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Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1000

Submitted via email to: rule-comments@sec.gov

October 10, 2023

Dear Ms. Countryman,

AIMA Comments on SEC Proposed Rule on Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (File No. S7-12-23)

The Alternative Investment Management Association ("AIMA")[1] welcomes the opportunity to comment on the proposed rule from the U.S. Securities and Exchange Commission ("SEC" or "Commission") to eliminate or neutralize conflicts of interest associated with broker-dealer or investment adviser interactions with investors through the use of technology that optimizes for, predicts, guides, forecasts or directs investment-related behaviors or outcomes (the "Proposal").[2]

We would like to emphasize at the outset that the vast number and expansive scope of the Commission's proposed rulemakings over the past two years is truly unprecedented. This has meant that our member firms have been overwhelmed and therefore unable to give each proposed rule their full attention. As a result, we want to reiterate our concerns that, despite our request[3] to extend the comment period for this Proposal, the Commission's overlapping and serially short comment periods have not provided

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[1] The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage $800 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

[2] SEC, Conflicts of Interest Associated With the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53960 (Aug. 9, 2023) (the "Proposing Release").

[3] *See*, https://www.sec.gov/comments/s7-12-23/s71223-245299-541662.pdf.

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stakeholders with sufficient time to fully analyze, consider and comment on the various proposed rules in a substantive manner.

While we support appropriate regulatory frameworks that protect investors, we find this Proposal unnecessary, inadequately reasoned and fatally flawed. We are also concerned that the Commission lacks statutory authority to adopt this Proposal.[4] This concern is especially heightened when the same authority relied upon in the Proposal is currently pending court review.[5] On behalf of our members who include investment advisers and other stakeholders across the U.S. capital markets, we request the Commission withdraw this Proposal.

In our comment letter we explain the reasons behind our request to withdraw the Proposal, including:

- the definitions of "covered technology", "conflicts of interest", and "investor interaction" are vague and unworkable;
- the proposal should not apply to private fund advisers and other institutional investors;
- the economic analysis of the effects of the proposed rule is flawed and does not provide an indication of the estimated costs or benefits;
- the Proposal fails to account for interconnectedness and interdependencies with other pending proposals;
- the Proposal overrides existing rules;
- the Commission lacks statutory authority to adopt these rules; and
- the proposal fundamentally redefines conflicts of interest.

The proposed definition of "covered technology" is so overbroad that the Proposal, if adopted, would place no limits on the Commission's or the Staff's authority to determine what constitutes technology subject to the rule, stretching the definition past its breaking point. The scope of technology that would need to be analyzed and documented is unreasonable and unworkable. For example, large investment advisers could have hundreds of distinct covered technologies. The Commission should not regulate (or in this case, indirectly ban) technological innovation that could drastically and unnecessarily overhaul the regulatory infrastructure and status quo of U.S. capital markets. The Commission notes that the Proposal "is intended to be technology neutral,"[6] and yet the incredibly expansive scope of its restrictions would have a severely chilling effect on investment advisers' use of "covered technology" (as broadly defined).

The Proposal demonstrates a fundamental misunderstanding of how investment advisers rely upon technology in a myriad of ways for the benefit of investors, both directly and indirectly (e.g., by allowing

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4 *See* Comment Letter from Trade Associations (Sept. 12, 2023) (requesting the Commission withdraw the Proposal).

5 Pending the outcome of this review, this SEC should not enact any further rules using this statutory authority. *See* Petition for Review, *Nat'l Ass'n of Priv. Fund Managers v. SEC*, No. 23-60471 (5th Cir. Sept. 1, 2023).

6 Proposing Release at 53971.

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investment advisers to enjoy operating efficiencies and thereby reduce costs). For example, advisers often make use of regulatory technology designed to enhance reporting, risk management and compliance with SEC rules. Ironically, this very technology designed to facilitate compliance with SEC rules now finds itself under the SEC's scrutiny as a "covered technology" through this Proposal's broad definition since regulatory technology can be used to "guide" investment.[7] Furthermore, any mere communication involving the use of regulatory technology would be considered an "investor interaction" due to the simple conveyance of information regarding its usage.[8] The onerous and operationally unfeasible requirements in the Proposal would compel investment advisers to shun technological innovations in order to avoid the excessively prohibitive costs of compliance with the Proposal. In reality, the lack of discernible boundaries on what comprises a "covered technology" is likely to curtail the use of existing technology and act as a significant roadblock in adopting new or innovative technology for the benefit of investors. This will unduly restrict competition in the markets, place the U.S. asset management industry at a distinct disadvantage compared to the rest of the world and ultimately harm the investors that the Commission seeks to protect. With this Proposal, the Commission continues its resistance to technological innovation, by seeking to adopt regulation that makes it harder for investment advisers to improve their systems and business efficiency.

Furthermore, the overly broad definition of "conflict of interest" would mean that virtually all of the technology used by advisers to enhance their systems and create efficiencies could be deemed "conflicted." This triggers additional analysis and essentially requires the adviser to prove the negative, i.e., why the "covered technology" does not put the adviser's interest first.

