Submitted Electronically to: rule-comments@sec.gov

October 10, 2023

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

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:

This will serve as comments from Cetera Financial Group ("Cetera") regarding proposed rules applicable to the use of Predictive Data Analytics ("PDA") by broker-dealers and investment advisers.[1] (We will refer to the proposed regulations and accompanying text collectively as the "Proposal"). The Proposal would create an assortment of new obligations for broker-dealers and investment advisers in connection with the use of PDA and other technologies when interacting with customers.

Cetera is the corporate parent of four broker-dealers and three investment advisers. Our firms operate in all 50 states and provide securities brokerage and investment advisory services to more than 1 million individual investors and small businesses through more than 9,000 individual financial professionals. We are vitally interested in this issue and the immediate negative effects that it will have on the firm and our customers.

We will offer detailed comments on specific aspects of the Proposal, but in summary, it represents a giant and unwarranted leap into the unknown, with far-reaching and inestimable effects for both investors and providers of investment advice. Under the guise of addressing risks that might potentially arise out of the recently-developed technologies behind PDA and artificial intelligence ("AI"), the Proposal takes a comprehensive and well-established regulatory framework and essentially throws it out the window.

Make no mistake: The relationship between the Proposal and the use of PDA by financial advisers is tenuous at best. Any risks that PDA or any other technology may pose are already addressed in existing regulations, and the Proposal goes far beyond anything currently in existence. Adoption would represent a fundamental restructuring of the obligations of broker-dealers and investment advisers to their customers, and will produce enormous costs and burdens on both financial professionals and customers without producing measurable benefits for the

[1] 88 FR 53960

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investors that it seeks to protect. It exceeds the jurisdiction of the Commission under existing law, and is grossly inconsistent with existing SEC regulations.

In its' present form, the Proposal cannot possibly be fixed. It should be withdrawn, and if the Commission elects to proceed further in this area, reconfigured into something that is limited to new risks that actually arise out of the use of PDA.

I. Background – The Existing Regime and Recent Initiatives by the Commission

In order to appreciate the truly radical nature of the Proposal, it is necessary to consider recent Commission action with respect to identification and management of conflicts of interest between financial advisers and customers.

A. Regulation Best Interest

In 2019, the Commission adopted Regulation Best Interest ("Reg. BI")[2]. Reg. BI created an entirely new and expanded set of regulations for broker-dealers and investment advisers dealing with individual investors. It required them to act in the customer's best interests and not place their own interests above those of the customer. It required broker-dealers and investment advisers to create and deliver comprehensive disclosure documents to inform customers about their business practices, compensation methods, and conflicts of interest. Most importantly, Reg. BI created a specific framework requiring broker-dealers to identify and manage conflicts of interest that arise in connection with provision of investment-related services to customers regardless of the manner in which they are provided and the facilities or tools that are employed in the process. Reg. BI can fairly be described as transformational with respect to the re-ordering of the obligations of broker-dealers to customers, and was the ultimate product of several years of study and research by the Commission staff.[3]

Reg. BI became effective in July 2020, slightly more than three years ago. To be sure, it has its' detractors. During the process of adoption, many interested parties recommended application of a fiduciary standard for broker-dealers that would be similar to that established by the Investment Advisers Act of 1940. After long deliberation and consideration of hundreds of comments and multiple approaches, the Commission reached the conclusion that Reg. BI represented the best balance between investor protection and maintenance of investor choice, and adopted it in its current form. Not all broker-dealers endorsed the approach taken in Reg. BI, but they have accepted it and spent the last four years and hundreds of millions of dollars developing processes to meet its requirements.

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[2] https://www.sec.gov/files/rules/final/2019/34-86031.pdf

[3] See, for example, Staff Study on Investment Advisers and Broker-Dealers: https://www.sec.gov/news/studies/2011/913studyfinal.pdf, and an additional study by the Rand Corporation commissioned by the SEC https://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR556.pdf

A key feature of Reg. BI is that the best interest obligation applies only to "recommendations" to customers relating to transactions in securities or adoption of investment strategies. We will discuss this in more detail below, but in order for Reg. BI to apply to a communication with a customer, it must constitute a recommendation that the customer is intended to act upon. This usually entails some form of one-on-one communication between the financial professional and the customer that is directly related to the action being suggested by the financial professional.

