October 10, 2023

Vanessa Countryman
Division of Investment Management
United States Securities and Exchange Commission
100 F Street
Washington, D.C. 20549

Re: Release No. 34-97990, Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (the "Proposal")[1]

Dear Ms. Countryman:

The Institute for Portfolio Alternatives ("IPA") welcomes the opportunity to submit this letter concerning the Proposal.[2] This letter supplements three comment letters that we have submitted with other associations.[3] We appreciate the opportunity to provide our separate views on the Proposal.

1. Retail Investors Deserve Appropriate Access to Alternative Investments.

During the past five years retail investors have endured extraordinary stock market volatility. The VIX index reached its 30 level at least thirteen times during that period, reaching over 66 on March 23, 2020, at the advent of the pandemic.[4] Institutional investors manage this volatility by diversifying their portfolios. For example, the largest pension fund in the United States, CalPERS, allocates about 13% of its assets under management to private equity, 15% to real estate, and 2% to private debt.[5] This

[1] 88 Federal Register 53960.

[2] For over 35 years, the Institute has advocated for increased investor access to alternative investment strategies with low correlation to equity markets as part of a diversified portfolio and subject to effective investor protections. These strategies include real estate, public and private credit and other real assets through investment vehicles such as REITs, BDCs, closed-end funds, interval funds and private placements. With over $450 billion in capital investments, these portfolio diversifying investments are a critical component of an effectively balanced investment portfolio and serve an essential capital formation function for our national, state and local economies.

[3] *See* Letter to Vanessa A. Countryman from the Institute, *et al* (September 19, 2023); Letter to Vanessa A. Countryman from the Institute, *et al* (September 12, 2023); Letter to Vanessa A. Countryman from the Institute, *et al* (August 15, 2023).

[4] *See* https://www.macrotrends.net/2603/vix-volatility-index-historical-chart.

[5] *See* CalPERS, "A Trust Level Review, " at 13, https://www.calpers.ca.gov/docs/board-agendas/202309/invest/item05b-01_a.pdf (June 30, 2023).

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allocation to alternative investments reduces volatility in the investment portfolios of CalPERS and other institutional investors.

Retail investors also need to reduce their overall portfolio risk. Retail investors should be afforded diversification opportunities similar to those that institutional investors employ. In fact, many highly regulated alternative investments are now available to retail investors.

Alternative investments such as non-listed real estate investment trusts and business development companies that are priced at net asset value ("NAV REITs and BDCs"), as well as interval funds and tender offer funds, provide retail investors with the chance to achieve investment diversification and a reduction in their overall portfolio risk – while affording them with the protections of the federal securities laws. Alternative products are typically distributed through federally-regulated broker-dealers who must act in their clients' best interest and investment advisers who are subject to a fiduciary duty. The Commission has made Regulation Best Interest and the investment adviser's fiduciary duty part of its examination priorities.[6] The Institute strongly supports the vigorous enforcement of Regulation Best Interest and the investment adviser's fiduciary duty.

The Commission regulates interval funds and tender offer funds under the Investment Company Act of 1940. NAV REITs and BDCs register under the Securities Act of 1933 and publicly offer their shares and FINRA vigorously regulates their distribution to retail investors. Thanks largely to FINRA regulatory initiatives, NAV REITs and BDCs today provide more transparent valuations, better liquidity, and lower fees to retail investors.[7] NAV REITs and BDCs are sponsored by global asset management companies and are distributed through some of the largest wire houses, investment advisers and other financial intermediaries. Most NAV REIT and BDC sales occur without any sales load. For example, during the three months ending July 31st, over 54% of NAV REIT sales occurred without any sales load, almost 46% were sold with a low load, and .2% were sold with a full load.[8]

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[6] *See* FY 2022 SEC Agency Financial Report 22, https://www.sec.gov/files/sec-2022-agency-financial-report.pdf (November 10, 2022).

[7] *See. e.g.,* Regulatory Notice 15-02, SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Programs and Unlisted Real Estate Investment Trust Securities, https://www.finra.org/rules-guidance/notices/15-02 (January 5, 2015).

[8] *The Stanger Market Pulse* 18 (July 2023). *The Stanger Market Pulse* defines "low load" as being a load of less than 6%. *Id.* at 49.

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These federally-regulated investments can provide retail investors, acting with the advice of their financial advisors acting in their best interest, with an opportunity to reduce their overall portfolio risk. Unfortunately, the Proposal would deny many retail investors of this advantage.

2. The Proposal Would Thwart Portfolio Diversification by Retail Investors.

The Proposal would require broker-dealers and investment advisers to evaluate any use or reasonably foreseeable potential use of a covered technology in any investor interaction, identify any conflict of interest associated with that use or potential use, determine if any conflict of interest results in placing the interest of the firm or an associated person ahead of the interest of investors, and eliminate or neutralize the effect of the conflict of interest.[9] The Proposal's key words have sweeping definitions.

