OPPORTUNITY OR BURDEN

UNDERSTANDING THE SEC'S PROPOSED RULES REGULATING THE USE OF AI AND OTHER NEW TECHNOLOGIES BY BROKER-DEALERS AND INVESTMENT ADVISERS

by **John Eden** | Counsel

INTRODUCTION

The Securities and Exchange Commission ("SEC") recently proposed new rules ("Proposed Rules") under the Securities and Exchange Act of 1934 ("Exchange Act") and the Investment Advisers Act of 1940 ("Advisers Act') designed to address the potential for artificial intelligence ("AI") and other predictive data analytics ("PDA") tools to create conflicts of interest between broker-dealers and investment advisers, on the one hand, and their clients, on the other.

For the purposes of the Proposed Rules, a conflict of interest would exist when a firm uses a PDA technology which considers "any firm-favorable information" in connection with an investor interaction (defined below) in a way that privileges the firm's commercial interests. For example, imagine that a client of a broker-dealer or investment adviser (each a "Covered Entity") goes to a website in order to purchase shares of a publicly traded company. If the firm uses a PDA technology to create a list of ranked options that is partially ordered by giving consideration to the firm's revenue-generating interests, then the firm's use of the PDA would constitute a conflict of interest.

The central concern motivating these new rules is that Covered Entities could use AI and PDA technologies to promote business activity that is not in the best interests of clients, which will in turn cause significant conflicts of interest. What is unusual about the Proposed Rules is that traditional cleansing of conflicts through full disclosure and consent are not sufficient to achieve compliance. To comply with such new rules, Covered Entities must identify and eliminate conflicts of interest.

Of course, not all of the SEC's commissioners believe that an "identification and elimination" scheme is the right way to regulate AI and similar technologies. The SEC voted 3 to 2 to publish the Proposed Rules, indicating significant disagreement among the commissioners regarding the best way to approach the regulation of advanced PDA technologies.

SCOPE AND OPERATION OF THE PROPOSED RULES

The **Proposed Rules** were announced on July 26, 2023. These rules prohibit Covered Entities from using PDA technologies in a fashion that places their commercial interests above those of their clients. The SEC's concern here is a serious one, and there are a number of basic types of problematic uses of PDA that the Proposed Rules are designed to address:

- Deployment of Poorly Understood Technology: Uses of PDA technologies where the Covered Entity in question does not understand how the PDA technology produces its output or results.
- Use of Properly Understood Technology Powered by Flawed Data: Uses of PDA technologies where there is a good technical understanding of how the platform or tool functions, but where the PDA utilized corrupted or otherwise inaccurate data.
- Use of Properly Understood Technology to Generate Revenue: Uses of PDA technologies to intentionally increase the generation of revenue by a firm through processing, analyzing, and leveraging behavioral data that makes it easier to nudge investors to make certain investment decisions

If the Proposed Rules were passed in their current form, broker-dealers and investment advisers would be required to take the following steps:

1. Evaluate the use of a covered technology, **identify any conflicts of interest** related to that use that place the interests of a Covered Entity before those of its clients, **and subsequently eliminate or neutralize the impact of such conflicts of interest**.
2. Develop and implement written policies and procedures that are "reasonably designed" to ensure compliance with the proposed rules.[1]
3. Comply with record-keeping requirements set forth in the final adopted rules.

UNDERSTANDING A COVERED TECHNOLOGY

The key to the Proposed Rules is the SEC's working definition of a "covered technology": "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."

This expansive definition of "covered technology" includes AI, machine learning tools and techniques, neutral networks, and natural language processing offerings, along with other similar and or adjacent technologies that will one day reach the market. The SEC did make an effort to exclude certain technologies from the "covered technology" definition, including (1) tools and platforms that do not guide or direct investment-related decisions, and (2) mass-market chatbot services that deliver basic customer service functions to clients.

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[1] The Proposed Rules seemingly make a distinction between broker-dealers and investment advisers. Broker-dealers must have written rules that ensure compliance with the new rules, whereas investment advisers must have written policies and procedures that prevent violations of the Proposed Rules. According to footnote 196, however, the SEC does not "believe . . . that there is a substantive difference between how firms (i.e., broker-dealers and investment advisers) would need to comply with each proposed rule."

UNDERSTANDING THE APPLICATION OF THE PROPOSED RULES

The Proposed Rules would apply to “investor interaction,” which in the current draft of the rules means **any engagement or communication with a client that could - either by design or otherwise - guide, influence or impact a client’s decision to make investments.** In other words, the “investor interaction” concept is much broader than explicit investment recommendations or offers to consider new products or opportunities. An investor interaction is functionally defined to ensure that the Proposed Rules apply to all forms of interaction or communication (whether inbound or outbound) by a Covered Entity which could influence investing behavior.

