October 10, 2023

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

VIA EMAIL AND ELECTRONIC PORTAL

Re.: File Number– S7–12–23 *Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers*

Dear Ms. Countryman:

The Committee on Capital Markets Regulation (the "Committee") offers these comments to the U.S. Securities and Exchange Commission (the "SEC") on its proposed rule "Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers" (the "Proposal").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-six leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Our letter proceeds in two parts. Part I describes how the Proposal would introduce unprecedented and sweeping obligations for broker-dealers and investment advisers to "eliminate" or "neutralize" "conflicts of interest" in connection with any investor interaction that uses "technologies that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes." Part II assesses the proposed changes and their underlying policy rationale.

We find that the Proposal would be unnecessary, impracticable, and extremely costly. Broker-dealers and investment advisers are already subject to comprehensive conflict-of-interest rules and the SEC articulates no rationale for the Proposal's new requirements. The Proposal would apply unworkably broad definitions that create pervasive impediments for all aspects of the business operations of investment advisers and broker-dealers. The Proposal would be virtually impossible to comply with and the mere attempt at compliance would entail massive costs. It is likely to harm investors by increasing costs and reducing technologies that have opened markets to millions of retail investors. It would also put firms and investors at risk of data breaches. Further, the SEC's

[1] SECURITIES & EXCHANGE COMMISSION ["SEC"], *Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers* Fed. Reg. Vol. 88 No. 152, 53,960, https://www.govinfo.gov/content/pkg/FR-2023-08-09/pdf/2023-16377.pdf [the "Proposal"].

economic analysis fails to consider or quantify the Proposal's costs or substantiate its purported benefits. Finally, the Proposal exceeds the SEC's statutory authority. The Committee therefore calls on the SEC to withdraw the Proposal.

I. Overview of the Proposal

Subpart (1) below briefly summarizes the conflict-of-interest rules that presently apply to investment advisers and broker-dealers. Subpart (2) then reviews how the Proposal would layer another set of requirements on top of these existing rules.

1. Current conflict-of-interest rules for investment advisers and broker-dealers.

The Investment Advisers Act of 1940 (the "Advisers Act") and the Securities Exchange Act of 1934 (the "Exchange Act") and the regulations thereunder provide that investment advisers and broker-dealers have duties to their clients that include a duty to identify conflicts of interests that exist between them and their clients and to either eliminate those conflicts or to make "full and fair" disclosure of the conflict to the client.[2] These rules already apply to conflicts that arise in connection with the use of "predictive data analytics" ("PDA") and other covered technology for which the Proposal would create an entirely new standard. Even the Proposal acknowledges that these rules apply to PDA-like technology as it notes that the SEC "has and will continue to bring" enforcement actions for violations of these rules from the use of PDA-like technology.[3]

2. How the Proposal would create an additional set of conflict-of-interest rules.

Notwithstanding these existing protections, the Proposal would create new rules under the Exchange Act and the Advisers Act that operate in addition to, not in place of, the conflict-of-interest rules that already apply to broker-dealers and investment advisers. More specifically, the Proposal would require registered broker-dealers and investment advisers ("firms") to identify all conflicts of interest associated with any "use or reasonably foreseeable use" by the firm of "covered technology" in any "investor interaction."[4]

"Covered technology" would mean any "analytical, technological, or computational, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes."[5] "Investor interaction" would mean "engaging or interacting" with an investor "including by exercising discretion with respect to an investor's account; providing information to an investor; or soliciting an investor."[6] These definitions are intended to capture an extremely broad range of technologies and actions. Everything from a complex machine learning algorithm to a simple spreadsheet that optimizes

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[2] *See, e.g.*, 17 CFR § 240.151–1(a)(2)(iii)(D); 17 CFR § 240.151–1(a)(2)(iii)(B); SEC, Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256 (July 2, 2004), https://www.sec.gov/rule-release/ia-2256; SEC, Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95 238 (Apr. 3, 1963), https://www.sechistorical.org/collection/papers/1960/1963_SSMkt_Chapter_01_1.pdf.
[3] Proposal at 53,967.
[4] *Id*. at 53,971.
[5] *Id*. at 53,970.
[6] *Id*. at 53,974.

asset allocation recommendations to investors would be covered.[7] In fact, the definition would cover any action that involves computation or calculation, regardless of whether any computer or other "technology" – as that term is generally used – is involved.

