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SEC Update

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SEC Proposes Rules Relating to Use of Predictive Data Analytics by Investment Advisers and Broker-Dealers

On July 26, 2023, the Securities and Exchange Commission (SEC), by a 3-2 vote of the Commissioners, issued a rulemaking release proposing, for the first time, to regulate the use of "predictive data analytics" (PDA) by registered investment advisers and broker-dealers (collectively, firms).[1] The Proposing Release states that the SEC's goal is to eliminate, or neutralize the effect of, certain conflicts of interest associated with firms' interactions with investors through such firms' use of technologies that "optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes."[2] In furtherance of that goal, the SEC proposed new rule 15l-2 (Proposed Rule 15l-2) under the Securities Exchange Act of 1934, as amended (the Exchange Act), and new rule 211(h)(2)-4 (Proposed Rule 211(h)(2)-4, and, combined with Proposed Rule 15l-2, the Rules) under the Investment Advisers Act of 1940, as amended (the Advisers Act). Additionally, the SEC proposed amendments to Exchange Act rules 17a-3 and 17a-4 and Advisers Act rule 204-2 (collectively, the Proposed Recordkeeping Amendments).[3] This column (1) provides background context that helped lead to the Proposing Release; (2) summarizes the Proposing Release; and (3) discusses key issues raised by the Proposing Release.

Background

The adoption and use of newer technologies such as PDA by firms has accelerated and become a point of discussion in recent years.[4] In particular, the so-called gamification of smartphone applications by broker-dealers and investment advisers became a topic of debate and political scrutiny following the "meme stock" events of early 2021.[5] Following the market upheavals associated with those events and Congressional hearings identifying investor protection concerns associated with alleged gamification by firms, in August 2021 the SEC issued a request for information and public comment (the 2021 Request for Comment) on what it referred to as "digital engagement practices" (DEPs) of broker-dealers and investment advisers. The 2021 Request for Comment sought input on behavioral prompts, differential marketing, game-like features, and other design elements or features designed to engage with retail investors on digital platforms; the analytical and technological tools and methods used in connection with DEPs; and investment adviser use of technology to develop and provide investment advice.[6] The SEC issued the 2021 Request for Comment in part to assist the Commission and its Staff in understanding market practices associated with the use of DEPs, as well as to provide a forum

for market participants, including investors, to share their perspectives on the use of DEPs and related tools and methods, including potential benefits that DEPs provide to retail investors and potential investor protection concerns.[7]

The SEC received over 2,300 public comments to the 2021 Request for Comment, reflecting broad public interest in the issue.[8] The SEC noted in the Proposing Release that many commenters to the 2021 Request for Comment raised concerns regarding the potential harm to investors if the SEC did not act to address issues presented by DEPs and their underlying technologies.[9] The SEC noted that many commenters suggested a need to address standards of conduct applicable to firms when interacting with retail investors through digital platforms.[10] The SEC also received comments on other areas of law and regulation applicable to broker-dealers and investment advisers and the sufficiency, or lack thereof, of current regulations and regulatory guidance in their application to DEPs, including regulation of advertising, marketing and communications with the public; compliance and supervision obligations; data privacy and cybersecurity concerns; customer onboarding concerns; the applicability of previous SEC Staff guidance relating to robo-advisers; and the applicability of the Advisers Act recordkeeping rule to DEPs.[11]

Following the 2021 Request for Comment, the SEC added items to its Unified Agenda of Regulatory and Deregulatory Actions (Reg Flex Agenda) for Spring 2022 that indicated that the SEC intended to propose rules relating to DEPs by investment advisers and broker-dealers.[12] SEC Chair Gensler also spoke on the topic in March 2022, noting his concerns that investment advisers and broker-dealers may face conflicts of interest associated with their DEPs and could be "optimizing for other factors [beyond the benefit of investors], including the revenues and performance of the platforms" such advisers and broker-dealers operate.[13] He also noted a concern that analytic models "could reflect historical biases, or may be proxies for protected characteristics, like race and gender" and noted that DEPs and associated practices implicate systemic risk.[14]

In addition, on November 30, 2022, tech startup OpenAI released ChatGPT, a large language model that uses deep learning to generate human-like text.[15] The immediate success of this artificial intelligence (AI) program increased public awareness and attention on AI, as well as increased investment in AI technologies.[16] In particular, a recent report indicates that financial services companies plan to spend $31 billion worldwide on AI.[17] Perhaps as a result of this increased focus on AI, the descriptions of the anticipated rulemakings from the relevant RegFlex Agenda items changed from a focus on DEPs to a focus on "conflicts in the use of predictive data analytics, artificial intelligence, machine learning, and similar technologies" in the Spring 2023 Reg Flex Agenda.[18] The Proposing Release was issued about a month after that Reg Flex Agenda was made public.[19]

