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SEC Issues Proposal on Conflicts of Interest Related to Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers

[35390]

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TO: Advertising Compliance Advisory Committee
Broker/Dealer Advisory Committee
Investment Adviser and Broker-Dealer Standards of Conduct Working Group
Investment Advisers Committee
Operations Committee
Pension Committee
SEC Rules Committee
Transfer Agent Advisory Committee RE: SEC Issues Proposal on Conflicts of Interest Related to Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers

On July 26, 2023, the SEC proposed new rules (the "Proposal") that would require broker-dealers and investment advisers (collectively, "firms") to take certain steps to address conflicts of interest associated with their use of predictive data analytics (PDA) and similar technologies to interact with investors.[1] The Proposal is broad and is intended to prevent firms from placing their own interests ahead of investors' interests. Further, the Proposal seeks to establish essentially identical standards regarding conflicts of interest for both registered investment advisers and broker-dealers. The Proposal was approved by a 3-2 vote, along party lines, and follows a request for information and public comment on matters related to the use of digital engagement practices by broker-dealers and investment advisers in August of 2021.[2]

This memorandum summarizes those aspects of the Proposal most relevant to advisers, registered funds, and broker-dealers that sell fund shares. The SEC requests comment on every aspect of the Proposal through a series of specific and general requests for comment. Comments on the Proposal are due to the SEC 60 days following publication of the Proposal in the Federal Register.

Overview of the Proposal

Proposed rules 15l-2 under the Securities Exchange Act of 1934 ("Exchange Act") applicable to broker-dealers and 211(h)(2)-4 under the Investment Advisers Act of 1940 ("Advisers Act") applicable to registered investment advisers (collectively, the "proposed conflicts rules") are substantially identical and are intended to align with (and in some respects may satisfy) firms' existing regulatory obligations. The proposed conflicts rules would only apply where the firm uses a defined covered technology. The Commission explains that it designed the Proposal protect investors from the conflicts associated with the use of PDA-like technologies. Further, the Commission intends for the rules to be broad, principles-based and technology neutral to continue to be applicable as technology evolves and to provide firms with flexibility to develop technology consistent with their business model.

The proposed conflicts rules would generally require the following:

- Elimination, or neutralization of effect of, conflicts of interest. Firms must (i) evaluate any use or reasonably foreseeable potential use by the firm or its associated person[3] of a covered technology in any investor interaction to identify any conflict of interest associated with that use or potential use;[4] (ii) determine whether any such conflict of interest places or results in placing the firm's or its associated person's interest ahead of the interest of investors; and, if it does, (iii) eliminate or neutralize the effect of such conflict.
- Policies and procedures. Firms that have investor interactions using covered technologies must adopt, implement, and, in the case of broker-dealers, maintain, written policies and procedures reasonably designed to achieve compliance with the conflicts rules.
- Recordkeeping. Proposed amendments to applicable recordkeeping rules would require firms to make and keep books and records related to the requirements of the conflicts rules.

1) Applicability and Scope of the Proposed Conflicts Rules

a. Covered Technology

The proposed definition of a "covered technology" is expansive and would include 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. The Proposal's definition is designed to capture PDA-like technologies, such as artificial intelligence (AI), machine learning, or deep learning algorithms, neural networks, natural language processing (NLP), or large language models (including generative pre-trained transformers), as well as other technologies that make use of historical or real-time data, lookup tables, or correlation matrices among others. Further, the proposed definition is intended to be evergreen and capture the variety of technologies and methods that firms currently use as well as future technologies and would include widely used and bespoke technologies, sophisticated and relatively simple technologies, and technologies that are both developed or maintained at a firm and those licensed from third parties.

The Commission explains the definition of a covered technology is designed to capture a broad range of functions. The proposed definition is intentionally not limited to providing investment advice or recommendations, and also encompasses design elements, features, or communications that nudge, prompt, cue, solicit, or influence investment related behaviors or outcomes from investors. Further, the Commission notes that investment-

related behavior or outcomes can manifest themselves in many forms in addition to buying, selling, and holding securities, such as an investor making referrals or increasing trading volume and/or frequency. The Commission explains that the proposed definition would apply to the use of PDA-like 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 on particular investment products, because the use of such technology has been shown to guide or influence investment-related behaviors or outcomes.

