- Aligning the formulation of the duty to loyalty closer to former policy position
- Extending disclosure requirements to all conflicts, not just material conflicts
- Highlighting informed consent component of disclosure

- **Examinations and Enforcement Considerations:**

- Provides a checklist and likely will improve OCIE's processes
- (Yet) Leaves flexibility to the staff to interpret and enforce the Interpretation

# Disclosure of Financial Conflicts

October 2019 Division of Investment Management Guidance substantiates, even legitimizes, SEC positions in examinations and enforcement

- **Focuses on All Financial Conflicts of Interest:** Guidance speaks to compensation beyond 12b-1 fees and revenue sharing arrangements; focus should be on all direct and indirect compensation
- **Provides Examples of Material Facts to be Disclosed**
  - Includes existence and effect of different incentives and resulting conflicts, nature of conflicts, and how adviser addresses the conflict
  - Disclosure must be concise, direct, appropriate to the level of financial sophistication for the client and written in plain English
- **Addresses “May”-Based Disclosure:** “May”-based disclosure is not sufficient if the conflict actually exists; “may” be used only if conflict does not yet exist but might reasonably present in the future

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# Focus: Oversight of Sub-Advisers

# Oversight of Sub-Advisers

Proper oversight requires a comprehensive and defined program

- **Sub-adviser oversight process should be risk-based**
  - Whether sub-adviser is affiliated is one of the factors considered in designing a risk-based program
- **Based on written plan** - Ideally, would include written plan that outlines the strategy for selecting the sub-adviser, identifies the potential risks of the sub-advisory activity, and details how the adviser selects, assesses, and oversees the sub-adviser
- **Key components of oversight process would include:**
  - Due diligence in selecting a sub-adviser
  - Written contracts that outline the rights and responsibilities of all parties

# Oversight of Sub-Advisers

Proper oversight requires a comprehensive and defined program

- **Key components of oversight process would include:**
  - Ongoing monitoring of the sub-adviser's activities and performance
  - Contingency plans for terminating the sub-advisory relationship in an effective manner
  - Clear roles and responsibilities for overseeing and managing the relationship and risk management process
  - Documentation and reporting that facilitates oversight, accountability, monitoring, and risk management
  - Period reviews to test whether the oversight process aligns with the adviser's strategy and effectively manages risks
- **Review OCC guidance by analogy**



**Questions**

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