

SEC Proposes Rules to Address Conflicts of Interests Associated with the Use of Predictive Data Analytics

by David Tang and Michael Schmieder

The Securities and Exchange Commission (the “SEC”) proposed new rules¹ under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to address the risks to investors from conflicts of interest associated with the use of predictive data analytics (“PDA”) by broker-dealers and investment advisers (collectively, “firms”). The proposed rules would require firms to: (i) eliminate or neutralize the effect of “conflicts of interest” related to the use of a “covered technology” in any “investor interaction;” (ii) adopt and implement written policies and procedures reasonably designed to prevent violations of the proposed rules; and (iii) make and keep records related to the requirements of the proposed rules.

Scope of the Proposed Rules

Covered Technology. The proposed rules would define covered technology as “an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes.” According to the SEC’s proposing release, the definition of covered technology is designed to cover PDA-like technologies, such as AI, machine learning, or deep learning algorithms, neural networks, NLP, or large language models (including generative pre-trained transformers), as well as other technologies that make use of historical or real-time data, lookup tables, or correlation matrices. The proposed rules would encompass a broad range of uses of covered technology, including not only investment advice or recommendations, but also design elements, features, or communications that nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors.

Investor Interaction. The term investor interaction would be defined as “engaging or communicating with an investor, including by exercising discretion with respect to an investor’s account; providing information to an investor; or soliciting an investor; except that the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support.” Investor interaction is intended to encompass the wide variety of methods, using current

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and future technologies, that firms could use to interact with investors and would include engagement between a firm and an investor's account, on a discretionary or non-discretionary basis, as well as any advertisements that offer or promote services or that seek to obtain or retain one or more investors.²

Conflict of Interest. Under the proposed rules, a conflict of interest would exist "when a firm uses a covered technology that takes into consideration an interest of the firm, or a natural person who is a person associated with the firm." Firms would be required to evaluate whether a conflict of interest exists whenever a covered technology considers any information favorable to the firm or its associated persons in an investor interaction. For example, according to the proposing release, a covered technology that takes into account the profits or revenues of the firm would be a conflict of interest under the proposal regardless of whether the firm places its interests ahead of investors' interests.

Elimination or Neutralization

The elimination or neutralization requirement of the proposed rules would require firms to:

- (i) evaluate any use or reasonably foreseeable potential use of a covered technology by the firm, or a natural person associated with the firm, in any investor interaction to identify any conflict of interest associated with that use or potential use (including by testing each such covered technology prior to its implementation or material modification, and periodically thereafter, to determine whether the use of such covered technology is associated with a conflict of interest);
- (ii) determine if any such conflict of interest places or results in placing the interest of the firm, or a natural person associated with the firm, ahead of the interests of investors; and
- (iii) promptly eliminate, or neutralize the effect of, any such conflict of interest (other than conflicts of interest that exist solely because the firm seeks to open a new client or investor account).

Policies and Procedures

The proposed rules would require firms to adopt and implement, and, with respect to broker-dealers, maintain, policies and procedures that include a written description of the process for:

- (i) evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction;
- (ii) determining whether any identified conflict of interest results in an investor interaction that places the interest of the firm or an associated person of the firm ahead of the interests of investors; and
- (iii) a written description of the process for determining how to eliminate, or neutralize the effect of, any such conflicts of interest.

Firms' policies and procedures must also include a review, no less frequently than annually, of the adequacy and effectiveness of the policies and procedures adopted

pursuant to the proposed rules.

Dorsey Observations

In view of the proposed rules, firms may wish to evaluate their use or potential use of covered technologies in investor interactions. Firms that use covered technologies in investor interactions may wish to evaluate the existence of conflicts of interest that results in the interests of the firm, or a natural person associated with the firm, being placed ahead of the interests of investors, and the firm's ability to eliminate or neutralize such conflicts of interest.

[1] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Release Nos. 34-97990; IA-6353; File No. S7-12-23 (July 26, 2023) *available at* <https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf>

[2] With respect to an investment adviser, investor is defined to include any prospective or current investor in a pooled investment vehicle advised by the investment adviser.