

## **DRAFT**

# **RECOMMENDATION OF THE SEC INVESTOR ADVISORY COMMITTEE'S DISCLOSURE SUBCOMMITTEE REGARDING DIGITAL ENGAGEMENT PRACTICES**

## **INTRODUCTION**

The IAC has been examining the use of digital engagement practices (“DEPs”) by broker-dealers and investment advisers. Before discussing our recommendations, we highlight relevant developments that have occurred over the past two years that have informed our recommendations. These include:

- SEC’s initial request for comments on the use of DEPs in August 2021.
- Letter of the IAC to Chair Gensler regarding establishment of an ethical artificial intelligence framework for investment advisers, April 6, 2023.
- IAC’s panel discussion on the use of DEPs in June 2023.
- The SEC’s rule proposals related to the use of predictive data analytics in July 2023.

We then provide the rationale and analysis supporting our recommendations.

## **BACKGROUND AND SEC REQUEST FOR COMMENT ON DIGITAL ENGAGEMENT PRACTICES**

In August 2021, the SEC requested information and comment on broker-dealer and investment adviser digital engagement practices and use of technology to develop and provide investment advice.<sup>1</sup> The SEC noted the increased use of DEPs by online trading platforms and mobile apps that appeal to an increasing number of retail investors. These include behavioral prompts, differential and targeted marketing, game-like features (commonly referred to as gamification), and other design elements or features to engage with retail investors on digital platforms. While these platforms and apps can make investing in securities easier and more accessible, they also often include features designed to encourage investors to trade more frequently, take more risk, and to

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<sup>1</sup> Request for Information and Comments on Broker-Dealer and Investment Adviser DEPs, 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, Securities Exchange Act of 1934 (“Exchange Act”) Release No. 92766, Investment Advisers Act of 1940 (“Advisers Act”) Release No. 5833 (Aug. 27, 2021) [86 FR 49067 (Sept. 1, 2021)] (“Request for Comment Release”).

manipulate investors' behavior.<sup>2</sup> For example, predictive analytics and certain DEPs can be designed with optimization features to drive revenue, collect user data, or increase time spent on a platform. These features also may lead to conflicts between the platforms and investors.<sup>3</sup>

DEPs have amplified the rise of new investors participating in the securities markets. New investors are benefiting from reduced barriers to entry as firms offer low or “zero” cost commission trading, no minimum balance accounts and the opportunity to trade fractional shares. According to a recent FINRA study, 38% of new accounts opened during 2020 were by investors who did not own other investment accounts before the year 2020.<sup>4</sup>

While expanded participation in the securities markets is a positive development that the IAC applauds, it places additional importance on the need to properly inform and protect new investors. Newer investors typically have lower incomes and come from racially and ethnically diverse backgrounds.<sup>5</sup> These investors often lack direct investment experience and access to professional advice, which creates opportunities for firms using DEPs to shape investor behavior in ways that may not be in the investors' best interest. For example, data shows that in recent years young black Americans often begin investing through high-risk cryptocurrency investments in reaction to targeted marketing by well-known athletes and celebrities. According to a 2022 Ariel-Charles Schwab survey, nearly 23% of black investors under 40 indicated that their first investment was in cryptocurrency.<sup>6</sup> Unfortunately, a significant amount of losses in cryptocurrencies have been borne by these investors seeking rapid gains without the knowledge or information to assess the risks associated with such investments.<sup>7</sup>

The SEC received hundreds of comments on its request for information on DEPs.<sup>8</sup> Most of the comments came from retail investors. Comments were also received from

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<sup>2</sup> *Id.* at 49069-70.

<sup>3</sup> Gary Gensler, Chairman, U.S. Securities and Exchange Commission, Statement on Request for Comment Release (Aug. 27, 2021), available at <https://www.sec.gov/news/public-statement/gensler-dep-request-comment>.

<sup>4</sup> FINRA Investor Education Foundation, *Investing 2020: New Accounts and The People Who Open Them* (Feb. 20, 2021), available at [https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them\\_1\\_0.pdf](https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf) at 1.

<sup>5</sup> *Id.* at 4.

<sup>6</sup> Ariel Investments and Charles Schwab, 2022 Ariel-Schwab Black Investor Survey (Jan. 20, 2022), available at <https://www.schwabmoneywise.com/tools-resources/ariel-schwab-survey-2022>.

