Digital Engagement Practices and Legal Challenges[1]

SIFMA COMPLIANCE & LEGAL SOCIETY

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CLE Outline

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1. Background

On July 26, 2023, the Securities and Exchange Commission ("SEC") proposed new rules designed to regulate the conflicts of interest associated with the use of predictive data analytics ("PDA") and artificial intelligence ("AI") technology by broker-dealers and investment advisers (the "Rule Proposal"). The Rule Proposal was followed by a comment period. An Adopting Release is expected this year, perhaps soon.

A little history is in order. During the COVID pandemic, stock trading through the use of computer trading apps was soaring.[2] But in January 2021, the GameStop trading halt exploded across the nation's headlines,[3] prompting a Congressional investigation into "meme stocks," collateral deposit requirements, payment for order flow, and certain features of the trading apps used by the GameStop investors prior to the halt.[4] According to one broker-dealer, these features were designed to make trading easier for a broader range of investors.[5] Collectively, the features have been described as the "gamification" of trading. The features are also referred to as "Digital Engagement Practices" or "DEPs."

The SEC Requests Information on DEPs

In August 2021, the SEC issued a release requesting information and comments on broker-dealer and investment adviser use of DEPs when interacting with retail investors through digital platforms, as well as the tools and methods used in connection with such practices.[6] The SEC also requested comments on investment adviser use of such technology to develop and provide investment advice.

DEPs were defined to include behavioral prompts, differential marketing, game-like features, and other design elements or features to engage with retail investors on digital platforms (e.g., on websites, portals, and apps). In particular, DEPs included:

- linking the digital platform to social networking content;
- employing games or contests with prizes or incentives for trading, referrals, linking accounts, funding accounts, promoting the app, or engaging in community forums;
- scorekeeping features using points, badges, or leaderboards;
- notifications regarding certain stocks or trading inactivity;
- celebrations for trading;
- visual cues or prompts based on portfolio performance;
- presenting investment "ideas;" and
- use of Chatbots that simulate live, human conversations.

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[2] https://www.businessofapps.com/data/stock-trading-app-market/.
[3] https://www.washingtonpost.com/business/2021/01/29/gamestop-stocks-robinhood-reddit/.
[4] https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=409578.
[5] https://www.businessinsider.in/tech/news/robinhoods-ceo-rejects-his-app-allows-for-the-gamification-of-investing-and-denies-using-rewards-and-confetti-animation-to-encourage-trading/articleshow/81080888.cms.
[6] *Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, 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*, SEC Rel. No. 34-92766 (Aug. 27, 2021) [(the "Release")], available at: https://www.sec.gov/rules/other/2021/34-92766.pdf.

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The SEC Release requested information regarding industry practices including the types of DEPs used, the extent to which they were designed to alter or "nudge" retail investor behavior, information on customers' ability to opt in or out of interacting with DEPs, information about the market forces driving the adoption of DEPs, and the extent to which firms target specific groups of retail investors through DEPs.

The Comments

The SEC received comments from two major industry groups. The first was brokerage firms that employ DEPs and trade associations that represent the interests of industry professionals. These comments generally held that no additional rulemaking was necessary and the existing regulatory regime adequately addressed firms' use of DEPs, preserving the benefits of DEPs while appropriately managing potential risks and conflicts. As an example, the Securities Industry and Financial Markets Association (SIFMA) submitted the following:

> "FINRA's communications (and related) rules and guidance cover [communications to retail investors], and the SEC's Regulation Best Interest ('Reg BI') covers [potential recommendations to retail investors]. Accordingly, new rules, guidance, or interpretations are not necessary or appropriate to address DEP use in our industry today. In fact, such additional regulation may well have the effect of undermining its very purpose by limiting information and access to investment opportunities and educational tools by under-represented, less financially educated, and/or less affluent retail investors – the presumed beneficiaries of such prospective regulation."

A second, smaller group of industry comments came from investor-oriented trade associations that generally held that the existing regulatory regime adequately addressed most issues arising from DEPs, but that there may be a need for some gap-filling to address particular issues. As an example, the North American Securities Administrators Association (NASAA) submitted the following:

> "[E]xisting rules, regulations, and principles are broad enough to address most DEP tools and market practices. For example, the principles behind what constitutes a recommendation and the standards of conduct for broker-dealers and investment advisers are already developed. In our view, these principles apply regardless of whether a recommendation comes from a person, an algorithm, or some other technology. . . [But,] to the extent gaps are identified, the Commission should act to curtail practices that allow registrants to interact with investors without applying and observing appropriate standards of care."

