October 1, 2021

Via Electronic Filing

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Request for Information and Comments on Investment Adviser Digital Engagement Practices and the Use of Technology to Develop and Provide Investment Advice

Dear Ms. Countryman:

The Investment Adviser Association (**IAA**)[1] appreciates the opportunity to comment on the August 27th request for information on the use of digital engagement practices (**DEPs**) and technology to provide investment advice by investment advisers.[2] We appreciate the Commission's efforts in seeking to better understand the market practices associated with the use of DEPs and for providing a forum for market participants, including retail investors, to share their perspectives. We provide our initial views in this letter regarding certain aspects of the Request as they apply to investment advisers.[3]

Given the enormous breadth of the Request and the amount of information being asked for, however, we are concerned that the very short comment period in this instance is insufficient for commenters, including the IAA, to provide extensive and thoughtful responses. In light of the importance and complexity of the issues involved, the IAA respectfully requests that the

[1] The IAA is the leading organization dedicated to advancing the interests of investment advisers. For more than 80 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA's member firms manage more than $25 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[2] *Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice* (**Request**), 86 FR 49067 (Sept. 1, 2021), available at https://www.govinfo.gov/content/pkg/FR-2021-09-01/pdf/2021-18901.pdf.

[3] We look forward to continuing our engagement with the Commission and its staff as we further consider these and the many other important questions and issues raised in the Request.

Commission extend the comment period to allow more time for considered public input.[4] The IAA believes that technology has enormous potential to benefit retail investors and that it is critical for the SEC to proceed cautiously with the goal of preserving and facilitating further exploration and implementation of innovative beneficial DEPs and use of technology.

We begin by suggesting several general principles and recommendations for the Commission to consider as it assesses the use of DEPs and technology by investment advisers. We also broadly discuss how existing principles-based regulations under the Investment Advisers Act of 1940 (**Advisers Act**) along with bedrock principles of the investment adviser fiduciary duty provide the SEC and its staff the tools necessary to achieve the Commission's investor protection goals. Specifically, we provide our views regarding how this robust and remarkably adaptable regulatory framework applies to the use of technology by advisers to provide investment advice to investors, including retail investors that engage with advisers through digital platforms. Finally, we discuss application of this regulatory regime to the use of DEPs by investment advisers to enhance their engagements with retail investors.

I. Overview

The Request describes a wide variety of DEPs employed by firms when interacting with investors though digital platforms. The advent, growth, and use of digital platforms for investing have provided more opportunities for investors to meet important financial goals, including investing for retirement, home ownership, or education. As noted in the Request, certain DEPs have also been credited with making investment platforms more accessible to retail investors, particularly younger investors, and assisting in the development and implementation of beneficial investor education tools and resources. Some advisers also use various analytical and technological tools to develop and provide investment advice, including through online platforms or as part of enhancing their in-person investment advisory services. Investment advisers may also engage in DEPs to develop and provide investor education and related tools. Indeed, given the nature of modern financial services, it is our belief that a very large number of advisers have some measure of digital engagement with clients.

A. General principles and recommendations to consider in assessing the use of DEPs and technology by investment advisers

We appreciate the SEC's concerns stemming from the market volatility that occurred last year in connection with engagement practices of certain online trading platforms. Reportedly, these platforms were using systems that appeared to encourage and incentivize continuous and repeat trading by investors in certain high-profile stocks (so-called "meme" stocks and gamification). These practices do not, however, reflect how investment advisers typically use DEPs with their clients. Thus, as the Commission assesses the use of DEPs and technology in

[4] We suggest that the Commission provide, at a minimum, an additional 60 days for public input.

financial services more broadly, we ask that you keep the following general principles and recommendations in mind with respect to investment advisers:

- **Consider the overarching adviser fiduciary duty:** Investment advisers are fiduciaries to their clients. Advisers have an affirmative duty of care, loyalty, honesty and utmost good faith to act in the best interest of investors when providing investment advice. As fiduciaries, advisers have a special relationship of trust and confidence with their clients, acting in their clients' best interest throughout and with respect to all aspects of their advisory relationship. This strong principles-based standard remains at the heart of an investment adviser's relationship with its clients, and applies to both the adviser's general activities with its clients as well as to client engagements conducted through DEPs.

- **Foster responsible innovation through engagement and technology-neutral principles-based regulations:** Technology is evolving rapidly and investors increasingly want to engage with their myriad service providers using digital tools. The SEC should continue to support and facilitate exploration and implementation of innovative DEPs and use of technology for the benefit of investors, consistent with investor protection.[5]

  Moreover, the Commission's regulations and enforcement efforts should be technology neutral and not based solely on the presence, absence, or type of technology used in connection with providing investment advice. Regulations also should facilitate the ability of firms to continue to develop and innovate in this area, including by developing new ways of communicating with and onboarding investors. For example, as the Commission has recognized, the use of technology by digital advisers to offer investment services does not change the fiduciary nature of their advice or the regulatory environment in which they operate. We strongly recommend that you continue to reaffirm this important principle.

