Use of Alternative Data by Investment Advisers

By Paul M. Miller and Lancelot A. King, Seward & Kissel LLP*

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The search for "alpha" by investment advisers has led to new ways to capture and utilize data in the investment decision-making process.[1] Many advisers believe that incorporating alternative data, which is often characterized as a non-traditional source of investment research, into the investment decision-making process can provide a competitive advantage with respect to investment returns. Technological advancements, including electronic commerce, cellphone technology and satellite imagery, have spurred the development and collection of alternative data. According to a recent report by Grand View Research, the global alternative data market size was valued at $1.06 billion in 2019 and is expected to grow at a compound annual rate of approximately 40% from 2020 to 2027. Although the most common early users of alternative data were advisers using computer-driven or quantitative strategies, traditional asset managers are increasingly employing alternative data in their investment processes.

This article explains the term "alternative data" and then describes its uses by advisers. It also discusses certain risks of using alternative data in the investment process, recent regulatory focus on such use and how advisers can address those risks in their compliance programs.

Paul M. Miller, Seward & Kissel LLP

Lancelot A. King, Seward & Kissel LLP

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What is alternative data?

Alternative data encompasses a broad category of information used to gain insight into the investment process. Alternative data includes information about a particular issuer or its products and services that is published by sources other than the issuer and can provide unique and timely insights into investment opportunities and inform new analytical approaches. Alternative data also includes information that can be aggregated about particular industries or sectors. Alternative data differs from traditional research information that has been provided by the issuer through its SEC filings, management commentary, company presentations (including earnings calls) and press releases.

Examples of alternative data include geolocation (*e.g.,* foot traffic), credit card transactions, email receipts, point-of-sale transactions, website usage, mobile app or app store analytics, satellite images, social media posts, online browsing activity, shipping container receipts, product reviews, price tracking, shipping trackers, internet activity and quality data, analyst surveys, as well as many other data sources.

Alternative data is typically made available in both raw and aggregated forms. Raw data is unstructured data in its original form but can be processed and used for greater insights. Aggregated data, which often is less expensive, is structured and generally easier to apply but more widely distributed, and thus may have less potential to deliver alpha.

Because alternative data is made available in a less structured and organized format than traditional data, the mechanisms for employing alternative data in investing are often more advanced and costly than the mechanisms for employing traditional research in investing. Therefore, an effective infrastructure, which includes the right personnel, technology and

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financial resources, is necessary to convert alternative data into useful insights.

How exactly do advisers use alternative data?

Alternative data is used by advisers in a variety of ways, which may depend in part on the specific type of data at issue. For instance, an adviser may ascertain current industry or sector trends *(e.g.,* declining revenues in a market or growing segments of a market) and changes in consumer behavior from social media sentiment data (*e.g.,* comments, tweets and posts). Or an adviser may rely on alternative data to obtain more current (or real-time) information or clues indicating individual company performance to supplement historical information or other fundamental research gleaned from sources such as earnings reports and financial statements in SEC filings. For example, customer transaction activity reflected by credit card data may be used to analyze potential positions in retail stocks, and satellite imagery may be used to glean information on parking lot occupancy or smartphone data may be used to measure retail foot traffic in order to determine the degree of market acceptance of a particular product or service. Depending on the adviser and the type of alternative investment data, such data may be used to provide new perspectives and investment ideas, supplement existing fundamental research, or significantly drive investment decisions.

Who provides alternative data?

There are numerous providers of alternative data, some of which are data specialists and others of which are data originalists. The former category describes a group of data providers that has grown significantly over the last 10 to 15 years, due in large part to the substantial increase in alternative data sources and the usages of data in the investment process. These firms specialize in obtaining, formatting and analyzing specific information that can then be resold in data sets. The latter category describes those entities that have traditionally collected data as a result of their service or product offerings. These entities have collected the data as a by-product of their principal business and are in a position to monetize (or resell) that information. In addition, many firms employ their own data scientists to mine alternative data through activities such as web scraping, which refers to the process of extracting data from a website.