The Rules and the Proposed Recordkeeping Amendments

Basis for and Scope of the Rules

The SEC stated in the Proposing Release that the Rules are designed to address conflicts of interest associated with firms' use of PDA-like technology when engaging in certain investor interactions.[20] The SEC acknowledged in the Proposing Release that the use of PDA-like technologies in certain interactions are already subject to existing obligations, such as obligations related to investment advice and recommendations as well as general and specific requirements aimed at addressing conflicts of interest (for example, disclosure obligations) and the antifraud obligations of the federal securities laws.[21] Citing the "rapid acceleration" of PDA-like technologies and their adoption in the investment industry, "additional challenges associated with identifying and addressing conflicts of interest resulting from the use of . . . new technologies," and "concerns relating to scalability," the SEC stated that the Rules

were necessary to specifically address those issues.[22] In particular, the SEC said that "disclosure may be ineffective" at addressing such conflicts of interest in light of the rate of investor interactions, the size of the datasets to which PDA-like technologies are applied, the complexity of the algorithms on which PDA-like technology is based, and the ability of the technology to learn investor preferences or behavior, all of which could lead to overly complex disclosure.[23] In addition, the Commission cited the possibility that PDA-like technologies could expose investors to unnecessary risks, such as excessive trading, using trading strategies that "carry additional risk" such as options trading or margin trading, and trading in "complex securities products that are more remunerative to the firm but pose undue risk to the investor."[24]

As a result of those identified concerns, the Rules would require firms to identify and eliminate (or neutralize the effect of) conflicts of interest arising from investors' interactions with a firm through the firm's use of covered technologies, such as PDA, that, among other things, predict, guide, forecast, or direct investment-related behaviors or outcomes in an investor interaction. More specifically, the Rules would require a firm to (1) evaluate any use or reasonably foreseeable potential use by the firm or its associated person of a covered technology in any "investor interaction" (a defined term of the Rules discussed below) to identify any conflict of interest associated with that use or potential use; (2) determine whether any such conflict of interest places or results in placing the firm's or its associated person's interest ahead of the interest of investors; and (3) eliminate, or neutralize the effect of, those conflicts of interest that place the firm's or its associated person's interest ahead of the interest of investors.[25] The SEC stated that the rules are intended to be "broad and principles-based," scoping in novel technologies over time but also allowing for firms to have "flexibility to develop approaches to their use of technology consistent with their business model," so long as such use does not lead to the firm placing its interest ahead of investor interests.[26] The Rules would apply to all broker-dealers and to all investment advisers registered, or required to be registered, with the SEC.[27]

Definition of Covered Technology

The Rules only apply when a firm uses "covered technology," which is defined 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."[28] The Proposing Release makes clear that "PDA-like" technologies are to be included within the broader definition of covered technologies, and specifically cites AI, machine learning, or deep learning algorithms, neural networks, natural language processing, or large language models, as well as "other technologies that make use of historical or real-time data, lookup tables, or correlation matrices among others" as included within the scope of the "covered technology" definition.[29] In addition, the proposed definition would apply to the use of PDA-like technologies that analyze investors' behaviors to proactively provide curated research reports on particular investment products, as well as algorithmic-based tools to provide tailored investment recommendations to investors.[30] The definition is intentionally open-ended so as to capture technologies and methods that may develop over time.[31]

There are limitations to the breadth of what would be considered a "covered technology" for the purposes of the Rules. Specifically, the definition is limited to those technologies that "optimize for, predict, guide, forecast, or direct investment-related business outcomes."[32] The Proposing Release states that this could include providing investment advice or recommendations, but also encompasses design elements, features, or communications that nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors.[33] However, the proposed definition would not include technologies "designed purely to inform investors" but

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that do not otherwise optimize for or predict future results, or otherwise guide or direct any investment-related action.[34]

Investor Interactions

The Rules include definitions for both "investor" and "investor interaction" for the purposes of the Rules. For a broker or dealer, "investor" would mean "a natural person, or the legal representative or a natural person, who seeks to receive or receives services primarily for personal, family or household purposes."[35] For an investment adviser, "investor" would mean "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."[36] The "investor" definition does not draw distinctions between retail investors and other persons (in the case of broker-dealers) or prospective or current clients (in the case of investment advisers).[37] For both Rules, "investor interaction" would mean "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; except that the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support."[38] The SEC clarified in the Proposing Release that this would capture a firm's correspondence, dissemination, or conveyance of information to or solicitation of investors "in any form," subject to the exceptions embedded in the definition.[39]

