October 10, 2023

Via E-Mail
Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 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 are submitting this letter on behalf of the Committee of Annuity Insurers (the "Committee"),[1] in response to the U.S. Securities and Exchange Commission's (the "SEC") proposed rules regarding "Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers."[2] The Committee appreciates the opportunity to comment on the Proposal.

The Committee believes that the Proposed Rules should be withdrawn because they are problematic, unworkable, and, if adopted, would significantly alter broker-dealers' and investment advisers' existing business models and standards of care without providing any meaningful investor protection benefit. The Proposed Rules would require firms to identify and evaluate *every conflict* resulting from any use of a "covered technology" in an "investor interaction." For those conflicts that "place the interests of the [firm] . . . ahead of the interests of investors," the firm would be required to "eliminate or neutralize" the conflict. The SEC's proposed definitions of "covered technology," "investor interaction," and "conflict of interest" are so overbroad as to capture nearly every element of a firm's business.

The Proposal would be especially impactful for firms that transact solely, or primarily, in proprietary products issued by an affiliate given the inherent compensation model in the proprietary distribution business model, which could result in conflicts. Many Committee members act as issuers of variable annuities and also have one or more broker-dealer affiliates that serve as wholesale and/or retail distributors of variable annuities. As such, Committee members are very concerned that the adoption of the Proposed Rules would significantly impact how insurance

[1] The Committee is a coalition of many of the largest and most prominent issuers of annuity contracts. The Committee's 32 member companies represent approximately 80% of the annuity business in the United States. The Committee was formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of insurance, securities, banking, and tax policies regarding annuities. For over three decades, the Committee has played a prominent role in shaping government and regulatory policies with respect to annuities at both the federal and state levels, working with and advocating before the SEC, CFTC, FINRA, IRS, Treasury Department, and Department of Labor, as well as the NAIC and relevant and Congressional committees. A list of the Committee's member companies is available on the Committee's website at www.annuity-insurers.org/about-the-committee/.

[2] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, SEC Release Nos. 34-97990; IA 6353 (July 26, 2023), 88 Fed. Reg. 53960 (Aug. 9, 2023) (the "Proposal" or the "Proposed Rules"), available here.

products are distributed and very likely would result in fewer choices for investors who seek to add annuities as part of their investment portfolios, strategies, and plans. With that in mind, the Committee requests that the SEC withdraw the Proposal and engage with industry participants to better understand the impact of any future proposal.

I. The Proposed Rules Would Upend Insurance Product Distribution.

Most Committee members are part of holding company complexes that include a number of regulated entities. Specifically, many Committee members are issuers of variable annuities and have one or more broker-dealer affiliates that serve as wholesale and/or retail distributors of variable annuities (and, in many cases, other securities). The Proposed Rules could significantly jeopardize the viability of the current distribution model for the delivery of proprietary insurance products to current or prospective contract owners.

As noted above, under the Proposed Rules firms would be required to eliminate or neutralize conflicts arising from the use of "covered technology" that place the interest of the firm ahead of the investor's interest.[3] Insurance-affiliated broker-dealers that distribute proprietary insurance products employ compensation models that could be seen as a "conflict of interest" (as that term is defined in the Proposed Rules) in favor of proprietary product sales. This compensation model is an inherent attribute of the insurance-affiliated broker-dealer business model – when a proprietary product is sold, revenue flows both to the distributing broker-dealer and to the affiliated issuer. Therefore, under the Proposed Rules, an insurance-affiliated broker-dealer that uses "covered technology" may have a "conflict of interest." It is important to note that this compensation model is not unique to insurance-affiliated broker-dealers – but implicates any firm that engages in the sale of proprietary products.

