

October 10, 2023

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-12-23, Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers

Dear Secretary Countryman,

On behalf of the undersigned organizations, we are writing to express our strong support for the Commission's above-captioned proposal¹ to ensure that financial firms do not use technology in ways that put firms' interests ahead of investors' interests.

Firms are increasingly incorporating technology into their interactions with customers and clients, including through digital trading platforms/apps and advisory programs. While this trend can benefit investors by increasing efficiencies and facilitating broader market access, firms may also use technology in ways that place firms' interests ahead of investors' interests.

Specifically, firms may use manipulative digital engagement practices (DEPs), predictive data analytics (PDAs), and other advanced technologies to influence investors to:

- enroll in products or services that financially benefit the firm but that are not consistent with investors' investment goals or risk tolerance;
- encourage investors to enter into more frequent trades or employ riskier trading strategies, such as engaging in margin or options trading, that increase the firm's profits at investors' expense; or
- inappropriately steer investors toward complex and risky securities products inconsistent with investors' investment objectives or risk profiles that result in harm to investors but that financially benefit the firm.

When firms use technology in this way, they can quickly harm many investors in significant ways. Existing regulatory protections fail to prevent these harms from occurring.

In response, the Commission has proposed a regulatory framework for addressing the conflicts of interest that can arise in technology-driven interactions between financial firms and investors. If enacted, this framework would help to prevent firms from using advanced technology to take advantage of investors and would provide durable protections for investors as new technologies are developed and deployed. Importantly, the proposal rests on the well-grounded conclusion that disclosure of complex conflicts, including those associated with advanced technology, is

¹ Proposed Rule, *Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers*, Release Nos. 34-97990; IA-6353 (July 26, 2023), <https://bit.ly/45tbNM1> ["Proposing Release"].

highly unlikely to address the potential risks and harms that investors face. Accordingly, we agree that firms should be required to eliminate or neutralize the effect of technology-driven conflicts of interest that place a firm's or its financial professionals' interests ahead of investors' interests, as the Commission has proposed in this rulemaking.

1. Background on How Firms Use Advanced Technology to Place Their Own Interests Ahead of Investors' Interests.

Firms are increasingly using advanced technology to influence investors to behave in ways that benefit firms' bottom lines, even when it undermines investors' financial security. This includes using behavioral prompts, differential marketing, game-like features, and other design elements or features designed to engage and influence retail investors in particular ways. For example, firms may use behavioral prompts or nudges in ways that exploit common psychological biases or tendencies in investors and lead investors to make suboptimal decisions.

Firms may design their choice architecture to appear to give investors choice about their options, while effectively constraining investors' ability to make decisions freely. For example, firms may use "dark patterns,"² that manipulate, obscure, subvert, or impair consumer autonomy, decision-making, or choice, ensuring that investors act in ways that are financially optimal for the firm, irrespective of the harmful outcomes investors experience.

In addition, firms may use game-like features, such as points, rewards, badges, leaderboards, interactive interfaces, celebrations, visual cues, push notifications, chat bots, and other methods to encourage users to engage with the firm's app in particular ways.³ The more investors engage, the more they trade, and the more money firms make. Research confirms that trading is hazardous to investors' wealth and health.⁴ Firms may also design their user interface to encourage investors to trade particular securities or engage in particular strategies, such as options or margin, even if they are not appropriate for these investors.

Firms also may collect and analyze investor data to determine what features are likely to prompt investors to take particular actions that would be more remunerative to the firm. Then, they design their user interface to target investors with those features. With specific data about specific investors, firms may be able to tailor their user designs and choice architecture to make

² See, e.g., NASAA, *Comment Letter Re: File No. S7-10-21 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* at fn 14 (October 1, 2021), <https://bit.ly/43kXSqc>

³ See, e.g., Sivananth Ramachandran, *Examining Gamification's Power and Influence in the Markets*, InvestmentNews (February 15, 2023), <https://bit.ly/3RJh7Yr>.