Notably, an "investor" would include clients and investors in a pooled investment vehicle advised by the investment adviser.[8] Thus any advertisements that solicit investment in a fund or any investment strategies applied by a fund would be covered.[9]

The Proposal would use an unprecedentedly broad definition of "conflict of interest" that covers any scenario where a covered technology "takes into consideration an interest" of the firm or its associated persons.[10] Notably, this definition does not require that the interest of the firm conflicts with an interest of the investor.[11] Thus if an algorithm that the firm uses could potentially incentivize an investor to trade more often or open an options or margin account, thus increasing the firm's revenue, a conflict of interest would exist, even if such trading was beneficial for the investor.[12] Similarly, if an adviser received a fee based on assets under management or performance-based compensation, conceivably every trade that the adviser executes on behalf of the client would be a conflict of interest, since it potentially affects an "interest" of the adviser.

Having identified a conflict of interest, the firm would then be required to determine if the conflict "places the interests of the firm or its associated persons ahead of those of the investor."[13] If a firm makes or "reasonably should" make this determination, the firm must "eliminate or neutralize" the conflict such that the interaction "no longer places the interests of the firm ahead of the interests of investors."[14] The Proposal prescribes no method for this determination or how a firm would eliminate or neutralize such a conflict and provides only a handful of examples: a firm could eliminate a conflict by, for example, ceasing the use of the "technology" (as broadly defined) that created the conflict or neutralize a conflict by "subordina[ting]" consideration of firm-favorable information to investors' interests, or ceasing to earn revenue from the products and services they provide.[15] Notably, a firm could *not* eliminate or neutralize a conflict by disclosing it to the investor.[16]

The Proposal would require firms to adopt and implement written policies "reasonably designed" to achieve compliance with these conflict-of-interest rules.[17] Firms would also be required to maintain and preserve "all books and records" related to their compliance with the proposed rules, including documentation of their identification of any conflict of interest associated with covered technology in any investor interactions, their determination of whether any such conflict was

[7] *Id*. at 53,972.
[8] *Id*. at 53,974.
[9] *Id*.
[10] *Id.* at 53,981.
[11] *Id*. at 53,982.
[12] *Id*.
[13] *Id*. at 53,985.
[14] *Id*. at 53,986.
[15] *Id*.
[16] *Id.* at 54,007.
[17] *Id*.

prohibited by the rule, and how the conflict was neutralized or eliminated.[18] The books and records requirement would also require firms to "make and maintain" records of each instance in which any covered technology of the firm "was altered, overridden or disabled."[19]

II. Analysis of the Proposal

In Part II we identify six significant flaws with the Proposal.

1. The SEC fails to establish any policy rationale for the Proposal.

The Proposal acknowledges that the existing regulatory regimes for investment advisers and broker-dealers include comprehensive conflict-of-interest protections. However, the SEC asserts that additional rulemaking is necessary due to "unique risks" associated with PDA technology that can "rapidly transmit or scale conflicted actions across a firm's investors base."[20] The SEC is concerned that "firms will intentionally or unintentionally take their own interest into account in the data or software underlying the applicable AI, as well as the applicable PDA-like technologies, resulting in investor harm."[21]

However, the SEC presents virtually no evidence of these "unique risks" or that existing rules are inadequate to address conflicts that arise from such technology. The SEC offers anecdotal reports that use of artificial intelligence ("AI") and other PDA technology in the investment advisory and brokerage industries is increasing.[22] But the SEC cites only one example of an actual instance of a conflict of interest in support of its assertion: an enforcement action against a firm providing automated investment advisory services where the firm was alleged to have failed to disclose a conflict of interest.[23] Even in this case it is unclear whether or how the lack of disclosure related specifically to PDA technology. If the use of such technology is indeed increasing as the SEC suggests, then the near total absence of any actual examples of misuse of that technology by investment advisers and broker-dealers belies the SEC's assertion that investors face "unique risks" stemming from such technology that are not addressed by existing rule. And indeed, in the only example the SEC cites, existing conflict-of-interest rules were evidently sufficient to identify the conflict and provide a remedy.

