August 10, 2023

Skadden

Investment Management Alert

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Ken D. Kumayama
Partner / Palo Alto
650.470.4553
ken.kumayama@skadden.com

Stuart D. Levi
Partner / New York
212.735.2750
stuart.levi@skadden.com

Anna Rips
Partner / New York
212.735.3237
anna.rips@skadden.com

Resa K. Schlossberg
Partner / New York
212.735.3467
resa.schlossberg@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

525 University Ave.
Palo Alto, CA 94301
650.470.4500

SEC Proposes New Conflicts of Interest Rule for Use of AI by Broker-Dealers and Investment Advisers

The passage of omnibus federal legislation on the use of artificial intelligence (AI) is unlikely in the short term, but individual federal agencies continue to address the implementation of AI within the areas they regulate. The Securities and Exchange Commission (SEC) has proposed broad new rules under the Securities Exchange Act of 1934 (Exchange Act) and the Investment Advisers Act of 1940 (Advisers Act) to address conflicts of interest that the SEC believes are posed by the use of AI and other types of analytical technologies by broker-dealers and investment advisers.

The SEC's 3-2 vote on the proposed rules reflects a split among the SEC commissioners as to whether creating such a rule is the right approach. Comments on the proposed rules are due 60 days from when the proposed rules are published in the Federal Register.

Overview

The proposed rules, announced July 26, 2023, are intended to prevent a broker-dealer or an investment adviser from using "predictive data analytics" (PDA) and similar technologies, which includes AI, in a manner that results in the firm placing its own interests above those of its investors. The SEC is concerned that a firm might use these technologies when engaging or communicating with its investors to optimize the firm's revenue or to generate behavioral prompts or social engineering to change investor behavior in a manner that benefits the firm but is to the detriment of the investor.

The SEC is particularly concerned about:

- So-called "black box" PDA technologies where firms may not be aware of how the PDA technology it utilizes has reached a certain result or recommendation.

- The possibility that the PDA used corrupted or mislabeled data, biased data or data from unknown sources.

- The fact that this technology could exponentially proliferate conflicts of interest with investors.

The SEC has therefore proposed rules intended to eliminate or neutralize the effects of these conflicts, rather than addressing the conflicts through disclosure and consent.

Investment
Management Alert

Under the proposed rules, firms would be required to:

- Evaluate any use or reasonably foreseeable potential use by the firm or its associated persons of a "covered technology" (defined below) in any investor interaction; identify any conflicts of interest related to that use that place the firm's interests ahead of that of the investors'; and eliminate or neutralize those conflicts' effects.

- Adopt, implement and (in the case of broker-dealers) maintain 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.

- Comply with certain record-keeping requirements related to the proposed rules.

What Is a 'Covered Technology'?

A "covered technology" is 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.

So that there is no confusion about whether AI is swept into this definition, the SEC specified that, while this proposed definition is technology-agnostic, it is designed to capture many PDA-like technologies currently in existence, such as AI, machine learning, deep-learning algorithms, neural networks and natural language processing and large language models (including generative pre-trained transformers), whether developed at a firm or licensed from third parties.

According to the SEC, examples of covered technology include:

- PDA-like technologies that analyze investors' behaviors to provide curated research reports on particular investment products.

- Algorithm-based tools that provide tailored investment recommendations.

- Use of a conditional auto-encoder model to predict stock returns.

- Third-party AI technology used by a firm to draft or revise advertisements guiding or directing investors or prospective investors to use its services.

The SEC stated that covered technology does not include:

- Technologies designed purely to inform investors that do not optimize for or predict future results, or otherwise guide or direct investment-related action.

- Technologies that predict whether an investor would be approved for a particular credit card.

- Use of a PDA-enabled chatbot that provides basic customer support.

When Would the Rules Apply?

The proposed rules would apply to a firm's use of a covered technology in connection with a firm's engagement or communication with an investor, including any exercise of discretion with respect to an investor's account, provision of information to an investor or solicitation of an investor — each activity that the proposed rules term an "investor interaction."

The proposed rules would apply to all broker-dealers and to all investment advisers registered, or required to be registered, with the SEC. "Investor" would include clients that receive investment advisory services from an investment adviser and investors in a pooled investment vehicle advised by an investment adviser.