Evaluation and Identification of Conflicts

As noted, the Rules would require firms to evaluate any use or reasonably foreseeable potential use of a covered technology by the firm (or a natural person who is an associated person of the firm) in any investor interaction to identify any conflict of interest associated with that use or potential use.[40] The Proposing Release states that the Rules would not mandate a particular means by which a firm is required to evaluate its particular use or potential use of a covered technology or to identify a conflict of interest associated with that use or potential use.[41] Instead, the firm may adopt an approach that is "appropriate for its particular use of covered technology, provided that its evaluation approach is sufficient for the firm 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 by the firm."[42] Firms would be expected to evaluate "reasonably foreseeable" scenarios associated with the use or potential use of the covered technology.[43] The SEC indicated that firms that use more advanced covered technologies may need to take additional steps to evaluate the technologies and identify associated conflicts adequately.[44] The SEC also stated that the Rules would apply to technologies that "lack explainability as to how the technology functions in practice" (for example, "black box" algorithms).[45] For such technologies, the Proposing Release suggests that, while firms likely will be unable to identify all conflicts of interests associated with the use of such technologies, firms may be able to modify the technologies and/or adopt back-end controls (such as limiting the personnel who can use a technology or the cases in which the technology is employed) to satisfy the requirements of the Rules.[46]

Testing

As part of the identification and evaluation requirement, the Rules would include a requirement to test each covered technology prior to its implementation or material modification, and periodically thereafter, to determine whether the use of such covered technology is associated with a conflict of interest.[47] The Rules do not specify any particular method of testing or frequency of retesting (absent material modification).[48] The Proposing Release states that a firm's testing methodologies and frequencies may vary depending on the nature and complexity of the covered technologies the firm deploys (similar to the proposed identification and

evaluation requirements)[49] as well as whether the technology continues to be used as intended and as originally tested.[50]

Conflict of Interest

Under the Rules, a conflict of interest would exist when a firm uses a covered technology that takes into consideration an interest of the firm or its associated persons.[51] The Proposing Release clarifies that "if a covered technology considers *any* firm-favorable information in an investor interaction or information favorable to a firm's associated persons, the firm should evaluate the conflict" pursuant to the Rules.[52] The specific interest that is taken into account, and the degree to which that interest is weighted in or by a covered technology, would not affect the determination as to whether a conflict of information exists; the presence of any firm interest in any degree would constitute a conflict of interest.[53]

Determination of Conflicts

The Rules would require a firm, after the evaluation discussed above, to determine whether such conflict of interest places or results in placing the firm's or its associated person's interest ahead of investors' interests.[54] The Proposing Release notes that this determination is a facts and circumstances analysis, and the outcome of the determination depends on a variety of factors such as "the covered technology, its anticipated use, the conflicts of interest involved, the methodologies used and outcomes generated, and the interests of the investor."[55] Based on that determination, the firm must either (a) reasonably believe that the covered technology does not place the interests of the firm or its associated persons ahead of investor interests, or (b) take additional steps to eliminate, or neutralize the effect of, the conflict.[56] The Rules do not prescribe strict numerical weights in this determination, but the determination should take into account the relative level of benefits to the firm and its investors as well as other relevant facts and circumstances.[57] If a firm cannot determine that its use of a covered technology in investor interactions does not result in a conflict of interest that places its interest ahead of those of investors, the firm generally should consider such conflict as one that must be eliminated (or its effect neutralized) and take steps necessary to do so.[58]

Elimination or Neutralization of Effect

The Rules would require a firm to eliminate, or neutralize the effect of, any conflict of interest it determines results in an investor interaction that places the firm's (or its associated persons') interest ahead of the interests of its investors.[59] Such elimination or neutralization must occur "promptly" after the firm determines (or reasonably should have determined)[60] that the conflict places the interest of the firm or its associated persons ahead of the interest of investors.[61] What constitutes "prompt" elimination or neutralization depends on the facts and circumstances, and the Proposing Release acknowledges that certain efforts to eliminate or neutralize a conflict would not happen immediately in all circumstances.[62] However, the SEC also noted that in certain cases it may be impossible to comply with a firm's applicable standard of conduct without stopping the use of a covered technology until the conflict of interest can be adequately addressed.[63]

The Proposing Release notes that the Rules do not prescribe a specific way in which a firm must eliminate, or neutralize the effect of, applicable conflicts of interest.[64] With respect to "elimination," the Proposing Release cites the example of "completely eliminating the practice . . . that results in a conflict of interest or removing the firm's interest from the information considered by the covered technology."[65] By contrast, "neutralizing" an applicable conflict would involve "tak[ing] steps to prevent [the use of data or an algorithm] to prevent it from biasing the output towards the interest of the firm or its associated persons," through "modification or counterweighting" the relevant inputs.[66] The test for whether a firm has successfully eliminated or