We also believe that the Commission has failed to appropriately analyze the disparate impact on institutional investors, including private funds, and that the stated reasons and bases for the Proposal are not applicable to private funds. The proposed definition of "investor interaction" would include discretionary management of accounts where the engagement is with the investor's account, even if there is no communication or other interaction with investors themselves at the time of trades in their accounts. This would mean that all of a private fund adviser's portfolio management activities may be captured by the Proposal. Again, this would create an enormous scope encapsulating an extensive amount of activity that would be operationally unworkable. Moreover, the decision to treat all investors as the same is inconsistent with prior Commission action. For example, the fiduciary duty interpretation discussing disclosure in the context of investment advisers vis-à-vis retail investors notes that for an institutional client it can differ, in some cases significantly, from disclosure for a retail client because "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[9]

Although the Proposal in name focuses on the use of predictive data analytics ("PDA"), in substance it threatens to upend longstanding precedent – including the Commission's own formal interpretation – regarding the treatment of conflicts of interest in accordance with investment advisers' fiduciary duties. Existing obligations already restrict investment advisers from placing their interests ahead of clients or

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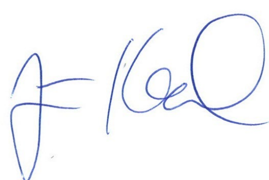
[7] *Id.* at 53972.
[8] *Id.* at 53974.
[9] SEC, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019).

investors in certain contexts, such as when providing investment advice or recommendations, including because of conflicts of interests related to their use of technology. The Commission states in the Proposal, "firms using covered technology to provide advice or make recommendations are subject to standards of conduct, among other regulatory obligations, that already apply to such advice or recommendations."[10] Considering this admission, as well as the Commission's broad-based regulatory initiatives such as the fiduciary duty interpretation, it is unclear as to why the Proposal is either necessary or appropriate.

As we have outlined in the Annex of this letter, we believe the Proposal is unnecessary, inadequately reasoned and its overbroad application is unworkable. The Commission should withdraw the Proposal and engage with market participants to better understand the use of technology by investment advisers and broker-dealers, and how advisers holistically handle conflicts to determine the necessity of further regulation in this area. With this Proposal, the Commission has effectively proposed that the adoption of any new or existing "covered technology" used by an investment adviser will be subject to the regulatory conditions imposed by the Commission without appropriate consideration of the costs of imposing such conditions versus the benefits of such technology. The Commission also must respect the limitations to its statutory authority and the substantive and procedural guardrails to its rulemaking authority.

We have elaborated on our members' concerns with the Proposal in greater detail in the accompanying Annex. We would be happy to elaborate further on any of the points raised. For further information, please contact Jennifer Wood, AIMA's Global Head of Asset Management Regulation and Sound Practices (jwood@aima.org).

Yours sincerely,



Jiří Król
Deputy CEO and Global Head of Government Affairs

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner
Dr. Jessica Wachter, Chief Economist and Director, DERA
William Birdthistle, Director, Division of Investment Management

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[10] Proposing Release at 53967.

ANNEX

I. The Definitions of "Covered Technology", "Conflicts of Interest" and "Investor Interaction" are Vague and Unworkable

Proposed Definition of "Covered Technology" is Overbroad

"Covered technology" is defined in the Proposal as "an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes."[11] This definition creates an immense scope, as most technology utilized by impacted investment advisers is, at minimum, used to "guide" investment-related behavior. While understanding the Commission's desire to create a rule that allows flexibility for technological change, this scope is far too broad.

The Commission's definition of "covered technology" is antithetical to the way in which the Proposing Release appears to frame the rule as purely focused on "predictive data analytics."[12] In the Proposing Release, the Commission argued "the proposed definition is designed to capture PDA-like technologies, such as AI, machine learning, or deep learning algorithms, neural networks, NLP, or large language models (including generative pre-trained transformers)."[13] However, the Commission also suggested inclusion of "technologies that make use of historical or real-time data, lookup tables, or correlation matrices."[14] Most financial technology (including rudimentary spreadsheets) makes use of historical and real-time data.[15] Moreover, the Commission directly states that spreadsheets would be considered "covered technologies" when using a financial modeling tool.[16] Even when using simpler spreadsheets consisting of only basic, elementary financial models, a firm *still* must evaluate the technology under the Proposing Release.[17] Regulating such elementary financial formulas that are the basis of the industry is completely unnecessary.

The Commission must heavily scale back its definition of "covered technology" to address the purposes of the rule more adequately. Such extensive regulation of technology vital to business operations naturally imposes significant challenges and expensive burdens on investment advisers who use virtually any form of technology, to any degree. The Proposal requires not only for advisers to go through all "covered technology" (as broadly defined) looking for conflicts of interest, but additionally to evaluate if

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[11] *Id.* at 53970.