The Proposing Release acknowledges this inherent conflict by stating that "firms that offer proprietary products have an incentive to favor those products over other non-proprietary alternatives" and "unless adequately addressed, these conflicts of interest can cause broker-dealers and investment advisers to place their interests ahead of investors' interests."[4] The problem lies in that under the Proposed Rules, the only way for a broker-dealer or investment adviser to "adequately address" a conflict that places the interest of the firm ahead of the interest of investors is through "elimination or neutralization." As discussed in more detail below, this approach is contrary to that taken in Regulation Best Interest ("Reg BI") and the investment adviser fiduciary duty (together, the "Standards of Conduct."), where many conflicts can be addressed through disclosure and/or mitigation. Because of the inherent compensation structure involved in proprietary insurance product sales – eliminating all "conflicts" that place the interest of the firm ahead of the interest of investors (as opposed to addressing those conflicts through disclosure and/or mitigation) could completely destroy insurance product distribution as it currently exists. Annuities benefit millions of investors, both in their current investment goals and in their retirement, and they are structured appropriately to provide significant benefits for investors. The distribution model for these investment products provides investors with significant protections for their assets along with a sales approach that helps investors understand what they are buying.

Furthermore, the Committee notes that the Proposed Rules arguably do not appear to be limited to interactions concerning or involving "securities" transactions, but rather cover any interaction using a covered technology that "optimizes for, predicts, guides, forecasts, or directs *investment-related behaviors or outcomes* (emphasis added)." Given this, the Proposed Rules could possibly significantly impact the sale and distribution of non-security fixed insurance

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[3] The Committee acknowledges that "conflicts of interest that exist solely because the [firm] seeks to open a new investor account" are excepted from the "elimination or neutralization requirement" in the Proposed Rules. However, the Proposal fails to adequately explain the scope of this exception, particularly with regard to the sale of insurance products. *See* Proposed Rules 15l-2(b) and 211(h)(2)-4(b).

[4] *Id.* at 53961.

products such as fixed life insurance and fixed annuities – many of which are issued by the same issuers as, and purchased by the same contract owners of, variable insurance contracts.

The SEC's Proposal fails to explain adequately why investors are not already protected by Reg BI. The SEC addressed conflicts associated with proprietary product sales in the adopting release for Reg BI (the "Reg BI Adopting Release"), and specifically addressed situations in which broker-dealers place material limitations on the securities or investment strategies that they offer, including broker-dealers that only make proprietary product recommendations. Under Reg BI, broker-dealers are required to establish, maintain, and enforce written policies and procedures to: (1) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended and any associated conflicts of interest; and (2) prevent the limitations and associated conflicts of interest from causing the broker-dealer or its associated persons to make recommendations that place the interest of the broker-dealer or associated person ahead of the interest of the retail customer.[5] By way of example, the Reg BI Adopting Release notes that, to mitigate the conflict of interest, a broker-dealer could establish "product review processes or establish procedures addressing which retail customers would qualify for the product menu."[6]

The Proposed Rules would effectively override the SEC's conflict disclosure and mitigation guidance under Reg BI. Instead of evaluating how to appropriately disclose and mitigate conflicts related to proprietary product sales, insurance-affiliated broker-dealers would be forced to "eliminate or neutralize" said conflicts if the firm determines that the conflict results in it placing its interest ahead of the interest of investors – which, practically, may only be possible if the firm stops selling proprietary insurance products entirely. While the SEC's cost analysis in the Proposal recognizes that some firms "would likely bear greater costs" than others in implementing the requirements of the Proposed Rules, it does not consider or account for the fact that the Proposed Rules could completely eliminate certain business models, including the business model for proprietary insurance distribution.