<sup>7</sup> See Annie Lowrey, *The Black Investors Who Were Burned By Bitcoin*, *The Atlantic* (Nov. 29, 2022), available at <https://www.theatlantic.com/ideas/archive/2022/11/black-investors-bitcoin-cryptocurrency-crash/671750/>; Taylor Nicole Rogers, *Crypto Collapse Reverberates Widely Among Black American Investors*, *Financial Times* (July 5, 2022), available at <https://www.ft.com/content/47d338e2-3d3c-40ce-8a09-abfa25c16a7f>; Jacob Zinkula, *Black Americans Saw Crypto As A Path To Building Wealth, Now They're Bearing The Brunt Of Its Decline*, *Business Insider* (Dec. 22, 2022), available at <https://www.businessinsider.in/policy/economy/news/black-americans-saw-crypto-as-a-path-to-building-wealth-now-theyre-bearing-the-brunt-of-its-decline-/articleshow/96380249.cms>.

<sup>8</sup> See Comments on Request for Comment Release, File No. S7-09-20, <https://www.sec.gov/comments/s7-09-20/s70920.htm>.

industry commenters, including brokerage firms that employ DEPs and trade associations that represent industry professionals, and investor-oriented groups.

## **IAC PANEL DISCUSSION OF THE USE OF DIGITAL ENGAGEMENT PRACTICES**

On June 22, 2023, the IAC had a panel discussion on the use of various DEPs, targeted marketing, and the impact on investors. We discussed the various types of DEPs, investor experience with platforms that employ these practices, and the benefits and risks of such practices. We also discussed the use of analytical tools and technology, and whether regulatory action is needed to enhance investor protection while preserving the ability of investors to benefit from the use of these technologies by broker-dealers and investment advisers.

The IAC had a distinguished group of panelists to discuss this important issue. The panelists were:

- Melanie Cherdack, Acting Associate Director, Practitioner in Residence, University of Miami School of Law Investor Rights Clinic.
- Algernon Austin, Director for Race and Economic Justice, Center for Economic and Policy Research (comments submitted).
- Sivananth Ramachandran, Director of Capital Markets Policy for the CFA Institute.
- Jasmin Sethi, Associate Director of Policy Research, Morningstar, Inc. and CEO of Sethi Clarity Advisors.
- James Tierney, Assistant Professor of Law, Chicago-Kent College of Law.

The IAC panel discussion highlighted a number of positive developments that have been driven by the emergence of DEPs:

- Innovation by market participants, including DEPs, has led to more engagement in the securities markets;
- Technology has played a key role in helping financial intermediaries provide lower cost products and services that have helped open the markets to a significant number of new investors;
- Technology has also empowered many retail investors to make their own trading and investment decisions through self-directed mobile platforms making investments accessible to a new generation of Americans;
- Technology has helped to make interactions between financial services firms and their customers more efficient and informative; and
- DEPs can be used to benefit investors by promoting financial education and literacy.

Panelists also discussed the idea that while emerging technologies, such as predictive data analytics, machine learning and artificial intelligence hold great promise, they also noted these technologies can result in significant risks for investors. DEPs can be used to encourage excessive trading by investors and investment in complex securities products that investors do not understand or appreciate the risks or costs involved.

Some panelists were quick to add that inappropriately tailored new regulatory requirements focused on technologies could stifle innovation and result in investors losing access to the benefits of the securities markets by increasing the costs to invest and reducing rates of investor participation, particularly among younger and historically underserved groups of investors.

The panelists discussed whether:

- Existing regulations or guidance is sufficient to regulate DEPs;
- There is a need to address conflicts regarding the use of certain DEPs;
- Additional guidance is needed on what constitutes a recommendation for purposes of Regulation Best Interest (whether certain DEPs should be deemed recommendations); and
- Additional guidance or regulation is needed to protect self-directed investors.

## **SEC RULE PROPOSALS ON USE OF PREDICTIVE DATA ANALYTICS**

Subsequent to the IAC’s panel discussion, on July 26, 2023, the SEC proposed new rules that, if adopted, would regulate conflicts of interest associated with broker-dealers and investment advisers use of predictive data analytics (“PDA”) and artificial intelligence (“AI”) technology (collectively, the “PDA Rule Proposal”).<sup>9</sup> Proposed Rule 151-2 under the Securities Exchange Act of 1934 and proposed Rule 211(h)(2)-4 under the Investment Advisers Act of 1940 would apply where “covered technologies” are used in “investor interactions.” A “covered technology” is defined as any 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.