[12] The title of the proposed rule is "Conflicts of Interest Associated With the Use of *Predictive Data Analytics* by Broker-Dealers and Investment Advisers" (emphasis added).

[13] Proposing Release at 53972.

[14] *Id*.

[15] Commissioner Hester M. Peirce Statement, 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) (stating "commonly used software, math formulas, statistical tools, and AI trained on all manner of datasets, could fall within the ambit of this rulemaking" and citing question 36 in the release that discusses "whether technologies 'trained on all books in the English language' should be excluded from the [Proposal's] coverage").

[16] Proposing Release at 53972.

[17] *Id.* at 53977.

there is any "reasonably foreseeable potential conflict of interest" (as that term is broadly defined).[18] This brings up the subjective issue of what is considered "reasonably foreseeable." The burden caused by this regulation will force advisers to conduct a conflicts check (as well as potential conflicts check) every time a new technology is adopted or modified. Given the integration of technology, advisers would be forced to check many more covered technologies than just the one initially modified or adopted. Additionally, it would be particularly burdensome to follow the requirements around material changes to the use of technology (including the testing requirement), and the requirement to record each instance in which a technology is "altered, overridden, or disabled."[19] For example, this requirement would be operationally unworkable given how often software patches are released and changes are made without the input of the adviser or firm. Something as recurrent and mundane as a software update to fix a bug would become an unworkable, operational encumbrance. Moreover, the delays these rules would impose will impede swift patching and bug fixes thereby creating cyber security risks.

The Proposal is intended to be technology neutral.[20] However, as the dissenting Commissioners point out, the new rule would impose a substantial burden on the use of any technology in communicating with investors or managing investments. This burden would likely disincentivize the adoption of new technologies that would otherwise be *beneficial to* investors. It is because of this, as well as the other reasons outlined in this letter, that we believe the Proposal is firmly anti-technology and would have a catastrophic impact on both investment advisers and investors.

Issues with Identifying Conflicts of Interest

Taken literally, almost every "covered technology" (as broadly defined) used by an investment adviser likely considers the interests of that investment adviser – it is, after all, a for-profit enterprise. Thus, the assessment would require an unbounded inquiry about ways the use of a technology may take into consideration an interest of the investment adviser. For example, investment research and analysis that is intended to improve performance or decrease portfolio risk would favor the investment adviser's business, if successful. Marketing activity, which expands the business of the investment adviser, favors the investment adviser's business. These activities, while potentially self-interested, may be fully aligned with the interests of the clients of the investment adviser. The question emerges whether any other industry outside of the financial sector is forced to run its operations without taking into consideration its self-interest (even when fully in-line with investor interests). Ignoring the reality and importance of business self-interest is not good for the health of the industry. As stated before, the fiduciary duty standard is already sufficient.

Even more worrisome is ignoring the unworkable. The Commission notes that "[i]n certain cases, it may be *difficult or impossible* [emphasis added] to evaluate a particular covered technology or identify any conflict of interest associated with its use or potential use within the meaning of the proposed rules . . . [for example] there may be situations where a firm does not have full visibility into all aspects of how a

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[18] *Id.* at 53996.
[19] *Id.* at 53997.
[20] *Id.* at 53971.

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covered technology functions, such as if the firm licensed it from a third party. However, a firm's lack of visibility would not absolve it of the responsibility to use a covered technology in investor interactions in compliance with the proposed conflicts rules."[21] We find it troubling that the Commission is proposing rules that it believes to be "difficult or impossible" to comply with.

Additional Areas of Concern with Vague Definitions

The requirements in the Proposal would apply "when a firm uses covered technology in an investor interaction." The Commission purposefully crafted a "broad [definition of covered technology] to encompass a wide variety of methods, using current and future technologies, that investment advisers could use to interact with investors" and would capture the most sophisticated technologies to simple spreadsheets.[22] The Commission likewise broadly defined "investor interaction" so that the Proposal would apply even when an investment adviser is not communicating with an investor.[23] As a result, no reasonable line can be drawn by an investment adviser on when they are in fact using a "covered technology" for an "investor interaction." Furthermore, by defining "investor interaction" to include discretionary management the scope of the rule expands far beyond any of the Commission's purported concerns expressed in the Proposal. Given the seemingly limitless definition of "covered technology," advisers would be required to evaluate virtually every analytical tool used in connection with an adviser's portfolio management activities.

Moreover, the Proposal requires investment advisers to produce "a written description of any material features of any covered technology used in any investor interaction."[24] Such a requirement is particularly cumbersome considering industry dynamics where superior technology, models and algorithms are often what distinguish investment advisers from their competition. In addition, it is difficult to understand how such a written description of the material features of any "covered technology", such as a spreadsheet used by a firm solely for internal purposes, would provide a real benefit to any investors. Instead, it would be yet another incredibly costly compliance burden for every adviser.

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[21] *Id.* at 53978.

