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Client Alert | Investment Management

To Bot or Not To Bot: The SEC's Proposed Conflict Rules May Stifle Use of Innovation

On July 26, 2023, the Securities and Exchange Commission (SEC or Commission) proposed new conflict of interest rules (PDA Proposal) for investment advisers' and broker-dealers' use of certain predictive data analytics (PDA) under the Securities Exchange Act of 1934 (Exchange Act), and the Investment Advisers Act of 1940 (Advisers Act).¹ If the rules are adopted as proposed, investment advisers and broker-dealers (collectively firms) would be required to conduct onerous and, in some instances, impractical screenings of their use of technology. In the Internet Advisers Proposal, the SEC also proposed to narrow the internet advisers' exemption under the Advisers Act (Internet Advisers Proposal).² This alert summarizes the PDA Proposal and Internet Advisers Proposal and highlights some key observations and issues for firms to consider.

Key observations

- The PDA Proposal is based on the authority granted to the SEC under the Dodd-Frank Act, which, among other things, authorizes the SEC to “promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers that the Commission deems contrary to the public interest and the protection of investors.” Thus, the PDA Proposal is not based on anti-fraud authority, and firms could be liable for violations regardless of full disclosure and in the absence of any materiality determination.³
- The PDA Proposal does not include a compliance period. The SEC has indicated a plan to address the compliance period during the rule adoption process and has asked for comment on this topic.

¹ Conflicts of Interest Associated with Predictive Data Analytics by Broker-Dealers and Investment Advisors, Investment Company Act Release No. 34-98890, July 26, 2023 (available at <https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf>). Comments on the PDA Proposal are due by Oct. 10, 2023.

² Exemption for Certain Investment Advisers Operating Through the Internet, Investment Company Act Release No. IA-6354, July 26, 2023 (available at: <https://www.sec.gov/files/rules/proposed/2023/ia-6354.pdf>). Comments on the Internet Advisers Proposal are due by Oct. 2, 2023.

³ Commissioner Peirce expressed concern over the PDA Proposal's suggestion that the risks to investors associated with conflicts of interest arising from increased use of PDA technology cannot be circumvented through disclosure. “In many ways, the discussion surrounding the inadequacy of disclosure is the most troubling aspect of the proposal. 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.” (Citations omitted.)

- The Internet Advisers Proposal would narrow the scope of the exemption by requiring relying advisers to maintain an “operational” interactive website and provide advice exclusively through that website.

The SEC justifies the PDA Proposal in its concerns that firms might be using such technologies (either intentionally or unintentionally) in ways that place the firms’ interests ahead of investors’ interests. The SEC also expressed concerns that the scalability of these technologies and the potential for firms to reach a broad audience at rapid speed could magnify conflicts of interest.

The PDA Proposal

- The PDA Proposal would require firms to eliminate or neutralize the effect of conflicts of interest associated with a firm’s use of “covered technologies” in “investor interactions” that puts a firm’s interests above investors’ interests. A firm would be required to evaluate any use or reasonably foreseeable potential use by the firm or its associated person of a “covered technology” to identify potential conflicts of interest. While the firm would be required to eliminate or neutralize only actual conflicts, it would be required to make and document evaluations of each use of a covered technology, test each covered technology prior to its implementation or material modification, and periodically thereafter determine whether the use of such covered technology is associated with a conflict of interest that places the firm’s (or its associated person’s) interest ahead of the interest of investors.
- The PDA Proposal also would require a firm that has any investor interaction using covered technologies to adopt written policies and procedures reasonably designed to achieve compliance with the PDA Proposal and to review such policies no less frequently than annually.
- The PDA Proposal also would require firms to make and keep certain books and records related to its requirements.

The definitions of covered technology and investor interaction are quite broad.

The PDA Proposal broadly defines covered technology as “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.”

Examples

- PDA-like technologies, such as artificial intelligence (AI), machine or deep learning algorithms, neural networks, natural language processing (NLP) or large language models (including generative pretrained transformers), as well as other technologies that make use of historical or real-time data, lookup tables or correlation matrices, among others.
 - This could include technologies that analyze investor behavior (e.g., spending patterns, browsing history on the firm’s website and updates to social media) in order to guide or influence investment-related behaviors or outcomes. This would include technology used by a firm to draft or revise advertisements guiding or directing investors to use the firm’s services.
 - This would not include technologies designed purely to inform investors (e.g., a website describing an investor’s current account balance or past performance or a chatbot to assist investors with basic customer service support) that do not and are not intended to, affect an investment-related behavior or outcome.
 - This would include providing investment advice or recommendations and also would encompass design elements, features or communications that nudge, prompt, cue, solicit or influence investment-related behavior or outcomes from investors.