The Commission proposes to exclude from the definition technologies that are designed purely to inform investors. Examples provided by the Commission include a website that describes the investor's current account balance and past performance but does not optimize for or predict future results, or otherwise guide or direct any investment-related action. Similarly, the use of a firm's chatbot that employs PDA-like technology to assist investors with basic customer service support (e.g., password resets or disputing fraudulent account activity) would not qualify as covered technology under the proposed definition because it is not intended to affect an investment-related behavior or outcome.

b. Investor Interaction

The proposed conflicts rules define both "investor" and "investor interaction." These definitions encompass interactions with both current and prospective clients of a firm, as well as current and prospective investors in a registered or private fund.

Investor. For brokers or dealers, the definition of investor would include 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. The definition is designed to capture both existing and prospective retail customers. For investment advisers, the definition of investor would include an existing or prospective client, retail or institutional, as well as an existing or prospective investor in a pooled investment vehicle advised by the investment adviser. "Pooled investment vehicle" includes both registered and private funds.[5]

Investor Interaction. The proposed conflicts rules would generally define investor interaction as 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. Importantly, "investor interaction" would encompass activity far beyond recommendations and advice. The definition would capture a firm's correspondence, dissemination, or conveyance of information to or solicitation of investors, in any form, including communications that take place in-person, on websites; via smartphones, computer applications, chatbots, email messages, and text messages; and other online or digital tools or platforms. This definition would also include engagement between a firm and an investor's account, on a discretionary or non-discretionary basis. This definition would further include any advertisements, disseminated by or on behalf of a firm, that offer or promote services or that seek to obtain or retain one or more investors.

The use of covered technologies in an "investor interaction" would not be limited to the direct use of such technologies by broker-dealers and advisers to interact with an investor (e.g., a behavioral feature on an online or digital platform that is meant to prompt or "nudge" investors, or has the effect of prompting, investors' investment-related behaviors), but also would include the indirect use of covered technologies by broker-dealers and advisers, where the resulting information is then provided to the investor (e.g., an email from a broker recommending an investment product when the broker used PDA-like

technology to generate the recommendation).

The Commission states that it would exclude from the investor interaction definition interactions solely for purposes of meeting legal or regulatory obligations. In addition, the proposed definition would also exclude interactions solely for purposes of providing clerical, ministerial, or general administrative support (e.g., technologies used for purely ministerial or back-office functions). In either case, the exclusions would be limited to interactions that are "solely for the purpose" of the relevant category (or categories) of conduct to help ensure that interactions that serve several purposes, including purposes that are not excluded, will be within the scope of the definition of investor interaction.

2) Identification, Determination, and Elimination, or Neutralization of the Effect of, a Conflict of Interest

The proposed conflicts rules are prescriptive and outline a three-step process requiring firms to eliminate, or neutralize the effect of, certain conflicts of interest associated with the use of a covered technology in investor interactions. The following are the affirmative steps firms would be required to follow:

- First, a firm would be required to evaluate any use or reasonably foreseeable potential use of a covered technology in any investor interaction to identify whether it involves a conflict of interest, including through testing the technology.
- Second, a firm would be required to determine if any such conflict of interest results in an investor interaction that places the interest of the firm or an associated person ahead of investors' interests.
- Third, the proposed conflicts rules would require a firm to take specific action—elimination or neutralization—to address any conflict of interest the firm determines does result in an investor interaction that places its or an associated person's interest ahead of investors' interests.

