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October 10, 2023

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

Re: Request for Comment on 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:

Seward & Kissel LLP[1] submits this letter in response to the specific requests of the Securities and Exchange Commission (the "Commission") in Release No. IA-6353 (the "Release")[2] for comment on proposed new Rule 211(h)(2)-4 under the Investment Advisers Act of 1940 (the "Advisers Act") (the "Proposed Rule"). The Proposed Rule is intended to address certain conflicts of interest associated with the use of "covered technologies"[3] by a registered investment adviser ("adviser") in investor interactions.

We appreciate the opportunity to comment on the Proposed Rule and respectfully request that the Commission consider these comments before adopting any final rule. We represent a number of clients that would be affected by the adoption of the Proposed Rule. The views expressed in this letter, however, are our own and do not necessarily reflect those of our clients.

We support the Commission's efforts to protect investors from harms arising from conflicts of interest, however we believe the Proposed Rule exceeds the statutory authority cited by the Commission; is overly broad and, in certain respects, too vague; unnecessarily departs from the well-established "disclosure and consent" framework; and would dissuade advisers from using technologies and thereby deter innovation. For these and other reasons set forth herein, we believe the Proposed Rule should be withdrawn.

[1] Seward & Kissel LLP is a leading U.S. law firm with offices in New York City and Washington, DC. We represent a comprehensive range of asset management organizations, including serving as counsel to investment advisers.

[2] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Release Nos. 34-97990 and IA-6353, 88 FR 53960 (proposed July 26, 2023) (the "Release").

[3] The Proposed Rule defines "covered technology" 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."

I. Purpose of the Proposed Rule and Summary of the Proposed Rule for Purposes of this Letter

The Commission observes that advisers' adoption and use of PDA-like technologies[4] has accelerated, and that investors can be harmed when advisers use such technologies to optimize for their own interests in a manner that places their interests ahead of investor interests. The Commission notes that conflicts resulting from the use of PDA-like technologies *could* harm investors "in a more pronounced fashion and on a broader scale than previously possible" due to the scalability of PDA-like technologies and the potential for advisers to "reach a broad audience at a rapid speed," and that such conflicts may expose investors to "unique and opaque" conflicts which may not be sufficiently addressed by the current regulatory framework.[5] Against this backdrop, the Commission believes that the current regulatory framework should be updated to help ensure that advisers appropriately address conflicts of interest associated with the use of PDA-like technologies. The Proposed Rule would:

(i) require an adviser to eliminate or neutralize the effect of conflicts of interest associated with the adviser's use of covered technologies in investor interactions that place the adviser's or its associated person's interest ahead of investors' interests; and

(ii) require an adviser that has any investor interaction using covered technology to have written policies and procedures reasonably designed to prevent violations of the Proposed Rule.

II. Statutory Authority and Scope

The Commission cites Section 211(h) of the Advisers Act as authority for promulgating the Proposed Rule.[6] Section 211(h)(2) provides that the Commission shall "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."[7] As the Proposed Rule would dissuade advisers from using various technologies (thereby deterring innovation) and therefore would likely substantially impact the economy over the long term,[8] the Commission must establish "clear congressional authorization" to promulgate the Proposed Rule.[9]

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[4] The Release defines "PDA-like technologies" to include predictive data analytics ("PDA") as well as artificial intelligence (AI), including machine learning, deep learning, neural networks, natural language processing (NLP), or large language models (including generative pre-trained transformers (GPT)), as well as other technologies that make use of historical or real-time data, lookup tables or correlation matrices. Release at n.3.

[5] The Commission provides no empirical support for these claims.

[6] Release at 39, 228.

[7] 15 U.S.C. § 80b-11(h)(2).

[8] The likely impact on the investment industry and the overall economy – especially over the long term – should not be understated. *See infra* Section VII (discussing the cost-benefit analysis).

[9] *See West Virginia v. EPA*, 142 S. Ct. 2587 (2022).

