MEMO# 33752

September 2, 2021

SEC Request for Information on Broker-Dealer and Investment Adviser Digital Engagement Practices

[33752]

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TO: Chief Compliance Officer Committee
Investment Adviser and Broker-Dealer Standards of Conduct Working Group
Operations Committee
Pension Committee
Pension Operations Advisory Committee
SEC Rules Committee RE: SEC Request for Information on Broker-Dealer and Investment Adviser Digital Engagement Practices

On August 27, the Securities and Exchange Commission issued a request for information and public comment on broker-dealer and investment adviser digital engagement practices (RFI).[1] The RFI, which is summarized below, includes questions about broker-dealer and investment adviser use of "digital engagement practices" (DEPs), including behavioral prompts, differential marketing, game-like features (commonly referred to as "gamification"), and other design elements or features intended to engage with retail investors on digital platforms (e.g., websites, portals, and applications), as well as the analytical and technological tools and methods used in connection with these DEPs. The RFI focuses on, among other issues, investor protection concerns raised by the use of DEPs, as highlighted in the Congressional hearings earlier this year on trading activity in meme stocks.[2] The RFI also includes questions regarding investment adviser use of technology to develop and provide investment advice.

Comments on the RFI are due on October 1. At this time, ICI does not expect to comment on the RFI. If you have comments, please contact Sarah Bessin at sarah.bessin@ici.org no later than September 10, 2021.

The SEC explains that the growth of digital platforms for investing and trading in securities has increased retail investor participation in the US securities markets in recent years. The Commission issued the RFI to (i) better understand and assess the market practices associated with the use of DEPs; (ii) provide a forum for market participants, including investors, to share their perspectives on the use of DEPs and related tools and methods, including potential benefits and investor protection issues;[3] and (iii) facilitate an assessment by the SEC and its staff of whether existing regulations are adequate or further regulatory action may be needed regarding firms' use of DEPs and related tools and methods.

DEPs include behavioral prompts, differential marketing, game-like features, and other design elements or features designed to engage retail investors. The Commission provides specific examples of DEPs, including (i) social networking tools; (ii) games, streaks and other contests with prizes; (iii) points, badges, and leaderboards or similar "scorekeeping" features; (iv) notifications by email, text, or other means; (v) animations and graphics that "celebrate" trading activity by the investor; (vi) visual cues, such as displaying certain information more prominently; (vii) presenting trading or investing ideas to the investor prior to order placement (e.g., curated lists or features, news headlines, etc.); (viii) subscriptions and membership tiers that offer additional services or features; and (iv) chatbots to respond to customer inquiries.

The Commission asks a series of detailed questions regarding industry practices relating to brokerage and advisory digital platforms.[4] It then asks about the analytical and technological tools and methods that firms use to develop their DEPs.[5] The Commission requests feedback on the benefits associated with DEPs, as well as their risks and costs, and the implications for investor behavior of the tools and methods used to develop DEPs.[6]

The Commission requests comment on the regulatory issues raised by DEPs. It sets out the existing legal obligations that apply to broker-dealers and investment advisers and asks how firms are approaching their compliance with these legal obligations in connection with their use of DEPs.[7] It explains that "[t]he use of a DEP by a broker-dealer may, depending on the relevant facts and circumstances, constitute a recommendation for purposes of Reg BI. . . "[8] The Commission asks whether, for a broker-dealer, particular types of DEPs may be a recommendation, and whether, for an investment adviser, particular types of DEPs may constitute providing investment advice.[9] The RFI also includes questions about how broker-dealers ensure that the DEPs they adopt comply with Regulation Best Interest and other sales practice rules,[10] and how investment advisers satisfy their fiduciary duty when using DEPs.[11]

The SEC requests feedback on potential modifications to existing regulations or new regulations or guidance that may be necessary to address investor protection concerns raised by broker-dealer and investment advisers' use of DEPs.[12] For example, the SEC asks whether "any such modifications or additional regulations [should] be targeted specifically to address particular risks, such as those related to certain types of securities (e.g., options, leveraged and inverse funds, or other complex securities), services (e.g., margin), or conflicts (e.g., payment and revenue sources) . . ."[13]