- **In considering regulatory objectives, balance any assessment of risks against potential benefits for investors:** We recommend that the assessment of potential risks and concerns that may be associated with the use by advisers of technology to provide investment advice or DEPs should also include a fair and balanced assessment of the potential benefits to investors of emerging digital-based advice and DEPs.[6] We also submit that the regulatory objectives relating to these practices are

[5] In particular, the SEC's Strategic Hub for Innovation and Technology (FinHub) is a model for agency engagement in technology innovation. The IAA and our members look forward to continuing our open dialogue with the Commission in general and FinHub and the staff of the Division of Investment Management in particular to help foster responsible innovation.

[6] While the Request acknowledges the potential benefits of technology to provide investment advice and DEPs, the majority of the questions appear to focus primarily on the related risk and concerns. We strongly encourage the SEC and its staff to seek and consider additional input regarding the emerging potential of technology and DEPs to benefit investors.

not inherently any different than those associated with the more traditional ways advisers engage with investors. For example, advisers are required to have adequate controls in place to obtain complete and accurate information from clients to enable them to provide advice in their clients' best interest. This obligation remains the same, regardless of how advisers engage with clients.

- **Carefully assess emerging technology and market practices using all available data:** To the extent that today's ever-increasing use of evolving technology, including DEPs, may represent a transformative change in how financial services are delivered, it is imperative that the Commission proceed cautiously and deliberately prior to any potential regulatory action by considering all available data. For example, we encourage the SEC, in addition to extending the comment period, to conduct comprehensive investor testing regarding, among other things, the impact of technology on financial services, particularly with respect to determining how investors respond to the various ways of engaging advisers, including through DEPs. We also encourage the Commission to study investor preferences relating to electronic disclosures.

  The IAA also encourages and supports ongoing information collection by SEC staff as a means by which the Commission can both learn about emerging trends and business practices and communicate its priorities and observations to the industry.[7] We also support other informal engagement with market participants including, for example, through investor town hall meetings and roundtable discussions.[8] Publication of the SEC's compliance examination priorities and other informational guidance that maintains constructive lines of communication with advisers can also be a productive way for the SEC to share observations and compliance practices relating to emerging DEPs and technology.[9]

[7] The Request also seeks input on whether Form ADV should be amended to collect information about the types of technology that advisers use to develop and provide investment advice as well as efforts by advisers to monitor outputs of such technology. In our view, it is not necessary for the Commission to amend Form ADV to collect this information. For example, we note that the Division of Examinations engages in informal information gathering from registrants through examinations and other means. Indeed, the stated pillars of the SEC's compliance examinations program include monitoring risk and informing policy decisions by the Commission. Moreover, we also understand that the Analytics Office in the SEC's Division of Investment Management provides the Division and Commission with practical reviews and actionable analyses of the asset management industry by, among other things, "gathering and analyzing operational information directly from participants in the asset management industry."

[8] The SEC hosted a forum in 2016 to discuss innovation in the financial services industry. We suggest that the SEC or its staff consider convening a similar forum to discuss the important questions raised in the Request. *See SEC Announces Agenda, Panelists for Nov. 14 Fintech Forum*, available at https://www.sec.gov/news/pressrelease/2016-234.html.

[9] The SEC's examination staff periodically publishes Risk Alerts intended to raise awareness of emerging compliance and industry risks. For example, the SEC's many Cybersecurity Risks Alerts and its Cybersecurity and Resiliency Observations have been extremely beneficial to firms as they continuously assess and improve their cybersecurity programs in response to emerging threats.

- **Seek broader input prior to issuing guidance or interpretations:** We strongly recommend that any guidance or interpretations published by the Commission or its staff be subject to public notice and an opportunity for comment to ensure that such guidance is helpful and operationally feasible for the industry, and that it does not effectively impose substantive new requirements, either explicitly or through changed examination expectations.