The SEC also reasons that the Proposal is necessary because of purported gaps in the scope of Regulation Best Interest ("Reg BI"), which applies to broker-dealers, because Reg BI only covers "recommendations" and certain PDA-associated actions are outside the scope of recommendations.[24] But if such a gap exists, it does not justify a complete remaking of the basic features of conflict-of-interest regulation.

The underlying rationale for the Proposal appears instead to be an attempt to limit the increasingly broad range of legitimate options available to investors and increasing participation of retail

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[18] *Id*. at 54,008.
[19] *Id*.
[20] *Id.* at 53,962.
[21] *Id*. at 53,965.
[22] *Id*. at Note 3.
[23] *Id.* at 53,968.
[24] *Id*. at 53,975.

investors in financial markets. For example, a significant portion of the sources upon which the SEC relies consists of letters expressing concerns that investors are trading too frequently or cannot make decisions for themselves.[25] As another example, the Proposal specifically names any use of a covered technology that incentivizes an investor to open an option or margin account as a conflict of interest.[26] Options and margin trading are legal products, and merely offering them to qualified investors should not constitute a conflict of interest. These concerns also apply in respect of the Proposal's application to non-retail clients, which the SEC previously recognized have "greater capacity and more resources" than retail clients.[27]

2. <u>Complying with the Proposal would be unworkable, extremely costly, and impede the business operations of firms</u>.

The Proposal would create a compliance burden that would hinder virtually every aspect of the operation of broker-dealers and investment advisers. The mere attempt to comply with such sweeping provisions would be prohibitively costly. In many cases compliance would be virtually impossible. We highlight here only the most significant examples.

First, the definition of "covered technology" is so broad that it would cover virtually any action that involves calculation or computation, whether or not computers or other technology are actually involved, and that influences investor behavior or "outcomes." Thus, everything from complex confidential trading algorithms to the most basic technology, including an Excel spreadsheet or an article on a website, or indeed calculations performed by hand, could be covered. Firms would thus be required to catalog and analyze potentially hundreds of thousands, or even millions, of functions, programs, algorithms, and data feeds to determine if they influence investor behavior or "outcomes." The Proposal would also require that the firm keep a record of "each instance in which a covered technology was altered, overridden, or disabled [and] the reason for such action."[28] Since the uses and effects of technology can change, and because the Proposal defines technology so broadly, firms would be required to repeat this process constantly. For example, broker-dealers and investment advisers are constantly modifying the computer code that undergirds their systems. They are also constantly adjusting their methods of analysis using calculations and formulas that may not even involve computers or technology in the typical sense of the term. In the case of large firms, the modifications may occur hundreds of thousands of times per year. Each one of these modifications would need to be documented, pursuant to the firm's obligation to maintain records of each time a covered technology is "altered," then assessed, disclosed to investors, and, in most cases, "neutralized" or "eliminated" regardless of whether any true conflict of interest exists. This would represent an impossible compliance burden.

Second, the definition of "investor interaction" is similarly unbounded and would cover any engagement or communication with an investor as well as any exercise of discretion with respect

[25] *Id*. at Note 81.
[26] *Id*. at Note 160.
[27] SEC, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers* 25 (July 12, 2019), https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf.
[28] Proposal § 275.204-2(a)(24)(vi). A separate section of the Proposal (§ 275.204-2(a)(24)(i)(A)(1)) would require the firm to keep a list of each date on which covered technology is "materially modified," but there is no materiality qualifier in this subparagraph (vi).

to an investor's account or provision of information to an investor.[29] As a result, an effectively unlimited range of minute and innocuous decisions would necessitate continual analysis and monitoring. For example, the color coding of options on a retail brokerage's or adviser's client-facing interface, or indeed any aspect of such interfaces, could create compliance concerns under the Proposal. Furthermore, by including any exercise of discretionary authority over an investor's account, the Proposal's definition defies the plain meaning of the term "interaction." A grant of such authority by the investor to an adviser is based on the investor's wish for the adviser to act on the investor's behalf *without* interacting with the client.