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neutralized a conflict of interest would be whether the interaction no longer places the interest of the firm ahead of the interest of investors.[67]

There are limited exceptions to the requirement to eliminate, or neutralize the effect of, applicable conflicts of interest. The Rules would not require the elimination or neutralization of conflicts of interest associated with the use of covered technologies that exist solely because of a firm seeking to open a new investor account.[68] While the use of a covered technology in connection with opening a new account would likely present a conflict of interest as defined under the Rules, the Proposing Release states that the Rules "are not designed to limit firms' abilities to attract clients and customers," and thus the Rules provide an exception in those circumstances.[69]

Policies and Procedures

Proposed Rule 211(h)(2)-4 requires every investment adviser that is subject to paragraph (b) of that Rule and uses covered technology in any investor interaction to adopt and implement written policies and procedures reasonably designed to prevent violations of paragraph (b).[70] Similarly, Proposed Rule 15l-2 requires every broker-dealer that is subject to paragraph (b) of that Rule and uses covered technology in any interaction to adopt, implement, and maintain written policies and procedures reasonably designed to achieve compliance with paragraph (b).[71] Notwithstanding the slightly different wording in the Rules around the policies and procedures requirement, the SEC stated in the proposing release that there is no substantive difference between investment advisers and broker-dealers in complying with the Rules.[72]

For all firms, these policies and procedures would need to include the following:

- A written description of the process for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction covered by the Rules and a written description of any material features of, including any conflicts of interest associated with the use of, any covered technology used in any investor interaction prior to such covered technology's implementation or material modification, which must be updated periodically;[73]
- A written description of the process for determining whether any identified conflict of interest results in an investor interaction that places the interest of the firm or an associated person ahead of the interests of the investor;[74]
- A written description of the process for determining how to eliminate, or to neutralize the effect of, any conflicts of interest determined to result in the interest of the firm or an associated person being placed ahead of the interests of the investor;[75] and
- A review and written documentation of that review, no less frequently than annually, of the adequacy of the policies and procedures and written descriptions established pursuant to the policies and procedures requirement, as well as the effectiveness of their implementation.[76]

Recordkeeping

The Proposed Recordkeeping Amendments would require firms to maintain and preserve, for the specific retention periods in those existing recordkeeping rules,[77] books and records relating to the Rules. Specifically, the Proposed Recordkeeping Amendments would require firms to make and maintain the following records:

- 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 investor interactions, including (i) the date on which each covered technology is first implemented 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;[78]

- Documentation describing any testing of a 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;[79]
- Written documentation of the determination whether any identified conflict of interest places the interest of the firm, or associated persons of the firm, ahead of the interests of investors. This would include the rationale for such determination;[80]
- Written documentation evidencing how the effect of any conflict of interest has been eliminated or neutralized.[81] This written documentation generally would include a record of the specific steps taken by the firm in deciding how to eliminate, or to neutralize the effects of, any conflicts of interest, as required under the Rules;[82]
- The written policies and procedures, including any written descriptions, adopted, implemented (and, with regard to broker-dealers, maintained) pursuant to the Rules. This documentation would include the date on which the policies and procedures were last reviewed and written documentation evidencing a review (occurring at least annually) of the adequacy of the policies and procedures and the effectiveness of their implementation[83]
- 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 or the date such disclosure was updated;[84] and
- Records of each instance in which a covered technology was altered, overridden, or disabled, the reason for such action and the date thereof.[85]

SEC Authority

To promulgate the Rules and the Proposed Recordkeeping Amendments, the SEC cited its authority in Sections 204 and 211 of the Advisers Act and Sections 15 and 17 of the Exchange Act.[86] In the Proposing Release, the SEC states that the Rules are consistent with prior actions intended to mitigate conflicts of interest by firms.[87]

Proposed Transition Period/Compliance Date

Unlike many rulemaking proposals from the SEC, the Proposing Release does not set forth a proposed transition period and/or compliance date.

Issues Raised by the Proposing Release

The Rules and the Proposing Release raise a number of issues for firms and have received pointed criticism from some quarters, including in vigorous dissenting statements of the two Commissioners who voted against the Rules. Those primary points of concern and criticism follow.