[22] The Proposal defines "covered technology" to cover "an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes." *See* Proposed Rule 211(h)(2)-4(a). The SEC notes that the proposed definition of "covered technology" is designed to capture predictive data analytics-like technologies such as "AI, machine learning, or deep learning algorithms, neural networks, [natural language processing], or large language models, as well as other technologies that make use of historical or real-time data, lookup tables, or correlation matrices among others." *Id.* at 53970 and 53972. *See also* Commissioner Hester M. Peirce Statement, "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) (stating "commonly used software, math formulas, statistical tools, and AI trained on all manner of datasets, could fall within the ambit of this rulemaking" and citing question 36 in the release that discusses "whether technologies 'trained on all books in the English language' should be excluded from the [Proposal's] coverage").

[23] The Proposal defines "investor interaction" as "engaging or communicating with an investor including by exercising discretion with respect to an investor's account; providing information to an investor; or soliciting an investor . . . ." *See* Proposed Rule 211(h)(2)-4(a). The definition "would include engagement between a firm and an investor's account" and would capture "any advertisements . . . that promote or offer services or that seek to obtain or retain one or more investors." *Id*. at 53974.

[24] *Id.* at 53971.

The Proposal does not provide insight on who should be conducting the assessment and assumes without a basis that an investment adviser would have personnel with "sufficient knowledge of both the applicable programming language and the firm's regulatory obligations to review the source code of the technology, review documentation regarding how the technology works, and review the data considered by the covered technology (as well as how it is weighted)."[25] This is unlikely to be true. Thus, many investment advisers will either need to hire individuals with the requisite expertise or eliminate their use of "covered technology" to ensure that they comply with these new, onerous requirements.

Further, because compliance resources within investment advisers are not limitless, this massive reallocation of resources risks misplacing attention within compliance, potentially away from areas where far more serious concerns could exist. An investment adviser should consider conflicts of interests in its business holistically, and not elevate conflicts within one area (those arising from the use of "covered technology") over potential concerns arising in any other area.

II. The Proposal Should Not Apply to Private Fund Advisers and Other Institutional Investors

The proposed rule will apply with respect to "covered technology" used in interactions with all clients of an investment adviser, including institutional investors, as well as investors in registered funds and private funds. For brokers-dealers, the proposed rule, however, would only apply with respect to interactions with retail customers. The rule applies differently to broker-dealers and investment advisers. By eliminating the ability to cure a conflict of interest via full and fair disclosure, institutional clients of investment advisers would receive fewer benefits from "covered technology" than their institutional customers investing with a broker-dealer.

The Commission failed to appropriately analyze the disparate impact on institutional investors, including private funds, and the stated reasons and bases for the Proposal are not applicable to institutional investors. The proposed definition of "investor interaction" would include discretionary management of accounts where the engagement is with the institutional investor's account, even if there is no communication or other interaction with institutional investors themselves at the time of trades in their accounts. This would mean that all of a private fund adviser's portfolio management can be captured by the Proposal. Again, this would encapsulate an enormous amount of activity and be operationally unworkable. Moreover, the decision to treat all investors the same is inconsistent with prior Commission action. For example, the fiduciary duty interpretation discussing disclosure in the context of investment advisers vis-à-vis retail investors notes that for an institutional client it can differ, in some cases significantly, from disclosure for a retail client because "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[26]

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[25] *Id.* at 53977.

[26] SEC, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, [84 Fed. Reg. 33669] (July 12, 2019).

III. The Economic Analysis of the Effects of the Proposed Rule is Flawed and Does Not Provide an Indication of the Estimated Costs or Benefits

The economic analysis regarding the costs and benefits of the Proposal lacks any substance. The law requiring the Commission to examine the economic implications of any rule is very clear, as set forth by the Administrative Procedure Act (the "APA"). Indeed, the Commission has a unique obligation to consider the effect of a new rule upon "efficiency, competition, and capital formation." Moreover, the Commission's failure to "apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation" makes promulgation of the rule arbitrary, capricious and not in accordance with law.[27]

The SEC failed to properly analyze the costs and benefits of the Proposal. Furthermore, the purported benefits of the rule offered by the SEC are questionable at best and largely overshadowed by the massive cost.

The Commission failed to adequately analyze the proposed rules' impact on institutional investors, particularly considering that none of the purported harms the Commission is attempting to address involve institutional investors. For example, the Proposal frequently references the growth of retail investing and gamification, such as the "GameStop Report".[28] The Proposal does not contain any data on how covered technologies have harmed investors (retail or not) or whether investors currently lack confidence in investment advisers using covered technologies. There is only vague speculation on the huge compliance costs for an industry already grappling with a deluge of new rulemakings. In fact, the Commission admits as such, when it states in the Proposal that it "is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges."[29]

The economic analysis reflects no real attempt at understanding the extent of "covered technology" in scope with the Proposal. The economic analysis does not at any point estimate the number of technologies that an investment adviser might have, and, as outlined above, the Proposal is vague enough that investment advisers will have to conservatively consider almost all technology to be "covered technology."

