Welcome to the August issue of Investments & Wealth Institute’s Washington Insights. This month’s column reviews a new rule proposal by the Securities and Exchange Commission (SEC or Commission) for broker–dealers and registered investment advisers (RIAs) addressing conflicts of interest involving the use of predictive data analytics (PDA) and separate amendments clarifying the so-called “internet exemption” from state registration for online internet advisors. Washington Insights also provides a brief wrap-up of other public policy topics of interest to wealth and institutional managers.

SEC Releases Predictive Data Analytics Rule for Public Comment

The SEC on July 26, 2023, voted 3–2 along partisan lines to release for public comment a rule that would place restrictions on the use by Wall Street firms of artificial intelligence (AI) and other PDA when interacting with clients. Although disclaiming any bias toward specific technologies, the SEC press release said the proposal would require broker–dealers and investment advisory firms registered with the Commission to “eliminate, or neutralize the effect of” conflicts of interest generated by various forms of AI, including machine learning, deep learning, neural networks, natural language processing, and large language models, when interacting with clients.

The proposed rule expressed concerns with using PDA-like technologies, on purpose or not, “to automatically develop advice and recommendations that are then transmitted to investors through the firm’s chatbot, push notifications on its mobile trading application, and robo-advisory platform.” The rule also states, “if the advice or recommendation transmitted is tainted by a conflict of interest because the algorithm drifted to advising or recommending investments more profitable to the firm ... the transmission of this conflicted advice and recommendations could spread rapidly to many investors.”

While acknowledging the benefits of new technological innovations in increasing investor participation in the stock markets, Commissioner Caroline Crenshaw, one of the three Democratic Commissioners supporting the rule, expressed concern with certain aspects of the technologies that she said could influence investors to increase so-called “gamification” transactions or to invest in risky products that yield higher firm profits at the investor’s expense.

The two Republican Commissioners pushed back, saying the definition of a technology covered by the rule was overly broad and may lead to increased costs without any clear benefit.
Republican Commissioner Hester Peirce said, “the proposal reflects a hostility toward technology” while rejecting “one of our primary regulatory tools—disclosure.”

The proposing release cited examples of conflicts such as product sponsors offering revenue-sharing payments as an incentive for firms to promote their products, as well as firms offering proprietary products having an incentive to favor those investments over nonproprietary options. Although the proposing release went into detail on the existing disclosures already required to inform investors of conflicts, disclosure is not a remedy under the rule. Nor does the release offer examples of how firms could “neutralize” the conflict (which is repeated 87 times in the 243-page proposing release). One example suggested firms consider using A/B testing, which refers to running a learning model on two different datasets with a single change between the two to identify causal relationships. But as the SEC acknowledged in the example, it is a way to assess the impact of the conflict on investors. It does not offer a way to neutralize the conflict.

The proposal also would require firms to maintain written policies and procedures, as generally required for any market conduct rule, to achieve compliance and to keep appropriate books and records demonstrating compliance.

The rule is bound to stir controversy and isn’t expected to be approved until sometime in 2024. Interested parties have 60 days following publication in the Federal Register to submit comment.

THE WRAP-UP

Congress

Crypto regulatory bill advances in House. Only seven days after being introduced, a second House committee approved legislation on July 27 that would give the Commodity Futures Trading Commission (CFTC) new powers and funding to create a regulatory framework for digital currency investments. A day earlier the House Financial Services Committee also passed its part of the measure, garnering some Democratic support. The House Committee on Agriculture, which has oversight of the CFTC, approved the Financial Innovation and Technology for the 21st Century Act by voice vote.

The SEC, which has taken enforcement action against a number of players in the crypto industry, would have a reduced oversight role under the proposal.

SEC Regulation

SEC proposes narrow exemption from state registration for internet advisers. The SEC has proposed significantly narrowing the definition of a so-called “internet adviser”—firms eligible for registration with the Commission instead of state securities regulators—from a hybrid-type to delivering advisory services exclusively through an interactive internet portal.

The often partisan split in Commission votes was absent this time in a 5–0 vote supporting public comment on the changes. Republican Commissioner Hester Peirce said the exemption, adopted in 2002 by the SEC, “should stay on the books, but it needs a tune-up.” She noted that in a 2021 staff risk alert, nearly “half of the [examined] advisers claiming reliance on the Internet Adviser Exemption were ineligible ...”
The comment period will be open for 60 days after publication in the *Federal Register*. According to the proposing release, up to 40 percent of the 256 registrants relying on the exemption (as of December 2022) may not be eligible; if approved, the number relying on the exemption would be reduced to about 160 firms. Most traditional advisory firms with less than $100 million in assets under management are required to register with one or more states instead of the SEC.

