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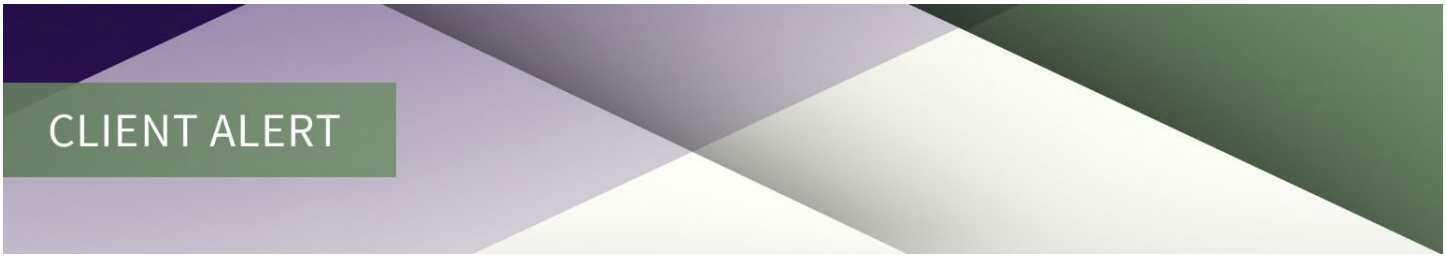

The SEC Proposes Conflicts Rules to Confront the Use of Artificial Intelligence Technologies by Broker-Dealers and Investment Advisers

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On July 26, 2023, the Securities and Exchange Commission (the "SEC") proposed new rules (the "Proposed Rules") to require SEC-registered broker-dealers and investment advisers to address conflicts of interest associated with using "Covered Technologies," such as predictive data analytics, artificial intelligence, and similar technologies, in "Investor Interactions," defined to encompass a broad range of communications and actions firms make that implicate investors' assets or interests.[1] The Proposed Rules would require a firm to eliminate, or neutralize the effect of, any "Conflict of Interest" resulting from the use of Covered Technologies that places or results in the placing of the interests of the firm or its associated persons ahead of the interests of investors.[2] Notably, the Proposed Rules would not allow firms to rely on disclosure and consent to address certain of these conflicts. The Proposed Rules also would require a firm using Covered

[1] *Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers*, Securities Exchange Act of 1934 (the "Exchange Act") Release No. 34-97990 (July 26, 2023), 88 Fed. Reg. 53960 (Aug. 9, 2023) (the "Proposing Release"), available here and here. As authority for the Proposed Rules, the SEC cites provisions adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 15(l)(2) of the Exchange Act and Section 211(h)(2) of the Investment Advisers Act of 1940 (the "Advisers Act"). These sections authorize 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."

[2] The SEC proposed Rule 15l-2 under the Exchange Act, which would apply to all SEC-registered broker-dealers and those required to be registered. The SEC also proposed Rule 211(h)(2)-4 under the Advisers Act, which would similarly apply to all SEC-registered investment advisers and those required to be registered. The Proposed Rules would not apply to, for example, exempt reporting advisers or state-registered advisers.

Technologies to adopt and implement policies and procedures reasonably designed to prevent violations of, or to achieve compliance with, the requirements. These policies and procedures would necessitate, among other things, written descriptions of the process for evaluating any use (or reasonably foreseeable potential use) of such technology in Investor Interactions and of the process for determining how to eliminate, or neutralize the effects of, conflicts that place the interest of the firm or an associated person ahead of investors' interests. Further, the SEC proposed amendments to the existing recordkeeping rules to require firms to make and keep books and records that document compliance with the requirements of the Proposed Rules.[3]

In proposing these rules, the SEC cited the accelerating use of digital engagement practices, game-like features, and newer technologies by broker-dealers and investment advisers.[4] The SEC stated that conflicts associated with these technologies "could cause harm to investors in a more pronounced fashion and on a broader scale than previously possible" because of the "scalability of these technologies and the potential for firms to reach a broad audience at a rapid speed."[5] The SEC further explained that the Proposed Rules are "sufficiently broad and principles-based" to allow for continued technology innovation and provide market participants with flexibility to develop approaches consistent with their respective business models.[6] In addition, the SEC stated that the proposal is "technology neutral," meaning that it is not intended to identify technologies that should be used.[7]

Comments on the Proposed Rules are due by October 10, 2023, 60 days after the Proposing Release was published in the Federal Register. If the Proposed Rules are adopted, the Proposing Release does not identify the date by which SEC-registered broker-dealers and investment advisers would need to come into compliance.

I. The Scope of the Proposed Rules: Using a Covered Technology in an Investor Interaction

The Proposed Rules would apply when firms use: (i) "Covered Technology" (ii) in an "Investor Interaction." Because of these terms' surprisingly broad definitions, a wide variety of technologies and interactions would be subject to the Proposed Rules. As SEC Commissioner Mark Uyeda said, "a myriad of commonly used tools could qualify such as a simple electronic calculator, or an application that analyzes an investor's future retirement assets based on, for example, changing the broad

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3 Rules 17a-3 and 17a-4 under the Exchange Act and Rule 204-2 under the Advisers Act.

4 *See* Proposing Release at 6, 88 Fed. Reg. at 53961. SEC Chairman Gary Gensler has been acutely focused on the "gamification" of investing. In his testimony before the House Committee on Financial Services on May 6, 2021, Chair Gensler warned of "the use of game-like features—such as points, rewards, leaderboards, bonuses, and competitions—to increase customer engagement." Available here. On August 27, 2021, the SEC published a request for public comment on the use of new and emerging technologies by financial industry firms. Available here.

5 *See* Proposing Release at 6, 88 Fed. Reg. at 53961.

6 *See* Proposing Release at 39, 43, 88 Fed. Reg. at 53970, 53972.