And crucially, for investment advisers, the definition of "investor" would expressly include any prospective or current client of an adviser (which would include an investment adviser's institutional clients such as private funds and registered investment companies), or investor in a pooled investment vehicle advised by the investment adviser and presumably include the vehicle itself too. The Proposal does not exempt any class of investment vehicle or investor, such that even private funds and their high-net-worth individual and institutional investors would be covered. The Proposal articulates no rationale for its coverage of non-retail clients of investment advisers or for why definition of "investor" is limited to retail clients in the broker-dealer context but not in the adviser context. Indeed, the Proposal fails entirely to analyze or consider the application of the proposed rules to non-retail clients and the funds in which they invest.

Because every trade a fund undertakes can affect an investor's outcome, an adviser would presumably be required to treat every trading decision as a potential conflict of interest that would at a minimum need to be analyzed, documented, and disclosed, and then potentially "neutralized" or "eliminated" – though it is unclear how the firm would accomplish this. Investment managers of both actively and passively managed funds are continually evaluating and executing decisions on behalf of their funds, and funds that use algorithmic trading or other automated trading processes may trade hundreds of thousands of times per day. In addition to the massive compliance costs such an effort would entail, these requirements would hamstring the ability of investment advisers to provide the very services their clients rely on by creating a pervasive regulatory compliance risk for every investment decision. Such a burden would encumber the ability of an investment adviser to manage the fund effectively.

3. <u>The Proposal's definition of "conflict of interest" and its refusal to recognize conflict mitigation through disclosure are unprecedented and unwarranted</u>.

The Proposal would define "conflict of interest" as any instance when a firm uses a covered technology that "takes into consideration an interest" of the firm. This definition conflicts with the plain meaning of the term "conflict of interest" as well as the use of the term in other relevant federal statutes and regulations.

In particular, a "conflict of interest" is commonly defined as "a conflict between competing duties."[30] But the Proposal's definition would not require that there be any "conflict" between the

[29] *Id*. § 275.211(h)(2)-4(b)(1).
[30] MERRIAM-WEBSTER.COM DICTIONARY, "Conflict of interest" https://www.merriamwebster.com/dictionary/conflict%20of%20interest (last visited Sept. 17, 2023).

interests of the firm and those of the customer. Instead, the mere existence of any "interest" of the firm would suffice.

This unprecedented definition would treat the entire business models of broker-dealers and investment advisers as conflicts of interest. Broker-dealers make money by, among other things, facilitating trades by their customers. Each time a customer trades or considers whether to trade (whether at the recommendation of the broker or in a purely self-directed capacity), an interest of the broker-dealer is at stake. Thus, the rule would presumably treat every trade of a broker-dealer's customer, and indeed any decision of a customer to trade or not trade, as a conflict of interest.

Investment advisers are commonly compensated via fees based on assets under management, thus any action that could increase or decrease the assets of an account or managed fund would presumably be a conflict of interest. Furthermore, the investment advisers to many funds are compensated via a carried interest – that is, a percentage of the profits of the fund, or other performance-based metrics. Because any investment decision the adviser makes on behalf of the fund could conceivably increase or decrease the profits of the fund, each such decision – which could number in the hundreds of thousands each day – would presumably be a conflict of interest.

