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Broker-Dealers and Advisers Beware: The SEC's "PDA" Proposal Could Upend Firms' Interactions With Customers, Clients and Investors

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On July 26, 2023, the Securities and Exchange Commission (SEC or Commission) narrowly approved (3-2) a proposed rulemaking under the Securities Exchange Act of 1934 (Exchange Act) and the Investment Advisers Act of 1940 (Advisers Act)[1] intended to address conflicts of interest related to the use of "predictive data analytics" by broker-dealers and investment advisers (Proposal).[2]

The Proposal arises, in part, from concerns expressed by some SEC officials regarding digital engagement practices, the "gamification" of retail stock trading and the events surrounding early 2021's volatile trading in GameStop stock.[3] Notwithstanding the discrete nature of these concerns, the Proposal is very broad and would capture many communications and interactions that are not the product of "predictive data analytics." It would extend broadly to well-established and mundane

[1] It is notable that the Proposal was promulgated under Section 211 of the Advisers Act, and not Section 206, even though the Proposal would operate as an antifraud rule.

[2] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53960 (Aug. 9, 2023) (Proposing Release). The SEC also refers to "predictive data analytics" as "PDAs."

[3] *See, e.g.*, Chair Gary Gensler, *Statement on Conflicts of Interest Related to Uses of Predictive Data Analytics* (July 26, 2023), https://www.sec.gov/news/statement/gensler-statement-predictive-data-analytics-072623; SEC Staff, *Staff Report on Equity and Options Market Structure Conditions in Early 2021* (Oct. 14, 2021), https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf; Rick Fleming, *Investor Protection in the Age of Gamification: Game Over for Regulation Best Interest?* (Oct. 13, 2021), https://www.sec.gov/news/speech/fleming-sec-speaks-101321; 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, 86 Fed. Reg. 49067 (Sept. 1, 2021).

forms of technology, such as spreadsheets, research and financial models, and data libraries, that provide input or background into commonplace investor interactions, like email communications from a registered representative to a customer or an investment adviser's exercise of discretion over a client's account.

The Proposal is notable not only for its breadth but also because it would redefine how broker-dealers and investment advisers must deal with conflicts of interest. For example, broker-dealers and advisers could no longer "disclose and mitigate" many conflicts of interest relating to their use of technology (as permitted by the SEC's Regulation Best Interest and long-standing fiduciary standards of conduct). Instead, they would be required to follow a new standard requiring them to "eliminate or neutralize the effect of" these conflicts. If adopted, the Proposal could overlap and conflict with existing rules and standards applicable to broker-dealers and investment advisers, including Regulation Best Interest and interpretations of an adviser's fiduciary duties.

The comment period for the Proposal ends on October 10, 2023.

1. *Which Interactions and Communications Are Covered by the Proposal?*

The Proposal has the potential to encompass a wide variety of technologies and interactions with a retail customer (for a broker-dealer) and an advisory client or fund investor (for an investment adviser). It would apply to any covered technology that is used or reasonably foreseen to be used in an investor interaction. Moreover, in contrast to other SEC regulations that impose a duty of care only when there is a "recommendation" (such as Regulation Best Interest), the Proposal would apply to ***any*** investor interaction involving a covered technology. Specifically, broker-dealers and investment advisers would be required to:

- Eliminate or neutralize the effect of "**conflicts of interest**" associated with the firm's use "**or reasonably foreseeable use**" of "**covered technologies**" in "**investor interactions**" that place the firm's or its associated persons'[4] interests ahead of investors' interests;
- Establish and implement 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
- Create and keep additional books and records relating to the proposed rules, including written documentation of all covered technologies used in investor interactions, descriptions of all material features and material modifications, and the evaluation and annual testing of each covered technology.

While in a vacuum these requirements may not seem excessively onerous, the triggering definitions have the potential to capture almost every communication and other interaction with a retail customer, an advisory client or a fund investor.

[4] For purposes of the Proposal, "associated person" refers only to natural persons.