The PDA Proposal defines an investor interaction as “engaging or communicating with an investor, including by exercising discretion with respect to an investor’s account, providing information to an investor or soliciting an investor.”⁴

- This 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 and via smartphones, computer applications, chatbots, email messages, text messages and other online or digital tools or platforms.
- This would include engagement between a firm and an investor’s account on a discretionary or nondiscretionary basis.
- This would include any advertisements disseminated by or on behalf of a firm that offers or promotes services or that seeks to obtain or retain one or more investors.

The PDA Proposal makes clear the SEC’s intention to broaden the scope of interactions with investors beyond “recommendations” for broker-dealers. The proposed definition would capture broker-dealer communication that may not rise to the level of a recommendation if the communication is designed to or has the effect of guiding or directing investors to take an investment-related action. Given the broad scope of the proposed definition of investor interaction and the requirement to eliminate or neutralize actual conflicts, it is unclear how the PDA Proposal, if adopted as proposed, would impact the conflicts of interest obligation under Regulation Best Interest, which permits a broker-dealer to adopt and maintain policies and procedures to identify conflicts of interest associated with a recommendation and at a minimum, disclose or eliminate them.

The SEC recognizes that, in some cases, “it may be difficult for the firm to understand exactly what is in the data set that the model is considering; for example, if it was trained on a data set from the entire internet.” Similarly, the SEC acknowledges that a firm may not have full visibility into all aspects of how a covered technology functions, such as if the firm licenses it from a third party or if the technology is a “black box” algorithm. Nonetheless, the PDA Proposal would cover the use of such technologies in investor interactions.

The Internet Adviser Exemption

The SEC also has proposed amendments to Rule 203A-2 under the Advisers Act, which permits internet investment advisers to register with the SEC despite not meeting the minimum assets under management requirement for registration. The current internet adviser exemption requires an investment adviser to provide investment advice to all clients on an ongoing basis exclusively through an interactive website, but it allows the adviser to provide investment advice to fewer than 15 clients through other means during the preceding 12 months.

The Internet Advisers Proposal would remove the fewer-than-15-clients exception, meaning that an internet adviser could provide advice only through its interactive website. It also would require an internet adviser to maintain an operational interactive website, which would be defined as “a website or mobile application through which the investment adviser provides digital investment advisory services on an ongoing basis to more than one client.” In particular, the Internet Advisers Proposal would limit the exemption to investment advice “that is generated by the operational interactive website’s software-

⁴ For broker-dealers, “investor” would include a natural person, or the legal representative of such natural person, who receives or seeks to receive services primarily for personal purposes. For investment advisers, “investor” would include a client or prospective client and any current or prospective investor in a pooled investment vehicle advised by the investment adviser.

based models, algorithms or applications based on personal information each client supplies through the operational interactive website.” The proposing release reiterates the current rule’s prohibition on providing personalized advisory services through human interaction.⁵

For more information, contact:



Sara P. Crovitz
Partner
202.507.6414
scrovitz@stradley.com



Lawrence P. Stadulis
Co-Chair, Fiduciary Governance
202.419.8407
lstadulis@stradley.com



Peter M. Hong
Co-Chair, Derivatives & Commodities
202.419.8429
phong@stradley.com



Aliza S. Dominey
Associate
202.507.6405
adominey@stradley.com



Alexa Tzarnas
Associate
212.404.0646
atzarnas@stradley.com

www.stradley.com | Pennsylvania | Washington, DC | New York | New Jersey | Illinois | Delaware

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⁵ Id. at 21 (“Like the current rule, this new definition is designed to reflect that an adviser’s personnel are not permitted to generate, modify or otherwise provide client-specific investment advice through the operational interactive website or otherwise. Said differently, human-directed client-specific investment advice, delivered through electronic means, would not be eligible activity under the investment adviser exemption.”) (Citations omitted.)