- **Broaden assessment of disclosure issues relating to DEPs to include the potential for technology to improve required disclosures:** While not directly related to digital advice or the use of DEPs, the SEC should broaden its consideration of the use of technology to include the potential for technology to improve required disclosures and regulatory documents provided to investors. The IAA strongly supports modernization of the SEC's framework for delivery of required information by facilitating electronic or digital delivery of client communications as the default option.[10]

B. Address the adviser practices and concerns discussed in the Request within the existing principles-based framework of the Advisers Act and the existing rules and regulations thereunder

The Advisers Act regulatory framework has proven to be remarkably flexible and adaptable as technology has evolved and new market practices have developed. The IAA believes that the practices and concerns discussed in the Request with respect to digital advice or the use of DEPs by advisers are well addressed within this existing framework and that no further regulatory action by the SEC is necessary.[11] Indeed, the Commission has recognized that the principles-based Advisers Act framework is well suited to keep pace with evolving technology and market practices.[12]

Advisers should of course be expected to manage the risks associated with all aspects of their business, including with respect to the provision of digital advice and the use of DEPs. In

[10] *See* Letter from Karen Barr to SEC Chair Gary Gensler on the Regulation of Registered Investment Advisers (May 17, 2021), available at https://www.investmentadviser.org/publications/comment-letters/comment-letter-may-17-2021. As discussed above, we recommend that, at a minimum, the Commission conduct investor testing around electronic disclosures and the use of DEPs in general as it considers changes in this area.

[11] Where appropriate, the IAA has recommended and generally supported efforts by the Commission to re-evaluate existing regulations on a regular basis to ensure they remain effective, efficient, tailored, and appropriately targeted to protecting investors and the integrity of our markets and fostering capital formation. For example, as discussed below, we generally supported the SEC's recently adopted Marketing Rule that we believe will significantly improve the information delivered by advisers to their current and potential clients about their advisory services, including through the use of emerging DEPs and other technology.

[12] For example, in adopting the new Marketing Rule, the Commission explicitly stated that the "rule contains principles-based provisions designed to accommodate the continual evolution and interplay of technology and advice." *See Investment Adviser Marketing*, 86 FR 13024 (Mar. 5, 2021), available at https://www.federalregister.gov/documents/2021/03/05/2020-28868/investment-adviser-marketing.

this regard, as with all risk controls advisers must adopt, we ask that the SEC and its staff support financial firms taking a reasonable, risk-based approach when assessing, implementing, and using DEPs to communicate with investors or using technology to provide investment advice. The regulatory objectives and requirements relating to these practices are not inherently any different from those associated with the more traditional ways advisers engage with investors.

The key elements of the Advisers Act regulatory framework include:

- Overarching principles that impose on investment advisers an affirmative fiduciary duty of care, loyalty, honesty and utmost good faith to act in the best interests of investors when providing investment advice. As fiduciaries, advisers have a special relationship of trust and confidence with their clients, and must act in their clients' best interest throughout and with respect to all aspects of their advisory relationship, whether or not they use technology in connection with their client relationships. The Commission's recent fiduciary duty interpretation reaffirmed these principles.[13]

- The anti-fraud provisions of the Advisers Act apply to all communications made by all types of investment advisers and flatly prohibit fraudulent, deceptive or manipulative practices, including by advisers providing digital advice or using DEPs.

- Rules adopted by the SEC to refine these principles to further protect investors and promote a high standard of conduct.

We discuss our views regarding how this regulatory framework addresses the use by investment advisers of technology to provide investment advice and DEPs in greater detail below.

II. Regulation of Investment Adviser Use of Technology to Provide Investment Advice

A. Digital Advice

We commend the Commission for seeking to better understand the nature of analytical tools and other technology used by investment advisers to develop and provide investment advice to clients.[14] The Request notes that digital advisers may provide advice under a variety of

[13] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 84 FR 33669 (July 12, 2019) (**Fiduciary Interpretation**), available at https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

[14] We refer to advisers that use technology to develop and provide investment advice as "digital advisers" in this letter. However, we note that these advisers are no different than more traditional types of investment advisers in that, while certain business practices may differ, all SEC-registered investment advisers are subject to the same principles-based fiduciary and regulatory obligations.

business models, including with respect to the level of reliance on the use of algorithms to oversee and manage individual client accounts. The use of technology to provide investment advice has myriad potential benefits for investors. For example, as the Request notes, the use of digital advice has generally lowered the costs and expanded the availability of advisory services for a certain segment of retail clients. Digital advice reaches many individual investors who may not have typically invested or saved for important life events, providing a straightforward and low entry-point path for investment.[15] The services provided by digital advisers are thus an important component in empowering Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth. The Request also notes, however, that the use of technology may present certain risks to investors, particularly retail investors. We provide input in this section regarding the current regulatory framework for the use of technology in providing advice in light of the risks and concerns identified in the Request.

The Commission believes that the provision of advice by these digital advisers "may raise novel issues" when seeking to comply with their regulatory obligations. Specifically, the Request asserts that the use of algorithms to provide investment advice may subject digital advisers and their clients to certain risks, including: (i) ensuring that the algorithms are designed and working as intended; (ii) the ability of advisers to obtain complete and accurate information from clients in order to provide advice that is suitable; and (iii) failing to disclose pertinent material facts and potential conflicts of interest. The Request essentially questions whether the specific risks associated with the use of automated algorithms in the provision of digital advice warrant additional regulatory action to protect investors. As discussed below, we believe that these concerns are not inherently unique to digital or algorithm-based advice and are addressed well by the current regulatory framework for investment advisers.

