March 26, 2024

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

Re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (File Number S7-12-23); 88 Fed. Reg. 53960 (Aug. 9, 2023)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to provide further comment on the above-captioned Proposed Rule ("Proposal" or "Release").[2] The Proposal would require broker-dealers and investment advisers to eliminate, or neutralize the effects of, certain conflicts of interest associated with their use of technology in their interactions with investors. The Proposal is a necessary measure to ensure that the securities laws keep pace with technological innovations.

Better Markets submits this supplemental comment letter to address the criticisms that have been leveled against the Proposal. Those criticisms include claims that the Proposal is unnecessary because existing rules address conflicts of interest, that the Proposal is flawed because it goes beyond requiring the disclosure of conflicts of interest, and that the Proposal is overbroad because it covers even mundane uses of technology. These criticisms lack merit.

As discussed below, the Proposal is an essential response to the increasing use of artificial intelligence in the securities industry. The use of predictive data analytics allows firms to collect information on customer preferences and trading patterns and then target investors with particularized nudges and cues about trading opportunities.[3] The firms also use digital engagement practices, such as stock leaderboards, push notifications, and lottery-like rewards, that encourage interaction with the firm's trading app.[4] This "gamification" in investing apps "can encourage trading that is excessive or maladaptive."[5] Thus, the Proposal is designed to prevent firms from using technology in a way that benefits the firm but harms investors—

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[1]   Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2]   88 Fed. Reg. 53,960 (Aug. 9, 2023).

[3]   Jill E. Fisch, *GameStop and the Reemergence of the Retail Investor*, 102 B.U. L. REV. 1799, 1855 (2022).

[4]   James Fallows Tierney, *Investment Games*, 72 DUKE L.J. 353, 357 (2022).

[5]   *Id.*

including by leading investors to engage in excessive trading and become addicted to trading, which can destroy their careers, finances, and lives.[6]

<u>The Proposal addresses investor interactions that do not rise to the level of an investment recommendation but that can induce investors to trade excessively</u>

The Proposal addresses the increasing use by broker-dealers and investment advisers of advanced and predictive technologies like artificial intelligence and machine learning that "introduce new conflict-of-interest challenges that . . . are not adequately addressed under the existing regulatory framework."[7] These technologies are "often opaque" yet "pervasive" in the securities industry.[8] The concern is that broker-dealers and investment advisers "will use these technologies in ways that prioritize the interests of the firm over the client."[9]

For example, the problem with saying that the Proposal is unnecessary because existing rules address conflicts of interest is that those rules only cover recommendations. Regulation Best Interest (Reg BI) "requires broker-dealers in making recommendations to have a reasonable basis for believing that a series of recommended transactions—even if in the retail customer's best interest when viewed in isolation—is 'not excessive and is in the retail customer's best interest   . . . and does not place the financial or other interest of the broker . . . ahead of the interest of the retail customer.'"[10] But "absent a 'recommendation,' Reg BI's duties do not apply."[11] And "it is somewhat unnatural to think of most gamification features in terms of recommendations—'calls to action'—to buy, sell, or hold a particular security."[12] Most gamification features "are more naturally thought of as inducements to trade generally."[13] So the Proposal is necessary to eliminate the conflicts that arise when brokers use predictive analytics, digital engagement practices, and gamification in a way that produces de facto recommendations and that induces investors to engage in a series of transactions that are not in their own interest.

These concerns are not theoretical. Two months ago, Robinhood "agreed to pay a $7.5 million fine and overhaul its practices to resolve allegations by Massachusetts' securities regulators that it encouraged inexperienced investors to place risky trades."[14] The case stemmed from a complaint that said Robinhood "used strategies that 'attract and manipulate customers.'"[15]

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[6] Dennis M. Kelleher, Jason Grimes, and Andres Chovil, *Securities-Democratizing Equity Markets With and Without Exploitation: Robinhood, GameStop, Hedge Funds, Gamification, High Frequency Trading, and More*, 44 W. NEW ENG. L. REV. 51, 87 (2022).

[7] James Fallows Tierney, *Algorithmic Conflicts in Financial Advice* (Feb. 8, 202), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4524766, at 2-3.

