Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

October 10, 2023

Via Electronic Submission

Vanessa A. Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers; File No. S7-12-23

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] submits these comments to the Securities and Exchange Commission ("**Commission**" or "**SEC**") in response to the Commission's request for comments on the above-referenced proposal ("**Proposal**")[2], with a focus on the aspects of the Proposal applicable to investment advisers that are registered or required to be registered in accordance with the Investment Advisers Act of 1940 ("**Advisers Act**"), *i.e*., the proposed amendments to Advisers Act Rule 204-2 and the proposed new Rule 211(h)(2)-4.[3]

MFA and its members[4] acknowledge the Commission's concern with respect "to help[ing] ensure that firms are appropriately addressing conflicts of interests associated with the use of PDA [predictive data analytics]-like technologies."[5] The Proposal, however, reflects a fundamental misunderstanding of how the vast majority of registrants, particularly MFA

[1] MFA, based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

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

[3] Please note that although for purposes of this letter, we have not commented specifically on the aspects of the Proposal applicable to broker-dealers, MFA expects that certain of the comments raised in this letter would apply to such aspects as well. As a general matter, our focus on the aspects applicable to investment advisers should not be viewed as an endorsement of the broker-dealer-related proposed rules and associated discussion in the Proposal.

[4] The global alternative asset management industry, including hedge funds, credit funds, and crossover funds, has assets under management of $4 trillion (Q4 2022). The industry serves thousands of public and private pension funds, charitable endowments, foundations, sovereign governments, and other global institutional investors by providing portfolio diversification and risk-adjusted returns to help meet their funding obligations and return targets.

[5] Proposing Release, *supra* note 2, at 53,961.

members, deploy such technologies. Indeed, the Commission eschews the "technology-neutral" approach it claims to employ[6] in favor of proposing a regime so sweeping and restrictive that it would shut down not only innovation and technological advancement but also some registrants themselves. The Proposal's requirements would introduce such significant risks and costs to advisers' day-to-day operations that many advisers would find the management of their businesses no longer feasible—leading to dramatic consolidation of the industry and far fewer options for institutional investors, quite contrary to the Commission's stated purpose of fostering competition and capital formation. Further, and in certain respects even more critically, the Proposal upends precedent regarding fiduciary obligations and the ability to manage potential conflicts of interest by means of disclosure and informed consent.

Finally, we believe that the Proposal is fundamentally flawed with respect to application of the Administrative Procedure Act of 1946 ("**APA**") and that it plainly exceeds the Commission's authority under the Advisers Act and other applicable law. Among the Proposal's other deficiencies, it fails to give adequate consideration to less costly alternatives and does not come close to offering a justification for the significant adverse consequences that its restrictions would impose on technological advancement or that its starting premise—that disclosure and informed consent are no longer a valid means of conflict management—would introduce for the industry as a whole.

I. EXECUTIVE SUMMARY

For the reasons set forth below, MFA strongly recommends that the Commission withdraw the Proposal. We respectfully urge the Commission to consider the following key concerns, discussed in greater detail in subsequent sections of this letter:

A. **The Proposal abandons full and fair disclosure and informed consent** as a valid means of addressing potential conflicts of interest, upending the historical and current approach to satisfaction of investment advisers' fiduciary duties. The Commission fails to acknowledge the inevitable costs and consequences of this action, including consolidation and less competition with fewer choices for investors.
B. **The Proposal's core definitions are markedly overbroad** and thereby can be read to capture nearly every aspect of an adviser's business. The new requirements would therefore render advisers unable to operate in many contexts without significant delays, harming investors and capital markets.
C. **The Commission's cost-benefit analysis in support of the Proposal is inadequate.** The Proposing Release fails to establish the insufficiency of the existing applicable regulatory framework and also fails to recognize the Proposal's tremendous costs, including the implementation challenges and risks of the Proposal's overbroad

[6] *Id*. at 53,971.

requirements and the resulting detrimental tradeoffs advisers would be forced to make in their allocations of compliance and other resources.

D. **The Proposal is arbitrary and capricious** and suffers from multiple legal failures.

In light of the above, the Commission should withdraw the Proposal and consider anew the appropriate scope and applicability of any new regulation[7] in this area. MFA and its members would be willing to share with Commission staff their knowledge, expertise, and insights regarding the use of technology by registered investment advisers[8], the varied and profound benefits that technology has conferred upon investors and the marketplace as a whole, and the significant and, in many cases, unmanageable costs that the Proposal's requirements would impose. Engaging with registrants and other market participants on this topic would allow the Commission to undertake a proper cost-benefit analysis—a fatal omission from this Proposal. Any future rulemaking should not jettison, ignore, or, arbitrarily and without explanation, deem inadequate the other guidance, rules, and regulations that also govern advisers' interactions with investors—doing so constitutes a violation of the APA.