Notwithstanding their different business models, all of these advisers continue to operate effectively as fiduciaries within the flexible, principles-based regulatory structure of the Advisers Act. They simply offer a modernized and accessible approach to traditional fiduciary investing. We do not believe that concerns identified in the Request are necessarily unique to digital advice but may exist with respect to advice provided through more traditional means as well. While differing underlying business practices among advisers may call for potentially different controls to address regulatory obligations and risks, all advisers are subject to the same principles-based obligations regardless of the manner in which the advice is developed and provided to investors. An adviser that fails to meet its regulatory obligations with respect to any of these concerns will be treated by the SEC and its staff as violating the provisions of the Advisers Act.

The Commission's Fiduciary Interpretation reaffirmed that digital advisers are subject to the Advisers Act fiduciary duty, citing to earlier staff guidance that also addressed how digital

[15] This past year digital advisers have added nearly three million new clients as the fastest growing area of new investment adviser clients. *See IAA Investment Adviser Industry Snapshot 2021*, available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/industry-snapshots/Investment_Adviser_Industry_Snapshot_2021.pdf.

advisers can meet their suitability, disclosure, and other compliance obligations under the Advisers Act.[16] We understand that advisers generally support the suggested compliance practices in the 2017 Guidance and have considered and incorporated applicable practices into their overall compliance programs. We agree that the 2017 Guidance presents a reasonable application of the existing rules and regulations governing all advisers and their conduct and support the Commission's and staff's reaffirming it. While the 2017 Guidance focuses primarily on digital advisers, we believe the practices suggested in that guidance may also be helpful for advisers more generally. For example, advisers may consider and have similar procedures regarding DEPs or technology more broadly, including artificial intelligence/machine learning (**AI/ML**) tools. We do not think that further rulemaking or guidance is necessary. We share some thoughts on controls for digital advice below.

Testing and Monitoring of Algorithms

The Request generally seeks input regarding the extent to which advisers oversee, monitor, and test the use of algorithms when providing investment advice. As suggested in the 2017 Guidance, advisers already should consider adopting and implementing written policies and procedures addressing, for example, the development, testing, and backtesting of the algorithmic code and the post-implementation monitoring of its performance. To the extent applicable, this may include implementing procedures designed to ensure that: (i) the code is adequately tested before and periodically[17] after it is integrated into the digital advice platform; and/or (ii) the code performs as represented, and any modifications to the code would not adversely affect client accounts.

As suggested in the 2017 Guidance, advisers could also consider, to the extent applicable, having risk-based written policies and procedures tailored to their business, that address: (i) the appropriate oversight of any third party that develops, owns, or manages the algorithmic code or software modules utilized by the adviser; (ii) the prevention and detection of, and response to, cybersecurity threats;[18] (iii) the use of social and other forms of electronic media in connection with the marketing of advisory services *(e.g.*, websites, compensation of bloggers to publicize services, "refer-a-friend" programs); and (iv) the protection of client accounts.[19] Advisers should also have plans in place with respect to key advisory systems. Specifically, the fiduciary duty

[16] *See* Robo-Advisers, IM Guidance Update No. 2017-02 (Feb. 2017) (**2017 Guidance**), available at https://www.sec.gov/investment/im-guidance-2017-02.pdf.

[17] How often advisers test or monitor certain technology systems depends largely on an adviser's own risk assessment of the particular technology and its potential to harm clients. For example, systems relating to daily trading (especially during market volatility) may warrant more frequent monitoring, whereas other systems relating to long-term asset allocations or targets may require less monitoring.

[18] Regulation S-P and Regulation S-ID also, among other things, require advisers to protect individual clients' nonpublic personal information and to disclose certain information about their privacy policies and practices. Advisers are also required to develop and implement a written identity theft prevention program designed to detect, prevent, and mitigate identity theft in connection with certain existing accounts or the opening of new accounts.