“Investor interactions”, for purposes of the proposed rules, would consist of broker-dealers, investment advisers, or associated natural persons engaging or communicating with certain investors, where such “investors” include a broker-dealer’s retail customers and prospective customers and an adviser’s clients and prospective clients.

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<sup>9</sup> Conflicts Of Interest Associated With the Use of Predictive Analytics By Broker-Dealers And Investment Advisers, Exchange Act Release No. 97990, Advisers Act Release No. 6353 (July 26, 2023) [88 FR 53960 (Aug. 9, 2023) (“PDA Rule Proposal” or “Proposing Release”).

The PDA Rule Proposal's conflicts rules would require firms to develop policies and procedures to:

- identify and evaluate any conflict of interest resulting from the firm's use or foreseeable use of a covered technology in an investment interaction prior to using such technology and periodically thereafter;
- determine if any "conflict of interest" places or results in placing the interest of the firm ahead of investors; and
- eliminate or neutralize promptly the effects of such conflicts of interest with certain narrow exceptions.

As part of the PDA Rule Proposal, the SEC also proposed related amendments to the Exchange Act and Advisers Act recordkeeping rules.

The PDA Rule Proposal addresses several of the significant issues identified in our IAC panel discussion. For example, the PDA Rule Proposal addressed the question of whether the existing definition of a recommendation for purposes of Regulation Best Interest was sufficient to protect investors with regard to the use of certain DEPs. The PDA Rule Proposal would appear to address this concern by covering investor interactions that some have viewed as outside the scope of the term "recommendation". The PDA Rule Proposal release states that design elements, features, or communications that nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors are covered technologies. The PDA Rule Proposal generally would apply to a firm's use of a covered technology to the extent it is used in connection with the firm's engagement or in communication with an investor, including by a firm's exercising discretion with respect to an investment account, providing information to an investor, or soliciting an investor. Accordingly, the proposed rules would apply even if the interaction with the investor does not fall under the existing understood definition of a "recommendation."

The PDA Rule Proposal also addresses conflicts of interests associated with the use of DEPs and would provide protections for self-directed investors any time a broker-dealer uses a defined "covered technology" in connection with engaging or communicating with an investor. Firms would be required to evaluate any use or reasonably foreseeable use of a covered technology in any investor interaction to identify whether such interaction might involve a conflict of interest, including through testing the technology. Firms would also be required to determine if any conflicts of interest results in an investor interaction that places the interest of the firm or associated person ahead of the investor's interest. The proposed rules would then require the firm to take action to eliminate or neutralize this conflict of interest.

## **IAC VIEWS ON THE PDA RULE PROPOSAL**

We applaud the efforts of the SEC to take steps to address concerns around PDA, including the potential risks and conflicts associated with certain DEPs and the need to ensure investor protection in connection with their use. We welcome this effort on the part of the SEC to get out in front of and head off emerging issues, including the increasing use of technologies that are transforming the securities industry, some of which could do harm to investors.

However, while the proposal addresses several of the significant issues with DEPs that the IAC identified, we are concerned that certain aspects of the PDA Rule Proposal may have unintended consequences that negatively impact the very investors the PDA Rule Proposal is intended to protect. We are concerned that the PDA Rule Proposal imposes many rigorous prescriptive requirements on an overly broad swath of technologies. Efforts by firms to comply with the current formulation of “covered technologies” combined with the current formulation of “investor interactions” could have unintended adverse impacts on investors by overly curtailing access to valuable information, tools, and assistance, and impeding the adoption of new, beneficial technologies.

### **Definition of Covered Technology**

In the proposal, the definition of “covered technology” could be construed to cover practically any forward-looking use of advanced technology, theory, correlation analysis, or other technique in the context of an investor interaction and, by the PDA Rule Proposal’s own admission could even include internal analyses compiled on Excel spreadsheets.<sup>10</sup>

We acknowledge that the SEC attempts to carve out certain benign technologies, expressly saying “...the proposed definition ...would not include technologies that are designed purely to inform investors, such as a website that describes the investor's current account balance and past performance but does not, for example, optimize for or predict future results, or otherwise guide or direct any investment-related action ... For the same reason, the use of a firm's chatbot that employs PDA-like technology to assist investors with basic customer service support (e.g., password resets or disputing fraudulent account activity) would not qualify as covered technology under the proposed definition...”<sup>11</sup>

However, as currently formulated, the PDA Rule Proposal could very likely be interpreted by a firm’s legal advisors and technology strategists to apply to virtually any technologies used in connection with investment issues, including daily portfolio management and trading where the investment adviser has investment discretion.