The Commission lacks clear authority under Section 211(h) to promulgate the Proposed Rule. Although the Proposed Rule may appear to fit within the rulemaking authorized by Section 211(h)(2) because it can be characterized as "prohibiting or restricting" conflicts of interest, the Section must not be examined in isolation. The Supreme Court has stated that "[i]t is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme," and that if "the statute at issue is one that confers authority upon an administrative agency, that inquiry must be 'shaped, at least in some measure, by the nature of the question presented' – whether Congress in fact meant to confer the power the agency has asserted."[10] The statutory context does not evidence Congress' intention to authorize the Commission to promulgate the Proposed Rule. Congress added Section 211(h) to the Advisers Act pursuant to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[11] which authorizes the Commission to establish a standard of care applicable to advisers' and broker-dealers' provision of advice and recommendations to "retail customers."[12] Given this statutory context, Section 211(h) should be interpreted as authorizing the Commission to promulgate rules relating only to *retail* investors.[13] The Proposed Rule is not tailored to this statutory authorization, as it would apply to advisers' interactions with both retail and non-retail investors.[14] The Commission would therefore exceed its authority under Section 211(h) if it promulgates a final rule with such scope.

Even if the Commission were deemed to have clear congressional authority to promulgate the Proposed Rule, the Commission has failed to act within such authority, which is established by the plain language of the statute. Under Section 211(h)(2), the Commission must:

- ***Conduct an Examination:*** Section 211(h)(2) provides that the Commission "*shall* … examine and, where appropriate, promulgate rules prohibiting or restricting certain … conflicts of interest." (emphasis added). We believe this language clearly evidences Congress' intention that the Commission must conduct an examination and may promulgate rules only after conducting the examination – *i.e.*, Congress contemplated that any rules promulgated under Section 211(h) would be supported

[10] *Id.* at 2607-2608 (quoting *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803, 809 (1989) and *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159 (2000)).

[11] *See* Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[12] *See* H.R. REP. NO. 111-517, at 870 (Conf. Rep.) (2010) (stating that Subtitle A of Title X of the Dodd-Frank Act directs the Commission "to study the standards of care applicable to broker-dealers and investment advisers giving investment advice to *retail* customers," and authorizes the Commission "to promulgate rules imposing a fiduciary duty on broker-dealers and investment advisers to protect *retail* customers") (emphasis added)).

[13] Commissioner Hester Peirce has expressed a similar view on the statutory authority conferred by Section 211(h). *See* Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Statement by Commissioner Hester M. Peirce (Aug. 23, 2023) (discussing the legislative history of Section 211(h) and noting that Section 913 of the Dodd-Frank Act was added "to address concerns around standards of care for retail investment advisers and broker-dealers," and that such statutory provision is "clearly aimed at retail investors' relationships with their financial professionals").

[14] The Commission appears to recognize this concern. *See* Release at 56 ("Should we narrow the definition of investor for investment advisers? For example, should we only apply it to retail investors, as defined in Form CRS?").

by information learned through the examination. Nowhere in the Release does the Commission indicate that it has conducted the required examination.[15]

- ***Make an Appropriateness Determination:*** Section 211(h)(2) includes the words "where appropriate" – these words require the Commission to make an appropriateness determination in connection with any rules that it promulgates under the Section, *i.e.*, the Commission may promulgate a rule only if the Commission has determined that the rule would be appropriate. As noted in the following bullets, because the Commission has failed to identify the "certain conflicts" that it seeks to restrict or prohibit and accordingly cannot make the public interest determination, it clearly cannot and has not made the "appropriateness" determination.

- ***Identify the "Certain Conflicts" that the Commission Seeks to Prohibit or Restrict:*** Section 211(h)(2) requires the Commission to identify the "certain conflicts" that it seeks to restrict or prohibit. As the Commission has failed to conduct the required examination for this purpose, it has not identified those "certain conflicts." The Release implies that the "certain conflicts" are tied to PDA-like technologies, however given the overly broad definitions of "covered technology" and "investor interaction," the conflicts subject to the Proposed Rule appear to be nearly *all* conflicts associated with an adviser's activities, even those activities that are specifically permitted by the federal securities laws (*e.g.*, effecting principal and agency cross transactions, charging performance fees and using soft dollars).[16]

- ***Make a Determination that "Certain Conflicts" are "Contrary to the Public Interest and the Protection of Investors":*** The Commission must determine that the "certain conflicts" are "contrary to the public interest and the protection of investors." This determination is predicated upon the above-mentioned identification of the "certain conflicts" that the Commission seeks to prohibit or restrict. Having failed to identify those "certain conflicts," the Commission cannot make this determination.