II. DISCUSSION OF KEY CONCERNS

A. The Proposal Abandons the Concept of Full and Fair Disclosure and Informed Consent as a Valid Means of Mitigating and/or Managing Potential Conflicts *(Proposing Release Question 25; Question 37; Question 53; Question 58; Question 104; Question 106)*

As one of the SEC's own Commissioners observed, the Proposal "reflects this Commission's loss of faith in one of the pillars of our regulatory infrastructure: the power of disclosure and the corresponding belief that informed investors are able to think for themselves."[9] The erosion of this bedrock principle would have vast consequences for the interpretation of advisers' fiduciary obligations and how advisers may fulfill such obligations in contexts that cover every corner of adviser-investor relationships, well beyond interactions in

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[7] As discussed in Section II.C of this letter, we note that all registered investment advisers already must comply with the recently-revamped Rule 206(4)-1 of the Advisers Act ("**Marketing Rule**"), including with respect to disclosure of the risks and conflicts associated with the use of predictive data analytics ("**PDA**") in developing marketing materials for prospective investors. In addition, we wish to emphasize that many of our members currently disclose to investors and prospects in a variety of ways the risks and potential conflicts involved in portfolio management, including with respect to the use of quantitative and other models, non-traditional data, artificial intelligence, and other tools and technologies.

[8] We provide several examples of advisers' uses of technologies for the benefit of investors in Section II.C of this letter, and also wish to highlight that many technological functions currently deployed by advisers represent more efficient means of carrying out what were previously manual functions, *e.g.*, cross-checking data received against public sources, refreshing information pulled from internal databases, or running pricing comparisons across trading counterparties. That an adviser would be restricted from doing with assistance from a technological tool the very same task it could ask employees to undertake manually seems an illogical result with poor outcomes for the efficiency of capital markets.

[9] Statement by Commissioner Hester M. Peirce, "Through the Looking Glass: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers Proposal," July 26, 2023, available at https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623.

which certain types of technology are deployed. Among other negative results[10], this would undoubtedly lead to a reassessment of risk by every registered investment adviser and potential new registrant.[11] Certain advisers, and in particular smaller and emerging managers, including many women- and minority-owned firms, may conclude that the risk of taking on external clients is simply not worthwhile and exit (or never enter) the market, reducing competition, fostering consolidation, and limiting investor choice. Compounding the likelihood of disparate impacts, the Proposal would also dissuade smaller and emerging managers that lack the considerable resources (or commercial ability to raise investor fees) necessary to navigate the panoply of onerous new requirements from developing and deploying new technologies—leaving them at an increasing competitive disadvantage in the marketplace and further hastening industry consolidation. We urge the Commission to withdraw the Proposal as it considers these inevitable unintended consequences.

Moreover, to proceed with the Proposal would be to overturn the Commission's own relatively recent Commission Interpretation on the fiduciary duties of registered investment advisers[12], in which the Commission explicitly provides that investment advisers may address conflicts of interest in a manner consistent with their fiduciary obligations <u>either</u> by eliminating an identified conflict of interest or by providing full and fair disclosure to investors regarding the conflict and obtaining investors' informed consent. Any future rulemaking should not jettison, ignore, or, arbitrarily and without explanation, deem inadequate the other guidance, rules, and regulations that also govern advisers' interactions with investors—as noted above, doing so constitutes a violation of the APA. Advisers should continue to be able to rely on disclosure of relevant conflicts—a fundamental principle of investment adviser regulation for decades—and informed consent mechanisms, and yet the Proposal's requirement that firms need to "eliminate

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[10] We wish to emphasize that the day-to-day operations of an advisory business often do not, as a practical matter, allow for the opportunity to *promptly* isolate and eliminate and/or neutralize the myriad "conflicts" (as defined in the Proposal) that would arise in the ordinary course. The requirements of the proposed rules would therefore in many cases lead to the loss of certain investment opportunities and the associated potential returns for investors. As just one example, consider a scenario in which an adviser learns of a quickly-moving opportunity for a fund, receives certain information regarding the opportunity, and uses PDA tools to verify the reliability of the information it has received. Under the Proposal, the adviser would need to halt its investment process to first determine that it could eliminate or neutralize any conflicts before entering into the deal—which may not be possible in the first instance, given that the adviser's interest would align with the fund's interest—and then risk losing the time-sensitive opportunity altogether, rather than merely disclosing the use of PDA in its investment processes to investors ahead of their investment in the fund. This opportunity cost risk is, of course, that much more acute when applied to virtually all conflicts, as the Proposal seems to suggest.

[11] The Commission itself concedes that the costs and burdens of identifying any conflicts of interest in the virtually unlimited panoply of "covered" technologies under the proposed new rules would indeed risk "dissuad[ing] firms from using certain technologies" even if the technologies may not create any conflicts of interest and even if "the firm complied with and *made adequate disclosure under* all preexisting rules regarding conflicts of interest." Proposing Release, *supra* note 2, at 54,010.

[12] 17 CFR Part 276, "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Advisers Act Release No. IA-5248, 84 Fed. Reg. 33,669 (July 12, 2019) (the "**Fiduciary Interpretation**"); release available at https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf.

or neutralize" conflicts of interest would not permit these widely-used and accepted approaches. The Commission fails to acknowledge this sea change in approach, particularly as it would apply to sophisticated institutional investors in private funds that are exempt from registration under the Investment Company Act of 1940 ("**Investment Company Act**").

