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October 10, 2023

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By E-mail (rule-comments@sec.gov)

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

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

Dear Ms. Countryman:

We submit this letter on behalf of a group of our broker-dealer clients (collectively, the "Firms") in response to the U.S. Securities and Exchange Commission's (the "Commission" or "SEC") proposed rules intended to address conflicts of interest related to the use of "predictive data analytics" by broker-dealers and investment advisers (the "Proposal").[1] The Firms include large, multi-service broker-dealers that are registered with the SEC and engaged in the business of preparing and distributing investment research globally, as well as sales, trading, and investment banking activities.[2]

Investment research is a category of communication that is highly regulated by both the SEC and self-regulatory organizations ("SROs") and that Congress, the SEC, and SROs have long recognized as critical in promoting efficiency, competition, and capital formation in the U.S. securities markets. The Firms are submitting this letter because the Proposal would apply to investment research in many ways that would be disruptive and harmful to both investors and the securities markets.[3] As discussed more fully below, the Firms are deeply concerned by the

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

[2] By "investment research," we mean content that is produced by a Research Department at an SEC-registered broker-dealer. We use the term "research firms" to mean firms engaged in the business of preparing investment research. *See* FINRA Rule 5280 (applying conflicts rules to material produced by a "Research department"); FINRA Rule 2241(a)(10) (defining "Research department"); FINRA Rule 2242(a)(14) (defining "Research department").

[3] In the Proposing Release, the SEC provides two non-exclusive examples that illustrate how the Proposal would apply to investment research: (1) financial models (including a spreadsheet), and (2) technologies that analyze investors' behaviors to provide curated research reports. *See* Proposing Release at 53972.

Proposal's potential application to investment research for two fundamental reasons, and they urge the Commission to withdraw the Proposal.

- **First, the Proposal would inhibit the timely and free flow of investment research.** Because the Proposal's definitions of "covered technology" and "investor interaction" are so broad, the Proposal could apply to many forms of investment research that have been distributed to investors for years and significantly disrupt their efficient and timely dissemination. This is contrary to the public interest, as Congress and the SEC have consistently acknowledged that investment research plays a unique and important role in promoting the vibrancy and efficiency of the U.S. securities markets, facilitating capital formation, and informing investors. These consequences are also inconsistent with the SEC's rulemaking authority under Section 3(f) of the Securities Exchange Act of 1934 ("Exchange Act"), which requires the SEC to engage in rulemaking that promotes efficient markets, competition, and capital formation.

- **Second, the Proposal's application to investment research is inconsistent with Congress' mandate that the SEC and SROs address conflicts of interest through disclosure and other investment research-specific mitigants.** Because investment research plays a unique, important role in the U.S. securities markets, existing regulation already applies greater restrictions to investment research than to other forms of broker-dealer communications. Congress mandated in the Sarbanes-Oxley Act ("SOA")[4] that the SEC (or the SROs at the SEC's direction) require broker-dealers to address material conflicts of interest that could affect investment research by providing specific, unequivocal disclosures of conflicts relating to the subject of the research.[5] And, in the SEC's view, the disclosures currently required by SEC and SRO regulations are already reasonably designed to "fulfill the mandates of the SOA" and "address conflicts of interest" with the preparation of investment research.[6] The industry has spent millions of dollars over the years to provide these disclosures, and FINRA regularly monitors and enforces their validity and completeness. Without any clear reason, and contrary to Congress's mandate and the SEC's long-standing position, the

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[4] Pub. L. No. 107–204, 116 Stat. 745 (2002).

[5] 15 U.S.C. § 78o–6.

[6] Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 ("Supervisory Analysts"), 345A ("Continuing Education for Registered Persons"), 351 ("Reporting Requirements") and 472 ("Communications with the Public") and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change by the New York Stock Exchange, Inc and Amendment No. 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest, SR-NASD-2002-154, SR-NYSE-2002-154 (July 29, 2003), *available at* https://www.sec.gov/files/rules/sro/34-48252.htm.

Proposal would upend this well-established framework by rendering insufficient the use of disclosures to address conflicts of interest.

The Firms appreciate the opportunity to respond to the Proposal and the SEC's consideration of these comments. The Firms also share the concerns with the Proposal that have been expressed in comment letters submitted by the Securities Industry and Financial Markets Association ("SIFMA") and SIFMA's Asset Management Group and multiple other trade organizations (collectively, the "Trade Association Letters").[7]

I. The Proposal Would Damage the Timely and Free Flow of Investment Research and, In Doing So, Would Be Contrary to the Public Interest and SEC Rulemaking Authority.