The above elements of the statutory language require the Commission to be concise, supported by experience and study and deliberate in effecting the intent of Congress.

The application of the Proposed Rule would create a dichotomy in the standards applicable to advisers, which would effectively discourage the use of technology. Advisers that forgo covered technologies would be subject to the current fiduciary standard, which reflects the historical approach to regulating the conduct of advisers.[17] By contrast, advisers that use covered technologies would be subject to the current fiduciary standard *plus* the standard imposed by the Proposed Rule. We do not believe that Congress intended to create such a dichotomy or to discourage advisers from using technology.

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[15] In our view, this "examination" requires the Commission to conduct a formal study and not simply rely on staff examinations of advisers.

[16] *See infra* Section VI (discussing these "permitted activities").

[17] *See infra* Section V (discussing the fiduciary standard).

III. Definition of "Covered Technology"

The Proposed Rule defines "covered technology" 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." This definition is extremely broad and can be interpreted to encompass nearly any tool that advisers use in operating their businesses, such as spreadsheets. The Release states that the definition is "designed to capture PDA-like technologies,"[18] but the scope of the definition far exceeds what seems reasonably necessary to accomplish that goal. For example, a spreadsheet that an adviser uses to calculate investments would seem to be a covered technology but would not generally be recognized as a PDA-like technology. We appreciate the challenge that the Commission faces in crafting regulations that are designed to accommodate future technological developments, and we understand the Commission's interests and advisers' interests in having evergreen regulations. However, we believe the challenge of designing a workable definition of covered technology is an indication that the Commission should exercise restraint in regulating advisers' use of technology – indeed, an incremental approach seems preferable in an area as complex and fast-evolving as PDA-like technology. We therefore urge the Commission to tailor the definition of covered technology more closely to the specific characteristics of PDA-like technologies that have drawn the Commission's interest. If the Commission intends to retain this concept, it should be significantly narrowed to comply with the statutory construction of Section 211(h).

IV. Definition of "Investor Interaction"

The Proposed Rule 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; except that the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support." The Commission has requested comment on whether the definition is sufficiently clear.[19] We believe the definition is not sufficiently clear for the following reasons.

The Release states that the definition "is intended to be sufficiently broad to encompass the wide variety of methods … that firms could use to *interact with investors*", and "is generally designed to limit the [Proposed Rule's] scope to a firm's use of covered technology in *interactions with investors*." (emphasis added).[20] However, the definition expressly includes "exercising discretion with respect to an investor's *account*," and the Release states that the definition "would include engagement between a firm and an investor's *account*"[21] and "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

[18] Release at 42.

[19] *Id.* at 57.

[20] *Id.* at 50-51.

[21] *Id.* at 50-51.

accounts." (emphasis added).[22] Therefore, the Commission's intention is to focus the definition on engagement or communication *with investors*, but the definition itself expressly includes engagement *with accounts*. We believe this definitional construct would be especially problematic in the discretionary management context, wherein advisers engage with clients and with accounts in a wide variety of ways. The Commission has requested comment on whether discretionary management of accounts should be included within (or excluded from) the definition of investor interaction.[23] We believe discretionary management should be excluded because any conflicts of interest associated with discretionary management of accounts using covered technologies are sufficiently addressed under the current regulatory framework (as discussed in Section V below).

If the Commission determines to adopt a final rule wherein discretionary management of accounts is included in the definition of investor interaction, we request clarification on the scope of the "clerical, ministerial, or general administrative support" exclusion. Where an adviser manages an investor's account on a discretionary basis, any engagement by the adviser *with the account* would be an investor interaction, unless an exclusion applies. Therefore, it would be crucial for advisers to understand exactly which forms of engagement are investor interactions and which are not. We believe the exclusion is not sufficiently clear for the following reasons:

- The Release states: "[A] firm could implement covered technology for *automation* of, for example, 'back office' processes like the routing of customers' orders and accounting and trade settlement. In each of these examples, the use of covered technology for these processes does not involve an investor interaction, and therefore would not be subject to the proposed conflicts rules." (emphasis added).[24] The Release's inclusion of the word "automation" could be interpreted to mean that only *automated* back office processes would qualify for the exclusion. We therefore request that the Commission clarify whether back office processes that are *not* automated would qualify for the exclusion.