**SEC adopts cyberattack disclosure rule for public companies; RIAs on deck.** The SEC on July 26 approved a rule that requires public companies to disclose details of a cyber intrusion within four days after determining that it resulted in a material impact on company operations. The key disclosure requirement is it must be reported four days after the company’s conclusion that the attack was material—not the date of the incident.

Final action on a disclosure rule covering RIAs and investment companies is expected in October for consideration by the Commission. The rule would require confidential notification to the agency of a significant cyber event, add disclosure of cybersecurity risks and incident-related information on Form ADV, and establish policies and procedures for addressing cybersecurity risks.

**403(b) Plans**

**403(b) plan fee disclosures need parity with other DC plans, GAO says.** Participants in public and nonprofit 403(b) retirement plans need more disclosures of how investment fees impact their accounts, according to a July 24 report by the Government Accountability Office (GAO).

The Employee Benefits Security Administration (EBSA), a subagency of the Department of Labor (DOL), doesn’t provide the same level of detailed information for 403(b) plans as it does for 401(k)s and other private-sector defined contribution plans, the GAO said.

Currently 403(b) plans cannot access collective investment trusts, which generally are less costly than mutual funds and are popular investment options in 401(k)-type plans. A Republican-sponsored bill passed recently by a House committee would provide parity in this area for 403(b) plans.

The GAO noted that EBSA recently drafted enhanced disclosures to help participants understand fees, but the disclosure doesn’t reference 403(b) plans at all, the report said. EBSA Assistant Secretary Lisa Gomez responded in a letter to the GAO that the agency neither agreed nor disagreed with the GAO findings.

**DOL Enforcement**

**DOL targets New Jersey concrete manufacturer for withholding, loan violations.** The DOL filed a complaint against New Jersey concrete producers Hall Wilbert Company and De Ferraro Inc., on July 7 in the U.S. District Court of the District of New Jersey, alleging the companies failed to remit weekly employee contributions and loan repayments, including employer matches, during a six-year period.

The DOL filed six counts alleging breach of fiduciary duty, including self-dealing and failing to ensure the plan received the employer matches. The DOL asked the Court to remove the principals as fiduciaries and to appoint an independent fiduciary to calculate the total amount of losses to the plan due to violations under the Employee Retirement Income Security Act.
IRS Enforcement

**GAO: IRS should target large, complex partnerships.** The Internal Revenue Service (IRS) should focus on large and complex partnerships during audits, the GAO said in a report released July 27.

The GAO noted that the number of large partnerships—with more than $100 million in assets and 100 or more partners—increased almost 600 percent between 2002 and 2019. However, the IRS’s audit rate of large partnerships has dropped to less than 0.5 percent since 2007.

The Biden administration’s Inflation Reduction Act provided the IRS with $45.6 billion in funding for enforcement, although a subsequent agreement with the GOP reduced that amount by $20 billion.

GAO recommended that the IRS develop guidance to define large and complex partnerships and ways to track noncompliance in audits. The IRS said it agreed with all the GAO’s recommendations.

Research

**Workers more likely to stay if offered retirement plan.** 401(k) Specialist reports that a new study from Voya Financial finds that 71 percent of employees are likely to stick around if the company offers a retirement plan option. According to the study, the number is up from October 2022, when just 60 percent gave the same response.

Voya suggests current economic conditions might have something to do with their opinions. Three-quarters of respondents said they strongly or somewhat agree that the impact of inflation on their ability to save is worrisome, and even higher for those still paying off student loans.

**Gen X falling far behind in saving for retirement.** Gen X is on track to have saved less for retirement than Gen Z and millennials. According to a report by the National Institute on Retirement Security (NIRS), the first generation to enter the labor market following the shift from defined benefit to defined contribution plans shows the median account balance is only about $10,000 while the bulk of savings is concentrated in the top quartile, which holds nearly $250,000.

Across race, gender, marital status, or income, the vast majority are far behind. Only 14 percent have access to a retirement plan and only about half participate in the plan, NIRS said.

ABOUT WASHINGTON INSIGHTS

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