The Proposal's application to investment research would disrupt and, in some cases, eliminate the timely and free flow of investment research due to the onerous requirements that would make it more difficult for firms to disseminate investment research to "investors" covered by the Proposal (i.e., retail investors, third-party broker-dealers with retail customers, and investment advisers that use the research for covered clients). This disruption would undermine the unique and important role of investment research in conveying valuable information to investors and facilitating the efficiency of the U.S. securities markets. It also would be inconsistent with the SEC's rulemaking authority.

A. Investment research is widely recognized as playing a critical role in the efficient operation of the U.S. securities markets.

Appreciating the role of investment research, Congress, the Commission, and the international financial regulatory community have long recognized the importance of promoting (not hindering) the dissemination of investment research in a timely and broad manner.[8] Indeed,

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[7] *See* Letter from American Council of Life Insurers et al. to Vanessa A. Countryman, Secretary, SEC (Sept. 12, 2023), *available at* https://www.sec.gov/comments/s7-12-23/s71223-258279-605062.pdf.

[8] *See, e.g.*, Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, 71 Fed. Reg. 41978 (July 24, 2006) ("Recognizing the value of research in managing client accounts… Congress enacted Section 28(e) of the Exchange Act…."); Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, 51 Fed. Reg. 16004 (Apr. 30, 1986) ("In adopting Section 28(e), the Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to money managers and created a safe harbor to permit money managers, in certain circumstances, to continue to use commission dollars paid by managed accounts to acquire research as well as execution services."); Future Structure of Securities Markets, 37 Fed. Reg. 5286, 5290 (Mar. 14, 1972) ("It is, therefore, the Commission's premise that broad-based securities research and its prompt and fair dissemination to large and small investors is indispensable to an efficient system of securities markets."). *See also* Technical Comm., Report on Analyst Conflicts of Interest, International Organization of Securities Commissions 2 (2003), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD152.pdf ("Information is the lifeblood of modern capital

the SEC Staff expressly acknowledged and reiterated the importance of investment research as recently as last year:

> Research and its prompt and fair dissemination to investors has been recognized as valuable to an efficient system of securities markets. The Commission has frequently acknowledged the important role of research to U.S. capital markets, in particular its significance in discovering issuer information and sifting, digesting and transmitting it in a manner that may be used by investors.
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> Investors may view research as an important component of the information environment and use accounting-based information (e.g., analyst forecasts, earnings announcements, earnings pre-announcements, management forecasts, SEC filings) for investment decisions. Further, academic literature has detailed the benefits of research coverage of publicly traded issuers. It has shown, for example, that (1) research coverage of an issuer may affect the liquidity of its stocks, and (2) research analysts provide an external governance mechanism by monitoring issuers' management.[9]

Consistent with this view, the SEC's rulemaking over the years has excluded investment research from many restrictions imposed on other forms of communication. These carve outs are designed to facilitate—and not inhibit—the timely and broad dissemination of investment research.[10] Congress has also acknowledged the importance of disseminating investment research by providing a safe harbor that makes it easier for investment advisers to receive investment

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markets. The flow of timely and accurate information among market participants promotes investor confidence in the markets, which aids in the flow of capital to businesses. However, the volume and complexity of information and raw data which is available—including, issuer disclosure statements, economic and employment statistics from governments, and marketing and purchasing trend reports from private sources—can often be overwhelming and confusing for investors. As a result, research analysts play an important role in the relationship between companies and investors, both retail and institutional.").

[9] SEC Staff, *Staff Report on the Issues Affecting the Provision of and Reliance Upon Investment Research Into Small Issuers* (Feb. 18, 2022), https://www.sec.gov/files/staff-report-investment-research-small-issuers.pdf at 10-11 ("Staff Report").

[10] For example, Rules 138 and 139 under the Securities Act of 1933 ("Securities Act") provide a safe harbor for research in many circumstances from the restrictions that apply to written communications during a securities offering. *See* 17 C.F.R. § 230.138; 17 C.F.R. § 230.139. Similarly, Regulation M under the Exchange Act excludes certain research from the prohibitions that apply to communications during a distribution of securities. 17 C.F.R. § 242.101. *See also* 17 C.F.R. § 240.15a-6.

research and comply with their fiduciary duties.[11] In contrast to these longstanding positions, the Proposal would inhibit and curtail the dissemination of investment research as discussed below.