[8] *Id.* at 3.

[9] *Id.*

[10] Tierney, 72 DUKE L.J. at 431 (quoting 17 C.F.R. § 240.15*l*-1(a)(2)(ii)(C)).

[11] *Id.*

[12] *Id.* at 432.

[13] *Id.*

[14] Nate Raymond, *Robinhood settles Massachusetts regulators' trading case for $7.5 million*, Reuters (Jan. 18, 2024), https://www.reuters.com/legal/transactional/robinhood-settles-massachusetts-regulators-trading-case-75-million-2024-01-18/.

[15] Sean P. Murphy, *Robinhood agrees to pay $7.5 million to settle complaints over its sales practices*, Boston

In other words, broker-dealers that utilize these practices "rely on behavioral psychology to dupe the retail investor into more frequent trading."[16] This problem is not specific to the securities industry. A lawsuit recently filed against the maker of popular dating apps Tinder and Hinge alleges that the apps are really designed to turn users into addicts.[17] According to the lawsuit, the apps' maker employs "'psychologically manipulative features to ensure [users] remain on the app perpetually as paying subscribers.'"[18] The apps "use 'powerful technologies and hidden algorithms' to keep users hooked and continuing to pay."[19] Similarly, sports betting apps use "sophisticated AI, data, and engineering" to "entice[ ] fans to make snap bets, not just on games, but on every play within games."[20] The use of these technologies has "given rise to a surge in young gambling addicts."[21] The "AI-powered odds on every snap," as well as the "tailored push notifications," are "engineered to keep bettors betting."[22] The Proposal is a necessary step to prevent broker-dealers from using predictive data analytics, digital engagement practices, and gamification to similarly turn retail investors into investing addicts.[23]

The Proposal's opponents themselves seemingly recognize that existing rules do not address these issues. In arguing that the Proposal should have only required disclosure of conflicts, they say that the SEC did not explain why disclosure was not "an effective means for addressing potential conflicts of interest even in interactions that do *not* involve a recommendation or actual transaction."[24] We address below why disclosure is not an effective means for addressing the investor interactions at issue in the Proposal, but this claim shows the need for regulation of these investor interactions in the first place. The fact that these investor

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Globe (Jan. 18, 2024), https://www.bostonglobe.com/2024/01/18/business/robinhood-agrees-pay-75-million-settle-complaints-over-its-sales-practices/.

[16]   Justin M. Taylor, *The Perform Storm: A Look at the Robinhood Shutdown and the Shady Security Practices of Payment for Order Flow, Gamification, and Clickwrap Agreements*, 18 U. MASS. L. REV. 242, 254 (2023).

[17]   Bobby Allyn, *Maker of Tinder, Hinge sued over 'addictive' dating apps that put profits over love*, NPR (Feb. 14, 2024), https://www.npr.org/2024/02/14/1231513991/tinder-hinge-match-group-lawsuit#:~:text=Match%20Group%2C%20which%20owns%20dating%20apps%20including%20Tinder,than%20helping%20people%20find%20romantic%20partners.%20Patrick%20Sison%2FAP.

[18]   Jennifer Hassan, Tinder, Hinge 'deliberately turn users into swiping addicts, lawsuit says, Wash. Post (Feb. 19, 2024), https://www.washingtonpost.com/technology/2024/02/19/tinder-hinge-dating-app-lawsuit/.

[19]   *Id.*

[20]   Jon Wertheim, *Technology has fueled a sports betting boom and a spike in problem gambling, addiction therapist warns*, 60 Minutes, CBS News (Feb. 4, 2024), https://www.cbsnews.com/news/technology-fuels-sports-betting-boom-and-problem-gambling-spike-addiction-therapist-warns-60-minutes-transcript/.

[21]   *Id.*

[22]   *Id.*

[23]   *See* Neal F. Newman, *Gamestopped: How Robinhood's GameStop Trading Halt Reveals the Complexities of Retail Investor Protection*, 28 FORDHAM J. CORP. & FIN. L. 395, 403 (2023) (noting that some brokers design their online platforms "with the same dopamine-producing features of social media that trigger addiction or dependency").