- The Release makes clear that the exclusion would capture trade settlement and the routing of customers' orders,[25] but it is less clear on whether the exclusion would capture certain other functions. When discussing the exclusion, the Release refers to "'back office' processes like the routing of customers' orders and accounting and trade settlement,"[26] while in a different context the Release refers to "back office or administrative functions, such as trade settlement, the routing of customers' orders, accounting, or *document review and processing*." (emphasis added).[27] Given the wide range of functions and processes that occur in the course of an adviser's discretionary

[22] *Id.* at 59-60.

[23] *Id.* at 59-60.

[24] *Id.* at 51.

[25] *See* Release at 58-59 (referring to the phrase "clerical, ministerial, or general administrative support," and asking, "is it clear this phrasing would capture trade settlement and the routing of customers' orders or would further explanation be helpful?"); *Id.* at 51, n.132 (stating that "routing of customers' orders is not covered by this proposal").

[26] *Id.* at 51.

[27] *Id.* at 48.

management of accounts and the variety of ways that such functions and process could be characterized,[28] we request clarification on which types of functions and processes would qualify for the exclusion. We also request clarification on the Commission's rationale for the exclusion in the discretionary management context – *i.e.*, does the Commission propose to carve out interactions that do not impact advisers' investment decisions? The exclusion appears to contemplate a distinction between (i) interactions that impact advisers' investment decisions (*e.g.*, using an algorithm to make buy/sell decisions) and (ii) all other interactions, including interactions that implement investment decisions (*e.g.*, routing trade orders). It would be helpful to understand the Commission's views on this question.

V. Shift from "Disclosure and Consent" to "Eliminate or Neutralize"

Section 206 of the Advisers Act establishes a federal fiduciary duty for advisers,[29] which includes a duty to eliminate conflicts of interest or, at a minimum, make full and fair disclosure of conflicts such that clients can provide informed consent.[30] This fiduciary standard – which is well established by case law and recognized by the Commission – has long been the foundation of the regulatory framework governing the conduct of advisers. The Proposed Rule would represent a significant departure from that regulatory framework by requiring advisers to either eliminate, or neutralize the effects of, certain conflicts of interest. The Commission justifies this departure by citing concerns regarding PDA-like technologies, such as the "more pronounced fashion" in which investors can be harmed; the "rapid speed" with which advisers can reach broad audiences; the scalability, complexity and opacity of such technologies; and the "unique and opaque" conflicts associated with advisers' use of such technologies.[31]

We recognize these concerns but do not believe they justify an expansion of advisers' obligations. Generally similar concerns existed when the securities industry was moving from paper-based to electronic communications in the 1960s and 1970s, and even that seismic shift did not justify an expansion of advisers' obligations. The "disclosure and consent" approach embodied in the fiduciary duty has endured over many decades primarily because it has proven effective in balancing the policy objectives of investor protection and investor choice and access to investment products and services – *i.e.*, it permits advisers to engage in activities that benefit investors

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[28] Advisers perform various functions in managing accounts, many of which would seem to qualify for the exclusion, depending on the context. For example, advisers perform functions such as risk management, trade order management, performance reporting, valuation, pricing, portfolio accounting, tax reporting, billing and best execution analysis, and advisers also engage in communications with clients, counterparties and service providers. All of these functions could be viewed as "engaging" with a client account, and we believe any of them could reasonably be characterized as "clerical, ministerial, or general administrative support," depending on the context.

[29] *See Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) ("As we have previously recognized, § 206 [of the Advisers Act] establishes 'federal fiduciary standards' to govern the conduct of investment advisers"); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, at n.11 (1977); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

[30] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019).