A third, even smaller group of comments came from investor advocacy groups and academics that were generally wary of DEPs, such as Better Markets,[7] which cited the "substantial risks" of DEPs and urged the SEC to consider certain features of the apps to

[7] https://www.sec.gov/comments/s7-10-21/s71021-9315815-260050.pdf (October 1, 2021 Comment of Better Markets).

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constitute recommendations subject to Reg BI; the Pace University Investor Rights Clinic,[8] which called DEPs a "double-edged sword" and also called for application of Reg BI to such practices; and the Public Investors Advocate Bar Association (PIABA),[9] which cited the risks of DEPs, called for fair and balanced use of DEPs, and the application of Reg BI to DEPs in many instances.

Individual investors were also asked to describe their experiences with Online Trading and Investment Platforms. Most were positive about their experiences but some were not.

2. The Rule Proposal

In July 2023, almost two years after the SEC Release requesting information, the SEC issued a Rule Proposal aimed at regulating the conflicts of interest associated with the use of PDA and AI by broker-dealers and investment advisers.[10] Although the text of the proposed rules is relatively short, the release itself is 239 pages long. Beyond the lengthy discussion of the proposed conflicts rules, it includes an economic analysis, associated recordkeeping amendments, and a request for comment.

The SEC's Purpose

The SEC's purpose behind the Rule Proposal may be summed up by SEC Chair Gary Gensler in the accompanying press release:[11]

> "We live in an historic, transformational age with regard to predictive data analytics, and the use of artificial intelligence . . . Today's predictive data analytics models provide an increasing ability to make predictions about each of us as individuals. This raises possibilities that conflicts may arise to the extent that advisers or brokers are optimizing to place their interests ahead of their investors' interests. When offering advice or recommendations, firms are obligated to eliminate or otherwise address any conflicts of interest and not put their own interests ahead of their investors' interests. I believe that, if adopted, these rules would help protect investors from conflicts of interest — and require that, regardless of the technology used, firms meet their obligations not to place their own interests ahead of investors' interests."

The Text of the Rule Proposal

The Rule Proposal first defines the relevant terms: "conflict of interest," "covered technology," "investor," and "investor interaction."

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[8] https://www.sec.gov/comments/s7-10-21/s71021-9316491-260086.pdf (October 1, 2021 Comment of the Pace Investor Rights Clinic); *see also* https://www.sec.gov/comments/s7-10-21/s71021-9316165-260078.pdf (October 1, 2021 Comment of University of Miami School of Law).
[9] https://www.sec.gov/comments/s7-10-21/s71021-9315857-260056.pdf (October 1, 2021 Comment of PIABA).
[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; https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf.
[11] https://www.sec.gov/news/press-release/2023-140.

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- A "conflict of interest" exists when a broker or dealer uses a covered technology that takes into consideration an interest of the broker or dealer, or a natural person who is an associated person of a broker or dealer;
- "Covered technology" means 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;
- "Investor" means a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes; and
- "Investor interaction" means 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.

The Rule Proposal then sets forth the requirement for broker-dealers and advisers to eliminate or neutralize the effect of conflicts of interest. Specifically, that broker-dealers and advisers must:

- Evaluate the use or reasonably foreseeable use of a covered technology in any investor interaction to identify any conflict of interest resulting from that use;
- Determine if any such conflict of interest places the interest of the broker-dealer or advisor ahead of the interests of the investor;
- Eliminate or neutralize the effect of any such conflict of interest;
- Adopt, implement, and maintain written policies and procedures reasonably designed to achieve compliance with the preceding requirements; and
- Comply with certain additional books and records requirements documenting compliance.

The Rule Proposal then sets forth the requirement for written policies and procedures that are reasonably designed to prevent violations of the above.

Industry Comments

The SEC received more than a hundred comment letters about the Rule Proposal, far fewer than those following the initial release. To start, more than a dozen trade associations requested an extension of the 60-day comment period.[12] The request was ignored. Industry leaders subsequently presented multiple arguments against adoption of the rule as proposed.[13] The arguments include:

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[12] *See, e.g.,* https://www.sec.gov/comments/s7-12-23/s71223-245299-541662.pdf (August 15, 2023 joint request of the Alternative Investment Management Association, American Council of Life Insurers, American Investment Council, Financial Services Institute, Inc., Institute for Portfolio Alternatives, Insured Retirement Institute, Investment Adviser Association, Investment Company Institute, LSTA, Managed Funds Association, National Association of Insurance and Financial Advisors, National Association of Investment Companies, The Real Estate Roundtable, Securities Industry and Financial Markets Association, SIFMA Asset Management Group, and U.S. Chamber of Commerce).

