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

October 10, 2023

Comment letter of scholars of securities regulation, financial advice, and technology law

Re: File No. S7-12-23

Dear Ms. Countryman:

We appreciate the opportunity to comment on the Securities and Exchange Commission's proposed rules ("proposed conflicts rules") governing conflicts of interest in the use of data analytics and other covered technologies in investor interactions.[1] We are law professors and legal scholars who teach and research about the regulation of broker-dealers, investment advisers, retail financial advice, and the regulation of innovative technologies.[2] We write in our capacity as scholars with an interest in promoting the development of federal securities law.

In short, we support the proposed conflicts rule. The proposal would push the securities laws' investor-protection mandate in ways that extend beyond the traditional categories of human advice and recommendation. It would fill important regulatory gaps, promoting firm awareness and self-management of conflicts of interest beyond recommendations to the many ways algorithm-driven advice shapes investor behaviors and market outcomes on a broad scale.

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[1] Proposed Rule, Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, Exchange Act Release No. 97990, Advisers Act Release No. 6353, File No. S7-12-23 (July 26, 2023) ("Data Analytics Proposal" or "proposed conflicts rules").

[2] *See*, *e.g.*, James Fallows Tierney, *The SEC's data analytics rule and the "Netflix" problem in securities regulation* (manuscript) (Aug. 1, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4524766 (Tierney, *Data Analytics*); James Fallows Tierney, *Investment Games*, 72 DUKE L.J. 353 (2022) (Tierney, *Investment Games*); Kyle Lanvgardt & James Fallows Tierney, *On "Confetti Regulation": How Not to Regulate Gamified Investing*, 131 YALE L.J. FORUM 717 (2022); Kyle Langvardt, Regulating Habit-Forming Technology, 88 FORDHAM L. REV. 129 (2020); Benjamin P. Edwards, *The Rise of Automated Investment Advice: Can Robo-Advisers Rescue the Retail Market*, 93 CHI.-KENT L. REV. 97 (2018) (Edwards, *Robo-Advisers*); Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L.J. 181 (2017) (Edwards, *Conflicts*).

We write specifically to address questions raised in the proposal. We focus on six broad issues: the definitions of "covered technology," "investor interaction," "conflict of interest," and "eliminate or neutralize," as well as the compliance requirement and the economic analysis.

I. **Proposed Conflicts Rules — Scope — "Covered Technology"** (questions 5 and 9)

Question 5: ***Use of AI and predictive data analytics technology in investor interactions***

We begin with the proposed definition of "covered technology." The proposed rule's purpose is to ensure that predictive data analytics technologies having a material influence on investment decisions and behavior are transparent, fair, and operate without conflicts that put the broker-dealer or investment adviser's interests ahead of the client's. In this light, it is prudent for the definition to include technologies that "optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes," both directly and indirectly. Technologies like these may allow firms to offer broader ranges of services, make predictions with greater accuracy, and enhance their efficiency.[3] Conflicts of interest can easily arise from direct uses of these technologies, such as the presentation of investment choices that make more salient to clients the options that are highest revenue to the broker.

Yet indirect influences can be as impactful as direct ones. For instance, an AI tool might not provide explicit recommendations but might guide the investor towards certain news articles or sentiment analysis that skews their perception and thus their investment decisions. Or a brokerage firm might use algorithmically generated push notifications to inform clients about market events, like greater than average volatility in one of the stocks in their portfolio.[4]

Beyond the obvious direct use of predictive tools, the SEC's definition of covered technologies should be capacious enough to include both digital engagement practices (commonly known as gamification) as well as other tools that guide content delivery on financial platforms: sentiment analysis tools, AI-driven news aggregators focused on investments, AI-driven chatbots that provide investment analysis, and AI-driven behavioral analysis tools that guide

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[3] Nicole G. Iannarone, *Fintech's Promises and Perils Computer as Confidant: Digital Investment Advice and the Fiduciary Standard*, 93 CHI.-KENT L. REV. 141 (2018).

[4] *See*, *e.g.*, Langvardt & Tierney, supra note 2, at 727 (citing Nicole Casperson, *Robinhood Under Pressure for Bringing "Gamification" to Investing*, INVESTMENTNEWS (Dec. 18, 2020), https://www.investmentnews.com/robinhood-underpressure-for-bringing-gamification-to-investing-200607 [https://perma.cc/7VR3-FSPB]).

the delivery of investment-related content on financial platforms. These technologies indirectly shape investor behavior by influencing the information environment or playing on behavioral biases.[5] At a macro scale, algorithms can introduce biases, inaccuracies, and even systemic risks.[6]

Inclusion of both direct and indirect use of covered technologies in the proposed definition would ensure a more comprehensive regulatory framework. For this reason, we discourage the Commission (as in question 9) from artificially cabining the regulatory intervention to "direct" use in investment advice or by investors, or by excluding technologies used by a firm's associated persons in communicating with investors.

We encourage the Commission, however, to explicitly define the boundaries of "indirect" uses to ensure that the rules are targeted, practical, and do not stifle beneficial technological advancements. If taken to the extreme, the term "indirectly" could include the use of generic technologies like internet search engines or broad financial education platforms not designed for predictive investment purposes. This could impede the development of tools that provide valuable information to the public without guiding or shaping their decisions or outcomes.[7]

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[5] *See*, *e.g.*, Tierney, *Investment Games*, *supra* note 2, at 365 ("Scholars have shown the role of user-interface design in encouraging repeat engagement with stock trading apps.") (citing Sayan Chaudhry & Chinmay Kulkarni, Design Patterns of Investing Apps and Their Effects on Investing Behaviors, in PROCEEDINGS OF THE DESIGNING INTERACTIVE SYSTEMS CONFERENCE 777 (2021), https://dl.acm.org/doi/pdf/10.1145/3461778.3462008 [https://perma.cc/EP9U-RZJ3]); *see also*, *e.g.*, Austin Moss, *How Do Brokerages' Digital Engagement Practices Affect Retail Investor Information Processing and Trading?* (dissertation, University of Iowa, autumn 2022), https://iro.uiowa.edu/esploro/outputs/doctoral/How-do-brokerages-digital-engagement-practices/9984362557402771.

[6] See, e.g., Langvardt, *supra* note 2; Elana Zeide, *The Silicon Ceiling: How Artificial Intelligence Constructs an Invisible Barrier to Opportunity*, 91 UMKC L. REV. 403 (2023); cf. Aziz Huq, *A Right to a Human Decision*, 106 VA. L. REV. 611 (2020).

[7] The most optimistic scholarly views in this respect hold "that dispersed retail trading, mediated by digital brokerage apps, will help overcome typical barriers to retail participation in shareholder voting and corporate governance." Tierney, *Investment Games*, *supra* note 2, at 409; *see*, *e.g.*, Jill E. Fisch, *GameStop and the Reemergence of the Retail Investor*, 102 B.U.L. REV. 1799 (2022); Abraham J. B. Cable, *Regulating Democratized Investing*, 83 OHIO ST. L.J. 671 (2022); Sergio Alberto Gramitto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Collective Power of Retail Investors*, 22 NEV. L.J. 51 (2021); Kobi Kastiel & Yaron Nili, *In Search of the "Absent" Shareholders: A New Solution to Retail Investors' Apathy*, 41 DEL. J. CORP. L. 55 (2016); *cf.* Alon Brav, Matthew Cain, and Jonathon Zytnick, *Retail shareholder participation in the proxy process: Monitoring, engagement, and voting*, 144 J. FIN. ECON. 492 (2022) (discussing role of retail shareholders in corporate governance). For a more pessimistic view, *see* Tierney, *Investment Games*, *supra* note 2, at 409-10 nn. 226 & 227; *see also* Nizan Geslevich Packin, *Financial Inclusion Gone Wrong: Securities Trading For Children*, 74 HASTINGS L.J. 349 (2023). To the extent that the Commission is concerned about deterring

From a risk-based perspective, it could also invite criticism and legal challenges from regulated industry about the broadening scope of regulatory obligations at little tangible regulatory payoff.[8]

Question 9: ***Refining the Definition for Use of Covered Technology in Investor Interactions***

The Commission also asks (as in question 5 above) about aspects of the definition that should be altered. The Commission should approach the definition from a perspective that promotes investor protection, technological evolution, and periodic regulatory review to determine whether these rules are working in the public interest and for the protection of investors.

