Client Alert

August 2023

SEC rule targets conflicts of interest in predictive data analytics

In brief

Last week the SEC published new proposed rules and amendments (Proposal) to address certain conflicts of interest associated with the use of predictive data analytics (PDA) by broker-dealers and investment advisers (firms) in interactions with investors. The wide-ranging Proposal would require firms to implement detailed policies and procedures to identify and “eliminate or neutralize” the effects of such conflicts of interest.

In depth

At a high level, the Proposal would require firms using "covered technologies" in "investor interactions" to:

- evaluate any use or potential use of a covered technology by the firm or its associated persons in an investor interaction to determine whether there is a conflict of interest;
- determine if the conflict of interest places the interests of the firm and its associated persons ahead of the interests of investors;
- "eliminate or neutralize" the effect of conflicts associated with the use of technologies that influence investor decisions or behavior and place the firm’s or its associated person’s interest ahead of investors’ interests; and
- adopt written policies and procedures, implement comprehensive controls, and generate detailed records to memorialize compliance with the proposed conflicts rule.

The concepts of covered technologies and investor interactions are defined broadly and would potentially capture almost every interaction with prospective and existing customers and clients. However, the more significant impact of the Proposal is the SEC's position that the rapid acceleration, complexity, and scalability of PDA-like technology means that disclosure is ineffective in mitigating the related risks. In other words, firms would not have the option to disclose conflicts of interest and rely on informed consent under investment adviser concepts of fiduciary duty (IA Fiduciary Duty) or to disclose, mitigate, or eliminate conflicts of interest as set forth under Regulation Best Interest (Reg BI). Rather, in the event of a conflict of interest that places the firms’ interest ahead of investors, the only option would be to “eliminate or neutralize” such conflict.

As Commissioner Peirce notes in her dissenting statement, the Proposal “rejects one of our primary regulatory tools—disclosure. If a firm determines that the use (or *potential* use) of a covered technology involves a conflict of interest, then the firm has to eliminate or neutralize the conflict. Disclosure is not an option. . . . The long-term ramifications of the Commission's rationale for dismissing the value of disclosure —namely, that disclosure is of no use to investors – cannot be exaggerated."

As discussed below, there are a number of areas for further analysis and comment - including the broad definitional provisions and the SEC's conclusion that disclosure is inadequate. We encourage clients to reach out to us as they evaluate the impact of these proposals on their business and consider commenting on the proposal.

Comments are due within 60 days of publication in the Federal Register.

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Why is the SEC proposing a new rule to address conflicts from covered technologies?

According to the Proposal, the SEC believes that the current regulatory framework needs to be updated to help ensure firms are appropriately addressing conflicts of interests associated with the use of PDA-like technologies. This view is based, in part, on mixed responses to the SEC's 2021 request for comment on firms' digital engagement practices (DEP Release). The SEC suggests that if potential conflicts arising from covered technologies in investor interactions are not addressed, the ability for covered technologies to reach numerous investors rapidly increases the risk that such conflicts could permeate the market more rapidly than when the same conflicts arise in human interactions.

Our Observations: *While its concern is not necessarily unfounded, the SEC struggles to substantively support its position that existing regulations are ill-equipped to adapt to technological advancements, or to address resulting conflicts of interest. In fact, much of the historical SEC and FINRA guidance cited in the Proposal as support for a new rule actually reflects the opposite—that existing regulations are designed to be both flexible and technologically neutral in application, in order to foster (or at least not inhibit) technological advancements.*

Are the potential conflicts identified by the SEC already covered by existing rules?

The primary conflict identified by the SEC in the Proposal is that firms will take their own interest into account in the design or use of the covered technologies, resulting in investor harm. For instance, the SEC speculates that firms may use the covered technologies to optimize the firm's revenue or to affect investor behavior in a manner that benefits the firm or its associated persons to the detriment of the investor. Moreover, if the covered technologies rely on bad data, the outputs could be skewed with "opaque biases as well as unintended failures."

Our Observations: *The conflicts identified by the SEC are not unique to the use of technology, and, as the SEC describes in the Proposal, are addressed by numerous existing regulations. Moreover, as noted above, the SEC and FINRA have made clear over many years that application of existing regulations, particularly those addressing conflicts, are intentionally principle-based and flexible to adapt to evolutions in firms' use of technology. The Proposal ultimately fails to identify any conflicts arising from the use of covered technologies that are so unique they cannot be addressed by existing regulations. In fact, there is a litany of press releases and similar documents describing enforcement proceedings in which each agency has trumpeted the utility and flexibility of existing regulatory tools to reach novel technologies and products.*

What is a "Covered Technology" and an "Investor Interaction"?