[13] *See, e.g.,* https://www.sec.gov/comments/s7-12-23/s71223-258279-605062.pdf (September 12, 2023 joint comment of the American Council of Life Insurers, American Investment Council, Alternative Investment Management Association, American Securities Association, Financial Services Institute, Inc., Financial

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- The proposal illustrates the SEC's continued war on technology and that the requirements of the rule would likely make firms opt out of deploying technological innovations to avoid the prohibitive costs of compliance. In particular, the lack of discernible boundaries on what is a "covered technology" is likely to operate as a *de facto* ban on the use of technology.
- The SEC lacks statutory authority to adopt these rules because it extends beyond investment recommendations or advice to investors. In particular, the SEC cites Sections 211(h) of the Advisers Act and 15(l) of the Exchange Act as sources of authority but does not provide analysis as to how those provisions provide the authority for such a sweeping proposal.
- The definition of "conflict of interest" in the Rule Proposal does not exist anywhere else in the federal securities laws and conflicts with existing definitions of the term. *Any interest* of a broker-dealer or adviser would be considered a potential conflict, with the limited exception of conflicts related to opening new investor accounts. Further, *any technology* making a broker-dealer or adviser more user friendly or effective would present a conflict, reading out of the statutory requirement that there be a conflict between the interests of the investor and the firm that involves both a sales practice and a compensation scheme.[14]
- The definition of "covered technology" is too broad, possibly capturing commonly used software, math formulas, algorithms, models, statistical tools, and AI used with all manner of datasets, even Excel spreadsheets. And the number of covered technologies might be in the thousands for certain firms, making compliance virtually impossible.
- The definition of "investor interaction" is too broad, capturing virtually every contact with an investor, from emails to phone calls to in-person meetings to hosting a website or operating a mobile app.
- The proposal abandons the current disclosure framework regarding conflicts of interest. In particular, the proposal does not explain why the existing standards of conduct for advisers or broker-dealers do not apply to conflicts presented in the use of covered technologies, nor why disclosure to address the covered conflicts of interest is insufficient. Instead, the proposal requires elimination or "neutralization" of any conflicts, a word with no history in federal securities laws.

Technology Association, Finseca, Investment Company Institute, Institute for Portfolio Alternatives, Insured Retirement Institute, LSTA, Managed Funds Association, National Association of Insurance and Financial Advisors, National Association of Investment Companies, National Society of Compliance Professionals, and U.S. Chamber of Commerce. See also https://www.sec.gov/comments/s7-12-23/s71223-261319-615782.pdf (September 19, 2023 joint comment of the American Benefits Council, American Securities Association, Finseca, Institute for Portfolio Alternatives, Insured Retirement Institute, and National Association of Insurance and Financial Advisors); https://www.sec.gov/comments/s7-12-23/s71223-269759-651802.pdf (October 10, 2023 Comment of The Capital Group Companies); https://www.sec.gov/comments/s7-12-23/s71223-271299-654022.pdf (October 10, 2023 Comment of Robinhood); and https://www.sec.gov/comments/s7-12-23/s71223-269619-651383.pdf (October 9, 2023 Comment of Raymond James) ("It all seems so needlessly complex when a firm could just inform clients about fees and costs").

[14] This is in contrast to, for example, an investment adviser's fiduciary duty, which encompasses any interest that might incline the adviser, consciously or unconsciously, to provide advice that is not disinterested, or in contrast to the broader universe covered by Regulation Best Interest, which similarly defines a "conflict of interest" as "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer – consciously or unconsciously – to make a recommendation that is not disinterested." 17 C.F.R. § 15l-1(b)(3).

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- The proposal does not account for the interconnectedness and interdependencies with other existing rules and rule proposals.
- The proposal overrides existing rules without notice and comment as required by the Administrative Procedures Act.
- The proposal contains no economic analysis or data supporting any economic benefits of the proposal, only bare assertions that the requirements "could enhance investor protection," "investors could have greater confidence in interactions with firms," and "could positively affect competition between firms and result in lower fees and higher service quality for investors." Absent such analysis and data, the Rule Proposal is based on speculation and, as such, is arbitrary and capricious.
- The Rule Proposal does not compare the costs to investors to any possible benefits.
- The effect on low- and middle-income investors would be devastating because the Rule Proposal places the most pressure on the brokerage model because normal commissions and similar payments to broker-dealers are viewed as conflicts of interest. This will accelerate the trend away from brokerage services to advisory services, but advisory services are often not available to small investors. The result will be that firms will cease providing services to smaller accounts.
- Compliance with the Rule Proposal would be challenging at best, impossible at worst. In particular, the definition of covered technologies is without discernible limit and, in any event, requires onerous compliance burdens to assess whether the technology is within the scope of the proposal. Considering that almost every technology used by a firm likely considers the interests of that firm in some respect, the impact of the Rule Proposal is potentially boundless. And the massive reallocation of compliance resources necessary to comply with the Rule Proposal regarding covered technologies risks diverting attention and resources away from areas where more serious conflicts could exist.
- Finally, the cost for compliance will ultimately be borne by investors, including retirement participants.

