Idaho Department of Finance Financial Innovation Lab

Emerging Technology Advisory Committee Report

Protecting Innovation for Retail Investors:

Analyzing the Impact of Harmful Predictive Data Analytics Regulation on Financial Inclusion and Technological Advancement

Executive Summary

Technology has empowered millions of previously underserved Americans to engage in capital markets by minimizing costs and democratizing financial access, but the Securities and Exchange Commission's (SEC) Predicative Data Analytics' Rule (PDA) would create a barrier to this progress by placing extreme limitations on the use of technological innovations that have the potential to benefit both investors and the financial industry.

Proposed regulations such as the PDA at both federal and state levels risk dismantling the significant progress achieved in enabling a diverse range of Americans to enter financial markets and take control of their finances.

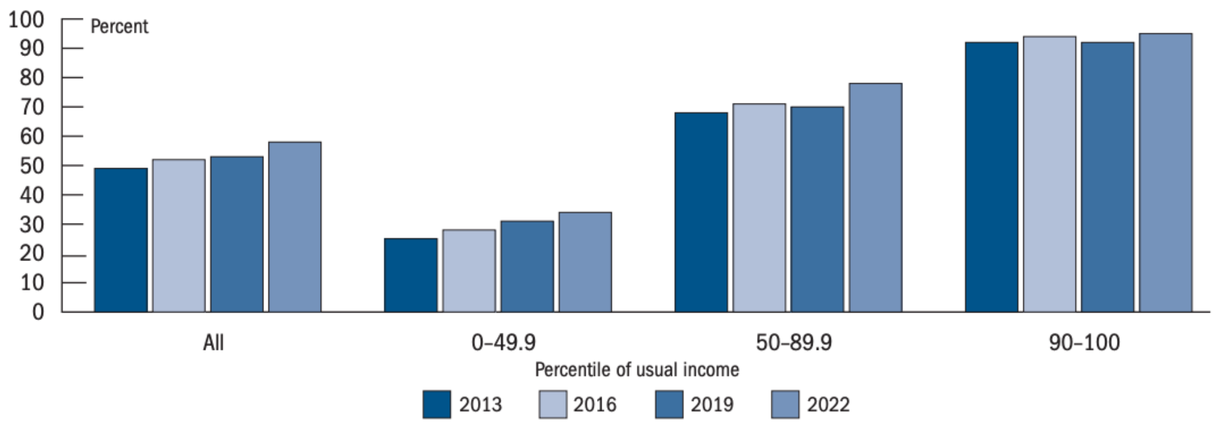
To ensure we harness the full potential of emerging technologies while safeguarding investor interests, the U.S. should develop fintech sandboxes for experimentation, research and develop roles and responsibilities for technology users, deployers, and builders, and foster robust dialogue on the opportunities and risks an innovation presents to strike a prudent balanced approach to emerging technology regulation.

Technology Has Helped Foster Retail Participation and Financial Inclusion in Capital Markets

Technological innovations have democratized access to financial markets, significantly benefiting underserved communities. We live in a golden age of increased access, lower costs, and enhanced financial inclusion for the average retail investor. Investment advisers and broker-dealers nationwide have leveraged technology to provide Americans from all walks of life with products that were previously costly or widely inaccessible. Notable examples of these benefits include low-cost advisory services, no account minimums, commission-free investing, matched Individual Retirement Accounts (IRAs), and much more.

The 2022 Survey of Consumer Finances (SCF) by the Federal Reserve revealed a significant increase in stock ownership amongst Americans. Between 2019 and 2022, when direct and indirect stock holdings are combined, the 2022 survey showed a step-up in stock ownership to 58 percent, compared with 53 percent in 2019 and 52 percent in 2016 (see chart below).[i]

Figure A. Families with direct and indirect holdings of stock, by usual income group, 2013–22 surveys



Note: Key identifies bars in order from left to right.

The introduction of intuitive web-based and mobile applications has been a primary driver for increased economic participation and financial inclusion. Everyday Americans now use apps to manage a range of activities, from buying groceries to obtaining loans to making investment decisions, thus fostering greater economic participation. This trend reflects a broader democratization of financial markets, allowing more Americans to invest directly in stocks and take greater control of their financial futures. The Financial Industry Regulatory Authority ("FINRA") has released reports demonstrating how technological innovations have brought traditionally underserved investors like first-time investors, rural investors, women investors and minority investors into our capital markets at unprecedented rates.[ii]

Proposed Federal and State Regulations Threaten to Undo Progress in Financial Inclusion

Implementing wide-reaching prescriptive regulation on the use of emerging technologies can create obstacles to financial inclusion and stifle innovation. On July 26, 2023, the SEC proposed File No. S7-12-23: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers ("PDA Proposal").[iii] This proposal aims to establish a heightened standard of conduct for investment advisers and broker-dealers in virtually all investor interactions using any technology (from basic spreadsheets to Artificial Intelligence), regardless of whether a recommendation or personalized investment advice is offered to the retail customer.

Additionally, the North American Securities Administrators Association (NASAA) has proposed a Model Rule that would broadly expand the definition of "recommendation." This rule states:

"If the broker-dealer or agent utilized any means, method or mechanism to feature or promote an account type, specific security, or investment strategy to a retail customer, whether directly or through a third party, then that transaction will not be deemed an unsolicited transaction, but rather will be deemed a recommendation to which all of the foregoing obligations set forth in this subsection apply."[iv]

This expansive definition appears to cover nearly every form of digital interaction with a customer, including basic digital tools (such as colors, font, and text size, graphic design, and information layout), technologies/products available on a website or app (including news feeds, financial education tools, lists, charts, investment tracking tools, price notifications, and pop-up warnings), and digital advertisements for products and services.