It is worth highlighting that the Advisers Act was debated and adopted at the same time as the Investment Company Act, and was deliberately designed to provide a more flexible framework with respect to addressing potential conflicts of interest. In contrast to the Investment Company Act, which contains prohibitions or restrictions on transactions that may raise certain conflicts with no opportunity to address such conflicts through disclosure and informed consent, the Advisers Act considers disclosure and consent to be a sufficient and appropriate means of addressing certain conflicts. As one example, the Advisers Act permits investment advisers to engage in principal transactions on behalf of clients so long as certain specific disclosure and consent requirements are met[13]; under the Investment Company Act, by contrast, principal transactions are prohibited without the oversight of the applicable registered fund(s) board of directors, including its independent directors[14]. Congress has also applied a "disclosure is insufficient" approach in the context of other statutes, such as the Employee Retirement Income Security Act of 1974[15]. It therefore rings hollow to claim that Congress intended for disclosure to be insufficient in the Advisers Act context as well—clearly, when that was the Congressional intent, the applicable statute indicates as much.[16]

B. <u>The Proposal's Definitions Are Profoundly Overbroad; Consequently, the Commission Exceeds its Statutory Authority under the Advisers Act</u> *(Proposing Release Questions 1-9; Questions 11-12; Question 15; Question 20; Question 24; Question 36; Question 44; Question 55; Questions 73-74)*

The Proposal overreaches in a number of respects, and primary among these is the marked overbreadth of its defined terms. Taking together the proposed definitions of "covered technology," "investor," "investor interaction," and "conflict of interest" in the proposed new rule 211(h)(2)-4, the rule's requirements and restrictions may be read to apply to nearly every single aspect of an adviser's business. As a result, the Proposal exceeds the Commission's statutory authority set forth in Sections 204 and 211 of the Advisers Act.

First, the Proposal's definition of "covered technology" is misguided. The language of the Proposing Release—and even the Proposal's title itself—misleadingly suggests that the

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[13] *See* Section 206(3), Advisers Act.
[14] *See* Section 17, Rule 17a-7(e), and Rule 17a-7(f), Investment Company Act.
[15] *See, e.g.*, Section 406(a), Employee Retirement Income Security Act of 1974.
[16] Relatedly, the U.S. Supreme Court noted this distinguishing feature of the Advisers Act in its Securities and Exchange Commission v. Capital Gains Research Bureau, Inc. decision, stating that the "Advisers Act thus reflects… a congressional intent to eliminate, *or at least to expose*, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested" (emphasis added). *See* S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963).

policies driving the new rules relate to the use of artificial intelligence and other newer technologies; indeed, in the "Overview" section of the Proposing Release, the Commission explains, "Artificial intelligence is generally used to mean the capability of a machine to imitate intelligent human behavior and machine learning is a subfield of artificial intelligence that gives computers the ability to learn without explicitly being programmed."[17] The actual proposed definition of "covered technology," by contrast, could be interpreted as going dramatically beyond AI and its subfields to cover nearly any type of technology, even basic Excel models and calculators that can perform "analytical" functions.[18]

Second, the proposed definition of "conflict of interest" is overbroad; under the proposed rule, a "conflict of interest" would exist when an adviser uses a "covered technology" "that takes into consideration an interest of the investment adviser or an associated person of the adviser." The effect would be to render advisers unable to operate in any situation in which they enjoy any benefit—ignoring the fact that these are precisely the situations in which investors benefit as well, whether through direct cost efficiencies or because the adviser is able to devote more resources to higher-order tasks, thereby enabling better client service, fostering innovation, or creating other positive effects. Without any exceptions, materiality qualifiers, or other exclusions, advisers would be required to halt progress and activity in order to evaluate nearly any action they intend to take, even where such action is also in the interest of providing quality advisory services. In order to be able to continue their own operations and in turn to serve all of their investors and clients, advisers need to meet their operating costs, attract and retain employee talent, fund research and development efforts, and support client service, among many other aspects of their day-to-day businesses. Actions of an adviser that incorporate technology (which, as discussed above, are effectively nearly all actions) not only would but *need to* "take into consideration an interest of the investment adviser"—otherwise, the adviser could not sustain its own existence. The Proposal ignores this fundamental point.

Third, the definition of "investor interaction" is contrary to the Commission's stated goals for the Proposal, in that it covers not only marketing and provision of recommendations to investors when they make allocation decisions, but also the management of portfolios, including for pooled private funds—notwithstanding the fact that when investors invest in a private fund, they are deliberately granting decision-making authority with respect to their invested assets to the adviser. In other words, advisers' actions in the context of managing private fund portfolios are intentionally and by design *not* interactions with investors; rather, they are actions on behalf of the pooled fund, which is by regulation the actual client of the adviser. Restricting advisers' abilities to deploy technology in the context of portfolio management will undoubtedly introduce inefficiencies, degrade returns, limit application of various strategies, and increase costs, but it would not address the Commission's stated concerns regarding advisers' interactions with