The Proposal also departs from decades of legal and regulatory precedent, including existing SEC rules, by refusing to permit conflicts to be managed through disclosure. Even in the case of retail customers, the Advisers Act, Exchange Act, and the rules thereunder allow firms and their customers to mitigate conflicts of interest through disclosure of the relevant facts.[31] This approach allows investors to determine for themselves whether they are willing to accept a particular conflict. But the Proposal claims in conclusory fashion that disclosure would be uniquely ineffective in the context of PDA technologies because of their complexity, which the Proposal claims would render any possible disclosure incomprehensible to investors.[32] The Proposal cites no evidence for this assertion and leaves unexplained why such technology would be uniquely incomprehensible to investors whereas the complex trading strategies, legal structures, and other processes that firms already employ that are outside the areas of expertise of most investors are susceptible to comprehensible disclosure. This would be "arbitrary and capricious" under the basic tenets of administrative law.

Furthermore, in failing to make any distinctions between retail and institutional investors, the Proposal conflicts with the SEC's prior interpretation of investment advisers' duties under the Advisers Act. In particular, the SEC noted that "[f]ull and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair 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."[33]

The inability of firms and investors to voluntarily resolve potential conflicts with full and fair disclosure is likely to lead to firms restricting the products and services they offer to investors. In this regard the Proposal reflects a fundamental distrust of investor access and choice. This

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[31] Proposal at 53,966.
[32] *Id.* at 53,967.
[33] SEC, *supra* note 27.

approach is even more unwarranted when applied to high-net-worth individuals and institutional investors, including those who invest in private funds, who can draw on even greater stores of expertise and sophistication to decide whether a disclosed conflict is acceptable to them, including those that relate to PDA technology.

4. The Proposal would place firms and investors at risk of data breaches.

The Proposal's recordkeeping provisions could put at risk extremely valuable and sensitive intellectual property of broker-dealers and investment advisers. In particular, the Proposal would require firms to create a centralized written record of all covered technology. As explained above, the Proposal's definitions are so broad that this requirement could be interpreted to encompass certain information about a firm's technologies, systems, and strategies, including a fund's confidential investment strategies, and every change to those technologies, systems, and strategies. Storing all of this information in a centralized record would create a target for cyberattacks and create a risk that a successful attack would result in the loss of all or a significant portion of a firm's valuable intellectual property.

5. The SEC's economic analysis is inadequate.

The SEC's economic analysis ignores or fails to quantify several significant costs of the Proposal and fails to substantiate or quantify its purported benefits.

With regard to costs, the economic analysis's only attempt at quantification consists of an estimate of the direct labor costs associated with firms' identification, evaluation, and elimination of conflicts of interest. But the estimates of the number of labor hours associated with these efforts are unrealistically low. For example, the analysis estimates that a "complex" firm would need to invest only 350 initial hours and 175 hours for each year thereafter to comply with the Proposal.[34] However, as explained above, compliance with the Proposal would likely require firms to evaluate and continually reevaluate thousands of pieces of technologies (as broadly defined in the Proposal) and hundreds of thousands of trades. The number of labor hours associated with such efforts would more realistically number in the thousands.

More generally, the direct compliance costs would constitute only a fraction of the costs associated with the Proposal. The economic analysis either dismisses these costs with no consideration or fails to contemplate them entirely. For example, while it purports to acknowledge the potential that the Proposal's compliance burdens could make firms "less efficient,"[35] it does not contemplate the full breadth of the Proposal's effect on firms' operations and does not analyze at all whether these costs would outweigh the Proposal's purported benefits. The analysis fails to consider entirely how the Proposal would impede the investment strategies of funds, or how the Proposal would affect private funds at all. It also fails to consider the risk of data breaches outlined above, or how the Proposal is likely to negatively affect competition among broker-dealers and investment advisers by creating onerous compliance burdens that are likely to make it harder for smaller firms to compete. The analysis acknowledges the possibility that the Proposal could harm investors by

[34] *Id.* at 54,009.
[35] *Id*. at 54,010.

reducing the availability of beneficial technologies, but it fails to analyze or quantify those potential costs.[36]

With regard to benefits, the economic analysis is devoid of any quantification. And the generalized benefits that the analysis purports will flow from the Proposal are speculative and unsubstantiated. Indeed, the entire discussion of benefits is virtually devoid of citations to any evidence or real-world occurrences. The discussion contains one generalized reference to the Gamestop incident that occurred in January 2021 in support of an assertion that PDA technology promotes "herding behavior."[37] But the analysis does not explain how this incident evidences a need to redefine the concept of "conflict of interest" or substantiate how the Proposal would actually prevent such behavior. Indeed, the structure of the discussion reveals that the Proposal is not truly aimed at conflicts of interest but is rather an attempt to limit the use of technology by investors and their service providers.

