Quick Take- SEC Proposed Rule on Predictive Data Analytics

Monday, October 23, 2023

Take-Away: The SEC has proposed a new rule that would substantially curtail the use of AI and predictive data analytics now used to guide investors.

Background: On July 26, 2023 the Securities and Exchange Commission (SEC) issued a proposed rule that it believes will eliminate conflicts of interest between financial advisors and their investors. The SEC proposal relates to the use of artificial intelligence (AI) by financial professionals. Specifically, the SEC proposal relates to how the use of such predictive data analytics could harm investors when such technology in fact optimizes the advisor's interests over the investor.

Proposal: The proposed rule would apply to *covered technology,* that would include the advisor (or the advisor's firm's) *"use of analytical, technological, or computational functions, algorithms, models, correlation matrices, or similar methods or processes that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes of an investor."* The proposed rule would require the investment advisor to *'eliminate or neutralize'* the use of such technology when working with investors. The concern addressed by the SEC proposal is that a robo-advisor or brokerage app that uses a function to optimize its own interests and not solely for the investor benefit, creates a conflict of interest. Yet the heart of the SEC proposed rule, to *eliminate or neutralize* potential conflicts with the advisor, is not defined in the rule.

Existing Conflict of Interest Rules: Currently SEC Best Interest Regulation (BI) requires brokers to disclose and mitigate conflicts of interest. The fiduciary duty standard applies with regard to investment advisors, in that the advisor must disclose conflicts and if not eliminate them, then disclose the conflict to the point that the investor can give informed consent to the disclosed conflict.

Predicted Industry Response: It will come as no surprise that the financial services industry vehemently opposes the proposed SEC rule. A couple of examples follow.

> Morningstar, Inc. criticized the proposed SEC rule as a measure that is *'too expansive as it tries to address 'gamification' of on-line trading, AI and conflicts of interest….They're extending Regulation Best Interest, essentially making it more stringent.'*
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> The ERISA Industry Committee, which represents retirement plan sponsors, asserts that the proposed SEC rule would apply to a *'vast swath of tools that investors rely on daily, including those related to helping investors save for retirement.'* This Committee's assertion is that if the SEC rule is implemented, financial firms will likely offer less useful information and that qualified plan participants will have reduced access to 'financial wellness' programs *'which are likely to become less robust and useful over time.'* This Committee has publicly taken the position that the proposed SEC rule needs to be entirely withdrawn.
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> Fifteen Republican members of Congress even jumped on the bandwagon of opposition, having written a letter to the SEC Commissioner in which they assert that the SEC's proposed AI rule is intended to rewrite existing SEC Regulations that address advisor conflicts of interest, such as the Regulation Best Interest (BI) for brokers and fiduciary duty for investment advisors. The thrust is that as an alternative to the AI proposal, the SEC should instead revisit Regulation BI and its related interpretation of fiduciary duty under the Investment Advisers Act, to provide more clarity on Regulation BI and more guidance to investment advisors who rely on such technology when advising their clients.

Conclusion: The elicited comment period on the SEC's proposed rule just closed. It will be interesting to see if the SEC takes all of the criticism that it has received to heart in rewriting the proposed , withdrawing the proposed rule, or at least define what it means by its use of the phrase *eliminate or neutralize technology.*