7 *See* Proposing Release at 40, 88 Fed. Reg. at 53971.

asset allocation mix among stocks, bonds and cash."[8] The broad scope of the Proposed Rules are likely to affect every broker-dealer and investment adviser in some way. For example, Covered Technologies used in Investor Interactions might include a hedge fund adviser that uses tools for its algorithmic trading strategy or a private equity fund adviser that uses an Excel spreadsheet for financial modeling.

a. Broad Definition of a Covered Technology

"Covered Technology" would be broadly defined under the Proposed Rules 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."[9]

Predictive Data Analytics. This proposed definition captures predictive data analytics ("PDA") and PDA-like technologies, such as artificial intelligence, machine learning, deep learning algorithms, neural networks, natural language processing, large language models, and generative pre-trained transformers.[10] Further, other technologies that use historical or real-time data, lookup tables, or correlation matrices are picked up by this proposed definition.[11]

Investment-Related Behaviors or Outcomes. The Proposed Rules capture a broad range of actions, beyond merely providing investment advice or recommendations, and include design elements, features, or communications that nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes.[12] "Investment-related behaviors or outcomes" encompass more than buying, selling, or holding securities. Such behaviors or outcomes could manifest in an investor making referrals, trading more frequently, or trading at increased volumes.[13]

Examples of Covered Technologies. Covered Technologies would include: (i) algorithmic-based investment analysis tools that tailor recommendations to investors; (ii) conditional auto-encoder models that predict stock returns; (iii) models in a spreadsheet using financial calculations that consider historical data to optimize asset allocation recommendations; (iv) off-

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8 Commissioner Mark T. Uyeda, *Statement on the Proposals re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers* (July 26, 2023), available here.

9 Proposed Rules 15l-2(a) under the Exchange Act and 211(h)(2)-4(a) under the Advisers Act.

10 *See* Proposing Release at 42–43, 88 Fed. Reg. at 53972.

11 *Id.*

12 The SEC has requested comments on whether the proposed definition of Covered Technology should include a "directly or indirectly" modifier—that is, whether the definition should include technologies that only indirectly optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes.

13 *See* Proposing Release at 41 and 43, 88 Fed. Reg. at 53972.

the-shelf natural language processing technologies that a firm licenses and uses in advertisements; and (v) websites that provide an investor's account balance or past performance and predict future results.[14]

Examples of Non-Covered Technologies. Technologies that only inform investors, but do not affect an investment-related behavior or outcome, would not be a Covered Technology. For example, Covered Technologies would not include: (i) websites that describe an investor's current account balance or past performance but do not guide or direct investment-related action; (ii) technologies that predict, based on existing information about the investor from such technologies, the approval for a credit card issued by a firm's affiliate; and (iii) chatbots that employ PDA-like technology solely to assist investors with basic customer service support (e.g., resetting passwords or disputing fraudulent account activity).[15]

b. Broad Definition of an Investor Interaction

The Proposed Rules would define "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."[16] This definition would include discretionary and non-discretionary advice and recommendations, as well as any advertisement that offers or promotes services or that seeks to obtain or retain investors, whether disseminated by the firm or a third party. It also would capture any form of a firm's correspondence, dissemination, or conveyance of information to or solicitation of investors, including whether the communications occur in-person, on websites, or through other digital tools or platforms (e.g., smartphones, computer applications, chatbots, e-mail messages, or text messages).[17] The communications could occur directly through the technology itself (e.g., behavioral features on digital platforms that prompt investment-related behaviors), or indirectly, through firm personnel using the technology and communicating resulting information to an investor (e.g., an e-mail recommending an investment product when the broker-dealer used a Covered Technology to generate such recommendation).[18]

Notably, the proposed definition includes interactions that generally have been viewed as outside the scope of broker-dealer "recommendations." The proposed definition would capture firm communications that do not amount to a recommendation, but guide or direct investors to take an investment-related action. For example, an Investor Interaction could include a firm using: (i) an electronic library that provides investors with access to research reports from the firm's website, or (ii) simple technology that generates e-mails to investors of news articles affecting securities on an investor's watch list.[19]

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[14] *See* Proposing Release at 44–45, 88 Fed. Reg. at 53971–53972.

[15] *See* Proposing Release at 45, 88 Fed. Reg. at 53972–53973.

[16] Proposed Rules 15l-2(a) under the Exchange Act and 211(h)(2)-4(a) under the Advisers Act.

[17] *See* Proposing Release at 50–51, 88 Fed. Reg. at 53974.

[18] *See* Proposing Release at 52, 88 Fed. Reg. at 53974.

[19] *See* Proposing Release at 52–53, 88 Fed. Reg. at 53974.

Investor. The definition of "Investor" captures prospective and current Investors, but is defined differently for broker-dealers and investment advisers.[20] For broker-dealers, "Investor" would be defined as "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."[21] For investment advisers, "Investor" would be defined as "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."[22]

Examples of Investor Interactions. Investor Interactions using Covered Technologies would include: (i) chatbots that answer investment-related questions, such as whether to invest in a security; (ii) technologies that provide customized insights concerning an investor's needs and interests that could be used to make suggestions to such investor; (iii) game-like prompts that nudge investors to take investment-related actions on digital platforms; and (iv) technologies that scrape public data that a firm then uses to solicit clients.[23]

Examples of Non-Investor Interactions. The proposed definition limits the Proposed Rules' scope to a firm's use of Covered Technologies in interactions with investors only. Use of a Covered Technology that does not involve any Investor Interaction, and where such interaction is not reasonably foreseeable, would not be picked up by the Proposed Rules. For example, without implicating the Proposed Rules, a firm could use a Covered Technology solely to: (i) make investment decisions about its own assets; (ii) analyze historical and current-market data to identify trends and make predictions concerning the firm's intra-day liquidity needs or working capital requirements; and (iii) automate "back office" processes like routing customer orders and settling trades.[24]

Exclusions from the Definition of Investor Interaction. The proposed definition provides exclusions for Investor Interactions that are solely for the purpose of: (i) meeting "legal or regulatory obligations," or (ii) providing "clerical, ministerial, or general

[20] The Proposing Release does not explain why different definitions of the term "Investor" are used for broker-dealers and investment advisers. Also, the term "prospective investor" is not defined in the Proposed Rules. The SEC has asked if "prospective investor" should be defined, and if so, whether the definition should include any person or entity that engages in some way with a firm's services (*e.g.*, downloads the firm's mobile app, visits the firm's website, or creates a log-in).