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<sup>10</sup> See *id.* at 53972.

<sup>11</sup> See *id.* at 53972-73.

Moreover, the PDA Rule Proposal could likely be construed to cover basic technologies that would enable retirement plan participants to determine how much in total they need to have saved by retirement age or how much money they can afford to spend annually during retirement.

## **Definitions of Investor Interaction and Conflict of Interest**

Additionally, the definition of “investor interaction” is also quite broad and could be interpreted to include virtually any communication or presentation of visual or other sensory data to investors by whatever means. It could also include activities that are not actually investor interactions, such as the exercise of investment discretion. Again, we are concerned that by capturing this broad range of interactions, firms will be subject to overly burdensome compliance costs without corresponding potential benefit to investors, and with the effect of depriving investors of potentially beneficial technologies.

Further, the PDA Rule Proposal defines conflict of interest as using any covered technology in a way that takes into consideration an interest of the broker-dealer, the investment adviser, or the associated person. This definition is unworkably broad in a practical sense as it could have the effect of defining any interest as a conflict. For example, the definition is not limited to those interests that are contrary to the interests of the customer or client, and therefore has the potential to capture interests not necessarily harmful to investors. Moreover, there is no requirement that the conflicts be material.

## **Approach to Handling Conflicts of Interest**

Under Regulation Best Interest<sup>12</sup> and the Adviser Fiduciary Duty Interpretation,<sup>13</sup> a firm is generally able to fully and fairly disclose its material conflicts of interest to investors. If a material conflict cannot be fully and fairly disclosed, the conflict must be “mitigated or eliminated.” For example, Regulation Best Interest allows a broker-dealer to have a limited product set such as distributing only mutual funds advised by an affiliate. Additionally, some investment advisers only offer investments in the funds they manage. These practices are permissible under Regulation Best Interest and the Adviser Fiduciary Duty Interpretation with full and fair disclosure.<sup>14</sup>

However, under the PDA Rule Proposal, a broker-dealer or investment adviser cannot simply disclose the conflict of interest related to covered technologies, they must

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<sup>12</sup> Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019) [84 FR 33318 (July 12, 2019)] (“Regulation Best Interest Adopting Release”).

<sup>13</sup> Commission Interpretation of the Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] (“Adviser Fiduciary Duty Interpretation”).

<sup>14</sup> See e.g., Regulation Best Interest Adopting Release at 33394. The Commission states that, to mitigate a conflict of interest resulting from a broker-dealer’s sale of a limited set of products (including proprietary products), a broker-dealer could establish product review processes or establish procedure addressing which retail customers could qualify for the product menu.

“eliminate or neutralize” that conflict. The obligation to eliminate or neutralize the conflict is without regard to whether it can be fully and fairly disclosed. Clearly, deeply complex and opaque artificial intelligence algorithms cannot be fully and fairly disclosed, and the IAC is not proposing that they be handled with disclosure. But some adjacent and more benign and understandable technologies might be adequately handled by a disclosure-based approach.

The PDA Rule Proposal appears to assume that any interests or conflicts related to covered technologies may never be adequately disclosed. These assumptions and obligations may lead to unintended effects. For example, under the PDA Rule Proposal, a broker-dealer or investment adviser might conclude that the firm could not use any technological tool of any sort to communicate with investors about a limited product set of investments, nor could an investment adviser use technological tools of any sort to manage investment portfolios if it included affiliated investment products in those portfolios but excluded nonaffiliated products. An approach based on such an interpretation would severely limit investor choice. Today, with full and fair disclosure, an investor can choose an investment manager who only uses proprietary products because of the adviser’s track record, low fees, or reputation for fair dealing and compliance with regulatory requirements.

Given the far-reaching nature of the PDA Rule Proposal and its potential adverse impact on investors if adopted, we recommend below that the Commission narrow the scope of the PDA Rule Proposal to the unique risks posed by artificial intelligence and predictive data analytics. A narrowly tailored rule should target predictive data analytics and artificial intelligence technologies that interact directly with investors. These rules should align and be consistent with Regulation Best Interest and the Adviser Fiduciary Duty Interpretation.

