

AI technology and its effects on the new SEC rules

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I. Introduction

The Securities and Exchange Commission (SEC) recently proposed a new rule to address potential conflicts of interest between investment advisors or broker-dealers and their clients regarding the use of artificial intelligence and predictive data. The proposed rules apply to “all broker-dealers and to all investment advisors registered, or required to be registered,” with the SEC.¹ The rule-making has two stated primary goals:

- 1) Eliminate or neutralise the effect of any conflict of interest arising from a broker-dealer or investment advisor’s use of technology while interacting with its investor clients; and
- 2) Ensure investment firms create and maintain records to monitor the firm’s use of covered technology.

The proposed rule seeks to mitigate or eliminate alleged conflicts arising out of the adoption and implementation of novel technologies in financial markets. Some investment firms increasingly use artificial intelligence and predictive data analytics to identify potential risks, optimise lending and investment decisions, improve customer relations, and increase customer targeting.² Predictive data analytics can use data mining and artificial intelligence to analyse

voluminous datasets, predict future events, and assess investor behaviour. In some circumstances, predictive data analyses apparently might segment investors based on their preferences and behaviours in order to tailor marketing campaigns and offers. In addition, some client-interfacing technologies may fail to account for the inherent, disparate financial interests between an advisor and the advisor’s client.

These proposed rules would require firms to eliminate or neutralise “conflicts of interest” created by a broker-dealer or investment advisor’s use of “covered technology” during an “investor interaction.” A conflict of interest would arise when “a bro-

ker or dealer uses a covered technology that takes into consideration an interest of the broker or dealer [or of their associated entities’ or individual’s interest].”³ The SEC broadly defines “covered technology” to include anything from artificial intelligence to automated customer service “chatbots.”⁴ An “investor interaction” refers to any engagement or communication between a broker-dealer or an investment advisor and an investor,⁵ unless the interaction occurred solely for purposes of the firm satisfying legal or regulatory requirements.

As discussed in more detail below in Section III, if a firm uses covered technology during an investor interaction, the firm must satisfy two sets of requirements. First, a firm would have to:

- Evaluate any reasonably foreseeable or actual use of the technology to assess whether it creates a conflict of interest;
- Determine if the technology prioritises the firm’s interest over the investor’s; and

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- Eliminate or neutralise any conflict of interest.⁶

Second, a firm would have to create written policies and procedures reasonably designed to prevent violations of the Conflicts Requirements, including the “process for evaluating any use or reasonably foreseeable use” of the technology and of the “material features of” the technology.⁷

II. Scope of Covered Technology

The proposed rules apply when a firm utilises covered technology, causing a conflict of interest, during an investor interaction. Covered technology encapsulates all predictive data analytic tools “[created in the] future and existing,” including similar technologies that use correlation matrices and historical or real-time data.⁸ Notably, a firm only implicates the rules when it acts.⁹ Firm action involving covered technology includes providing advice or recommendations, soliciting or influencing investment-related behaviours, analysing an investor’s behaviour and providing a report on

particular stocks, or using algorithms to provide tailed recommendations. On the other hand, firm action does not include technologies designed to inform investors of deadlines or to technologies assisting investors with basic customer service support.¹⁰

III. Evaluation, Determination, and Elimination or Neutralisation of Conflicts

Under the proposed framework, a firm that wants to use covered technology in an investor interaction would have to:

- Evaluate whether any use or reasonably foreseeable use of the covered technology creates a conflict;
- Determine if the conflict places the firm’s interest before an investor’s; and
- Take affirmative steps to eliminate or neutralize the effect of any conflict.

Evaluation. The proposed rule would require a firm to assess if its covered technologies create conflicts of

interest during investor interactions. A firm would have to test its covered technology three times: (1) prior to its implementation; (2) when applying any material modification to the technology (when “new functionality” is added, but not “minor modifications, such as standard software updates, ... patches..., or minor performance improvements”); and (3) “periodically.”¹¹

While the proposed rules do not prescribe specific testing periods, periodic testing should “be sufficient under the facts and circumstances to evaluate its use or reasonably foreseeable potential use of the covered technology” to determine whether its use caused conflicts during investor interactions. Practically, the proposed rules recommend firms test complex covered technologies more often than simpler technologies.

The SEC raised an interesting issue facing firms and broker dealers. Many of these entities license pre-existing covered technologies from third-party providers. The proposed rule would require firms to test

the underlying code to assess whether the model creates conflicts. But firms and broker dealers may lack access to the underlying code from which they must evaluate the covered technology. If licensing technology from third parties, the SEC suggests firms ensure third-party providers tailor the code to satisfy the firm's conflict requirements or request access to view and adjust the underlying code. If a firm cannot access and adjust the underlying code, it must ensure its third-party provider does not introduce a technology creating a conflict of interest. If the third-party provider fails to ensure the technology mitigates conflict, the client has a cause of action against the firm, not the third party. Notably, the proposed rule states that a "lack of visibility does not absolve" the firm if using a third-party system creating a conflict.

Determination. Based on the language of the proposed rule, a firm's covered technology may routinely cause a conflict of interest.¹² A conflict exists when the firm uses covered technology during an investor interaction that considers *any* firm favourable information. Resultingly, a conflict exists no matter the specific interest affected or the weight of the affected interest. Once a firm discovers a conflict, the firm must ascertain the gravity of the conflict. The rule would require firms mitigate the conflict only if it places the firm's interest before an investor's. The firm must consider all the facts and circumstances when determining if its interest supersedes the client's, including the technology, its use, the conflict, and the interests of the investor and the firm. To continue using a covered technology and to satisfy this test, the firm must reasonably believe, or reasonably should believe, that the covered technology does not place the firm's interest ahead of its investor's.¹³ Notably, a firm can continue using the affected technology if the outcome "[is] equally (or more) favourable to the investor" than the firm. If the firm's interest outweighs the client's, the firm must eliminate or neutralize the conflict.