Under the SEC proposal, "investor interaction" would include those interactions that have generally been viewed as outside the scope of "recommendations" for broker-dealers but which are nonetheless designed to, or have the effect of, guiding or directing investors to take an investment-related action.

Conflict of Interest Defined

The proposed rules define "conflict of interest" broadly and include any situation where a covered technology considers any firm-favorable information in an investor interaction. This is the case even if the firm does not place its interests ahead of investors' interests.

Requirements When Using a Covered Technology

Identification, Evaluation and Elimination/Neutralization

Evaluation and identification. Under the proposed rules, a firm is first required to evaluate whether any use or reasonably foreseeable use of a covered technology in an investor interaction might create a conflict of interest. The rule does not mandate a specific approach to conducting this evaluation, and firms may adopt different approaches for different covered technologies. The SEC notes that for "more advanced covered technologies" this might entail a review of the source code (where available), documentation and data used by the covered technology, including how such data is weighted by the technology.

Importantly, the SEC states that, under the proposed rules, the fact that the evaluation may be difficult or impossible would not absolve a firm of its obligation to comply with the rules. For example, the rules would apply in the case where an AI model considers millions of different data points, rendering it difficult to determine whether certain of those data points implicate the firm's interest, or where the AI model uses a "black box" algorithm, where it is unclear exactly what inputs the technology relies on and how it much weight it assigns to those inputs.

Investment
Management Alert

Testing. Firms would also be required to test each covered technology before implementation or any material modification (*e.g.*, to add new functionality), and to conduct periodic testing thereafter to determine whether the use of the covered technology is associated with a conflict of interest. The SEC acknowledges that a firm's testing methodologies and frequencies may vary depending on the nature and complexity of the covered technologies.

The SEC notes that certain AI models can "drift" or "decay" over time, such as when the data used for training the models differs from the data used at the time of deployment. Firms are required to take this into account when evaluating and testing a covered technology.

Determination. Once the evaluation phase is complete, a firm must determine — using a facts and circumstances analysis — whether any identified conflict of interest places or results in placing the firm's or its associated person's interest ahead of investors' interests, subject to certain exceptions. For example, a machine learning model would violate the proposed rules if it is designed to screen out an investment if it would not result in a sufficient performance-based fee for the adviser despite acceptable returns for investors. The SEC notes that if the firm determines that an identified conflict of interest does not result in the interests of the firm being placed ahead of those of the investor, that conflict should, under the proposed rules and current law, be disclosed to investors with sufficient specificity that the investor may provide its informed consent.

Elimination or neutralization of effect. If a firm identifies a conflict of interest in an investor interaction that places the firm's (or its associated persons') interest ahead of the investors' interests, it is required "promptly" to eliminate or neutralize the effect of that conflict. There are several ways to neutralize a conflict's effect, including by changing how the firm-favorable information is analyzed or weighted, or by requiring trained personnel to screen for any conflicts.

Policies and Procedures Requirement

Under the proposed rules, investment advisers and broker-dealers would be required to adopt and implement (and in the case of broker-dealers, maintain) 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. This would include:

- A written description of the process for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction — including any potential conflicts of interest — before implementing or modifying the covered technology. This process must include how any required testing will be performed, and must be implemented periodically.

- A written description of the process for determining whether any conflict of interest identified by this evaluation results in an investor interaction that places the firm's or its associated persons' interests ahead of any of its investors'.

- A written description of the process for determining how to eliminate, or neutralize the effect of, any such conflicts of interest.

- A review and written documentation of that review, at least annually, of the adequacy of the policies, procedures and written descriptions, and the effectiveness of their implementation.

The SEC notes that firms may only use covered technologies with difficult or impossible to explain outcomes (*e.g.*, "black box" algorithms) if they meet all requirements of the proposed conflicts rules. In other words, these technologies could not be used under the proposed rules if all conflicts of interest could not be identified.

The SEC also suggests that additional training on covered technologies, how they work and related conflicts of interest may be useful.