### **IAC VIEWS ON USING EXISTING REGULATORY REQUIREMENTS TO ADDRESS ISSUES WITH DIGITAL ENGAGEMENT PRACTICES**

The IAC understands and acknowledges the new, inherently opaque, and powerful potential for AI and machine-learning driven PDAs to undermine investor interests and widely propagate subtle conflicts of interests. And we understand and acknowledge the need for a careful and conservative approach to the regulation of these PDAs, including their use with DEPs. However, we still see the potential for elegance and efficiency in trying to address these technologies via modification and expansion of the existing rules, as contrasted with creating a whole separate and parallel set of rules. Again, we are not minimizing the potential dangers of these technologies, nor advocating for less than strenuous regulation of them; we are focusing on finding the best method of regulating which results in the greatest clarity, easiest roll-out and best investor cost/benefit ratio.

Accordingly, we believe that the Commission could rely on existing regulations and principles with necessary modifications sufficient to address issues identified with



DEPs.<sup>15</sup> Regulation Best Interest requires that broker-dealers act in the best interests of retail customers when recommending securities, investment strategies involving securities, and account types, and not place their interests ahead of their retail customers. The rule does not distinguish whether the interaction is in person or via digital means, protecting the customer equally in both contexts. In addition, broker-dealers also must provide certain disclosures designed to inform customers of the standard of care they are owed, the products and services offered by the firm, associated fees, and any conflict of interest associated with the recommendation. Regulation Best Interest also requires that firms not only identify and disclose relevant conflicts, but that they mitigate and even eliminate certain types of conflicts. We believe that clarifying the definition “covered technologies” combined with clarification of the scope of what constitutes a “recommendation” for purposes of Regulation Best Interest could address the problematic use of DEPs, as described below.

The IAC also believes that the SEC has ample authority under the Investment Advisers Act to oversee and monitor the investment advisory industry’s use of technology to provide advice to investors. Investment advisers are fiduciaries with respect to the investment advisory services they provide their clients, including specific recommendations and investment advice. In its 2019 interpretive guidance on the Standard of Conduct for Investment Advisers, the Commission clarified that digital advisers are subject to the Advisers Act Fiduciary Duty citing to earlier staff guidance.<sup>16</sup> This ongoing fiduciary duty is composed of a duty of loyalty and a duty of care, which requires investment advisers to provide advice in the best interests of their client. Investment advisers are also required to “eliminate, or at least to expose, all conflicts which might incline an investment adviser – consciously or unconsciously to render advice which is not disinterested.”<sup>17</sup> This principled-based approach already expresses the standard to which investment advisers are held when employing the use of DEPs.

Robo-advisers have generally been helpful in automating investment services and assisting cost-conscious and relatively underserved investors who are unable to receive traditional wealth management services.<sup>18</sup> The robo-adviser space has continued to become more competitive, with major financial firms adding robo-advisers to their

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<sup>15</sup> Indeed, in the Proposing Release, the Commission acknowledges that the Advisers Act Fiduciary Duty Requirement, as well as its Compliance Rule (Rule 206(4)-7) and its Marketing Rule (Rule 206(4)-1) already addresses conflicts of interest in connection with advisers’ use of technology. See Proposing Release at 54002-03.

<sup>16</sup> See U.S. Securities and Exchange Commission, Division of Investment Management, Robo-Advisers, IM Guidance No. 2017-02 (Feb. 2017), available at <https://www.sec.gov/investment/im-guidance-2017-02.pdf>.

<sup>17</sup> See Adviser Fiduciary Duty Interpretation at 33676.

<sup>18</sup> See Insider Intelligence Editors, Young Investors Drove Use of Robo-Advisers During the Pandemic, Insider Intelligence (June 30, 2021), available at <https://www.insiderintelligence.com/content/young-investors-drove-robo-advisor-use>.

platforms and offering services at low cost to investors.<sup>19</sup> We share the Commission’s concern regarding conflicts of interest, including the circumstances where digital advisers may cause an account to trade more to the extent that the adviser integrates trade execution services, which may benefit the adviser at the expense of the client. This may be an example of an opaque algorithmic covered technology where disclosure is not enough and a heightened “eliminate the conflict” standard might need to be applied. However, in other conflict cases, such as less-than-transparent costs, disclosure and informed consent may be adequate. For example, when “zero” or low management fees are substituted for higher cash allocations to allow firms to earn a return on the cash, investors are paying for the service whether they realize it or not. We believe in a case like this the Commission could require straightforward disclosures telling investors how they are paying for the services they are receiving, either through an explicit management fee, order flow, sale of data, or higher cash allocation requirements. Investors would be empowered to compare services and to choose how they want to pay for these services. The Commission then should bring enforcement actions when these disclosures are not made.<sup>20</sup>

## **IAC RECOMMENDATIONS**

For the reasons outline above, the IAC makes the following recommendations:

1. Narrow the scope of the PDA Rule Proposal to target the unique risks of predictive data analytics and artificial intelligence that interact directly with investors.

