October 10, 2023

BY ELECTRONIC SUBMISSION

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

Re: File No. S7-12-23, RIN 3235–AN00, Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers

Dear Ms. Countryman:

Andreessen Horowitz ("a16z") appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission ("Commission")[1] requiring broker-dealers and investment advisers to eliminate or neutralize the effect of conflicts of interest arising through these firms' use of certain predictive data technologies (the "Rule" or "Proposed Rule"). Our principal concerns are that the Proposed Rule does not clearly define the harms it seeks to address; is consequently over-broad in its proposed prescriptions and remedies; proceeds without an adequate understanding of the current state of artificial intelligence ("AI") in the United States, and, through its inflexible approach, likely poses great risk of impeding innovation in U.S. AI generally, and in U.S. AI-based financial services specifically.

[1] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53,960 (Aug. 9, 2023) (the "Proposal").

We believe that if adopted in its current form, the Proposed Rule would effectively chill the adoption of AI technologies in financial services, impose unfeasible standards on firms that use or develop such technologies, and mandate a uniform requirement to eliminate or neutralize conflicts that is patently unsuitable to the wide range of AI technologies firms may use. We therefore take this opportunity to provide context for the Commission around the likely impact of the Proposal's application to AI. Traditionally, AI has been focused upon making predictions or classifications based on existing data, whereas the recent paradigm shift in generative AI is toward models can now produce new content.[2] Therefore a regime in which the firm utilizing AI must anticipate all potential outputs in order to neutralize possible conflicts is ill-advised and patently unworkable.

We also believe that if adopted as proposed, the Commission's failure to craft a rule that more accurately reflects the state of AI technologies today risks placing the Commission in breach of its obligations under the Administrative Procedure Act. More specifically, our survey of the Proposed Rule leads us to conclude that nowhere in the Rule does the Commission adequately explain any of the questions we note below:

(1) What risks or concerns are uniquely posed by broker-dealers' and investment advisers' use of technologies that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes (the "Covered Technologies")?

(2) Why are the Commission's existing laws and regulations relating to investment advisers and broker dealers insufficient to address any such risks or concerns raised by the use of Covered Technologies?

(3) Why are existing remedies such as disclosure or mitigation insufficient to address at least some conflicts, instead of requiring elimination or neutralization in each instance?

As one of Silicon Valley's preeminent venture capital firms with over $35 billion in committed capital, a16z has been investing in artificial intelligence for many years, and today,

[2] ***See*** Financial Services Will Embrace Generative AI Faster Than You Think, a16z available at a16z.com/financial-services-will-embrace-generative-ai-faster-than-you-think.

we manage pooled vehicles which hold investments in nearly 100 AI development firms. Our managed fund family invests across a broad cross section of advanced technology builders and consumers. Therefore, we can confidently state that AI is now a substrate in every subsegment of the broader economy, regardless of firm size or industry.

Our investments in AI include a broad and diverse range of projects:[3]

- A prospective broker-dealer building infrastructure that removes the complexities of embedding fixed income investments in any application;
- A wealth manager seeking to offer its customers access to private investment opportunities typically reserved for the most affluent and connected individuals, and combining these investment opportunities with services such as tax and estate planning;
- A company providing instant, risk-free ACH & card settlement to fintech and crypto companies, enabling them to stop payment fraud and increase conversion rates;
- An external vector database where developers can store and search relevant contextual data for large language model applications; and
- A platform for hosting and running machine-learning models in the cloud.

As one of the earliest and largest investors in many AI companies and projects, and as one of the largest investment advisers in the private technology space, a16z is well-positioned to evaluate the potential impact of the Proposed Rule on the nation's young but vital AI industry, and on investment advisers using AI tools, in particular.

Our deep and broad involvement in AI projects and companies leads us to believe that the Proposed Rule risks chilling the development and increased adoption of AI technologies in asset management and financial services. We recognize, of course, that the Proposed Rule is not

[3] For more detail on our involvement in AI, please ***see*** "AI + a16z" on our firm's website, at https://a16z.com/ai/.

restricted to AI or investment advisers using AI[4] — but any regulation that seeks to apply (as the Proposed Rule does) uniformly over a range of technologies that vary significantly in terms of sophistication, intended use, and implications for investors, carries with it the inherent risk of overbreadth. The enormous potential of the U.S. AI industry, and the unwarranted and unnecessary challenges that the Proposed Rule would pose to AI firms in the financial services sector, compel us to offer our comments below.

INTRODUCTION AND EXECUTIVE SUMMARY

The Commission's proposed new predictive data analytics rule is unnecessary, hard to comprehend, and near-impossible to implement. The rule would require investment advisers and broker-dealers to eliminate or neutralize conflicts of interests that arise when, in connection with communicating with investors, such advisers or brokers use Covered Technologies to optimize or direct investor behavior or outcomes. More specifically, the Proposed Rule would require investment advisers and broker-dealers to do the following:

- Evaluate any use or reasonably foreseeable potential use of a Covered Technology to identify any conflict of interest associated with that use;

- Determine whether any such conflict of interest places the adviser's interest ahead of investors' interests;

- Eliminate or neutralize the effect of any conflicts of interest that place the adviser's interest ahead of investors' interests;

- Have, and at least annually review written policies and procedures to prevent violations of the Proposed Rule if any investor interactions use covered technologies; and

- Make and keep books and records related to the requirements of the Proposed Rule.

a16z has serious concerns about the Proposed Rule, and its likely impact on the U.S. AI industry, in its current state. Consistent with the requirements of the Administrative Procedure

[4] Proposed Rule, 88 FR at 53,977.