[31] Release at 6, 25-27.

notwithstanding conflicts. This approach has also endured because it has proven flexible enough to address the various conflicts that may result from advisers' use of ever-changing technologies across a wide range of interactions with investors. We believe this approach is a durable, time-tested regulatory framework that will remain effective as the technology landscape continues to change. The Commission has not produced sufficient evidence to justify departing from that framework.[32]

We urge the Commission to abandon the proposed eliminate/neutralize requirement and, instead, refocus on the existing regulatory framework (disclosure and consent), which we believe would better advance the Commission's mission of protecting investors, promoting fair, orderly, and efficient markets and facilitating capital formation. As discussed in Section VI below, current regulations specifically permit advisers to engage in certain activities that involve conflicts, provided that there is disclosure and consent. PDA-like technologies should be treated similarly – *i.e.*, investors should be given the opportunity to review advisers' disclosures and to decide for themselves whether to consent to the conflicts. The eliminate/neutralize approach seems likely to deprive investors of the benefits of technologies[33] due to the existence of conflicts that the investors might – if presented with appropriate disclosures – be willing to accept. By contrast, it is far preferable to use the "disclosure and consent" approach, which would encourage advisers to educate investors through disclosure on how they use technologies and would empower investors to make their own decisions regarding investment advisory services, including weighing conflicts. In this regard, the Commission might consider amending Form ADV to require disclosures that specifically address technology-related conflicts, similar to how Form ADV currently requires disclosures that specifically address certain "permitted activities" discussed in Section VI below.[34]

VI. Treatment of Specifically Permitted Activities: Principal and Agency Cross Transactions, Performance Fees and Soft Dollars

The Proposed Rule's definition of "investor interaction" encompasses effecting principal and agency cross transactions, charging performance fees and using soft dollars ("permitted activities").[35] All of these activities involve conflicts of interest but are nonetheless specifically permitted by current provisions of the federal securities laws, subject to conditions.[36] Given the Proposed Rule's

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[32] The Release states that the Commission has "observed instances where conflicts of interest associated with a firm's use of PDA-like technologies have resulted in harm to investors," and refers to an enforcement action involving a robo-adviser service. Release at 30-31. For a rulemaking of this magnitude, we would have expected the Commission to provide clear evidence of actual harm to investors and an analysis of such evidence as part of the examination required by Section 211(h)(2), in order to justify departing from the "disclosure and consent" framework. *See supra* Section II (discussing the statutory provision that the Commission cites as authority).

[33] *See, e.g.,* Release at 188-189 ("Investors would lose the benefit of such technologies if firms determine that the process of eliminating, or neutralizing the effect of, conflicts is too difficult, costly, or uncertain to succeed.").

[34] *See* Form ADV, Part 2A, Item 6 (performance fees); Item 11.B. (principal transactions); Item 12.A.1. (soft dollars).

[35] For purposes of this Section VI, we assume that the functions and processes that an adviser uses in effecting principal and agency cross transactions, charging performance fees and administering soft dollar arrangements would be "investor interactions," as the Proposed Rule defines such term to include, among other things, "exercising discretion with respect to an investor's account." However, as discussed in Section IV above, certain functions and processes may qualify for an exclusion.

[36] *See* Section 206(3) of the Advisers Act (permitting an adviser to engage in a principal or agency cross transaction with a client if the adviser makes written disclosure and obtains the client's consent prior to completing the

broad definition of "covered technology," we assume that an adviser would use some form of covered technology when engaging in the permitted activities[37] – accordingly, the adviser would *use* a covered technology *in* an investor interaction, and there would be a conflict of interest associated with that use. Under the Proposed Rule, the adviser would be required to determine whether the conflict places or results in placing the interest of the adviser ahead of the interests of investors, and if the adviser makes that determination in the affirmative, then the adviser would be required to eliminate, or neutralize the effect of, the conflict. We assume the adviser would take a conservative position and determine – in the context of each permitted activity – that the conflict places or results in placing the adviser's interest ahead of investors' interests.[38] The adviser would therefore be required to, at a minimum, *neutralize* conflicts of interest associated with activities that are specifically permitted by current statutory provisions and rules. This outcome seems contrary to the Commission's statement in the Release that the Proposed Rule would "supplement, rather than supplant, existing regulatory obligations related to conflicts of interest,"[39] and we therefore question whether the Commission's intent is to alter the regulation of the permitted activities in such a significant manner.

