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SEC Proposes New Rules With Heightened Conflict of Interest Standards for Use of Predictive Data Analytics by Broker – Dealers and Investment Advisers

Proposed Rule Requires Broker-Dealers and Investment Advisers to Eliminate or 'Neutralize' Conflicts of Interest

SUMMARY

On July 26, 2023, the Securities and Exchange Commission (the "SEC") voted 3 to 2 (Commissioners Peirce and Uyeda dissenting) to propose new rules and amendments under the Securities Exchange Act of 1934 (the "Exchange Act") and the Investment Advisers Act of 1940 (the "Advisers Act") intended to address conflicts of interest associated with the use of predictive data analytics ("PDAs") and similar technologies by broker-dealers, investment advisers, and their associated persons (collectively, "firms") in interactions with investors.[1] The SEC also proposed amendments to rules under the Exchange Act and the Advisers Act that would require firms to make and maintain certain records in accordance with the proposed new rules. The SEC noted that the proposed rules are a response to the acceleration of the adoption and use of newer technologies, such as PDAs and artificial intelligence, by firms, which has increased the risk that such technologies may be used in a way that would place firms' interests ahead of investors' interests.[2] The proposed rules would impose a different conflict framework on the use of PDAs than the framework for conflicts under Regulation Best Interest ("Reg BI") and the SEC's 2019 interpretation regarding the fiduciary duties of investment advisers (the "Fiduciary Interpretation").

Comments should be received on or before 60 days after the date of publication of the proposed rule in the Federal Register.

Key Takeaways

- The proposal potentially overrides or conflicts with the existing standards of conduct for broker-dealers and investment advisers. In a footnote, the SEC notes that: "the elimination or 'neutralization' requirement of the proposed rules applies only to a narrower, defined subset of the broader universe of conflicts – those conflicts that a firm determines actually place the interests of the firm or certain associated persons ahead of the interests of investors. This is in contrast to, for example, an investment adviser's fiduciary duty, which encompasses any interest that might incline the adviser, consciously or subconsciously, to provide advice that is not disinterested, or similarly in contrast to the broader universe of conflicts covered by Reg BI. Other conflicts of interest that only might affect the firm's investor interactions would continue to be subject to these other obligations, as applicable."
- The proposed rule may present conflicts for investment advisers with the Marketing Rule[3] because it covers solicitation activities. To the extent a firm relies on third-party technologies, the proposed rules may also conflict with the outstanding proposal regarding the outsourcing of certain services and functions.[4]
- The proposal's broad definitions of covered technology and investor interactions may potentially make it difficult for firms to build reasonably appropriate policies and procedures to meet the obligations of the proposed rules.
- Due to the broad nature of the definitions, the proposed rules would apply a heightened best interest and fiduciary standard to potentially any activity by a firm that involves a covered investor. Broker-dealers and investment advisers provide recommendations and advice to investors and all of their activities (and tools, including technology, related to these activities) are arguably related to that business. The proposing release notes that the definition is designed to cover communications that do not rise to the level of a recommendation but can have the effect of 'guiding or directing investors to take an investment-related action'. The dividing line between a recommendation and communications that 'guide or direct investors to take an investment-related' action is unclear.
- The proposal would eliminate the ability of firms to meet their best interest obligations by disclosing or mitigating the conflicts of interest, as appropriate. The SEC eliminated disclosure as a means to address these conflicts of interest "because a conflict can replicate to a much greater magnitude and at a much greater speed than would be possible to address through timely disclosure." It also noted its belief that an adviser cannot fully and fairly disclose these conflicts and receive informed consent. While the proposed rules allow a firm to "neutralize" a conflict, it is unclear how this would be different from eliminating the conflict. As conflicts of interest are inherent in a principal-agent relationship, it is also unclear how a firm could meet this heightened standard of conduct, particularly given the all-encompassing nature of the proposed rules.

The proposed rule for investment advisers applies to all clients and prospective clients of the adviser, including any current or prospective investor in a pooled investment vehicle advised by the investor. Unlike the Fiduciary Interpretation, the rule does not differentiate between retail and institutional clients of the adviser. On the other hand, the proposed broker-dealer rule applies only to natural persons who receive advice for personal or household purposes.

