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October 1, 2021

VIA ELECTRONIC SUBMISSION

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Re: File Number S7-10-21, Digital Engagement Practices

Dear Secretary of the Securities and Exchange Commission:

The Pace Investor Rights Clinic at the Elisabeth Haub School of Law at Pace University,[1] operating through John Jay Legal Services, Inc.,[2] welcomes the opportunity to respond to the SEC's request for information and comment on the use of digital engagement practices (DEPs) by broker-dealers and investment advisers. As SEC Chair Gary Gensler noted in the press release accompanying the request, "While new technologies can bring us greater access and product choice, they also raise questions as to whether we as investors are appropriately protected when we trade and get financial advice." We share these concerns.

The Clinic's mission is to represent investors who have been harmed by the misconduct of their brokers, as well as to advocate for the protection and education of

[1] The Pace Investor Rights Clinic, which opened in 1997, was the nation's first law school clinic in which law students, for academic credit and under close faculty supervision, provide pro bono representation to individual investors of modest means in arbitrable securities disputes. *See* Barbara Black, *Establishing A Securities Arbitration Clinic: The Experience at Pace*, 50 J. LEGAL EDUC. 35 (2000); *see also* Press Release 97-101, Securities Exchange Commission, *SEC Announces Pilot Securities Arbitration Clinic To Help Small Investors – Levitt Response To Concerns Voiced At Town Meetings* (Nov. 12 1997), *available at* http://www.sec.gov/news/press/pressarchive/1997/97-101.txt.

[2] John Jay Legal Services, Inc. is a not-for-profit legal services firm that houses and runs the clinic and externship programs at the Elisabeth Haub School of Law at Pace University. In our clinics, students provide direct legal representation and access to justice for clients on a pro bono basis while being supervised by clinical faculty. In our externships, students work with and learn from practicing lawyers in a variety of placements tailored to their interests. These experiential learning programs offer students the opportunity to gain real-world practical legal experience during their time at Haub Law.

small investors. We appreciate that DEPs can help expand access to the markets, particularly for groups who have historically faced barriers to access. However, we are concerned with the use of DEPs to influence investors' decision-making in ways that do not align with their best interest. The Clinic has been contacted by many small investors seeking representation for claims related to the use of online platforms employing DEPs.

In addition to our role as student interns at the Clinic, we are also a group of law students in our late twenties and early thirties who are new to investing. As novice investors, we have experienced both the pros and cons of DEPs. We will address the questions proposed by the SEC from that vantage point. To help gain a broader perspective, we conducted a small, informal survey of fellow law students and other young professionals to understand their experiences with DEPs. This comment letter will address the responses to our survey, some psychological effects of DEPs, the opinion that novice investors believe DEPs are giving them investment recommendations, the benefits and harms associated with DEPs, and recommendations to protect the interests of retail investors.

Law School Student Survey

As noted above, we conducted a limited, informal survey to assess the impact of DEPs, particularly in online platforms, on novice investors' decision-making. We asked about the age of the participants, the number of years investing, their experiences using online platforms that employ DEPs, the influence of DEPs on the participants' investment decisions, and other comments and concerns about their investment experience.

The survey participants had an average of 1.5 years of investment experience, with the outlier having five years of investment experience. The main takeaways from the survey were that online platforms made it easier for novice investors to invest and that the DEPs influenced their decision-making, in ways both overt and subtle.

First, the participants stressed that online platforms made it easier for them to invest. This can be attributed to the app or website design. We believe this positively correlates to the increased number of young investors using these platforms. As one participant stated, "the design is appealing and easy to the eye, which makes it more enjoyable." Another participant highlighted that "the minimalist design is very appealing." Other participants expressed how features, such as referring a friend to open an account and being rewarded with a free stock, has kept them more engaged. Participants also noted that they used their mobile devices to access their investment information.

Second, the participants, particularly the more novice participants, felt that the DEPs influenced their decision-making. One participant noted that "the app's top movers list, analyst ratings, app design and layout has influenced my investing decisions." Another participant noted that the use of colors (*e.g.*, red used to connote a loss or green used to connote a gain) triggered them to trade. One participant noted, "the design made me want to be on the platform all the time. At one point I would clock in over 12 hours a day on that app." Other participants indicated the push notifications made them check their investment portfolio more frequently. By contrast, the most experienced participant stated, "I have been investing for five years in a diverse set of assets classes and I do not rely on the education or investment advice from the platforms."