[17] Proposing Release, *supra* note 2, at 53,961-53,962 (footnote 9).
[18] *See, e.g.,* Proposing Release, *supra* note 2, at 53,977 ("For example, a firm that only uses *simpler covered technologies in investor interactions, such as basic financial models contained in spreadsheets* or simple investment algorithms, could take simpler steps to evaluate the technology and identify any conflicts of interest…" (emphasis added)).

investors themselves. Finally, and relatedly, the Proposal's definition of "investor" is overbroad and goes beyond the Commission's statutory authority. Perplexingly, although in the context of the proposed broker-dealer rules, the definition of "investor" is limited to natural persons, in the investment adviser context it extends to sophisticated institutional investors as well as private funds themselves without any sufficient justification. The Commission relies principally on Section 211 of the Advisers Act for its rulemaking authority in this case; Section 211(h), however, was intended by Congress to regulate interactions with retail customers in the context of marketing to or giving investment advice to retail investors.[19]

Instead of creating a new all-encompassing concept of "investor" that includes retail investors, institutional investors, and pooled private funds, the Commission should recognize that investors in private funds are sophisticated and, by definition, need to meet certain qualification standards—in practice, typically they are required to qualify at a minimum as "accredited investors" under SEC rules and, in the case of funds that are exempt from registration under Section 3(c)(7) of the Investment Company Act, must satisfy heightened eligibility standards. That was the framework intentionally set forth by Congress[20]. This entire regulatory framework and exemption availability is based on the premise that such investors are capable of understanding the risks that an investment in a private fund may pose, provided that the adviser shares with them full and fair disclosure as they make their investment determination(s). Advisers are required to do so both in their Form ADV brochures and in their fund offering memoranda, and to the extent that an adviser provides any advertisement to a prospective investor, such advertisement must comply with all of the requirements and prohibitions set forth in the Marketing Rule. The Commission has failed to identify any reason why this set of requirements and obligations—combined with its examination regime and ability to impose penalties on bad actors—is insufficient.

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[19] *See, e.g.*, comment letter submitted by multiple trade associations in respect of the Proposal (September 12, 2023) ("**Joint Trades Letter**"), available at https://www.sec.gov/comments/s7-12-23/s71223-258279-605062.pdf. The Joint Trades Letter cites the Conference Report on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Conf. Rept. 111-517, 111th Cong., 2d Sess.), and in particular that report's discussion of Subtitle A of Title IX, which included Section 913—the source of Rules 211(g) and 211(h) under the Advisers Act: "Subtitle A directs the SEC to study the standards of care applicable to broker-dealers and investment advisers *giving investment advice to retail customers*, and it authorizes the SEC to promulgate rules imposing a fiduciary duty on broker-dealers and investment advisers *to protect retail customers*… Subtitle A also clarifies the authority of the SEC to *require investor disclosures* before purchase of investment products and services" (emphasis added). *See* Joint Trades Letter, p. 4.

[20] *See, e.g.*, Statement from Commissioner Hester Peirce, "Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews," August 23, 2023; available at https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023. In this Statement, Commissioner Peirce notes that "[p]rivate funds have grown up, as Congress planned, outside of the requirements that govern registered investment companies, which are designed for the general public… Congress, by exempting private funds from the Investment Company Act, set up a system in which private funds would not be subject to the same level of regulation as retail-oriented registered investment companies."

C. The Proposal's Cost-Benefit Analysis is Fatally Inadequate *(Proposing Release Question 45; Question 52; Question 60; Questions 62-63; Question 67; Questions 70-72; Question 75; Question 78; Question 85; Questions 85-87; Questions 94-106)*

The Commission failed to undertake an adequate cost-benefit analysis in respect of the Proposal, as evidenced by (1) the glaring lack of recognition evidenced in the Proposing Release of the severe unintended consequences and resulting costs that these new rules would effect, (2) the absence of evidence that the existing applicable Advisers Act and other rules discussed in the Proposing Release are insufficient, and (3) the Commission's own acknowledgement that it does not have data sufficient to estimate at least some of the costs that comprise its assessment. As a result, we urge the Commission to withdraw the Proposal so that it may properly undertake this critical component of the rulemaking process.

Lack of Recognition of Severe Unintended Consequences and Resulting Costs

The Proposing Release includes some discussion of the costs that the Proposal's new rules would impose, but both dramatically underestimates direct costs to advisers (estimating, for example, that the ongoing *annual* cost to a "Simple Covered Technology Firm" to "Determine Which Conflicts of Interest Require Elimination or Neutralization" would be $1,115[21]—a rate similar to that charged by law firm partners in the industry for *one hour* of their time) and does not even attempt to quantify the indirect costs that the Commission itself acknowledges exist. The Commission notes:

> "The overall costs… could also cause some firms to avoid using certain covered technologies in investor interactions, even if the technologies did not create any conflicts of interest… In these types of situations, firms would lose the potential revenues that these technologies could have generated, and investors would lose the potential benefits of these technologies. In addition, in the absence of these technologies, firms might raise the costs of their services, thus increasing the costs to investors."[22]

This acknowledgement that the Proposal could deter technological progress and thus deprive investors of benefits as well as raise costs to investors is plainly stated but, without any quantification, not considered as an increase to actual cost estimates used in the analysis. And in our view, the statement is accurate but does not go nearly far enough.