Centralizing the definition around predictive data analytics might be a wise strategy as these are the primary tools with potential to influence investment decisions in significant ways. To be sure, it is a better definitional strategy than trying to target "gamification" with "confetti regulation."[9] But technological evolution may mean regulations will need to update periodically to reflect these newer tools and any newer costs and benefits they present to society.

Ensuring the rule remains applicable to emerging technologies requires flexibility in its wording. Over-specification could render the rule obsolete in the face of rapid technological advancements, while under-specification could render the rule ineffective as too much is excluded from its scope.[10] As a drafting matter, moreover, a too-strict focus on "data analytics" (or "certain iterations" thereof) may also unintentionally risk a court limiting the definition against less technologically savvy or more picayune digital engagement practices under the interpretive canon of *noscitur a sociis*, which says a word's meaning is dictated by the company it keeps.[11]

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potential prosocial uses of retail investor participation in corporate governance, it should consider updates to the proxy rules to harmonize the framework for the use of technology in interactions between investors and other participants in the proxy system, rather than holding back with respect to conflicts of interest in this space.

[8] *See*, *e.g.*, Langvardt & Tierney, *supra* note 2.

[9] *See generally id.*

[10] The investor-protection regulatory concern would not obviously be better addressed, nor done so in a manner better calculated to provide certainty to regulated entities, by "target[ing] only specific forms of technology such as certain [undefined] iterations of AI," as another comment letter has suggested. Comment Letter of Professors Sergio Alberto Gramitto Ricci and Christina M. Sautter, at *3 (Oct. 9, 2023) ("Ricci and Sautter Letter").

[11] *See*, *e.g.*, Yates v. US, 135 S. Ct. 1074, 1085 (2015) (describing the "principle of *noscitur a sociis*—a word is known by the company it keeps—[which is applied] to 'avoid ascribing to one word a meaning so broad that it is inconsistent

The definition's scope should not be limited to technologies that are used to provide investment advice or recommendations. The point of the rulemaking to fill a regulatory gap left by Regulation Best Interest's ("Reg BI's") focus on "recommendations."[12] If the definition were limited only to technologies providing investment advice or recommendations, the rule might miss out on other impactful technologies that affect investor behavior and outcomes even if they do not count under legacy definitions of what constitutes a "recommendation." For instance, a broker-dealer's use of an algorithmically generated or "curated" stream of financial news might influence investor sentiment and behavior. Even if not a recommendation, it still plays a role in shaping investor behavior.

The definition's scope also should not be limited to technologies investors use (and so should not exclude technologies that investors don't directly use). This contemplated limitation would exclude or overlook platforms that train or assist financial advisors. These present no less of a risk that a firm will be unaware that its use of technology presents a risk of putting its interest ahead of the client's.

Nor should the definition exclude technologies employed by individuals associated with firms.[13] Technologies used by associated persons when communicating with investors can have a direct bearing on investor decisionmaking. Consider a customer relationship management tool enhanced with AI to analyze investor behavior and sentiment, used by a firm associate to guide conversations with investors. Or consider a Monte Carlo simulation that an adviser uses to project possible outcomes of an investor's chosen and alternative asset allocations. Even if

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with its accompanying words, thus giving unintended breadth'"). The Commission may enjoy *Auer* deference in its interpretation of the proposed rule under existing law, but only because of a "hair's-breadth victor[y]" in a challenge before the Supreme Court about which "there is nothing secure." Michael Herz, *Symposium: In* "Gundy II," Auer *survives by a vote of 4.6 to 4.4*, SCOTUSBLOG (Jun. 27, 2019) (describing how the decision in *Kisor v. Wilkie*, 139 S.Ct. 2400 (2019), narrowly declined to overrule the doctrine of *Auer* deference to an agency's interpretation of its own regulations, "result[ing] in the preservation of the status quo").

[12] *See* Data Analytics Proposal, *supra* note 1, at 53,975 ("The proposed definition of investor interaction would include interactions that have generally been viewed as outside the scope of "recommendations" for broker-dealers.").

[13] These uses present different concerns about scalability (*see infra* note 48), but the greater significance of firm-level conflicts does not necessarily mean we should ignore associated-person-level conflicts. Cf. Sophia Duffy and Steve Parrish, *You Say Fiduciary, I Say Binary: A Review and Recommendation of Robo-Advisors and the Fiduciary and Best Interest Standards*, 17 HASTINGS BUS. L.J. 3, 26 (2021) (describing firm-technology-mediated conflicts as "arguably more detrimental than personal conflicts between an advisor and client because the number of clients impacted by the firm[-level] conflict is potentially exponentially higher").

not used directly by the investor, as in the case of self-directed brokerage, the use of these technologies might well be the most salient features on both sides of these two example client interactions.

Taken together, the use of covered technologies under the contemplated exclusions may still shape investor interactions and decisions. They should be considered within the scope of the proposed rules' definition of covered technology.

II. **Proposed Conflicts Rules — Scope — "Investor Interaction"** (questions 10, 16, 17, and 21)

Question 10: ***Refining the definition of "investor"***

The proposed rules are designed to apply to investor interactions, so we begin with the definition of an "investor."[14]

The proposed rules' definition is broader than the "retail customer" definition in Reg BI.[15] We acknowledge that narrowing the definition to "retail customer" would help promote investor protection for the potentially most vulnerable group of investors, and would be a solution that promotes some regulatory harmonization and clarity. But it might also inadvertently leave out other categories of investors who, despite having more resources or sophistication, may still face challenges in understanding or in acting upon unremediated conflicts of interest in the use of predictive data analytics technologies.

Indeed, the Commission might even go further and expand the definition to cover all types of investors, including institutional ones, to ensure a comprehensive protective framework. Given the complexities of these technologies, certain non-retail investors might also benefit from regulatory protection. This could include smaller institutions or high-net-worth individuals who, while not "retail," might not have the technological expertise to fully grasp covered technologies and protect themselves from unremediated conflicts of interest arising from the use of these covered technologies. We recognize that this first-best approach might be vigorously opposed as overly broad, however, potentially increasing the regulatory burdens

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[14] Data Analytics Proposal, *supra* note 1, at 53,973-76.

[15] *Compare* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,341-45 (July 12, 2019) ("Reg BI Adopting Release").

on broker-dealers when dealing with sophisticated investors who may not require the same levels of protection.

We acknowledge that limiting the scope of the proposed rule for investment advisers to services "primarily for personal, family or household purposes" aligns the definition more closely with that of broker-dealers.[16] Considering investment advisers often cater to a diverse clientele beyond household investors, however, a limitation like this may well be too restrictive and not reflective of the broader array of relationships investment advisers maintain. The project of harmonizing the standards of conduct for broker-dealers and investment advisers is best furthered by leveling up the regulatory obligations of broker-dealers, not by relaxing the obligations of investment advisers.

A phased approach, starting with protections for retail investors and then evaluating if further categories require similar protections, could be a feasible strategy here.

Question 16: *Conflicts of interest in investor interactions*

Investor interactions involving data analytics can introduce unique conflicts of interest that are harder to discern and have the potential to result in investor harm. The opaque nature of these technologies may obscure biases or influences that could lead to suboptimal or even misleading advice or direction for investors. Conflicts of interest also drive misallocation of capital to valuable projects in the real economy.[17] The Commission is on safe ground, we believe, with respect to its investor-protection mission and statutory authority in pursuing the proposed analytics rules as a method of reducing agency costs.

Some comment letters have warned that a court would not agree with the Commission's claim of statutory authority here.[18] In our view, the Commission is on safe textual ground in relying

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[16] Data Analytics Proposal, *supra* note 1, at 53,961 n.6.

[17] *See*, *e.g.*, Edwards, *Conflicts*, *supra* note 2.

