CADWALADER

Cabinet News and Views

Informed analysis for the financial services industry

SEC Proposes Rule to Address Use of AI By Broker-Dealers and Investment Advisors

By Mercedes Kelley Tunstall
Partner | Financial Regulation

Spurred by the prevalent use of predictive data analytics by broker-dealers and investment advisers to direct their recommendations to investors and to ensure that investor interests remain paramount, the Securities and Exchange Commission ("SEC") announced yesterday that it has proposed a rule that purports to provide a means by which firms may "evaluate and determine whether its use of certain technologies in investor interactions involves a conflict of interest that results in the firm's interests being placed ahead of investors' interests." Should such a conflict of interest be identified, then "firms would be required to eliminate, or neutralize the effect of, any such conflicts."

The commentary to the proposed rule explains that the SEC's use of the term "predictive data analytics" is intended to include artificial intelligence ("AI") solutions as well as technology solutions that may not technically include AI, and all such technologies are defined under the proposed rule as a "covered technology." Expanding on the kinds of technologies intended to be covered by the rule, Chair Gary Gensler admits that the predictive data analytics used by streaming platforms identify him as a "rom-com" enthusiast and analogizes that result to the use of such predictive data analytics in interactions with investors. He emphasized the need for proper controls to be placed on such technologies by explaining, "if the robo-adviser or the brokerage app is using a function… to optimize for its own interests" is it then communicating with investors because it will be good for their investment decisions, "or because it might benefit the firm's revenues, profits, or other interests"?

Offering a pointed criticism on the "covered technology" definition, Commissioner Hester Peirce points out that the breadth of the definition is so broad that it could include "spreadsheets, commonly used software, math formulas, statistical tools, and AI trained on all manner of datasets," subjecting even simple Excel documents potentially to compliance with the rule.

Other than the broad definition of technologies subject to the proposed rule, the rest of the proposed rule is technology-agnostic and instead focuses upon defining results from the use of covered technologies that may be problematic for investors because a conflict of interest is created. Further, the proposed rule requires that firms establish policies and procedures to ensure that each use of a covered technology does not cause a conflict of interest and to establish protocols for ameliorating conflicts should they be identified.

Comments on the proposed rule are due 60 days from when the proposed rule is published in the Federal Register.