⁴ See, e.g., Brad Barber and Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, *Journal of Finance*, Vol. 55, No. 2 (April 2000), <https://bit.ly/3ruBCxe>; Brad Barber et al., *Attention Induced Trading and Returns: Evidence from Robinhood Users*, *Journal of Finance*, Forthcoming (Date Written: October 12, 2021), <https://bit.ly/3Q0lZaf>; Tim de Silva, *What Motivates Retail Options Traders?*, *Traders Magazine* (September 9, 2022), <https://bit.ly/3rCsqak>; Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes With Devastating Results*, *The New York Times* (September 25, 2021), <https://bit.ly/3LMfYeR>.

it more likely that those investors will take particular action.⁵ Many of the features that firms use can take advantage of investors and lead them to make impulsive, irrational investment decisions that increase firm profits while undermining investors' financial security.

Researchers Kyle Langvardt and James Tierney have observed how firms “use behavioral psychology to encourage frequent and often maladaptive trading activity[,]” and “by appealing to impulse rather than deliberation, [trading apps'] features promote patterns of risky trading that may not be in most retail investors' best interests.”⁶ In another article, Tierney observed that “behind-the-scenes technological features can potentially learn what kinds of prompts get us to trade, so we can be offered individual prompts that encourage us to trade even more.”⁷

Moreover, firms may design advisory programs to prefer certain assets that generate more revenue to the firm.⁸ For example, they may populate portfolios with proprietary funds, funds that pay revenue sharing, or cash management vehicles that pay interest to the firm. They may also construct portfolio allocations so as to weight revenue-paying assets to help meet revenue targets, irrespective of whether those assets or their weights are in the best interest of investors. As firms increasingly rely on technology (and third-party providers of technology) to deliver investment-related services,⁹ the risk that these technologies can be used in a biased way increases as well.¹⁰

It would be unreasonable to expect investors, who are by and large technologically and financially unsophisticated, to understand and protect themselves against all of the potential risks associated with firms' use of advanced technology and their related conflicts of interest, given the complexity, opacity, and dynamic nature of these kinds of technology.

2. Existing Regulatory Protections for Investors are Insufficient to Address the Risks and Harms Associated with Firms' Technology-Related Conflicts of Interest

The Commission's existing regulations do not sufficiently protect investors from firms' technology-related conflicts of interest. First, Regulation Best Interest (Reg. BI) only applies to recommendations. To the extent a broker-dealer uses technology to encourage and influence investor behavior without providing a recommendation, Reg. BI would not apply. For instance, if a firm employs DEPs on a trading platform that don't rise to the level of a recommendation but nonetheless encourage investors to trade more frequently or engage in complex, costly, or risky

⁵ James Fallows Tierney, *The SEC's Data Analytics Rules and the “Netflix Problem” in Securities Regulation* (August 27, 2023), <https://bit.ly/3EY8Hoq>.

⁶ Kyle Langvardt and James Fallows Tierney, *On “Confetti Regulation”: The Wrong Way to Regulate Gamified Investing*, *The Yale Law Journal* (January 17, 2022), <https://bit.ly/3rz9Qjc>.

⁷ James Fallows Tierney, *Investment Games*, 72 *Duke Law Journal* 353-446 (2022), <https://bit.ly/3ZCJjhq>.

⁸ See, e.g., Sarah Max, *Schwab's Heavy Cash Allocation Is Costing Its Robo Clients*, *Barron's* (August 13, 2021), <https://bit.ly/3PYT1rf>; Julie Verhage and Dani Burger, *Wealthfront Wants to Make Investing Complicated Again*, *Bloomberg* (May 11, 2018), <https://bit.ly/3S0004X>.

⁹ See, e.g., Tierney, *The SEC's Data Analytics Rules and the “Netflix Problem” in Securities Regulation* at 2; Holly Deaton, *Advisors Struggle with Their Technology — But They Want More*, *RIA Intel* (March 1, 2023), <https://bit.ly/3LM1FH4>.

¹⁰ See, e.g., Michael Kitces, *The Latest In Financial #AdvisorTech*, *Kitces Blog* (September 4, 2023), <https://bit.ly/3F1HFwE>, (section titled, Federal And State Regulators Investigate RIAs' And Broker-Dealers' Use Of AI).

strategies (thus benefiting the firm but potentially harming investors), Reg. BI's obligations wouldn't apply. Yet investors receiving such prompts would still risk being harmed from such activity, just as if a recommendation were made.

