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Client Alert

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United States: SEC requests comment on broker-dealer and investment adviser digital engagement practices

In brief

The US Securities and Exchange Commission (SEC) recently published a request for information and comment on how broker-dealers and investment advisers use digital engagement practices (DEPs) — behavioral prompts, differential marketing, "gamification," and other design elements and features that firms use to engage with retail investors through digital platforms and mobile applications.

The SEC seeks input about the current use of DEPs, tools and methods such as predictive data analytics and artificial intelligence/machine learning models that firms may use to operate and customize DEPs based on investor behavior or characteristics, and how DEPs interact with existing regulatory requirements for broker-dealers and investment advisers. The SEC is also focused on how investment advisers use technology to develop and provide advice both through digital programs and more traditional advisory services.

Comments are due 30 days after publication in the Federal Register.

The SEC request is long and detailed — more than 70 pages — comprising reminders of existing legal and regulatory standards, descriptions of the SEC's take on current practices, and many specific questions of interest for comment, along with a general request for comment to cover the possibility that even with all of that detail, something may have been missed.

We offer here just a summary. Of course, we are available to discuss the request in detail and to assist if your firm is considering comment.

Contents

In depth

What are DEPs?

"DEPs" is an umbrella term the SEC uses in the request to refer to design elements and features that are incorporated into online interfaces and mobile applications to engage retail investors. The list of DEPs covers a broad spectrum of activities, and it will be difficult to differentiate between DEPs that relate to advertising, engagement, education and customer service, versus those that are designed to, or have the effect of, influencing trading and investment decisions. The request for comment outlines the following DEPs:

- Social networking tools. Linking digital platforms to social networking content in order to enable users to access social sentiment, create online personas or avatars, or copy the trading of other investors (copy trading)
- Games, streaks and other contests with prizes. Relying on games that use interactive graphics and offer prizes (e.g., slot-machine style interactive graphics, interactive wheels of fortune, or virtual "scratch-off" lottery tickets); providing incentives for investors to

complete certain "to-do lists" or tasks with a specified time period (streaks); or other types of contests, including performance-based contests[1]

- Points, badges, and leaderboards. Using "scorekeeping" features, such as points or badges, that are visual markers of achievement, as well as leaderboards to rank individuals based on performance-based criteria
- Notifications. Sending push notifications through email, text or other means to offer account updates, indicate that a certain stock is up or down, show top "movers," or remind clients that it has been a certain number of days since they last traded
- Celebrations for trading. Incorporating animations and graphics, such as digital confetti or crowds applauding that "celebrate" when investors enter orders or purchase stocks
- Visual cues. Relying on customized visual cues, including displaying certain information more prominently, shifting the coloration of the screens, or promoting particular content based on the investor's portfolio performance
- Ideas presented at order placement. Presenting "ideas," such as curated lists or features or news headlines, prior to allowing an investor to place an order
- Subscription and membership tiers. Offering subscriptions or tiered memberships that provide access to additional features (e.g., research reports, briefs, webcasts, credit line access, exemptions or reductions of fees) based on balances and holdings reaching certain thresholds
- Chatbots. Interacting with investors and responding to investor inquiries through computer programs that simulate live, human conversation

What is the purpose of this SEC request for information?

The SEC is requesting this information to better understand market practices associated with the use of DEPs; provide a forum for firms, investors and other market participants to share their perspectives on the advantages and risks of DEPs; and help the SEC evaluate whether rulemaking may be required.

Why is the SEC focusing on these activities now?

Consumer protection for retail investors continues to be one of the primary focuses of the SEC rulemaking, examination and enforcement programs. The intersection of retail investor protection and technology is particularly relevant to the SEC because digital solutions allow investment advisers and broker-dealers to scale their services to reach more retail investors. This creates tremendous advantages in terms of making investment solutions more accessible to retail investors and those saving for retirement; promoting financial literacy, guidance and education; and increasing engagement and communication between firms and investors. At the same time, the SEC is concerned that certain uses of DEPs might encourage trading activities or investment decisions that are not consistent with a retail investor's investment goals or risk tolerance, or might promote investments that are not in the best interest of the investor.

[1] Prizes may include free stock, cash, gaining access to additional features on the platforms, or a free trial period for a subscription to certain market data or levels of service. Tasks that may generate awards include referring others to the platform, engaging in community forums, linking a bank account, funding an account, trading, or promoting the app on social media.

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The attention on DEPs in particular is no doubt related to Chair Gensler's May 2021 testimony addressing the market volatility that occurred in January 2021[2] and high profile enforcement actions at the federal and state level relating to gamification — strategies designed to encourage and incentivize continuous and repeat engagement with online trading platforms.