[18] *See*, *e.g.*, Comment Letter of Andrew Vollmer (Sept. 29, 2023). Even the best reading of the federal securities laws will not deter industry groups and anti-administrativist activists from raising the specter of litigation risk for the Commission. To be clear, the best or "correct" reading of the statute may not be the same as what a court determines the statute means. "While it is risky business to predict what courts will do, the [Commission] has had a poor track record in rulemaking and enforcement before the Supreme Court and the D.C. Circuit in recent years." Langvardt & Tierney, *supra* note 2, at 735-36. From a realist perspective, for example, we should expect the U.S. Court of Appeals for the Fifth Circuit to continue its campaign of anti-administrativism. This is no reason for the Commission to roll over in defeat in advance on a *statutory authority* question, even if the Commission might

on a statutory authority to undertake this rulemaking in addition to the rulemaking contemplated by Dodd-Frank Section 913(f). That section authorized a rulemaking tied to a particular study mandated by Congress. By contrast, the provision relied upon here, Exchange Act Section 15(*l*), separately authorizes the SEC to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes" for broker-dealers and investment advisers that the SEC finds are in the public interest and for the protection of investors. The sections are not tied together by text or by principle.

We stress the *legal* weakness of objections that the Commission cannot exercise its explicit statutory authority because it is enumerated in a section called "other matters."[19] The relevant doctrinal rule is that "the title of a statute and the heading of a section are tools available for the resolution of a doubt about the meaning of a statute," but that "a title will not ... override the plain words of a statute."[20]

Question 17: ***Exclusions from the definition of investor interaction***

We tend to agree that the definition of investor interaction should exclude interactions solely for purposes of meeting legal or regulatory obligations, or for purposes of providing clerical, ministerial, or general administrative support.

We note several things about these proposed exclusions. To begin with, expanding the scope to consider obligations arising from compliance with foreign law or directives of SROs is logical. We caution the Commission to attend that the inclusion does not inadvertently broaden the definition too much. In addition, as to clerical, ministerial, or general administrative support functions, the rationale behind excluding these interactions is the assumption that they have minimal influence on investment-related behaviors or outcomes. However, with the increasing

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otherwise "design policy with a goal of [First Amendment] constitutional avoidance in mind." *Id*. at 736-37 (arguing that the Commission "should address applicable harms from [digital engagement practices] through the familiar methods and techniques of securities law without creating a target-rich environment for [First Amendment] challenges"). We therefore welcome the Commission's recognition that the regulatory approach taken here, requiring firms to adopt policies and procedures to carry out the elimination or neutralization of conflicts with respect to use of certain technology in investor interactions, is an amalgam of regulatory theories and doctrines throughout broker-dealer and investment adviser regulation. *See* Data Analytics Proposal, *supra* note 1, at 53,965-67.

[19] *See*, *e.g.*, Investment Adviser Association Comment Letter at *7-11 (Oct. 10, 2023) ("IAA Comment Letter").

[20] Dubin v. United States, 599 U.S. 110, 120-21 (2023).

use of data analytics technology in back-office processes, potential areas of conflict could still arise.[21]

If the excluded interactions employ covered technology, especially in ways that can indirectly influence investment decisions or perceptions, the Commission should re-evaluate these exclusions. There may be other doctrinal solutions, as well. One solution might be for the exemption to be based on a rebuttable presumption that these uses of covered technologies are exempt, with the presumption flipping upon a sufficient showing of a known, unremediated conflict of interest arising from the use of the covered technology in these ways.

Question 21: *Compatibility of proposed conflicts rules with existing regulatory framework for broker-dealers and investment advisers*

The proposed conflicts rules are compatible with the existing regulatory framework for broker-dealers and investment advisers, and would not be duplicative. As the Massachusetts Supreme Judicial Court recently explained in upholding that state's administrative fiduciary rule as not preempted under Regulation Best Interest, the nature of how financial advisers interact with clients has changed dramatically in recent decades—yet financial regulation largely has not kept up.[22] And as that court explained in rejecting industry challenges to a regulator's attempt to change approaches against the baseline legal rules, regulators can

[21] The request for comment notes that the phrase "clerical, ministerial, or general administrative support" is contemplated to cover "trade settlement and the routing of customers' orders." The general term is broad and can lead to ambiguity, such that specificity would be beneficial. For instance, payment for order flow raises conflicts of interest in a firm's decisions about "the routing of customers' orders," even if the narrowly defined use of "ministerial" technology in carrying out the routing of a particular order to a particular predefined market center may not itself consider any PFOF revenue the firm receives on account of order routing. Yet the conflict of interest may be in how the system is set up to route to predefined market centers, such that using the technology in a "ministerial" way can shroud the conflict's existence. Some additional explanation about the contemplated exemption would help clarify that a firm could not rely on this kind of ministerial exemption to avoid having to consider conflicts about its use of PFOF in determining how to set up its order routing processes. (Of course, the point is not that the data analytics rule would ban PFOF; it is to require a firm to evaluate, identify, and remediate how PFOF might create conflicts of interest in the use of covered technologies in investor interactions. We would not want to artificially exclude the channels and mechanisms through which conflicts of interest may manifest.)

[22] *See* Robinhood Fin. LLC v. Sec. of Commonwealth, — N.E.3d —, 2023 WL 5490571, at *3-4 (Mass. Aug. 25, 2023) (*Robinhood II*) (observing that the "once-clear dichotomy between the services offered by broker-dealers, on the one hand, and investment advisers, on the other, has 'blurred,'" and as a result "Federal and State authorities have questioned whether adhering to [that] traditional dichotomy . . . continues to make sense in this evolving marketplace") (quoting XY Planning Network, LLC v. SEC, 963 F.3d 244, 247 (2d Cir. 2020)); Tierney, *Data Analytics*, *supra* note 2.

decide to move the law forward.[23] There is no *legal* basis to the arguments in some comment letters that the Commission would be doing something impermissible by moving beyond existing regulatory frameworks like Reg BI or its focus on disclosure.[24]

There are of course overlaps in principle. In certain areas, the proposed conflicts rules overlap with existing obligations of broker-dealers and investment advisers. For instance, both Reg BI and the Investment Advisers Act emphasize the importance of acting in the best interest of clients and disclosing conflicts, which have parallels in the proposed conflicts rules.[25]

Yet in our view the proposed conflicts rules target unique challenges posed by retail investor decisionmaking in the shadow of advanced, often unexplainable technologies that gives rise to significant investor-protection concerns. Reg BI is subject to well known limits, such as its applicability only to "recommendations."[26] By extending the regulatory coverage of *conflicts rules* beyond recommendations to all kinds of investor interactions that make use of covered technologies, the proposed rules provide an additional layer of protection against new-age conflicts that have emerged and may continue to develop in the use of data analytics.

III. **Proposed Conflicts Rules — "Identification, Determination, and Elimination, or Neutralization of the Effect of, a Conflict of Interest"** (questions 22 and 25)

Question 22: *Evaluation and identification for conflicts arising from covered technologies*

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[23] *Robinhood II*, 2023 WL 5490571, at *10 (holding that the regulatory articulation of the Massachusetts Uniform Securities Act's standards of care "stand shoulder-to-shoulder" with the "rights and protections . . . under the common law"); *id.* at *15 (concluding that Reg BI "constitutes a regulatory floor that does not foreclose State regulation to more clearly protect investors").

[24] *See*, *e.g.*, WilmerHale Comment Letter for Broker-Dealer Clients, at *8-10 (Oct. 10, 2023) (implying that Sarbanes-Oxley's statutory directives about disclosure with respect to research-related conflicts somehow preclude later-enacted statutory authority); AIMA Comment Letter, at *8 (Oct. 10, 2023) (complaining that "the proposal overrides existing rules"); *see also*, *e.g.*, IAA Comment Letter, *supra* note 19, at *7-11 (Oct. 10, 2023).