The Commission believes the proposed conflicts rules "supplement, rather than supplant," existing regulatory obligations related to conflicts of interest. It asserts that, because of the nature of these covered technologies (for example due to their inherent complexity and ability to rapidly scale transmission of conflicted actions across a firm's investor base), requiring additional steps to address conflicts associated with their use is necessary.

a. Evaluation and Identification

The proposed conflicts rules would require a firm to evaluate any use or reasonably foreseeable potential use by the firm or its associated persons of a covered technology in any investor interaction to identify any conflict of interest associated with that use or potential use. The proposed conflicts rules do not mandate a specific method by which a firm is required to evaluate or to identify a conflict of interest and the Commission acknowledges that a firm could adopt different approaches for different covered technologies.[6]

Moreover, the Commission suggests when evaluating a covered technology and identifying conflicts of interest, a firm should consider the circumstances in which a covered technology would be deployed in investor interactions. In certain cases, the Commission recognizes it may be difficult or impossible to evaluate a particular covered technology or identify whether its use in an investor interaction would raise a conflict of interest that would place the firm's interest ahead of investors' interests. In this situation, the Commission suggests that the firm may conclude that, to comply with the conflicts rules, it

could not use the covered technology.

b. Testing

As part of the Proposal's identification and evaluation requirement, the proposed conflicts rules include a requirement to test each covered technology prior to its implementation or material modification, and periodically thereafter, to determine whether the use of such covered technology is associated with a conflict of interest.

Although the Proposal does not stipulate any particular method of testing or frequency of retesting that the firm must conduct, there are two specific times testing is required: 1) a firm would be required to conduct testing prior to the covered technology being implemented; and 2) a firm also would be required to conduct testing before deploying any "material modification" of the technology (e.g., if there is a modification to add new functionality like expanding the asset classes covered by the technology).[7]

The proposed requirement to retest a covered technology periodically does not specify how often retesting would be required, thus methods and frequencies may vary. Consequently, a firm would need to determine how often, and the manner to retest covered technologies used in investor interactions. The Commission suggests that as firms consider appropriate timing and manner of retesting, they should consider the nature and complexity of the covered technology and whether the covered technology continues to be used as intended and as originally tested.

c. Conflicts of Interest

The Proposal provides that a conflict of interest exists when a firm uses a covered technology that takes into consideration an interest of the firm or its associated persons. The proposed conflicts rules define "conflict of interest" broadly and make clear that, if a covered technology considers any firm-favorable information in an investor interaction or information favorable to a firm's associated persons, the firm should evaluate the conflict and determine whether such consideration involves a conflict of interest that places the interest of the firm or its associated persons ahead of investors' interests. If so, the firm would have to determine how to eliminate, or neutralize the effect of, that conflict of interest. The Commission notes that a covered technology that, directly or indirectly, takes into account the profits or revenues of the firm would involve a conflict of interest under the proposed rules, regardless of whether the firm places its interest ahead of investors' interests.

d. Determination

After evaluating and identifying any existing or potential conflict of interest, the proposed conflicts rules would require that a firm determine whether such conflict places or results in placing the firm's or its associated person's interest ahead of investors' interests.

Under the Proposal, the determination step is a facts and circumstances analysis, and would depend on a consideration of a variety of factors, such as the covered technology, its anticipated use, the conflicts of interest involved, the methodologies used and outcomes generated, and the interests of the investor. Based on this analysis, a firm must reasonably believe that the covered technology either does not place the interests of the firm or its associated persons ahead of investors' interests, or the firm would need to take additional steps to eliminate, or neutralize the effect of, the conflict.

e. Elimination or Neutralization of Effect of a Conflict

In order to satisfy the proposed conflicts rules, after identifying a conflict of interest, the Commission would require a firm to promptly eliminate, or neutralize the effect of, the conflict only if the firm determines that the conflict results in an investor interaction that places the firm's (or its associated persons') interest ahead of the interests of its investors. Disclosure would not be adequate in this situation. Instead, the Commission views this additional step as an enhancement to the existing standards of conduct that apply when firms are providing advice or making recommendations.[8]

The proposed conflicts rules do not prescribe a specific way in which a firm must eliminate, or neutralize the effect of, its conflicts of interest given of the breadth and variations of firms' business models as well as their use of covered technologies. The Commission believes the decision of whether to eliminate or neutralize a conflict is a facts and circumstances analysis. The Proposal states the test for whether a firm has successfully eliminated or neutralized the effect of a conflict of interest is whether the interaction no longer places the interests of the firm ahead of the interests of investors. The Commission suggests a firm could "eliminate" a conflict of interest by completely eliminating the practice (whether through changes to the algorithm, technology, or otherwise) or by removing the firm's interest from the information considered by the covered technology. A firm also has the option to "neutralize the effect of" a conflict of interest by taking steps to address the conflict.