While the survey was limited and anecdotal, the responses support the general idea that DEPs and online platforms have expanded access to the market to new investors, while at the same time influencing the decision-making of those investors – particularly novice investors – in ways that are often in conflict with their bests interest.

Psychology/Marketing and the Influences of DEPs on Retail Investors

In Question 1.24, the SEC asked: "Is there research in the fields of experimental psychology and marketing that contains evidence regarding the ability of DEPs to influence retail investors? Are there findings in those fields that suggest retail investors may not be fully aware that they have been influenced by a particular DEP?"

While we are unaware of research in the fields of experimental psychology and marketing evidencing the topic of how DEPs impact investors specifically, we believe that research in these fields, if viewed broadly, can help us understand how DEPs may influence retail investors. We explore the social proof theory, the stimulus organism response model, and the implemental mindset concept below.

First, the social proof theory refers to the concept that when humans feel uncertain, they tend to look to others for answers as to how to behave or think.[3] In other words, when someone is in a situation where they are not aware of how to behave or act, they will look for external examples of how to behave. We believe that this concept can help illustrate how DEPs influence investors, particularly those new to investing. Novice investors may feel that the DEPs are assisting them in the uncharted territory of investing by showing them how to act in an area in which they are unfamiliar. As highlighted in our student survey, novice investors were influenced by DEPs such as the top movers list and analyst ratings when making investment decisions.

Second, the stimulus organism response model explains how a certain stimulus can lead to a desired responsive behavior.[4] We believe this theory can be used to explore how businesses employ marketing techniques that maximize their profits by analyzing and influencing consumer behavior. For example, placing five stars on a product on display in a store or on a website can increase the likelihood that a consumer will purchase that product. We believe this theory can help explain how DEPs, such as analyst ratings, top mover lists, and rewards for making trades can trigger certain human

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[3] *Social Proof: Why we Look to Others for What we Should Thank and Do*, FS, available at https://fs.blog/2009/09/mental-model-social-proof/ (last visited Sept. 29, 2021); *Social Proof and How it Affects Our Investments,* Nasdaq (Oct. 20, 2015), available at https://www nasdaq.com/articles/social-proof-and-how-it-affects-our-investments-2015-10-20.

[4] *See* S-O-R psychology, available at https://dictionary.apa.org/s-o-r-psychology.

behavior, including the buying and selling of stocks or other securities. Analyst rating and top mover lists can encourage novice investors to buy or sell certain stocks; the dropping of confetti or similar encouragements can create a positive feeling about a trade which may lead to additional transactions. We believe these forms of DEPs can both influence investor decision-making and then reassure the investor that the decision they made was a good one, when ultimately it may not align with their investment goals or be in their best interest.

Third, DEPs tend to evoke an implemental mindset as opposed to a deliberative mindset.[5] Rather than prompting reflection or the option to make a decision, many DEPs aim to overcome the actor's hesitation.[6] In other words, DEPs encourage investors to make decisions without giving much thought, consideration, or research to the decision. For example, a DEP like push notifications or the top mover list creates an implemental mindset and prompts quick investment decisions. Investors are not alerted to any potential risk associated with investing in a DEP's featured stock unless they do their own research. Investors may believe that they are in control of their investment trading, when in fact the implemental mindset purposefully induced by the DEPs leads to a loss of control. This illustrates how DEPs can influence an investor's decision-making without them realizing it.

Retail Investors Believe They are Receiving Investment Advice and Recommendations

In Question 1.19, the SEC asked: "Do retail investors believe they are receiving investment advice or recommendations from DEPs or certain types of DEPs? If so, please explain."

We believe that retail investors, particularly novice investors, believe that they are receiving advice or recommendations from DEPs. This includes the top mover list, analyst ratings, push notifications, and other DEPs that encourage investment activity. Many of our survey participants stated that they believe that these DEPs influenced their decision-making. At the same time, DEPs may also influence investor decision-making without investors being conscious of it.

Benefits and Harm of DEPs

In Question 1.19, the SEC also asked: "What types of DEPs do retail investors believe are most beneficial, and what types of features are most harmful, in meeting their own trading or investment objectives?"