Interaction with Fiduciary and Regulation Best Interest Obligations/Shift from Disclosure-Based Regime

Certain commenters have argued that the Rules are unnecessary in light of existing obligations for firms under the federal securities laws and, with respect to broker-dealers, Financial Industry Regulatory Authority (FINRA) rules, that are designed to protect investors from conflicts of interest. In particular, registered investment advisers are already bound by fiduciary duties to their clients, and broker-dealers are subject to Regulation Best Interest obligations.[88] In light of those

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standards of conduct and applicable obligations for firms, Commissioner Mark Uyeda called the Rules "wholly unnecessary," that in his view "layer[] on duplicative requirements" to the standard of conduct rulemakings the SEC completed in 2019.[89] In her dissent, Commissioner Hester Peirce stated that the Proposing Release "reflects the Commission's loss of faith in . . . the power of disclosure" and asked Staff at the meeting proposing the Rules whether the rules were "a backdoor attempt to expand Regulation Best Interest?"[90] Ten major trade associations, including the Investment Company Institute, further argue in a joint comment letter (the Joint Trades Letter) that the Proposing Release seems to seek to override the applicable standards of conduct by applying a novel definition of "conflict of interest," arguing that the Rules' application to conflicts of interest that "might" exist is broader than any prior-existing requirements applicable to firms.[91]

Broad Definition of "Covered Technology"

Commenters have noted that the "covered technology" definition is very broad and would bring many widely used technology applications into the Rules' scope. In his dissent, Commissioner Uyeda noted that the Proposing Release explicitly acknowledged that spreadsheets that embed financial calculations would be covered technologies, but he noted that, under the Rules' definition, "a myriad" of other commonly used tools could qualify, including a simple electronic calculator or even "non-electronic calculators like an abacus," so long as such technology's use is "analytical, technological, or computational."[92] Given the breadth of the definition, Commissioner Peirce argued that the Proposing Release risked "depriving investors of the benefits of technological advancement,"[93] and the Joint Trades Letter argues that "[t]he lack of discernible boundaries on what is a 'covered technology' is likely to operate as a *de facto* ban on the use of [innovative] technology."[94]

Potentially Overbroad Approach to "Investor Interactions"

Commenters also have noted the breadth of the "investor interaction" definition. Commissioner Uyeda said that the standard "suffers from vagueness" and that "virtually any investor interaction that is not purely administrative appears to be covered."[95] The Joint Trades Letter noted that the definition is so broad (including, *inter alia*, "exercising discretion" with respect to any client account) that it likely applies even when a firm is not communicating with an investor, and as a result of this breadth "no reasonable line can be drawn by a [firm]" on when a covered technology is used in an "investor interaction."[96]

Lack of Investor Harm

Some commenters have questioned whether the conflicts of interest identified in the Proposing Release and intended to be eliminated or mitigated by the Rules justify the rulemaking. In a *Wall Street Journal* op-ed, former Attorney General Bill Barr and former US Representative Barbara Comstock argued that "[t]he SEC has failed to point to any evidence the technology it seeks to restrict is being abused by firms or harming investors. The evils are purely speculative."[97] They argued that instead of adopting the rules, the SEC should wait to adopt more tailored regulation "until some specific, concrete harm arises."[98]

Compliance Burden

The Rules and the Proposed Recordkeeping Amendments would impose new burdens on a large number of firms, as they introduce new requirements that will require additional compliance resources and the need to adopt and maintain new policies and procedures. The Proposing Release indicated that, following an initial 350 hours, the annual burden for firms with "complex covered technology" would only face an additional 175 hours of compliance time at an estimated cost of $78,050, but does not explain how those numbers

were arrived at and sought comment on the costs of the proposed requirements that could improve the cost estimates.[99] Commissioner Uyeda argued these estimates were likely unrealistic, noting that the Proposed Recordkeeping Amendments would "result in countless hours of efforts to document why things like the simple desktop calculator do not have any conflicts of interest."[100] Commissioner Peirce argued that the effect of (and likely intended purpose of) the compliance requirements of the Rules and the Proposed Recordkeeping Amendments was to "ban[] technologies we do not like" and questioned whether "any but the largest firms have the personnel and resources needed to comply with the proposed evaluation and testing standards."[101]

SEC Authority

Certain commenters have questioned whether the SEC has the authority to adopt the Rules. The Joint Trades Letter argues that the expansiveness of the Rules and the Proposed Recordkeeping Amendments and the breadth of the activities they would seek to prohibit "raise serious questions" regarding whether Sections 211(h) of the Advisers Act and 15(l) of the Exchange Act provide authority to adopt the rules as proposed.[102] Specifically, the Joint Trades Letter argues that those provisions of the Advisers Act and Exchange Act are intended solely to allow for the SEC to adopt additional, related rulemakings in furtherance of separate provisions of the Advisers Act and Exchange Act that grant the SEC authority to adopt a harmonized standard of conduct for investment advisers and broker-dealers, rather than a broad provision that grants the SEC authority to adopt any rulemakings intended to mitigate conflicts of interest applicable to investment advisers and broker-dealers.[103] In addition, the Barr/Comstock Article argues that, to the extent that the Rules prohibit communications that are not deceptive, the Rules would violate the First Amendment.[104]