[24]   Robinhood, Comment Letter re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (Oct. 10, 2023), https://www.sec.gov/comments/s7-12-23/s71223-271299-654022.pdf, at 13 (emphasis in original).

interactions may not involve what has historically been viewed as a recommendation or transaction is precisely why existing rules are not sufficient.

<u>Disclosure is not an effective means to prevent firms from taking advantage of investors through predictive data analytics, digital engagement practices, and the gamification of investing</u>

As noted above, some say the Proposal should require only that conflicts of interest from the use of predictive data analytics be disclosed and that the SEC failed to demonstrate "how and why disclosure will not work when it has worked well for decades in contexts involving actual conflicts."[25] But the fact is that disclosure has *not* worked well. "There are now many, many studies which tend to indicate that mandated disclosure as a remedy . . . is often ineffective."[26] Not only that, "'mandated disclosure has unintended and undesirable consequences, like driving out better regulation and hurting the people it purports to help.'"[27] Indeed, the 2008 financial crisis "highlighted the limits of a disclosure regime in that in many areas where tragedy struck proper information was available for all to see, yet the disclosure did not prevent disaster."[28]

There are many reasons why a disclosure-based regime is particularly ill-suited to protect retail investors. Retail investors "tend not to read existing disclosures."[29] And retail investors "will not make more informed and rational decisions if they simply ignore disclosures."[30] Retail investors also "typically have reduced time, resources, and capacity to understand and use any disclosed financial information relative to their sophisticated counterparts, meaning even incremental disclosure increases do not necessarily lead to better decision making."[31]

These problems with disclosure-based regimes are exacerbated in the context of firms' use of technology in their investor interactions. "An essential question in any disclosure regime . . . is the capacity of the audience to process and understand the information that is eventually disclosed."[32] The use of technology in finance "presents particularly thorny receptivity problems."[33] "The existence of such problems suggests that fintech disclosures will require a significant amount of 'translation' work aimed at making the disclosures readily accessible and easily understood by the desired audiences."[34] Complex financial disclosures "are simply not intended for the common retail investor."[35] Even "[s]imple disclosure obligations may not be

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25   *Id.* at 12.
26   Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059, 1105 (2011).
27   *Id.* (quoting Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 651 (2011)).
28   *Id.* at 1105-06.
29   Tierney, 72 DUKE L.J. at 427.
30   Chris Mao, *Stealing from the Poor: Regulating Robinhood's Exchange-Traded Options for Retail Investors*, 107 CORNELL L. REV. 323, 343 (2021).
31   *Id.*
32   William Magnuson, *Financial Regulation in the Bitcoin Era*, 23 STAN. J.L. BUS. & FIN. 159, 192 (2018).
33   *Id.*
34   *Id.*
35   Mao, 107 CORNELL L. REV. at 344.

sufficient for machine learning algorithms."[36] As a result, when it comes to the conflicts that arise as a result of firms using technology in their interactions with investors, "disclosure will be an ineffective solution standing alone, and regulators should not rest on that solution."[37]

For these reasons, we disagree with the recommendation of the SEC's Investor Advisory Committee that the SEC should allow firms to disclose the existence of conflicts of interest with respect to their use of some technologies rather than eliminate those conflicts.[38] That approach would leave investors exposed to predatory behavior on the part of firms with greater insight into the technologies that they use to interact with investors and the ability to tailor the disclosures in a way that would prevent investors from protecting their own interests.[39] Disclosures "may be confusingly drafted or ill-timed, causing investors to overlook, misunderstand, or ignore them," especially "when the underlying product or service is complex."[40]

We urge the Commission to consider that "a law that says: 'Don't subordinate your customers' interests to your own' will have more beneficial impact than a law that says: 'Tell customers that you do not have to subordinate your interests to theirs.'"[41] Put another way:

> "It has become a truism on Wall Street that conflicts of interest are unavoidable. In fact, most only seem so, because avoiding them makes it harder to get rich. That's why full disclosure is suddenly so popular: it requires no substantive change. . . . Transparency is well and good, but accuracy and objectivity are even better. Wall Street doesn't have to keep confessing its sins. It just has to stop committing them."[42]

The Commission must retain the Proposal's requirement that firms eliminate or neutralize the conflicts of interest arising from their use of certain technology in their interactions with investors because "disclosure alone seems a frail tool with which to attack the many ills that arise from blatant conflicts of interest in the financial industry."[43]

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[36]   William Magnuson, *Artificial Financial Intelligence*, 10 HARV. BUS. L. REV. 337, 377 (2020).