We believe DEPs are a double-edged sword – they can help expand access, but they can also influence investors to act adverse to their own best interest. The benefits associated with platforms using DEPs include increasing access, particularly for those

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[5] *See* SEC Investor Advisory Committee September 9, 2021 Panel Discussion: *Reimagining Investor Protection in a Digital World: the Behavioral Design of Online Trading Platforms*, statement of Dr. Punam Keller, available at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac090921-1.

[6] *Id.*

who have been historically left out of the markets; appealing to younger investors; making investing easier; removing intimidation factors related to investing; and providing autonomy to investors.

First, DEPs and online trading platforms have helped encourage more people to start investing, while adding more diversity among those who are investing. As FINRA recently noted, since the beginning of 2020, "individual investors entered the markets in unprecedented numbers—often through self-directed accounts at online brokers."[7] DEPs also have increased both the youth and minority engagement in investing.

Second, online platform design and DEPs resemble apps that are familiar to the younger crowd. We believe this has sparked the interest of and led to an increase in the number of young and first-time investors. As noted in our survey, the participants stated that the design and aesthetic of the online platforms has made it more enjoyable to invest.

Third, DEPs have made investing less complex and made it easier for novice investors to enter the market. Many of our survey participants attested to the ease of the investing app as being one of the factors that influenced their decision to invest. From the comforts of their home or with just the phone in their pockets, investors can execute a trade by simply clicking the highlighted buy or sell button. Many DEPs share the performance of a particular stock or list of stocks or stock volatility. Practices like this can lower barriers to entry to the market for those investors who feel like they are not sophisticated enough to do their own outside research.

Fourth, DEPs reduce the intimidation factor that may have prevented novice investors from entering the market in the past. Traditional investment platforms and practices, such as complex financial charts, can appear confusing and intimidating to novice investors. Certain DEPs highlight the stocks progress by day, week, and month, which novice investors may find helpful in alleviating some of this confusion in an unintimidating way.

Fifth, the use of DEPs can help investors feel empowered to chart their own investment experience. Investors can conveniently trade on their own whenever they choose without the assistance of an individual broker or adviser. Investors may believe that they are in charge of their own investments, and that they can determine their own financial fate.

However, many of these benefits have associated harms, which include DEPs leading investors to make decisions not in their best interest, to trade more frequently, to suffer from increased anxiety relating to their portfolio, and to believe that their trading has no cost.

First, our survey participants believed that DEPs influenced their decision making. We also note that sometimes investors may not be fully cognizant that they are

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[7] FINRA Special Notice, *Investor Education: FINRA Requests Comment on Effective Methods to Educate Newer Investors* (2021), at 1, https://www.finra.org/sites/default/files/2021-06/Special-Notice-063021.pdf.

being influenced by DEPs. This can lead investors to make decisions adverse to their best interest or investment goals, as the online platforms are often making these recommendations via the use of DEPs without regard to an investor's individual profile.

Second, many DEPs can lead investors to trade more frequently and more often than is in their best interest. For example, the push notification feature provides investors with live price updates. This intentionally prompts investors to check their portfolios after receiving the notification, which can lead them to make additional trades or spend more time on the platform than they would have otherwise. Traditionally, the goal of investing for most retail investors is to save for the long term. Frequently checking their portfolio may cause investors to make decisions not in line with the goal of long-term saving and generational wealth building.

Third, DEPs can lead to a heightened state of anxiety in investors. As noted above, the push notification feature may prompt investors to constantly check their portfolios. This can have a negative effect on an investor's mental health, especially if the market or their portfolio is down that day.

Fourth, investors may feel that they are in control of their own investments because they can buy and sell whenever they choose to with the belief that there is no cost to their trades, as they are not being charged an overt fee or commission. This can lead to high volume trading from investors who do not fully understand the risks related to this practice or the underlying costs of trading on an online platform. High volume trading can lead to increased profits for the platform with little to no benefit to the investor.

Recommendations

In Question 3.16, the SEC asked: "Should any such modifications or additional regulations be targeted specifically to address particular risks, such as those related to certain types of securities (e.g., options, leveraged and inverse funds, or other complex securities), services (e.g., margin), or conflicts (e.g., payment and revenue sources)? If so, how? Should any such modifications or additional regulations be targeted specifically to increase protection for certain categories of investors (e.g., seniors or inexperienced investors)? If so, how?"