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What are the risks of using alternative data in the investment decision-making process?

The risks of using alternative data in the investment decision-making process are similar in some respects to the risks of using any type of research in that process. In other respects, the risks differ due to the nature or source of the data. Certain of these risks are as follows:

Data Risk. Investment decisions based on alternative data may be flawed for various reasons, such as incomplete or misunderstood data, or problems with the technology used to collect and analyze it.

Section 204A/Material Non-Public Information (MNPI) Risk. Section 204A of the Investment Advisers Act of 1940 requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such adviser's business, to prevent the misuse of material, nonpublic information. Alternative data sets may contain MNPI, or information that, when aggregated, could be considered MNPI. Trading while in possession of such information could result in liability under the federal securities laws.

Privacy/Personally Identifiable Information Risk. Alternative data may contain personally identifiable information (PII) or other similar information that raises privacy protection concerns. Privacy protection is an area of increasing legal and regulatory focus, in the U.S. and abroad. For example, the California Consumer Privacy Act of 2018 became effective in January 2020, and Europe's General Data Protection Regulation became effective in May 2018.

Right to Use Risk. The right to access data may pose legal questions about how the data can be used. For example, web scraping may involve activity that could violate the terms and conditions of the website from which the data was obtained. Despite a ruling in 2019 by the U.S. Court of Appeals for the Ninth Circuit that found that the Computer Fraud and Abuse Act (CFAA) cannot be used to prohibit the scraping of publicly available data, there is still uncertainty around the legal risks arising from the use of web-scraped data. In fact, the U.S. Supreme Court recently vacated the CFAA decision and remanded the case to the Ninth Circuit for further consideration.

Regulatory Risk and Reputational Risk. The use of alternative data is still in its early stages, and the way in which regulators may view or treat particular practices is unclear. Consequently, regulators may adopt or amend laws or regulations that affect an adviser's

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ability to source and utilize certain data, such as with respect to geolocation data or web-scraped data. In addition, regulators may increasingly bring actions involving such data, particularly when it potentially contains MNPI or PII.

In the absence of clear regulatory guidance, it is important that the users of alternative data avoid data collection practices and data uses that are inappropriate or illegal, as such practices and uses could adversely affect the user's business reputation.

Is the use of alternative data by an adviser an area of focus for the SEC and its staff?

Yes. As noted above, the use of alternative data by advisers is an area of focus for regulators, including the SEC and its staff. In 2020 and 2021, the SEC's examination staff mentioned alternative data in its exam priorities. The exam priorities for 2021 included, for example, the following statement:

> Alternative data, or data gleaned from non-traditional sources, is increasingly being used by firms, including advisers to private funds and registered investment companies, as part of their business and investment decision-making processes. *Reviews will include examining whether firms are implementing appropriate controls and compliance around the creation, receipt, and use of such information* (emphasis added).

Have there been legal and other actions involving the collection and use of alternative data?

Yes. In 2014, the Office of the Attorney General of New York announced its interim agreement with 18 financial firms to stop their practice of cooperating with research analyst surveys administered by certain buy-side firms. Through a survey, the research analyst provided his or her assessment of a covered company prior to the official release of the analyst's research report concerning that company. The survey results were systematized into a data set, which could then be used by the buy-side firm to make investment decisions. The agreements with the New York Attorney General effectively ended the use of this type of alternative data.

In the case of *SEC vs. Huang,*[2] the SEC obtained a jury verdict in its favor against the defendant for insider trading on information he misappropriated from his employer, a large credit card issuer. The defendant, a data analyst, searched a nonpublic company database that recorded the credit card activity for millions of customers at numerous retail companies. In violation of his company's code of conduct, the defendant conducted thousands of searches in this database, which allowed him to view and analyze aggregated sales data for the companies he searched. The defendant then used the data to make profitable securities transactions in advance of the public release of quarterly sales and earnings reports by these companies.