[25] We are agnostic as to the likely consequences of any regulatory overlap here. Firms with robust compliance systems in place for existing regulations might find it easier to integrate compliance mechanisms for the new conflicts rules. For example, a process for conflict identification under Reg BI could be adapted to include conflicts specific to AI and predictive analytics. Conversely, stringent adherence to the proposed conflicts rules, which emphasizes transparency and the avoidance of tech-driven conflicts, could indirectly facilitate compliance with broader regulatory principles already in place. *See* discussion below for question 62.

[26] *See*, *e.g.*, Reg BI Adopting Release, *supra* note 15, at 33,334–35; Tierney, *Investment Games*, *supra* note 2, at 434-35.

The proposed rules would require that a firm evaluate any use or reasonably foreseeable potential use of a covered technology to identify any conflict of interest. We believe this articulation is sufficient for a firm to understand how it should comply with the proposed conflicts rules. Mandating firms to evaluate current and foreseeable firm-specific uses of a covered technology is a proactive approach, ensuring that firms look inward to consider not just their present conflicts but potential future issues that may arise.[27] The broad scope may, however, increase the compliance burden.

The proposal raises the possibility of restricting the evaluation not just to when it is reasonably foreseeable, but to when firms "reasonably believe," that the use of technology is associated with a conflict that results in placing their financial interest ahead of the client's. This is sure to attract attention among industry because it seems more practical and less burdensome. But it may also rely heavily on firms' interpretations of what constitutes a reasonable belief, which could lead to inconsistencies in application. A recklessness standard might strike the right balance of incentivizing firms to be on the lookout for red flags and not incentivizing them to avoid thorough evaluations to claim ignorance (as under an actual knowledge standard, or a belief standard contemplating a subjective-knowledge component for the reasonableness of the belief).

The Commission also asks about what it might mean to identify and evaluate conflicts, if it were to define these terms further. The Commission will need to provide guidance on these issues during the practical implementation stage anyway, so it is prudent to begin thinking about how to define them. To "identify" a conflict might be defined as "recognizing with particularity and evidencing on the firm's books and records conflicts associated with the use or potential use of the technology." Likewise, "evaluate" might mean "assessing the extent, implications, potential harms, and choice of remedy (including susceptibility to being neutralized rather than eliminated) with respect to identified conflicts, considering both current and foreseeable technological applications."

Question 25: *Ineffectiveness of disclosure in retail financial advice markets*

[27] *See* infra notes 52-55.

Several Commissioners and commenters have urged that disclosure might be a more appropriate alternative here.[28] We disagree. In our view, a disclosure solution would not be adequate in the public interest or for the protection of investors. The Commission should not rely on a disclosure-based strategy here.

Disclosure is a fundamental regulatory technique in securities regulation and thus an apparently ideal solution.[29] Yet full and fair disclosure and informed consent are more difficult, if not unachievable, in retail financial advice relative to other areas of securities regulation. The reasons for disclosure's prominence as a regulatory feature in securities law relate to deeply liquid capital markets, not markets for financial advice. As we explain, the situation is entirely different in atomized retail financial markets due to complexity, behavioral biases, and market dynamics. Disclosure's effectiveness can be compromised as a result.

Why are there limits on the effectiveness of disclosure in retail financial advice markets? One answer is complexity, as we discuss below.[30] Another answer relates to overload. The volume of information that investors face can lead to information overload, making it difficult for them to discern the essentials. Like consumers in other contexts, they may focus on what is highly salient to them, even if it is not the most important consideration.[31] As a result, only a small subset of investors are likely to read and comprehend these disclosures.[32] What's more, even when presented with clear information, behavioral biases, such as overconfidence or loss

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[28] *See*, *e.g.*, Commissioner Hester M. Peirce, Through the Looking Glass : Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers Proposal (July 26, 2023) (noting that the proposed rule "rejects one of [the SEC's] primary regulatory tools—disclosure"); Commissioner Mark T. Uyeda, Statement on the Proposals re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (July 26, 2023); *see also*, *e.g.*, Comment Letter of the Managed Funds Association 3-5 (Oct. 10, 2023); *compare* Data Analytics Proposal, *supra* note 1, at 53,967 (describing difficulties with disclosure in this context).

[29] *See*, *e.g.*, Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1043 (2009); *see also*, *e.g.*, Ricci and Sautter Letter, *supra* note 10, at Appendix B (enumerating disclosure mandates throughout the securities laws); *supra* note 24 and accompanying text.

[30] *See* text accompanying *infra* note 36.

[31] *See*, *e.g.*, John Beshears, James J. Choi, David Laibson & Brigitte C. Madrian, *Behavioral Household Finance*, in 1 HANDBOOK OF BEHAVIORAL ECONOMICS: APPLICATIONS AND FOUNDATIONS 177, 225 (B. Douglas Bernheim, Stefano DellaVigna & David Laibson eds., 2018) (collecting literature on "situations in which households have been shown to overweight salient attributes and underweight shrouded attributes"); Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2098 (2005); *cf.* Tierney, *Investment Games*, *supra* note 2, at 379-80 (discussing salience models with respect to digital-engagement-practice mediated zero-commission trading).

[32] *See*, *e.g.*, Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WISC. L. REV. 1059, 1070.

aversion, can impede rational decision-making. If most consumers don't read disclosures, the primary purpose of providing them—to inform and protect the investor—gets undermined.

The problem of informational inefficiency in retail financial advice markets means that retail investors who don't read disclosures aren't going to be protected by the market mechanisms that securities regulation supposes exist to protect them (and other non-consumers of disclosure) in capital markets more broadly. Retail markets for financial markets are subject to different information-impoundment mechanisms than semi-strong-form efficient capital markets. Such capital markets are characterized by their efficiency in quickly integrating publicly available information into asset prices. In such markets, discerning consumers of corporate disclosures drive price formation processes, and the logic of informationally efficient markets means non-consuming investors are protected by relying on the market price. The process of price discovery provides incentives for market participants to learn nonpublic information that has not been priced into those securities to earn profits by buying securities that are undervalued and selling those that are overvalued relative to this private information.[33]

By contrast with semi-strong-form efficient capital markets, retail financial markets might not exhibit the same speed or precision in adjusting to new information. Retail financial markets are also more fragmented, with participants having diverse levels of expertise and access to information. The effect of ignored disclosures is also more pronounced in these markets. If there are too few discerning consumers on the margin who select for some non-salient attribute of the good or service, "the market" will be ineffective at protecting the unaware consumers *through disclosure*.[34] In other words, if only a small subset of consumers prioritizes and understands these disclosures, there's limited market pressure on firms to improve.

The bottom line with disclosure proposals in the retail investor context is that retail investors widely ignore them, meaning they don't influence investor behavior. As a result, regulators should consider more interventionist approaches to protect investors, beyond just mandating disclosures.

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[33] *See*, *e.g.*, LASSE HEJE PEDERSEN, EFFICIENTLY INEFFICIENT 40-42 (2015).

[34] *See* Tierney, *Investment Games*, *supra* note 2, at 427 ("If disclosures are not salient and there are too few disclosure-reading consumers on the margin selecting on the disclosures, those consumers are unlikely to move the market.").

Even if effective disclosure were achievable in the retail investor *context*, we would have qualms about the effectiveness of disclosure about these *topics*. The traditional financial adviser interaction contemplates easy-to-understand disclosures. Consider a Second Circuit case involving a broker that "[made] a market in the securities it sold [its customer] in the over-the-counter market," and which the court said investors "must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest."[35] Unlike the clear conflict associated with a broker recommending securities in which it also is an OTC market maker, the details and thus the potential conflicts here may be less amenable to full and clear disclosure.

Modern financial instruments and strategies can be intricate, and explaining them in a simple, comprehensible manner is challenging. This complexity can reduce the efficacy of disclosures that are too technical for the average investor to understand. While some conflicts can be articulated clearly, others stemming from deep within algorithmic processes might be inherently difficult to elucidate. Data analytics technologies primarily relying on statistical processes might be relatively easier to explain than neural networks or other "black box" technologies.[36]

The Commission also asks about the possibility of categorizing technologies and assorted conflicts into distinct classes. This might simplify the compliance process. For instance, covered technologies might be classified with respect to direct advisory technologies (those tools directly advising on investments); indirect influence tools (those that shape investment behaviors more subtly, like sentiment analysis); and support technologies (tools used for administrative tasks with presumptively attenuated effects on investment decisions or outcomes). Different classes might have tailored rules, balancing needs for flexibility and practicality of compliance with transparency.