The Proposal, if effected, would stifle the very types of innovation that have created enormous value for the industry, including not only advisers and broker-dealers but also investors and even regulators. [23] Investors benefit from any number of technological

[21] Proposing Release, *supra* note 2, at 54,009.
[22] *Id.* at 54,010.
[23] This applies to nearly all types of technology; of note, with respect to AI specifically, Chair Gensler himself has publicly remarked that, "while recognizing the challenges, we at the SEC also could benefit from staff making greater use of AI in their market surveillance, disclosure review, exams, enforcement, and economic analysis."

developments that make markets more efficient and transparent and facilitate greater choice, from smart order routers to index-replicating ETFs.[24] Advisers rely on technology to enhance their portfolio management capabilities through improved risk monitoring, data cleaning and analysis, transaction cost management, settlement efficiency, and innumerate other means, all of which combine to allow for decreased costs and improved returns and risk management capabilities for investors. Regulators both in the U.S. and globally have come to rely on systemic risk reporting that is only feasible through the use of technological tools. The consideration and use of any of these technologies is so closely interwoven throughout advisers' businesses that in many cases, to ask advisers to stop and undertake a prescriptive assessment and documentation process for any of them would be to require them to halt trading, client service, and regulatory reporting altogether.

Despite the Commission's emphasis on robo-advisers in the Proposing Release—indeed, the release refers to robo-advisers over 40 times—the Proposal would affect every single investment adviser in a dramatic fashion. As Commissioner Uyeda noted in his Statement regarding the Proposal, the proposed rules "encompass nearly everything… the proposed rules cover anything that is either analytical, technological, or computational,"[25] from actual PDA to basic spreadsheets to electronic calculators. It cannot be the Commission's intention to prevent advisers from carrying out the most basic elements of their portfolio management services and client service functions without being subject to significant delay introduced by the rules' requirements, and yet this would without question be the result. Further, as noted above, the Proposal would have a disproportionate impact on smaller advisers (including many small and emerging firms that are minority- and women-owned) that may lack the internal resources to devote to the required evaluation and documentation efforts, which would be full-time jobs in themselves given the breadth of coverage; many such firms may inevitably be forced to consider the Commission's recently proffered "option of reducing their assets under management to forgo registration, thereby avoiding the costs of the final rule"[26] at the expense of their own hopes to build growing, thriving businesses. The ultimate effect will be industry consolidation,

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Chair Gary Gensler, "'Isaac Newton to AI' Remarks before the National Press Club," July 17, 2023, available at https://www.sec.gov/news/speech/gensler-isaac-newton-ai-remarks-07-17-2023.

[24] *See, e.g.,* "Artificial Intelligence and Machine Learning in Asset Management," BlackRock, October 2019, available at https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-artificial-intelligence-machine-learning-asset-management-october-2019.pdf. As BlackRock discusses in this white paper, "Simply processing large quantities of data from portfolio managers, exchanges, custodians, rating agencies, and pricing services requires some level of automation to ensure efficiency and accuracy." Advisers are using AI and machine learning "to improve the customer experience, increase the efficiency and accuracy of operational workflows, and enhance performance by supporting multiple aspects of the investment process." *Id.* at p. 1. The example of "smart order routers" is discussed on p. 8 of the paper.

[25] Statement by Commissioner Marc T. Uyeda, "Statement on the Proposals re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers," July 26, 2023, available at https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623.

[26] Securities and Exchange Commission, "Final Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance," 88 Fed. Reg. 63206 (September 14, 2023), at 63,361; 63,382 (footnote 1881).

dramatically reducing choice for investors and putting smaller, emerging managers as well as innovative and forward-thinking advisers of any size[27] out of business.

Another cost that the Proposal seems to ignore is the risk to advisers' intellectual property and the potential downstream consequences of advisers' recognition of this risk. In creating a set of requirements that would compel investment advisers (1) to document details regarding technology and its uses not only in marketing communications but also in portfolio management and (2) to share such documentation with Commission examination or other staff when asked, the Proposal introduces the significant and unnecessary risks of inadvertent disclosures and misuses of proprietary adviser information. The proposed new Rule 211(h)(2)-4(c)(1) provides that investment advisers will need to produce "a written description of any material features of, including any conflicts of interest associated with the use of, any covered technology used in any investor interaction prior to such covered technology's implementation or material modification, which must be updated periodically." Any such written description would presumably need to be produced for Commission staff in the context of an examination or other request, and in light of the breadth of the definitions of "covered technology" and "investor interaction" (as discussed in Section II.B above), advisers would therefore be asked to share details regarding nearly every type of technology they deploy, including algorithms, coding features, signals, and other highly proprietary and commercially sensitive information. The information that advisers would be required to document and disclose is precisely the type of adviser information that the Advisers Act itself identifies as worthy of confidentiality protections,[28] and yet the Proposal's discussion of costs ignores entirely the significant commercial risks posed by the disclosure or misappropriation of this information.