B. The Digital Engagement Practices Request

In August 2021, the Commission issued a Request for Information and Comment on the use of "Digital Engagement Practices" with customers (the "DEP Request").[4] Among other things, it inquired about the need to expand the coverage of Reg. BI to communications between providers of investment advice and customers that do not rise to the level of recommendations under the current definition. Specifically, it posited the theory that certain types of communications between financial professionals and customers or potential customers might prompt them to take action, and should therefore be subject to the provisions of Reg. BI. As we will discuss in more detail below, the Proposal incorporates the notion that all manner of communications between financial advisers and customers or prospective customers that do not constitute recommendations should be subject to the provisions of Reg. BI. This leaves many industry participants wondering about the evolution from a highly controversial discussion topic to a far-reaching proposed regulation.

C. The Proposal

The primary thrust of the Proposal is summarized in the following passage:

> " *The proposed conflicts rules would require a firm to (i) evaluate any use or reasonably foreseeable potential use by the firm or its associated person of* ***a covered technology*** *in* ***any investor interaction*** *to identify any conflict of interest associated with that use or potential use; (ii) determine whether any such conflict of interest places or results in placing the firm's or its associated person's interest ahead of the interest of investors; and (iii)* ***eliminate, or neutralize*** *the effect of, those conflicts of interest that place the firm's or its associated person's interest ahead of the interest of investors."*[5] *(Emphasis added, internal footnotes omitted.)*

All of this sounds simple enough until the reader unpacks the specific elements, specifically the terms *"covered technologies", "investor interactions",* and *"eliminating or neutralizing the effect"* of conflicts of interest. Reading the title of the Proposal, one might have expected that it was directed toward identifying and managing conflicts that arise uniquely in connection with the use of PDA. Nothing

[4] https://www.sec.gov/files/rules/other/2021/34-92766.pdf
[5] 88 FR at 53975

could be further from the truth. Not only are these three concepts new and unique in their application to the regulation of investment advice, they are so broad as to encompass all manner of activities that have literally nothing to do with the use of PDA. In particular:

- "Covered technologies" are not limited to tools or applications that utilize what should reasonably be classified as PDA, but are defined far more broadly to include numerous tools and applications that are routinely utilized by financial advisers in communications with customers and developing investment recommendations. They include Excel and other spreadsheet applications, applications showing hypothetical investment returns under various scenarios, and other similar applications that in many cases have been part of the landscape for more than 50 years;

- "Investor interactions" include virtually any kind of communication originated by a financial professional and received by any person or audience, whether or not it is personalized or directed to them; and

- "Elimination or neutralization of conflicts" requires that any potential conflict of interest between either the firm or the individual financial professional and the customer be not only identified and managed as required by Reg. BI, but eliminated or neutralized**.** The concept of eliminating conflicts is both novel and unworkable in this context, but at least it is capable of interpretation. We cannot say the same with respect to "neutralization". Indeed, we have been unable to locate any other instance in which an SEC regulation utilizes the term "neutralize", much less describes what it entails.

Individually, each of these concepts are entirely new and represent a fundamental reordering of both Reg. BI and other longstanding regulations designed to protect the interests of investors. In combination, they become a veritable trip through the looking glass. When Reg. BI was adopted, many commenters stated that it did not go far enough to protect investors. We disagree, but even if one accepts this as a valid premise for debate, the Proposal has leaped far ahead of the existing regulatory regime without building a logical foundation. If the Commission wishes to gut Reg. BI in the ways set forth in the Proposal, it should explicitly say so and either propose amendments or an entirely new rule. The current approach is disingenuous at best.