IV. **Proposed Conflicts Rules — "Identification, Determination, and Elimination, or Neutralization of the Effect of, a Conflict of Interest" — Conflict of Interest** (questions 36, 37, 38, 40, 46, and 50)

Question 36: *When has there been a conflict of interest?*

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[35] Chasins v. Smith Barney & Co., Inc., 438 F.2d 1167, 1172 (2d Cir. 1970).

[36] Cf. Data Analytics Proposal, supra note 1, at 53,977; Simon Chesterman, *Through a Glass, Darkly: Artificial Intelligence and the Problem of Opacity*, 69 AM. J. COMPAR. L. 271 (June 2021).

We agree that a firm should be deemed to have a conflict of interest with an investor if the firm takes into consideration its profits and revenues in its investor interactions using covered technology.[37] As part of the regulatory baseline under Regulation Best Interest, and "[g]enerally consistent with the fiduciary duty under the Advisers Act," the Commission has adopted a definition of a conflict of interest associated with a recommendation as "an interest that might incline a broker, dealer, or natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested."[38] Under the Reg BI baseline, a conflict should be deemed exist if a broker-dealer took into consideration profit interests that might incline it to make a recommendation that is not disinterested. In addition, longstanding Commission adjudications precedent recognizes that a conflict can exist where a broker considers "economic self-interest."[39]

We also agree that a firm's consideration of any factor which is not directly in the interest of the investor may, but will not necessarily, give rise to a conflict of interest. A firm's consideration of a factor not in the investor's interest may indicate a firm or associated-person level conflict of interest where the consideration arises from a firm's indifference or shirking.

There is also inherent difficulty in identifying an investor's interests.[40] We caution the Commission against trying to hardwire a definition of investor interest as meaning strict wealth maximization.[41] Revealed preferences among investors suggest that they may value and

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[37] Note that the existence of a conflict does not mean that the firm has violated the conflict rule. Rather, once the firm has identified and determined that it has a conflict, it must take steps to eliminate or neutralize, as discussed below.

[38] Reg BI Adopting Release, *supra* note 15, at 33,347; *see also id.* at 33,327 at n.74 ("An adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.")

[39] *RichMark Capital Corp.*, Exchange Act Release No. 48758, 2003 WL 22570712, at *3 (Nov. 7, 2003) ("When a securities dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of 'adverse interests' such as 'economic self-interest' that could have influenced its recommendation.").

[40] *See*, *e.g.*, Tierney, *Investment Games*, *supra* note 2, at 410 n.226 (explaining that "retail shareholders have multifaceted roles in society, as workers, consumers, and people living on earth—so their 'interests reflect [their] overall role in society, and each shareholder's individual utility function reflects his or her preferences with respect to stakeholder issues" other than strict wealth maximization).

[41] *Contrast* U.S. Dep't of Labor, *Financial Factors in Selecting Plan Investments*, 85 Fed. Reg. 72,846, 72,846 (Nov. 13, 2020) ("A fiduciary's evaluation of an investment or investment course of action must be based solely on pecuniary factors . . . ."). As the late law professor Lynn Stout has explained, "many and perhaps most of our corporate problems can be traced . . . to . . . the idea that corporations are managed well when they are managed

have an interest in factors or considerations that go beyond wealth maximization in a narrow sense.

Question 37: *Defining conflicts of interest with clarity*.

We believe that the Commission could achieve greater clarity in the description of when a conflict of interest exists. Advisers and broker-dealers already operate under duties to eliminate or expose conflicts. Their understanding of conflicts is framed within these existing regulatory obligations. If the concept of a conflict of interest differs in this context, it will be essential to clearly describe how the concept differs to ensure uniform understanding and compliance. While some conflicts are obvious, others can be subtle and nuanced.

Using the same term in the proposed rules and in existing obligations might lead to confusion if the contexts diverge. That is especially so if the scope of conflicts is perceived to be different from the background regulatory contexts. We therefore support the Commission's use of language, either in a definitions section or in the adopting release, making clear that the use of "conflict of interest" is meant to be specific to the proposed rule and does not import or export other overlapping concepts from other regulatory contexts. The use of the term "potential conflict of interest" here might emphasize the proactive identification and handling of conflicts even before they manifest significantly. It underlines the precautionary principle.

We do not believe it would be necessary to use a term like "technology related conflict of interest," at least not if the Commission otherwise defined the term as limited to this rulemaking's purpose. The alternate term would explicitly tie the conflict conceptually to the use of technology, an element or component of the analysis already addressed by the "covered technology" angle. It could inadvertently narrow the perceived scope.

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to maximize share price." LYNN STOUT, THE SHAREHOLDER VALUE MYTH 11 (2012). For additional perspectives on defining shareholders' range of acceptable interests here, see Malcolm Baker, Mark L. Egan, & Suproteem K. Sarkar, *How Do Investors Value ESG?*, NBER Working Paper No. 30708 (Dec. 2022); Dorothy S. Lund, *Toward a Fair and Sustainable Corporate Governance System: Reflections on Leo Strine, Jr.'s Writing on Institutional Investors*, 24 U. PA. J. BUS. L. 835 (2022); Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393 (2022); Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020); Ann M. Lipton, *What We Talk about When We Talk about Shareholder Primacy*, 69 CASE W. RES. L. REV. 863 (2019); Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 6 (2007).

Question 38: ***Extending "conflicts of interest" to firms' associated persons.***

We believe firms would face modest challenges related to considering their associated persons within the scope of their conflicts of interest. A tiered or risk-based approach, where firms are given guidelines but also the flexibility to implement them based on their size, structure, and associated risks, might be a solution that balances the need for protection against undue regulatory burden.

One implication of extending the definition this way would be a greater need for due diligence at the associated person level. Firms would need to undertake deeper vetting processes to identify and remediate their associated persons' interests in connection with the use of covered technologies in investor interactions. Depending on how extensively associated persons use these technologies in ways covered by the regulation, this could increase administrative burdens. There may also be greater complexity in identifying conflicts; determining and monitoring the varying interests of all associated persons could become complicated, especially for larger firms. Ongoing surveillance might ensure associated persons don't acquire new conflicting interests over time. Implementing standardized due diligence processes or policies that mandate regular disclosures by associated persons regarding their interests can help in preemptively identifying potential conflicts. Such procedures would emphasize proactive conflict management.

The proposed rule also raises the possibility of limiting the definition to conflicts of which the firm is aware or reasonably should be aware, a point we discuss above. Defining what a firm "reasonably should be aware of" might be challenging. To what extent does the Commission contemplate this as different from a recklessness inquiry?[42]

Finally, including entities controlling, controlled by, or under common control with firms could capture a broader range of potential conflicts. This would be particularly relevant for conglomerates or financial groups with interconnected interests. However, it would foreseeably amplify the challenges in conflict identification and monitoring.

Question 40: ***Incorporating additional policy considerations.***

While the proposed rule focuses on conflicts of interest, the Commission is tasked with undertaking rulemaking in the public interest and for the protection of investors. These

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[42] *See* discussion of question 22 above.

statutory goals contemplate a wide array of programmatic interests and Commission priorities, to say nothing of broader public policy implications. Incorporating some of these other programmatic interests and policy considerations could be advantageous.

Such considerations could include ethical sourcing of data, such as ensuring it doesn't result from exploitative processes; eliminating discriminatory bias and promoting fairness for the use of covered technologies that have broad societal implications; and enabling clear documentation and auditability of data sources and algorithmic processes. Still, the more the Commission strays from the core investor protection interventions involving "sales practices, conflicts of interest, and compensation schemes" under its statutory authority, the greater the risk that these will be challenged as too attenuated. To the extent the Commission pursues these goals, these measures should be designed to promote investor protection, market efficiency, and public participation and trust in data-driven decision-making processes within the financial industry.

