Securities Regulation Daily Wrap Up, FINANCIAL INTERMEDIARIES—SEC proposes rules on predictive analytics, internet advisers, (Jul. 26, 2023)

Securities Regulation Daily Wrap Up

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By Lene Powell, J.D.

The proposals aim to eliminate potential conflicts of interest arising from new AI-based technological capabilities and modernize registration requirements for investment advisers that operate exclusively through the internet.

The SEC issued two rulemaking proposals at an open meeting on Wednesday, July 26. One proposal would impose new requirements on the use of predictive analytics and similar technologies by broker-dealers and investment advisers. The other would impose new conditions on the "internet adviser" exemption from the prohibition on SEC registration for smaller investment advisers (*Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker Dealers and Investment Advisers*, Release No. 34-97990; *Exemption for Certain Investment Advisers Operating Through the Internet*, Release No. IA-6354, July 26, 2023).

The Commission voted 3-2 to issue the predictive analytics proposal and 5-0 to issue the internet advisers proposal.

Both proposals will be open for comment for 60 days following publication in the Federal Register.

Predictive analytics. According to SEC Chair Gary Gensler, modern predictive data analytics models allow an increasing ability to make predictions about each of us as individuals. This makes differential communications to individuals possible at scale.

While such "narrowcasting" can enhance user experience and promote financial inclusion, it is also potentially a problem. Advisers or brokers may use these technologies to optimize in a manner that places their interests ahead of investor interests, creating conflicts of interest and harming investors. And, such conflicts could manifest efficiently at scale, said Gensler.

"How might we respond to individualized communications or nudges?" asked Gensler. "How might we respond to individualized product offerings? How might we respond to individualized pricing? This includes means to optimize for, predict, guide, forecast, or direct investors' investment decisions."

Gensler cited flashing buttons and push notifications as examples of predictive data analytics: "the colors, the sounds, the well-engineered subtleties of modern digital life."

As a fact sheet explains, the proposal would:

- Require a firm to analyze and identify, then eliminate or neutralize the effect of conflicts of interest associated with the firm's use of covered technologies in investor interactions that place the firm's or its associated person's interest ahead of investors' interests;
- Require a firm that has any investor interaction using covered technology to have written policies and procedures reasonably designed to prevent violations of (in the case of investment advisers) or achieve compliance with (in the case of broker-dealers) the proposed rules; and
- Impose recordkeeping requirements related to the proposed conflicts rules.

Commissioner reactions. Gensler and Commissioners Caroline Crenshaw and Jaime Lizárraga voted to issue the proposal, while Commissioners Hester Peirce and Mark Uyeda voted against it.

Based on the Commission's analysis and extensive public input, the current framework on conflicts of interest needs to be modernized in light of new technology, said Lizárraga.

Crenshaw pointed to recent developments in national policy on artificial intelligence.

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"Acknowledging the considerable promise and great risk offered by artificial intelligence in particular, on Friday the White House announced that seven leading artificial intelligence companies in the United States have agreed to voluntary safeguards on the technology's development, pledging to manage the risks posed by these new tools," said Crenshaw. "It is similarly important for the SEC to build in safeguards to protect investors from the potential for harm posed by firms using new technologies that are optimized in a way that could place their interests ahead of investor interests."

Peirce said the proposal amounted to "banning technologies we don't like," unduly rejected disclosure as an option, and inexplicably disregarded operational feasibility. Peirce asked 10 questions about costs, compliance period, and other areas.

"The rule appears to assume that AI is so complex it needs special rules. Aren't humans even more complex?" asked Peirce.

Internet advisers. As Gensler explained, in 2002 the SEC granted a narrow exception allowing internet-based advisers to register with the Commission instead of with the states. But a lot has changed in 21 years, and the 2002 exemption creates gaps in 2023, he said.

According to a fact sheet, the proposal would:

- Require an investment adviser relying on the exemption in 203A-2(e) under the Investment Advisers Act of 1940 to at all times have an operational interactive website through which the adviser provides investment advisory services on an ongoing basis to more than one client;
- Eliminate the current rule's de minimis exception for non-internet clients. This would have the effect of requiring that an internet investment adviser must provide advice to all of its clients exclusively through an operational interactive website.

Commissioner reactions. The Commission voted unanimously to issue the proposal.

Lizárraga said SEC staff has observed numerous instances where advisers do not operate nationally and have failed to qualify for SEC registration. In 2021, Examinations staff found that nearly half of firms relying on the exemption were ineligible to do so. He noted that the SEC has taken enforcement actions against several firms for these violations.

This is Release No. 34-97990 and Release No. IA-6354.

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