We want to ensure that SEC regulations provide safeguards to protect and inform investors when they interact with an online trading platform or other entities using DEPs. We recommend requiring compliance with Regulation Best Interest when online trading platforms are making recommendations to their customers, requiring compliance with FINRA Rule 2360(b)(16) regarding due diligence related to options, and recommending that online trading platforms add an educational component to their platforms.

Applying Regulation Best Interest to Broker-Dealer Use of DEPs that Provide Recommendations

Regulation Best Interest establishes that broker-dealers who engage in the practice of making recommendations of an investment strategy or securities shall do so in accordance with the best interest of the investor disregarding any interest of the broker-dealer. To comply with this standard, a broker-dealer must abide by four component obligations: disclosure, care, conflict of interest, and compliance.

Whether a recommendation has been made turns on a facts and circumstances analysis. We have seen that inexperienced investors believe that they are receiving recommendations from DEPs. In addition, some investors may not be consciously aware that they are, in fact, receiving recommendations, but are nevertheless basing their actions on the DEPs. We believe many DEPs used by online trading platforms constitute recommendations and are designed to solicit trading.

When online trading platforms are making recommendations, they must act in the best interest of their customers at the time the recommendation is being made and abide by the obligations prescribed by Regulation Best Interest.

The care obligation requires the broker-dealer to understand the risks, rewards, and costs associated with the recommendation and to have a reasonable basis to believe the recommendation is in the best interest of the investor. When making recommendations through the use of DEPs, online trading platforms must, at a minimum, gather information that tells them that the investment or strategy they are recommending is, in fact, consistent with their customers' investment profile.

The disclosure obligation requires broker-dealers to provide, in writing, fair and full disclosure to an investor that the broker-dealer is acting as a broker-dealer with respect to the recommendation, of the material fees and costs that apply to the investor's transactions, and the type and scope of the services being provided to the investor including any material limitations on the securities or investment strategies. The obligation also requires disclosure of all material facts relating to conflicts of interest that are associated with the recommendation. These disclosure obligations should apply even when the recommendation comes via a DEP on an app.

Due Diligence Related to Options Accounts

We have concerns with online platforms approving novice investors for options accounts when they are not appropriate. FINRA Rule 2360(b)(16) requires broker-dealers to abide by three main requirements before an investor can start options trading. First, broker-dealers must execute due diligence when opening an options account. This entails obtaining information related to the customer's investment objectives, employment status, estimated annual income from all sources, estimated net worth, estimated liquid net worth, marital status, age, and investment experience and knowledge. Second, broker-dealers must verify the information provided by the investor. Third, broker-dealers must obtain from the investor a written agreement indicating that the investor understands and agrees to adhere to these rules.

It appears that online trading platforms are easily circumventing this rule by gathering the bare minimum amount of information on their customers. For instance, there are platforms that only require investors to provide their personal and tax information, but do not ask for investment goals or objectives. Additionally, some online trading platforms have an instant approval process when investors seek to open an options trading account. It seems improbable that these platforms are verifying the essential information their customers provide in a matter of seconds. Another concern with the instant approval process is that if investors are declined on the first try, they can resubmit their application using modified information to obtain approval. These practices do not meet the standard set out by the rule. Moreover, online trading platforms utilize bots and algorithms to gather the information from their customers which further suggests that this information is not being verified.

Investor Education

DEPs have been shown to be effective in activating investor behavior, and we would like their attributes to be used for the greater good to help educate investors so they can make informed decisions. We recommend that the use of DEPs be expanded to introduce true investor education to investment platforms. We also recommend that the SEC consider the use of DEPs on its own website and other modes of communication to encourage and engage investors to view and interact with the SEC's invaluable and unbiased investor educational material, as well as to consider requiring online platforms to include links to SEC or FINRA investor education websites or other materials.

DEPs that offer true educational information can help investors make informed decisions. Education content via DEPs should come in various communication forms, such as quizzes, videos, and articles, to help cater to all learning styles. As novice investors, we would like to see content that addresses long term investment strategies, portfolio diversification, and investment terms including different types of securities, dividends, volume, and volatility. Employing educational DEPs at certain points in time (*e.g.*, before opening an account or before a trade or certain type of trade) can assist investors in real time as they are making decisions.

We appreciate the opportunity to provide feedback to the SEC on this important investor protection concern and look forward to contributing more on this issue in the future.

Respectfully submitted,

Pace Investor Rights Clinic

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