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Legal Update

SEC Proposes Rules on Broker-Dealer and Investment Adviser Use of Predictive Data Analytics and on Internet Investment Adviser Registration

On July 26, 2023, the U.S. Securities and Exchange Commission ("SEC" or the "Commission") released two sets of rule proposals. First, the SEC proposed new and amended rules under the Securities Exchange Act of 1934 (the "Exchange Act") and the Investment Advisers Act of 1940 (the "Advisers Act") to address conflicts of interest associated with the use of predictive data analytics ("PDA") and similar technologies by broker-dealers and investment advisers (collectively, "firms") in investor interactions (the "Proposed Conflicts Rules").[1] Second, the SEC proposed to amend the existing registration exemption for "internet advisers."[2] Comments are due within 60 days after publication in the Federal Register.

We provide an overview of the rule proposals in this Legal Update.

Proposed Conflicts Rules

BACKGROUND

The Proposed Conflicts Rules seek to ensure that firms are appropriately addressing conflicts of interest associated with the use of PDA and similar technologies, such as artificial intelligence, including machine learning, deep learning, neural networks, natural language processing or large language models, and other technologies that make use of historical or real-time data, lookup tables or correlation matrices (collectively, "PDA-like technology"). In the SEC's view, the Proposed Conflicts Rules are needed due to the scalability of PDA-like technology and the potential for firms to reach a broad audience at a rapid speed, such that any resulting conflicts of interest could cause harm to investors in a more pronounced fashion and on a broader scale than previously possible.

The SEC intends for the Proposed Conflicts Rules to supplement, rather than supplant, existing regulatory obligations related to conflicts of interest (*e.g.*, an investment adviser's fiduciary duty and a broker-dealer's duties under Regulation Best Interest ("Reg BI")).[3]

Importantly, the SEC believes disclosure (and informed consent) relating to conflicts of interest in the context of firms' use of PDA-like technology may be ineffective due to the rate of investor interactions, the size of the

datasets, the complexity of the algorithms on which the PDA-like technology is based, and the ability of the technology to learn investor preferences or behavior. In this regard, firms could be required to provide disclosures that are lengthy, highly technical, and variable, which could cause investors difficulty in understanding the disclosures. As a result, the SEC has proposed elimination or neutralization of actual conflicts of interest, as described in more detail below.

Finally, the SEC expressly states that "[t]he proposal is intended to be technology neutral" and does "not seek[] to identify which technologies a firm should or should not use," although concerns have been raised that the proposal "reflects a hostility toward technology" and "[t]hat antagonism is trained at [PDA-like technology]."[4]

SCOPE; DEFINITIONS

The Proposed Conflicts Rules would apply to all broker-dealers and investment advisers registered, or required to be registered, with the Commission. As such, the rules would not apply to, for example, exempt reporting advisers and state-registered advisers.

The Proposed Conflicts Rules would apply when a firm uses "covered technology" in an "investor interaction." Importantly, the "use" of covered technology in an investor interaction can occur *directly* through the use of a covered technology itself (*e.g.*, a behavioral feature on an online or digital platform that is meant to prompt, or has the effect of prompting, investors' investment-related behaviors) or *indirectly* by firm personnel using the covered technology and communicating the resulting information gleaned to an investor (*e.g.*, an email from a broker recommending an investment product when the broker used PDA-like technology to generate the recommendation).

The Proposed Conflicts Rules applicable to broker-dealers and investment advisers would be substantially identical, except as noted below.

Covered Technology. The term "covered technology" would be defined broadly to mean an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes.

This definition would include widely used and bespoke PDA-like technology, *future and existing technology*, sophisticated technology as well as relatively simple technology, and technology that is developed or maintained at a firm or licensed from third parties.

By way of specific examples, a "covered technology" would include a firm's use of:

- PDA-like technologies that analyze investors' behaviors (*e.g.*, spending patterns, browsing history on the firm's website, updates on social media) to proactively provide curated research reports on particular investment products;
- Algorithmic-based tools, such as investment analysis tools, to provide tailored investment recommendations to investors;
- A conditional auto-encoder model to predict stock returns; and
- A spreadsheet that implements financial modeling tools or calculations, such as correlation matrices, algorithms, or other computational functions, to reflect historical correlations between economic business cycles and the market returns of certain asset classes, in order to optimize asset allocation recommendations to investors.

By contrast, technology that does not, and is not intended to, affect an investment-related behavior or outcome would be excluded, such as the following:

- A technology that is designed purely to inform investors, such as a website that describes the investor's current account balance and past performance, but does not, for example, optimize for or predict future results, or otherwise guide or direct any investment-related action;
- A technology that predicts whether an investor would be approved for a particular credit card issued by the firm's affiliate based on other information the firm knows about the investor; and
- A chatbot that employs PDA-like technology to assist investors with basic customer service support (*e.g.*, password resets or disputing fraudulent account activity).