Even if the interaction rose to the level of being a recommendation and Reg. BI did apply, its conflict of interest obligation is unlikely to protect investors sufficiently. This is because under Reg. BI, firm-level conflicts of interest can be disclosed rather than mitigated or eliminated. We know that disclosure of complex conflicts of interest is unlikely to protect investors, given that it can be exceedingly challenging, if not impossible, for the vast majority of retail investors to fully understand the nature and extent of complex conflicts of interest or factor them into their decision making. Combining complex conflicts of interest with complex and rapidly evolving technology is likely to make it even more difficult for investors to understand such conflicts and conflict disclosures and protect themselves against potential harms.

Second, while investment advisers are fiduciaries and therefore must, at all times, serve their clients' best interest and not subordinate their clients' interest to their own, with the increasing use of technology, some advisers are using technology in ways that appear to be inconsistent with their fiduciary duty. Moreover, because the Commission has allowed investment advisers to satisfy their duty of loyalty by providing conflict disclosures to conflicts, many advisers engage in harmful conflicts of interest by disclosing conflicts in ways that investors are unlikely to understand or actually consent to. No reasonable investor would consent to advice that puts the adviser's interest ahead of their own.

The potential risks and harms arising from conflicted investment advice are magnified with advisers' use of technology, which has the potential to increase the number of investors who are exposed to such conflicted practices and the speed with which conflicted practices can be deployed. These risks and harms counsel against relying exclusively on a disclosure and consent approach.

3. We Strongly Support the Commission's Proposed Framework

Recognizing these potential risks and investor harms, the Commission has proposed a regulatory framework that would require firms to proactively ensure that they do not use technology in ways that put their interests ahead of investors' interests.

Specifically, the proposed rules would require broker-dealer and investment adviser firms to identify conflicts associated with the use or reasonably foreseeable potential use of certain covered technology in any investor interaction. As part of this process, firms would be required to determine whether any use of technology results in an investor interaction that places the interest of the firm or its financial professionals ahead of investors' interests. Firms would need to eliminate or neutralize the effect of these conflicts such that the interaction no longer places the interests of the firm ahead of the interests of investors. Importantly, the terms "covered technology," "investor interaction," and "conflict of interest" are defined broadly in the proposal in order to capture a wide variety of technology uses, interactions, and conflicts of interest. This approach would help to ensure that the regulatory approach remains evergreen and adaptable to evolving technology and market practices.

The proposal would provide investors with critical protections from conflicts of interest that they do not currently receive. As the proposal states: “the proposed definition [of “investor interaction”] would capture firm communications that may not rise to the level of a recommendation, yet are nonetheless designed to, or have the effect of, guiding or directing investors to take an investment-related action.”¹¹

In addition, the proposal recognizes that, due to the complex nature of advanced technology and associated conflicts of interest, investment advisers “may be unable to rely on disclosure to address their existing conflicts obligations to the extent that the complex nature of the technologies and associated conflicts makes it difficult or impossible for the adviser to accurately determine whether it has designed a disclosure to put its clients in a position to be able to understand and provide informed consent to the conflicts.”¹² By providing a clear framework for advisers to follow that sidesteps these challenges, compliance with the proposed rule could help advisers satisfy their fiduciary duty.

Importantly, the Proposing Release recognizes the limits of disclosure. As the proposal correctly observes, “The scope and frequency of investor interactions with new technologies and the complex, dynamic nature of those technologies may make it difficult for investors to understand or contextualize disclosures of conflicts of interest to the extent that the investors interact with the technologies, with interfaces or communications which feature outputs of the technologies, or with associated persons who make use of outputs of the technologies.”¹³ The proposal correctly recognizes, disclosure in this context “can potentially be too broad and unspecific to be useful to a particular investor, or alternatively could entail too many disclosures to be useful to an investor.”¹⁴ The proposal further observes that, “disclosure alone may not necessarily address negative outcomes when ‘the issue lies in human psychological factors, rather than a lack of information.’”¹⁵ In short, disclosure in the face of psychological manipulation won’t protect investors. An approach that requires firms to eliminate to neutralize the harmful effect of conflicts of interest would protect investors.

Conclusion

The Commission has proposed a strong, pro-investor rule that would help to ensure that firms do not use technology in ways that place firms’ interests ahead of investors’ interests. We strongly support it and urge the Commission to finalize it without undue delay.

Respectfully Submitted,

Americans for Financial Reform Education Fund
Consumer Federation of America
Economic Policy Institute

¹¹ Proposing Release at 53.

¹² *Id.* at 104.

¹³ *Id.* at 176.

¹⁴ *Id.* at 173.

¹⁵ *Id.* at fn 181.