Even more perplexing are the estimates in "Table 2 of the Direct Costs of Proposed Rules Requirements to Evaluate, Identify, Determine, and Eliminate, or Neutralize the Effect of, Certain Conflicts of Interest".[30] For example, in the case of a "Complex Covered Technology Firm," Table 2 estimates that it would take 100 hours to evaluate the use of "covered technology" and identify conflicts of interest. We are aware of at least one firm that has estimated that it could potentially have tens of thousands of covered technologies. That would mean that each "covered technology" could be evaluated and analyzed in mere seconds, according to the Commission's unexplained analysis. We agree with Commissioner Peirce that

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27 *See Business Roundtable & U.S. Chamber of Commerce v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).
28 Proposing Release at 54000.
29 *Id.* at 53998.
30 *Id.* at 54009.

it is hard to reconcile the estimates in Table 2 with the complexity of the processes required by the Proposal.[31]

The Proposal recognizes the costs to investors but makes no effort to compare it to any possible benefits. The Proposal admits that investors could bear substantial costs, when it notes that "requirements to test and document conflicts related to the use of technologies would not only add costs to firms that use covered technologies in investor interaction, they could also slow down the rate at which firms update existing or develop or adopt new technologies…These delays and associated monetary costs could reduce the quality or increase the cost of the technology or service for investors".[32]

There has been no obvious attempt to quantify the costs of the Proposal or compare them to any perceived benefits, especially since there is no clear analysis of any material benefits. Without the ability to outline any material benefit, as well as considering the Commission's lack of cost analysis, the Proposal should be withdrawn.

IV. The Proposal Fails to Account for Interconnectedness and Interdependencies with Other Pending Proposals

In a rush to finalize an aggressive agenda to inexplicably reshape the U.S. capital markets, the Commission is eschewing its obligations under APA. The Commission's lack of separation of interconnected rule proposals in time and analysis renders the comment process deficient and may cause harm to investors and the markets. It is the Commission's obligation at the proposing stage to come forward with well-informed analyses of how markets operate, the likely effect of the changes it is proposing, and why such changes are necessary and appropriate. Instead, as is evident in the onslaught of proposed rules over the past couple of years, the Commission, yet again, simply ignores the substantive work required to publish a thoughtful proposal that shows an understanding of the markets, the implications of the proposed changes and why such changes are necessary or appropriate.

For example, in the Commission's proposed rule, Outsourcing by Investment Advisers,[33] the Commission would prohibit investment advisers from outsourcing "covered functions" without conducting due diligence and monitoring of the service providers. These include functions that would be covered by the Proposal.[34] In a footnote in the Proposal, the Commission "encourage[s] commenters to review that proposal [on outsourcing] to determine whether it might affect comments on this proposal."[35] Rather than doing the necessary analysis mandated by the APA and presenting such analysis for public

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31 Commissioner Hester M. Peirce, Statement 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) (stating "The estimate for firms with simple covered technology is 25 hours initially and 12.5 thereafter and for firms with complex covered technology is 350 hours annually and 175 thereafter. I found it hard to reconcile those estimates with the complexity of the processes the release describes").

32 Proposing Release at 54011.

33 SEC, Outsourcing by Investment Advisers, 87 FR 68816 (Nov. 16, 2022).

34 Proposing Release at 53972.

35 *Id.*

comment, the Commission appears to be shifting the burden of analyzing costs and benefits to commenters.

Further, the Proposal does not account for the myriad of rules and regulations (other than the Standards of Conduct) that already require investment advisers to identify and evaluate covered conflicts of interest. Investment advisers have rules in place that require the conduct of annual risk assessments around conflicts of interest. For example, Rule 206(4)-7 under the Investment Advisers Act of 1940 (the "Advisers Act") requires investment advisers to adopt compliance policies and procedures to ensure reasonable compliance with the Advisers Act and the rules thereunder, including fiduciary obligations to clients. The Commission has not done its diligence in studying the current regulatory landscape and outlining why further regulation is appropriate.[36]

V. The Proposal Overrides Existing Rules

The Proposal is unnecessary because there are no gaps in existing regulatory requirements that need to be filled in this manner. The Commission has failed to identify a persistence of compliance failures, let alone any compliance failure tied to conflicts of interest connected inherently to PDA-like technologies, that justify this Proposal. The Proposal only cites a single settled enforcement action in which an investment adviser failed to adequately disclose a conflict of interest and that case did not deal with PDA technology.[37]

Investment advisers today are subject to many existing rules and regulations which indirectly address the oversight of an adviser's use of technology for investor interactions. For instance, investment advisers' fiduciary duty comprises a duty of loyalty and a duty of care, the latter of which includes providing investment advice in the best interest of the client, based on the client's objectives. Investment advisers cannot waive their fiduciary duty, which is already broad in scope. Adoption of prescriptive requirements that are already covered by pre-existing legislation and regulation runs the risk of creating more problems, such as an inconsistent application of the new requirements by investment advisers. The Proposal even points out, "advisers already have a fiduciary duty to eliminate, or at least to expose, all conflicts of interest which might incline them – consciously or unconsciously – to render advice that is not disinterested."[38] The Commission goes further though, stating "firms using covered technology to provide advice or make recommendations are subject to standards of conduct, among other regulatory obligations, that already apply to such advice or recommendations".[39] Considering this admission as well as the Commission's broad-based regulatory initiatives such as the fiduciary duty interpretation, it is not clear as to why these new rules are necessary.