While this case involved the use of credit card data, a form of alternative data commonly used in the financial industry, such data was used without the consent of the defendant's employer (in violation of a duty owed to the employer) and was determined to be MNPI. This case illustrates the importance of safeguards related to the use of alternative data, so advisers that use alternative data should conduct adequate due diligence of data providers and their data sets (as discussed in the next section).

How should an adviser address the risks of using alternative data?

As with any risk, the process of addressing the risks associated with using alternative data should begin by understanding how the data sets will be used by the adviser and the associated risks. Once that is understood, the adviser should consider adopting policies and procedures (*i.e.*, an alternative data provider policy) to address those risks. Such policies and procedures should address the following:

- ***Diligence.*** Prior to the adviser entering into any arrangement with a data provider, the adviser should conduct due diligence on the data provider and the types of data made available by the provider. The due diligence on the data should, for example, include reviewing:
  - — whether the data is originated by the provider or collected from third parties;
  - — the types of data collected by the provider;
  - — the sources of the data (*e.g.*, whether the provider engaged in web scraping);
  - — whether the data may include PII or nonpublic information; and
  - — the provider's legal rights to access, obtain and provide the data.

  The due diligence should also consider the number and types of other persons that receive the data from the provider and the adequacy of the provider's policies and procedures, including those addressing material nonpublic information, PII and data security. In many instances, this due diligence may involve testing the data set for its accuracy and validity.

- ***Agreement with the Data Provider.*** The adviser should enter into a contract with each data provider, which contract includes, for example, representations by the data provider as to the provenance of the data and its authority to provide the data to the adviser. The contract should also obligate the provider to refrain from providing MNPI to the adviser.

- ***Restrictions and Retention.*** The adviser should adopt restrictions appli-

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cable to the adviser's personnel with respect to receipt of alternative data from a data provider, which may include requiring prior written approval from the adviser's compliance personnel to communicate or meet with the data provider, or to receive information from the data provider. The adviser should adopt procedures addressing how the data will be retained and protected.

- ***Review of Policy and Procedures.*** The adviser should review its data provider policy annually (or periodically) to ensure that best practices are being followed and should consider conducting periodic due diligence of existing data providers in response to business or legal developments.[3]

What is the future of alternative data?

The ever-present search for alpha by advisers and the increased growth of innovative technologies suggest that the market for alternative data will continue to expand. And systems based on artificial intelligence, which are increasingly being used by advisers to analyze alternative data sets, will make it easier to analyze larger volumes of such data. Firms that do not embrace alternative data may, over time, place themselves at a competitive disadvantage. At the same time, users of alternative data will likely continue to face legal and other challenges as data sources increase and technology becomes more sophisticated. This expected growth may soon lead to a more mature legal and regulatory landscape to address such challenges.

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[1] "Alpha" is the coefficient measuring the pattern of an investment's return arising from specific (nonmarket) risk. See JOHN DOWNES & JORDAN GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS (B.E.S. Publishing Co., 10 ed. 2018). It is also referred to as the excess return of an investment relative to the return of a benchmark index. See Alpha, INVESTOPEDIA, https://www.investopedia.com/terms/a/alpha.asp (last visited July 8, 2021).

[2] See SEC v. Nan Huang, 2016 U.S. Dist. LEXIS 22903 (E.D. Pa. Feb. 25, 2016); see also SEC Litigation Release No. 23476, 2016 SEC LEXIS 742 (Feb. 26, 2016).

[3] Seward & Kissel maintains a sample alternative data provider policy as part of its SKRC services.

**Paul M. Miller is a partner in the Washington, DC office of Seward & Kissel LLP. He can be reached at millerp@sewkis.com. Lancelot King is a counsel in the Washington, DC office of Seward & Kissel LLP and can be reached at king@sewkis.com.*

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