Investor. For broker-dealers, the term "investor" would be defined to mean a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes, which is consistent with the definition used for purposes of Form CRS. For investment advisers, the term "investor" would be defined to mean any prospective or current client of an investment adviser *or any prospective or current investor in a pooled investment vehicle* (as defined in Rule 206(4)-8 under the Advisers Act)[5] advised by the investment adviser.

Investor Interaction. The term "investor interaction" would be defined to mean engaging or communicating with an investor (including by exercising discretion over an investor's account), providing information to an investor, or soliciting an investor; except that the term does not apply to interactions *solely* for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support.

This definition would capture a firm's correspondence, dissemination, or conveyance of information to or solicitation of investors, in any form, including communications that take place in-person, on websites; via smartphones, computer applications, chatbots, email messages, and text messages; and other online or digital tools or platforms, such as trading apps. This definition would also capture any advertisements, disseminated by or on behalf of a firm, that offer or promote services or that seek to obtain or retain one or more investors.

Conflict of Interest. As defined in the Proposed Conflicts Rules, a "conflict of interest" would exist when a firm uses a covered technology that takes into consideration an interest of the firm or its associated persons.[6]

As further described below, if a covered technology considers *any* firm-favorable information in an investor interaction or information favorable to a firm's associated persons (such as when covered technology takes into account the profits or revenues of the firm, either directly or indirectly), the Proposed Conflicts Rules would require a firm to evaluate the conflict and determine whether such consideration involves a conflict of interest that places the interest of the firm or its associated persons ahead of investors' interests, and*, if so, eliminate, or neutralize the effect of, that conflict of interest. For investment advisers, this means that disclosure and informed consent, a common way for advisers to address conflicts of interest with advisory clients, is not enough.*

REQUIREMENTS

The Proposed Conflict Rules generally would impose the following obligations on a firm when it uses covered technology in an investor interaction.

Identification, Determination, and Elimination/Neutralization of Conflicts

The Proposed Conflicts Rules would require a firm to:

(a) *Evaluate* any use, or reasonably foreseeable potential use, by the firm or its associated persons of a covered technology in any investor interaction to identify any associated conflicts of interest associated with that use or potential use, including through *testing* each such covered technology prior to its implementation or material modification, and periodically thereafter;

(b) *Determine* whether any such conflict of interest places or results in placing the firm's or its associated person's interest ahead of the interests of investors; and

(c) *Eliminate, or neutralize the effect of*, those conflicts of interest (other than conflicts of interest that exist solely because the firm seeks to open a new investor account)[7] that place the firm's or its associated person's interest ahead of investors' interests.

Evaluation. The Proposed Conflicts Rules do not mandate a particular means by which firms must evaluate their use or potential use of a covered technology or identify an associated conflict of interest. Instead, firms may adopt an evaluation approach that is appropriate for their particular use of covered technology, and could adopt different approaches for different covered technologies based on, for example, the nature and complexity of the covered technology, and how firm uses or plans to use it.

Testing. The Proposed Conflicts Rules would include a requirement to test each covered technology prior to its implementation or *material* modification, and periodically thereafter, to identify any associated conflicts. The term "material modification" would not include standard software updates, security or other patches, bug fixes or minor performance improvements. Each firm would need to determine its own testing methodologies and frequencies depending on, for example, the nature and complexity of the covered technologies.

A Note About Evaluation and Testing Challenges – The SEC is aware that in certain cases, it may be difficult or impossible to evaluate a particular covered technology or identify associated conflicts. For example, large language models may consider millions of data points, in which case it could be difficult for the firm to determine whether the technology implicates the firm's interest. Another example is where a firm does not have full visibility into all aspects of how a third-party licensed covered technology functions. However, a firm's lack of visibility would not absolve it from compliance with the requirements of the Proposed Conflicts Rules.

The Commission is also aware that some more complex covered technologies lack explainability as to how the technology functions in practice, and how it reaches its conclusions (*e.g.*, a "black box" algorithm where it is unclear exactly what inputs the technology is relying on and how it weights them). Firms would only be able to continue using these technologies where all requirements under the Proposed Conflicts Rules have been met.

The SEC acknowledges, however, that as a practical matter, firms that use these covered technologies likely may not be able to identify all conflicts of interest associated with the use of the technology. In such cases, firms may be able to modify the technology by, for example, embedding explainability features into their models and adopting back-end controls (such as limiting the personnel who can use a technology or the use cases in which

it could be employed) in a manner that will enable firms to satisfy these requirements. It is unclear what explainability features would satisfy the SEC or its staff, and further what features would enable a firm to support its compliance with this element of the proposed rules.