The Commission explains that in a neutralization scenario, the covered technology could continue to use the data or algorithm that includes the firm's (or associated person's) interest as a factor, but the firm would be required to take steps to prevent it from biasing the output towards the interest of the firm or its associated persons. The measure of whether the effect of the conflict has been neutralized would be if the investor interaction does not place the firm's (or associated person's) interest ahead of the investor. As an example, the Commission states that neutralization could include rendering the consideration of the firm favorable information subordinate to investors' interests, and thus making the conflict harmless, either by applying a "counterweight" (such as considering additional investor-favorable information not previously considered to balance consideration of a firm-favorable factor) or by changing how the information is analyzed or weighted such that the technology always holistically weights other factors as more important so that biased data cannot affect the outcome.

Use of Proprietary Products in an Advice Offering

The Commission discusses how firms that use proprietary funds in their robo-advice offerings could eliminate or neutralize the effects of conflicts. The Commission provides an example of a firm that is a robo-adviser that determines that it uses covered technology to direct or steer investors to funds the firm itself sponsors and advises when more suitable or less expensive options for the investor are available through the robo-adviser, and thereby prioritizes the firm's own profit over investors' interests. The Commission states that the firm could eliminate this conflict of interest by removing any data that would allow the robo-adviser to determine which funds are sponsored or advised by the firm, thus eliminating any bias in favor of the firm's interest. The firm, alternatively, may choose to neutralize the effect of the conflict. For instance, the firm could neutralize the effect of the conflict of interest by sufficiently increasing the weights given to certain factors, such as cost to the investor or risk-adjusted returns (including, in each case, comparisons to funds sponsored or advised by other firms), to provide a counterweight that prevents any

consideration of the firm's own interests from resulting in an investor interaction that places the firm's interests ahead of investors' interests. The Commission does not discuss in any detail how the proposed conflicts rules would apply to firms that only offer proprietary products.

Eliminate or Neutralize "Promptly"

The proposed conflicts rules would require a firm to eliminate or neutralize the effect of a conflict of interest "promptly" after the firm determines, or reasonably should have determined, that there is a conflict. Establishing what constitutes "promptly" in any given situation under the proposed conflicts rules is a facts and circumstances analysis. If eliminating, or neutralizing, the effect of the conflict is straightforward, the Commission expects elimination or neutralization should happen soon after the identification of the conflict of interest.

The Commission recognizes that eliminating or neutralizing the effect of a conflict may require modifications to covered technologies, which may take some time to complete. The Commission asserts, however, that, "[t]hough we recognize that modifications would not happen immediately in all circumstances, an extended period of implementation may raise questions about whether the firm acted promptly and may raise questions as to whether they are acting in accordance with their standard of care."[9]

Reasonable Standard

The proposed conflicts rules would require a firm to use reasonable care to determine whether these conflicts could arise. The Commission states that the "reasonably should have identified" standard is designed to require firms to understand the covered technology they are deploying sufficiently well to consider all the material features of the technology both when evaluating the technology and identifying conflicts, and later when determining whether those conflicts place their own (or their associated persons') interests ahead of investors' interests.

Because firms' use of covered technology is likely to be continuously changing, the Commission recommends that firms generally consider how they will proactively address reasonably foreseeable uses (which would include potential misuses) of the covered technology. Firms should identify future and evolving conflicts when evaluating their potential use of covered technology to make sure that they have eliminated, or neutralized the effect of, all conflicts they should have determined place their interests ahead of investors' interests, including as their use of technology evolves.