Proposed Record-Keeping Amendments

The proposed rules would also amend Rules 17a-3 and 17a-4 under the Exchange Act and Rule 204-2 under the Advisers Act to require broker-dealers and investment advisers, respectively, to maintain certain books and records related to the proposed rules. These include:

- Written documentation of the evaluation of any conflict of interest related to the use or potential use by the firm or associated person of a covered technology in any investor interaction. This would include a list or other record of all covered technologies used by the firm in investor interactions, including: (i) the date on which each covered technology is first implemented (*i.e.*, first deployed) and materially modified, and (ii) the firm's evaluation of the intended use as compared to the actual use and outcome of the covered technology. Firms would also be required to maintain documentation describing any testing of the covered technology, including: (i) the date when testing was complete, (ii) the methods used to conduct the testing, (iii) actual or reasonably foreseeable potential conflicts of interest identified as a result of the testing, (iv) a description of any changes or modifications made to the covered technology that resulted from the testing and the reason(s) for those changes, and (v) any restrictions placed on the use of the covered technology as a result of the testing.

- Written documentation of the determination as to whether there was a conflict of interest.

- Written documentation evidencing how the effect of any conflict of interest has been eliminated or neutralized, including a record of the specific steps taken by the firm.

Investment
Management Alert

- Written policies and procedures, including any written descriptions adopted, implemented and, for broker-dealers, maintained pursuant to the proposed conflicts rule.

- A record of any disclosures provided to investors regarding the firm's use of covered technologies, including, if applicable, the date the disclosure was first provided and updated.

- Records of each instance in which a covered technology was altered, overridden or disabled; the reason for such action; and the date thereof.

SEC Request for Comments

The SEC has sought input on a wide range of issues, including for example:

- Is the scope of the proposed definition of a "covered technology" sufficiently clear?

- Does the phrase "investment-related behaviors or outcomes" sufficiently clarify the intended scope of the rule and which technologies would not be within the definition?

- Will the proposed definition of "investor" present challenges for firms that are dually registered as investment advisers and broker dealers?

- Is the proposed definition of "investor interaction" sufficiently clear?

Observations

The proposal's highly detailed and prescriptive set of rules is a major departure from the traditional approach of the securities laws: the disclosure of potential conflicts of interest and informed consent of the investor.

Before a broker-dealer or an investment adviser can use technology to serve a client, the SEC's proposed rules would require them to prove a negative (that the technology does not in any way possibly put the firm's interest ahead of the client's), a notoriously difficult if not impossible thing to do — particularly when dealing with "black box" technologies where even the world's foremost experts in these technologies would be unable to articulate exactly how they arrive at a given result.

The proposed rules are aimed at predictive data analytics technologies, and the SEC clarifies that this specifically includes AI, machine learning, neural networks and similar technologies. However, the

scope of "covered technologies" is broader than that because it is intended to be technology-agnostic. As a result, it would seem to include technologies that have been used by broker-dealers and investment advisers for years, such as spreadsheets, statistical tools, mathematical formulas, valuation tools and similar tools.

Given the breadth and ambiguity of the meaning of this term, it may even be interpreted to include search engines and other general purpose technologies that are not designed with functionality that is likely to give rise to a conflict of interest, but could, at least in theory, be used in a way that would put the interests of the firm ahead of those of investors.

Given the degree of reliance on technology among investment advisers and broker-dealers, should the rules be adopted as proposed, the implementation period may need to span years to permit the type of investigation the rules contemplate into the inner workings of technologies used on daily basis.

Similarly problematic is the scope of the "investor interaction" concept, which is written broadly enough to pick up not just recommendations to investors but also internal analyses and other processes used by broker-dealers and investment advisers in collecting, analyzing and presenting data, making investment decisions and formulating investment advice.

The compliance burden presented by the proposed rules, including the novel elimination/neutralization requirement, is expected to be significant and particularly more burdensome for smaller firms that may be looking to use new technology to achieve a comparative advantage in an otherwise saturated industry.

There's also a concern that the operationally complex compliance regime could have a chilling effect on the kinds of technologies that would make broker-dealers and investment advisers more effective in making decisions on behalf of investors.

Lastly, regulators across industries and jurisdictions are just getting started in formulating rules, tests and regulations to address discrimination, bias and other concerns similar to those raised by the SEC, with respect to the use of AI systems. Broker-dealers and investment advisers should monitor these more general regulatory activities, as they will likely inform the SEC's approach on this topic.