[21] Proposed Rule 15l-2(a) under the Exchange Act, which applies to "natural persons" consistent with *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 86031 (June 5, 2019) ("Regulation Best Interest").

[22] Proposed Rule 211(h)(2)-4(a) under the Advisers Act. For investment advisers, the proposed definition of "Investor" would include institutional investors and would incorporate the definition of "pooled investment vehicle" from Rule 206(4)-8 under the Advisers Act (*i.e.*, any investment company defined in Section 3(a) of the Investment Company Act of 1940 (the "1940 Act") or any company that would be an investment company under Section 3(a) of that 1940 Act but for the exclusion provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of the 1940 Act). However, as proposed, "Investors" would not include vehicles that rely on other exclusions from the definition of investment company. For example, "Investors" would not include companies primarily engaged in holding mortgages (excluded under Section 3(c)(5)(C) of the 1940 Act) or certain collective investment trust funds or separate accounts (excluded under Section 3(c)(11) of the 1940 Act).

[23] *See* Proposing Release at 52–53, 55, 88 Fed. Reg. at 53974–53975.

[24] *See* Proposing Release at 52–55, 88 Fed. Reg. at 53974–53975.

administrative support."[25] These exclusions are limited to interactions that are "solely for the purpose" of one of these two categories. However, for dual-use Covered Technologies, or where Investor Interactions serve more than one purpose, such other non-excluded use or purpose could bring the technology or interaction within the scope of the Proposed Rules. The "solely for the purpose" language would require a firm to ensure that all reasonably foreseeable functions of a dual-use technology are considered when evaluating Conflicts of Interest associated with the use of Covered Technologies in Investor Interactions.[26]

c. Broad Definition of Conflicts of Interest

Under the existing regulatory framework, the SEC has taken the view that a conflict of interest is an interest that might incline a broker-dealer or investment adviser, consciously or unconsciously, to make a recommendation or render advice that is not disinterested. Under the Proposed Rules, "Conflict of Interest" is defined more broadly: a conflict would exist when a firm, or the firm's associated persons, use a Covered Technology that considers *any* interest of the firm or *any* interest of the firm's associated persons.[27] The Proposing Release makes clear that a "Conflict of Interest" includes the use in a Covered Technology of *any* information favorable to the firm or its associated persons in an Investor Interaction.

There are many ways in which the SEC might view a Covered Technology used in Investor Interactions as being associated with a Conflict of Interest. For example, a Covered Technology that considers firm profits or revenues[28] would be associated with a Conflict of Interest, regardless of whether the firm places its interests ahead of investors' interests.[29] The specific interest that is considered, and the degree to which it is weighted by the Covered Technology, would not affect the

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[25] Proposed Rules 15l-2(a) under the Exchange Act and 211(h)(2)-4(a) under the Advisers Act. For example, the proposed definition of Investor Interaction would exclude: (i) electronically delivering Form ADV; (ii) electronically tracking investor activity to flag suspected fraudulent transactions for anti-money laundering purposes; or (iii) two-factor authentication messages for investor verification purposes. The proposed definition also would exclude technological interactions that answer questions like the business hours of a branch office, the balance of an investor's account, or routing customers to an appropriate customer service representative. *See* Proposing Release at 54–55, 88 Fed. Reg. at 53975.

[26] *See* Proposing Release at 55, 88 Fed. Reg. at 53975.

[27] A "Conflict of Interest" would exist for brokers or dealers when "a broker or dealer uses a Covered Technology that takes into consideration an interest of the broker or dealer, or a natural person who is an associated person of a broker or dealer." (Proposed Rule 151-2(a) under the Exchange Act). A "Conflict of Interest" would exist for investment advisers when "an investment adviser uses a Covered Technology that takes into consideration an interest of the investment adviser, or a natural person who is a person associated with the investment adviser." (Proposed Rule 211(h)(2)-4(a) under the Advisers Act). *See* Proposing Release at 230, 88 Fed. Reg. at 54021.

[28] Revenue or profits can be considered directly, such as if a firm populates an asset allocation algorithm on its website to prioritize investments that benefit the firm (*e.g.*, promoting proprietary funds or by over-weighting funds that make revenue-sharing payments). *See* Proposing Release at 81, 88 Fed. Reg. 53982. Revenue or profits can also be considered indirectly, such as through incentivizing increased trading activity or opening margin accounts, if increased trading or account openings would benefit the firm (*e.g.*, through increased commissions from a wholesaler or increased firm profits). *See* Proposing Release at 82, 88 Fed. Reg. 53982.

[29] *See* Proposing Release at 81, 88 Fed. Reg. 53982.

determination of whether a conflict exists. The presence of any interest of the firm or its associated persons, to any degree, would constitute a conflict under the proposed definition.

II. Identification, Determination, and Elimination, or Neutralization of the Effect of, a Conflict of Interest

The Proposed Rules would require a firm to eliminate, or neutralize the effect of, certain "Conflicts of Interests" associated with the use of Covered Technologies in Investor Interactions. The SEC designed these rules to supplement, rather than supplant, existing regulatory obligations regarding Conflicts of Interest.[30] Under the Proposed Rules, firms would be required to take the following affirmative steps to address conflicts:

(i) evaluating 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 Conflict of Interest associated with that use or potential use, including through testing and re-testing the technology;

(ii) determining whether any such Conflict of Interest in an Investor Interaction places, or results in placing, the firm's or its associated persons' interests ahead of the interests of investors; and

(iii) eliminating, or neutralizing the effect of, those Conflicts of Interest that place the firm's or its associated persons' interests ahead of the interests of investors.[31]

In light of the broad definitions of "Covered Technology," "Investor Interaction," and "Conflict of Interest" discussed above, the Proposed Rules' requirements to identify, determine, and eliminate (or neutralize the effect of) any conflict has the potential to limit innovation and development of technologies that could benefit investors and enhance the level and type of services made available to investors because of the Proposed Rule's onerous requirements and the uncertainty about potential violations of the Proposed Rule if conflicts are not effectively identified and eliminated or neutralized. Since disclosure would not be sufficient to eliminate or neutralize the effect of such a conflict, the Proposed Rules raise questions as to whether the requirements could effectively bar any such digital engagement practices.

a. Evaluation and Identification of Conflicts of Interest

The Proposed Rules do not mandate how a firm would be required to evaluate its use, or potential use, of a Covered Technology, or how to identify a Conflict of Interest associated with such use or potential use. Rather, a firm may adopt an approach that is appropriate for its particular use, provided that it is sufficient to identify the Conflicts of Interest that are associated with how the technology has operated in the past and how it could operate once deployed. If a technology could

[30] *See* Proposing Release at 61, n. 142, 88 Fed. Reg. at 53976–53977, n. 142.