Given the broad definition of covered technologies, which the Commission acknowledges, firms will have tens of thousands of covered technologies to test at considerable expense, a segment of which do not raise issues for investors. It is fair to assume that these expenses will be passed on in some form to investors. We fear that these overbroad proposals, if adopted, will harm investors, limit investor choice, and result in investors losing access to some benefits of the securities markets. Therefore, the SEC should target its proposals on predictive data analytics and artificial intelligence that interact directly or that facilitate direct interaction with investors rather than using language which could be construed as covering virtually every technology used by broker-dealers and advisers.

We urge the Commission to consider limiting the scope of the rules to PDA-like technologies as described in the proposing release: artificial intelligence, including machine-learning, deep learning algorithms, neural networks, natural language

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<sup>19</sup> See Hillary Schmidt, Robo-Advisers Usage Expected to Surge Throughout the Coming Decade, International Banker (December 29, 2022), available at <https://internationalbanker.com/technology/robo-advisory-usage-expected-to-surge-throughout-the-coming-decade/>.

<sup>20</sup> See e.g., In the Matter of Charles Schwab & Company, Inc., et. al Exchange Act Release No. 95087, Advisers Act Release No. 6047 (June 13, 2022), available at <https://www.sec.gov/files/litigation/admin/2022/34-95087.pdf>.

processing or large language models, including generative pre-trained transformers or GPT, as well as other technologies that make use of historical or real-time data, lookup tables, or correlation matrices. We suggest that the Commission incorporate definitions of artificial intelligence and predictive data analytics that are recognized and well-accepted.<sup>21</sup>

Narrowly tailored rules designed to address the novel risks specifically posed by firms' use of artificial intelligence and predictive data analytics would better promote investor protection and allow investor access to useful and value enhancing technology. Such a narrow rule should be aligned and designed to work with Regulation Best Interest and the Adviser Fiduciary Duty Interpretation. We further suggest that the scope of the rules apply only to covered technologies that interact directly with investors or that are used by brokers and advisers to aid their interactions with investors. We therefore recommend that the definition of investor interaction be narrowed and not include exercising investment discretion as advisers that rely on technology to formulate investment advice are already subject to fiduciary obligations.

2. The Commission is also encouraged to build upon the existing regulatory framework which requires firms to “eliminate, mitigate or disclose conflicts of interest” while recognizing that for certain inherently opaque and complex PDA and AI technologies, disclosure is not sufficient and use the existing definition of conflicts under Regulation Best Interest and the Adviser Fiduciary Duty Interpretation.

As currently written, the PDA Rule Proposal's definition of “conflict of interest” is quite broad and would expand the rules beyond decades of Commission regulation and settled law.

- Definition of Conflict of Interest: The PDA Rule Proposal defines a conflict of interest in using any covered technology in a way that takes into account any interest of the broker-dealer, the investment adviser, or associated person. Thus, the definition does not actually require a conflict, just consideration of a firm's own interests. This is in contrast to the traditional definition of conflict of interest which requires a firm to place its interest ahead of its customers or clients. The evaluation requirement would be burdensome in light of the fact that it is fair to assume that a broker-dealer or adviser would not employ a technological tool that did not somehow advance its interest, whether it be for efficiency and cost reduction or other reasons. Under the PDA Rule Proposal,

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<sup>21</sup> For example, the recent White House Executive Order on Safe, Secure and Trustworthy Development and Use of Artificial Intelligence, defines artificial intelligence by referencing 15 U.S.C. 9401(3); the European Union defines artificial intelligence in the proposed EU Artificial Intelligence Act and the International Committee for Information Technology Standards also has developed a definition of artificial intelligence.

firms may conclude they are required to inventory, test, and monitor all technology, including tools and technologies that have been used without meaningful concerns for decades. Accordingly, we do not believe that there is defensible net investor benefit in expanding the definition of conflict of interest in this context. We also believe that it is desirable to avoid competing and inconsistent definitions of the term conflict-of-interest – one that applies when a covered technology is used and another for interactions that do not involve covered technology.