Determination. If a conflict of interest exists in a firm's use of covered technology, the firm would be required to determine whether such conflict of interest places or results in placing the firm's or its associated person's interest ahead of investors' interests. This is a facts and circumstances analysis, and would depend on a consideration of a variety of factors (*e.g.*, the nature of the covered technology, its anticipated use, the conflicts of interest involved, the methodologies used and outcomes generated, and the interests of the investor). Based on this analysis, the firm must either: (a) reasonably believe that the covered technology does not actually result in the firm's or an associated person's interests being placed ahead of those of investors; or (b) take steps to eliminate, or neutralize the effect of, the conflict.

Elimination or Neutralization of Effect. To eliminate a conflict of interest that places the firm's or its associated person's interest ahead of investors' interests, a firm could either completely eliminate the practice that results in the conflict or remove the firm's or associated person's interest from the factors considered by the covered technology. Alternatively, the firm could neutralize the effect of the conflict by taking steps to prevent the technology from biasing the output towards the interest of the firm or its associated persons. For example, a firm could apply a "counterweight" such as considering additional investor-favorable factors that would not have been considered otherwise in order to counteract consideration of a firm-favorable factor. A firm could also change how the information is analyzed or weighted so that the technology always holistically weights other factors as more important than firm-favorable factors so that biased data cannot affect the outcome.

Policies and Procedures

The Proposed Conflicts Rules would require a firm that has any investor interaction using covered technology to have written policies and procedures reasonably designed to achieve compliance with the Proposed Conflicts Rules, including:

(a) A written description of the process for evaluating any use (or reasonably foreseeable potential use) of a covered technology in any investor interaction;

(b) A written description of any material features of any covered technology used in any investor interaction and of any conflicts of interest associated with that use;

(c) A written description of the process for determining whether any identified conflict of interest results in an investor interaction that places the interest of the firm or person associated with the firm ahead of the interests of the investors;

(d) A written description of the process for determining how to eliminate, or neutralize the effect of, any conflicts of interest determined to result in an investor interaction that places the interest of the firm or associated person ahead of the interests of the investors; and

(e) A review and written documentation of that review, no less frequently than annually, of the adequacy of the policies and procedures established pursuant to the Proposed Conflicts Rules and the effectiveness of their implementation as well as a review of the written descriptions referenced above.

The SEC emphasizes that for a firm that makes extensive use of more complex covered technology, or a firm whose conflicts of interest are more complex or extensive, the policies and procedures would need to be

substantially more robust than firms engaging in a very limited use of covered technology or that only use covered technologies that are relatively simple.[8]

Recordkeeping Amendments

The Proposed Conflicts Rules would amend the existing recordkeeping rules applicable to broker-dealers and investment advisers to require that firms make and keep books and records related to the requirements of the proposed rules, including: written documentation of conflict evaluations (including a list of all covered technologies used in investor interactions and documentation describing any testing thereof); documentation regarding conflict determinations, eliminations and/or neutralizations; written policies and procedures reasonably designed to achieve compliance with the Proposed Conflicts Rules; a record of any disclosure provided to investors regarding the firm's use of covered technologies; and technology change records (*e.g.*, altering, overriding or disabling covered technologies).

Exemption for Certain Investment Advisers Operating Through the Internet

Since 1997, responsibility for regulating investment advisers has been divided between the SEC and state regulators, generally prohibiting SEC registration for investment advisers that had less than $25 million in assets under management ("AUM") (later raised to $100 million, subject to certain exceptions, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act), and leaving those advisers subject to state regulation and registration requirements. The SEC, through rulemaking, also provided a number of exemptions from that general prohibition, allowing investment advisers with less than the requisite AUM to register with SEC rather than with applicable states. These rule-based exemptions included an exemption in SEC Rule 203A-2(e) for certain investment advisers operating through the internet (the "Internet Adviser Exemption"). Currently, the Internet Adviser Exemption is generally available if the investment adviser provides investment advice to all of its clients exclusively through an interactive website, except it may provide advice to fewer than 15 clients through other means during the preceding 12 months.