BACKGROUND

On June 5, 2019, the SEC adopted a package of new rules and amendments and interpretations to enhance the quality of retail investors' relationships with broker-dealers and investment advisers. The package was designed to enhance investor protections and align the standard of conduct with retail investors' reasonable expectations. Reg BI imposed a new standard of conduct on broker-dealers with respect to

recommendations of any securities transactions or investment strategies involving securities made to retail customers.[5] Reg BI requires broker-dealers to act in the best interest of their retail customers at the time a recommendation is made, without placing their financial or other interests ahead of the retail customer's interests. It also requires broker-dealers to address conflicts of interest by establishing, maintaining and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose or, where disclosure is insufficient, mitigate or eliminate, conflicts associated with a recommendation.[6] The SEC made clear when adopting Reg BI that the standard of conduct cannot be satisfied solely through disclosure.

The SEC concurrently adopted the Fiduciary Interpretation to reaffirm and clarify the fiduciary duty investment advisers owe their clients.[7] An adviser's fiduciary duty, which is broad and applies to the entire adviser-client relationship, comprises both a duty of care and a duty of loyalty, meaning the adviser must, at all times, serve the best interest of the client and not subordinate its client's interest to its own. The duty of care requires an adviser to provide advice that is in the best interest of the client. The duty of loyalty requires the adviser to either eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser to render advice which is not disinterested.

The SEC's proposed new Exchange Act Rule 240.15l.2 and new Advisers Act Rule 211(h)(2)-4 (the texts of which are substantially identical) address conflicts of interest associated with the use of PDAs that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes. Under the proposed rules firms would be required to: (1) evaluate the use (or reasonably foreseeable potential future use) of any covered technology in any investor interaction to identify any conflicts of interest associated with that use; (2) determine whether any such conflict of interest places or results in placing the interest of the broker-dealer or investment adviser ahead of the investor's interests; (3) eliminate or "neutralize" the effect of such conflict of interest; and (4) adopt and maintain written policies and procedures reasonably designed to prevent violations of (investment advisers) or achieve compliance with (broker-dealers) the proposed rules, including a documented annual review of the adequacy and effectiveness of such policies and procedures.[8] The SEC also proposed amendments to its recordkeeping rules to require broker-dealers and investment advisers to establish and maintain books and records related to the proposed conflicts requirements.[9] The SEC noted that the proposed recordkeeping amendments are to help facilitate the SEC's examination and enforcement capabilities.

SUMMARY OF THE PROPOSED RULES AND AMENDMENTS

Scope of Proposed Rules

The proposed rules would apply when a firm uses a "covered technology" in an investor interaction. The term "covered technology" is broadly defined to cover "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." The SEC notes that the proposed definition is designed to capture PDA-like technologies such as "AI, machine learning, or deep learning

algorithms, neural networks, [natural language processing], or large language models, as well as other technologies that make use of historical or real-time data, lookup tables, or correlation matrices among others." The SEC notes that it is using this purposefully broad definition to cover existing and future technologies given the rapid development of technology. While limited to technologies that "predict, guide, forecast, or direct investment-related behaviors or outcomes", it is nonetheless intended to capture a broad range of actions from providing advice or recommendations to design elements, features or communications to nudge, prompt, cue, solicit or influence investment-related behaviors or outcomes. Investment-related behaviors or outcomes are not limited to buying, selling or holding securities.

For broker-dealers, the definition of investor would include a natural person who seeks or receives services primarily for personal, family or household purposes. For investment advisers, the definition would include a client or prospective client, and any current or prospective investors in pooled investment vehicles advised by the investment adviser. With respect to the definition of the term "investor interaction," the SEC is proposing a broad net to pull in any communications or engagements. The proposing release notes that the definition is designed to cover communications that do not rise to the level of recommendations but can have the effect of guiding or directing investors to take an investment-related action.

The proposed rule excludes interactions that are solely for the purpose of providing clerical, ministerial, or general administrative support. For example, it would exclude chatbots or phone trees that firms use to direct customers to customer service representatives. The SEC included the language "solely for the purpose of" in the investor interaction exclusion to ensure that interactions that serve several purposes are not excluded from the rule's coverage.

Elimination or "Neutralization" of Conflicts of Interest

The proposed rules would require a firm to eliminate or "neutralize" the effect of conflicts associated with the use of PDAs. The rules require the following affirmative steps by firms:

- First, evaluation of any use or reasonably foreseeable future use of a covered technology in any investor interaction to identify whether it involves a conflict of interest, including through testing the technology. The proposed rules do not mandate any particular means by which a firm should evaluate and identify conflicts in the use of PDAs. The release provides some examples based on whether the firm uses simple or more advanced technologies in investor interactions. Firms would also be required to test each covered technology prior to its initial use or material modifications, and periodically thereafter, to determine where the covered technology is associated with a conflict of interest.
- Second, determination if any such conflicts of interest result in an investor interaction that places the interests of the firm ahead of investors' interests. A conflict of interest is defined under the proposed rules to exist when a firm uses a covered technology that takes into consideration an interest of the firm. A conflict of interest is covered by the proposed rules if the covered technology considers favorable information about the firm or associated person in *any* investor interaction. Determination on whether the covered technology places the firm's interest ahead of the investors' interests is facts and circumstances driven.

