Hogan Lovells

Private Capital Alert
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SEC proposes new regulation to address AI conflicts concerns

The U.S. Securities and Exchange Commission (the SEC) proposed new rules for broker-dealers and registered investment advisers (RIAs) on Wednesday, July 26, 2023 that are intended to address potential conflicts of interest arising from the proliferation of new artificial intelligence (AI) tools and other predictive data analytics (PDAs). Proposed Rule 211(h)(2)-4 under the U.S. Investment Advisers Act of 1940 (the Advisers Act) would require RIAs to identify and eliminate, or neutralize the effect of, certain conflicts of interest associated with use of PDA-like technologies. [1]

The SEC simultaneously proposed a similar rule for broker-dealers – proposed Rule 151-2 under the U.S. Securities Exchange Act of 1934 (the 1934 Act) – as well as corresponding changes to the recordkeeping requirements for broker-dealers and for RIAs. [2]

While the SEC acknowledged that the use of AI, PDA and similar technologies can provide benefits in market access, efficiency and returns, it argued that the proposed rule is necessary due to the inherent complexity and opacity of these technologies, the scalability of such technologies, the potential for firms to reach a broad audience at a rapid speed, with any conflicts of interest causing unique harm to investors in a more pronounced fashion and on a broader scale. The SEC emphasized that the proposed rule is intended to be technology-neutral, so that the SEC is not attempting to identify which technologies a firm should or should not use. The additional protections are designed to complement existing protections for investors under the current regulatory framework.

A new approach to AI- and PDA-driven conflicts

The proposed rule would require RIAs to: [3]

i. evaluate any use (or reasonably foreseeable potential use) of a "covered technology" by the adviser (or any natural person associated with the adviser) in any "investor interaction" to identify any conflict of interest associated with that use;

ii. determine if any conflict of interest so identified places or results in placing the interest of the adviser (or associated person) ahead of the interests of investors; and

1 In a separate rule proposed on July 26, the SEC also seeks to amend Rule 203A-2(e), which provides an exemption from registration to certain "internet investment advisers." The amendments would require an exempt internet adviser at all times to have an operational interactive website through which the adviser provides investment advisory services on an ongoing basis to more than one client. The definition of "internet investment adviser" is limited to certain kinds of "robo-advisers" and advisers that provide advice through an interactive website. By way of example, an investment advisory firm that is 100% remote would not meet the definition of "internet investment adviser" by that fact alone.

2 Rules 17a-3 and 17a-4 under the 1934 Act for broker-dealers and Rule 204(2) (commonly known as the books and records rule) under the Advisers Act for RIAs.

3 Proposed Rule 211(h)(2)-4(b).

iii. eliminate, or neutralize the effect of, any conflict of interest (other than conflicts that exist solely because the adviser seeks to open a new client account) resulting in an investor interaction that places the interests of the adviser (or associated person) ahead of the interests of investors promptly after the RIA makes such a determination or reasonably after such time the adviser should have made such determination.

Generally, the regulatory regime for investment advisers is disclosure-based, whereby prior disclosure of conflicts, in some cases bolstered by client consent, is traditionally sufficient to meet an adviser's fiduciary duty of loyalty, with some exceptions. Notably, the SEC believes that what it considers the unique risks of the conflicts potentially resulting from use of a covered technology requiring treating such conflicts as one of those exceptions. Accordingly, RIAs would have an obligation to eliminate or neutralize the conflict. Prior disclosure and client consent would be insufficient under the proposed rule to meet an adviser's duty.

Furthermore, each RIA would have to adopt the following written policies and procedures: [4]

i. a written description of the processes for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction to determine whether conflicts of interest exist;

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 adviser (or associated person) ahead of the interests of investors;

iii. a written description of the process for determining how to eliminate or neutralize such conflicts of interest that place the RIA's interests ahead of investor interests; and

iv. a review and written documentation of at least annual review of the adequacy of such policies and procedures and the effectiveness of their implementation.

The proposed rule's definitions are key to understanding its scope. [5]

An "investor" would include not only advisory clients, but the individual investors of pooled investment vehicles, as well as any prospective client or fund investor.

An "investor interaction" would include any engagement or communication with an investor, including by exercising discretion with respect to an investor's account, providing information to an investor or soliciting an investor. [6]

The central definition of the proposed rule is "covered technology," which is defined as "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 proposed definition is designed to capture PDA-like technologies, such as AI, machine learning, or deep learning algorithmic, neural networks, natural language processing, or large language models, as well as other technologies that make use of historical or real-time date, lookup tables, or correlation matrices, among others. The definition would not cover technologies that are designed purely to inform investors.