- Addressing Conflicts of Interest: The PDA Rule Proposal’s requirement to “neutralize or eliminate” conflicts of interest is also a concern to the IAC. Implementing a new standard (“neutralize or eliminate” in all cases as compared to “mitigate or eliminate” where disclosure is inadequate) takes these technologies into a regulatory realm that is beyond decades of the SEC’s own guidance for investment advisers and broker-dealers.

We agree with the Commission that certain AI and PDA technologies are inherently complex and opaque which would make it impossible for firms to provide full and fair disclosure, with the result that firms would be required to eliminate or mitigate conflicts. The IAC recommends that the Commission emphasize this position emphatically in any new rulemaking. However, rather than a one-size-fits-all approach to all new technologies, we believe that the focus should be on clearly defining the opaque AI and PDA technologies which should be “covered technologies” and allowing the possibility of disclosure where appropriate for more benign adjacent technologies. In the view of the IAC, for non covered technologies, a context-driven, facts and circumstances test of whether disclosure is sufficient for a particular conflict with a particular set of investors, would be the preferred approach in this proposed rulemaking.

We put our focus on elimination for the opaque AI and PDA technologies because the conflicts are likely to be embedded at the earliest design stages and may not be able to be evaluated after the fact. As we suggested in our April 6, 2023 letter to Chairman Gensler regarding the ethical use of artificial intelligence, we believe broker-dealer and investment advisory firms should have a robust risk management and governance framework to ensure that artificial intelligence is built properly from the ground up before it is rolled out so that it may be used in the best interest of investors without bias, which includes appropriately addressing conflicts of interest.

Our position on having a certain group of technologies held to a blanket “eliminate” standard is congruent with existing rules. Currently, when conflicts of interest are present in a relationship, firms have historically been

permitted or required to provide full and fair disclosure of the conflict and obtain informed consent from the client. However, even the current law recognizes that some conflicts are not capable of full and fair disclosure and therefore need to be eliminated or mitigated rather than disclosed. We assert that opaque PDA technologies represent such a situation. This position has been reflected in both the Adviser Fiduciary Duty Interpretation and Regulation Best Interest, each of which was adopted in 2019. It is also important to note that the SEC has provided extensive guidance on how broker-dealers should handle conflicts of interest.<sup>22</sup>

Further, such an approach of clearly delineating certain technologies for which disclosure is not adequate would allow the Commission to strengthen and build on decades of guidance and interpretations as to the terms used and the practices regulated.

The reason the IAC prefers the approach of strengthening the existing rules rather than creating a parallel standard is that the Commission has experience enforcing the current rules, and the industry has notice as to how terms will be interpreted. Diligence should be given to how the rules can be crafted in a manner that more easily facilitates adoption of its stated goals utilizing understood frameworks where at all possible. Applying the existing regulations supplemented with a clear delineation of which opaque AI and PDA technologies must adhere to an elimination standard is the more direct regulatory path. Such delineation should include examples and guidance as to how material conflicts of interest flowing from the use of the covered technologies must be disclosed, mitigated, or eliminated will ensure investors remain protected as these powerful technologies evolve. By making it clear from the outset that material conflicts related to certain technologies may never be capable of full and fair disclosure and that they are required to be mitigated or eliminated, the existing rules have been strengthened, while leveraging the benefits of the familiarity of the existing rules.

In summary, we are not convinced that the PDA Rule Proposal's blanket elimination of a disclosure option is the right approach. We agree that disclosure is inadequate for inherently opaque AI and PDA technologies, but

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<sup>22</sup> See U.S. Securities and Exchange Commission, Division of Trading and Markets, Staff Bulletin, Standards of Conduct for Broker-Dealers and Investment Advisers, Conflicts of Interest (Aug. 3, 2022), available at <https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest>. See also U.S. Securities and Exchange Commission, Division of Investment Management, Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (October 19, 2019), available at <https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation>; U.S. Securities and Exchange Commission, Division of Investment Management, Robo-Advisers, IM Guidance No. 2017-02 (Feb. 2017), available at <https://www.sec.gov/investment/im-guidance-2017-02.pdf>.

we believe that a disclosure option might be useful with adjacent non-opaque, benign technologies. An outright elimination of the disclosure option, despite the technology involved and regardless of the materiality of the conflict, the complexity of the conflict and the simplicity of the disclosure that could describe the conflict, or the sophistication of the relevant investors is unnecessary and should be reserved for the truly opaque AI and PDA technologies for which disclosure is inherently insufficient.