[31] Proposed Rules Proposed Rule 15l-2(b) under the Exchange Act and 211(h)(2)-4(b) under the Advisers Act. *See also* Proposing Release at 61, 77, and 95, 88 Fed. Reg. at 53977, 53980, and 53985.

be used in different scenarios, a firm should consider all scenarios in which it intends to use it, as well as any other uses that are reasonably foreseeable. A firm may adopt different approaches for different Covered Technologies.[32]

When evaluating a Covered Technology and identifying Conflicts of Interest, a firm should consider how such technology would be implemented or deployed in Investor Interactions. For more simple Covered Technologies, such as basic financial models contained in spreadsheets or straightforward investment algorithms, a firm could take more simple steps to evaluate the technology and identify any Conflicts of Interest.[33] However, for more advanced Covered Technologies, a firm may need to take additional steps.[34] Covered Technologies that operate autonomously, or with limited involvement by firm personnel, may require additional scrutiny because such personnel may not immediately notice if a conflict becomes apparent once the technology is deployed or if the technology's output changes over time. Further, even when a firm identifies a Conflict of Interest associated with a Covered Technology, depending on the facts and circumstances, it may determine that such conflict does not actually result in the interests of the firm or its associated persons being placed ahead of those of investors and, thus, the conflict would not need to be eliminated or its effects neutralized.

In certain cases, it may be difficult or impossible for a firm to evaluate a particular Covered Technology or to identify Conflicts of Interest associated with its use or potential use within the meaning of the Proposed Rules. For example, such technologies could include large language models considering millions of different data points, models trained on a data set from the entire internet, or "black box" algorithms where it is unclear exactly what inputs the technology is relying on or how it is weighting those inputs. These difficulties or impossibilities would not absolve a firm of its responsibility to comply with the Proposed Rules. In such cases, a firm may be able to modify these technologies. For example, it could embed explainability features into the models or adopt back-end controls (e.g., limiting the personnel who use a technology) to enable it to satisfy the Proposed Rules' requirements. Firms may not be able to continue using certain technologies, however, if firms cannot meet the evaluation requirement with respect to such technologies.

b. Testing Covered Technologies

As part of the evaluation and identification requirement, the Proposed Rules would require testing and re-testing of each Covered Technology to determine whether its use is associated with a Conflict of Interest. Firms would be required to test

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[32] *See* Proposing Release at 61–62, 88 Fed. Reg. at 53977.

[33] For example, a firm could require a review of the Covered Technology to determine if it weights factors that are firm-favorable (such as the revenue generated by a course of action). *See* Proposing Release at 62, 88 Fed. Reg. at 53977.

[34] For example, a firm could instruct its personnel to review the technology's source code and other documentation or could review the data considered by the technology (and the weighting of such data). A firm could build "explainability" features into the technology to give the model the capacity to explain why it reached a particular outcome, recommendation, or prediction. When a firm relies only on the technology's documentation, testing methodology would be particularly important to allow the firm to identify any undocumented functionality that might raise a Conflict of Interest. *See* Proposing Release at 63, 88 Fed. Reg. at 53977.

each Covered Technology: (i) prior to deploying or implementing the technology; (ii) prior to materially modifying the technology; and (iii) periodically thereafter.[35] While the material modifications are being tested, a firm could continue to use the unmodified version of the technology so long as such use complies with the Proposed Rules.

Since the Proposed Rules do not specify how often or the manner in which firms must re-test Covered Technologies used in Investor Interactions, firms must make a reasonable determination. Testing methodologies and frequencies may vary depending on the nature and complexity of the Covered Technologies implemented or deployed. For example, a firm that uses relatively straightforward Covered Technologies may expend the majority of its testing efforts when the technology is first implemented or substantially modified, and any periodic testing may focus only on a sampling of the firm's Covered Technologies. On the other hand, a firm that uses more complex Covered Technologies may use testing methodologies and frequencies[36] that are tailored to the technology's complexity and based on a review of the features that make such technology more or less likely to involve a Conflict of Interest.[37]

c. Determining Whether a Conflict Places, or Results in Placing, the Firm's or its Associated Person's Interest Ahead of Investors' Interests

After identifying the Conflicts of Interest associated with the use of a Covered Technology, the Proposed Rules would require a firm to determine whether such conflict places, or results in placing, the firm's or its associated person's interest ahead of its investors' interests. This determination requires a facts-and-circumstances analysis and depends on considering a variety of factors, such as: (i) the Covered Technology; (ii) its anticipated use; (iii) the Conflicts of Interest involved; (iv) the methodologies used and outcomes generated; and (v) the interests of the investor.[38] Based on this analysis, and before using such Covered Technology in an Investor Interaction, a firm must reasonably believe that the Covered Technology either does not place the interests of the firm or its associated persons ahead of investors, or the firm would need to take

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35 *See* Proposing Release at 73, 88 Fed. Reg. at 53980. Adding a new functionality to a Covered Technology (*e.g.*, expanding it to cover an additional asset class) would be a material modification. Standard software updates, security patches, bug fixes, or minor performance improvements, however, would not be material modifications.

36 *See* Proposing Release at 75, 88 Fed. Reg. at 53980. A firm may determine to re-test a Covered Technology more frequently if it functions with limited involvement from firm personnel, is constantly optimized, or is prone to "drift" or "decay."

37 For more complex Covered Technologies, a firm may use A/B testing to determine what factors are being optimized, whether any such factors involve the firm's interests, or to estimate the effect of the methodology with and without factors that involve the firm's interests. Firms could also review data about a Covered Technology's historical performance to monitor signs that it may be optimizing for firm-favorable factors. A firm may determine to re-test a Covered Technology more frequently if it functions with limited involvement from firm personnel, is constantly optimized, or is prone to "drift" or "decay." *See* Proposing Release at 74–75, 88 Fed. Reg. at 53980.