Failure to Provide Evidence that Existing Applicable Rules are Insufficient

In addition to grossly underestimating the costs that its new rules would impose, the Proposal fails to establish the insufficiency of the array of rules that already offer investors the very protections that the Commission proffers as the benefits of the new rules. The Commission fully acknowledges in the Proposing Release that both broker-dealers and investment advisers "operate within regulatory frameworks that in many cases require them to, as applicable, disclose, mitigate, or eliminate conflicts. These regulatory frameworks play a fundamental role in protecting retail investors of broker-dealers, clients of investment advisers, and investors in

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[27] The discussion in the Proposing Release indeed seems to contemplate this, going so far as to note that it may be "impossible" for quantitative trading firms that deploy complex trading systems and other technologies to comply with various provisions of the proposed new rules. (*See, e.g.*, Proposing Release, *supra* note 2, at 53,978.) The proposal of rules with which the Commission itself believes certain types of registrants could not comply seems particularly capricious.

[28] Section 204(b)(10) of the Advisers Act establishes an exception to otherwise applicable disclosure-related requirements for "proprietary information," which the Advisers Act defines as information including "sensitive, non-public information regarding," among other things, "investment or trading strategies of the investment adviser," "analytical or research methodologies," and "trading data."

pooled investment vehicle clients of investment advisers."[29] We agree that it is appropriate for the Commission to "evaluat[e] our regulations' effectiveness"[30] from time to time in light of the continuing evolution of various aspects of the industry. But a critical failure of the Proposal is its lack of evidence that the existing applicable regulations have become ineffective. In other words, the Proposal is founded on the assumption that the existing regulatory framework designed to protect investors' interests is insufficient—and yet offers no evidence in support of this assumption.

The Proposing Release itself, in fact, discusses the various aspects of applicable existing rules in a fair amount of detail, and states that "the Commission has addressed firms' relationships with investors in a variety of ways to ensure investor protection as use of technology in those relationships has evolved over time." Further, in this same discussion, the Proposing Release explains, "Broker-dealers and investment advisers are currently subject to extensive obligations under Federal securities laws and regulations… that are designed to promote conduct that, among other things, protects investors, including protecting investors from conflicts of interest. To the extent PDA-like technologies are used in investor interactions that are subject to existing obligations, those obligations apply"[31]. One of the first citations in the Proposing Release is to the Fiduciary Interpretation, which the Commission cites as the source "describing an adviser's fiduciary duties to its clients."[32] The Commission then goes on in the same footnote: "Additionally, rule 206(4)-8 under the Advisers Act prohibits certain statements, omissions, and other acts, practices, or courses of business as fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in a pooled investment vehicle."[33] The Commission references its own success in pursuing bad actors under this rule, noting that it "has reinforced fraud protection for investors in pooled investment vehicles against conflicts of interest through rule 206(4)-8" and citing to a recent order of settlement with an adviser alleged to have failed to disclose conflicts of interest and to have breached fiduciary duty to multiple private funds.[34] These allegations seem to align quite closely with the concerns the Commission identifies in the Proposing Release, and yet there is no explanation offered for why these types of enforcement actions—seemingly directly on point—are insufficient.

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[29] Proposing Release, *supra* note 2, at 53,961.
[30] *Id.*
[31] *Id.* at 53,965-53,966.
[32] *Id.* at 53,961 (footnote 8).
[33] *Id*.
[34] *Id.* at 53,966. The settled order cited by the Commission in footnote 65 of the Proposing Release is In re. Virtua Capital Management, LLC, et al., Advisers Act Release No. 6033 (May 23, 2022). Note that this matter does not appear to have involved any malevolent use of technology, whether PDA-like or otherwise; the Commission states that it "has and will continue to bring enforcement actions for violations of the Federal securities laws that entail the use of PDA-like technologies," but cites no such examples, further underscoring the lack of a cognizable failure.

Lack of Sufficient Data to Estimate Costs

The Marketing Rule, also referenced multiple times in the Proposing Release, is another clear example of an SEC rule directly applicable to the potential conflicts and risks that the Commission argues the Proposal is intended to address. That rule, which the Commission cites in the Proposing Release as an example of a rulemaking update prompted by advisers' current uses of technology,[35] had a compliance date of *less than one year ago*, and there is no evidence offered in support of the notion that it is already somehow failing to achieve its intended purpose. The Commission itself even quotes from the Marketing Rule's proposing release in this Proposing Release, pointing readers to its statement in the former that the updates to the then-existing Advertising Rule and Cash Solicitation Rule were "designed to accommodate the continual evolution and interplay of technology and advice."[36] It is MFA's understanding that examinations that test for (among other things) compliance with the Marketing Rule have only recently begun, which makes sense in light of the compliance date and the fact that the Commission would need to allow for a reporting period of some length during which advisers would have needed to comply with the new rule. On this timeline, how could the SEC possibly have had any meaningful amount of data relating to investment advisers' Marketing Rule compliance failures when drafting the Proposing Release?