[19] *See* Rule 206(4)-2 (Custody Rule).

requires advisers to take necessary steps "to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services."[20]

Obtaining Client Information to Provide Suitable Advice

Under the fiduciary duty, advisers have a duty of care to provide investment advice that is in the best interest of the client, based on a reasonable understanding of the client's objectives, including financial situation. The Request cites various potential concerns regarding the ability of digital advisers to obtain and clarify information from clients to provide suitable advice. All advisers, including those that provide digital advice, are required to have procedures and controls in place to ensure that suitable advice is being provided at all times. The compliance program rule (**Compliance Rule**)[21] requires advisers, among other things, to adopt and implement policies and procedures that are reasonably designed to address an adviser's obligations regarding the provision of suitable advice. The Fiduciary Interpretation reaffirmed that with respect to retail clients, this generally means advisers must have a process in place to develop a reasonable understanding of a client's objectives by, at a minimum, making a reasonable inquiry into the client's financial situation and financial goals (*i.e.*, developing a client's "investment profile").

The Request cites concerns about the ability of digital advisers to obtain "clarifying information where client questionnaire responses seem conflicting or address risk tolerance levels based on client reaction to stressed market conditions." We note, however, that the use of questionnaires is a common means by which all advisers get information from their clients. Digital advisers, like all advisers, may use various methods to address inconsistent or unclear client responses, for example by implementing manual or electronic systems to flag certain responses for additional follow up. Digital advisers may also utilize certain design features on their online platforms (*e.g.*, pop-up or hover boxes) to provide additional clarification examples to clients that could elicit more accurate responses.

The Request also cites concerns associated with limited, if any, direct interaction between the client and the adviser's personnel, including with respect to the ability to discuss and refine an algorithm-generated investment plan, particularly during market volatility. We do not believe that these concerns are unique to digital advisers. In fact, we note that some advisers may use electronic or other digital tools to be responsive to clients during extreme market conditions. For example, digital advisers may offer client services on their online portals or other applications,

[20] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Rel. No. 2204 (Dec. 17, 2003). The Request seeks input regarding how advisers using digital platforms address operational or cybersecurity risks, such as a loss of internet service or data. Digital advisers, like all advisers, have fiduciary and regulatory obligations to take steps (*e.g.*, business continuity planning) to protect clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after a disaster, death of key personnel, or other interruption of the business. Advisers should also consider how to address third-party service providers in connection with their planning. Moreover, Rule 204-2 (Recordkeeping) requires advisers that maintain records in electronic formats to establish procedures to safeguard the records from destruction or loss.

[21] *See* Rule 206(4)-7.

including online access to important information and resources at all hours of the day, which could help an adviser continue to be accessible to its clients during market dislocations.

Providing Suitable Advice

The Commission also expresses concerns regarding whether an automated algorithm may produce investment advice for a particular client that is inconsistent with the client's investment strategy either through a design flaw or reliance on incomplete information about the client that depends on limited input data. According to the Request, this reliance may also result in a failure to detect changes in clients' circumstances that may warrant a change in investment strategy. The Request further asserts that the quality of the investment advice may depend on an algorithm that may not be adequately monitored by human personnel.[22] The adviser's duty of care requires an adviser to provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship. Accordingly, digital advisers, like all advisers, should have procedures and controls in place reasonably designed to ensure that suitable advice is being provided at all times. All advisers, including digital advisers, are also obligated to have a process in place to ensure that they maintain their understanding of the client's investment profile and adjust their advice accordingly to reflect any changed circumstances.[23]

Disclosure

The Request expresses concerns regarding whether digital advice may present certain unique risks or conflicts of interest that can be disclosed effectively. An adviser's duty of loyalty requires that it make full and fair disclosure of all material facts relating to the advisory relationship and eliminate or make full and fair disclosure of all conflicts of interest that might incline it to render advice that is not disinterested. The disclosure must be such that a client can provide informed consent to the conflict. This duty applies equally to all advisers, regardless of the means through which they interact with their clients.

The 2017 Guidance is helpful in this regard. It suggests that advisers consider disclosing, for example, a general description of the algorithmic functions used to manage accounts including any assumptions or limitations. Other disclosures could include, if applicable, how the algorithm might rebalance accounts in response to certain market conditions, circumstances that may warrant the adviser to override the algorithm (*e.g.*, defensive measures taken in stressed market conditions, the degree of human involvement in oversight and management of accounts, including the extent to which client accounts are being monitored, and an explanation of how and

[22] *See, e.g.*, In the Matter of AXA Rosenberg Group LLC et al., Advisers Act Rel. No. 3149 (Feb. 3, 2011) (settled action); *see also* In the Matter of Barr M. Rosenberg, Advisers Act Rel. No. 3285 (Sept. 22, 2011) (settled action) (finding, in part, that an adviser breached his fiduciary duty by directing others to keep quiet about, and delay fixing, a material error in computer code underlying his company's automated model).

[23] *See* Fiduciary Interpretation.

when a client should update information previously provided). Advisers should also consider disclosing changes to the algorithmic code that may materially affect their portfolios.