II. Specific Issues in the Proposal

The Proposal is fundamentally flawed for a number of specific reasons, including the following:

A. Adoption of the Proposal would exceed the statutory authority of the Commission.

On September 12, 2023, a coalition of securities industry trade organizations submitted a letter to the Commission containing comments about the Proposal (the "Joint Trades Letter A").[6] Among other things, it set forth a detailed discussion of the statutory authority possessed by the Commission in this area and why the Proposal exceeds it. In short, neither the Securities Exchange Act, the Investment Advisers Act, or any other existing statute affords the Commission authority to regulate activities that do not constitute the provision of investment advice. The proposed expansion to cover investor interactions beyond the traditional realm of investment recommendations attempts to regulate conduct that is clearly beyond any existing authority.

Joint Trades Letter A points out that:

> "*The rule would apply "when a firm uses covered technology in an investor interaction." The Commission purposefully crafted a "broad [definition of covered technology] to encompass a wide variety of methods, using current and future technologies, that firms could use to interact with investors" and would capture the most sophisticated technologies to simple spreadsheets.* ***The*** *Commission likewise broadly defined "investor interaction" so that the Proposal would apply even when a firm is not communicating with an investor.* ***As a result, no reasonable line can be drawn by a broker-dealer or an investment adviser on when they are using a "covered technology" for an "investor interaction."*** *The Commission does not have authority under Sections 211(h) and 15(l) to regulate the entirety of the business of broker-dealers and investment advisers.)* (Emphasis added, internal footnotes omitted.)

Joint Trades Letter A also points out that the Proposal would override the provisions of Reg. BI without complying with the provisions of the Administrative Procedures Act ("APA"). Whatever one thinks of the Proposal, the Commission cannot simply discard the substance Reg. BI without going through the publication, notice and comment requirements in the APA.

B. The Proposal fails to adequately consider the costs it would inflict on both providers of investment advice and investors, measure any imagined benefits, or balance the benefits with the burdens.

A different coalition of industry trade organizations has submitted comments regarding the Proposal and requirements for administrative agencies with respect to proposed regulations ("Joint Trades Letter B").[7] It discusses the provisions of the APA and requirements for administrative agencies to perform an assessment of the costs to the regulated industry and other affected parties, the benefits to the class of

[6] https://www.sec.gov/comments/s7-12-23/s71223-258279-605062.pdf
[7] https://www.sec.gov/comments/s7-12-23/s71223-261319-615782.pdf

individuals or entities that it purports to protect, a comparison of the benefits and burdens it would impose, and an examination of other alternatives that would accomplish similar results in a less burdensome way. The Proposal includes only a brief and conclusory discussion of these topics and contains no useful data to inform the process.

We are sympathetic to the difficulties involved in performing such an analysis. The concepts in the Proposal are so unprecedented that using existing standards as a baseline would be unlikely to produce much in the way of usable information or conclusions. However, it does not excuse the failure to consider the economic impact of the Proposal before proceeding. That is an absolutely necessary predicate.

In addition to imposing costs on broker-dealers and investment advisers, the Proposal would create tangible negative impacts on the investors that it seeks to protect. The scope of its' coverage would inevitably cause financial professionals to limit the type and nature of their communications with customers and prospective customers, which will limit customer access to information about investment products and services that they may find valuable. This is clearly a negative and unintended result.

We would also note that the costs of regulation are almost always borne by the ultimate consumer of the product, service, or industry being regulated. While neither we, nor apparently the Commission, can accurately estimate the potential costs associated with implementation of the Proposal, we are certain that they would be enormous. Every broker-dealer and investment adviser would be required to perform an analysis of every means by which it communicates with customers or prospective customers, every technology or application it uses to perform investment research or analysis, and not just identify and manage conflicts of interest, but eliminate or neutralize them. Such an effort would be without precedent, but its scope is far beyond anything in recent memory and the cost would clearly be very high at both the firm and industry level.

In addition to direct costs, the Proposal would also create a more subtle drag on financial innovation by providers of investment advice. If the use of technology in an interaction with a customer is a trigger for application of the unrealistic "eliminate or neutralize" standard, firms will be encouraged not to employ any kind of technology in interactions with customers or prospective customers. This is bad enough in the abstract, but even more bizarre in the context of how technological developments have benefited U.S. investors. The costs of trade execution, investment selection and research, and virtually every other service provided by broker-dealers have declined steadily in both nominal and real terms for at least 50 years. Transactions that once required direct contact with an individual financial adviser (assuming they could be reached timely in person or by telephone) and incurred a cost of 1% of the transaction value are now routinely done by investors in seconds with a few strokes on a computer keyboard at no transaction cost.[8] This is the result of technological

[8] https://www.investopedia.com/schwab-cuts-base-commissions-to-zero-4772028

advances made by the securities industry, and its' positive impacts on investors should not be ignored.