The Proposal would apply to all broker-dealers and SEC-registered investment advisers (and their associated persons) using "covered technologies" in an "investor interaction."

A "**covered technology**" would be (1) an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process (2) that optimizes for, predicts, guides, forecasts, or directs (3) investment-related behaviors or outcomes. The SEC intends the definition to capture current PDA-like technologies such as artificial intelligence (AI), machine learning, or deep learning algorithms, but also is intentionally broad to capture both current and future technologies regardless of complexity or simplicity.

To that end, the proposed definition would capture technologies that analyze investor behaviors, algorithm-based tools (such as investment analysis tools), as well as financial modelling tools or even calculations performed through spreadsheets. In general, the proposed definition would capture a broad range of actions from providing investment advice and recommendations to design elements, features, or communications and advertisements that "nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors." The definition would also cover technology that the firm has developed itself, as well as technology licensed from a third party.

The only real limitation on the scope of the proposed definition is that the technology must optimize for, predict, guide, forecast, or direct ***investment-related behaviors or outcomes***. While not a defined term, the SEC provided that investment-related behaviors would include investors: (i) buying, selling, and holding securities; (ii) making referrals; or (iii) increasing trading volume and/or frequency.

In contrast, technologies would not be captured by the proposed definition if providing: (i) purely factual information to investors about their accounts; (ii) predictions of whether an investor will be approved for a credit card issued by the firm or its affiliates; and (iii) basic customer service support through chatbots.

An "**investor interaction**" would be any of the following:

(1) engaging or communicating with an investor, including by exercising discretion with respect to an investor’s account;

(2) providing information to an investor; or

(3) soliciting an investor.

The only express exception to the definition would be interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support.

Further, the "**use**" of a covered technology in an investor interaction can occur directly through the covered technology itself or indirectly through communications by the firm or its associated persons communicating results generated by the technology to the investor. Thus, an associated person using a covered technology behind-the-scenes to assist in formulating their electronic or in-person communication with an investor would be captured by the proposed definition. As drafted, the proposed definition would capture a firm's correspondence, dissemination, or conveyance of information to, or solicitation of, investors in <u>any</u> form, including in-person or electronically via websites, smartphones, chatbots, emails, text messages and other online or digital tools platforms.

Our Observations: *While acknowledging that the Proposal would capture covered technology providing investment advice or recommendations, the SEC ties itself in knots to make sure that the proposed rule covers communications that affect investors' investment-related behaviors or outcomes but do not necessarily rise to the level of providing a recommendation or advice. However, it is not clear what universe of communications beyond recommendations and advice the Proposal seeks to regulate. As a practical matter, this means that firms would either need to undertake an exercise (similar to identifying recommendations under Reg BI) of having to identify all investor interactions that use - or potentially could use - a covered technology that affects investment-related behaviors or outcomes without clear guidance or, alternatively, would have to subject virtually all communications to the new rule.*

Who is an "Investor"?

The proposed rule would define "investor" differently for broker-dealers and investment advisers, as shown in the following table:

	Broker-Dealers	Investment Advisers
Definition of "Investor"	Any natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes.	Any prospective or current client of an investment adviser or any prospective or current investor in a pooled investment vehicle advised by the investment adviser.

For broker-dealers, the proposed definition is pulled from the definition of "retail investor" for purposes of Form CRS and would be interpreted in a manner consistent with the Form CRS guidance. In other words, the proposed rule for broker-dealers is focused on retail investors. In contrast, the proposed rule for investment advisers is broader and not limited to retail investors. Instead, the proposed definition for investment advisers would include all current and prospective clients, as well as all investors in any investment company or private fund (exempt under section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940) advised by the investment adviser.

Our Observations: *This distinction makes sense in the context of the difference between Reg BI and the IA Fiduciary Duty in that Reg BI is designed to address recommendations provided to retail investors while the IA Fiduciary Duty applies broadly to all investment advisory clients. However, it is not clear why the SEC is carrying this distinction into the PDA Proposal. The proposed approach disadvantages investment advisers, who would not be able to limit the application of the conflict of interest rule (and its prescriptive process and record keeping requirements) to retail investors. In addition, although investment advisers are already subject to fiduciary duty with respect to their existing clients, the SEC stated in the 2019 IA Interpretation that the anti-fraud provisions of Section 206—rather than the fiduciary duty—applies to prospective clients. The Proposal thus arguably expands the duty of loyalty obligations that currently arise at the inception of the advisory relationship to cover all prospective investment advisory clients that are subject to an investor interaction based on a covered technology, while at the same time eliminating an adviser's ability to rely on disclosure and informed consent to address conflicts of interest for existing clients.*

What are the key provisions of the conflicts of interest rule?