- Third, elimination or "neutralization" of the conflict of interest. The release notes that a firm can neutralize the effect of a conflict of interest "by taking steps to address the conflict." For example, a firm could apply a counterweight to firm-favorable information in order to subordinate its interests to investors' interests, thereby making the conflict harmless. The manner in which a conflict is eliminated or "neutralized" depends upon the facts and circumstances of the specific conflict and the proposed rules do not prescribe a particular manner by which a firm must eliminate or "neutralize" the conflict. Disclosure is not included as a remediating measure in the proposed rules.

Policies and Procedures

The proposed rules require firms to adopt and implement policies and procedures reasonably designed to prevent violations of (investment advisers) or achieve compliance (broker-dealers) with the proposed rules. All such policies and procedures would need to include:

- a written description of the process for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction and a written description of any material features of, including any conflicts of interest associated with the use of, any covered technology used in any investor interaction prior to such covered technology's implementation or material modification, which must be updated periodically;

- a written description of the process for determining whether any such identified conflict of interest results in an investor interaction that places the interest of the firm or its associated persons ahead of the interests of the investor;

- a written description of the process for determining how to eliminate, or "neutralize" the effect of, any such identified conflicts of interest determined to result in the interest of the investment adviser, broker-dealer, or the firm's associated persons being placed ahead of the interests of the investor; and

- a review and written documentation of that review, no less frequently than annually, of the adequacy of the policies and procedures and written descriptions established pursuant to this policies and procedures requirement and the effectiveness of their implementation.

The SEC also notes that firms should consider other elements, such as:

- compliance review and monitoring systems and controls;
- procedures that clearly designate responsibility to appropriate personnel for supervision of functions and persons;
- processes to escalate identified instances of noncompliance to appropriate personnel for remediation; and
- training of relevant personnel on the policies and procedures, as well as the forms of covered technology used by the firm.

A firm that does not identify any conflicts of interest associated with the use of covered technologies is nonetheless required to adopt and implement policies and procedures "so as to be prepared to address any instance where such a conflicts of interest is later identified by the firm in the course of its ongoing operations."

Recordkeeping

The SEC also proposed amendments to the recordkeeping rules for broker-dealers and investment advisers to require broker-dealers and investment advisers to maintain and preserve, for the retention periods specified in the rules,[10] all books and records related to the requirements of the proposed rules. The recordkeeping amendments also include making and maintaining six specific types of records:

- written documentation of the evaluation conducted including a list of all covered technologies, intended use, and descriptions of any testing;
- written documentation of each determination of any identified conflicts of interest, including rationale for the determination;
- written documentation of each elimination or neutralization of a conflict;
- written policies and procedures, including date of last review;
- a record of disclosures made to investors regarding the firm's use of a covered technology; and
- a record of each instance when a covered technology was altered, overridden or disabled and the reason for such action, including when an investor requests such action;

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ENDNOTES

1 Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, SEC Release Nos. 34-97990; IA-6353 (Jul. 26, 2023), available at: https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf (the "Proposing Release").

2 The SEC suggests in the Proposing Release that the emergent use of artificial intelligence by investment management firms and the rise of novel technologies has demonstrated that there are regulatory gaps that the new requirements of the proposed conflicts rules are necessary to address. *See* Id. at 6.

3 17 CFR 275.206(4)-1.

4 Proposed Rule 206(4)-11.

5 17 CFR 240.15l-1(a)(1).

6 17 CFR 240.15l-1(a)(2)(i)(B).

7 Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. 4889 (Apr. 18, 2018).

8 17 CFR 240.15l-2; 17 CFR 275.211(h)(2)-4.

9 *See* 240.17a-3 and 240.17a-4 of the Exchange Act and 204-2 under the Advisers Act.

10 For broker-dealers, rule 17a-4(a) under the Exchange Act would require that records be "preserve[d] for a period of not less than 6 years, the first two years in an easily accessible place." For investment advisers, rule 204-2(e)(1) under the Advisers Act provides that records, including those under the proposed recordkeeping amendments, "shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser."

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