Covered Technology. A **"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.[5]

This definition would capture many different technologies used by firms today. For example, in the Proposing Release, the SEC stated that the following tools could be in scope and considered "covered technology"—*even if they do not recommend* a securities transaction or investment strategy involving securities:[6]

- Spreadsheets that include basic financial modeling tools or calculations;
- Commercial off-the-shelf technology used by a firm to draft or revise advertisements guiding or directing investors or prospective investors to use its services;
- Research models, financial models and simple investment algorithms;
- Research pages or "electronic libraries" that provide investors with the ability to obtain or request research reports, news, quotes and charts from a firm-created website;
- Technologies that generate emails to investors as part of a firm-run email communication subscription that investors can sign up for and customize, and that alerts investors to items such as news affecting the securities in the investor's portfolio or on the investor's "watch list"; and
- Technologies that analyze investors' behaviors (e.g., spending patterns, browsing history on the firm's website, updates on social media) to proactively provide curated research reports or advertisements.[7]

As the SEC notes in the Proposing Release, "use" of covered technology may "occur directly through the use of a covered technology itself … or indirectly by firm personnel using the covered technology and communicating the resulting information gleaned to an investor."[8]

Conflict of Interest. A **"conflict of interest"** would exist anytime a firm uses a covered technology "that takes into consideration an interest" of the firm or a natural person who is an associated person of the firm.[9] The business objective of generating revenue could be a "conflict of interest."

Investor. The term **"investor"** is also broadly defined. For investment advisers, an "investor" means "any prospective or current client of the adviser or any prospective or current investor in a pooled investment vehicle advised by the adviser."[10] As proposed, this definition includes not only

[5] Proposed Rule 15l-2(a); Proposed Rule 211(h)(2)-4(a).

[6] Proposing Release, at 53972, 74–75.

[7] *Id.*

[8] *Id.*, at 53978.

[9] Proposed Rule 15l-2(a); Proposed Rule 211(h)(2)-4(a).

[10] *Id.*

retail and institutional clients but also investors in both private funds and registered investment companies and, presumably, the private funds and registered investment companies themselves.

For broker-dealers, "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."[11] This definition is consistent with the definition of "retail investor" used for purposes of Form CRS.

Investor Interaction. The term **"investor interaction"** includes all forms of engaging or communicating with an investor, including by (i) exercising discretion with respect to an investor's account, (ii) providing information to an investor or (iii) soliciting an investor. It does not, however, include interactions if they are solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial or general administrative support.[12]

The Proposal does not make any distinctions based on the manner in which an investor or the investor's account interacts with the covered technology or the manner in which the broker-dealer or adviser uses the technology in the interaction. The SEC states in the Proposing Release that "'use' of covered technology in an investor interaction can occur directly through the use of a covered technology itself (e.g., a behavioral feature on an online or digital platform that is meant to prompt, or has the effect of prompting, investors' investment-related behaviors) or indirectly by firm personnel using the covered technology and communicating the resulting information gleaned to an investor (e.g., an email from a broker recommending an investment product when the broker used PDA-like technology to generate the recommendation)."[13]

Investment advisers should pay particular attention to the prong of the "investor interaction" definition that covers exercising discretion with respect to an investor's account. The Proposing Release observes that "the definition would include discretionary management of accounts where the engagement is with the investor's account, even if there is no communication or other interaction with investors themselves at the time of trades in their accounts" and asks whether the discretionary management of accounts should be included within the definition of investor interaction.[14]

2. *What Must Firms Do If They Are Covered by the Proposal?*

If a broker-dealer's or an adviser's activities are captured by these definitions, the Proposal would require the firm to undertake a multistep process to (i) identify conflicts of interest related to the use of covered technology, (ii) eliminate or neutralize the effect of certain conflicts of interest associated

[11] *Id.*

[12] Proposed Rule 15l-2(a); Proposed Rule 211(h)(2)-4(a).

[13] Proposing Release, at 53974 (emphasis added).