B. The Proposal would inhibit the dissemination of investment research, stripping investors of access to important information and impairing market quality.

The definitions of "covered technology" and "investor interaction" in the Proposal are exceedingly broad and could apply to any number of technologies that are used in the day-to-day development and dissemination of investment research to investors. Because the Proposal would apply to any "investor interaction," the Proposal could bring investment research into scope in at least two ways: (1) the Proposal would apply directly to research firms when they use covered technology (which broadly includes spreadsheets or research models) to produce investment research for, or disseminate it to, "investors"[12]; and (2) the Proposal would apply directly to other broker-dealers and investment advisers that use or disseminate investment research provided by research firms (thus, applying the Proposal indirectly to research firms).[13] The heavy costs and burdens imposed by the Proposal on firms that provide investment research to investors will inhibit the flow of information to the market and diminish the benefits associated with prompt, broadly disseminated investment research.

If a research firm uses a covered technology to develop or disseminate investment research directly to investors, the firm would be required to (1) evaluate each technology (including testing) to identify any actual use or potential use of the technology that might take into consideration *any* firm interest; (2) determine whether this "conflict of interest" places the firm's or its associated persons' interests ahead of investors; (3) eliminate or neutralize the effect of any such conflict of interest; and (4) repeat steps 1-3 on a periodic basis and every time there is a material change to the technology, documenting in painstaking detail each step of this process, which itself must be evaluated at least annually. If a research firm provides investment research products to another broker-dealer or an investment adviser for the benefit of investors, then the research firm would be considered a covered technology vendor and that broker-dealer or investment adviser would have to undertake the same process to evaluate the technology used by the research firm. This

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[11] 15 U.S.C. § 78bb(e).

[12] For broker-dealers, "investor" means "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." This definition is broader for investment advisers and includes both natural person and institutional customers. *See* Proposed Rules 15l-2(a) and 211(h)(2)-4(a).

[13] Notably, the Commission states that it was unable to quantify the Proposal's impact on third-party service providers. *See* Proposing Release at 54001.

would require an invasive analysis of the research firm's proprietary technology by third parties, a cost which the SEC could not quantify in its cost-benefit analysis.[14]

By increasing the costs and burdens associated with using "covered technology," the SEC would restrict the utility and availability of investment research by disincentivizing, or potentially preventing in some cases, firms from using even mundane, long-available technologies to support this function and deterring them from sharing investment research with other firms, another division within the firm, or investors impacted by the Proposal. In fact, the SEC expressly acknowledged in the Proposal that firms may decide to stop using certain covered technology altogether because of the costs and burdens that the Proposal would impose on the dissemination of information.[15] To contextualize these concerns, below are three non-exhaustive, real-world examples of how the Proposal would apply to firms that provide investment research directly or indirectly to investors:

- Research firms use financial models to establish a reasonable basis and support for an investment thesis or recommendation.[16]

- Research firms may use analysis to screen companies that meet certain criteria identified by a client or may provide tools that allow clients to screen for and identify these companies directly (e.g., public companies in the technology sector with a small market cap).

- Research firms also may provide an investment research database to investors that uses curation tools and algorithms to help investors sort through the copious amounts of research content or highlight new investment research for investors in areas that they have prioritized (e.g., if an investor has expressed an interest in non-U.S. companies in the technology sector, the algorithm may highlight recent research on those companies).

Under the Proposal's expansive definitions, each of these tools would be a "covered technology" and their use by investors would be an "investor interaction." But the SEC's concerns regarding these types of technologies are misguided. These types of tools have been used by research firms for years, have been consistently recognized as an important service and product, requested by investment research customers, and are entirely non-controversial. Making it more difficult for research analysts to use technologies to support their research recommendations and

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[14] *See id.*

[15] *See id.* at 53987.

[16] FINRA Rule 2241 requires equity research analysts to have a reasonable basis for any recommendation, rating or price target and provide a "clear explanation of any valuation method used."

service their clients, as the Proposal would do, would be disruptive and harmful to investors. For investors that rely on curation and screening tools to timely identify relevant research content, eliminating such tools would be akin to removing the search bar function from Google.com and leaving users to their own devices to pore through a list of all public internet domains to find what they need.

