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Investment Funds & Private Capital Market Insights

SEC Rulemaking: Proposed Rule on Use of Predictive Analytics, AI and Other Technologies

3-MINUTE READ

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On July 26, 2023, the SEC proposed new rules applicable to registered investment advisers and broker-dealers ([available here](#)) intended to address certain conflicts of interest relating to the use of predictive analytics, artificial intelligence, and other covered technologies in interactions with clients.

Why it matters: The rule proposal joins a substantial slate of pending and in-process SEC rules that, if adopted, are expected to significantly increase compliance burdens and costs for registered investment advisers, including:

- [Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information](#);
- [Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies](#);
- [Safeguarding Advisory Client Assets](#);
- [Outsourcing by Investment Advisers](#);
- [Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices](#); and
- [Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews](#).

On its face the rule is intended to curb the use of technologies that have the effect of placing an adviser's interests ahead of those of its clients—for example, algorithmic recommendation or trading models that are biased towards investments that are more profitable to regulated firm. However, as Commissioners Hester Pierce and Mark Uyeda pointed out in statements objecting to the rule, the broad scope of the proposal picks up commonly-used technology applications and may result in firms opting to forego certain technologies or being subject to unnecessary compliance requirements even where any perceived conflicts are unlikely.

It is unclear what the implications may be from the SEC's split opinion on whether technology can be held to the same regulatory standard as client investment advice generally.

Key takeaways:

- Registered investment advisers would be required to identify the use of “covered technology” in “investor interactions.”
- The relevant terms are broadly defined, and could encompass commonly-used technology applications that are not likely to pose conflicts of interest:
 - “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 behaviors or outcomes.
 - “investor interaction” means 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; except that the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support [emphasis added].
- For any such “covered technology,” advisers would be required to:
 - determine whether its use poses any conflict(s) of interest that places the adviser’s interests ahead of those of its clients.
 - eliminate or neutralize such conflicts of interest—under the proposal, disclosure is not an option for addressing the use of a “covered technology” or potential conflicts of interest.
 - adopt policies and procedures designed to prevent violations of the rule, undertake annual compliance reviews and maintain books and records relating thereto.
- The proposal included numerous questions/requests for comments and there will likely be significant industry discussion around the proposal.

The public comment period for the proposal is sixty (60) days from the date of publication in the Federal Register.

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