

Point of view (POV) for regulatory compliance of digital investment advice services

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Digital advice and regulatory scrutiny

- ▶ The proliferation of digital platforms for retail advice has drawn heightened regulatory scrutiny from global regulators.
- ▶ The 2017 examination priorities letter from the Securities and Exchange Commission (SEC) identified electronic investment advice as a growth industry that will be subject to examination in 2017. Examinations are expected to focus on compliance practices for overseeing algorithms that generate recommendations, compliance programs, marketing, formulation of investment recommendations, data protection and disclosures relating to conflicts of interest. In addition, the SEC's Division of Investment Management has also issued guidance for investment advisors with suggestions on meeting disclosure, suitability and compliance obligations under the Investment Advisers Act of 1940.
- ▶ The 2016 Report on Digital Investment Advice from the Financial Industry Regulatory Authority (FINRA) focused on governance and supervision, investor profiling, rebalancing and training, all of which pose unique compliance challenges to digital advisors.
- ▶ The United Kingdom (UK) Financial Services Consumer Panel, an independent statutory body that scrutinizes the work of the Financial Conduct Authority (FCA), published a report in December 2016 and called on the regulator to "vigorously" enforce its rules applicable to digital advisors.
- ▶ Other non-US securities regulators, including the Australian Securities & Investments Commission (ASIC), have published detailed regulatory guides for firms providing digital financial product advice to retail clients.

Timeline of regulatory guidance, publications and alerts related to digital investment advice



The role of compliance in digital advice

- ▶ Digital advisors must employ an effective governance and supervisory framework so that the resulting advice is consistent with securities laws and rules. Sustainable processes for digital advice will need to be integrated into a business-as-usual course of operations.
- ▶ The design, implementation and management of digital advisory services will be reviewed by regulators with a key focus on compliance topics identified in the compliance life cycle.
- ▶ As firms continue to build out digital products and capabilities, it is essential to identify new and existing risks these capabilities pose and implement the proper risk and technology controls in the product development life cycle. As digital features go live and operate in a business-as-usual environment, there is a need for ongoing monitoring of risks, especially as these digital assets interact with existing firm and vendor technologies.
- ▶ Firms should develop robust internal controls and a compliance program reasonably designed to support and monitor the following aspects:
 - ▶ **Identifying regulations/assessing risks:** conduct a review of the inventory of regulatory risks captured in risk assessments, identify compliance gaps and map those risks to their business processes
 - ▶ **Program development:** establish key compliance function and business policies and procedures and determine the adequacy of training programs within the compliance organization and in the business
 - ▶ **Oversight execution:** develop performance monitoring and testing, performance metrics, exception reporting, approval requirements, management interface, complaint tracking/trending and ethical allegation review
 - ▶ **Communication/reporting:** consider the complexity and effectiveness of compliance activity and issue reporting and the controls and oversight to enable timeliness, accuracy and proper escalation

Compliance life cycle: technology and data enablement in product development



Compliance considerations for digital advice

Compliance life cycle stage

Sample key considerations

Identifying regulations/ assessing risk

Roles and responsibilities

- ▶ Identify and coordinate compliance roles and responsibilities with respect to the digital advisory services
- ▶ Identify and comply with relevant laws, regulations and policies

Conflicts of interest

- ▶ Identify conflicts and controls to mitigate, manage or eliminate them (For example, conflicts of interest may result from particular securities in portfolios ("assets under management" fees, tiered pricing, product-based fees, proprietary products/expense ratios) and incentive structures.)

Third-party oversight

- ▶ Conduct risk assessments of the third party and verify regulatory and compliance requirements
- ▶ Provide ongoing oversight of third-party activities
- ▶ Facilitate active participation from compliance in assuring the existence of an effective third-party (vendor) oversight program, due diligence, risk assessment and testing

Record-keeping

- ▶ Establish record retention policies and procedures to properly retain client communications, recommendations and other required records

Technology risk governance

- ▶ Design and implement a governance framework that includes roles and responsibilities, oversight and risk management processes for the product development life cycle and ongoing business activities
- ▶ Analyze and document processes and controls and define a governance process for ongoing risk management
- ▶ Build a user interface to manage workflow, approvals

Program development

Customer portfolios and disclosures

- ▶ The development and implementation of algorithms include input from compliance.
- ▶ Investor profile determination and criteria for determining appropriate securities for each portfolio are clearly documented. Performance and risk characteristics are appropriate for the types of investors to whom portfolios are offered.
- ▶ Policies and procedures are in place for how tools and algorithms will act in the event of major market movement.
- ▶ Appropriate disclosures concerning the firm's particular business model and related risks in addition to the scope and limitations of the service are disclosed to the customer.

