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Recent Developments in the Investment Management Industry

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Robo-Advice and FinTech – Capitalizing on High Demand

Derek N. Steingarten, Partner, New York

ROBO-ADVISERS AND REGULATORY RESPONSES

- "Robo-advisers" implement multiple, overlapping business models:
  - Direct client interaction
    - Favored by younger investors comfortable with social media and virtual relationships
    - Favorable fee structure
  - Traditional advisers relying on robo-advisers for certain functions
    - Refer clients to robo-advisers for certain aspects of portfolio management
    - Incorporate robo-advisers into traditional financial planning
  - Use of robo-advisers in providing investment advice
    - portfolio construction
    - automated tax-loss harvesting
    - portfolio rebalancing
    - "white label" / customized robo-advice platforms

PROLIFERATION OF ROBO-ADVISERS

- Cerulli Associates (2015): assets managed by robo advisers to rise 2,500% between 2015 and 2020, to $489 billion
- Tiburon Strategic Advisors (2016): 51 robo advisers in the market, collectively managing close to $250 billion
- InvestmentNews*:
  - 7.3% of independent advisory firms use a robo-advice platform
  - 63.2% of independent BDs plan to offer robo-advisory services over the next two years
  - Of those, 50% plan to do so by the end of 2016
- Independent robo-advisers (e.g., Betterment, Wealthfront) receive a lot of press, but represent only 3% of digital wealth management AUM**

*Liz Skinner, Robo-Advisers Demand Attention, InvestmentNews, December 20, 2015.

**"The hard truth about the rise of robo advisers," Financial Planning, October 3, 2016.

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SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

"*While automated investment tools may offer clear benefits—including low cost, ease of use, and broad access—it is important to understand their risks and limitations before using them.*"

"*Investors should be wary of tools that promise better portfolio performance*."

SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

1. Understand any terms and conditions.
   - Ask an automated investment tool sponsor whether it receives any form of compensation for offering, recommending, or selling certain services or investments.
2. Consider the tool's limitations, including any key assumptions.
   - Be aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation.
   - Automated investment tool may be programmed to consider limited options.
3. Recognize that the automated tool's output directly depends on what information it seeks from you and what information you provide.
4. Be aware that an automated tool's output may not be right for your financial needs or goals.
5. Safeguard your personal information.
   - Collection of personal information for purposes unrelated to the tool.
   - Beware of phishing and other scams.

FIDUCIARY STATUS OF ROBO-ADVISERS

"*What would a fiduciary duty mean to a robo-adviser? Or suddenly, is there no fiduciary duty if it's automated advice?*"

-*Commissioner Kara Stein, Investment Adviser Association Compliance Conference (March 10, 2016)*

- Duty of Loyalty
  - Conflicts of interest and disclosure
  - Standard criteria for determining the appropriate investments drawn from a defined universe of potential investments
  - Disclosure of inherent and latent conflicts of interest
- Duty of Care
  - Competence and suitability of recommendations
  - Suitability is the real issue--Knowledge of client's financial status and investment needs may not be sufficiently established by an automated, inflexible set of questions
- Effectiveness of robo-adviser disclaimer of consideration of retail investor's entire financial situation?
- Impact of ERISA?

INDUSTRY GROWTH

- The number of investment advisers registered under the Investment Advisers Act of 1940 has risen by 17% in the last two years.
- Collectively they manage $70 trillion in assets, an increase of more than $40 trillion over the last decade.
- In response, the SEC has recently increased by 20% the number of examiners that monitor investment advisers and investment companies.
- New developments in Robo-Advice Platforms, Fintech and Exchange-Traded Funds

INCREASED REGULATION, REPORTING AND ENFORCEMENT

- SEC Changes Regulation for Registered Advisers and Registered Funds
  - Final Rule on Liquidity Risk Management Programs for Registered Funds
  - Proposed Rules for Adviser Business Continuity and "Living Will" Transition Plans
  - Proposed Derivatives Rule
  - Final Amendments to Form ADV for Disclosure of Separately Managed Accounts
  - Continued Emphasis on "Distribution-in-Guise"

- DOL Fiduciary Regulation
  - Already adopted and effective
  - Compliance date April 2017
  - Political Open question

- SEC Enforcement
  - Record-breaking number of new enforcement actions, whistleblower awards
  - Whistleblower Developments – Rule 21F-17 and Anti-Retaliation Cases
  - Cybersecurity Enforcement Actions

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POST-ELECTION – A NEW DIRECTION?