II. The Proposed Rules Would Reshape, Override, and Conflict With Existing Standards of Care.

The SEC's Proposal would override existing rules and established law, such as Reg BI and the investment adviser fiduciary duty without providing appropriate opportunity for notice and comment. In 2019, the SEC overhauled the broker-dealer standard of conduct through its adoption of Reg BI and issued a detailed interpretation of the investment adviser fiduciary duty (the "Fiduciary Interpretation").[7] A centerpiece of the Standards of Conduct is conflict of interest identification, and subsequent disclosure, mitigation, or elimination in connection with a securities transaction or investment strategy recommendation, in the broker-dealer context, or investment advice, in the investment adviser context. In both contexts, the SEC has stressed the importance of "flexibility" for broker-dealers and investment advisers in addressing conflicts. For example, in the Reg BI Adopting Release, the SEC noted that the Conflict of Interest Obligation "was intended to provide flexibility to broker-dealers regarding how to address conflicts of interest, whether through disclosure . . . or elimination."[8]

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[5] 84 Fed. Reg. at 33326-27.

[6] *Id.* at 33327.

[7] *See* Regulation Best Interest, Securities Exchange Act Release No. 86031 (June 5, 2019), 84 Fed. Reg. 33318 (July 12, 2019), available here.; *See also* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019), 84 Fed. Reg. 33669 (July 12, 2019), available here.

[8] 84 Fed. Reg. at 33388.

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Through the Proposed Rules, the SEC has signaled an intent to abandon the concept of "flexibility" in how conflicts of interest are addressed through (1) the introduction of a new definition of "conflict of interest" that is not tied to an investment recommendation or advice; and (2) a prescriptive requirement to "eliminate or neutralize" certain conflicts that, under existing Standards of Conduct, could be addressed through disclosure and/or mitigation. "Conflict of interest" is defined in the Proposed Rules as "when a broker or dealer uses a covered technology that takes into consideration an interest of the broker or dealer, or a natural person who is an associated person of a broker or dealer."[9] This definition is so broad, and represents such a significant departure from the Standards of Conduct, that the SEC recognized it in the Proposing Release as a "distinct, but related, concept."[10] Importantly, the definition takes into account any use of a "covered technology"[11] – which has a broad (and potentially limitless) definition – and not just a use that is tied to a securities recommendation or investment advice. If a broker-dealer or investment adviser determines that such a conflict of interest "results in an investor interaction that places the interest of the [broker-dealer or investment adviser] . . . ahead of the interests of investors," the firm must "eliminate, or neutralize the effect of" the conflict.[12]

Under the Proposed Rules, firms would be forced to identify, evaluate, and categorize *every conflict or potential conflict* resulting from the use of "covered technology" – even if the firm has already addressed those same conflicts through the existing Standards of Conduct. In the Proposing Release, the SEC attempts to draw a line between when firms would need to address conflicts under the Standards of Conduct (*i.e.,* through disclosure and mitigation) versus under the Proposed Rules (*i.e.,* through elimination or neutralization). The SEC states that "the elimination or neutralization requirement of the Proposed Rules applies only to a narrower, defined subset of the broader universe of conflicts – those conflicts that a firm determines *actually place* the interests of the firm or certain associated persons ahead of the interests of investors. (emphasis added)."[13] This is, according to the SEC, different from existing Standards of Conduct, which require firms to address a broader set of conflicts that "might incline" a broker-dealer or investment adviser to make a recommendation or render advice which is not disinterested. The line drawn by the SEC – between conflicts that *actually exist* and conflicts that *might exist* – lacks explanation or logic, and ignores the reality that firms would still need to "identify" any conflict under the Proposed Rules regardless of whether it *actually places* the firm's interest above the investor's interest.

In reality, if the Proposed Rules are adopted, there will be many instances where both conflict of interest regimes will apply.[14] For example, if a broker-dealer identifies a conflict related to its use of covered technology in the provision of an investment recommendation, the firm would be subject to *both* the conflict of interest regime in Reg BI and in the Proposed Rules. The firm would have to evaluate the conflict under both standards, and if the firm determines that the conflict places the interests of the firm ahead of the interests of investors, it would be forced to

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[9] Proposed Rules 15l-2(a). The "conflict of interest" definition is substantially similar in the investment adviser context in Proposed Rule 211(h)(2)-4(a).

[10] 84 Fed. Reg. at 53983.