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NOTES

1. *Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers*, 88 Fed. Reg. 53,960 (proposed Aug. 9, 2023) (to be codified at 17 C.F.R. pts. 240, 275) (the Proposing Release).
2. *Id.* at 53,960.
3. *See id.*
4. *See id.* at 53,961–62.
5. *See, e.g.*, Staff of H. Comm. on Fin. Servs., 117th Cong., Game Stopped: How the Meme Stock Market Event Exposed Troubling Business Practices, Inadequate Risk Management, and the Need for Legislative and Regulatory Reform 7 n.12 (2022), *https://democrats-financialservices.house.gov/uploadedfiles/6.22_hfsc_gs.report_hmsmeetbp.irm.nlrf.pdf* (arguing that certain stock trading platforms "use app designs intended to increase consumer engagement, time spent on an investment platform, and the number of trades through gamification"); *see also* H.R. 4685, 117th Cong. (2022) (as reported to H.R., placed on Union Calendar No. 165, January 20, 2022) (bill proposing to require the Government Accountability Office to study and report on the use of techniques including adding game-like elements to encourage investor participation and psychological nudges by online investment trading platforms).
6. *Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice*, Exchange Act Release No. 34-92766, 86 Fed. Reg. 49,067 (Sept. 1, 2021).
7. *See id.* at 49,068.

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[8] *See* SEC, Comment File for Exchange Act Release No. 34-92766 (File No. S7-10-21), *https://www.sec.gov/comments/s7-10-21/s71021.htm*.

[9] *See* Proposing Release, *supra* n.1, at 53,969.

[10] *Id.* at 53,970.

[11] *Id.*

[12] U.S. Gen. Servs. Admin. & Off. of Mgmt. & Budget, Agency Rule List—Spring 2022 (2022), *https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPubId=202204&showStage=active&agencyCd=3235&csrf_token=5AC62B6AEC61A0ECAFF6B391D06B7EAF8E5FFF19080E15284259CECEBDE43577F75318ECFC8F28BA265563BA3CF1181EA818*.

[13] Gary Gensler, Chair, SEC, Prepared Remarks before the Investor Advisory Committee (Mar. 10, 2022), *https://www.sec.gov/news/speech/gensler-iac-2022-03-10*.

[14] *Id.* Before becoming Chair of the SEC, Mr. Gensler co-authored an article regarding the advance of PDA and its potential effect on systemic risk. *See* Gary Gensler & Lily Bailey, "Deep Learning and Financial Stability," *SSRN* (Nov. 1, 2020), *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723132*.

[15] Alyssa Stringer & Kyle Wiggers, "ChatGPT: Everything You Need to Know About the AI-Powered Chatbot," *TechCrunch* (updated Sept. 28, 2023), *https://techcrunch.com/2023/09/07/chatgpt-everything-you-need-to-know-about-the-open-ai-powered-chat-bot/*.

[16] *See, e.g.*, Goldman Sachs, "AI Investment Forecast to Approach $200 Billion Globally by 2025" (Aug. 1, 2023), *https://www.goldmansachs.com/intelligence/pages/ai-investment-forecast-to-approach-200-billion-globally-by-2025.html* (showing global AI investment likely to more than triple between 2020 and 2025, and mentions of AI on earning calls approximately doubling in the two quarters following the release of ChatGPT).

[17] *See* Nathan Eddy, "Financial Services Firms Ramp Up AI Investment," *Techstrong.ai* (June 12, 2023), *https://techstrong.ai/articles/financial-services-firms-ramp-up-ai-investment/*.

[18] U.S. Gen. Servs. Admin. & Off. of Mgmt. & Budget, Prohibition of Conflicted Practices for Investment Advisers that Use Certain Covered Technologies (2023), *https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202304&RIN=3235-AN14*; U.S. Gen. Servs. Admin. & Off. of Mgmt. & Budget, Prohibition of Conflicted for Broker-Dealers that Use Certain Covered Technologies (2023), *https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202304&RIN=3235-AN00*. The Proposing Release includes discussion about the growth and increased adoption of AI. *See* Proposing Release, *supra* n.1, at 53,964–65.

[19] *Cf.* Gary Gensler, Chair, SEC, Statement on the Spring 2023 Regulatory Agenda (June 13, 2023), *https://www.sec.gov/news/statement/gensler-statement-unified-agenda-061323*).

[20] Proposing Release, *supra* n.1, at 53,970.

[21] *Id.* at 53,966.

[22] *Id.* at 53,967.

[23] *Id.*

[24] *Id.* at 53,967–68.

