

Regulatory Alert

Regulatory Insights for Financial Services

August 2023

“Covered Technologies” and Conflicts of Interest: SEC Proposal

KPMG Insight:

- SEC states “these rules would help protect investors from conflicts of interest – and require that, regardless of the technology used, firms meet their obligations not to place their own interests ahead of investors’ interests.”
- Proposed definitions are intentionally broad, with “covered technologies” defined to include predictive data analytic technologies (such as AI and ML) and other technologies “that rely on historical or real-time data, lookup tables, or correlation matrices,” and “investor interaction” defined to include a variety of communications with investors (current and potential) including through advertisements.
- If adopted as proposed, broker-dealers and investment advisers would be required to identify and determine existing and potential conflicts of interest via the use of “covered technologies”, take steps to eliminate or neutralize them, and test for ongoing compliance.
- Note: The SEC proposal helps reiterate federal agency expectations in the use of “covered technologies”. This proposal aligns with an interagency statement on “automated systems” released earlier this year, which broadly applies to software and algorithmic processes, such as AI – with clear regulatory expectations that systems must be developed and deployed in a manner consistent with federal laws (See KPMG Regulatory Alert, [here](#)).

The SEC issues [proposed new rules](#) under the Securities Exchange Act of 1934 (“Exchange Act”) and the Investment Advisers Act of 1940 (“Advisers Act”) that would seek “to eliminate, or neutralize the effect of, conflicts of interest associated with broker-dealers’ or investment advisers’ interactions with investors through the use of technologies that optimize for, predict, guide, forecast, or direct, investment-related behaviors or outcomes.” The SEC also proposes amendments to the Exchange Act and the Advisers Act that would require broker-dealers and investment advisers to “maintain and preserve” books and records in accordance with the proposed rules.

Below are highlights from the proposal.

Scope. The proposed rules would apply:

- To all broker-dealers and investment advisers (together “firms”) registered, or required to be registered, with the SEC.
- When a firm uses “covered technology” in an “investor interaction” as defined in the proposed rule.

Definitions.

Covered Technology	<p>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.</p> <p>Examples include “predictive data analytics-like” technologies such as artificial intelligence (AI), machine learning (ML), deep learning algorithms, neural networks, natural language processing (NLP) or large language models (LLM - including generative pre-trained transformers), as well as other technologies that make use of historical or real-time data, lookup tables, or correlation matrices.</p>
Investor	<p>For broker-dealers, an investor is a natural person or legal representative of such person, who seeks to receive or receives services primarily for personal, family, or household purposes.</p> <p>For investment advisers, an investor is a client or prospective client, and any current or prospective investor in a pooled investment vehicles advised by the investment adviser.</p>
Investor Interaction	<p>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. An investor interaction would not include interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support.</p> <p>Examples include a firm’s correspondence, dissemination, or conveyance of information to or solicitation of investors, in any form, including communications that take place in-person, on websites; via smartphones, computer applications, chatbots, email messages, and text messages; and other online or digital tools or platforms. The definition would also include advertisements by or on behalf of the firm that offer or promote services or seek to obtain or retain one or more investors.</p>
Conflict of Interest	<p>Exists when a firm uses a covered technology that considers <i>any</i> “firm-favorable” information in an investor interaction or information favorable to a firm’s associated persons, even if the interests of the firm or associated persons are subordinated to those of investors.</p>

Conflicts of Interest Associated with Use of Covered Technologies. The proposed rules would require a firm to eliminate or neutralize the effect of certain conflicts of interest associated with the use of covered technologies in investor interactions. To do so, firms would be required to take affirmative steps, outlined in the table below.

Evaluate and Identify	<p>Evaluate any use, or “reasonably foreseeable” potential use, of a covered technology in any investor interaction to identify whether it involves a conflict of interest, including through testing the technology prior to implementation and periodic re-testing before deploying any material modification(s).</p> <p>SEC notes that the proposal does not include a frequency requirement for technology re-testing and expects firms to do so as needed given the technology’s complexity and firm’s reliance on it.</p>
Determine	<p>Determine if any identified conflicts of interest result in investor interactions that place the interest of the firm or an associated person ahead of investors’ interests, based on a “facts and circumstances” analysis and subject to certain exceptions (as proposed).</p>
Eliminate or Neutralize	<p>Eliminate, or neutralize the effect of, any conflict of interest determined to result in investor interactions that place a firm’s (or associated persons’) interest ahead of the interests of investors. Action must be taken “promptly” after the conflict is determined or should have been determined. The measure for successful elimination or neutralization of the effect of conflicts of interest would be if the investor interaction does not place the firm’s or associated person’s interest ahead of the investor. SEC notes that consideration of any firm interest would be sufficient for a conflict of interest to exist under the proposed rules but may not require elimination or neutralization unless investors’ interests were subordinated to the interest of the firm or associated persons.</p>

Policies and Procedures. The proposed rules would require all broker-dealers and investment advisers using a covered technology in investor interactions to adopt and implement written policies and procedures reasonably designed to achieve compliance with the proposed rules, including:

- Written descriptions of the processes for:
 - Evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction, as well as material features of, including any conflicts of interest associated with the use of, the technology prior to implementation or modification.
 - Determining whether any conflict of interest identified results in an investor interaction that places the interest of the firm or associated persons ahead of investor interests.
 - Determining how to eliminate, or neutralize the effect of, any such conflicts of interest.
- Review and written documentation of the review, at least annually, of the adequacy of these policies and procedures and the effectiveness of their implementation, as well as a review of the written descriptions.

Recordkeeping. The proposal would amend Rules 17a-3 and 17a-4 under the Exchange Act and Rule 204-2 under the

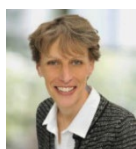
Advisers Act to require broker-dealers and investment advisers to maintain and preserve (for specific retention periods) documentation related to the firm's use of covered technology and the requirements of the proposed rules, including:

- Evaluations conducted and the related testing.
- Determinations made.
- Eliminations or neutralizations made.
- Written policies and procedures prepared.
- Disclosures provided to investors regarding the use of covered technologies.
- Any instance where a covered technology was altered, overridden, or disabled, as well as the date and reason for the action, and any instance where an investor requested a covered technology be altered or restricted.

Comment Period. SEC is seeking public comments on the proposed rules, with a submission deadline of sixty (60) days following publication in the Federal Register.

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