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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 and assessing the benefits and risks they pose to investors. 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 from 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 issued in July 2023.

We then provide the rationale and analysis supporting our recommendations.

BACKGROUND AND SEC REQUEST FOR COMMENTS ON DIGITAL ENGAGEMENT PRACTICES

In August 2021, the SEC requested information and comments on broker-dealer and investment adviser digital engagement practices and the use of technology to develop and provide investment advice.[1] 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. These platforms often include features designed to encourage investors to trade more frequently, take more risk, and to manipulate investors' behavior.[2] For example, predictive analytics and certain DEPs can be designed

[1] 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, 2012)] ("Request for Comment Release").

[2] Id. at 49069-70.

with optimization features to drive revenue for the firm, collect user data, or increase the time an investor spends on a platform. These features also may lead to conflicts between the firms hosting these platforms and investors.[3]

While these platforms and apps create risks for investors, they can also make investing in securities easier and more accessible. 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.[4]

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.[5] A majority of these new investors do not use financial professionals as a source of information when making investment decisions.[6] 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.[7] 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.[8]

[3] 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.
[4] 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 at 1.
[5] Id. at 4.
[6] Id. at 14.
[7] 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.
[8] 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.

The SEC received hundreds of comments in response to its request for information on DEPs.[9] Most of the comments came from retail investors. Comments were also received from industry commenters, including brokerage firms that employ DEPs and trade associations that represent industry professionals, and investor-oriented groups. As expected, there was a wide and varied range of viewpoints on the topics covered in the release.

IAC PANEL DISCUSSION OF THE USE OF DIGITAL ENGAGEMENT PRACTICES

On June 22, 2023, the IAC hosted 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;

[9] See Comments on Request for Comment Release, File No. S7-09-20, https://www.sec.gov/comments/s7-09-20/s70920.htm.

- Technology has improved accessibility and empowered many retail investors to make their own trading and investment decisions through self-directed mobile platforms;
- 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 and often, investors do not appreciate the risks or costs involved in their trading decisions.

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").[10] Proposed Rule 15l-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

[10] 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").

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.

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 investor 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 and AI, 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.[11]

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…"[12]

[11] See id. at 53972.
[12] See id. at 53972-73.

However, as currently formulated, the PDA Rule Proposal could be interpreted by a firm's legal advisors and technology strategists to apply to a wide array of technologies used in connection with investor interactions, including daily portfolio management and trading where the investment adviser has investment discretion. Moreover, the PDA Rule Proposal could be construed to cover basic technologies that provide projections such as enabling 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 potentially be interpreted to include any communication or presentation of visual or other sensory data to investors by whatever means. It could also include activities that are not direct 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 benefits 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 i.e. making a recommendation or rendering advice that is not disinterested, 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

The PDA Rule Proposal provides that if a firm uses or foresees the use of a covered technology that places or results in placing the interest of the firm ahead of investors, the firm must promptly eliminate or neutralize the effects of such conflict of interest. This formulation incorporates the standard utilized under existing requirements not to place a firm's interest ahead of the retail customers or clients interest.

Under Regulation Best Interest[13] and the Adviser Fiduciary Duty Interpretation,[14] there is a consistent overarching obligation to act in the retail customer's or client's best interest and not place the firm's interest ahead of the retail customer's or client's interest. Additionally, an adviser's fiduciary duty requires an adviser to eliminate or at least

[13] 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").
[14] 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").

expose through full and fair disclosure all conflicts of interest which might incline an adviser to render advice which was not disinterested. Importantly, this disclosure is dependent on the adviser additionally acting in the client's best interests. Similarly, under Regulation Best Interest's Conflict of Interest Obligation, a broker-dealer must establish and enforce policies and procedures reasonably designed to, among other things, identify and at a minimum disclose or eliminate, all conflicts of interest associated with a recommendation; identify and mitigate conflicts of interest at the associate level and prevent any limitations placed on securities or investment strategies involving securities that may be recommended to a retail customer and associated conflicts of interest from causing the broker-dealer or associated person of a broker-dealer to make recommendations that place the interest of the broker-dealer or associated person ahead of the retail customer.[15]

When combined with modifications to the PDA Rule Proposal, these existing standards and requirements seem sufficient to address the conflicts targeted by the rulemaking. This is particularly the case as both Regulation Best Interest and the Adviser Fiduciary Duty Interpretation both provide that a firm, notwithstanding any disclosure, may not place its interest ahead of its customers or clients, which is the linchpin of the requirement under the PDA Rule Proposal to neutralize or eliminate conflicts.

We therefore 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. It is important that any new regulations adopted protect investors while also allowing innovation that can benefit investors.

As we set out in further detail below, our recommendation focuses on narrowing the scope of the PDA Rule Proposal to both avoid unintended consequences and to better align it with existing regulations and guidance. We also recommend utilizing the existing

[15] 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.

regulatory framework more effectively by clarifying its application to DEPs and other technologies, and that the definition of what constitutes a recommendation be expanded to include any technology that impacts investor behavior.