[25] *See* Proposed Rule 211(h)(2)-4(b) and Proposed Rule 15l-2(b). Relevant terms are discussed *infra*.

[26] Proposing Release, *supra* n.1, at 53,970–71.

[27] *Id.* at 53,972.

[28] Proposed Rule 211(h)(2)-4(a) and Proposed Rule 15l-2(a).

[29] *See, e.g.*, Proposing Release, *supra* n.1, at 53,972.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.* The Proposing Release notes that the use of a chatbot that provides "basic customer service support" would not qualify as a covered technology. *Id.* at 53,973.

[35] Proposed Rule 15l-2(a).

[36] Proposed Rule 211(h)(2)-4(a). "Pooled investment vehicle" is defined making reference to and given the same meaning as Advisers Act rule 206(4)-8. *Id.*

[37] *See* Proposed Rule 15l-2(a) and Proposed Rule 211(h)(2)-4(a); *cf. also* Proposing Release, *supra* n.11, at 53,961 n.6 ("[T]he proposed conflicts rules do not use or define the term 'retail investors' . . . .").

[38] Proposed Rule 211(h)(2)-4(a); *see also* Proposed Rule 15l-2(a).

[39] Proposing Release, *supra* n.1, at 53,974.

[40] *See* Proposed Rule 211(h)(2)-4(b) and Proposed Rule 15l-2(b).

[41] *See* Proposing Release, *supra* n.1, at 53,977.

[42] *Id.*

[43] *Id.* Firms may exclude foreseeable scenarios for which the firm has taken reasonable steps to prevent use of the technology in scenarios it has not approved. *Id.*

[44] *Id.*

[45] *Id.* at 53,978.

[46] *Id.*

[47] *See* Proposed Rule 211(h)(2)-4(b)(1) and Proposed Rule 15l-2(b)(1).

[48] *See* Proposing Release, *supra* n.1, at 53,980.

[49] *See id.*

[50] *Id.* at 53,981.

[51] *See* Proposed Rule 211(h)(2)-4(a) and Proposed Rule 15l-2(a).

[52] *See* Proposing Release, *supra* n.1, at 53,982 (emphasis in original).

[53] *Id.*

[54] *See* Proposed Rule 211(h)(2)-4(b)(2) and Proposed Rule 15l-2(b)(2).

[55] Proposing Release, *supra* n.1, at 53,983.

[56] *Id.*

[57] *Id.* at n.164.

[58] *Id.* at 53,984.

[59] *See* Proposed Rule 211(h)(2)-4(b)(2) and Proposed Rule 15l-2(b)(2).

[60] According to the Proposing Release, the "reasonably should have determined" standard reflects that a firm is required to use reasonable care. Proposing Release, *supra* n.1, at 53,987. This standard is designed to require firms to understand the covered technology they are deploying sufficiently well to consider all the material features of the technology for the purposes of complying with the Rules. *See id.*

[61] *See* Proposed Rule 211(h)(2)-4(b)(2) and Proposed Rule 15l-2(b)(2).

[62] *See* Proposing Release, *supra* n.1, at 53,987.

[63] *See id.* The Proposing Release notes that this requirement is "designed to be consistent with a firm's applicable standard of conduct." *Id.* at 53,988. The Proposing Release notes, however, that, depending on the facts and circumstances, the requirement to eliminate or neutralize the effect of an applicable conflict of interest under the Rules "may apply in addition to existing requirements for addressing conflicts of interest" under applicable standards of conduct. *Id.*

[64] *Id.* at 53,986.

[65] *Id.*

[66] *Id.* The SEC notes that the Rules are intended to provide flexibility as to how or whether neutralization of applicable conflicts could be attained for given covered technologies, given the complexity of many covered technologies and the many ways in which conflicts of interests could be associated with their use. *Id.* at 53,971.

[67] *Id.* at 53,986.

[68] *Id.* at 53,988–89.

[69] *Id.* at 53,989.

[70] Proposed Rule 211(h)(2)-4(c)(3).

[71] Proposed Rule 15l-2(c).

[72] *See* Proposing Release, *supra* n.1, at 53,990 n.196.

[73] *See* Proposed Rule 211(h)(2)-4(c)(1) and Proposed Rule 15l-2(c)(1).

[74] *See* Proposed Rule 211(h)(2)-4(c)(2) and Proposed Rule 15l-2(c)(2).

[75] *See* Proposed Rule 211(h)(2)-4(c)(3) and Proposed Rule 15l-2(c)(3).

[76] *See* Proposed Rule 211(h)(2)-4(c)(4) and Proposed Rule 15l-2(c)(4).