EMPLOYING COVERED TECHNOLOGY IN A COMPLIANT FASHION

Under the Proposed Rules, firms are required to determine whether a particular PDA could cause a conflict of interest by following a specific process. That process includes the following successive steps (the “Compliance Process”):

1. **Evaluation, Identification, and Testing**: Covered Entities must evaluate whether a PDA could cause or be associated with a conflict of interest (as defined by the Proposed Rules). While the Proposed Rules are not prescriptive about how this evaluation must be completed, the SEC is clear that the method by which a PDA is evaluated must be commensurate with the sophistication of the PDA’s underlying technology. In addition, every time a covered technology is modified or enhanced in a material way, firms would be required to test that technology anew to determine whether it will create conflicts of interest if adopted.

2. **Determination of Status of PDA**: After the evaluation stage (which in practice will include identification and, in the case of covered technology that has been modified, testing), a firm must determine whether an identified conflict of interest places the firm’s interests above those of its clients.

3. **Elimination of the Impact of the PDA**: Whenever a Covered Entity identifies a conflict of interest produced through the use of a PDA that places its interests above its clients’, the Covered Entity must eliminate or neutralize the effect of the conflict. The elimination of a conflict must be undertaken on a case-by-case basis because each PDA creates conflicts of interest in a fact-specific manner. As a consequence, Covered Entities will either have to (a) ask technology vendors to modify their PDAs (so that they will not create conflicts of interest), (b) develop in-house capabilities that allow the offending features, capabilities, and/or uses of PDAs to be deleted, disabled, or turned off, or (c) decide not to use a specific PDA technology.[2]

In addition to the Compliance Process summarized above, the Proposed Rules would also require Covered Entities to adopt and implement written policies and procedures reasonably designed to, in the case of investment advisors, prevent violations of the rules, or, in the case of broker-dealers, ensure compliance with the new proposed rules. These written policies and procedures must satisfy the following requirements:

- **Evaluation Standards**: Covered Entities must create a written description of how they evaluate and identify whether a use or potential use of a covered technology creates a conflict of interest.

- **Determination Standards**: Covered Entities must provide a written description of how they determine whether an identified conflict of interest results in a situation where the entity’s interests are placed above those of its clients.

- **Elimination Protocols**: Covered Entities must create a written description of how they eliminate and/or neutralize a PDA’s creation of a conflict of interest that places an entity’s interests above those of its clients.

- **Review Procedures**: Covered Entities must also create a written annual review procedure to evaluate the adequacy of the other policies and procedures described immediately above that were adopted to comply with the rules.

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[2]If a Covered Entity asks a technology vendor to modify a PDA to eliminate a conflict of interest, that Covered Entity is still responsible for confirming that any modifications made successfully eliminate such conflict of interest.

CHALLENGES AND OPPORTUNITIES

On page 145 of the Proposed Rules, the SEC provides the best unified explanation of why it decided to introduce rules to regulate the use of PDA technology:

> *The capabilities of these technological advances—including the data the technology uses (including any investor data) and the inferences the technology makes (including in analyzing investor data, other data, securities, or other assets)—may be opaque to investors and firms. This opacity makes it more challenging for an investor to identify the presence of a conflict of interest, understand its importance, and take protective action when making an investment decision or otherwise interacting with the firm. Likewise, a firm's identification of such conflicts is more challenging without unique efforts to both fully understand the PDA-like technology it is using and oversee conflicts that are created by or transmitted through such technology for purposes of the firm's compliance with applicable Federal securities laws.*

The above rationale provides a window into the depth and gravity of the SEC's concern. In addition, this passage also underscores why the Commission feels justified in departing from its traditional approach to rulemaking in this domain (where disclosure and informed consent are sufficient to address conflicts of interest) to instead embrace an "identify and eliminate" regime.

With these policy objectives in mind, it is important to be aware of the most significant problems with the Proposed Rules.

Overly Broad Concept of Investor Interactions. The Proposed Rules employ a concept of an "investor interaction" that is far too abstract. As it is currently presented, "investor interactions" could mean anything from proactive product offerings (where a representative of a Covered Entity reaches out to a client) to responsive communications (where a representative of a Covered Entity simply provides requested information to a client) to responsive transactions (where a Covered Entity simply provides a requested service to a client).

This is problematic because the overall objective of the Proposed Rules is to protect investors from the misuse of new technologies. An overly broad conception of investor interaction does not accomplish this goal for one simple reason: firms do not have infinite compliance resources, which strongly suggests that a more refined definition of an investor interaction would help firms more effectively follow the spirit and letter of the Proposed Rules. For that reason, the SEC should consider revising the definition of "investor interaction" to clarify the specific kinds of actions that trigger the operation of the conflict elimination requirement.

One solution here would be to define "investor interaction" as any deliberate attempt to directly or indirectly communicate with a client or prospective client of a Covered Entity for the purpose of recommending, endorsing, or highlighting the benefits of an investment opportunity or product. This modified definition has the benefit of clarifying that a Covered Entity is only engaging in an "investor interaction" when that entity attempts to sell or market a specific investment opportunity or product to a client or prospective client. Under this proposed definition, Covered Entities would not be engaging in

investor interactions when they use software to collect, process, and analyze data in order to create and enhance investment products.