C. By restricting the free flow of investment research, the Proposal is also inconsistent with the SEC's rulemaking authority.

Section 3(f) of the Exchange Act directs the Commission to consider whether approval of a rule change will promote efficiency, competition, and capital formation.[17] As discussed above, both Congress and the SEC have long-recognized investment research as critical for efficient markets, competition, and capital formation. Thus, a reduction in the availability or timely dissemination of investment research would necessarily have an adverse impact on market efficiency, competition, and capital formation, contravening the Commission's statutory mandate under the Exchange Act to promote these objectives.[18]

First, the Proposal would interfere with efficiency of the securities markets by reducing the amount of investment research about issuers available to the markets. If less information is accessible to the markets, prices may become disjointed, moving away from the actual value of the underlying instruments, and the quality of the market may degrade. As identified by the SEC Staff, studies have shown that a decrease in research coverage can lead to information asymmetry, a reduction in stock liquidity, and a significant deterioration in bid-ask spreads, trading volumes, and institutional presence.[19]

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[17] 15 U.S.C. § 78c(f).

[18] *See id.*; *see also* 15 U.S.C. § 80b–2(c).

[19] *See* Staff Report at 12. *See, e.g.*, Inv'r Advisory Comm., *Recommendation of the SEC Investor Advisory Committee Structural Changes to the US Capital Markets Re Investment Research in a Post-MiFID II World* (Jul. 25, 2019), https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-research-post-mfid-ii-world.pdf ("A reduction of Research coverage has a knock-on effect on liquidity, which is also an essential component of our capital markets ecosystem…."); Robert C. Merton, *A Simple Model of Capital Market Equilibrium with Incomplete Information*, 42 J. FIN. 42, 483 (1987) (finding that the loss of analyst coverage for a stock will reduce investor interest, with adverse effects on liquidity); *see also* The IPO Task Force, *Rebuilding the IPO OnRamp: Putting Emerging Companies and the Job Market Back on the Road to Growth* (Oct. 20, 2011), https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf ("Lack of research coverage adversely impacts trading volumes, company market capitalizations and the total mix of information available to market participants."); Jeffrey M. Solomon, Cowen, Inc., *Capital Formation, Smaller Companies, and the Declining Number of Initial Public Offerings* (Jun. 22, 2017), https://www.sec.gov/spotlight/investor-advisory-committee-2012/jeffrey-solomon-presentation.pdf ("Little or no research coverage generally corresponds with lower stock liquidity.").

Second, the Proposal would be anti-competitive because it could deprive the subset of investors impacted by the Proposal—primarily retail investors—of important investment research and investment tools due to the increased costs and burdens associated with the Proposal. Also, a reduction in research coverage and dissemination would likely have an outsized negative impact on liquidity for smaller issuers which, as the SEC Staff acknowledged, are more dependent on research coverage to improve investor recognition.[20]

Third, the Proposal could inhibit capital formation by discouraging investment. As identified by the SEC Staff, issuer-specific investment research can encourage good corporate governance—analysts monitor companies, and their scrutiny can increase corporate transparency and help investors to detect managerial misconduct.[21] Reducing the availability of investment research would reduce the effectiveness of this control on issuer management conduct and leave investors in the dark about important corporate developments. Reduced scrutiny by research firms and the lack of available information could harm investors' confidence or interest in the market, reducing their overall market participation.

In sum, by limiting the availability of investment research, the Proposal would harm investors, inhibit market efficiency, hurt competition, and degrade capital formation—all these inevitable consequences contradict the SEC's statutory mandate under the Exchange Act.

II. The Proposal's Application to Investment Research Is Unwarranted and Conflicts with Congress' Mandate that the SEC and SROs Address Conflicts through Disclosure and Other Investment Research-Specific Mitigants.

The Proposal's application to investment research is also problematic because it would impose duplicative, costly, and burdensome requirements on top of the already robust regulations that apply to investment research. In certain key respects, these requirements would conflict with existing regulation.

As discussed above, Congress, the SEC, and SROs already have imposed greater restrictions and requirements on investment research to address conflicts of interest than on other forms of broker-dealer communications. For example, investment research is already subject to extensive restrictions and safeguards designed to foster transparency and objectivity, address conflicts of interest, and provide investors with more reliable and useful information to make investment decisions.[22] Regulation Analyst Certification requires that broker-dealers and certain

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[20] *See* Staff Report at 11-13.