New Accounts

The Commission recognizes that many investor interactions could have the sole goal of encouraging investors to open a new account, and that firms may use covered technologies for this purpose. The proposed conflicts rules would not require conflicts of interest that exist solely due to a firm seeking to open a new investor account to be eliminated or their effect neutralized.

3) Policies and Procedures Requirement

The proposed conflicts rules would impose a prescriptive policies and procedures requirement. Specifically, firms that have any investor interactions using covered technology will be obligated 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 conflicts rules.

For all firms, these policies and procedures would need to include: (i) a written description of the process for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction and a written description of any material features of, including any conflicts of interest associated with the use of, any covered technology used in any investor interaction prior to such covered technology's implementation or material modification, which must be updated periodically; (ii) a written description of the process for determining whether any conflict of interest identified results in an investor interaction that places the interest of the firm or its associated persons ahead of the interests of the investor; (iii) a written description of the process for determining how to eliminate, or neutralize the effect of, any conflicts of interest that result in the interest of the investment adviser, broker-dealer, or the firm's associated persons being placed ahead of the interests of the investor; and (iv) a review and written documentation of that review, no less frequently than annually, of the adequacy of the policies and procedures and written descriptions established and the effectiveness of their implementation.

The Commission is proposing minimum standards for the written descriptions and annual review that a firm's policies and procedures would need to include. However, the proposed conflicts rules would provide firms with flexibility to determine the specific means by which they address each element, and the degree of prescriptiveness the firm includes in their policies and procedures. To satisfy the policies and procedures requirement, firms generally should take into consideration the nature of their operations, and account for the covered technologies in use, to be used or reasonably foreseeable potential use.

In addition to the requirements outlined above, the Commission suggests firms generally should consider including other elements in their policies and procedures, as appropriate, such as: (i) compliance review and monitoring systems and controls; (ii) procedures that clearly designate responsibility to appropriate personnel for supervision of functions and persons; (iii) processes to escalate identified instances of noncompliance to appropriate personnel for remediation; and (iv) training of relevant personnel on the policies and procedures, as well as on the forms of covered technology used by the firm.

a. Written Description of Evaluation Process to Identify Conflicts of Interest and Written Description of Material Features

The written policies and procedures should include: (i) a written description of the process for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction; and (ii) a written description of the material features of, including any conflicts of interest associated with the use of, any covered technology used in any investor interaction.

According to the Proposal, the written description must articulate a process for the firm to use in evaluating any use or reasonably foreseeable potential use of a covered technology by the firm or its associated persons in any investor interaction to identify any conflict of interest associated with that use or potential use. Further, this process must address how the firm will conduct the required testing of each such covered technology prior to its implementation or material modification, and periodically thereafter, to determine whether the use of such covered technology is associated with a conflict of interest. Although the SEC recognizes that this process must be flexible enough to account for different types of covered technologies and investor interactions in which those technologies may be used,

the firm's written description generally should be specific enough to ensure the consistent identification of any associated conflicts of interest. The process described by the firm generally should detail those steps it will take in conducting this evaluation, as well as the means it will use in identifying each relevant conflict of interest.

Additionally, a firm's policies and procedures would be required to include a written description of the material features of any covered technology used in any investor interaction, including any conflicts of interest associated with the use of the covered technology, and would need to be prepared prior to its implementation or material modification, and updated periodically.[10]

The Commission notes that, at a minimum, the written description would need to explain the material features of the covered technology used by the firm at a level of detail sufficient for the appropriate personnel at the firm to understand whether its use would be associated with any conflicts of interest. A firm would be required to update this written description periodically. These periodic updates to the written description should occur where a covered technology has been upgraded, materially modified, or firm personnel become aware of a new material feature or use in a manner that would make the previously existing written description inaccurate or incomplete.