6. The Proposal exceeds the SEC's statutory authority.

The SEC claims to derive statutory authority for the Proposal from Advisers Act Section 211(h)(2) and Exchange Act Section 15(l)(2).[38] But in fact neither section authorizes the SEC to fundamentally reinvent the conflict-of-interest rules applicable to broker-dealers and investment advisers as the Proposal would. This is true for three independent reasons: (i) the Proposal conflicts with the plain meaning of the statute, (ii) the Proposal conflicts with the context of the statute and the overall statutory scheme, and (iii) the Proposal conflicts with the major questions doctrine.

i. The Proposal conflicts with the plain meaning of the statute.

Exchange Act Section 15(l)(2) and Advisers Act Section 211(h)(2) consist of identical language, and each provides that the SEC 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."

While the language authorizes the SEC to promulgate rules "where appropriate" with regard to certain "conflicts of interest," as noted above, the Proposal applies a definition of "conflict of interest" that conflicts with the plain meaning of that term. In particular, the Proposal would find a conflict of interest whenever an interest of a broker-dealer or investment adviser exists in the context of an investor interaction, even where there is no conflict with an investor's interests. While the SEC seeks to rely on the use of a term that occurs in the statute, the substance of the Proposal's use of that term is completely different from the term's plain meaning. Instead, the Proposal would ignore the statutory language by defining a term so broadly that it ceases to connote any meaningful category.

[36] *Id.*
[37] *Id.* at 54,007.
[38] *Id*. at 53,971.

Second, it is a canon of statutory construction that every word in a statute is to be given effect and no word should be interpreted such that it has no consequence.[39] The SEC's theory of statutory authorization violates this principle in two respects. First, the word "certain" precedes and qualifies "conflict of interest." "Certain" must have a limiting function or its inclusion in the statutory language would be superfluous. The statute thus contemplates that the SEC may identify a discrete subset of all conflicts of interest that are contrary to the public interest and the protection of investors. It does not contemplate the SEC's enactment of a blanket requirement with respect to all conflicts of interest. Second, the statute qualifies the SEC's authority to promulgate rules with the words "where appropriate." Again, these words must have a limiting function. The statutory language is thus clear that the SEC does not have unfettered discretion to deem any conflict of interest as contrary to the public interest and the protection of investors. The Proposal thus exceeds the statutory language even ignoring the Proposal's reinvention of the definition of "conflict of interest."

ii. *<u>The Proposal conflicts with the statutory context and overall statutory scheme</u>.*

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."[40] However, the authority the SEC claims to derive from these two sections is inconsistent with both the context and overall statutory scheme.

Advisers Section 211(h)(2) and Exchange Act Section 15(l)(2) were both enacted by Section 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("<u>Dodd-Frank</u>")[41] in 2010 following the 2008 financial crisis. The purpose of Section 913 was to strengthen and harmonize the regulation of broker-dealers and investment advisers, particularly addressing problematic techniques for the sale and provision of financial products and investment advice to retail investors. The need for these reforms was described in a report by the Treasury Department that observed "[r]etail investors face a large array of investment products and often turn to financial intermediaries – whether investment advisers or brokers-dealers – to help them manage their investments [but] investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks" and called for the SEC to be "empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest."[42] Moreover, the definition of "investor" for purposes of Section 913 presumes the offering of advice – in particular, investor is defined in relevant part as a natural person "who receives personalized investment advice."