The existing regulatory framework requires certain investment professionals to act in their customer's or client's best interests and addresses conflicts of interest, regardless of how they manifest. For example, 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. Importantly, the rule does not distinguish between recommendations made by a broker in person or by technology, 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. Admittedly, Regulation Best Interest only applies to conflicts of interest that arise in connection with a recommendation, and accordingly leaves certain conflicts of interest unaddressed.

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.[16] This ongoing fiduciary duty is composed of a duty of loyalty and a duty of care. Specifically, the duty of care requires an investment adviser to provide advice in the best interest of its clients. Under the duty of loyalty, an investment adviser must eliminate or make full and fair disclosure of all conflicts which might incline an investment adviser – consciously or unconsciously to render advice which is not disinterested, such that the client can provide informed consent. [17] This fiduciary duty provides that an adviser must at all times, serve the best interest of its clients and not subordinate the client's interest to its own. In other words, an adviser cannot place its own interest ahead of its clients. Accordingly, if technology is used by investment advisers in connection with investment advice, the investment adviser is held to a fiduciary standard and must ensure that the adviser is not putting its interests ahead of the client's. Moreover, under the current standards, in cases where an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser must

[16] 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.
[17] See Adviser Fiduciary Duty Interpretation at 33676.

either eliminate the conflict or adequately mitigate the conflict such that full and fair disclosure and informed consent are possible.[18]

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.[19] The robo-adviser space has continued to become more competitive, with major financial firms adding robo-advisers to their platforms and offering services at low cost to investors.[20] 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. Importantly, to the extent such conduct places the adviser's interests ahead of the client's, it is violative of the adviser's fiduciary duty and may not be disclosed away.

This may be an example of an opaque algorithmic covered technology where the conflict should be eliminated. However, in some cases the conflict may not place the adviser's interests ahead of the client's and may be adequately disclosed such that informed consent is possible. For example, there are many ways to pay for investment services, some of which result in smaller direct payments by clients. We believe in such cases, the Commission could require straightforward disclosures telling investors how they are paying for the services they are receiving, for example, 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 is empowered to bring enforcement actions when these disclosures are not made.[21]

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.

   The broad definition of covered technologies, which the Commission acknowledges, potentially includes tens of thousands of technologies, a segment of which may not raise issues for investors. By adopting an overinclusive definition,

[18] See id. at 33677.
[19] 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.
[20] 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/.
[21] 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.

firms will incur expenses to assess the technologies, even when they do not raise concerns, and will then likely pass such costs on in some form to investors. It may also discourage firms from exploring new technologies. We fear that such an overbroad definition, 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 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.[22]

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. <u>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.</u>

[22] 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.

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 is an interest that might incline a broker-dealer or investment adviser - consciously or unconsciously - to make a recommendation or render advice that is not disinterested.[23] 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, 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.

  To begin with, we believe the Commission is correct in prioritizing investors' interests when conflicts of interests are present. Disclosure should not be used as a justification for placing the firm's interests ahead of the investor's interests.

  Additionally, 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.. In such cases, firms should be required to eliminate or mitigate the conflicts, as is the case presently for investment advisers. The IAC recommends that the Commission emphasize

[23] See Regulation Best Interest and Adviser Fiduciary Duty Interpretation.

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 non-covered 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. As discussed above, investment advisers have a fiduciary obligation to act in their client's best interests. Investment advisers may, consistent with that obligation, provide full and fair disclosure of material conflicts and obtain informed consent from their clients. However, the current law also recognizes that some conflicts are not capable of full and fair disclosure and therefore must 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 material conflicts of interest.[24]

[24] 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. The Bulletin provides that firms may find that there are some conflicts that they are unable to address in a way that will allow the firm or its financial professionals to provide advice or recommendations that are in the retail investor's best interest. In such cases, firms may need to determine whether to eliminate the conflict or refrain from providing advice or recommendations that could be influenced by the conflict to avoid violating the obligation to act in the retail investors best 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.

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 IAC proposes incorporating existing terminology and guidance because the Commission has experience enforcing the current rules, and the industry has notice as to how such terms will be interpreted. The existing regulatory framework should be used to the fullest extent possible within the new rulemaking.

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 we believe that a disclosure option might be useful with adjacent non-opaque, benign technologies which do not place the firm's interests ahead of the investor's. 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. <u>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.</u>

When the Commission adopted Regulation Best Interest, it incorporated FINRA's guidance in determining what would be considered a recommendation. Unfortunately, neither FINRA nor the Commission has directly addressed whether DEPs are recommendations. In the adopting release, the Commission stated that "Factors considered in determining whether a recommendation has taken place include whether the communication reasonably could be viewed as a call to action and reasonably would influence an investor to trade a particular security or group of securities."[25]

We believe DEPs designed primarily to increase interaction with an application or platform, to encourage frequent trading, to engage in particular trading strategies, or to open particular types of accounts should be deemed communications that may reasonably be viewed as a call to action. Further, features such as alerts and

[25] Regulation Best Interest Adopting Release at 33335.

top investment lists, especially when coupled with frequent push notifications, may also be deemed to be communications that may reasonably be viewed as a call to action that would influence an investor to trade in a particular security or group of securities.

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.[26]

- 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 as a recommendation under Regulation Best Interest.

[26] 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.

- 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 investment advice, and should 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 when the communications from the firm would reasonably be viewed as calls to action.

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 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.