The 2017 Guidance also reminds digital advisers that they should provide disclosures regarding the scope of the advisory services being offered and that it could be misleading for these advisers to imply, for example, that they are providing a comprehensive financial plan when in fact they are only providing investment advice for a targeted goal (*e.g.*, retirement or college) and are not considering the client's broader financial situation. Advisers should also consider, if applicable, disclosing the extent to which advisory personnel are involved in the oversight and management of individual client accounts. While these examples may more typically arise in the context of digital advice, they are not unique to digital advice and, as with more traditional methods of providing investment advice, advisers are obligated to develop appropriate controls.

With respect to conflicts, the 2017 Guidance suggests that digital advisers consider disclosing a description of the involvement of a third party in the development or management of the algorithm being used and any conflicts that may arise, including with respect to compensation arrangements. The Request also identifies other potential conflicts in the area of digital advice, including, for example, whether algorithms may result in clients being invested in assets in which the adviser or its affiliate holds interests or advises separately (*e.g.*, mutual funds and ETFs), and those arising from certain compensation arrangements. These conflicts also are not necessarily unique to digital advisers. They, like all other advisers, must eliminate or fully and fairly disclose these conflicts and they may not let their conflicts taint their advice.

Disclosure is a critical component of the Advisers Act framework. The Commission and its staff have repeatedly noted that disclosures should in fact be effective (*e.g.*, not overly dense, buried or incomprehensible),[24] and they also note, including in the 2017 Guidance, that the timing of disclosure can be important. In this regard, we believe that DEPs can play a significant role in allowing advisers to use innovative design features or presentation to reach clients and ensure that disclosures are effective. The 2017 Guidance also suggests that the use of design features such as pop-up boxes, interactive text (*e.g.*, tooltips), or links to FAQs can be useful.

Effective Compliance Programs

As noted above, the Compliance Rule requires all advisers, including digital advisers, to establish an internal compliance program that addresses the adviser's performance of its

[24] Disclosures should be written in plain English and be understandable by investors. Accordingly, depending on the facts and circumstances and the level of sophistication of the investor, disclosures of complex or technical tools or software programs (*e.g.*, detailed explanations of algorithms or AI/ML) may be overly technical and complicated for a particular investor. Advisers must write material disclosures in a manner that satisfies their regulatory and fiduciary disclosure obligations (*e.g.*, informing clients of the associated risks of the use of DEPs that may adversely affect their investments in a way that clients can understand).

regulatory obligations. The 2017 Guidance reminds digital advisers that, when they develop their risk-based compliance programs, they should be mindful of the unique aspects of algorithm-based investment models, some of which we have discussed above.

Like other risk areas, the extent to which providing digital advice creates or accentuates risks for clients should be addressed through written policies and procedures that are appropriate to the adviser's business and its use of technology or digital practices. In this regard, the Commission appropriately recognizes that some of these risks may also be presented, or be presented differently, for advisers providing investment advice that does not rely upon the use of technology. Moreover, the Request correctly notes that advisers may weigh the risks and benefits differently in determining how to use technology in developing and providing investment advice.

B. The Use of AI/ML in Developing and Providing Investment Advice

Some advisers may use software or models incorporating AI/ML (including deep learning, supervised learning, unsupervised learning, and reinforcement learning) in developing and providing investment advice. The Request observes that certain methods of AI/ML have the potential to assist advisers in better understanding their clients' objectives and enabling them to provide clients with extremely customized advice consistent with those objectives. For example, these tools can be helpful in assessing large amounts of data or in providing clients with more customized trading and investment strategies. These tools may also be used to support human personnel's decision-making in other areas, including with respect to risk management, client identification, and monitoring of client accounts or the performance of specific securities or other investments. The Request notes that many investment advisers also increasingly use third-party service providers to generate investment models (*e.g.*, model portfolios) or strategies, and may use software based on, or otherwise incorporating, AI/ML models.

While the use of this technology has the potential to create significant benefits for investors, the Request notes that it may also amplify certain existing risks, for example with respect to the portfolio management process. We believe that the existing regime under the Compliance Rule is well suited to address these risks. Under the Compliance Rule, advisers must tailor their compliance programs appropriately to the needs and risks of their business. Thus, advisers should approach compliance in the area of AI/ML by, for example, requiring enhanced monitoring of and/or conducting risk-based reviews of those uses of AI/ML that impose greater risk to advisers or their clients. This sort of risk-based control framework is already well established in advisory practice and the adoption of controls, oversight, and testing regarding the use of AI/ML should be no different than in other areas an adviser must address.