Question 46: ***Prioritizing the firm's interest over investors: clarity and relevance***

The regulatory inquiry does not end when a firm evaluates its uses of covered technology to identify conflicts associated with those uses. The proposed conflicts rules would also require the firm to determine whether the conflict places or results in placing their interests ahead of the investor's. The proposal contemplates that this would be a facts-and-circumstances inquiry. The outcome of this determination process would then direct the firm to eliminate the conflict or neutralize its effect if it lacks a reasonable belief that the conflict won't put the firm's (or its associated persons') interests first.[43]

The proposal should be applauded as an attempt to ensure that neither the firm nor its associated persons prioritize their own interests over that of the investors. While the intention is commendable, the phrasing could be open to interpretation. A clearer, more unambiguous articulation could further benefit all stakeholders.

The generality of the requirement, as phrased, is intended to make it future-proof. The principle that firms should not prioritize their interests over investors is timeless and should

[43] Data Analytics Proposal, supra note 1, at 53,983.

apply regardless of technological advancements.[44] However, as new technologies emerge, there may be nuanced ways in which conflicts arise. It would be prudent for the SEC to periodically review and refine its definitions and guidance in response to these evolutions.

The Commission also asks about the interplay between the concepts of "placing" and "results in placing." Both phrases aim to capture the essence of a conflict of interest where the firm's interests are ahead of the investor. "Places" seems to contemplate a direct action. By contrast, the term "results in placing" seems to contemplate a broader scope, capturing indirect outcomes and consequences.

As we have suggested above, the Commission should not treat lightly the distinction between direct and indirect action here.[45] A data analytics rule that applies the conflicts rules to these indirect outcomes and consequences would be essential for ensuring fair play and investor protection. In both direct and indirect scenarios, there may be a misalignment between the adviser's interest and the client's best interest. Limiting the rule to "places" might cover overt conflicts but not subtle ones, and "results in placing" might ensure that all potential conflicts areadequately addressed. But if the intent is to streamline and simplify the language, the SEC could consider focusing on the broader "results in placing," which could encapsulate both direct and indirect conflicts.

Question 50: *The determination requirement*

An expanded determination requirement that encompasses a wider range of legal and ethical considerations would strengthen the rule's overall impact. It would be prudent to expand the

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[44] *See*, *e.g.*, Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 720-23 (2010) (describing historical approaches to fiduciary obligations of broker-dealers, indicating a longstanding if contested concern about brokers taking advantage of conflicts in their relationships with clients); Gregory A. Hicks, *Defining the Scope of Broker and Dealer Duties-Some Problems in Adjudicating the Responsibilities of Securities and Commodities Professionals*, 39 DEPAUL L. REV. 709, 716 n.16 (1990) (explaining that conflicts of interest in brokerage "has affected federal securities regulation and generated adverse comment from its earliest days," serving as "a major engine for reforming the practices of dealers") (citing, e.g., SEC, Report of Special Study of Securities Markets of the SEC, H.R. Doc. No. 95, 88th Cong., 1st sess., pt. 2, ch. VII, at 610-53 (1963)); *see also*, *e.g.*, Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 736; Martin Mayer, *Broker-Dealer Firms*, in ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS, REPORT TO THE TWENTIETH CENTURY FUND STEERING COMMITTEE ON CONFLICTS OF INTEREST IN THE SECURITIES MARKET 433 (1980); *see also* M. J. Rossant, *Foreword*, in ABUSE ON WALL STREET, at xiii ("We are, to paraphrase Chesterton, all conflicted now.").

[45] *See* discussion of questions 5 and 9 above.

determination requirement to account for situations that may not fall strictly under the definition of "conflict of interest" as proposed but could nonetheless implicate other federal securities laws. This broader scope can ensure that firms maintain a holistic approach to compliance, considering all relevant rules and regulations that their operations might touch upon. Ensuring that covered technologies operate within the bounds of the securities laws—not just those related to conflicts of interest—would foster trust and confidence in the financial markets. Shouldn't market participants expect this anyway?

V. **Proposed Conflicts Rules — "Identification, Determination, and Elimination, or Neutralization of the Effect of, a Conflict of Interest" — Elimination or Neutralization of Effect** (questions 52, 53, and 55)

One hallmark of the proposed rule is a shift from an eliminate-or-disclose regime under Regulation Best Interest to an eliminate-or-neutralize regime. This new regime puts firms to the choice of getting rid of a practice of using covered technology that gives rise to a conflict of interest that puts its interest ahead of the client's—or to take steps to address it, such as by "prevent[ing] it from biasing the output towards the interest of the firm or its associated persons," such that the output does not place the firm's interest first.

Question 52: *Overlap between proposed and existing regulatory requirements*

We agree that the proposed conflicts rules' elimination or neutralization evaluation requirement may overlap with existing regulatory requirements for broker-dealers and investment advisers.

Most important, the Reg BI baseline already contemplates the mitigation or elimination of conflicts where disclosure is deemed insufficient in context. Our discussion of question 25 above suggests that disclosure will be insufficient in this context. The proposed rule could be framed as a successor to and improvement upon that regulatory framework, eliminating the disclosure option where the Commission has deemed that option likely to be ineffective.

Other overlaps could relate to identification, mitigation, or elimination of conflicts of interest. Consider state securities regulation, such as the Massachusetts fiduciary rule obligations applicable to broker-dealers.[46] Under those standards, broker-dealers must make all reasonably

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[46] *See* Comment Letter of William Galvin, Secretary of State of the Commonwealth of Massachusetts (Oct. 10, 2023); *Robinhood II*, 2023 WL 5490571.

practicable efforts to avoid conflicts of interest, eliminate conflicts of interest that cannot reasonably be avoided, and mitigate conflicts that cannot reasonably be avoided or eliminated.[47]

These and other regulatory overlaps may result in compliance efficiencies. If the proposed conflicts rules align with existing regulatory requirements, firms could potentially streamline their compliance processes, leading to efficiencies in both time and resources. A single robust system or protocol that addresses both sets of requirements would be more efficient than disparate systems. What's more, by adhering to the highest standards set out in either the proposed or existing rules, firms would be fostering a culture of compliance that likely satisfies multiple regulatory demands. Overlaps might also allow firms to integrate training for staff, ensuring they are well-versed in all aspects of compliance, be it under existing rules or the proposed conflicts rules.

In addition, a positive outcome of overlaps could be mutual reinforcement. Compliance with the proposed conflicts rules might ensure compliance with certain aspects of existing regulations, and vice versa. For instance, if a broker-dealer follows strict protocols to eliminate conflicts of interest as mandated by the new rules, this might simultaneously satisfy similar requirements under existing regulations.

Question 53: *Scalability and its impact on disclosure and consent*

Scalability could amplify the effects of conflicts of interest exponentially.[48] As technologies become more intricate and their usage becomes more widespread, the repercussions of a conflict could ripple across a larger number of investor interactions, making timely and full disclosure challenging.

Certain conflicts might be more suited for disclosure as a general matter (though as we suggest in our response to question 25, it may not be effective in this context). For instance, straightforward conflicts where the benefit to the firm or associated person is direct and quantifiable might be effectively addressable through clear disclosure. Conflicts that are easy

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[47] See 950 Code Mass. Regs. 12.207(2)(b)(2) (2020).

[48] We understand the rule proposal to use "scalability" to refer to the "potential for firms" to expand the use of these of "these technologies and . . . reach a broad audience at rapid speed," raising the possibility that "any resulting conflicts of interest could cause harm to investors in a more pronounced fashion and on a broader scale than previously possible." Data Analytics Proposal, *supra* note 1, at 53,961.

for laypeople to understand—like “I am also acting as a market maker in the stock I am recommending you”—have traditionally been the sort of thing the securities laws have permitted to be handled through disclosure.[49] Complex, intertwined conflicts that arise from multifaceted algorithmic decisions might not be as easily understandable through disclosure alone.[50]

The effect of scalability might indeed vary based on the nature of the investor interaction and the technology in question. Direct use of a covered technology by an investor can be susceptible to rapid scalability, making conflicts harder to manage. In contrast, when an associated person provides recommendations based on technology, there’s a human layer of interpretation and judgment that might serve as a buffer, reducing the immediate scalability of any potential conflict.