In the name of making the impact on all technologies equal, the Proposal also ropes in all manner of tools and applications that have been utilized by both investors and financial advisers for decades even though they have no connection whatsoever to PDA. Covering all technologies does not make the Proposal technology-neutral. It makes it technology-destroying. It has been suggested that in the context of the Proposal the term "PDA" does not stand for "Predictive Data Analytics", but instead for "Preventing Digital Advancement." Stifling technological advancement in the name of highly attenuated and uncertain investor protection benefits is very unlikely to produce the results it advertises and will wreak many other negative and unforeseen consequences. The Commission should proceed very cautiously in this area, and at a minimum perform additional analysis on the cost and other impacts of such a sweeping change to existing regulations.

C. The Proposal makes unjustified and unverifiable assumptions about the impact that PDA will have on the provision of investment advice.

The Proposal would fundamentally restructure the nature of the obligations of broker-dealers and investment advisers to their customers and others. Its' premise seems to be that the use of PDA will produce such dramatic changes in how financial professionals provide advice to customers that it requires an entirely new approach to regulation. The current iteration of AI, which relies primarily upon the use of "large language" models, has only been publicly available for less than a year. While we have no doubt that AI and applications that are derived from it will have profound impacts on many businesses, it is far too early to blow up a well-established regulatory framework and replace it with something as profoundly different as the Proposal based on the very limited evidence currently available. Reg. BI represented a fundamental shift in the obligations of broker-dealers and investment advisers to customers, and it took nearly ten years of study and evolution before the Commission adopted it. At a minimum, the Proposal represents a rush to judgment. Before proceeding, the Commission should wait until the applications of AI become more developed, particularly in the investment advice industry. If significant portions of what the Proposal speculates upon ultimately occur, the subject can be reconsidered at that time.

We would also note that the text accompanying the Proposal is notably lacking in its discussion of exactly how the use of PDA has changed the nature of how financial professionals engage with and provide investment advice to their customers. Conflicts of interest have existed in the provision of investment advice since the industry began. The Proposal does not set forth any objective evidence establishing that the use of PDA will fundamentally alter the way in which financial professionals do research on investments or develop investment recommendations, they ways they contact and engage with customers, or the ways in which PDA may affect how recommendations to specific customers are developed or delivered. Reg. BI and

other existing regulations already require broker-dealers and investment advisers to identify and manage conflicts of interest, and in extremely limited circumstances, ban specific practices. Reg. BI is principles-based, and requires financial advisers to re-evaluate and update their practices with respect to conflicts of interest based on changes in investment products and business models. The Proposal sets forth its highly novel approach without adequately explaining the need for it.

Adoption of the Proposal also reinforces a concerning trend in which major changes to regulatory regimes are implemented before the regulated industry has been able to absorb and implement the previous round. Reg. BI produced major changes to the obligations of broker-dealers and investment advisers, and has only been in effect for slightly more than three years. A primary benefit of principles-based regulation is that it requires industry participants to continually review and adapt their policies and processes in light of changes in technology, markets, and customer expectations. The Proposal does not set forth a sufficiently compelling explanation for why such a dramatic change is necessary so soon after adoption of Reg. BI.

D. The Proposal fundamentally changes the scope of activities covered by Reg. BI by making virtually all communications with customers and prospective customers subject to its provisions.

One of the fundamental tenets of Reg. BI is that its provisions regarding conflicts of interest only apply in connection with communications that rise to the level of recommendations that the customer undertake an investment transaction or strategy in reliance on the advice of the financial professional. This has been referred to as the "call to action" to the customer, and has been an integral part of the rules applicable to suitability and best interest for more than 50 years. Reg. BI specifically incorporates it, as do FINRA rules.[9] The Proposal would extend coverage to all manner of communications to both customers and prospective customers, whether or not they are particularized or directed to any particular individual. This raises a number of issues:

- As noted in Joint Trades Letter A, existing statutes do not give the Commission authority to regulate all activities of broker-dealers and investment advisers. That authority is limited to communications in connection with recommendations to purchase or sell a security or engage in an investment strategy. The Proposal would cover all manner of other communications that are so far attenuated from recommendations that they clearly exceed the scope of the Commission's authority.