Each of these proposals is highly prescriptive and anti-technology, threatening to stifle innovation and hinder the progress made on financial inclusion thus far.

SEC PDA Rule Will Upend Existing Frameworks and Impose New Regulatory Barriers

The SEC's PDA proposal would effectively replace the existing framework with an expansive regulatory approach, that would give the SEC oversight over nearly all technological applications by broker-dealers and investment advisers in investor interactions—from simple tools like calculators and Excel spreadsheets to quantum computers and sophisticated AI. Additionally, the SEC's proposal would impose a new, unsupported uniform standard of conduct on any retail broker-dealer or investment adviser using technology to interact with customers, undermining the extensive research and analysis that culminated in the Commission’s Regulation Best Interest (Reg BI) rule and Fiduciary Interpretation.

This Advisory Committee acknowledges the transformative potential of technology—from basic spreadsheets to advanced artificial intelligence (AI), natural language processing, and other cutting-edge innovations—in shaping the future of investing. The committee also emphasizes the necessity of responsibly developing and implementing these technologies within the framework of existing SEC, FINRA, and state regulations designed to protect investors and the markets instead of creating new emerging technology regulatory barriers that will stifle innovation at the expense of both retail investors and the financial industry.

The SEC already has sufficient rules to regulate the use of “covered technologies,” including federal securities antifraud provisions, the SEC’s Reg BI, the fiduciary duty under the Investment Advisers Act, the SEC’s and FINRA’s advertising rules, and FINRA’s customer communications rule, amongst others. The SEC is attempting to expand its authority based on speculative, theoretical future harm that technology might cause, without pointing to any real issues the PDA Proposal would solve. In doing so, the SEC implies that retail investors—millions of hardworking Americans striving to improve their financial standing— lack the ability and/or capacity to grasp basic customer disclosures.

Lastly, each state has its own securities laws based on its preferred methods for fostering innovation and protecting retail investors and they should be able to create the emerging technology regulatory solutions that work for them.

Keys to Emerging Technology Regulation:
Sandboxes, Roles and Responsibilities, and Dialogue

While it is vital to continually review and refine the current set of laws and regulations, it is equally important to ensure that these laws are based on actual market problems and that they strike the right balance between fostering innovation, ensuring financial inclusion, and protecting retail investors. The best way to accomplish this is by:

- **Creating Fintech Sandboxes**- Emerging technology is constantly evolving and regulators should look to create sandboxes that enable innovations to be tested without stifling their development. This will help regulators better understand use cases and craft more effective regulations to protect investors. SEC Commissioner Hester Peirce is supportive of regulatory sandboxes stating that they, "have proven effective in facilitating innovation in highly regulated sectors."[v]

- **Defining Roles and Responsibilities**- By using real-world fintech sandboxes regulators can gain greater insight into the different roles emerging technology users, deployers, and builders play in an ecosystem and better define their regulatory responsibilities. This will enable the creation of smarter regulation.

- **Increasing Dialogue and Strategic Engagement**- Regulators should be meticulous in their review of regulatory frameworks and engage in a robust dialogue with stakeholders during the analytic process. This process should include academic studies subject to rigorous peer review; public roundtable discussions; and forums in other venues such as the Idaho Department of Finance's Financial Innovation Lab, which brings together subject matter experts to discuss the opportunities and risks inherent in emerging technologies.

It is important for regulators to understand that an overly prescriptive regime could erode the objective of supporting the use of new and emerging technologies. Regulators should ensure regulations are flexible, adaptable and appropriately applied. A strong understanding of innovative technologies is critical to ensuring any rule or regulation does not present unintended consequences and undermine any progress toward innovation and financial inclusion.

Endnotes

[i] Federal Reserve Board. "Survey of Consumer Finances, 2023." Board of Governors of the Federal Reserve System, 2023. https://www.federalreserve.gov/publications/files/scf23.pdf.

[ii] FINRA Investor Education Foundation. "The Changing Landscape of Investor Behavior." FINRA Foundation Investor Report, 2023. https://finrafoundation.org/sites/finrafoundation/files/NFCS-Investor-Report-Changing-Landscape.pdf; FINRA Investor Education Foundation. "Investors of Color in the U.S.: A Changing Landscape." FINRA Foundation, 2023. https://www.finrafoundation.org/sites/finrafoundation/files/investors-of-color-in-the-us.pdf.

[iii] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53,960 (Aug. 9, 2023) ("Proposing Release").

[iv] NASAA, Request for Public Comment, Proposed Revisions to NASAA's Dishonest or Unethical Business Practices Of Broker-Dealers And Agents Model Rule (Sept. 5, 2023), https://www.nasaa.org/wp-content/uploads/2023/09/Request-for-Public-Comment-on-BD-Best-Interest-Model-Rule.pdf ("Request for Comment").

[v] Commissioner Hester M. Peirce. Comment on Digital Securities Sandbox Joint Bank of England and Financial Conduct Authority Consultation Paper. (May 9, 2024). U.S. Securities and Exchange Commission. https://www.sec.gov/newsroom/speeches-statements/peirce-boe-fca-comment-05302024