[14] *Id.*, at 53976.

with the use of covered technology, (iii) establish policies and procedures to address compliance with the proposed rules, (iv) conduct annual reviews of covered technology and policies, and (v) maintain records of these steps. The costs of these tasks are significant, and, as the Proposing Release notes, one consequence of the Proposal may be that firms stop using certain covered technology altogether because of the costs.[15]

Identifying Conflicts. The Proposal would require firms to evaluate the "use" or "reasonably foreseeable potential use" of any covered technology in any investor interaction to identify whether there is a conflict of interest. If a covered technology considers any information favorable to a firm or its associated persons in an investor interaction, the firm would be required to evaluate the conflict. The identification process would involve pre-implementation and periodic testing to identify whether the technology involves a conflict of interest. As noted above, "use" for this purpose includes direct and indirect uses.

Determining Whether the Firm's Interest Is Placed Above the Customer's. Once a conflict of interest is identified, a firm must determine whether the conflict would result in placing an interest of the firm, or an associated person of the firm, ahead of the interests of investors.

Elimination or Neutralization of Effect of Conflicts. Promptly after the firm determines or reasonably should have determined that a conflict of interest placed the interests of the firm or associated person ahead of those of investors, the firm must eliminate or neutralize the effect of the conflict. Notably, the Proposal would except conflicts that exist solely from seeking to open a new customer or client account from the elimination or neutralization requirement.[16] This exception, however, does not apply to specific account types or products or services offered by the firm.

Adopting, Implementing and Maintaining Written Policies and Procedures. Broker-dealers would be required to adopt, implement and maintain written policies and procedures reasonably designed to achieve compliance with the proposed rules. Investment advisers would be required to adopt and implement written policies and procedures reasonably designed to prevent violations of the proposed rules. These policies and procedures would need to include written descriptions of the process for (i) evaluating the use (or reasonably foreseeable potential use) of a covered technology in any investor interaction, (ii) evaluating any material features of any covered technology used in any investor interaction prior to its implementation or material modification, (iii) determining whether conflicts of interest place the firms' or its associated persons' interests ahead of investors' interests, and (iv) determining how to eliminate or neutralize the effects of any such conflicts of interest.

Annual Review. No less frequently than annually, firms would be required to perform a documented review of the adequacy of such policies and procedures, the effectiveness of their implementation, and the written descriptions of their use of covered technologies and their conflict identification and neutralization or elimination process.

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[15] Proposing Release, at 54010 ("For example, a firm might opt not to use an automated investment advice technology because of the costs associated with complying with the proposed rules.").

[16] *See* Proposed Rule 15l-2(b)(3); Proposed Rule 211(h)(2)-4(b)(3).

Recordkeeping. Finally, the Proposal includes new, potentially onerous recordkeeping obligations. Each of the above steps for reviewing covered technologies and conflicts of interest would need to be thoroughly documented. More specifically, firms would need to create a list or other record of all covered technologies used in investor interactions and details regarding each technology's implementation, evaluation, testing, and conflict identification and mitigation, as well as a record of each instance in which the covered technology was altered, overridden or disabled.

3. Practical Problems With Implementation.

In the Proposing Release, the SEC justified the need for broad-based, sweeping regulation by noting technology's "inherent complexity," "opacity" and "ability to rapidly scale" such that the impact of conflicted actions can spread quickly among a firm's investor base, exposing investors to unique risks.[17] The SEC also stated that it wanted its Proposal to be broad enough to capture evolving technology.[18] However, this objective to have a purposefully broad rule with intentionally broad definitions will create significant compliance headaches if the Proposal is adopted in its current form.

First, as noted, the Proposal covers almost every use of technology (both direct and indirect), every customer interaction directly or indirectly using that technology, and every conflict associated or potentially associated with that technology. The Proposal effectively saddles market participants with the burden of proving that no conflicts of interest exist when they evaluate different covered technologies. It will be a daunting task for in-house personnel to inventory, scrutinize and document all forms of "covered technology."