38 *See* Proposing Release at 87, 88 Fed. Reg. at 53983.

additional steps to eliminate the conflict, or neutralize the effect of the conflict. Notably, firms cannot rely on disclosure and consent to address Conflicts of Interest.[39]

A Covered Technology that takes into account an interest of the firm does not necessarily result in the firm's interests being placed ahead of the interests of investors.[40] For example, many investment advisers create financial models of a portfolio company's financial statements to help evaluate whether to advise their clients to invest in a particular portfolio company. Where such a financial model inputs the potential performance-based fee received by the adviser, the adviser's consideration of metrics that are favorable to it would constitute a conflict under the Proposed Rules. Under the determination requirement, however, the adviser could determine that such conflict does not result in its own interests being placed ahead of investors' interests if the outcome is equally (or more) favorable to the investor. Conversely, where such a financial model is designed to screen investments that would not result in a sufficient performance-based fee for the adviser (despite acceptable investor returns), the adviser would determine that its interests would be placed ahead of investors' interests. Covered Technologies that explicitly or intentionally consider a firm's interest as an integral part of its outputs are likely to be Investor Interactions that place the interests of the firm ahead of the interests of investors.[41] A firm generally should tailor the methods by which it determines whether its use of Covered Technologies in Investor Interactions places its interests ahead of investors' interests based on the circumstances and the complexity of the underlying Covered Technology and Conflict of Interest.

d. Elimination, or Neutralization of Effect of, the Conflict

The Proposed Rules would require a firm to eliminate, or neutralize "promptly" the effect of, any Conflict of Interest it determines to result in an Investor Interaction that places the firm's or its associated persons' interests ahead of investors' interests.[42] Successful elimination or neutralization would be achieved once the Investor Interaction no longer places the firm's interests ahead of those of investors. Under the Proposed Rules, a firm could eliminate a conflict by, for example, terminating the practice that results in a conflict or removing the firm's interest from the information considered by the Covered Technology.[43] Alternatively, a firm could neutralize the effect of a conflict by taking steps to address it. In a neutralization scenario, the Covered Technology could continue to use the data that includes the firm-favorable factor, but

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39 *See* Proposing Release at 104, 88 Fed. Reg. at 53988.

40 *See* Proposing Release at 88, 88 Fed. Reg. at 53983–53984.

41 One method to determine whether a firm's or its associated persons' interests are being placed ahead of the interests of an investor is to review how outputs would vary if a firm's or associated persons' interests are not considered.

42 *See* Proposing Release at 96, 88 Fed. Reg. at 53986.

43 For example, a firm that determined Covered Technology used in Investor Interactions favored investments where its receipt of revenue sharing payments placed the firm's interests ahead of investors' interests could eliminate the conflict, among other methods, by ending revenue sharing arrangements or by ensuring that its Covered Technologies do not consider investments that pay it revenue sharing payments. *See* Proposing Release at 97, 88 Fed. Reg. at 53986.

the firm would need to take steps to prevent such use from biasing the output toward the interests of the firm or its associated persons.

The Proposed Rules do not prescribe a specific way in which a firm must eliminate, or neutralize the effect of, its Conflicts of Interest. For example, if a robo-adviser determines that it uses Covered Technology to steer investors to its own funds when more suitable options are available, the firm could eliminate this conflict by removing any data that would allow the robo-adviser to determine which funds are sponsored or advised by the firm. Alternatively, the firm could neutralize the effect of the conflict by, for example, increasing the weights given to other factors, such that it creates a counterweight to remedy the conflict.[44]

If a firm's evaluation indicates that a Covered Technology would result in a Conflict of Interest only in limited circumstances, it could eliminate the conflict by preventing the technology from being used in such circumstances or by choosing to eliminate the business practice associated with the conflict. Similarly, if a technology involves a Conflict of Interest only due to its consideration of certain data or the weights ascribed to it, the firm could prevent the technology from accessing that data or avert its consideration from affecting the outcome of the technology. The firm could do so by considering additional, investor-favorable data that provides countervailing signals to the technology, or by weighting the inputs such that firm-favorable data is not determinative to the output. Further, a firm could neutralize the effect of a conflict by requiring trained personnel to operate the technology and only provide information to investors after they deem it not to involve a conflict.[45]

Importantly, the Proposing Release states that firms "would not satisfy the Proposed Rules' requirement to eliminate, or neutralize the effect of, certain conflicts solely by providing disclosure to investors."[46] While existing requirements often address conflicts through disclosure and client or customer consent, certain conflicts identified by the firms under the Proposed Rules will require more than mere disclosure to adequately address them, even when a client or customer provides consent.[47]

The Proposed Rules would require a firm to eliminate, or neutralize the effect of, a Conflict of Interest "promptly" after the firm determines, or reasonably should have determined, that the conflict results in its interests being placed ahead of its

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44 *See* Proposing Release at 97–98, 88 Fed. Reg. at 53986.

45 *See* Proposing Release at 100–101, 88 Fed. Reg. at 53987.

46 *See* Proposing Release at 104, 88 Fed. Reg. at 53988.

47 The Fiduciary Interpretation applicable to investment advisers provided for the mitigation of Conflicts of Interest, rather than neutralization. *See* the *Fiduciary Interpretation* at 33670 ("In all of these cases where an investment adviser cannot fully and fairly disclose a Conflict of Interest to a client such that the client can provide informed consent, the adviser should either eliminate the conflict or adequately mitigate (*i.e.*, modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible.").

investors' interests. Determining what constitutes "promptly" would depend on the specific facts and circumstances.[48] Firms should also consider and seek to minimize potential risks posed to investors from the continued use of the Covered Technology.[49] Further, if a firm reasonably believes that pulling a Covered Technology out of service due to a conflict would be a greater risk to investors than the conflict itself, it should monitor the Investor Interactions associated with its continued use to evaluate whether it must cease using the Covered Technology.[50]