- It would define "covered technology" as any "analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes." This broad definition covers proprietary and third-party technologies and can range in complexity from artificial intelligence to basic spreadsheets.

  The Proposal would capture a wide range of technologies that are commonly used by federally-regulated intermediaries to manage their clients' portfolios. It would discourage the use of simple spreadsheets to calculate asset allocation or risk exposure. It would impede the ability of intermediaries to use more sophisticated technologies, such as machine learning algorithms, to identify investment opportunities or forecast market trends. Federally-regulated intermediaries would be encumbered by unnecessary compliance costs when they want to use covered technologies to identify asset classes and non-correlated investment strategies and to analyze large datasets of alternative investments to identify those that are most likely to outperform their benchmarks. The Proposal would discourage monte carlo simulations for financial planning, retirement calculators, and internal and third-party analyses and projections of portfolio performance used in portfolio assessments and construction.

- It would define "investor interaction" as "engaging or communicating with an investor, including by exercising discretion with respect to an investor's account; providing information to an investor; or soliciting an investor." This definition would capture most forms of investor engagement or communication, even those outside the scope of a "recommendation" and even when a firm is *not communicating* with an investor concerning a recommendation or trade.

[9] Proposal at 54021-54024.

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- The Proposal would treat the term "investor" differently for broker-dealers and investment advisers, which would create confusion, particularly for dual registrants. Regulation Best Interest defines "retail investor" as a natural person, or the legal representative of such person, who seeks to receive or receives services primarily for personal, family or household purposes. For investment advisers, an "investor" would be all of its clients and prospective clients, as well as investors and prospective investors in the pooled investment vehicles it advises. Unlike broker-dealers, advisers would have to treat their institutional clients and fund investors as investors under the Proposal.

- It would define "conflict of interest" in an unprecedented way to include any use of a covered technology "that takes into consideration" an interest of the firm or an associated person. The Proposal does not define what "takes into consideration" means, but it would treat "*any* firm-favorable information in an investor interaction" or to its associated persons as a conflict of interest.[10] Once confirmed as placing the firm's interests ahead of an investor, the firm would have to eliminate or "neutralize" each conflict, even if doing so means no longer using the technology.

Even a feature that the firm *does not want*, such as an algorithm drift or erroneous data, could be deemed a "conflict of interest" of the firm.[11] In fact, the firm must act even when there is *no conflict.* The Proposal does not require that any "interest" of the firm be different, inconsistent, contradictory, or otherwise in conflict with an investor's interest for its onerous prescriptions to apply. The Proposal stretches the term "conflict of interest" beyond any previous understanding.

The Proposal disregards the foundation upon which conflict of interest compliance programs are based. Regulation Best Interest for broker-dealers and the fiduciary duty of investment advisers apply to a broker-dealer's securities recommendation and an adviser's provision of investment advice. The Commission and the courts defined these concepts over many decades. The Commission and the courts have interpreted Regulation Best Interest and the fiduciary duty of investment advisers to require disclosure of material conflicts of interest or their mitigation when disclosure cannot adequately address those conflicts. The Proposal would turn this historical understanding on its head. It would create a form of duty to eliminate a so-called "conflict of interest" *in the absence of* any recommendation or provision of investment advice. Any "investor interaction" through a covered technology would trigger this new standard of conduct. Moreover, a conflict of interest would have to be eliminated or "neutralized" – a novel term without precedent. Disclosure would not suffice.

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[10] Proposal at 53982 (emphasis retained).

[11] Proposal at 53962, 53968.

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The Proposal would impose substantial burdens on Commission-regulated firms and third-party technology providers to test covered technology before its implementation or material modification and periodically thereafter, to determine whether it is associated with a "conflict of interest" as defined by the Proposal.[12] It would compel firms to "eliminate or neutralize" the effects of bugs or other features in covered technology. This novel approach of requiring a detailed evaluation of a conflict of interest when a covered technology serves any firm interest and deeming disclosure insufficient to address conflicts created by using covered technologies would substantially change the existing regulatory landscape for broker-dealers and investment advisers.

In short, the Proposal represents a reversion to a former age, when retail investors were not allowed to follow modern portfolio strategies that institutional investors employ. It would discourage the use of technologies that help investors make better investment decisions. It would impede federally-regulated intermediaries from using portfolio optimization technology to create diversified and risk-reducing portfolios for their clients. The Proposal would discourage the construction of customized portfolios that could help investors achieve their particular investment goals. It would stifle innovation in the use of "covered technologies" to reduce portfolio risk and improve investment performance.

For these reasons, the Institute urges the Commission to withdraw the Proposal and work with the industry to develop a more targeted and effective regulation to address any legitimate concern about the use of the covered technologies.

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The Institute appreciates the opportunity to comment on the Proposal. We are ready and willing to work with the Commission on these important issues. Should the Commission have any question about our comments, please feel free to contact me or Gina Gombar, Associate General Counsel, at (202) 548-7190.

Sincerely,

Anya Coverman
IPA President & CEO

[12] Proposal at 54023.

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