It is perhaps unsurprising, then, that the Proposing Release fails to present any evidence that the Commission's existing tools for finding and remedying instances of insufficient disclosure, *i.e.*, through examinations, deficiency findings, and enforcement actions, as well as issuance of risk alerts and guidance, have fallen short. The concern that the Commission flags—that "disclosure *may* be ineffective" because the implications of use of PDA-like technologies "*could* entail providing disclosure that is lengthy, highly technical, and variable, which *could* cause investors difficulty in understanding the disclosure" (emphasis added)[37]—is wholly speculative. Further, the Commission cites no instances of harm to investors in private funds resulting from receipt of technical disclosures.[38] On the contrary, the Proposing Release itself includes a noteworthy number of references to disclosure as an effective means of educating investors on potential conflicts of interest and allowing them to make informed determinations—an irony that seems lost on the Commission but that speaks to the Proposal's wholly misguided nature. As one example, the Commission raises the possibility of a requirement that advisers "deliver to investors prescribed and standardized disclosure of conflicts of interest" by means of

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[35] *See* footnote 23 of the Proposing Release, *supra* note 2, at 53,963. The Commission cites the Marketing Rule and text from its proposing release in support of the proposition that the "use of technology is now central to how firms provide their products and services to investors." *Id*.
[36] *See* footnote 19 of the Proposing Release, *supra* note 2, at 53,963.
[37] Proposing Release, *supra* note 2, at 53,967.
[38] The SEC's example of investor confusion resulting from technically-oriented disclosures relates to home mortgages extended to natural persons—an area entirely inapposite to the private funds world—and disclosures provided by mortgage brokers, not registered investment advisers. *See* Proposing Release, *supra* note 2, at 54,014.

a form, also filed with the Commission, that "would focus on the conflicts of interest associated with covered technologies and their use in investor interactions."[39] By the Commission's own description, this disclosure could be provided in a format that is "easily understood by investors" and could "reduce the costs to investors to understand and interpret information about covered technologies," also allowing "investors to more easily compare the conflicts of interest that firms have."[40] The Commission then backs away from this idea with the explanation that this disclosure could be "highly technical," but provides no evidence to demonstrate that investors are incapable of understanding technical descriptions; indeed, the Marketing Rule takes as a core assumption the fact that investors are capable of understanding disclosures related to the use of hypothetical performance in advertisements, for example. The majority of disclosures in many private funds' offering memoranda, in fact, are technical—whether about the technical mechanics of fund terms or about the risks and conflicts of interest associated with the fund's activities, including technical aspects such as best execution, cybersecurity risk, or systems-related disaster recovery plans.

Finally, we wish to emphasize that, once again, the Commission's cost-benefit analysis has failed to take into account the fact that, as emphasized in a previous comment letter submitted by MFA and multiple other trade associations in respect of the Proposal[41], the new proposed rules have not been released in a vacuum—they would have important implications for other SEC rules and proposals, including the new Marketing Rule. Moreover, it is critical that any contemporary cost-benefit analysis take into account the number and volume of proposed and final rules issued by the Commission over the past two years and the interconnectedness between such rules[42]—aspects that receive no discussion, consideration, or even mention in the Proposing Release.

D. <u>The Proposal is Arbitrary and Capricious and Raises APA Concerns</u> *(Question 10)*

In the Proposing Release, the Commission relies almost exclusively on concerns regarding trends related to retail investors (*e.g.*, robo-advisers and "gamification") as justification for its onerous proposed new obligations, and likewise points to statutory authority focused on retail investors and the protections that Congress deemed appropriate in the context of investment vehicles required to be registered under the Investment Company Act. Even taking as an assumption the validity of the identified concerns, the Proposal is arbitrary and capricious

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[39] Proposing Release, *supra* note 2, at 54,014.
[40] *Id.*
[41] Comment letter submitted by Trade Associations, August 15, 2023, available at https://www.sec.gov/comments/s7-12-23/s71223-245299-541662.pdf.
[42] *See, e.g.,* comment letter submitted by Managed Funds Association and National Association of Private Fund Managers, July 21, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-233002-486782.pdf. As just one example of the failure to address or acknowledge interconnectedness, the Proposing Release speculates that advisers "might pass the cost of the requirements along to investors through higher fees," yet does not attempt to explain how an adviser might navigate such an expense allocation under the new Private Fund Adviser rules.

in that it would impose restrictions on investment advisers' interactions with every possible type of investor and client, including not only retail investors (with whom many investment advisers, including many MFA member firms, deliberately do not engage[43]) but also sophisticated institutional investors and private funds in which qualified investors pool capital for investment. Crucially, the analogous restrictions under the Securities Exchange Act of 1934 ("**Exchange Act**") would only apply to broker-dealers' interactions with natural persons. The Commission offers no justification for this dramatically disparate treatment as between broker-dealers and investment advisers—the very definition of arbitrary.

