October 10, 2023

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

Re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (File No. S7–12–23) [RIN 3235–AN00; 3235–AN14]

Dear Ms. Countryman:

I am pleased to provide these comments with respect to the Commission proposed rule "Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers."[1]

Introduction

This proposed rule has very, very little to do with "predictive data analytics" and will operationally replace Regulation Best Interest with a bureaucratic morass. The only clear beneficiaries of the rule, were it to be finalized in its current form, are lawyers and compliance officers. It is also far from clear how the proposed rule will dovetail with the existing fiduciary duty imposed on Registered Investment Advisers (RIAs). That there is an adequate statutory basis for such a rule is highly doubtful.[2] That it is a mistake to promulgate the rule in anything

[1] "Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers," Proposed Rule, Securities and Exchange, *Federal Register*, Vol. 88, No. 152, August 9, 2023, pp. 53960-54024 https://www.govinfo.gov/content/pkg/FR-2023-08-09/pdf/2023-16377.pdf.

[2] Investment Advisers Act sec. 211(g) reads:

STANDARD OF CONDUCT.—

> (1) IN GENERAL.—The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this Act when providing personalized investment advice about securities, except the Commission shall not ascribe a meaning to the term ''customer'' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser. The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser.

Even though this provision is in the Investment Advisers Act, it also applies to broker-dealers. Regulation BI is the result of this section. The proposed rule is inconsistent with this statute in that it contains no materiality provision and applies far beyond "personalized investment advice" to "retail customers."

like its current form, however, is clear. It will impose major costs on almost every aspect of broker-dealer and investment adviser operations and further accelerate the precipitous decline in the number of small broker-dealers. Regulatory costs do not increase linearly with size and increased regulatory costs have a disproportionately negative impact on small firms. This, in turn, will adversely affect entrepreneurial capital formation and competition within the industry. Moreover, these higher costs will result in higher fees charged to broker-dealer and RIA customers.

The proposed rule is, presumably, meant to slow the uptake of the use of algorithms and artificial intelligence when providing investment advice. It is not entirely clear to me why emulating the Luddites is a desirable policy objective. Presumably also, the proposed rule is meant to reduce the likelihood that these technologies would harm investors. But that is not what the rule would actually do.

The proposing release does not explain what *factual* predicate requires that 'predictive analytics' be treated differently from every other means by which broker-dealers or investment advisers can act against their clients' interest. It is drafted in an almost absurdly overbroad manner and would have consequences far beyond those advertised in, for example, the SEC's "Fact Sheet" relating to the rule.[3] And those consequences are almost universally negative.

If the rule is not withdrawn, which it should be, then the Commission should dramatically narrow the definitions of "conflict of interest," "covered technology" and "investor interaction" in order to avoid very substantial adverse effects. As drafted, it will cover and bureaucratize virtually all communications and interactions from a broker-dealer or investment adviser to their customers, raising costs dramatically, provide a strong incentive for broker-dealers and investment advisers not to communicate with customers, reduce the information available to customers and harm rather than help customers.

The economic analysis of the proposed rule and the Paperwork Reduction Act cost estimates are inadequate. This could be because the economists undertaking the analysis rested their analysis on the "fact sheet" proposition that the rule actually is about predictive data analytics rather than actually reading and thinking through the language in the actual proposed rule. But the fact remains that the economic analysis is inadequate and virtually devoid of relevant facts. The cost estimates are unreasonably low and have no discernible basis.

See Andrew N. Vollmer, "The Relevant Statutes Do Not Authorize the Predictive Data Analytics Proposal," October 2, 2023 https://www.mercatus.org/research/public-interest-comments/relevant-statutes-do-not-authorize-predictive-data-analytics for a much more detailed analysis.

[3] Fact Sheet, Conflicts of Interest and Predictive Data Analytics https://www.sec.gov/files/34-97990-fact-sheet.pdf. ("Firms have accelerated their use of certain newer technologies, such as predictive data analytics, artificial intelligence, or similar technologies. ... Due to the scalability of these technologies and the potential for firms to reach a broad audience at a rapid speed, any resulting conflicts of interest could cause harm to investors in a more pronounced fashion and on a broader scale than previously possible. This proposal would require specific protections to compliment those already required under existing regulatory frameworks to better protect investors from harms arising from these conflicts.")

Discussion

The proposed rule defines 'conflict of interest' as follows:

> Conflict of interest exists when a broker or dealer [an investment adviser] uses a covered technology that takes into consideration an interest of the broker or dealer [investment adviser], or a natural person who is a person associated with the investment adviser.[4]

This is just about the broadest definition of a conflict of interest imaginable. It does not require a conflict *per se* but simply requires that the broker-dealer or investment adviser take into consideration the interest of the broker-dealer or investment adviser in order for there to be a 'conflict' for purposes of the rule. Since virtually all voluntary market transactions are *ex ante* mutually beneficial, virtually anything the broker-dealer or investment adviser does will take into consideration the interest of the firm offering the service. It is genuinely difficult to think of a situation where that would not be the case. If a firm assesses that they really want their clients to make lots of money so that the firm can keep them as clients, then the firm would have a "conflict" under the proposed rule's definition because keeping the clients is in the interest of the firm. That does not mean, of course, that there is necessarily an *actual* conflict of interest. Moreover, there is no requirement in the definition that the putative conflict be material.[5] Hypothetical, unlikely and trivial (immaterial) 'conflicts' will fall within the definition. Even fiduciaries earn fees and "take into consideration" their own business interest and livelihood. They do not, however, put their own interest ahead of those of their clients.