A Summation of the Industry View

> The Proposed Rules are a transformative shift from the consent and disclosure regime to one where advisers will be required to search for, identify, document, and neutralize or eliminate conflicts associated with all covered technology. The shift caused by the Proposed Rules will severely strain and impede portfolio making decisions, product and strategy developments, and investor communications. While advisers may bear the direct costs of compliance, these costs could influence the availability or pricing of investment services to clients and impose significant opportunity costs on investors from deferred or reduced technology. The Commission's unsupported concerns of technology would unjustifiably stifle innovation and reduce investment options for investors.
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> Investors would ultimately bear these costs, without receiving proportionate benefits. Existing laws, regulations and enforcement authority currently protect investors from conflicts arising from investment management activity.[15]

[15] https://www.sec.gov/comments/s7-12-23/s71223-269759-651802.pdf at 2.

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Non-Industry Comments

A small set of comments came from investor advocacy groups, such as the Americans for Financial Reform Education Fund, the Consumer Federation of America, and the Economic Policy Institute. Each strongly supports the Rule Proposal.[16] NASAA also supports the proposal, stating that new regulation is needed to address the conflicts in the use of covered technologies and that the proposed policies and procedures "make sense."[17]

3. What's Next

Should the Rule Proposal be enacted in its present form, it will require the allocation of substantial resources for firms to comply. Policies and procedures will need to be implemented, and personnel and consultants hired and trained to ensure compliance. Arguably, all systems of a broker-dealer or investment adviser are geared toward prediction, guiding, forecasting, and directing investor outcomes and behaviors. Thus, the broad definition of a covered technology would apply to almost every aspect of business operations, even to mundane systems like electronic reminders for customers to consider rebalancing, excel spreadsheets, and greeting card generators meant to create goodwill. It would also apply to providing market news and alerts to customers if such induced some customers to enter trades and generate commissions or fees to the broker-dealer or adviser, or to reallocations of target date funds using a portfolio of low-cost affiliated funds. And if any conflict could not be eliminated or neutralized, the firm would have to refrain from using the technology; *i.e.,* refrain from providing these services.

Of course, litigation will almost certainly ensue. The SEC is relying on Section 913 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act – specifically the additions of Section 211(h) of the Investment Advisers Act and Section 15(l) of the Securities Exchange Act – as justification for regulating conflicts related to covered technologies.

One likely argument may be to challenge the SEC's jurisdiction – that Congress intended Section 913 to cover broker-dealer and investment adviser recommendations made to retail investors and it does not grant the SEC unfettered authority to regulate any other aspects of broker-dealer or investment adviser activities. In addition, that the Rule Proposal applies to adviser communications with investors in private funds who, by definition, are typically institutional or accredited investors, not retail investors.

Another likely argument may be to challenge the SEC's compliance with the Administrative Procedures Act[18] – that the Rule Proposal is arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law.[19] In particular, that the SEC has

[16] https://www.sec.gov/comments/s7-12-23/s71223-270780-653522.pdf (Comment of October 10, 2023 from Americans for Financial Reform Education Fund, Consumer Federation of America, and Economic Policy Institute).
[17] https://www.sec.gov/comments/s7-12-23/s71223-270579-653282.pdf (Comment of October 10, 2023 of NASAA).
[18] 5 U.S.C. ch. 5, subch. I § 500 et seq.
[19] 5 U.S.C. § 706(2)(A).

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not demonstrated that it engaged in reasoned decision-making by providing an adequate explanation for its decision.[20] Instead, the SEC has offered speculative assertions, limited discussion regarding the benefits provided by the technology, and underestimates of the costs of compliance.

A third possible argument may be to challenge the Constitutionality of the Rule Proposal – that it violates the First Amendment because it improperly seeks to regulate free speech.

Stay tuned!

[20] *Motor Vehicle Manufacturers Association v. State Farm Auto Mutual Insurance Co*, 463 U.S. 29, 52 (1983) ("In this case, the agency's explanation for rescission of the passive restraint requirement is not sufficient to enable us to conclude that the rescission was the product of reasoned decision making.") (emphasis in original); *Petroleum Commc'ns, Inc. v. FCC*, 22 F.3d 1164, 1172 (D.C. Cir. 1994)

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