We note that the current regulations governing principal and agency cross transactions, performance fees and soft dollars were adopted *in recognition of* the conflicts associated with these activities[40] – *i.e.*, Congress enacted Section 206(3) of the Advisers Act and Section 28(e) of the Exchange Act and the Commission adopted Rules 205-3 and 206(3)-2 because they intended to allow advisers to engage in the permitted activities notwithstanding the conflicts, and Congress likewise authorized the Commission to adopt disclosure requirements as part of the "disclosure

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transaction); Rule 205-3 under the Advisers Act (permitting an adviser to charge performance fees to certain clients); and Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") (permitting an adviser to use client commissions to purchase research and brokerage services without violating the adviser's fiduciary duty if the adviser determines in good faith that the commission was reasonable in light of the services provided).

[37] For example, an adviser might use a spreadsheet or other program to perform calculations to (i) determine whether to effect a principal or agency cross transaction, (ii) manage accounts that pay performance fees or (iii) administer soft dollar arrangements (*e.g.*, track soft dollar credits or select broker-dealers to execute securities transactions).

[38] Release at 87. The Release states that such determination is a facts and circumstances analysis but does not clarify what it means for an adviser's interests to be placed "ahead of" investors' interests. Absent further guidance, we believe advisers would generally take a conservative position and determine that their interests are placed "ahead of" investors' interests in the principal and agency cross transaction, performance fee and soft dollar contexts.

[39] Release at 60-61.

[40] *See* Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Release No. IA-1732 (July 17, 1998) (discussing the conflicts of interest and potential abuses, and noting: "In adopting Section 206(3), Congress recognized the potential for these abuses, but did not prohibit advisers entirely from engaging in all principal and agency transactions with clients. Rather, Congress chose to address these particular conflicts of interest by imposing a disclosure and client consent requirement in Section 206(3) of the Advisers Act."); Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Release No. IA-996, at n.17 and accompanying text (Nov. 26, 1985) (describing the disclosure requirements of Rule 205-3 and noting advisers' disclosure obligations under Section 206 of the Advisers Act); Exemption to Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Release No. IA-1731, at nn.13-14 and accompanying text (July 15, 1998) (explaining that conflicts associated with performance fees are addressed through disclosure as part of an adviser's fiduciary duty); Disclosure by Investment Advisers Regarding Soft Dollar Practices, Release No. 34-35375 (Feb. 14, 1995) (discussing Section 28(e) and noting that "Congress recognized the conflicts that soft dollar practices present").

and consent" framework.[41] In other words, rather than simply prohibiting principal and agency cross transactions, performance fees and soft dollars, Congress and the Commission determined to specifically permit them subject to conditions. Given that these activities are specifically permitted and governed by long-established regulations, it is not clear to us why the regulation of these activities should be altered simply because certain technologies are used.[42] We question whether it is appropriate to impose the eliminate/neutralize requirement on advisers engaging in the permitted activities, and we also question how advisers could eliminate or neutralize conflicts associated with these activities. We believe the Proposed Rule is inconsistent with the existing statutory provisions and rules, as it would effectively prevent advisers from engaging in activities that have long been permitted despite the conflicts. Accordingly, we urge the Commission to consider how the permitted activities would be treated under any final rule.

VII. Cost-Benefit Analysis

The Release acknowledges that the Proposed Rule "could" (we strongly believe *"would"*) cause advisers to "avoid using certain covered technologies,"[43] but fails to appreciate the likely impact – especially over the long term – of dissuading advisers from using technologies. Such impact should not be understated. We believe the Proposed Rule would deter innovation generally throughout the investment industry and would favor larger advisers that have the resources and expertise to comply with the Proposed Rule's requirements, whereas smaller advisers would likely consider the compliance costs to be prohibitively high and potential start-ups might avoid entering the industry altogether given such costs.[44] Accordingly, the Proposed Rule seems likely to benefit larger advisers – especially a well-known handful of very large firms – at the expense of smaller advisers that could use innovative technologies to challenge the larger advisers (thereby creating more competition and lowering costs for investors) but would be dissuaded from doing so given the compliance costs and risks of non-compliance.

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[41] Item 12 of Part 2 of Form ADV requires advisers to disclose their soft dollar practices and how they address related conflicts of interest. The Commission adopted these disclosure requirements in recognition of the conflicts of interests. *See* Amendments to Form ADV, Release No. IA-3060 (Aug. 12, 2010) (discussing the conflicts of interest associated with soft dollars and the related Form ADV disclosure requirements).