Second, although the Commission offers several examples in the Proposing Release, the proposed rules do not prescribe specific steps for how to comply with the rules' procedural requirements. While this permits some flexibility in addressing different types of technology, it leaves certain aspects of compliance open to interpretation and potential second-guessing by regulators. The Proposing Release acknowledges that in some cases "it may be difficult or impossible" for firms to evaluate a covered technology.[19] This difficulty could arise, for example, where the technology is licensed from a third-party vendor or involves complex algorithms or user interfaces that have numerous technological inputs. The Proposal, however, offers no solutions for firms; instead, the SEC notes that "a firm's lack of visibility would not absolve it of the responsibility" to comply with the proposed conflicts rules.[20]

Third, the Proposal represents a departure from existing broker-dealer obligations, which generally do not involve the need to "eliminate or neutralize the effect of" conflicts of interest with customers. Unlike investment advisers, broker-dealers are not subject to fiduciary duties, particularly the duty

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[17] Proposing Release, at 53967, 77.

[18] *Id.*, at 53974.

[19] *Id.*, at 53978.

[20] *Id.*

of loyalty with respect to conflicts of interest. Rather, historically they have been recognized as having a "salesman's stake" in transactions they effect, which necessarily involves inherent conflicts of interest with their customers.[21] For decades, these conflicts have been addressed with disclosure and mitigation. The Proposal would upset this historic framework by eliminating broker-dealers' ability to address conflicts with disclosure. Instead, broker-dealers would have a new obligation to "eliminate or neutralize the effect of" conflicts. This new obligation would apply not only when a broker-dealer makes a recommendation to a retail customer but more broadly ***whenever a broker-dealer has an investor interaction*** involving a covered technology. This new obligation is particularly troubling because it goes beyond what is required when a broker-dealer makes a recommendation subject to Regulation Best Interest, to a retail customer. In those cases, a broker-dealer is not required to "eliminate or neutralize" all conflicts but rather may "disclose or mitigate" them in many cases. And here, of course, there does not have to be an actual recommendation to a customer to trigger the proposed rules' requirements.

The Proposal also raises significant questions for investment advisers. As noted, investment advisers owe fiduciary duties to their clients, including a duty of loyalty that requires advisers to eliminate or expose conflicts of interest. Under an adviser's duty of loyalty, if client conflicts of interest are not eliminated, an adviser must make full and fair disclosure of all such conflicts so that the adviser can obtain informed consent from the client to such conflicts.[22] Although the SEC states that the Proposal is designed to be consistent with existing fiduciary standards of conduct,[23] it is not clear whether that will be the reality. At the same time the SEC claims consistency, it also notes that it may not be possible to provide full and fair disclosure of conflicts relating to certain covered technologies due to "scalability," imposing a pseudo-duty of care standard with respect to the use of covered technology in investor interactions.[24] Accordingly, advisers would not be able to rely on disclosure alone and may need to undertake additional steps to address certain conflicts associated with covered technologies. In addition to diluting the use of disclosure to address conflicts in the context of the use of covered technologies, the Proposal raises questions about how effective disclosure will be perceived by the SEC's Enforcement Division outside of this context in the general operation of the adviser's business. And it reflects a general trend toward characterizing adviser misconduct as a violation of the duty of care, where historically the same conduct was evaluated through the lens of the duty of loyalty and conflicts disclosure. Finally, it is perplexing why the SEC believes this Proposal is necessary to protect investors given the Proposal's acknowledgment of a recent enforcement settlement that addressed abusive behavior using technology under Section 206 and existing standards of conduct.

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[21] *See, e.g.*, SEC Staff, Denial of No-Action Request, Brumberg, Mackey & Wall, P.L.C. (May 17, 2010).

[22] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019).

[23] Proposing Release, at 53988.

[24] The Commission identifies that it has concerns about "scalability" but in no instance elaborates on its specific concerns, thereby making it a challenge to understand precisely why disclosure is inadequate.

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In sum, there are many aspects of the Proposal that raise significant questions and concerns. We anticipate that the comment letter process will be vigorous and robust.

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