The Proposed Rules would not require the elimination or neutralization of conflicts that exist solely because a firm seeks to open a new investor account. Although account openings benefit a firm, the Proposed Rules are not designed to limit firms' abilities to attract clients and customers. Still, the Proposed Rules would cover a conflict that incentivizes other account activity (e.g., margin account openings) that would be particularly profitable to a firm and may not be in an investor's interest.[51]

III. Policies and Procedures Requirements

The Proposed Rules would require a firm that has any Investor Interaction using Covered Technology to adopt, implement, and, in the case of broker-dealers, maintain, written policies and procedures reasonably designed to achieve compliance with the Proposed Rules:

(i) a written description of: (a) the process for evaluating any use or reasonably foreseeable potential use of a Covered Technology in any Investor Interaction and (b) any material features of, including any Conflicts of Interest associated with any Covered Technology used in any Investor Interaction and of any Conflicts of Interest associated with that use, which must be updated periodically;[52]

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48 Where eliminating, or neutralizing the effect of, a Conflict of Interest is straightforward (as would be the case if a firm had to simply update the settings of an application or restrict user access), it could happen soon after the identification of the conflict. However, where doing so is more complicated (as would be the case if firm personnel had to do substantial amounts of coding), such modifications may take longer to implement. The Proposing Release identifies that "an extended period of implementation may raise questions about whether the firm acted promptly and may raise questions as to whether they are acting in accordance with their standard of care." *See* Proposing Release at 101, 88 Fed. Reg. at 53987.

49 This might include implementing heightened review of Investor Interactions to help ensure that the harm is relatively limited, and weighting the risks of continued exposure to a Conflict of Interest during remediation against the risk of making the Covered Technology unavailable.

50 *See* Proposing Release at 102–103, 88 Fed. Reg. at 53987.

51 *See* Proposing Release at 107, 88 Fed. Reg. at 53988–53989.

52 A firm would be required to update the written descriptions of the evaluation process and material features periodically. These periodic updates should occur when: (i) a Covered Technology was upgraded or materially modified such that it would make the existing description inaccurate or incomplete; (ii) firm personnel become aware of additional material features of the Covered Technology used by the firm; or (iii) the firm engages in a different use of the Covered Technology that was not previously contemplated by the written description.

(ii) a written description of the process for determining whether any Conflict of Interest identified results in an Investor Interaction that places the interests of the firm or person associated with the firm ahead of the interests of the investor;

(iii) 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 interests of the firm or associated person ahead of the interests of the investor; and

(iv) a review and written documentation of that review on at least an annual basis of the adequacy of the policies and procedures established pursuant to the Proposed Rules and the effectiveness of their implementation, which would include a review of the written descriptions established pursuant to the Proposed Rules.[53]

Even if a firm that uses Covered Technology in Investor Interactions does not identify any Conflicts of Interest, it must still adopt, implement, and, in the case of broker-dealers, maintain these written policies and procedures.[54] A firm's failure to do so would constitute a violation of the Proposed Rules, independent of any other securities law violation.

The Proposed Rules would provide firms with flexibility to determine the specific means by which they address each element, and the degree of prescriptiveness they include in their policies and procedures. Firms should consider the nature of their operations and account for the Covered Technologies in use or to be used, including any reasonably foreseeable potential use.[55] Firms should also consider including in their policies and procedures, as appropriate: (i) compliance review and monitoring systems and controls; (ii) procedures that clearly designate responsibility to appropriate personnel for supervision of functions and persons; (iii) processes to escalate identified instances of noncompliance to appropriate personnel for remediation; and (iv) training of relevant personnel on the policies and procedures, as well as the forms of Covered Technology used by the firm.[56]

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[53] Proposed Rules 151-2(c) under the Exchange Act and 211(h)(2)-4(c) under the Advisers Act. *See also* Proposing Release at 112–114, 88 Fed. Reg. at 53990.

[54] *See* Proposing Release at 114, 88 Fed. Reg. at 53990.

[55] As proposed, the policies and procedures would need to be "substantially more robust" for a firm that makes extensive use of more complex Covered Technology, such as machine learning technologies that function automatically without direct interaction with firm personnel, or a firm whose Conflicts of Interest are more complex or extensive. This could include consideration of all aspects of the Covered Technologies the firm uses, including the data used to train the technologies, "explainability" requirements, specific training for technical staff, and maintaining (and regularly reviewing) logs, sufficient to identify any risks the firm's use of a Covered Technology presents of non-compliance with the Proposed Rules. *See* Proposing Release at 115, 88 Fed. Reg. at 53991.

[56] *See* Proposing Release at 114–115, 88 Fed. Reg. at 53991.

a. Written Description of the Evaluation Process and Material Features of Covered Technologies

The written description of the evaluation process would be required to articulate how the firm will conduct the required testing of each Covered Technology before its implementation or material modification, and periodically thereafter. The written description also would be required to determine how the firm will identify whether the use of such Covered Technology is associated with a Conflict of Interest. Although the scope of any individual evaluation may depend on a variety of factors (e.g., the specific Covered Technology, the manner in which the technology interacts with investors, and how the technology is used), the evaluation process adopted should provide firms with a consistent approach to satisfy the requirements of the Proposed Rules.[57]

The written description of the material features of a Covered Technology used in Investor Interaction would be required to include any conflicts associated with the use of such Covered Technology. The written description would need to be prepared before the implementation or material modification of the Covered Technology and would be required to be updated periodically. The material features of a Covered Technology would include how the technology works, including how it optimizes, predicts, guides, forecasts, or directs investment-related behaviors or outcomes, in a manner that would enable the appropriate personnel at a firm to understand the potential Conflicts of Interest associated with the technology. Further, the written description should detail when and how the firm intends to use, or could reasonably foresee using, the Covered Technology in Investor Interactions.[58]

A high degree of specificity may not be necessary when creating the written description of every material feature of every Covered Technology used by the firm in Investor Interactions. For example, if a material feature could not reasonably be expected to be associated with a Conflict of Interest (e.g., a financial model that computes whether risks are sufficiently diversified in a portfolio containing various asset classes), a firm could reasonably determine that a simple description of that feature is sufficient.[59] At a minimum, however, the firm would need to describe the material features of the Covered Technology it uses with sufficient detail for the appropriate personnel at the firm to understand whether its use would be associated with any Conflicts of Interest.[60]

b. Written Description of Determination Process

The written description of the determination process should provide a consistent approach and clearly articulate the process for the firm to use in determining the effect that the Conflict of Interest has, or would have, on an Investor Interaction if the Covered Technology or material modification were put into use by the firm. The written description should also include a means of determining whether the interests of the firm or its associated person would be placed ahead of investors' interests

[57] *See* Proposing Release at 118–119, 88 Fed. Reg. at 53992.