[37]   Tierney, 72 DUKE L.J. at 427.

[38]   *See* Recommendation of the SEC Investor Advisory Committee's Disclosure Subcommittee Regarding Digital Engagement Practices, https://www.sec.gov/files/20240214-draft-recommendation-use-dep.pdf.

[39]   *See* Lital Helman, *Innovation Funding and the Valley of Death*, 76 SMU L. REV. 263, 292 (2023) (stating that "entrepreneurs inevitably know more than investors about their business, especially when complex technology is involved"); Avery Barber, *Comment: Redefining Fiduciary in the Robot Age: How the Department of Labor's New Definition Will Encourage Robo-Investment Platforms and Remove the Human Element From Investment Advising*, 18 WAKE FOREST J. BUS. & INTELL. Prop. L. 316, 335 (2018) (stating that most investors are "ill-equipped to evaluate the quality of automated investment platforms" and face the risk of "misunderstanding the disclosures and explanation of the business model"); Anita K. Krug, *Investors' Paradox*, 43 J. CORP. L. 245, 268 (2018) (stating that investors may not be able to understand disclosures about complex subjects and may not know what to do with the information regardless).

[40]   Christine Sgarlata Chung, *The Devil You Know: A Survey Examining How Retail Investors Seek Out & Use Financial Information and Investment Advice*, 37 REV. BANKING & FIN. 653, 740 (2018).

[41]   Prentice, 2011 WIS. L. REV. at 1106.

[42]   *Id.* (quoting James Surowiecki, The Talking Cure, New Yorker, Dec. 9, 2002, at 54).

[43]   *Id.*

<u>The Commission should not be persuaded by claims that the Proposal is overbroad</u>

Finally, some claim that the Commission should withdraw the proposal on the ground that it is overbroad.[44] They argue that the rule is not limited to "artificial intelligence, machine learning, complex computational functions, or even computer-based tools."[45] Instead, they say that the rule implicates "innumerable functions and models (*e.g.*, simple excel spreadsheets) that are necessary to support day-to-day operations of" broker-dealers and investment advisers.[46]

This is not the case. The Proposal clarifies that it applies only to 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 in an investor interaction."[47]

So the Proposal is "limited to those technologies that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes."[48] And it is limited to a firm's use of those technologies "in interactions with investors."[49] The Proposal applies to technologies that have the potential to lead to conflicts of interest in investor interactions; it does not cover a firm's use of mundane technologies such as spreadsheets.[50]

As a result, the Proposal "fill[s] an important regulatory gap" by addressing broker-dealers' and investment advisers' use of technology to shape behavior.[51] The Proposal addresses only "certain categories of technology that might pose conflicts of interest" by having "a profound influence on investor behavior and market outcomes."[52] The "concern is with the conflicts arising from use" of the technology,[53] and there is nothing overly broad about requiring that firms that use technological advancements ensure that they do not do so in a way that prioritizes their own interests over the interests of the investors they are supposed to serve.

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[44]   *See, e.g.*, SIFMA, Comment Letter re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (Oct. 10, 2023), https://www.sec.gov/comments/s7-12-23/s71223-271819-655302.pdf, at 30.

[45]   *Id*. at 10.

[46]   *Id.* at 10-11.

[47]   Release at 53,970.

[48]   *Id.* at 53,972.

[49]   *Id.* at 53,974.

[50]   *See* Better Markets, Comment Letter re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (Oct. 10, 2023), https://bettermarkets.org/wp-content/uploads/2023/10/Better_Markets_Comment_Letter_SEC_Conflicts_of_Interest_Predictive_Analytics.pdf, at 10-11.

[51]   Tierney, *Algorithmic Conflicts in Financial Advice*, supra note 7, at 31.

[52]   *Id.* at 22.

[53]   *Id.* at 23.

Conclusion

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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