[77] Exchange Act rule 17a-4(a) requires applicable records of broker-dealers to be preserved "for a period of not less than 6 years, the first two years in an easily accessible place." 17 C.F.R. § 240.17a-4(a) (2023). Advisers Act rule 204-2(e)(1) provides that records, including those under the proposed recordkeeping amendments, "shall be maintained and preserved

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in an easily accessible place for a period of not less than five years for the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser." 17 C.F.R. § 275.204-2(e)(1) (2001).

78 Proposed 17 C.F.R. § 240.17-3(e)(36)(i); 17 C.F.R. § 275.204-2(a)(24)(i).

79 *Id.*

80 Proposed 17 C.F.R. § 240.17-3(e)(36)(ii); 17 C.F.R. § 275.204-2(a)(24)(ii).

81 Proposed 17 C.F.R. § 240.17-3(e)(36)(iii); 17 C.F.R. § 275.204-2(a)(24)(iii).

82 *See* Proposing Release, *supra* n.1, at 53,996.

83 *See* proposed 17 C.F.R. § 240.17-3(e)(36)(iv); 17 C.F.R. § 275.204-2(a)(24)(iv).

84 Proposed 17 C.F.R. § 240.17-3(e)(36)(v); 17 C.F.R. § 275.204-2(a)(24)(v).

85 Proposed 17 C.F.R. § 240.17-3(e)(36)(vi); 17 C.F.R. § 275.204-2(a)(24)(vi).

86 *See* Proposing Release, *supra* n.1, at 54,018.

87 *See id.* at 53,966; *see also id.* at 53,971 n.114.

88 As noted *supra*, the SEC argues in the Proposing Release that the Rules are required notwithstanding existing standard of conduct requirements applicable to firms due to concerns associated with scalability and other aspects of PDA-like technologies. *See, e.g.*, Proposing Release, *supra* n.1, at 53,988.

89 Mark T. Uyeda, Comm'r, SEC, 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), *https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623* (hereinafter Uyeda Statement).

90 Hester M. Peirce, Comm'r, SEC, 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), *https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623* (hereinafter Peirce Statement).

91 Comment Letter from American Council of Life Insurers; American Investment Council; AIMA; American Securities Association, Financial Services Institute, Inc.; Financial Technology Association; Finseca; Investment Company Institute; Institute for Portfolio Alternatives; Insured Retirement Institute; LSTA; Managed Funds Association; National Society of Compliance Professionals; Center of Capital Markets Competitiveness—U.S. Chamber of Commerce to Vanessa A. Countryman, Sec'y, SEC 8-9 (Sept. 11, 2023), *https://www.ici.org/system/files/2023-09/23-cl-joint-trades-pda-proposal.pdf*. The Joint Trades Letter argues that this extension of standard of conduct requirements was proposed in violation of the Administrative Procedure Act. *Id.*

92 Uyeda Statement, *supra* n.89.

93 Peirce Statement, *supra* n.90.

94 Joint Trades Letter, *supra* n.91, at 3.

95 Uyeda Statement, *supra* n.89.

96 Joint Trades Letter, *supra* n.91 at 5.

97 William P. Barr & Barbara Comstock, "Gary Gensler's Plan to Control Information," *Wall St. J.* (Sept. 10, 2023), *https://www.wsj.com/articles/gary-genslers-plan-to-control-information-sec-financial-regulation-firms-investors-technology-market-927579dc?mod=opinion_lead_pos5* (hereinafter Barr/Comstock Article).

98 *Id.*

99 Proposing Release, *supra* n.1, at 54,009.

100 Uyeda Statement, *supra* n.89.

101 Peirce Statement, *supra* n.90.

102 Joint Trades Letter, *supra* n.91, at 4.

103 *See id.* This argument parallels similar arguments made against the SEC's authority to adopt the private fund adviser rulemaking. *See* Am. Inv. Council, Press Kit for Private Fund Advisers Rules (2023), *https://www.investmentcouncil.org/wp-content/uploads/2023/09/Press-Kit-for-Private-Fund-Advisers-Rules.pdf* ("Section 211(h) [of the Advisers Act] is a clean-up provision tacked on to a section of the Dodd-Frank Act addressing the provision of advice to ***retail*** customers. . . . [T]hat provision concerns the promotional methods employed by broker-dealers and investment advisers in interacting with retail customers, not the terms of an agreement.").

The Joint Trades Letter further notes that, even if Sections 211(h) of the Advisers Act and 15(l) of the Exchange Act do provide authority for rulemaking in this area, the Rules' requirement of "neutralizing" a conflict of interest appears to not be consistent with those statutory provisions, which involve facilitating the provision of disclosures. *See* Joint Trades Letter, *supra* n.91, at 10.

[104] *See* Barr/Comstock Article, *supra* n.97.

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