Other factors include the increased use of digital and mobile interfaces by more and more retail investors, many of whom are new to trading and/or are seeking the no-cost trading models now offered, as well as firms' movement toward implementing a myriad new and important features to their existing online offerings. Moreover, the pandemic has firmly entrenched investors' preferences for online services, including access to investment advice and trading tools. All of these industry changes suggest that an evaluation of whether the current regulatory tools are fit for purpose is timely.

What specifically is the SEC concerned about with DEPs?

It is clear from the public statement that Chair Gensler issued on August 27 that he is particularly focused on addressing the following investor protection concerns:

- Where the DEPs actually lead to statistically significant changes in investor behavior or change decision-making such that a firm is making a recommendation (under Reg BI) or providing investment advice
- Where the DEPs create conflicts of interest by directing investors to securities, investment strategies, or services that generate higher fees or third-party revenue for the firm, or may not be appropriate for a retail investor

In addition, based on Chair Gensler's remarks from September 1, it is plain that he has studied emerging technologies issues for some time and has significant concerns about the potential implications of deep learning models on market stability.

The request for input is wide-ranging and covers a lot of ground in relation to both the benefits and potential risks of DEPs. The topics covered by the request for information fall under the following general categories:

1. Influencing trading and investor behavior
    a. The SEC requests details about the degree to which firms have found that DEPs actually influence or change client behavior (e.g., accounts opened, amount invested, frequency of deposits, order frequency, order size, types of securities traded, risk profiles of securities traded, volume of client complaints, and the adoption and use of new features).
    b. The SEC requests whether researchers in behavioral finance, economics, psychology, marketing and related fields have studied the use of DEPs by investment advisers and broker-dealers and have evaluated whether DEPs influence or reinforce the behavior of retail investors.
    c. There is also the question of whether gambling or addiction offer evidence regarding whether and to what extent the immediate positive feedback provided by certain DEPs may influence retail investor decision-making, or whether there

[2] Robert Cook, President and CEO of FINRA, also addressed similar issues at the same May 2021 hearing. *See* https://www.finra.org/media-center/speeches-testimony/statement-financial-services-committee-us-house-representatives.

are findings that suggest that retail investors may not be fully aware that they have been influenced by a particular DEP.

2. Conflicts of interest and disclosure

    a. There is clearly concern about conflicts of interest and whether firms may use DEPs to promote or otherwise direct retail investors to securities, investment strategies or services that are more “lucrative” for the firm or that may be riskier to retail investors (e.g., margin services, options trading, proprietary products, products for which the firm receives payment for order flow, revenue sharing or other third-party payments, or other higher-fee products).

    b. The SEC requests comment on how effective disclosures are at informing retail investors of any conflicts of interest presented by the use of DEPs and whether those disclosures actually explain that DEPs could influence their trading and investing behavior.

3. Artificial intelligence (AI) and machine learning (ML)

    a. The SEC solicits information on the use of predictive analytics and AI/ML models, including deep learning, supervised learning, unsupervised learning and reinforcement learning processes that may be used to build and adapt DEPs based on observable investor activities. The SEC also raises the question of whether and how firms are using natural language processing (NLP) and natural language generation (NLG) to adapt their interfaces and prompts based on investor preferences.

    b. There is also focus on how firms develop, test, deploy, monitor and oversee the tools and methods they use, including AI. If these tools are provided by third-parties, there are questions about the oversight of these vendors, including whether they are affiliated, whether their compensation is tied to investor activity, and what formal governance mechanisms firms have in place for vendor oversight.

4. Investor data

    a. There are questions relating to the type of data that firms use to develop, evolve, implement, test and run DEPs. In particular, what the source of the data is and whether firms are using data acquired or purchased from third-parties or are collecting and selling data about their own clients’ or customers’ behavior on their digital platforms.

    b. There is also concern around whether the investor data used or collected in connection with DEPs raises unique issues associated with financial privacy, information security or identity theft prevention, and whether or how firms might minimize the risks of biases or disparities that may be perpetuated by the use of AI/ML models.

5. Compliance with regulatory obligations

    a. The SEC asks how firms are approaching compliance with existing investment adviser and broker-dealer regulatory obligations when designing and using DEPs. The questions cover: supervision of communications and marketing to retail investors; controls covering the design, development and use of DEPs; training of representatives; conflicts of interest; presentation of disclosures; compliance with applicable standards of conduct and sales practices rules; fiduciary duty; customer profile information; and record retention.

b. The SEC also asks for input about how the controls relating to DEPs might differ from controls governing other methods of engagement with retail investors.