The proposed changes to the Internet Adviser Exemption would generally make it available to fewer advisers. This proposed change reflects the SEC's view that the exemption, which was intended to be a "narrow" exemption, was being utilized by advisers with businesses that did not align with the SEC's intent that it should be used *only* by advisers that provide investment advice *exclusively* through an interactive website, and also did not reflect the proliferation of the use of websites and mobile applications in the advisory space since the time of the rule's initial adoption in 2002. Moreover, the SEC noted that in the years since the Internet Adviser Exemption was adopted, the SEC staff has observed "numerous compliance deficiencies by advisers relying on the rule," including a 2021 finding that nearly half of all advisers purporting to rely on the Internet Adviser Exemption were not in fact eligible to rely on the exemption, with many such advisers not being eligible for SEC registration at all.[9]

The proposed changes would potentially address these concerns raised by the SEC by requiring investment advisers relying on the Internet Adviser Exemption to have an "operational interactive website" through which they offer their "digital investment advisory services." Under these proposed amendments, internet advisers could no longer provide "de minimis" advisory services to a client other than through an operational interactive website.

Accordingly, under these proposed amendments, an internet investment adviser must: (1) ensure its website, application, or other online advising service forum aligns with the SEC's new service "operational" requirement *before* relying on the exemption to register with the SEC; and (2) halt any non-online advisory services with advisory clients. Internet-based investment advisers who wish to continue their non-online advising would need to consider whether they have a different basis for SEC registration or withdraw their SEC registration and register in the relevant the relevant state(s), as applicable.

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Endnotes

[1] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Exchange Act Release No. 97990, Advisers Act Release No. 6353 (Jul. 26, 2023), available at https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf.

[2] Exemption for Certain Investment Advisers Operating Through the Internet, Advisers Act Release No. 6354 (Jul. 26, 2023), available at https://www.sec.gov/files/rules/proposed/2023/ia-6354.pdf.

[3] The SEC emphasizes that compliance with the Proposed Conflicts Rules would not alter a firm's existing obligations under the federal securities laws; rather, the proposed rules would apply in addition to any other obligations under the Exchange Act and Advisers Act (as applicable) and SEC rules thereunder. In this regard, SEC Commissioner Hester Peirce suggested that, given the application of the Proposed Conflicts Rules to investor interactions more broadly (as opposed to merely recommendations), the proposed rules may be "a backdoor attempt to expand [Reg BI]." Commissioner Hester M. Peirce, Through the Looking Glass: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers Proposal (Jul. 26, 2023), available at https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623.

[4] *Id*.

[5] A "pooled investment vehicle" means any investment company as defined in Section 3(a) of the Investment Company Act of 1940 or any company that would be an investment company under Section 3(a) but for the exclusion provided from that definition by either Section 3(c)(1) or section 3(c)(7) of that act.

[6] For these purposes, the term "associated person" means, for broker-dealers, a natural person who is an "associated person of a broker or dealer" as defined in Section 3(a)(18) of the Exchange Act, and for investment advisers, a natural person who is a "person associated with an investment adviser" as defined in Section 202(a)(17) of the Advisers Act.

[7] The Proposed Conflicts Rules would not require conflicts of interest that exist *solely* due to a firm seeking to open a new investor account to be eliminated or their effect neutralized. Even though opening an account would likely be in the interest of the firm, *the Proposed Conflicts Rules are not designed to limit firms' abilities to attract clients and customers*. By contrast, incentivizing specific types of activity (such as margin or options trading privileges, as opposed to opening a general account, or investing in a particular type of investment, as opposed to just opening an account to invest) that is particularly profitable to a firm (and is not always in investors' interests) is intentionally addressed by the Proposed Conflicts Rules. By way of a specific example, if a robo-adviser determines that it uses covered technology to direct or steer investors to invest in funds that the firm itself sponsors and advises when more suitable or less expensive options for the investor are available through the robo-adviser, and thereby prioritizes the firm's own profit over investors' interests, the firm could eliminate this conflict of interest by removing any data that would allow the robo-adviser to determine which funds are sponsored or advised by the firm, thus eliminating any bias in favor of the firm's interest. Alternatively, the robo-adviser may choose to neutralize the effect of the conflict by, for example, sufficiently increasing the weights given to factors, such as cost to the investor or risk-adjusted returns (including, in each case, comparisons to funds sponsored or advised by other firms), to provide a counterweight that prevents any consideration of the firm's own interests from resulting in an investor interaction that places the firm's interests ahead of investors' interests.

[8] With respect to a firm that makes extensive use of more complex covered technology, or a firm whose conflicts of interest are more complex or extensive, the policies and procedures should include consideration of all aspects of the covered technology being used, including the data used to train the technology, "explainability" requirements (which give the technology/model the capacity to explain why it reached a particular outcome, recommendation, or prediction), specific training for technical staff, and maintaining (and regularly reviewing) logs sufficient to identify any risks of non-compliance with the Proposed Conflicts Rules presented by the firm's use of a covered technology.

[9] *See* Observations from Examinations of Advisers that Provide Electronic Investment Advice (Nov. 9, 2021), available at https://www.sec.gov/files/exams-eia-risk-alert.pdf.

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