This definition, however, is purposefully broad to capture additional technologies and methods that may develop in the future, and could ultimately cover a wider array of technologies than merely AI applications.

4 Proposed Rule 211(h)(2)-4(c).

5 Proposed Rule 211(h)(2)-4(a).

6 The definition states that it would not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial or general administrative support. By way of example, an AI-powered chatbot designed to facilitate general investor queries would not rise to the level of an investor interaction.

The proposed rule's effect on private funds

At first glance, the proposed rule most directly affects advisers and broker-dealers who serve retail investors, especially those who may use "digital engagement practices," such as behavioral prompts, differential marketing or gamification to engage retail investors or recommend investment opportunities to investors. For example, if the effect of an adviser's algorithm is to encourage investors to engage in a higher volume of trades and, therefore, generate higher fee revenues to an adviser, such a covered technology could have the effect of placing the adviser's interests higher than the client's.

Few private fund sponsors employ this kind of technology.

Nevertheless, private fund strategies – especially strategies of hedge funds – for decades employed algorithmic trading and machine learning models that analyze large datasets and identify patterns and signals to optimize for, predict, guide, forecast or direct investment-related behaviors or outcomes. Moreover, as the SEC notes in its proposal, "any risks of conflicts of interest associated with AI use will expand as firms' use of AI grows," and these risks "will have broad consequences if AI makes decisions that favor the firms' interest and then rapidly deploys that information to investors, potentially on a large scale." Private fund sponsors should, in particular, note (i) the breadth of the proposed definitions of "investor," "investor interaction," and "covered technology," (ii) the potential growth of AI technologies organically in future and (iii) the elimination/neutralization requirement (as opposed to mere disclosure) proposed by the SEC.

If adopted as proposed, all current RIAs would be required to implement policies and procedures, at a minimum, to evaluate their firms to determine if any covered technologies exist and if they result in any conflicts of interest, including related compliance tasks with respect to recordkeeping and annual review.

Investment advisers should already be cognizant of any practices, including the use of AI or PDA applications, that present material conflicts with their clients and investors.

All advisers (including exempt advisers) are subject to the anti-fraud provisions of Section 206 of the Advisers Act, as well as anti-fraud provisions under the U.S. Securities Act of 1933 and the 1934 Act. [7] The SEC may currently take direct action against all advisers (registered or exempt) engaged in fraudulent practices vis-à-vis clients and investors in pooled investment vehicles pursuant to Rule 206(4)-8 under the Advisers Act. [8] Moreover, the SEC in 2019 crystalized its view that all advisers have a fiduciary duty of care and loyalty to their clients and, indirectly, their investors, not to place an adviser's interests above its client's interests.

Conclusion

Although the SEC proposed the rule on a party-line 3-2 vote, the proposal represents the SEC's first major step to regulate the use and potential abuse of AI in the securities industry at a time when AI's cultural, social and economic impact is unknown and the subject of considerable speculation and contention.

The proposal follows over a half-dozen proposals issued in 2022 and the first half of 2023 under SEC chair Gary Gensler. These now include proposed rules on (i) cybersecurity practices, (ii) new restrictions and regulations on private funds, (iii) a new framework for disclosures on environmental, social and governance (ESG) standards, (iv) additional changes to Form PF proposed jointly with the U.S. Commodity Futures Trading Commission (beyond the final rule adopted in May 2023 making Form PF revisions that will affect large private funds and hedge funds), (v) a new 'outsourcing rule' designed to provide diligence to investors on a firm's third-party service providers

7 The SEC is proposing the new rule not under Section 206, but rather under Section 211(h), added to the Advisers Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which authorizes the SEC to promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors. The SEC also relied on Section 211(h) with the proposed introduction of three additional rules affecting private funds in February 2022.

8 Broker-dealers are subject to an additional layer of regulations, including Regulation Best Interest (or "Reg BI"), adopted by the SEC in 2019 to enhance the quality of broker-dealer recommendations to retail customers and reduce the harms to retail investors caused by conflicts of interest.

and (vi) broadening the custody rule into a new 'safeguarding rule.' In addition, RIAs are still adjusting to the new marketing rule, which took full effect in November 2022.

We continue to monitor ongoing SEC rulemaking, and we will provide updates as additional proposals emerge and/or the SEC adopts final rules regarding the safeguarding rule and other proposals.

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