Elimination or Neutralisation. The rule would require a firm act to eliminate or neutralise conflicts when the firm finds, or reasonably should have found, a conflict in its covered technology that results in the firm's inte-

rests outweighing a client's. The SEC included the "reasonably should have" language to hold firms to a reasonable standard of care when firms assess whether their covered technologies contain conflicts. When assessing the reasonability of a firm's decision to forgo elimination or neutralization, the SEC heavily weights the potential harm to investors from use of the technology. A firm successfully eliminates or neutralises a conflict when the technology no longer places the firm's interest before those of its client.

A firm eliminates a conflict by removing the firm's interest from the information considered by the covered technology. A firm neutralises a conflict by addressing the conflict and mitigating its effects, typically by preventing data from biasing the output toward the firm's financial interests. The SEC prescribes no method for neutralisation. A firm must only ensure the investor's interest is not displaced by the firm's. A firm acts promptly to eliminate or neutralise when acting to eliminate or mitigate after finding, or when it reasonably should have found, the existence of a conflict. When using covered technology, an advisor cannot satisfy his fiduciary duties under this rule by merely disclosing the conflict to a client. Instead, the advisor must affirmatively act to eliminate or neutralise the conflict.

IV. Policies and Procedures Requirement

Advisors eliminating or neutralising a covered technology must adopt and implement written policies and procedures reasonably designed to prevent violations and to achieve compliance with the proposed rules. Notably, a financial advisor must

only adopt and implement these procedures. A broker-dealer must adopt, implement, and *maintain* these procedures.¹⁴ These requirements instruct an advisor to:

- 1) Transcribe any process the firm used to evaluate the presence of conflicts in covered technology, including an evaluation of the covered technology's material features;
- 2) Transcribe the firm's process for determining if a conflict resulted in the firm's interest superseding the investor's;
- 3) Transcribe how the advisor neutralised or eliminated any conflict; and
- 4) Review annually any policy and procedure created pursuant to these proposed rules and describe the effectiveness of the firm's implementation of the same policies and procedures.

An advisor must carefully distinguish between actual and potential conflicts arising from its use of covered technology. If the conflict only arises from potential uses, the advisor must discuss how and why it determined, modified, or eliminated any conflicts *prior* to use during investor interactions. If within a pre-existing covered technology used in investor interac-

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tions, the firm’s disclosure must describe how the advisor eliminated or neutralised the conflict. Whether the advisor identifies an actual or potential use causing a conflict, the advisor must specifically detail how he or she made that determination.

The proposed rule includes a list of items firms should consider when crafting policies and procedures under this requirement:

- 1) Compliance review and monitoring systems;
- 2) Procedures designating oversight responsibility to certain individuals or entities;
- 3) Escalation process to identify instances of noncompliance and funnel to designated individuals; and
- 4) Training relevant personnel on the firm’s updated policies and procedures.

The proposed rules create a cause of action, independent of other securities violations, for a firm’s failure to properly describe: 1) how a covered technology operates; and 2) the actual or potential conflicts of interest stemming from the technology’s use.

V. Record Keeping Amendments

The SEC proposes amending Exchange Act Rules 17a-3 and 17a-4

and Advisors Act Rule 204-2 to require broker-dealers and investment advisors to create and maintain six categories of books and records relating to the evaluation, determination, and elimination or neutralization of conflicts. Investment advisors must maintain these records for six years, while broker dealers must maintain these records for five years.¹⁵

Advisors must make and maintain written documentation of:

- 1) Any conflict evaluation respecting covered technology;
- 2) Any conflict determination respecting covered technology;
- 3) Records showing how the firm neutralized or eliminated a conflict;
- 4) Anything adopted, implemented, and maintained by a broker-dealer;
- 5) Any disclosure provided to investors regarding the firm’s use of covered technology; and
- 6) Any instance the firm altered, overrode, or disabled a covered technology, including the firm’s rationale for the action.

VI. Conclusion

Labaton Sucharow will continue to monitor developments related to this rulemaking and advise interested clients who may be impacted by it. ■

Footnotes:

1. THE SECS. AND EXCHANGE COMM’N, CONFLICTS OF INTEREST ASSOCIATED WITH THE USE OF PREDICTIVE DATA ANALYTICS BY BROKER-DEALERS AND INVESTMENT ADVISERS, §III(A)(1) (July 26, 2023). (“Article”) (The rules applicable to broker-dealers and investment advisers are substantially identical).
2. Murtaza Hussain, *The Future of Data and AI in the Financial Services Industry* (Feb. 27, 2023).
3. Article at §VI.
4. *Id.* (“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 behaviours or outcomes.”).
5. Article at §III(A)(1)(b) (An “investor” includes any actual or prospective client of the broker-dealer or investment advisor. For broker dealers, an “investor” refers to anyone seeking to receive or receiving financial services for personal, family, or household purposes. For investment advisors, an “investor” refers to any actual or prospective client, including anyone in a pooled investment entity advised by the investment advisor).
6. Article at §III(A)(2)(e).
7. Article at §III(A)(3).
8. Article at §III(A)(1)(a).
9. *Id.* (“The proposed definition, however, would be limited to those technologies that optimize for, predict, guide, forecast, or direct investment related behaviours or outcomes.”).
10. *Id.*
11. Article at §III(A)(2)(b).
12. Article at §III(A)(2)(e). (A covered technology creates a conflict of interest when merely accounting for the profits or revenues of the firm during an investor interaction.).
13. Article at §III(A)(2)(d).
14. Article at §III(A)(3).
15. Article at §II(B).