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Securities Regulation Daily Wrap Up, AI NEWS—Investor Advisory Committee recommends scaling down SEC's predictive analytics proposal, (Mar 11, 2024)

By Lene Powell, J.D.

In a divided committee, supporters said the recommended changes would avoid unintended consequences while opponents were concerned the changes would undermine requirements on conflicts of interest.

The SEC Investor Advisory Committee (IAC) adopted a recommendation for the SEC to scale back proposed rules on digital engagement practices. A majority of the committee recommended that the SEC narrow some proposed definitions and increase focus on disclosing conflicts of interest.

Some members voted against the IAC's recommendation, believing that it unduly shifts the focus to disclosing rather than neutralizing conflicts of interest.

Proposed rules. The SEC's predictive data analytics proposal, released last July, would require firms to identify and eliminate any conflicts of interest arising from the use of covered technologies, as well as implement policies and procedures and keep certain records.

According to the proposal, firms are increasingly using a type of artificial intelligence called predictive data analytics (PDA) to understand and direct individual investor behavior. Firms may also use digital engagement practices (DEPs) like behavioral prompts, differential marketing, game-like features, and other design features to engage retail investors when using a firm's digital platforms for trading, roboadvice, and financial education.

These technologies can create conflicts of interest that place a firm's interests ahead of investors' interests, the SEC says. For example, firms could use PDA-like technologies to encourage investors to engage in activities like excessive or risky trading that are profitable for the firm but may increase investors' costs, undermine performance, or expose investors to unnecessary risks.

The proposal has met intensely polarized feedback. Better Markets called the proposed rules "essential to protect investors," while NASAA supported the proposal with some recommended changes. In contrast, major industry groups strongly criticized the proposal, including the U.S. Chamber of Commerce, Investment Company Institute, SIFMA, and Investment Adviser Association.

IAC recommendation. At a meeting on March 7, the IAC adopted a recommendation on the SEC's proposal. Committee member Paul Roye, former SVP and senior counsel at Capital Research and Management Company, said the recommendation suggests these changes:

- Narrow the scope of the definition of covered technologies to target the unique risk of predictive data analytics and artificial intelligence technologies;
- Narrow the definition of investor interaction to include technologies that interact directly with investors or that aid in that interaction with investors;
- Use the current definition of conflict of interest;

- Use the existing framework to mitigate or eliminate conflicts of interest involving predictive data analytics and artificial and technology when disclosures are inadequate; and

- Clarify the definition of what constitutes a recommendation under Regulation Best Interest.

Roye suggested the recommended changes would avoid unintended consequences and adverse effects on investors and not impede the adoption of new beneficial technologies.

Dissent. Two committee members said they could not support the IAC’s recommended changes.

SEC Investor Advocate Cristina Martin Firvida said if covered technologies were to be redefined to focus on the use of exceptionally complex and opaque technologies, then in her view firms should not be permitted to address conflicts of interest through disclosure alone. Rather, she supports requiring firms to eliminate conflicts or their effects when the conflicts are the result of covered technologies. This would build upon existing regulations and does not represent a dramatic departure from firms’ existing regulatory obligations, she said.

Leslie Van Buskirk, administrator of the Division of Securities, State of Wisconsin Department of Financial Institutions, said she “firmly opposes” elements of the recommendation. She outlined concerns including that the recommendation would undermine the primary benefit of the SEC's approach—that it would transition industry practices to addressing associated conflicts at the earliest opportunity.

Commissioner statements. SEC Chair Gary Gensler said that while the use of AI can promote greater financial inclusion and enhanced user experience, it can also raise conflicts of interest, which the proposed rules address. Gensler has previously said that under current rules, brokers and advisers cannot address conflicts of interest through disclosure alone.

Commissioner Hester Peirce questioned why the recommendation was changed from an earlier draft, particularly regarding the earlier version’s emphasis on disclosure versus mitigation of conflicts.

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