6. Changes to existing regulations or new regulatory approaches

   a. The SEC includes a series of questions about whether there are additions or modifications to existing regulations that might be warranted in order to address investor protection concerns raised by DEPs.

   b. This inquiry also seeks input on whether any current regulations might prevent firms from using DEPs in a way that may be beneficial to retail investors, or whether there are regulatory approaches that would facilitate the ability to innovate or test the use of new technology.

Why does the request for information include a whole section on the use of technology by investment advisers? What about broker-dealers?

Over the last several years, investment advisers have increasingly relied on financial technology to develop digital advisory services (so-called robo-advisers) or to augment investment advice provided through more traditional means. Despite the dramatic increase, the SEC really has not considered how reliance on financial technology affects investment advice and the related regulatory obligations and rules in any comprehensive manner. Like DEP's, the reliance on algorithms that are often used in digital advisory solutions presents another situation where financial technology may be driving investment decisions with limited direct human interaction, if any.

The SEC acknowledges that broker-dealers similarly use analytical tools and other technology to develop and provide recommendations, and it encourages comments on those issues as part of the general request for comment. Not insignificantly, on the broker-dealer side, the SEC inquires about whether some of the DEPs identified that are specifically designed to influence investor behavior and trading may rise to the level of a recommendation, which would in turn trigger Reg BI.

What specifically is the SEC concerned about regarding the use of technology by investment advisers?

Again, the request for information is extraordinarily broad and covers a range of issues, including the following:

1. Benefits and risks of using technology to develop and provide investment advice

   The SEC requests feedback on the various benefits and risks associated with digital advice, including why the client might choose to engage a robo-adviser rather than a traditional adviser and how investment advice developed or provided by the robo-adviser may differ from that provided by the traditional investment adviser.

2. Model governance

   The SEC asks for feedback around the controls that investment advisers use to develop, test, deploy, monitor and oversee the technology they use to provide advice. This includes reliance on AI/ML models and whether there are unique characteristics associated with the operation of AI/ML models during periods of unusual or volatile market activity, as well as controls to determine whether the output of the AI/ML models are accurate and reproducible.

3. Disclosure

   The SEC focuses on the nature of the conflicts associated with using technology to develop and provide advice, and to what extent the potential risks, fees and conflicts of interest are disclosed.

4. Fiduciary duty

   The SEC requests feedback on how advisers satisfy their fiduciary duty, and ensure that the advice provided through algorithms is in the client's best interest.

5. Policies and procedures

   The SEC requests feedback on the policies and procedures that advisers maintain to address their use of technology and the duties they owe to their clients.

6. Operational risks

   The SEC asks about the types of operational risks investment advisers face when using digital platforms to interact with clients — for example, if the platform is unavailable, or in the event of a loss of service or a loss of data. The SEC questions here are particularly focused on reliance on cloud service providers and on the circumstances under which an investment adviser may need to override its algorithm.

7. Regulatory changes.

   The SEC requests comment on whether it should consider amending Form ADV to collect more information about the types of technology that advisers use to develop and provide investment advice, and whether the SEC should update the exemption for internet investment advisers or create a new registration exemption that better reflects the current operating model.

8. Wrap fee programs

   The SEC asks to what degree investment advisers use digital platforms and other analytical tools in connection with wrap fee programs. However, the discussion here seems to go well beyond digital advice and raises more fundamental questions about whether there are concerns with respect to the fees charged by wrap programs that have minimal or no trading activity, particularly in light of the fact that commissions for trade execution have moved toward zero.

9. Investment Company Act Rule 3a-4

   The SEC requests comment about whether it should update certain aspects of Rule 3a-4 that are particularly challenging for digital investment advisers. These include the requirement that a client can consult with personnel of the adviser who are knowledgeable about the management of the client's account, the requirement that each client's account must be managed on the basis of the client's financial situation and investment objectives, and the requirement that the account must be managed in accordance with any reasonable restrictions imposed by the client. In particular, the SEC's questions with respect to reasonable restrictions suggests a willingness on the part of the SEC to acknowledge that there are alternative ways of customizing accounts or personalizing advice beyond simply relying on the ability of the client to impose reasonable restrictions.

The last time the SEC addressed issues associated with digital advice was in its February 2017 IM Guidance Alert on Robo-Advisers. Although many of the areas for comment described above were addressed to some degree in 2017, the IM Guidance Alert does not have the force of law. Rather, it is interpretive guidance that reflects the views of the staff of the Division of Investment Management and has not undergone SEC approval after notice and comment. The fact that the SEC is requesting input on these same issues here suggests that there is a willingness under Chair Gensler to engage in rulemaking, which was not the case under past SEC leadership.

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