In general, the Proposal would restrict firms from using covered technologies in investor interactions unless any conflicts associated with the technology that places or results in placing the firm's or its associated person's interest ahead of investors' interests is eliminated or its effects neutralized. In particular, the proposed rule sets forth a prescriptive process which would require firms to:

(1) evaluate the use or the reasonably foreseeable potential use of a covered technology in investor interactions to identify any associated conflict of interest (including by testing the covered technology prior to use or material modification, and periodically thereafter);

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

(3) eliminate or neutralize the effect of such conflicts.

The proposed rule would require firms to evaluate and test a covered technology to identify any associated conflicts of interest prior to its implementation or material modification, and periodically thereafter. Additionally, the evaluation must seek to identify potential conflicts that exist inherently within the covered technology's programming and underlying data it uses, as well as conflicts that may arise with how the covered technology is actually used by the firm or its associated persons in investor interactions.

What is a "conflict of interest"?

The first obligation of the Proposal would require firms evaluate their use of covered technology to identify any associated conflict of interest. The proposed rule also broadly defines "conflict of interest" as use of a covered technology that takes into consideration any interest of the firm or its associated persons. The proposed definition would include:

- prioritizing proprietary products or products for which the firm receives revenue sharing;
- displaying selected or ranked options for retirement accounts that take into account the firm's revenue; and
- incentivizing trading activity or opening of options or margin accounts that result in high revenue or profits to the firm.

Firms must develop an understanding of the covered technologies to identify potential conflicts based on the firms' intended use.

The Proposal does not prescribe the particular method for evaluating a covered technology, and instead it would be up to firms to determine the appropriate approach, which may be based on the firm's experience with the technology. Nonetheless, the SEC provided certain guiding principles noting that firms would need to:

- consider all scenarios in which the firm intends for the technology to be used, and reasonably foreseeable scenarios; and
- consider the knowledge and experience of the firm personnel conducting the evaluation with respect to both the programming of the technology and the firm's regulatory obligations.

If the technology is licensed from a third party, the firm would need to perform the same evaluation and any lack of visibility into the third-party's technology would not relieve the firm of its obligations under the proposed rule. In all cases, firms generally would need to be able to demonstrate the ability to understand how the covered technology itself (as well as any other technology used in evaluating the covered technology) operates and the data upon which it relies to demonstrate the firm's ability to identify any conflicts associated with use of the covered technology in investor interactions. To that end, if a covered technology is so complex or its underlying programming too opaque for a firm to understand its operation sufficiently to evaluate it for potential conflicts, the proposed rule would effectively prohibit the firm's use of such covered technologies.

Firms must test covered technologies to identify potential conflicts based on their actual use.

In addition to evaluating a covered technology for inherent or potential conflicts, the Proposal would require firms to test each covered technology to determine whether its actual use would involve any conflict of interest prior to its implementation or material modification, and periodically thereafter. As with the initial evaluation, the Proposal does not prescribe any particular method of testing a covered technology for conflicts, and the periodic retesting would depend on the nature and complexity of the technology. The SEC also did not define "material modification" and provided limited examples.

Our Observations: *The Proposal is silent with respect to whether firms' obligations for identifying conflicts is subject to any reasonableness standard. Instead, the Proposal broadly requires identification of all conflicts associated with a covered technology, and that evaluation must be "sufficient under the* *circumstances." This ambiguous language would create uncertainty that could potentially stifle innovation and permit the SEC to easily second guess firm evaluations with the benefit of hindsight.*

Issues with this broad standard may also have downstream impacts to third party technology firms that license covered technologies to broker-dealers and investment advisers. Determining what is a sufficient evaluation of a firm's own technology will be difficult enough, but the difficulty in determining whether an evaluation of a third party's technology is sufficient may cause firms to limit use of such third parties. This is a particular burden for smaller firms that cannot afford to build their own technology, which would be disadvantaged.

How would firms determine if a conflict puts the firm or its associated persons' interest first?

After identifying all conflicts of interest associated with a covered technology, the proposed rule would require firms to determine, based on a reasonable belief, whether such conflicts place or result in placing the firm's or its associated person's interest ahead of investors' interests. The determination is a facts and circumstances analysis that may depend on a variety of factors including: (i) the covered technology; (ii) its intended use; (iii) the conflicts of interest involved; (iv) the methodologies used and outcomes generated; and (v) the interests of the investor.