b. Written Description of Determination Process

The Proposal also requires firms' policies and procedures to include a written description of the process for determining whether any conflict of interest identified results in an investor interaction that places the interest of the firm (or the firm's associated persons) ahead of the interests of the investor. This written description generally should clearly articulate the process the firm uses to meet the determination requirement. Further, the process described by the firm generally should detail certain steps for determining the effect that the conflict of interest has, or would have, on an investor interaction if the covered technology or material modification were put into use by the firm. This should include a means of determining whether the interest of the firm, or associated person, is or would be placed ahead of investors' interests if the firm used the covered technology or a material modification to the covered technology in investor interactions.

c. Written Description of Process for Determining How to Eliminate, or Neutralize the Effects of, Conflicts of Interest

The proposed conflicts rules include a requirement that firms' policies and procedures have a tailored written description of the process for elimination or neutralization that accounts for the differing circumstances of each firm.

Because a firm's policies and procedures would need to address all covered technologies used by the firm in any investor interaction, and each conflict of interest involving such covered technologies, this written description should contain a clear articulation of the process the firm uses for determining how a conflict should be eliminated or its effect neutralized. In addition, when a firm's policies and procedures dictate a specific means of making such a determination, the firm's written description would need to reflect this. The Commission recommends that to support their efforts at compliance with the proposed conflicts rules, firms using covered technologies in investor interactions could consider providing additional training to staff who will be implementing their elimination and neutralization policies.

d. Annual Review of the Adequacy and Effectiveness of the Policies and Procedures and

Written Descriptions

The proposed conflicts rules would also require a review and a written documentation of that review, no less frequently than annually, of the adequacy of the policies and procedures established under the proposed conflicts rules and the effectiveness of their implementation, as well as a review of the written descriptions.

During this review, the Commission expects firms would need to specifically evaluate whether their policies and procedures and written descriptions have been adequate and effective over the period under review at achieving compliance with the proposed conflicts rules' requirements. Further, firms generally should use this annual review to consider whether there have been any changes in the business activities of the firm or its associated persons, any changes in its use of covered technologies generally, any issues that arose from its use of covered technologies during the previous year, any changes in applicable law, or any other factor that might suggest that certain covered technologies now present a different or greater risk than the firm's policies and procedures and written descriptions had previously accounted for, and what adjustments might need to be made to such documents or their implementation to address these risks.

Firms would also be required to prepare written documentation of the review that they have conducted.

B. Proposed Recordkeeping Amendments

The Commission is proposing to amend rules 17a-3 and 17a-4 under the Exchange Act and rule 204-2 under the Advisers Act to set forth requirements for broker-dealers and investment advisers to maintain and preserve, for the specific retention periods, all books and records related to the requirements of the proposed conflicts rules. The proposed recordkeeping amendments are designed to help facilitate the Commission's examination and enforcement capabilities by creating records staff can use to assess compliance with the requirements of the proposed conflicts rules, and to help facilitate assessment by firm compliance staff of such compliance. The recordkeeping amendments would require firms to maintain six types of detailed records, relating to each of the elements of the proposed conflicts rules.

C. Proposed Reforms Relating to Investment Advisers Operating Exclusively Through the Internet

Separately from the proposed conflicts rules, also on July 26, the SEC unanimously voted to propose amendments to rule 203A-2(e) under the Advisers Act, which permits certain smaller investment advisers that provide investment advisory services through the internet to register with the Commission. But for this exemption, these advisers otherwise would be ineligible to register with the Commission. The SEC's proposal would update the internet adviser registration rule to generally require an investment adviser relying on the rule to have at all times an operational interactive website through which the adviser provides digital investment advisory services on an ongoing basis to more than one client. The proposed amendments would also eliminate the de minimis exception from the current rule by proposing to require that an internet investment adviser provide advice to all its clients exclusively through an operational interactive website, and make certain corresponding changes to Form ADV. These reforms are intended to reflect technological advancements and align industry practices with the intended scope of the exemption. Comments on these proposed amendments are due to the SEC by October 2, 2023.