3. We recommend that the Commission rely on existing regulations and principles to improve the oversight of DEPs by clarifying the definition of what constitutes a recommendation.

For example, DEPs that encourage trading should be deemed to be recommendations for purposes of Regulation Best Interest. We believe DEPs designed primarily to increase interaction with an application or platform, or to encourage frequent trading, are problematic. Features such as alerts and top investment lists, especially when coupled with frequent push notifications, can prompt irrational investor behaviors by creating a false sense of urgency or a fear of missing out and should be deemed to be making recommendations for purposes of Regulation Best Interest. These practices should be recognized as calls to action under principles of what has historically been viewed as a recommendation.

Specifically, we think the Commission should clarify that:

- DEPs that are designed to affect investor behavior or that have the effect of doing so should be considered recommendations, particularly when a firm's business model is dependent on frequent trading by its customers. Gamification of trading applications and platforms raise these concerns. By using features such as confetti, scratch-off style graphics, and award systems, some firms are encouraging investors to engage in transactions that may not be in their best interests and serve the interest of the broker-dealer.

However, educational or informational DEPs should not be deemed recommendations. Many DEPs employed by firms are valuable tools that can help investors make more informed decisions. These types of DEPs can facilitate comparisons, research, and diligence before investors make decisions, and such content typically does not rise to a call to action to engage in specific securities transactions. The Commission should distinguish educational DEPs from the types of DEPs that raise investor protection concerns. To the extent educational DEPs are not designed to prompt trading activities, they do not raise investor protection concerns.

Additionally, many firms use digital means to market their offerings and such advertising and offering materials should not constitute recommendations. The SEC and FINRA have taken the position that simply distributing advertising and offering materials generally does not constitute making a recommendation.<sup>23</sup>

- Suggestions to follow the purchases and sales of particular traders or influencers are also calls to action either by design or effect and should be deemed recommendations. This practice has become commonplace in the cryptocurrency market.
  - Defaulting investors into margin accounts should be deemed a recommendation regarding account type and be covered under Regulation Best Interest.
  - The use of “dark patterns” in the context of investing is problematic. These design choices usually exploit cognitive biases and manipulate customers into acting in a certain way, such as buying things they do not need. Given that investors often are putting their retirement savings and financial futures at stake, the SEC should consider whether design choices that influence investors into making specific decisions should be deemed to be a recommendation for purposes of Regulation Best Interest.
  - DEPs that encourage the behavior of a statistically significant number of investors to trade should be deemed recommendations. The IAC believes that platforms should be designed to allow investors to interact with the securities market and trade at their discretion, not at the prompting of the broker-dealer.
  - Boilerplate language in customer agreements will not be determinative on the issue of whether the firm made a recommendation or provided advice, and does not absolve firms of their obligations under the federal securities laws. Customer agreements from some platforms and mobile apps have required investors to acknowledge that they did not receive any investment advice or that a recommendation has not been made.
4. The Commission and FINRA should bring the full weight of their enforcement authority against DEPs that are determined to be abusive, misleading, and manipulative. Abusive, misleading, or manipulative practices clearly violate an adviser’s fiduciary duty, the anti-fraud provisions of the Advisers Act, and, depending on the circumstances, other specific Advisers Act rules, such as the

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<sup>23</sup> See FINRA, Suitability Rule And Online Communications, Notice to Members 01-23 (Mar. 18, 2001), available at <https://www.finra.org/rules-guidance/notices/01-23>.

Advisers Marketing Rule. Moreover, the anti-fraud provisions of the federal securities laws and FINRA (see FINRA Rule 2111), broadly prohibit manipulative or deceptive conduct and require that broker-dealers deal fairly with customers, observing just and equitable principles of trade. We encourage the SEC and FINRA to pursue enforcement actions when it discovers DEPs that are abusive, misleading, and manipulative.

5. The Commission and FINRA should promote investor education in connection with the use of DEPs. Many DEPs employed by firms in the securities industry are valuable tools that can help investors make more informed investment decisions. They can provide focused educational information and facilitate research and diligence before decisions are made. Investor education should become a top priority of firms who attract customers through DEPs and employ safeguards to ensure that investors are being informed and educated, and trading on their own accord rather than being induced to do so against their best interests.