[21] *See id.* at 13-15.

[22] *See, e.g.,* FINRA Rules 2241, 2242 and 5280; SEC Regulation Analyst Certification; 15 U.S.C. § 77q(b); 15 U.S.C. § 78bb(e).

of their associated persons include in research reports certifications by the analyst that the views expressed in the report accurately reflect their personal views and disclose whether or not the analyst received compensation or other payments in connection with the specific recommendations or views.[23] Section 17(b) of the Securities Act, in turn, requires broker-dealers to disclose if they have received certain compensation for disseminating or preparing investment research. At the direction of the SEC pursuant to a Congressional mandate under Exchange Act Section 15D, FINRA also has promulgated specific rules addressing various conflicts of interest in investment research.[24] Under FINRA rules, research firms are required to (1) establish and implement specific policies and procedures to identify and manage investment research-related conflicts of interest, (2) prohibit certain practices that involve conflicts of interest considered too pronounced to be cured by disclosure, and (3) disclose material conflicts of interest associated with investment research.[25]

Compliance with these existing rules would conflict with the obligations of firms under the Proposal because existing rules emphasize and rely on the use of disclosure to resolve conflicts. Congress has mandated that the SEC, or the SROs at the SEC's direction, require broker-dealers to address material conflicts of interest that could affect investment research by providing specific, unequivocal disclosures of conflicts that a research analyst or broker-dealer may have regarding the research. The SEC has carefully considered these conflict disclosures, and FINRA regularly monitors and enforces the validity and completeness of these disclosures, including through enforcement actions. Moreover, the industry has spent millions of dollars over the years to invest in technology, systems, policies and procedures to provide specific conflict of interest disclosures in investment research, including, but not limited to, the following: analyst and firm ownership interest in securities of the issuer; compensation the firm or an analyst received from the issuer; whether the firm has provided investment banking and other services to the issuer in the past 12 months or seeks to provide investment banking services in the near future; and any other actual or potential material conflicts the analyst or firm may have with an issuer.[26]

Rather than endorsing disclosure as the means to address conflicts of interest, as existing regulation and Congressional mandates require, the Proposal would require firms to "eliminate, or neutralize the effect of," that conflict of interest. This new standard would directly conflict with the disclosure regime articulated by existing Commission and FINRA rules and required by Section 15D of the Exchange Act and Section 17(b) of the Securities Act.

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[23] Regulation Analyst Certification, 68 Fed. Reg. 9482 (Apr. 14, 2003).

[24] *See* FINRA Rules 2241 and 2242.

[25] *See, e.g.*, FINRA Rules 2241, 2242, and 5280.

[26] *See, e.g.*, FINRA Rules 2241(c) and 2242(c).

Finally, the SEC failed to consider the costly application of the Proposal to investment research in its cost-benefit analysis. The use of technology by research firms can provide significant benefits to investors receiving investment research, but the Proposal would make it harder, if not impossible, to realize those benefits. The Proposal fails to consider the unique issues and potential conflicts raised by imposing its sweeping and overly broad requirements on investment research. As a result, firms could be deterred or prevented from using technology to produce or disseminate investment research, even where the relevant conflicts of interest are already addressed by SEC and SRO rules. Moreover, because investment research already has restrictions and safeguards in place to address conflicts of interest, the Proposal's purported benefits are unnecessary at best when applied to investment research. The SEC's failure to weigh these considerations in its economic analysis represents another significant flaw with the Proposal.

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We appreciate the Commission's consideration of this letter. The Firms are concerned that the Proposal, rather than embracing the promise that technology holds in benefiting investors, takes an overly pessimistic view of the use of technology and strips investors of important tools. The Proposal's impact on investment research will result in collateral consequences that harm investors by taking away access to information that they use to make investment decisions and will impair market quality. Tailored regulations that are well understood by market participants already address conflicts of interest relating to investment research, and the Proposal would interfere with this long-standing framework. For these reasons and the additional reasons described in the Trade Association Letters, the Commission should not proceed with the Proposal.

If you have any questions concerning this letter or require any additional information, please contact me at the above number or my colleague, Kyle P. Swan, at (202) 663-6409.

Respectfully submitted,

Stephanie Nicolas