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Notes

[1] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Securities Exchange Act Release No. 34-97990 and Investment Advisers Act Rel. No. IA-6353, available at https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf. The Chair's statement is available at: https://www.sec.gov/news/statement/gensler-statement-predictive-data-analytics-072623?utm_medium=email&utm_source=govdelivery. Commissioner Peirce's statement is available at https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623?utm_medium=email&utm_source=govdelivery. Commissioner Crenshaw's statement is available at https://www.sec.gov/news/statement/crenshaw-statement-predictive-data-analytics-072623?utm_medium=email&utm_source=govdelivery. Commissioner Uyeda's statement is available at https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623?utm_medium=email&utm_source=govdelivery. Commissioner Lizárraga's statement is available at https://www.sec.gov/news/statement/lizarraga-statement-predictive-data-analytics-072623?utm_medium=email&utm_source=govdelivery.

[2] See 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, For a summary of the request for information, please see ICI Memorandum No. 33752 (DATE), available at https://www.ici.org/memo33752.

[3] The Commission defines the term "associated person" in the Proposal as follows: for investment advisers, a natural person who is a "person associated with an investment adviser" as defined in section 202(a)(17) of the Advisers Act and, for broker-dealers, a natural person who is an "associated person of a broker or dealer" as defined in section 3(a)(18) of the Exchange Act

[4] Covered technology, conflict of interest, and investor interaction are each a defined term in the Proposal and are discussed below.

[5] The Proposal explicitly provides than a pooled investment vehicle means any investment company as defined in section 3(a) of the Investment Company Act of 1940 ("Investment Company Act") or any company that would be an investment company under

section 3(a) of the Investment Company Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of the Investment Company Act.

[6] For example, the Commission advises when a firm identifies a conflict of interest associated with a simple covered technology, depending on the facts and circumstances, it may determine that such conflict of interest does not actually result in the firm's or an associated person's interests being placed ahead of those of investors, and that the conflict of interest does not need to be eliminated or its effects to be neutralized. Firms that use more advanced covered technologies may need to take additional steps to evaluate technology adequately and identify associated conflicts adequately. To the extent a technology is customizable, the Commission anticipates a firm will be able to evaluate the technology and identify the conflicts associated with its use through the choices it makes when customizing the technology. For technologies that are not customizable, the Commission anticipates a firm will be able to evaluate the technology and identify conflicts via other means.

[7] The Commission states that it would not generally view minor modifications, such as standard software updates, security or other patches, bug fixes, or minor performance improvements to be a "material modification." Further, the Commission notes during the time that the material modifications are being tested, a firm could continue to use an older version of the covered technology if the firm's use of such previous version of the technology complies with the proposed conflicts rules.

[8] Under existing standards of conduct, an investment adviser is a fiduciary and is prohibited from subordinating its clients' interests to its own. An adviser must eliminate, or expose through full and fair disclosure, all conflicts of interest that might incline the adviser, consciously or unconsciously, to render advice that is not disinterested. Under Regulation Best Interest, a broker-dealer must act in the best interest of a retail customer at the time the recommendation is made, without placing the firm's financial or other interest ahead of the retail customer's interest. Among other things, this requires the broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to, among other things, identify and at a minimum disclose, or eliminate, all conflicts of interest associated with a recommendation, as well as identify and mitigate conflicts of interest at the associated person level.

[9] See Proposal at p. 103.

[10] With respect to "black box" technologies, or those that are difficult or impossible to explain, the SEC takes the position that the proposed conflicts rules would apply equally to these covered technologies, and firms would only be able to continue using them where all requirements of the proposed conflicts rules are met. Further, if a firm is incapable of preparing a written description of all such conflicts of interest associated with the use of the covered technology in any investor interaction as a result of an inability to explain the analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process comprising the covered technology, as well as its resulting outcomes, it would not be possible for the firm to satisfy the requirements of the proposed conflicts rules. However, the Commission states where firms are not able to satisfy the requirements of the proposed conflicts rules with a particular covered technology in its current form, firms may be able to modify these technologies, for example by embedding explainability features into their models and adopting back-end controls in a manner that

will enable firms to satisfy these requirements.