C. Rule 3a-4 under the Investment Company Act

Investment advisory programs may rely on Investment Company Act Rule 3a-4 to determine that they are not sponsoring or otherwise operating an investment company.[25] The rule

[25] *See* 17 CFR 270.3a-4.

provides a non-exclusive safe harbor with respect to certain similarly-managed accounts provided that the discretionary account advisory services have certain "characteristics."[26] We believe that Rule 3a-4 should not be viewed as enumerating specific actions that must be taken to rely on the safe harbor, but rather that discretionary advisers should determine whether their program fits the characteristics in the rule. One of the characteristics, for example, is that the sponsor and portfolio manager of the client's account must be reasonably available to the client for consultation. The rule does not specify the manner in which such consultation with clients should occur, and, accordingly, in our view, the rule permits the use of either traditional means (*e.g.*, in-person meetings), or responsive technologies *(e.g.*, chatbots), or indeed other novel ways of interacting with clients.

For example, among other things, Rule 3a-4 also requires that client accounts be managed in accordance with any reasonable restrictions imposed by the client and that clients be given opportunities to modify these restrictions (*e.g.*, by being asked annually). The rule does not, and in our view it should not, require any specific mechanism regarding how the client and the adviser communicate regarding these sorts of reasonable restrictions. As noted in the Request, enhanced technological capabilities and industry practices have made it practicable for sponsors of these programs to satisfy this aspect of the rule through non-traditional means so that each client receives meaningful individualized treatment regarding the management of its account.

We strongly support aligning the expectations of how Rule 3a-4 can be applied to reflect the broad, flexible language already included in the rule with current technological developments that provide enhanced ways of interacting with clients. For example, we recommend that the rule not be applied in a check-the-box manner that focuses more on making sure that each specific element is met. Rather, we believe that the focus should be more on an assessment of the program to ensure that the overall characteristics of the program are more akin to an investment advisory program rather then an investment company (*i.e.*, mutual fund).

III. Application of the Existing Principles-Based Regulatory Regime to the Use of DEPs by Investment Advisers

The use of DEPs and related tools and methods by investment advisers has generally been credited, for example, with providing enhanced engagement with investors and increasing opportunities for investors to meet important financial goals. As noted in the Request, certain DEPs have also been credited with making investment platforms more accessible to retail investors, particularly younger investors, and assisting in the development and implementation of beneficial investor education tools and resources. The Request seeks input regarding the

[26] Specifically, Rule 3a-4 states that any "program under which discretionary investment advisory services are provided to clients that has the following *characteristics* will not be deemed to be an investment company…." (emphasis added) *See* 17 CFR 270.3a-4(a).

regulatory framework governing the variety of ways financial services firms create and employ DEPs when interacting with retail investors through digital platforms.[27]

We recognize that despite the potential for enormous benefits, the use of DEPs is not immune to the abusive or misleading practices by wrongdoers that can harm retail investors. For example, similar to traditional marketing practices, DEPs can also prompt investors to engage in trading activities that may not be consistent with their investment goals or risk tolerance. Moreover, abusive or misleading DEPs can also encourage frequent trading or trading strategies or products that carry additional risk and are not appropriate for certain retail investors. The apparent manipulative practice of "dark patterns" described in the Request is especially disturbing.[28] We believe that the Commission should bring the full weight of its enforcement authority to bear against DEPs that are determined to be abusive, misleading, or manipulative. Such practices would clearly violate an adviser's fiduciary duty, the anti-fraud provisions of the Advisers Act, and, depending on the circumstances, other specific Advisers Act rules, such as, for example, the current Advertising Rule and the new Marketing Rule, which we discuss below.

In addition to the above practices, the Request raises concerns about the use of certain DEPs primarily as a means to optimize revenue for the financial professional rather than for the investor, creating a material conflict of interest. As discussed above, the Request also describes various other conflicts that may be associated with the use of DEPs, including for example, relationships with vendors or affiliates that result in compensation based on investor activity. To the extent a DEP results in a material conflict of interest, investment advisers must eliminate the conflict or make full and fair disclosure of the nature and extent of the conflict, including the amount of any compensation the advisers will receive as a result of the conflict, and not allow the conflict to taint the advice given to the client. As we have discussed throughout this letter, the Advisers Act principles-based framework applies to DEPs in the same way that it applies to all investment adviser practices. Below, we address two specific rules under the Advisers Act that have clear applicability to DEPs, the Compliance Rule and the new Marketing Rule.

A. Compliance Rule

Most notably, and as discussed above in connection with digital advice, under the Compliance Rule, advisers must implement and regularly test and improve risk-based policies and controls to prevent violations of the Advisers Act, including the fiduciary duty, the general

[27] Examples of DEPs provided in the Request include social networking tools; games, streaks and other contests with prizes; points, badges, and leaderboards; notifications; celebrations for trading; visual cues; ideas presented at order placement and other curated lists or features; subscriptions and membership tiers; and chatbots. According to the Request, advisers may also use analytical and technological tools and methods to develop, test, and implement DEPs. These tools may employ predictive data analytics and AI/ML models that including deep learning, supervised learning, and unsupervised learning.