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[36] We note that the statutory authority the Commission is relying upon for this rulemaking requires demonstration that the rules are appropriate. *Id.* at 53970.

[37] *Id.* at 53966 and *In re Virtua Capital Management, LLC*, SEC Rel. No. IA-6033 (May 23, 2022) (allegedly failing to disclose conflicts of interest and associated fees, and breaching fiduciary duty to multiple private investment funds) (settled order).

[38] *Id.* at 54002.

[39] *Id.* at 53967.

The reason disclosure has been the primary tool by which to address actual and possible conflicts of interest is because the disclosure approach allows activities that may be of significant benefit to investors despite an investment adviser's conflicts. By contrast, the "eliminate or neutralize" requirement effectively will prevent investment advisers from communicating with investors using business models and other adaptive technologies that are expressly permitted by the fiduciary duty interpretation. The Proposal would put investment advisers in a contradictory position where they can rely on disclosure for certain conflicts, but would be required to eliminate or neutralize the same exact conflicts solely based on the investment adviser's use of technology.

The Proposal conflicts with, and potentially overrides without appropriate notice-and-comment under the APA, some of the Commission's current regulations (a few of which were recently adopted) including the fiduciary duty interpretation,[40] the Investment Adviser Marketing Rule (the "Marketing Rule"),[41] and the regulatory framework around soft dollars and securities lending.

First, the Proposal seeks to override the fiduciary duty interpretation by applying a previously non-existent definition of conflict of interest. In a footnote, the Commission notes that:

> "the elimination or neutralization requirement of the proposed rules applies only to a narrower, defined subset of the broader universe of conflicts – those conflicts, that a firm determines actually place the interests of the firm or certain associated persons, ahead of the interests of investors. This is in contrast to an investment adviser's fiduciary duty, which encompasses any interest that might incline the investment adviser, consciously or unconsciously, to provide advice that is not disinterested. Other conflicts of interest that only might affect the firm's investor interactions would continue to be subject to these other obligations, as applicable." [42]

The Proposal does not explain why the fiduciary duty interpretation does not apply to conflicts of interest presented in the use of "covered technology" and why such a standard is not sufficient to address the concerns noted in the Proposal.[43] There is nothing in the fiduciary duty interpretation that limits its application to conflicts that might, rather than conflicts that actually, exist. Additionally, the Commission fails to provide adequate lines between when a conflict might exist and when a conflict actually exists. For example, the Proposal covers any use or "reasonably foreseeable future use" of a "covered technology." It is unclear exactly how an investment adviser might be able to judge whether a conflict of interest would exist in future use. By its own admission, the Commission recognizes the rapidly evolving nature of technology. The Commission explicitly states that the Proposal, while limited to covered

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[40] SEC, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 FR 33669 (July 12, 2019).

[41] Investment Adviser Marketing, 17 C.F.R. § 275.206(4)-1.

[42] Proposing Release at 53967 n. 142.

[43] Commissioner Mark 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) ("To the extent this proposal addresses investor interactions that are not recommendations by broker-dealers and thus not covered by Regulation Best Interest or other rules or guidance, the proposal should have been narrowed to address that perceived gap. Instead, this proposal layers on duplicative requirements and an overly prescriptive approach to policies and procedures, all of which can lead to a 'check the box' mentality at firms.").

technologies, is intended to cover a broad range of actions from providing advice and recommendations, to design elements, features or communications to nudge, prompt, cue, solicit or influence investment-related behaviors or outcomes. How would an investment adviser know whether it should be looking to the fiduciary duty interpretation or this Proposal, when both cover recommendations and investment advice? What conduct is covered under the Proposal that is not covered by the fiduciary duty interpretation? The Proposal appears to generally cover the same conduct covered by the fiduciary duty interpretation apart from fund investors engaged in self-directed trades. If the Commission intends to extend the fiduciary duty interpretation to fund investors and self-directed trades, the Commission should explicitly state as such.