The proposed conflict of interest definition is different than and broader than the definition in Regulation BI, to wit:

> § 240.15l-1 Regulation best interest.
> …
> (b)(3) Conflict of interest means an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer —consciously or unconsciously—to make a recommendation that is not disinterested.

Assuming, *arguendo*, that the true purpose of the proposed rule is to police predictive data analytics (to wit, AI), then the Regulation BI definition would do the job and avoid the pitfalls of having multiple, inconsistent definitions of 'conflict of interest' in the regulations governing broker-dealers and investment advisers.

The proposed rule defines 'covered technology' as follows:

> Covered technology means an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that

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[4] Proposed §240.15l–2(a) and §275.211(h)(2)–4(a).
[5] Investment Advisers Act sec. 211(g), for example, has a materiality requirement. See note 2, above.

> optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes.[6]

This definition is breathtakingly broad. The printing press was a world transforming technological innovation that serves a 'function.' An *analytical function* would include just about any rational analysis of any form. A book or printed newsletter that 'predicts' or 'forecasts' that a stock, the stock market generally or the economy will go up (or down) falls within the definition. Finance papers published in academic journals are meant to predict, guide, forecast or direct "investment-related behaviors or outcomes." Otherwise, what is their point? If the printed word does not count as analytical or technological, then does it matter if the book or newsletter is in digital form or available on the internet? It is easier to ask what does not fall within the proposed definition than what falls within it. The Commission needs to do better than a definition of covered technology that encompasses virtually anything involving finance.

The proposed rule defines 'investor interaction' as follows:

> Investor interaction means 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.[7]

Just about any communication with an investor falls within this definition except for "Here is your IRS Form 1099" [legal obligation] or "Your user name is Gary Gensler" [administrative support]. The provision is not limited to personalized investment advice provided to retail customers.

So, we have the broadest imaginable definition of 'conflict of interest' combined with a breathtakingly broad definition of 'covered technology' combined with an extraordinarily broad definition of 'investor interaction.' Almost anything is a conflict. Almost anything is a covered technology. And almost anything is investor interaction. This predictive data analytics rule will govern and bureaucratize almost everything a broker-dealer or investment adviser does.

The proposed rule then requires that broker-dealers and investment advisers must:

> (1) Evaluate any use or reasonably foreseeable potential use of a *covered technology* by the broker or dealer, or a natural person who is an associated person of a broker or dealer, in any *investor interaction* to identify any *conflict of interest* associated with that use or potential use (including by testing each such *covered technology* prior to its implementation or material modification, and periodically thereafter, to determine whether the use of such *covered technology* is associated with a *conflict of interest*);
> (2) Determine if any *conflict of interest* identified pursuant to paragraph (b)(1) of this section places or results in placing the interest of the broker or dealer, or a

[6] Proposed §240.15l–2(a) and §275.211(h)(2)–4(a).
[7] Proposed §240.15l–2(a) and §275.211(h)(2)–4(a).

> natural person who is an associated person of a broker or dealer ahead of the interests of investors; and
> (3) Eliminate, or neutralize the effect of, any *conflict of interest* (other than conflicts of interest that exist solely because the broker or dealer seeks to open a new investor account) determined pursuant to paragraph (b)(2) of this section to result in an *investor interaction* that places the interest of the broker or dealer, or a natural person who is an associated person of a broker or dealer, ahead of the interests of investors, promptly after the broker or dealer determines, or reasonably should have determined, that the *conflict of interest* placed the interests of the broker or dealer, or a natural person who is an associated person of a broker or dealer, ahead of the interests of investors.[8]
> (emphasis added)

Subsection (b)(1) applies to almost everything. Almost every email, every newsletter, and every web page will be subject to evaluation because of this rule. Subsection (b)(3) then requires that any conflict of interest that the broker-dealer or investment adviser identifies be eliminated or neutralized if the conflict "placed the interest of the broker or dealer … ahead of the interest of investors."

The rest of the proposed rule is a lengthy set of documentation requirements, not required by Regulation BI, that will enrich compliance officers and lawyers but do nothing for investors other than increase their costs. It will also give the SEC and FINRA a host of reasons to fine broker-dealers and RIAs that have nothing to do with actually protecting investors. All of these added costs incurred by broker-dealers and investment advisers must be recovered by broker-dealers and RIAs by means of higher fees imposed on customers.

The bureaucratization required by (b)(1) and the related documentation requirements,[9] and the fact that it applies to all customers and all communications, not just personalized investment advice to retail customers, is what that this different from the existing requirement under Regulation BI that a broker-dealer "act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer."[10] Similarly, RIAs have a fiduciary duty with respect to their customers under current law. So, the substantive investor protections are not improved by the proposed rule. Only the scope and quantity of internal paperwork is greater. Thus, it is manifestly unclear what is being gained by this proposed rule.

The total cost estimates in Table 2 are ridiculously low. It assumes that a small firm can comply with the evaluation requirements in five hours annually and that a large firm can comply in fifty hours. Since virtually every web page, every customer email not purely ministerial in nature and every publication will have to be reviewed, these are simply impossibly low figures. They are almost certainly wrong by at least two orders of magnitude. The initial compliance figures (10

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[8] Proposed §240.15l–2(b). See and §275.211(h)(2)–4(b) for the investment adviser version which is the same except 'investment adviser' is substituted for 'broker and dealer.'
[9] And (c) Policies and procedures, § 240.17a–3, and § 240.17a–4 and the investment adviser analogs.
[10] 17 CFR §240.15l-1(a)(1).

hours and 100 hours, respectively) are also absurdly low. The costs will be many billions of dollars not a few hundred million dollars. The economists that prepared these estimates simply do not understand the scope and magnitude of the proposed rule.

Sincerely,

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