[28] As described in the Request, under this practice, user interfaces are knowingly designed to "confuse users, make it difficult for users to express their actual preferences, or manipulate users into taking certain actions."

and specific anti-fraud provisions, and the various rules adopted under the Advisers Act.[29] A critically important aspect of the Compliance Rule is that "[e]ach adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks." We urge the Commission to bear this instruction in mind as it considers the many issues raised in the Request or through comments it receives.

In adopting the Compliance Rule, the Commission specifically stated its expectation that advisers must have controls regarding, among other things:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions.

- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services, and allocates aggregated trades among clients.

- The continued accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.

- Marketing advisory services, including the use of solicitors and social media.

- Safeguards for the privacy protection of client records and information.

Many of these elements will likely be relevant to an adviser's use of DEPs and will thus need to be addressed in the adviser's compliance policies and procedures. Advisers must also review their policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures.[30] We believe that the Compliance Rule has proven to be a robust and effective means to ensure compliance by investment advisers with their regulatory obligations, including with respect to DEPs.

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[29] *See, e.g.*, Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 247 (Dec. 24, 2003), https://www.sec.gov/rules/final/ia-2204.pdf.

[30] *See* Rule 206(4)-7(b) and (c). In addition, the Recordkeeping Rule under the Advisers Act (Rule 204-2(a)(17)(ii)) also requires advisers to maintain "[a]ny records documenting the investment adviser[s'] annual review" of their compliance policies and procedures.

B. New Marketing Rule[31]

The SEC's new Marketing Rule is the result of herculean efforts by the Commission and its staff that included, among other things, accounting for all of the information technology, social media, and marketing practice advancements over more than half a century, working with stakeholders including the IAA to ensure informed public input, and fusing this all into a modern, principles-based, evergreen, workable framework that, when fully implemented, will significantly improve the information delivered by advisers to their current and potential clients about their advisory services. Notably, the SEC specifically designed the Marketing Rule to address evolving marketing practices in light of significant advancements in how advisers use technology, including DEPs, to disseminate information about their advisory services.

The Marketing Rule generally addresses any "direct or indirect"[32] communication an adviser makes to more than one person – regardless of how the communication is disseminated (*i.e.*, communications through DEPs are within scope of the rule's requirements).[33] The new rule also specifically addresses the use of paid or unpaid testimonials or endorsements and third-party ratings and includes highly prescriptive requirements relating to performance advertising. Perhaps most notably, the new Marketing Rule includes the following seven principles-based prohibitions as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, including through the use of DEPs:

i. Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which it was made, not misleading.

ii. Include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.

iii. Include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser.

iv. Discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and

[31] The compliance date for the new Marketing Rule is November 4, 2022. Until then, advisers that do not comply with the new rule must comply with existing Rule 206(4)-1, which governs advisers' advertisements, and Rule 206(4)-3, which governs cash payments for client solicitations.

[32] A communication distributed by an agent or intermediary on behalf of an adviser would generally be considered an "advertisement" of the adviser.

[33] This includes oral or written communications made through emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, and blogs.

balanced treatment of any material risks or material limitations associated with the potential benefits.

v. Include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced.

vi. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.

vii. Otherwise be materially misleading.

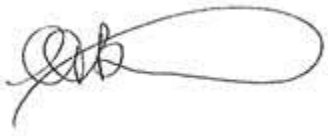
Applying the general prohibitions of the new Marketing Rule is a "facts and circumstances" analysis, which means that an adviser should consider the sophistication of the target audience, including whether an investor is a retail investor. Each of these prohibitions applies to all marketing communications, including through the use of DEPs or other types of technology. Implementing the new Marketing Rule requires advisers to assess and update policies and procedures with respect to their marketing practices.

In our view, the new Marketing Rule is extremely well suited to address the Commission's concerns with how investment advisers use DEPs and, when combined with the Advisers Act fiduciary duty and anti-fraud provisions, the Compliance Rule, and other Advisers Act requirements, is part of a robust regulatory framework that is strongly investor protective. For the reasons discussed above, we do not believe that any additional regulation in this area is warranted.

* * * *

The Request raises many important questions that we continue to consider carefully and the IAA looks forward to engaging with the Commission and its staff to provide additional feedback. In the meantime, please do not hesitate to contact the undersigned or Associate General Counsel Sanjay Lamba at [redacted] if we can be of further assistance

Respectfully,



Gail C. Bernstein
General Counsel

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison Herren Lee, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
Sarah ten Siethoff, Acting Director, Division of Investment Management