- The Proposal covers communications with individuals who are not even customers of the broker-dealer or investment adviser. We find it difficult to see how any communication with an individual that the financial professional does

[9] See FINRA Rules 2090 and 2111 and FINRA Regulatory Notice 11-02: https://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf.

not even know can contain the specificity necessary to constitute the call to action that is the lynchpin of a recommendation in Reg. BI, but if the communication is generated by or in response to an application that relies on PDA, it would be covered. For example, social media posts and all forms of print, broadcast, and online advertising are sent to large numbers of people whom the sender does not know and cannot necessarily identify. It would be literally impossible for the firm or the financial professional to know who is receiving these communications, their individual circumstances, or their subjective interpretation of the message. The call to action as a predicate for coverage under Reg. BI exists for good reason. The approach suggested the Proposal will lead to endless speculation and frivolous claims by individuals whom financial professionals have no reason to know, to whom they owe no duty, and who have no reasonable expectation of protection.

The PED Request was published by the Commission in 2022. It purported only to seek information about DEP, and did not propose regulations or state what such regulations might include. It appears that rather than consider the responses from commenters and the implications of adopting changes to the scope of covered activities, the Commission has simply moved forward on the assumption that DEP practices are equivalent to recommendations and are already part of the existing regime. They most certainly are not, and any such proposed expansion should be considered on its own merit without back-door inclusion in another proposal for which the nominal purpose is to address conflicts of interest created by new technologies.

In the text accompanying the Proposal, the Commission notes that it received 2,300 public comments in response to the DEP Request. A large number of them noted the extreme changes that the changes suggested would produce and strongly suggested that the Commission consider the question in more detail before proceeding. Despite that, the Proposal barrels forward, incorporating a novel concept about interactions with potentially everyone on earth and requiring firms to adopt procedures to manage conflicts of interest in circumstances where they do not even know the individual with whom they are communicating. It would create a highly subjective standard that would depend on who the individual receiving the communication was and their subjective interpretation of it. Adding to the confusion, the Proposal describes "investor interactions" as any use of covered technology by a Firm that could "nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors."[10] These terms are unfamiliar, vague, imprecise, and generally unhelpful. They actually undercut the traditionally understood meaning of what constitutes a recommendation, which is anchored in a call to action. Moreover, determining whether a covered technology has been used in a way that nudges, prompts, cues, solicits, or influences an investor's behavior would require an assessment of the investor's subjective interpretation of the circumstances. "Recommendation" and "call to

[10] 88 FR 53972

action" are objective and well-understood concepts. Rejecting them in favor of subjective and vague terms like nudge, prompt, cue, solicit, and influence would be inconsistent with historical precedent, create significant challenges for the establishment and implementation of effective compliance policies and procedures, and likely produce different results for different investors based solely on their individual state of mind.

We have a suggestion that would address the problems noted above. If the Commission believes that activities which heretofore would not have been considered recommendations should be covered by Reg. BI, it should publish proposed regulations on that limited topic for notice and comment. It should consider the legal, factual, and policy implications of such changes in the context of Reg. BI and come to a considered conclusion rather than bury them in a proposal that is nominally directed to solving a different problem. We specifically suggest that, given the stated concern with identifying and managing conflicts of interest that may arise in connection with specific new and emerging technologies, any rules proposed in this space be specifically limited to practices that actually arise out of the use of PDA or AI. Excel spreadsheets and investment illustrations have been covered by existing regulations for 50 years. The Proposal is superfluous.

E. The Proposal creates a new, unmanageable, and unnecessary standard for management of conflicts of interest.

1. Reg. BI establishes a regime under which broker-dealers and investment advisers are required to identify and manage all material conflicts of interest that arise in connection with investment recommendations they provide to customers. At a minimum, all material conflicts must be disclosed to customers, and if the firm determines that the conflict cannot be effectively managed through disclosure, it must be mitigated, or in very limited circumstances, eliminated.