Based on this analysis, the firm must reasonably believe that the covered technology does not place the interests of the firm or its associated persons ahead of investors' interests, or take additional steps to eliminate or neutralize the effect of the conflict. Firms generally would need to tailor the methods by which it determines whether its use of a covered technology in investor interactions places its interests ahead of investors based on the circumstances and complexity of both the covered technology and the conflict of interest. If a firm cannot determine whether use of a covered technology in investor interactions results in conflict by placing its interests first, the SEC indicated that firms must err on the side of eliminating or neutralizing the effect of that conflict.

Our Observations: *The SEC effectively creates a new definition of "conflict" for purposes of the Proposal without explaining how it is the same as or differs from Reg BI and the duty of loyalty incorporated into the IA Fiduciary Duty. For instance, the chart below compares these different definitions of a conflict of interest:*

Proposed Rule Definition	***Reg BI and IA Fiduciary Duty Definition***
An interest of the firm or its associated persons that places or results in placing the firm's or its associated person's interest ahead of investors' interests.	*An interest that might incline a firm or its associated persons—consciously or unconsciously—to make a recommendation or render advice that is not disinterested.*

How would firms eliminate or neutralize conflicts from covered technologies?

For any conflicts that the firm determines place or would result in placing the firms' or its associated persons' interests ahead of investors' interests, the proposed rule would require firms to eliminate or neutralize the effect of such conflicts. The Proposal lacks guidance on how such conflicts could be eliminated or neutralized other than providing that firms must take reasonable steps that may vary from firm to firm, and as to each covered technology, as well as its particular use. Regardless of the steps taken, firms must promptly eliminate or neutralize the conflict after the firm determines (or reasonably should have determined) that the elimination/neutralization threshold has been met.

The only exception to the requirement to eliminate or neutralize a conflict of interest are those conflicts "that exist solely because the investment adviser seeks to open a new client account." The Proposal does not discuss this carve out in any detail, but it suggests that the proposed rule is not focused on conflicts or incentives directed at opening account with the firm generally. Rather, the focus appears to be on conflicts that incentivise specific types of accounts, features or investments.

Our Observations: *The elimination/neutralization requirement effectively would amend Reg BI and the IA Fiduciary Duty with respect to conflicts when a recommendation uses a covered technology directly or indirectly. Unlike Reg BI where the SEC identified certain conflicts so inherently pervasive that elimination was the only option (e.g., high pressure sales practices), the Proposal focuses not on the conflicts themselves but the ability for technology to disperse conflicted communications at scale. However, a firm's ability to disseminate communications to numerous investors at scale does not necessarily have any relationship to (or any impact on) a reasonable investor's ability to understand the communication, evaluate any conflict disclosure, and make an informed decision. Nor is there anything that would prevent conflicted communications dispersed at scale from being actionable under existing rules.*

In addition, the SEC's articulated test for whether a conflict was sufficiently eliminated or neutralized is unhelpfully circular—i.e., a conflict that places the firm's interests first is eliminated or neutralized when it no longer places the firm's interests first. The SEC attempts to provide some examples of elimination or neutralization options, but rather than provide firms with guidance this proposed rule would create another opportunity for SEC staff to define acceptable standards through examination and enforcement.

Of course, no SEC proposal on conflicts would be complete without a shot fired at revenue sharing and payment for order flow practices. The SEC helpfully suggest that any conflicts from such arrangements could be eliminated by ending the practice. However, there is no discussion of how the Proposal would impact existing rules already requiring disclosure of such practices as well as the SEC's package of market structure proposals that in part directly target such revenue sharing arrangements.

What policies and procedures would firms need to adopt?

The Proposal would require firms to establish written policies and procedures reasonably designed to achieve compliance with (for broker-dealers) and prevent violations of (for investment advisers) the requirements of the proposed rule. In particular, the policies and procedures must include:

(1) written descriptions of the processes firms will employ for evaluating and identifying conflicts associated with a covered technology, determining whether such conflicts place or result in placing the firm's or its associated persons' interests ahead of investor interests, and eliminating or neutralizing the effect of the conflicts the firm determines place its or its associated persons' interests first;

(2) written descriptions of the material features, including the associated conflicts, of each covered technology use in investor interactions prior to its implementation or material modification, which must be updated periodically; and

(3) an annual review, documented in writing, of the adequacy of the policies and procedures (including the written descriptions) as well as a review of the effectiveness of their implementation.

The written descriptions generally should be designed to provide firms with a consistent approach to satisfying the conflict assessment obligations of the proposed rule and to detail the steps the firm will take to comply with each obligation.