Additionally, the Proposal would eliminate the ability of investment advisers to meet their best interest obligations, under their fiduciary duty, to investors by disclosing or mitigating conflicts, as appropriate. The Commission eliminated disclosure to address the covered conflicts of interests in the Proposal "because a conflict can replicate to a much greater magnitude and at a much greater speed than would be possible to address through timely disclosure."[44] The Commission also noted, without explanation, that investment advisers cannot fully and fairly disclose such conflicts and obtain informed consent. Given, by way of one example, that the Proposal covers conflicts of interest associated with reasonable future use of "covered technology", why would disclosure not be timely? The Proposal would also apply in cases when technology is not used directly with investors and the technology is not used for trading, such as when a human decision-maker acts as an intermediary between the technology and the investor. In those situations, there is ample opportunity for disclosure. It is not clear how the replication of the conflict in and of itself could not be explained by clear and timely disclosure.[45]

Instead, the Commission would require elimination or neutralization of the conflict. Neutralization is a word that has no history under Federal securities laws and overrides the fiduciary duty interpretation. Relying on its plain English meaning, "neutralization" is "to counteract the activity or effect of," "to render (something) ineffective or harmless by applying an opposite force or effect," or "to kill, destroy."[46] It is unclear how this is substantively different in effect from eliminate, which means "to put an end to or get rid of;" to the extent the standard is substantively different, the Proposal fails to articulate how it would work in practice. Therefore, with respect to all conflicts associated with the use of covered technologies that place the investment adviser's interest above investors' interests, the Commission would require elimination. This is a standard that is not achievable and would send investment advisers decades into the past, because they would have to dust off typewriters to service their clients.

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44 Proposing Release at 53988.

45 The lack of ability to disclose is not consistent with other Commission and FINRA rules that prescribe for disclosure when there is a conflict of interest. *See, e.g.*, 17 C.F.R. § 240.15c1-5 (requiring disclosure of control); 17 C.F.R. § 240.15c1-6 (requiring disclosure of interest in a distribution); 17 C.F.R. § 240.15c2-5 (requiring disclosure when extending or arranging credit in certain transactions); FINRA Rules 2241 and 2242 (requiring disclosure of conflicts in research reports); FINRA Rule 2262 (disclosure of control relationship with issuer); FINRA Rule 2269 (disclosure of participation or interest in primary or secondary distribution).

46 Webster's Third New International Dictionary (1961) ("Webster's Third").

The Proposal also conflicts with, and potentially overrides, the Marketing Rule.[47] The Commission states that the Proposal captures "any advertisements . . . that offer or promote services or that seek to obtain or retain *one or more* [emphasis added] investors."[48] Notably, the Marketing Rule defines an advertisement as "any direct or indirect communication an investment adviser makes to *more than one* [emphasis added] person . . . ."[49] It is not clear if the Commission is attempting to revise the definition of an "advertisement" via this Proposal. If the Commission is <u>not</u> intending to revise the definition – which must be the case as the Commission did not provide appropriate notice-and-comment under the APA – how are investment advisers to resolve this regulatory conflict?

The Proposal also potentially conflicts with statutory sections – and Congress has not granted the Commission authority to override the statutes it has enacted. For example, section 28(e) of the Exchange Act creates a safe harbor that allows investment advisers, under certain circumstances, to use client commission payments to purchase eligible brokerage and research services. Given the expansive definition of "covered technologies" and "investor interactions," it is likely that the Proposal would capture technology used in connection with soft dollar arrangements. Given the inherent conflict presented, an investment adviser would be required to eliminate the use of some research reports paid for through the use of soft dollar arrangements regardless of the statutory safe harbor allowing for such use. The Commission cannot, through rulemaking, override statutes.

The Proposal also conflicts with regulated practices, such as securities lending. Investment advisers use technology for all aspects of securities lending, and securities lending in some cases can present a conflict with a client. These conflicts must be disclosed and the Commission and its staff have issued exemptive orders, no-action relief and a variety of guidance over the years regarding securities lending practices. Would an investment adviser be required to interpret the technology involved as "covered technology" and therefore forgo its use in what would be deemed an "investor interaction" under the Proposing Release in order to be able to continue engaging in securities lending?

VI. The Commission Lacks Statutory Authority to Adopt these Rules

The Commission points to Section 211(h) of the Advisers Act as a source of authority for its extraordinarily broad Proposal.[50] The expansiveness of the Proposal, and the breadth of activities it would seek to prohibit, raise serious questions about whether this statutory provision supports the weight that has been put on it. The Commission fails to provide any analysis of the basis on which the proposed rules are supported by Section 211(h) of the Advisers Act. The Proposal lacks a meaningful discussion of both

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[47] *See* 17 C.F.R. § 275.206(4)-1.

[48] Proposing Release at 53974.

[49] *See* 17 C.F.R. § 206(4)-1(e)(1)(i) (emphasis added).

[50] The full text of Sections 211(h) of the Advisers Act and 15(l) of the Exchange Act is as follows: "(h) Other matters The Commission shall -- *(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors*." 15 U.S.C. § 80b-11(h)(2) (emphasis added).

the Commission's understanding of the scope of its authority under this statutory provision and the specific findings of the Commission, as they relate to covered technologies, that would support the link between each of the proposed prohibitions and its statutory authority.