   It is notable that Reg. BI identifies only a single practice that is deemed so problematic that it must be eliminated: Sales contests, which are arrangements in which the firm or financial professional receives greater selling compensation in connection with recommendations to purchase a given security for a limited period of time. The Proposal goes far beyond, and suggests that all manner of conflicts, both tangible and imagined, must be eliminated or neutralized. The discussion in the Proposal does not begin to make a sufficient argument about why conflicts produced by PDA or other covered technologies are so vastly different from other types of conflicts that they require wholesale elimination.

   Reg. BI also explicitly recognizes a difference between "firm level" and "adviser level" conflicts. Conflicts that arise out of compensation practices at the point of sale and directly influence the behavior of the individual financial professional making the recommendation are managed differently than those which exist only for the firm. For example, if a given security offers the financial professional a

higher sales charge or other compensation than another security of the same type, the financial professional has a direct interest in recommending the higher-paying security. Compensation to the firm such as revenue-sharing and marketing reimbursements are not generally shared with the individual making the investment recommendation, and require a different approach than adviser-level conflicts. The Proposal fails to recognize this important distinction, choosing to consider all conflicts of interest as equivalent and effectively casting aside much of the rationale behind Reg. BI.

Conflicts of interest are inherent not only in the investment advice industry, but also in any business in which a professional provides services in exchange for fees that vary according to the type and nature of the services provided. Attorneys, physicians, accountants, and virtually all other professionals have conflicts between their financial interests and those of their clients simply because the services they provide are often priced differently and the professional has an incentive to recommend the services that will yield them the highest compensation. Conflicts exist, but so long as they are adequately disclosed and managed they must be accepted and dealt with. Instead of recognizing this fact and the regime adopted in Reg. BI, the Proposal leaps to requiring elimination of a broad and undefined swath of business practices without any sufficient justification.

2. In addition to the unnecessary expansion of the categories of conflicts that must be eliminated, the Proposal creates an additional method of mitigation: Neutralization. This concept is new to us. While we disagree with the notion that large swaths of heretofore tolerable conflicts of interest must be eliminated, at least we understand what elimination would mean. Can any conflict of interested be neutralized through disclosure? Mitigation? Some combination thereof? The fact that we have to ask the question strongly indicates that the concept is unworkable.

   We find the following quote from the Release instructive:

   > "*The proposed conflicts rules do not prescribe a particular manner by which a firm must eliminate, or neutralize the effect of, any conflict of interest because of the breadth and variations of firms' business models as well as their use of covered technology. Because of the complexity of many covered technologies, as well as the ways in which conflicts of interest may be associated with their use, we are concerned that prescribing particular means to neutralize the effect of a conflict of interest could be inapplicable or otherwise ineffective with respect to certain covered technologies (or certain conflicts of interest, the nature and extent of which may vary substantially across firms depending on their particular business models and investor base). The proposed approach is intended to promote flexibility and innovation by allowing the firms that use covered technologies the freedom to determine the appropriate ways to operate. them, within the guardrails*

> *provided by the proposed conflicts rules, rather than requiring the technologies to be designed in a particular way solely to meet a regulatory requirement." (Internal footnotes omitted.)*

This appears to be a well-intentioned attempt to give firms flexibility in applying a novel and amorphous standard, but we are left with very little in the way of assistance in interpreting exactly how to apply it. Unfortunately, "neutralizing" conflicts is entirely new in this realm. Not only is this new standard overly complex and hard to interpret, but it also adds nothing to investor protections that already exist. Devotion of additional resources to this effort by the Commission is unwarranted and should be discontinued.

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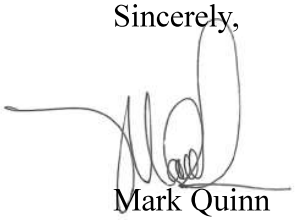
Thank you for the opportunity to share our views on this important matter. If we can offer any additional assistance or provide further information, please let me know.

Sincerely,



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