The SEC would expect written descriptions of "material features" of each covered technology to include:

- how the technology works (e.g., how it optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes);

- when and how the firm intends to use (or could reasonably foresee using) the covered technology in investor interactions; and

- the associated conflicts, including how and when they would arise.

The level of detail should be specific enough for relevant firm personnel to sufficiently understand whether its use would be associated with any conflicts. However, the level of specificity may vary depending on the complexity of the technology as well as whether it reasonably could be expected to be associated with a conflict.

The written descriptions would have to be updated periodically when:

- a covered technology has been upgraded or materially modified in a manner that would make the previous description inaccurate or incomplete;
- firm personnel become aware of either additional material features used by the firm; and
- firm personnel become aware of the firm engaging in a different use of the technology not previously contemplated.

Our Observations: *As the SEC itself acknowledged in the Proposal, the written descriptions provide the SEC with an examination and enforcement roadmap. Given the overlap with Reg BI and the IA Fiduciary Duty, existing policies and procedures for handling conflicts in recommendations and investment advice would have to be reviewed and updated.*

The Proposal would require written descriptions of the material features of a covered technology. Technologies that are "difficult or impossible" to explain might necessarily implicate the elimination or neutralization requirement because it would therefore be difficult or impossible to identify conflicts for evaluation. However, the Proposal provides no standard by which to determine whether a covered technology is too "difficult or impossible" to explain. Explainable to a reasonable person, a person knowledgeable with the technology, or the SEC examiner? The Proposal does not articulate a reasonable diligence standard.

What new annual reviews would firms need to conduct?

The proposed rule would require at least an annual review of each component of the firm's policies and procedures, which review must be documented in writing. The review must evaluate whether the firm's policies and procedures and written descriptions have been adequate and effective during the review period in achieving compliance with the proposed rule requirements. In addition, the SEC set forth considerations for the review, including:

- any changes to the firm's business activities;

- any changes to use of the covered technology;

- any issues that arose from use of the technologies during the review period;

- any changes to applicable law; or

- other factors that might suggest certain technologies now present different or greater risk than previously accounted for and what adjustments might be needed.

Our Observations: *As the Proposal recognizes, both investment advisers and broker-dealers are subject to at least annual review requirements with respect to their written policies and procedures. Establishing a specific annual review requirement for the proposed rule seems superfluous.*

How does the Proposal affect recordkeeping requirements?

The Proposal would impose prescriptive new recordkeeping requirements for firms to demonstrate compliance with the proposed rule, including, written documentation of the following:

(1) a list of all covered technologies used by the firm that includes date of first use and any material modification, and the firm's evaluation of intended vs. actual use and outcome;

(2) description of testing of the covered technology, including the testing date and methods, and actual or reasonably foreseeable potential conflicts, as well as modifications made and any restrictions placed on use as a result of the testing;

(3) the firm's conflict determinations and each elimination or neutralization decision;

(4) the firm's relevant written policies and procedures, including the date they were last reviewed;

(5) any disclosures provided to each investor regarding use of the covered technology, including the date provided and updated; and

(6) each instance in which a covered technology was altered, overridden, or disabled (including by investor request), and the date and reason for such action.

These records would be subject to the 6 year preservation requirement in Rule 17a-4(a) for broker-dealers, and the 5 year preservation requirement in Rule 204-2(e) for investment advisers.

Our Observations: *Despite the SEC's contention that the Proposal is principles based and not intended to be prescriptive, the proposed recordkeeping requirements would, in fact, impose very prescriptive elements that need to be considered and documented. We also note that the specific reference to retaining disclosures relating to the use of the covered technology seems odd given the SEC's view that disclosure is not effective for addressing conflicts of interest under the proposed rule. Presumably, the SEC is referring to disclosures (e.g., about risks, methodology, limitations) that may be required under other rules and regulatory obligations.*

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As noted in this Alert, the Proposal raises a number of interpretive and practical implementation questions, and appears to address conflicts otherwise covered by existing regulations solely because a "covered technology" may be involved in or used to disseminate communications to investors. While the SEC recognizes many of these major issues and limitations in its requests for comments, it does beg the question why the SEC proposed such a controversial new rule to begin with.

Historically, the SEC and FINRA have addressed use of new or developing technologies in financial services through guidance and interpretations, recognizing that the existing federal securities laws are technology neutral. Frankly this has always been the superpower of the securities regulatory regime - the ability to handle whatever new product or service the financial industry has developed, no matter how that might be delivered to investors. This Proposal, in contrast, seems to cut a new path, suggesting some weakness, while not really identifying any; expressing concerns about conflicts of interest, but not really describing how the existing Reg BI and IA Fiduciary Duty frameworks fail to address legitimate concerns about PDA-like technology.

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