In addition to being arbitrary and capricious in its disparate applications, the Proposal's process failures amount to violations of the APA. First, as noted above, the Proposal's requirements are in direct and unjustified conflict with existing rules and guidance, including the Marketing Rule and the 2019 Fiduciary Interpretation. Second, although MFA and its members appreciate the opportunity now to provide the Commission with feedback on the Proposal, we believe the Commission has not met its burden of demonstrating the existence of a market failure or that the benefits of its new rules would outweigh their costs.[44] Lastly, the Proposing Release frequently cites for support a Request for Comment (the "**RFC**") on "digital engagement practices" that the Commission released in August 2021. It is critical to note that the RFC received limited response from industry trade associations or registered advisers or their counsel, precisely because the scope of the RFC was dramatically different from that of the Proposal. Whereas the RFC focused on "gamification" and digital marketing to individual retail investors, the Proposal's breadth and scope unexpectedly extend to all aspects of registered investment advisers' businesses, including the management of private funds on behalf of sophisticated institutional investors. The significant and unforeseeable drift between the RFC and the Proposal has resulted in a set of responses from only a very specific and targeted set of actors (the Proposing Release quotes mainly natural persons trading on their own behalf) and not from those actually in a position to explain how registered advisers deploy different forms of technology in a wide variety of contexts. The Commission cannot rightly engage in this type of "bait-and-

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[43] In light of the requirements that interests in funds exempt from registration under Section 3(c)(7) of the Investment Company Act be offered only to accredited investors and qualified purchasers (as such terms are defined in the securities laws), MFA understands that many investment advisers require advance representations from any prospective investor that has expressed interest in one of their products that such prospect meets accredited investor and qualified purchaser standards. The adviser asks for these representations *before it will even share any marketing material or other fund-specific information*, much less accept an investment.

[44] *See, e.g.,* Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (finding that the Commission's adoption of Rule 14a-11 under the Exchange Act violated the APA due to the fact that the "Commission acted arbitrarily and capriciously here because it neglected its statutory responsibility to determine the likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation," requirements similar to those set forth in Section 202(c) of the Advisers Act (which provides, "Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation")).

switch" with respect to requests for comment and use public feedback on a different topic in support of its proposals without giving affected parties the opportunity to offer input as well.

III. RECOMMENDATIONS AND CONCLUSION

As noted in Section I of this letter, we strongly urge the Commission to withdraw the Proposal. We have serious concerns regarding the dramatic negative consequences that the Proposal would effect, from chilling technological advancement and innovation to preventing investment advisers from engaging in day-to-day operations, ultimately shutting down any number of firms and reducing investor choice and possibilities for returns and capital growth. We also believe that the Proposal is outside the scope of the Commission's statutory authority and contains provisions that are arbitrary and capricious.

Both the title of the Proposal itself and the focus of the Commission's discussion of its concerns in the Proposing Release relate to the risks the Commission perceives to retail investors from firms' deployment of PDA in their interactions with such investors. The Commission has ample tools at its disposal to pursue these goals in a manner that is appropriately tailored, is not arbitrary and capricious, and does not violate the APA. To the extent that the Commission pursues any aspect of its stated policy goals (1) to ensure that investment advisers are not deploying PDA technologies in a manner that puts advisers' interests ahead of investors and (2) to mitigate the potential risks to retail investors that may arise through advisers' use of PDA in the marketing and/or investment recommendation process, we urge the Commission to use such existing tools, which include issuing guidance in respect of the Marketing Rule to clarify disclosure obligations related to the use of PDA in marketing materials shared with prospective retail investors, as well as taking appropriate remedial action in circumstances in which individual advisers fail to comply with the Marketing Rule or otherwise fail to meet their fiduciary obligations or comply with other aspects of the Advisers Act.

If, after undertaking an appropriate rulemaking process (including providing sufficient opportunity for comment and completing an adequate cost-benefit analysis), the Commission determines to move forward with rulemaking of some form, then MFA recommends that any new Advisers Act requirements are strictly limited to instances in which investment advisers are providing investment recommendations directly to retail investors. For example, a new rule or rule amendment might require an investment adviser to provide prescribed disclosure to retail users of the adviser's website before the retail investor is permitted to use website technology that uses inputs from the individual to generate portfolio allocation recommendations. This would guard against the possibility of a retail investor failing to appreciate that an adviser's website tool could generate recommendations that result in higher fees paid by the investor.

MFA is of the firm belief that the principles set forth in the Commission's Fiduciary Interpretation of 2019—in other words, that an adviser can fulfill its duties of loyalty and care to its investors through full and fair disclosure and informed consent—remain as valid and essential today as they did just four years ago. We ask the Commission not to upend this precedent, both longstanding and recently revisited, in favor of a Proposal that raises so many serious concerns, would effect such dramatic negative consequences, and would directly counter the Commission's explicit goals of promoting efficiency, competition, and capital formation.

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MFA appreciates the opportunity to provide comments to the Commission on the Proposal. If you have any questions about these comments, please do not hesitate to contact Rachel Grand, Vice President & Senior Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

<u>/s/ Jennifer W. Han</u>

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cc: The Hon. Gary Gensler, Chairman, Securities and Exchange Commission
The Hon. Hester M. Peirce, Commissioner, Securities and Exchange Commission
The Hon. Caroline A. Crenshaw, Commissioner, Securities and Exchange Commission
The Hon. Mark T. Uyeda, Commissioner, Securities and Exchange Commission
The Hon. Jaime Lizárraga, Commissioner, Securities and Exchange Commission
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