Inadequate Compliance Incentives. The Proposed Rules, if passed in their current form, would require Covered Entities to create and annually update written rules, policies and procedures covering how they evaluate, identify, determine, and eliminate conflicts of interests enabled by new PDA technologies (the "Required Written Policies and Procedures"). This is a significant compliance burden affecting small and large firms alike. Smaller firms would be more deeply impacted, but even large firms would experience challenges creating, refining, and updating these policies. The key problem here is that a firm's compliance efforts do not necessarily translate into a meaningful compliance benefit. One natural way to address this would involve the introduction of a safe harbor regime (see below). If such a program were offered by the SEC, the preparation of Required Written Policies and Procedures could be treated as a "plus factor" in determining a Covered Entity's eligibility for safe harbor protection. As a consequence, small and large firms alike would be provided with a material incentive to invest in the creation of rules, policies, and procedures designed to stand the test of time.

Lack of Compliance Safe Harbor. In their current form the Proposed Rules set a very high compliance bar for Covered Entities. In most cases, any entity that seeks to comply must demonstrate that it is not using a PDA in a fashion that places its own interests ahead of those of its clients. There is no safe harbor for a good faith attempt to clear this bar by proving a negative, but perhaps there should be. Safe harbor regimes provide good faith actors with incentives to spend significant resources on compliance efforts even if success is not guaranteed. In addition, safe harbor regimes provide nuanced, detailed guidance that Covered Entities can use to build internal compliance procedures that will themselves be subject to meaningful oversight and enhancement by those entities.

In this case, safe harbor would protect a Covered Entity from enforcement actions or sanctions for violating the Proposed Rules, provided that (a) the breach is addressed in a timely manner by such Covered Entity, and (b) the following steps were taken by the Covered Entity prior to the occurrence of the breach:

1. **Client Education**: Clients need to better understand how covered technologies are being used to create new investment products and services. If a Covered Entity took steps to carefully educate its client base on how covered technology is used to produce those new products and services, clients would be in a better position to understand the compliance responsibilities of Covered Entities under the Proposed Rules. Since the SEC believes that covered technologies will in some cases lead to the placement of a firm's interest ahead of its clients, it makes sense to take proactive steps to disclose this to the clients of Covered Entities. Doing so would increase clients' ability to make informed decisions about whether to continue to use investment products and services crafted with the assistance of covered technologies.

2. **Client Opt-In**: Because clients may not want to use products and services produced by a covered technology, firms could provide the right to opt-in to every product or service created with the assistance of such technology. Again, since the SEC believes that covered technologies will in some cases lead to the placement of a firm's interest ahead of its clients due to the use of a covered technology, it makes sense to grant clients of a Covered Entity the right and ability to decide whether they are interested in purchasing products or services built with or enhanced by cutting edge software tools.

Two Potential Solutions. For the aforementioned reasons, the SEC should consider the following amendments to the Proposed Rules. First, the SEC could introduce a safe harbor regime. As suggested above, the preparation of Required Written Policies and Procedures would count as a "plus factor" the SEC would be compelled to consider when evaluating a Covered Entity's compliance efforts. Under this first proposed solution, the SEC would still have the right and ability to determine whether a Covered Entity is in compliance with the Proposed Rules. The SEC would have to take a Covered Entity's conduct into account, but a compliance determination would still occur after-the-fact.

Second, the SEC could allow a Covered Entity to obtain preclearance for its compliance program, including the contents of its Required Written Policies and Procedures (the "Preclearance Program"). In cases where the SEC approved a Covered Entity's Preclearance Program, there would be a defeasible presumption that such entity was in full compliance with the Proposed Rules. In cases where approval was granted by the SEC, the firm would have a (conditional) level of assurance that it was following the Proposed Rules. By contrast, in cases where a pre-approval request for a firm's written policies was rejected by the SEC, a firm would be able to make the necessary changes to become compliant.

A Preclearance Program would go beyond the narrower assurances provided by a safe harbor regime because the SEC would itself have to issue an official decision on a Covered Entity's request for preclearance. Of course, unlike a safe harbor regime, the Preclearance Program creates a significant administrative burden for the SEC. Despite that increased burden, if implemented properly a preclearance program would both (i) incentivize Covered Entities to develop robust internal compliance practices to share with the SEC, and (ii) serve the SEC's central mandate of protecting all investors.

SEC REQUESTS FOR COMMENTS

The SEC is seeking feedback on the Proposed Rules summarized in this alert. The commissioners would like to know whether key concepts in the Proposed Rules - including "covered technology" and "investor interaction" - are sufficiently clear to members of the broker-dealer and investment adviser ecosystems. Comments are due within sixty (60) days of the publication of the Proposed Rules in the Federal Register (July 26, 2023).

If you have further questions, please email **Gopal Burgher** (gburgher@burghergray.com), **John Eden** (jeden@burghergray.com), or **Wayne Chan** (wchan@burghergray.com).