By relying on Section 211(h) of the Advisers Act, a provision which was added to the Advisers Act with the intention of protecting retail investors and distinguishing the standards of conduct for investment advisers from broker-dealers, the Proposal is based largely on questionable statutory authority.[51] It suggests that the Commission thinks Congress granted it *carte blanche* to prohibit any sales practice, conflict of interest, or compensation scheme. This cannot be the case with a section with the title "Other Matters."

VII. The Proposal Fundamentally Redefines Conflicts of Interest

The Commission created a new definition of conflict of interest that does not exist anywhere else under Federal securities laws and conflicts with existing definitions of the term. The definition in the Proposal is vague; it is not clear what it means for a technology (rather than the investment adviser itself) to "take into consideration" the investment adviser's interest.[52] In fact, the Proposal takes the definition of conflict one step too far in indicating that, just because a manner of investor interaction may increase investor engagement and transactions (and therefore fees), there is a conflict. The Commission itself has made clear in the Proposal there would be a conflict of interest "if a covered technology considers *any* [emphasis added] firm-favorable information in an investor interaction or information favorable to a firm's associated persons."[53] This view cannot stand because it suggests that anything making an investment adviser more user friendly or effective presents a conflict.

Moreover, the mere fact that, for example, a particular activity of an investment adviser may entail a "conflict of interest" is not, by itself, sufficient under Section 211(h) of the Advisers Act to support its prohibition as the proposed rules would do. Rather, these sections should not be invoked unless the activity in question involves not only a "conflict of interest" but also a "sales practice" and a "compensation scheme."[54] This is a basic canon of statutory construction.[55] Congress grouped these three items

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[51] The Conference Report on Dodd-Frank describes the purpose of Subtitle A of Title IX, which included Section 913, as follows: "Subtitle A [of Title IX] 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. Finally, the subtitle requires studies on the enhancement of investment adviser examinations, financial literacy, mutual fund advertising, conflicts of interest, improved investor access to information on investment advisers and broker-dealers, and financial planners and the use of financial designations." SEC, Study on Investment Advisers and Broker-Dealers, (Jan. 2011).

[52] The Proposal defines "conflict of interest" as "when a firm uses a covered technology that takes into consideration an interest" of the firm or certain associated persons. *See* Proposing Release at 53981.

[53] *Id.* at 53982.

[54] *See* Comment Letter from Michael S. Hong, Chair, Private Investment Funds Committee, and John Fitzgerald, Chair, Investment Management Regulation Committee, New York City Bar Association Committee on Private Investment Funds and Committee on Investment Management Regulation (Apr. 25, 2022) ("NYC Bar Letter") on the Private Funds Proposal.

[55] *Dole v. United Steelworkers of Am.*, 494 U.S. 26, 36 (1990).

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together intentionally and any rule attributed to these sections should clearly be tied to activities that involve all three.[56]

The broad nature of the Proposal goes well beyond the plain meaning of these terms individually and collectively. The plain meaning of "sales practice" is a mode or method of making sales. The word "sales" refers to "operations and activities involved in promoting and selling goods or services."[57] While the word "practice" means "the usual mode or method of doing something."[58] Taken together, those terms refer to promotional methods in making sales of a good or service. In the context of investment advisory services, this would refer to recommendation or advice with respect to investments. This informs the meaning of the next two phrases in Section 211(h) of the Advisers Act list: "conflicts of interest" and "compensation schemes." These terms refer to incentives that may encourage an investment adviser to push an investor into an unsuitable transaction. Finally, the word "certain" preceding "sales practices, conflicts of interest, and compensation schemes" reinforces the limited nature of Congress's grant of rulemaking authority. The "certain" modifier "applies to the entire series."[59] It demonstrates that Congress carefully delineated the Commission's rulemaking authority to proscribe discrete promotional practices, tactics and compensation schemes that misalign the incentives of the regulated entities and the retail investors whom they advise.[60]

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[56] *See* NYC Bar Letter at 52 ("Section 211(h) should not be involved unless the activity in question involves not only a 'conflict of interest,' but also a 'sales practice' and 'compensation scheme'"); *see also Dole*, 494 U.S. at 36.

[57] Webster's Third.

[58] *Id.*

[59] *Facebook, Inc. v. Duguid*, 141 S. Ct. 1163, 1169 (2021).

[60] *See El Al Israel Airlines, Ltd. v. Tsui Yan Tseng*, 525 U.S. 155, 173 (1999) ("Inclusion of the word 'certain' in the [Warsaw] Convention's title . . . accurately indicated that the [C]onvention is concerned with certain rules only, not with all the rules relating to international carriage by air" (second alteration in original) (internal quotation marks omitted). Additionally, Section 211(h) of the Advisers Act received no legislative debate whatsoever—a strong indication that members of Congress understood the provision to confer a limited rulemaking power to supplement standards of conduct rules under Section 211(g). Through this ancillary provision, Congress did not grant the Commission unfettered authority to reshape the business model of investment advisers from soup to nuts. *See Whitman v. American Truckers*, 531 U.S. 457, 468 (2001) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes.").