[11] "Covered technology" is defined in the Proposed Rules 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." *See* Proposed Rules 15l-2(a) and 211(h)(2)-4(a).

[12] *See* Proposed Rules 15l-2(b) and 211(h)(2)-4(b). The SEC does not adequately explain in the Proposing Release the difference between "eliminating" and "neutralizing the effect of" a conflict.

[13] 88 Fed. Reg. at 53977, n. 142.

[14] The SEC acknowledges this overlap in the Proposing Release by noting that "[t]o the extent there is overlap among the existing and proposed requirements, it is incomplete overlap." 88 Fed. Reg. at 54020.

abandon any disclosure/mitigation approach that it developed under Reg BI and, instead, "eliminate or neutralize" the conflict. In this scenario, the Proposed Rules would effectively override and "neutralize" Reg BI, without providing any opportunity for notice and comment.

Further, the Proposed Rules set an almost impossible standard for compliance, as they require that firms neutralize or eliminate conflicts of interest for *all* covered technologies used in investor interactions resulting in the firm's interest being placed above the investor's interest. To conduct an evaluation of conflicts resulting from the use, or reasonably foreseeable use, of a technology, firms would be required to study and understand the inner workings of every technology used by the firm or its associated persons in an investor interaction. The firm would then have to analyze each associated person's use of that technology, and any other "reasonably foreseeable use" – which potentially includes an evaluation of unintended uses (or misuses) of the technology. This type of evaluation is impracticable. Even if a firm conducts a robust evaluation of a particular technology, with hindsight the SEC could easily question the "reasonableness" of the firm's evaluation if a conflict later arises that the firm did not discover during its evaluation. This is particularly troubling because many technologies undergo frequent, and necessary, software updates that may require ongoing review, analysis, and testing.

Further, if a firm uses a covered technology with investors, and there is an unexpected technical flaw or outcome as a result of using the technology, the Proposed Rules may deem there to have been a conflict that was not neutralized or eliminated, thus exposing a firm to a rule violation. As the SEC must understand, technological processes can be tested extensively, and they still may contain underlying flaws or actions that are not expected. These situations can be remediated by firms when they are discovered, but the operation of the rule may lead to a violation before any remediation is even considered. The prospect that latent problems could lead to rule violations would cause firms to spend an inordinate amount of time, effort, and cost in examining and testing (including the possibility of hiring outside consultants) covered technology in advance of launch. We believe that these costs are not sufficiently captured in the SEC's discussion of the costs and benefits of the proposal.

III. The SEC Failed to Comply With Its Obligations Under the Administrative Procedure Act (the "APA").

The Proposal does not comply with the APA's rulemaking requirements.[15] The APA requires that federal agencies give interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agency's deliberative process.[16] Further, rulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are "fairly apprised" of the content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests.[17] In any rule proposal, the SEC has an obligation to come forward with a well-informed analysis of how markets operate, the likely effect of the changes it is proposing, and why such changes are necessary and appropriate.

The SEC justifies the Proposal, in part, by pointing to comments received in response to the SEC's 2021 Request for Information and Comment on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches (the "2021 DEP Request").[18] One problem, of many, is that the Proposed

[15] 5 U.S.C. § 553.

[16] *Id.* at § 553(c).

[17] *See*, *e.g.*, *Mid Continent Nail Corporation v. United States*, 846 F.3d 1364, 1373-74 (Jan. 27, 2017).

[18] *See* Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice, SEC Release Nos. 34-92766; IA 5833 (Aug. 27, 2021), 86 FR 49067 (Sept. 1, 2021), available here.

Rules do not logically follow from the 2021 DEP Request, which was primarily focused on broker-dealers' and investments advisers' use of digital engagement practices ("DEPs") and other design elements or features designed to engage with retail customers on digital platforms. The Proposal eschews this direct focus on digital platform engagement and, instead, launches an attack on the general use of nearly any technology by broker-dealers and investment advisers.