[42] Our point would remain the same whether an adviser uses a simple covered technology such as a basic spreadsheet or a complex covered technology such as a computer program that uses artificial intelligence.

[43] Release at 188-192.

[44] The Release acknowledges these costs but, in our view, understates them. *Id.* at 193-194 (noting that (i) the Proposed Rule "could also result in costs that could act as barriers to entry or create economies of scale, potentially making it challenging for smaller firms to compete with larger firms utilizing covered technologies"; (ii) compliance with the Proposed Rule "would require additional resources and expertise, which could become a significant barrier to entry, potentially hindering smaller firms from entering the market or adopting new technologies; (iii) larger advisers "may have a competitive advantage over smaller firms because they may be better able to spread the (fixed) cost of the [Proposed Rule] across their clients, or more effectively negotiate with third party providers to obtain compliant technology externally"; and (iv) smaller advisers could "face a competitive disadvantage compared to larger firms when negotiating with technology companies to build software that complies with the [Proposed Rule]").

The Commission has requested comment on, among other things, whether the costs and benefits of the Proposed Rule are accurately characterized in the Release.[45] As a preliminary matter, we believe the 60-day comment period is not nearly enough time to develop and analyze data regarding the costs. Regardless, we are concerned that the costs are not adequately quantified. In particular, the Commission's estimates for direct costs lack empirical support, and we believe such estimates are likely significantly lower than the actual costs that advisers would incur in seeking to comply with the Proposed Rule.[46] Furthermore, the Commission fails to provide any quantifiable estimates for indirect costs that advisers would bear in seeking to comply with the Proposed Rule.

The Release does not describe any basis for the Commission's estimates regarding the hours that would be necessary to comply with the Proposed Rule or for the amounts used in calculating the expense of personnel hours. As discussed above, the scope of the Proposed Rule is broad. "Covered technologies" would generally cover a significant number of the technologies used by even Simple Covered Technology Firms.[47] The Commission estimates an initial burden of 25 hours for a Simple Covered Technology Firm to comply with the Proposed Rule.[48] It seems highly unlikely that an adviser of any size or complexity would be able to parse through the requirements of the Proposed Rule, review all of its covered technologies and implement an effective compliance program with a mere 25 hours of work. The Commission estimates an initial burden of 350 hours for a Complex Covered Technology Firm to comply with the Proposed Rule.[49] Likewise, this estimate seems far too low considering the complexity and pervasiveness of technologies that would need to be reviewed and potentially modified at a Complex Covered Technology Firm.

The Release acknowledges a range of indirect costs that advisers and investors could incur as a result of the Proposed Rule.[50] Such costs include, among others, that advisers may lose revenue, avoid using certain technologies and slow down the rate at which they develop or adopt new technologies, and such slowdowns could reduce the quality or increase the cost of the technology or service for investors.[51] The Commission does not quantify the impact these costs may have on advisers or investors.

We are also concerned that the benefits of the Proposed Rule are not clear based on the Release. The Release notes that the Proposed Rule would "protect investors from the negative effects" of conflicts of interest associated with advisers' use of PDA-like technologies,[52] but does not include sufficient evidence of actual harm to investors caused by advisers' use of such technologies. The lack of such evidence is glaring. We would have expected the Commission to

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[45] *Id.* at 203.

[46] *See id.* at 182-187.

[47] *See id.* at 184-185.

[48] *Id.* at 184-185.

[49] *Id.* at 184-185.

[50] *Id.* at 187-190.

[51] *Id.* at 188-190

[52] *Id.* at 177.

provide substantial evidence of actual harm to help support its justification for the costs of the Proposed Rule. Accordingly, the Proposed Rule would result in costs that we believe are not warranted given the lack of evidence of actual harm to investors.

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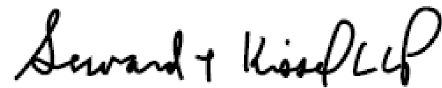
We appreciate the opportunity to comment on the Proposed Rule. If you have any questions regarding this letter, please contact Paul M. Miller at (202) 661-7155.

Very truly yours,



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