[58] *See* Proposing Release at 118–122, 88 Fed. Reg. at 53992.

[59] *See* Proposing Release at 121–122, 88 Fed. Reg. at 53992.

[60] *See* Proposing Release at 124, 88 Fed. Reg. at 53993.

if the firm used the Covered Technology (or a material modification to the Covered Technology) in Investor Interactions. Although the idiosyncrasies of differing Conflicts of Interest or different types of Investor Interactions may necessitate flexibility, the written description should be specific enough such that the process would be consistently effective in producing determinations by the firm that accurately reflect those Conflicts of Interest that would result in placing the interests of the firm or its associated persons ahead of the interests of investors.[61]

c. Written Description of Process for Determining How to Eliminate, or Neutralize the Effects of, Conflicts

The written description of the process for elimination or neutralization should be tailored to account for the differing circumstances presented to the firm when making its determination as to a particular Conflict of Interest. For example, the process described should account for whether the particular Conflict of Interest involves a Covered Technology that is already being used in Investor Interactions, or instead only involves a Conflict of Interest from a reasonably foreseeable potential use. Where the process pertains to a reasonably foreseeable potential use, the firm should address how its personnel would determine whether a Covered Technology has been sufficiently modified such that any identified Conflicts of Interest have been eliminated, or their effect has been neutralized, prior to any use in an Investor Interaction. Where a firm is already using a Covered Technology in Investor Interactions, the firm's written description of this process must address how it would promptly eliminate, or neutralize the effect of, any identified Conflict of Interest. The written process for a Covered Technology that is already used in Investor Interactions might, for example, require the firm to limit access to or use of the technology immediately or, if possible, immediately eliminate the identified Conflict of Interest, prior to considering further modifications. The written description should include the steps that the firm would take under its elimination or neutralization procedures to prevent any Investor Interaction that places the interests of the firm ahead of the interests of investors. The written description should contain a clear articulation of the process the firm uses for determining how a conflict should be eliminated or its effect neutralized. In addition, when a firm's policies and procedures dictate a specific means of making such a determination, the firm's written description would need to reflect this.[62]

Firms using Covered Technologies in Investor Interactions could provide additional training to staff who would implement their elimination and neutralization policies. Firms could provide, for example, additional training to personnel responsible for maintaining Covered Technologies to give them a better understanding of the legal framework governing the use of the Covered Technologies. Firms could also provide additional technical training to relevant personnel to allow them to better understand how the Covered Technologies work, and as a result can better understand the technical aspects of what is necessary to eliminate or neutralize a given Conflict of Interest. Steps a firm could take to eliminate, or neutralize the effects of, a Conflict of Interest include: (i) explicitly eliminating consideration of the factors that reflect the firm's interest(s) giving

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61 *See* Proposing Release at 125–126, 88 Fed. Reg. at 53993–53994.

62 *See* Proposing Release at 127–129, 88 Fed. Reg. at 53994.

rise to the Conflict of Interest; (ii) disabling a part of the Covered Technology; (iii) training the Covered Technology to use reinforcement learning to prioritize investors' interest(s) in all cases; or (iv) eliminating the business practice that is associated with the Conflict of Interest.[63]

d. Annual Review of the Adequacy and Effectiveness of the Policies and Procedures and Written Descriptions

The Proposed Rules require a written review, no less than annually, of the adequacy of the policies and procedures established pursuant to the Proposed Rules and the effectiveness of their implementation, which would include a review of the written descriptions established pursuant to the Proposed Rules. During this review, firms would need to evaluate specifically whether their policies and procedures and written descriptions have been adequate and effective over the period under review at achieving compliance with the Proposed Rules' requirements: (i) to identify and evaluate all instances where their use or potential use of a Covered Technology in an Investor Interaction involves a Conflict of Interest; (ii) to determine whether that Conflict of Interest places the interests of the firm, or an associated person of the firm, ahead of those of the investors; and (iii) to then eliminate, or neutralize the effect of, any such Conflict of Interest promptly after the firm has, or reasonably should have, identified the conflict. Further, firms generally should use this annual review to consider whether there have been any changes in the business activities of the firm or its associated persons, any changes in its use of technology generally, any issues that arose from its use of Covered Technologies during the previous year, any changes in applicable law, or any other factor that might suggest that certain Covered Technologies now present a different or greater risk than the firm's policies and procedures and written descriptions had previously accounted for, and what adjustments might need to be made to such documents or their implementation to address these risks. Under the Proposed Rules, firms also would be required to prepare written documentation of the review that has been conducted.[64]

IV. Proposed Recordkeeping Amendments

Proposed amendments to applicable recordkeeping rules would require firms to maintain and preserve, for the specific retention periods, all books and records related to the requirements of the Proposed Rules.[65] The proposed retention periods conform to existing retention periods applicable to broker-dealers and/or investment advisers.[66] The Proposed Amendments would require making and maintaining six specific types of records:

First, firms would be required to make and maintain written documentation of the evaluation of any Conflict of Interest associated with the use or potential use by the firm or associated person of a Covered Technology in any Investor Interaction. This written documentation would include a list or other record of all Covered Technologies used by the firm in

63 *See* Proposing Release at 129, 88 Fed. Reg. at 53994.

64 *See* Proposing Release at 131–132, 88 Fed. Reg. at 53995.

65 *See* Rules 17a-3 and 17a-4 under the Exchange Act and Rule 204-2 under the Advisers Act.

66 *See* Proposing Release at 135, 88 Fed. Reg. at 53996.