The statutory scheme thus contemplates discrete, targeted reforms aimed at harmonizing existing regulations and protecting retail investors from problematic forms of compensation in the context of the provision of personalized investment advice. This contrasts with the pervasive nature of the Proposal, which is neither limited to retail investors nor particular forms of compensation but

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[39] Bryan A. Garner & Antonin Scalia, *A Dozen Canons of Statutory and Constitutional Text Construction* 99(2) JUDICATURE (2015), https://judicature.duke.edu/articles/a-dozen-canons-of-statutory-and-constitutional-text-construction/.

[40] *FDA v. Brown & Williamson Tobacco Corp.* 529 U.S. 120, 133 (2000).

[41] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1623 (2010).

[42] DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 71-72 (2009), https://fraser.stlouisfed.org/title/financial-regulatory-reform5123.

would rather purport to find a conflict of interest in the most basic aspects of the services that investment advisers and broker-dealers provide and would apply in all contexts, even when no investment advice is offered.

With regard to context, one notes first that the sections on which the SEC relies contain no reference to PDA-like technologies. It is thus almost certainly not the case that Congress contemplated a pervasive and unprecedented remaking of existing conflict-of-interest rules on the basis of such technology. More generally, one notes Congress chose to introduce each section with the heading "Other Matters." The SEC's theory of statutory authorization therefore supposes that Congress would authorize an agency to fundamentally remake an entire regulatory structure beneath a heading indicative of ancillary matters. Such an interpretation is already highly dubious.

We note as well that the authority of the SEC to broadly regulate the advisers to institutional investors under Advisers Act Section 211(h) is being challenged in the courts in connection with the SEC's recently finalized private funds rule.[43] If this challenge is successful, it will likely require at a minimum that the Proposal be rolled back to exclude the advisers of institutional investors.

iii. *<u>The Proposal conflicts with the major questions doctrine</u>.*

The SEC's assertion of authority also conflicts with the major questions doctrine, which the Supreme Court recently applied in the case of *West Virginia v. EPA*. Under this doctrine, for an agency to assert rulemaking authority to change a statute from "one sort of scheme of . . . regulation into an entirely different kind" the agency must point to "clear congressional authorization."[44] The Proposal would completely transform the most fundamental aspects of the existing conflict-of-interest rules that regulate broker-dealers and investment advisers by reinventing the definition of "conflict of interest" so that it applies virtually without limit to all aspects of such firms' operations, and refusing to allow such firms and their clients to use full and fair disclosure to address conflicts of interest. Moreover, the Proposal would do so on the basis of a statute that contains no reference to the technology that the SEC claims warrants its complete remaking of the existing regulatory regime. The Proposal therefore conflicts with the major questions doctrine.

III. <u>Conclusion</u>

The SEC presents no evidence or policy rationale for a need to fundamentally remake the conflict-of-interest rules that apply to broker-dealers and investment advisers. Although the Proposal is framed as added protection for investors with respect to supposedly novel risks associated with the use of AI and similar technologies, the SEC has identified no evidence that existing conflict-of-interest rules are insufficient to deal with those risks. Moreover, far from being limited to novel technologies, the Proposal would apply to virtually any calculation-based process or application, whether computerized or not. The Proposal would also apply to interactions with institutional investors, who are even less in need of the Proposal's paternalistic rules. The Proposal would however result in extremely costly and unnecessary disruptions to the operations of broker-dealers and investment advisers. In addition to being impracticable, if not impossible, to comply with, the

[43] Proskauer Rose, *Lawsuit Challenges Private Fund Adviser Rules* (Sept. 6, 2023), https://www.proskauer.com/blog/lawsuit-challenges-private-fund-adviser-rules.
[44] *West Virginia v. EPA*, 597 U.S. __ (2022).

Proposal would create serious cybersecurity risks with respect to proprietary investment strategies and investors' personal information. The Proposal also exceeds the SEC's statutory authority. The Committee therefore calls on the SEC to withdraw the Proposal. To the extent the SEC in the future identifies compelling evidence of gaps in the application of existing conflict-of-interest regulations, these should be addressed with discrete and tailored adjustments to those regulations.

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Thank you for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,

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