Question 54: *Challenges with associated persons’ use of covered technology*

Requiring firms to oversee and control the use of covered technology by their associated persons could be challenging. Firms might find it difficult to monitor, in real-time, the myriad ways in which these persons use the technology, especially if they incorporate external tools or platforms. To address this, firms might need robust policies, procedures, and training programs tailored for associated persons. Regular audits and technology usage reviews could also be integral components of a compliance program.

Expanding the elimination or neutralization requirement to encompass entities that control, or are controlled by the firm, could increase the breadth and complexity of compliance. Given the interconnected nature of businesses and the potential for conflicts to arise at various organizational levels, this kind of extension might be warranted. It would promote a holistic strategy for addressing conflicts, regardless of where they originate within a corporate structure.

If the Commission decides to expand the scope, clear guidance or Exchange Act Section 21A reports detailing the expectations and responsibilities of both firms and their associated entities would be beneficial. So would tools or resources to help firms navigate these expanded responsibilities, such as best practice guidelines.

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[49] See supra note 35 and accompanying text.

[50] *See* answer to question 25 above.

Question 55: ***Obligations regarding conflicts of interest***

Firms should be required to eliminate, or neutralize the effect of, conflicts of interest that place the firm's interests ahead of investors' interests as required under the proposed rules. Ensuring investor trust is fundamental to the integrity and efficiency of financial markets. If firms or their associated persons are allowed to operate with unresolved conflicts, it could generate mistrust, which would undermine investor confidence and jeopardize market stability.

We disagree with the contemplated alternative approach of limiting the elimination or neutralization obligation solely to investor interactions involving investment advice or recommendations. This approach might be too narrow. Conflicts can manifest in various ways beyond direct advice or recommendations, such as in the pricing of services or the presentation of investment options, The proposed rule recognizes that the existing regulatory framework leaves too many gaps; a broad application ensures a comprehensive approach to conflict management.[51]

There are other ways to address risks, all of which are likely to be insufficient on their own but might supplement the rule proposal. Consider first *continuous monitoring*, under which firms are mandated to conduct regular monitoring and audits of the ways in which covered technologies are used. This proactive approach can help identify potential conflicts early. In addition, *radical transparency* could be used to promote clear, comprehensive, and timely disclosure about how covered technologies are used, including underlying algorithms, data sources, and audits for potential bias (though we have described problems with disclosure and the information disclosed is unlikely to be sufficiently radical here). Finally, the Commission could promote *education*, equipping investors with resources and educational materials to understand the implications of covered technologies and the potential risks of conflicts. We discuss implications with respect to question 104 below.

VI. **Proposed Conflicts Rules — Policies and Procedures Requirement** (question 62)

In his statement accompanying his vote against the proposal, Commissioner Mark Uyeda objected that the proposal uses "a highly prescriptive process for evaluating, testing, and documenting a firm's use of the covered technology with respect to conflicts of interest."[52] As

[51] See supra note 13 and accompanying text.
[52] Uyeda, *supra* note 28.

one of us has written, there are reasons to doubt that this regulatory technology is actually "prescriptive," except to the extent that it prescribes a policy intervention that industry would prefer not exist.[53]

Far from a pedantic debate, whether the data analytics rule is "prescriptive" raises important questions about how to achieve regulatory goals while reducing compliance costs arising from unnecessary requirements unrelated to a firm's specific risks. As a matter of regulatory technique, the conflicts rules combined with the policies and procedures requirement is better thought of as a kind of "principles based" or "risk based" rulemaking so often demanded by regulated industry.[54] To be certain, the proposed rule contemplates "minimum standards for the written descriptions and annual review that a firm's policies and procedures would need to include." But the point is to "provide firms with flexibility to determine the specific means by which they address each element, and the degree of prescriptiveness the firm includes in their policies and procedures."[55] They focus firms' attention on their firm-specific risks, requiring them to take stock of where they are at and to address their own risks, rather than to fit one-size-fits-all regulatory requirements as the "prescriptive" label might suggest.

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[53] Tierney, *Data Analytics*, *supra* note 2, at 15 (explaining that the proposal takes a "'risk-based approach,' focusing on the role of supervisory procedures in shaping a firm's awareness and management of its legal compliance obligations" particular to the firm's situation); *see also*, *e.g.*, Kurt Wolfe and Chris Ekimoff, *Addressing the "Netflix Problem" in Securities Regulation*, inSecurities Podcast, No. 101 at 30:12–32:37 (Practicing Law Institute, Sept. 2023), https://www.pli.edu/insecurities/episode-101.

[54] As one of us has written:

> This is the same approach used in other areas of law. For instance, under Rule 3310 of the broker-dealer self-regulatory organization FINRA's rulebook, member firms must "develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the Bank Secrecy Act ... and ... implementing regulations." As the SEC explained in Merrimac Corporate Securities, reviewing a FINRA enforcement action, in the anti-AML regime "broker-dealers would be expected to follow a 'risk-based approach'" to evaluating their own risks and adopting a "program that is appropriate for the particular broker-dealer in light of such risks." Merrimac Corp. Secs., Exchange Act Release No. 86404, 2019 WL 3216542 (SEC July 17, 2019). Firms already face litigation risk for failing to adopt or implement AML compliance programs appropriate for their own firm-specific risks. *Cf.* Press Release, FINRA Fines Merrill Lynch $6 Million for Longstanding AML Program Failures (July 11, 2023). This is also the main framing of the recent proposed Regulation Best Execution. See Proposed Rule, Regulation Best Execution, Exchange Act Release No. 96496, 88 Fed. Reg. 5,440, 5455-58 (2023) (describing proposed rule 1101(a)(1)).

Tierney, *Data Analytics*, *supra* note 2, at 15-16 (cleaned up, footnotes moved inline).

[55] Data Analytics Proposal, *supra* note 1, at 53,990 & n.200 (explaining that the proposal is "intended to encourage development of risk-based best practices by firms, rather than to impose a one-size-fits-all solution").

Question 62: ***Compatibility with existing regulatory framework***

The proposed conflicts rules' policies and procedures requirement could complement the existing regulatory framework for broker-dealers and investment advisers by adding an additional layer of scrutiny specific to conflicts arising from the use of covered technologies. It could help promote firms' ongoing compliance with regulatory principles, while the risk-based orientation would permit flexibility and updating to the nuanced challenges that advancements in technology present.

We acknowledge there might be areas where the proposed rules overlap with existing regulations. For example, broker-dealers and investment advisers are already required to have policies and procedures in place to ensure compliance with various regulations. If these existing procedures already address conflicts of interest related to technology use, the proposed rules might seem redundant. Indeed, if the proposed rules merely reiterate the obligations already covered by existing regulations without adding any specific or distinct requirements, it could lead to duplication. This could strain resources, especially for smaller firms, if they are obligated to adhere to multiple, identical compliance processes.

On balance, however, we believe that firms' compliance with these regulatory requirements will contribute to compliance with the proposed conflicts rules, and vice versa. This compliance with "other" requirements could streamline uptake and adherence to the proposed conflicts rules. Firms have incentives to have robust mechanisms in place already to identify and manage conflicts of interest. Adapting these mechanisms to address the specifics of the proposed rules might be more straightforward. Conversely, a firm diligently complying with the proposed conflicts rules may find themselves better prepared to meet the obligations of broader regulations due to the specialized nature of the new rules.