Despite noting that it received over 2,100 comments in response to the 2021 DEP Request, the SEC seems to give inordinate attention and consideration to certain commenters (*i.e.*, investor rights clinics) that make unsupported assertions about the purported danger of technology in financial services. The SEC downplays comments focused on how firms use technology to deliver better outcomes and innovative, cost-efficient products and services to investors. The SEC's use of certain "cherry-picked" comments to form the basis for the Proposed Rules – which touch almost every aspect of a broker-dealers' and investment advisers' use of technology in running their business – is flawed and purports to allow the SEC to justify that the benefits of the Proposed Rules outweigh the costs.

Further, in a rush to finalize an aggressive agenda including the Proposed Rules, the SEC failed to account for the interconnectedness and interdependencies with other pending proposals. Instead, the SEC has artificially separated a number of related proposals to avoid dealing with the complexity of a holistic and thoughtful rulemaking. Even worse, the SEC has shifted the burden of conducting this analysis onto commenters by, for example, "encouraging commenters to review the [SEC's Outsourcing by Investment Advisers proposal] to determine whether it might affect this proposal."[19] The SEC has implicitly acknowledged its failure to conduct the analysis required by the APA through its consistent issuance of proposed rules and subsequent reopening of comment periods for previously proposed rules.[20] The SEC's issuance of isolated and piecemeal proposals without adequate analysis or explanation threatens to introduce regulatory uncertainty and conflicting regulatory requirements, without adequate consideration of the resulting harm to broker-dealers, investment advisers, and investors.

IV. Considerations for Subsequent SEC Rule Proposals.

The SEC should withdraw the Proposed Rules and engage with broker-dealers and investment advisers to better understand the technology used by firms in their investor interactions. As a start, the SEC should engage in a holistic review of comments received in response to the 2021 DEP Request, and issue additional requests for comment as necessary to gather the information and conduct the analysis that is required by the APA to support any future proposal. In doing so, the SEC should consider how technological advances in auditing, reporting, recordkeeping, trading, and surveillance have left investors better protected and have increased retail investor participation in the markets and, in many instances, lowered costs.

With regard to the concerns raised by the Committee in this letter, the SEC should more appropriately analyze and consider the impact of any future proposal on firms that engage in proprietary product sales, or sales of limited products, including existing insurance distribution channels. The SEC should recognize the substantial and important protections that are already in place through the existing Standards of Conduct with regard to securities recommendations and/or

[19] 88 Fed. Reg. at 53972 n. 124.

[20] *See, e.g.,* Reopening of Comment Period for "Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies," 88 Fed. Reg. 16,921, 16,922 (Mar. 15, 2023) (Commission reopening comment period for specific purpose of how the proposal interrelates with the Regulation SCI Release, the Regulation S-P Release, and Cybersecurity Release) ("The Commission is reopening the comment period for the proposed rules so that commenters may consider whether there would be any effects of the Related Proposals that the Commission should consider in connection with the proposed rules."), available here.

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investment advice. The focus of any future proposal *should not* be on securities recommendations or investment advice that that are already covered under existing Standards of Conduct. Instead, the SEC should focus on the use of technology to directly interact and influence retail investor behavior through online, self-directed platforms. This tailored approach to rulemaking would avoid conflicts with existing law, rules, and regulations and provide the SEC an avenue to fulfill its core mission of protecting investors.

CONCLUSION

The Committee appreciates the opportunity to provide these comments on the Proposed Rules. Please do not hesitate to contact Clifford Kirsch (212.389.5052 or CliffordKirsch@eversheds-sutherland.com), Michael Koffler (212.389.5014 or michaelkoffler@eversheds-sutherland.com), or Benjamin Marzouk (202.383.0863 or benmarzouk@eversheds-sutherland.com) with any questions or to discuss this comment letter.

Respectfully submitted,

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FOR THE COMMITTEE OF ANNUITY INSURERS