Investor Interactions, including: (i) the date on which each Covered Technology is first implemented (i.e., first deployed), and each date on which any Covered Technology is materially modified; and (ii) the firm's evaluation of the intended use as compared to the actual use and outcome of the Covered Technology. Firms also would be required to make and maintain documentation describing any testing of the Covered Technology, including: (i) the date on which testing was completed; (ii) the methods used to conduct the testing; (iii) any actual or reasonably foreseeable potential Conflicts of Interest identified as a result of the testing; (iv) a description of any changes or modifications made to the Covered Technology that resulted from the testing and the reason for those changes; and (v) any restrictions placed on the use of the Covered Technology as a result of the testing.[67]

Second, firms would be required to make and maintain written documentation of the determination whether any Conflict of Interest identified places the interests of the firm, or associated persons of a firm, ahead of the interests of the investor. This would include the rationale for such determination. This written documentation of the rationale generally should include, for example, the basis on which a firm concludes that a Conflict of Interest did or did not result in an Investor Interaction that places the firm or associated person's interests ahead of those of investors.[68]

Third, firms would be required to make and maintain written documentation evidencing how the effect of any Conflict of Interest has been eliminated or neutralized. This written documentation generally should include a record of the specific steps taken by the firm in deciding how to eliminate, or neutralize the effects of, any Conflicts of Interest. The written documentation also generally should include the rationale for any determination to make changes or modifications to or place restrictions on the Covered Technology to eliminate, or neutralize the effect of, any identified Conflicts of Interest, the methodology used to make any such determination, and a description of the firm's analysis that resulted in any such determination.[69]

Fourth, firms would be required to maintain written policies and procedures, including any written descriptions, that were adopted, implemented, and, with regard to broker-dealers, maintained. This documentation would include the date on which the policies and procedures were last reviewed. Firms must also maintain written documentation evidencing a review, occurring at least annually, of the adequacy of the policies and procedures and the effectiveness of their implementation, as well as a review of the written descriptions.[70]

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67 *See* Proposing Release at 136, 88 Fed. Reg. at 53996. The written documentation should include a record of any research or third-party outreach the firm conducted related to any testing. Where a Covered Technology uses straightforward mathematical models (*i.e.*, a model in a spreadsheet) firms could simply list all such technologies as a single entry.

68 *See* Proposing Release at 137, 88 Fed. Reg. at 53996.

69 *See* Proposing Release at 137–138, 88 Fed. Reg. at 53996.

70 *See* Proposing Release at 138–139, 88 Fed. Reg. at 53996–53997. A firm may maintain records documenting other information regarding Covered Technology (*i.e.*, a record of any non-Investor Interaction uses that the firm reasonably foresees for each Covered Technology) to demonstrate a

Fifth, firms would be required to make and maintain a record of any disclosures provided to investors regarding the firm's use of Covered Technologies, including, if applicable, the date such disclosure was first provided and the date such disclosure was updated.[71]

Sixth, firms would be required to make and maintain records of each instance in which a Covered Technology was altered, overridden, or disabled, the reason for such action, and the date thereof. This requirement would include making and maintaining records of all instances where an investor requested that a Covered Technology be altered or restricted in any manner.[72]

V. Conclusion

The Proposed Rules emphasize the SEC's continued focus on gamification features and predictive data analytics, artificial intelligence, and similar technologies. Until new rules and regulations are adopted, we expect SEC examinations, administrative proceedings, and enforcement actions to continue as regulators tackle such new technologies and apply existing regulations to them.

The Proposed Rules would impose new requirements on certain Investor Interactions that are not currently covered by existing regulations, applying the existing standard of care and duties of financial services firms to interactions with investors that do not amount to recommendations or investment advice. While Regulation Best Interest is triggered when a broker-dealer recommends a security or investment strategy, and an investment adviser's fiduciary obligation is triggered when it renders investment advice, the Proposed Rules would apply to Covered Technologies in Investor Interactions even when recommendations or advice are absent.[73]

Departing from common law principles and the existing disclosure-based regime, the SEC warns that broker-dealers and investment advisers "would not satisfy the Proposed Rules' requirement to eliminate, or neutralize the effect of, certain conflicts solely by providing disclosure to investors."[74] Existing requirements, which allow firms to address conflicts through disclosure and client or customer consent, would not necessarily satisfy the Proposed Rules' requirements of elimination or neutralization. As Commissioner Hester Peirce noted, the SEC has lost faith in the "power of disclosure and the

reasonable approach to identifying and evaluating the Conflicts of Interest associated with the technology. *See* Proposing Release at 139, 88 Fed. Reg. at 53997.

71 Firms could do so by maintaining a simple bullet-point list with cross-references to all disclosures they make to investors regarding their use of Covered Technologies (whether the disclosure is made pursuant to an existing requirement or voluntarily). *See* Proposing Release at 139, 88 Fed. Reg. at 53997.

72 *See* Proposing Release at 139–140, 88 Fed. Reg. at 53997.

73 *See Regulation Best Interest*; *see also Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Advisers Act Rel. No. 5248 (Jun. 5, 2019) (the "Fiduciary Interpretation").

74 *See* Proposing Release at 104, 88 Fed. Reg. at 53988.

corresponding belief that informed investors are able to think for themselves."[75] Should the Proposed Rules be adopted, broker-dealers and investment advisers would need to consider the impact on the marketing and provision of investment strategies and products that involve the use of Covered Technologies. For example, it is not clear whether the Proposed Rules would prohibit firms from using Covered Technologies to market only proprietary products where the firms' platforms include third-party products. Similarly, the Proposed Rules might cause firms to limit the extent of products available through offerings that use Covered Technologies, including by only offering proprietary products to avoid potential conflicts of interest associated with open architecture platforms or to limit the types of products that are used in investment strategies so as to remove potential Conflicts of Interest associated with the selection between product types. In this regard, the Proposed Rules could potentially prohibit the use of Covered Technologies in circumstances that would not otherwise violate Regulation Best Interest, the Fiduciary Interpretation, or common law fiduciary principles.

The ambiguity and breadth of the activities that would trigger the Proposed Rules make it challenging to assess existing industry practices under the proposal. We expect the industry will engage with the SEC during the 60-day comment period, as industry participants review and apply the Proposed Rules' requirements to the wide variety of technologies they use in Investor Interactions.

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[75] 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* (July 26, 2023), available here.