In a separate section of the RFI, the SEC asks how investment advisers use analytical tools and other technologies to provide investment advice to clients, including (i) oversight of this

technology; (ii) how advisers and clients have benefited from technology; (iii) potential risks to

investment advisers, clients, and the markets more generally related to this technology; and (iv) whether regulatory action may be needed to protect investors while preserving the ability of investors to benefit from advisers' use of technology.[14] The Commission focuses on robo-advisers, which provide asset management services to clients through online algorithm-based platforms, and internet investment advisers, which provide investment advice solely through an interactive website and typically are eligible to register as advisers with the SEC, despite not meeting the SEC's assets under management threshold for registration.[15] The RFI includes questions about the potential benefits and risks of the digital tools and technologies advisers may use to develop and provide investment advice, including artificial intelligence (AI) and machine learning (ML) models.[16] It also asks how investment advisers use digital platforms and other analytical tools in connection with wrap fee programs that rely on Rule 3a-4 under the Investment Company Act of 1940 ("1940 Act"),[17] including "[t]o what extent . . . robo-advisers (as well as other sponsors of investment advisory programs) rely on Rule 3a-4 to determine that they are not sponsoring or otherwise operating investment companies under the [1940 Act]"[18] and how investment advisers satisfy the conditions of Rule 3a-4 when using digital platforms and other analytical tools.

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endnotes

[1] 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, Release Nos. 34-92766; IA-5833 (Aug. 27, 2021), 86 Fed. Reg. 49067 (Sept. 1, 2021), available at https://www.govinfo.gov/content/pkg/FR-2021-09-01/pdf/2021-18901.pdf (RFI).

[2] See RFI at nn. 6-7 and accompanying text. SEC Chair Gensler recently highlighted some of these concerns in a speech in which he explained that:

While new financial technologies can bring increased efficiencies in finance and greater access, in many cases these individualized features may encourage investors to trade more often, invest in different products, or change their investment strategy. Predictive analytics and other [DEPs] often are designed, in part, to increase platform revenues, data collection, and customer engagement, leading to potential conflicts between the platform and investors.

He noted several key questions raised by DEPs, including:

- How are investors protected in light of the potential conflicts of interest that may exist when DEPs optimize for platform revenues, data collection, or investor behavior?
- How does that affect whether DEPs are making a recommendation or providing investment advice, which has implications in our securities laws?
- How do these new business models ensure for fairness of access and pricing, particularly given underlying data used in the analytic models could reflect historical biases that may be proxies for protected characteristics, like race and gender?

He also noted the potential implications of new financial technologies for financial stability and resiliency. See Chair Gary Gensler, Remarks before the European Parliament

Committee on Economic and Monetary Affairs (Sept. 1, 2021), available at https://www.sec.gov/news/speech/gensler-remarks-european-parliament-090121.

[3] The RFI includes, as an appendix, a comment response form for individual investors to provide feedback to the SEC on their experiences with online trading and investment platforms.

[4] RFI at questions 1.1-1.26.

[5] Id. at questions 2.1-2.11.

[6] Id. at questions 2.12-2.17.

[7] Id. at questions 3.1-3.12. For example, the SEC asks in question 3.4:

What policies, procedures, and controls do firms have in place with respect to the use of DEPs that are designed to promote or that could otherwise direct retail investors to securities or services that are more lucrative for the firm such as: Proprietary products, products for which the firm receives revenue sharing or other third-party payments, or other higher fee products? . . .

[8] Id. at 49075.

[9] Id. at questions 3.6-3.9. The Commission asks whether broker-dealers and investment advisers consider the "observable impacts of DEPs" when determining if they are, respectively, providing recommendations or investment advice.

[10] Id. at question 3.7.

[11] Id. at question 3.9.

[12] Id. at questions 3.13-3.18.

[13] Id. at question 3.16.

[14] Id. at 49079.

[15] See Section 203A-2(e) of the Investment Advisers Act of 1940. The Commission asks whether it should update this registration provision for internet investment advisers to reflect changes in technology and industry practices since the provision was adopted.

[16] RFI at questions 4.1-4.24.

[17] RFI at questions 4.25-4.29. The RFI cites the SEC's July 2021 Division of Examinations Risk Alert: Observations from Examinations of Investment Advisers Managing Client Accounts That Participate in Wrap Fee Programs (July 21, 2021), available at https://www.sec.gov/files/wrap-fee-programs-risk-alert_0.pdf.

[18] RFI at 49085.