- President Trump's agenda involves reduced regulation of the financial services industry and changes in enforcement
  - Financial Choice Act / reforms to the Dodd-Frank Act
  - Open Questions about Status of Pending Rule Proposals
  - A proposed Executive Order to strike two regulations for each one approved

- Intense Pressures at the SEC
  - Departing senior staff
  - A proposed hiring freeze
  - Questions about the existing nominees

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DOL Fiduciary Regulation – the new FAQs

Robert L. Sichel, Partner, New York

TOPICS

- Regulation Status
- Common Misconceptions
- Background
- Selling/Promotional Activities

Common Misconceptions

COMMON MISCONCEPTIONS

- I’m already an ERISA fiduciary so the new regulation does not impact me
- I do not have to deal with ERISA because none of my funds are ERISA plan asset funds (e.g., ERISA investors are below 25%; mutual funds)
- My sales people do not provide investment advice

Background

HOW DOES ONE BECOME AN ERISA FIDUCIARY?

- ***Discretionary Fiduciaries***: By exercising discretionary authority or discretionary control with respect to the management of an employee benefit plan covered by ERISA (e.g., 401(k) plans) or an IRA
- ***Investment Advice Fiduciaries***: By rendering investment advice to such a plan for a fee or other compensation or having any responsibility to do so; regulations define the scope

NEW REGULATION

- In April 2016, the Department of Labor issued a new regulation that re-defines "investment advice fiduciary" and brings radical change to many aspects of the U.S. retirement industry
- The regulation greatly expands the group of market participants to be deemed ERISA fiduciaries and alters key "prohibited transaction" exemptions

UNDER THE NEW REGULATION

- Investment advice includes certain “recommendations”
- “Recommendations” broadly include statements that would reasonably be viewed as **suggestions** to take or refrain from taking a particular course of action (no mutuality requirement); for example, “you should invest in my fund” is a recommendation
- Content, context and presentation inform the determination
- The more individually tailored the communication, the more likely it is a recommendation
- Investment advice could include selling/promotional activity

Selling/Promotional Activities

TWO PHASES TO CONSIDER

Phase 1

Selling/Promotional

Hired

Phase 2

Providing Advice/
Exercising
Discretion

WHEN DOES FIDUCIARY STATUS ATTACH?

- Historically managers avoided ERISA fiduciary status when selling products and services (phase 1) by making sure there is no “mutual understanding” that the manager is providing investment advice
  - Disclaimers on marketing materials
  - Representations in subscription agreements and IMAs
- The new regulation may cause a manager to become an ERISA fiduciary during phase 1, even if the manager is selling a non-plan asset fund
- Adverse consequences were this to happen

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ANALYSIS OVERVIEW

Is the prospective client in scope?

IRAs	U.S. private sector retirement plans	Governmental plans[1]

If yes, has a "recommendation" been provided?

"Hire me" concept	Investment education	General communication

If yes, is an exclusion or exemption available?

Sophisticated fiduciary (institutional)	BIC Exemption (retail)

[1] Some governmental plans are subject to state and local laws that incorporate ERISA concepts or seek to be treated as ERISA investors contractually

ACTION STEPS

- Determine preferred approach or approaches
- Develop and implement a process to promote adherence
  - Sales training
  - Written procedures
  - Expanded compliance review of marketing materials and practices
  - Additional investor representations to fund documents and IMAs
  - Due diligence on the client's fiduciary

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Regulatory Hot Topics/Impact of U.S. Elections

Edward Dartley, Partner, New York and C. Todd Gibson, Partner, Boston/Pittsburgh

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