VII. **Economic Analysis — Request for Comment** (questions 96, 103, and 104)

Question 96: ***Analysis of Conflicts and Mitigation Practices***

Covered technologies, while offering numerous benefits, can introduce unique conflicts of interest. Conflicts of interest in the brokerage relationship are well known in the scholarship

on financial advice and generate meaningful costs to investors that warrant the Commission's exercise of its statutory investor-protection mandate.[56]

Some costs to investors are at the individual scale. Where a financial adviser elicits investment decisions or outcomes based on suboptimal inputs, or inputs that are tainted by factors or considerations other than the investor's best interest, investors will receive advice or product recommendations that aren't in their best interest. Unsuitable recommendations driven by underlying conflicts can lead to financial losses. Idiosyncratic, individual-level losses may be socially wasteful. These dynamics also have broader consequences related to loss of trust and risk of exposure to data breaches. There is no obvious reason to believe, as some commenters have suggested, that the proposed rule as drafted "will *eliminate* the ability of retail investors to use mobile investing platforms for the purchase or sale of securities" or for other purposes related to investor "education."[57]

The Commission asks about existing practices for eliminating or neutralizing conflicts. Existing processes may include audits, algorithmic transparency, and conflict walls. First, regular audits by independent entities can help in identifying and remediating biases or conflicts in the system. Second, registered firms and their associated persons may already (and should be encouraged or mandated to) employ algorithms that are transparent and maximally understandable to their audiences, including where appropriate laypeople. Third, informational barriers within organizations can help ensure decision-making mediated by the use of covered technology remains independent, in the investor's best interest, and unaffected by potential conflicts.

The Commission also asks about practices for mitigating the effects of conflicts. Possible responses include disclosure, monitoring, and training. First, although we have in this letter discouraged the Commission from considering a disclosure solution because of its likely

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[56] For examples of discussion of the agency costs from conflicts of interest inherent in the brokerage relationship, see Deborah A. DeMott, *Rogue Brokers and the Limits of Agency Law*, in CAMBRIDGE HANDBOOK OF INVESTOR PROTECTION (Arthur B. Laby ed., 2022); Daniel Bergstresser, John M. Chalmers & Peter Tufano, *Assessing the costs and benefits of brokers in the mutual fund industry*, 22 Rev. Fin. Stud. 4129 (2009); Peter Bolton, Xavier Freixas, and Joel Shapiro, *Conflicts of interest, information provision, and competition in the financial services industry*, 85 J. Fin. Econ. 297 (2007).

[57] Ricci and Sautter Letter, *supra* note 10, at 3 (emphasis added); *cf.* James Fallows Tierney, *Contract Design in the Shadow of Regulation*, 98 NEB. L. REV. 874 (2020) (describing how agency commenters will often suggest that the status quo experience under the best market-offered option is likely to go away under proposed regulation, framing the regulatory change in ways that make regulators perceive the status quo baseline, measured across all offerings in the market, as superior even if it isn't).

ineffectiveness, to be effective any disclosure-based mitigation regime would have to include robust, salient, and just-in-time disclosure of conflicts of interest to investors.[58] Existing solutions involving potentially non-salient disclosures, such as Form CRS, may be insufficient here. Second, we have mentioned the possibility of continuous monitoring. This may involve regularly monitoring and updating one's technologies (and one's risk-based approach to identifying and remediating conflicts) to ensure they function as intended. Third, firms should ensure that their associated persons understand technology and conflicts, so they can act as an additional line of defense. With respect to a training mandate, who hasn't been to a mandatory employee training webinar they didn't love?

The Commission asks last about current costs of practices that exist for mitigating the effects of these conflicts. We cannot provide specific numbers, but several sources of costs are readily identifiable. One involves technology overhaul. Firms might need to invest in overhauling or updating technologies to mitigate conflicts, which might be expensive. In addition, there are training costs associated with training associated persons about covered technology, mitigation techniques, and the like. Finally, there can be recurring costs as firms conduct regular audits and ensure compliance. On balance, however, we are confident that the overall benefits of the proposed rules outweigh these compliance costs.

Question 103: ***Transparency, Fairness, and Investor Confidence Resulting from Proposed Conflicts Rules and Recordkeeping Amendments***

We believe the proposed conflicts rules and recordkeeping amendments will enhance transparency and fairness in the use of covered technologies in investor interactions. By providing a common approach to identifying and remediating conflicts, while directing firms' attention and effort to their firm-specific risks, the proposals can promote greater investor confidence. A market perceived as transparent, fair, and regulated is more likely to inspire trust and participation, and hopefully to promote the health and growth of the real economy.

Ultimately, we are guided by what we think will be the impact on investor confidence and trust. The proposed rules are likely to promote a clearer understanding of conflicts on the part of registered entities and their associated persons, making it less likely that they will continue to use covered technologies in investor interactions subject to unidentified and unremediated conflicts of interest. Knowing that there are regulations in place to mitigate conflicts of interest can enhance trust, as investors will believe that the system is geared to operate fairly

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[58] *See*, *e.g.*, Tierney, *Investment Games*, *supra* note 2, at 426-27.

and not against their interests. With clear rules and recordkeeping, investors can be less wary of potential exploitation through the use of opaque algorithms or other covered technologies.[59] Greater transparency can encourage more investors to participate in the market, as they have clearer insights into the workings of the technological tools used by firms. Finally, the knowledge that firms are required to maintain records and that these records can be audited provides an additional layer of assurance to investors. This oversight can enhance the perception of the market's integrity.

Question 104: ***Alternative Approaches and Trade-Offs***

While there are several potential alternatives to the proposed conflicts rules and recordkeeping amendments, each comes with its own set of challenges and trade-offs. The Commission should aim to find a balance that ensures robust oversight and transparency without imposing undue burdens on firms or leaving retail investors vulnerable. In our view, the proposed conflicts rules strike the best balance relative to the potential alternatives, which we see as inadequate to the task.

First, we have addressed above why enhanced disclosure is not likely to be an effective solution in this context.[60]

Second, the Commission could require third-party audits. Instead of internal recordkeeping, firms could be mandated to undergo periodic third-party audits to ensure that conflicts are being properly managed and that the use of technology is in line with best practices. Third-party audits can come with added costs for firms above and beyond those contemplated by the data analytics rule's policies and procedures requirements.

Third, the Commission could prioritize certification programs. Firms could be required to obtain certifications demonstrating that their technological tools and processes adhere to a certain standard. This certification could be periodically reviewed and renewed. While certifications can instill a degree of trust, the criteria for certification and its periodic renewal could become contentious issues. There are also concerns that certification can result in

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[59] This is, after all, why "good" brokers have traditionally tolerated sales practices regulation that target "bad" brokers who depredate against their clients with unremediated conflicts of interest: it promotes the investor confidence that is necessary to elicit market participation and enable the brokerage business model in the first place. *See*, *e.g.*, James Fallows Tierney, *Reconsidering Securities Industry Bars*, 29 STAN. J. L. BUS. & FIN. (forthcoming 2023), https://www.ssrn.com/abstract=3761903.
[60] *See* answer to question 25 above.

"greenwashing," undermining the regulatory objectives sought to be promoted through certification.

Fourth, the Commission could focus on whistleblower protections and programs with respect to the use of covered technologies. Encouraging insiders to report unethical practices by providing them with protections and incentives could be another way to ensure firms are adhering to best practices. While whistleblower programs can be effective, relying on them too heavily could lead to under-detection of issues until they become significant problems. There may also be concerns with too much secrecy in the whistleblower program, which raises concerns about accountability.[61]

Finally, as discussed above, the Commission could invest in or mandate educational initiatives targeted at retail investors. These initiatives would aim to better inform them about potential conflicts associated with the use of certain technologies. But educational initiatives, though well-intentioned, may not reach all target audiences effectively. Furthermore, the rapid evolution of technology might outpace educational content, leaving gaps in knowledge.

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We thank you for your consideration. Please let us know if we can be of further assistance to the Commission, the Commissioners' counsel, or the Staff as the agency considers these issues further.

Sincerely,

James Fallows Tierney
Assistant Professor of Law
Chicago-Kent College of Law
jtierney1@kentlaw.iit.edu
(corresponding author)

Kyle Langvardt
Assistant Professor of Law
University of Nebraska College of Law

[61] *See*, *e.g.*, Alexander I. Platt, *The Whistleblower Industrial Complex*, 40 YALE J. ON REG. 688 (2023).

Benjamin P. Edwards
Professor of Law
William S. Boyd School of Law
University of Nevada–Las Vegas

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