Training

- ▶ Establish training programs within the compliance organization and in the business to assure that staff understand legal and regulatory responsibilities
- ▶ Verify that financial professionals have been trained and understand the limitations and proper usage of algorithms and digital investment advice tools

Compliance considerations for digital advice

Compliance life cycle stage

Sample key considerations

Oversight execution

Monitoring, testing, governance and supervision of algorithms

- ▶ Design suitability and monitoring checks to align advice with customers' risk profile and criteria
- ▶ Evaluate scenarios used in portfolio analysis tools and confirm results perform as expected both before and after implementation
- ▶ Perform a review of the control framework to test for completeness and accuracy of data
- ▶ Perform periodic assessments of models for appropriateness as market and other conditions evolve, and regularly test outputs

Data protection and cybersecurity

- ▶ Develop strong data privacy policies and processes that allow the sharing or otherwise limit utilization of client information only to the extent necessary to facilitate clients' stated objectives
- ▶ Review existing data encryption standards to protect both client accounts and key advisory systems
- ▶ Design strong controls, including obtaining cybersecurity insurance, maintain business continuity management plans and implement incident management frameworks
- ▶ Develop "write once read many" retention policies and practices for data and other books and records

Communication/ reporting

Issue tracking, exception reporting and escalation

- ▶ Develop exception reporting for anomalies and deviations from performance expectations
- ▶ Establish procedures to resolve any issues or errors resulting from algorithm design and code changes and create processes to trigger required escalation
- ▶ Establish centralized reporting to track exceptions, error reporting, output from suitability and monitoring checks to facilitate management oversight and supervision

Examples of laws, rules and definitions applicable to digital advice

- ▶ Given the emergence of digital advice, firms will need to evaluate their existing business, compliance and risk programs to confirm that they address both new and existing rules and regulations.
- ▶ The following table consists of examples of different laws, rules and definitions, which we anticipate will be crucial to understand from a compliance standpoint.

Focus area	Applicable rule/law	Description
Implementation of effective practices (including training and testing)	Know-your-customer rule (FINRA Rule 2090)	Mandates advisors to use reasonable due diligence in regard to opening and maintenance of customer accounts to know essential facts of every customer and to report suspicious activity
	FINRA suitability rule (FINRA Rule 2111)	Requires advisors' financial recommendations to be suitable for the customer investment profile, based on reasonable due diligence
	Blue sky laws (vary by state)	Protects investors against fraudulent sales practices and activities by requiring firms making offerings of securities to register security offerings and license brokers/investment advisors
Governance and supervision	Department of Labor fiduciary rule	Requires that advisors (in instances where there is an interaction between a human advisor and an algorithm) provide investment advice that is in the best interest of clients
Record-keeping	Investment Advisers Act of 1940 (SEC Rule 17 CFR Part 275)	Requires investor advisors to make and keep true accurate and current books and records relating to their investment advisor business in defined categories
	SEC 17a-3 and 17a-4	Specifies what pieces of information any broker-dealer who transacts in securities must keep in records and requires broker-dealers to preserve electronic media exclusively in a non-rewriteable and non-erasable format
Registration	Securities Exchange Act	Generally requires a person engaged in the business of a broker or dealer to be registered with the SEC in addition to "associated persons" who work for a registered broker-dealer
	Investment Advisers Act of 1940 (SEC Rule 17 CFR Part 275)	Defines advisors' roles and responsibilities in operating in US financial markets

Key contacts

For additional information on how we can assist you with the role of compliance in digital advice, please contact a member of our team:



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