Act, we would request the Commission to consider the likely impact of the Proposed Rule on the existing economic landscape for AI firms in the U.S. This letter identifies below many of the challenges that emerging U.S. AI firms struggle with today — including the costs of access to compute resources, cloud infrastructure, and large datasets; the reliance on external model providers; and the difficulties of automating and scaling up tasks that require a high degree of accuracy.

These and other heavy economic burdens that many U.S. AI firms face today already place smaller firms at a significant disadvantage. We fear that the Proposed Rule could further harm prospects for U.S. AI firms, and smaller firms in particular, that develop, deploy or utilize AI for financial advisory. We note, in this regard, that the Proposal neither

(1) adequately explains the rationale for and operation of the Proposed Rule; nor

(2) adequately considers its impact on firms, and smaller firms in particular.

While these are two of our principal concerns regarding the Proposed Rule, our discussion below will identify a number of more specific deficiencies or flaws in the Rule, including several that could potentially render the Rule vulnerable to challenge under the Administrative Procedure Act. We discuss our concerns in greater detail below.

DISCUSSION

I. The Proposal Does not Adequately Explain the Rationale for, and Operation of the Proposed Rule

The Commission's Office of General Counsel states that "Rule releases must include a discussion of the need for regulatory action and how the proposed rule will meet that need."[5] Yet this Proposal provides no real discussion of the need for regulatory action beyond superficially noting that the use of Covered Technologies has increased, and that "due to the scalability of these technologies and the potential for firms to reach a broad audience at a rapid speed…any resulting conflicts of interest could cause harm to investors in a more pronounced fashion and on a broader scale than previously possible."[6] These conclusory assertions must be supported by substantial data and findings in order to meet the Commission's own requirements for its rule releases.

More specifically, the Proposal provides no evidence at all of why the conflicts posed by Covered Technologies are necessarily so opaque, complex or scalable that they need their own new rule. The Proposal contains some discussion, but furnishes no evidence on why resolution of these conflicts necessarily requires their elimination, rather than their disclosure or mitigation. And the Proposal provides no substantial discussion on why existing laws and regulations are insufficient to deal with these conflicts, even when such existing laws and regulations appear plainly applicable and adequate on their face.

The Proposal identifies "two broad economic themes" that are raised by firms' use of Covered Technology in investor interactions. First, the use of Covered Technology in investor interactions can entail conflicts of interest related to the principal-agent problem between firms and investors, and second, the use of complex and opaque technologies can potentially create events that can harm investors.[7] For the first economic theme, the Commission provides few

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[5] ***See*** Memorandum to Staff of the Rulewriting Divisions and Offices from RSFI and OGC (Mar. 16, 2012) ("OGC Memorandum") available at *https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf*.

[6] Proposed Rule, 88 FR at 53,961.

[7] *Id.* at 53,998.

examples of the type of conflict that must be eliminated or neutralized, although it never explains why elimination or neutralization is the only acceptable solution. The Commission does not explore the second economic theme further at all — the Proposal never appears to explain why, and in what way, the Covered Technologies are particularly complex or opaque. Yet, an explanation on this point is of vital importance to the Proposed Rule. It is only if use of the Covered Technologies is somehow qualitatively different from other adviser tools or technologies that the Commission's adoption of the Proposed Rule can be justified.

The Commission fails in three significant ways to explain its rationale for the Proposed Rule. First, the Commission fails to explain why conflicts created by the use of Covered Technologies are somehow graver, more complex, more difficult to resolve, or more deserving of elimination than conflicts posed by the use of other technologies. Second, the Commission fails to explain why conflicts created by the use of Covered Technologies must uniformly be addressed only through elimination or neutralization — put differently, why does the Commission conclude that disclosure or mitigation can never be adequate remedies for any conflict of interest posed by use of the Covered Technology? The Proposal puts forward no research, points to no data collected or survey done that might support the inflexible requirement of elimination or neutralization in every case. Third, given the vast range of technologies covered by the Proposed Rule, the Commission fails to explain why all Covered Technologies must be subject to the same elimination requirement, irrespective of their complexity. The Proposal appears to assume, on unclear grounds, that the conflicts created by a simple spreadsheet, at one extreme, and the most complex algorithm, on the other, are so similar and so serious that they can both only be addressed by requiring their elimination.

These failures do not merely amount to an inadequate justification of the Proposed Rule. They effectively make the Proposed Rule incomprehensible for most investment advisers and broker-dealers. In the absence of an adequately reasoned explanation for the Rule, investment advisers and broker-dealers will struggle to understand vital aspects of the Rule, including the following elements:

- What the Proposed Rule considers to be a "conflict of interest" and what types of conflicts the Proposed Rule seeks to address;

- Why the Proposal does not meaningfully consider the principal alternatives to the requirement that advisers and broker-dealers eliminate all conflicts posed by Covered Technologies — namely, disclosure and mitigation;

- Why these conflicts are so pernicious that they can only ever be addressed by elimination and neutralization, and never, in any instance, by disclosure or mitigation; and

- Why existing laws and regulations are insufficient to address these conflicts of interest.

We discuss these failures and omissions in the Proposed Rule further below.

A. The Proposed Rule Does Not Adequately Explain its Definition of a "Conflict of Interest."

The Proposed Rule states that a "conflict of interest" "exists when an investment adviser uses a [C]overed [T]echnology that takes into consideration an interest of the investment adviser, or a natural person who is associated with the investment adviser."[8] This proposed definition is so broad that is almost impossible to parse what this would mean across a range of situations. The Proposal, however, discusses conflicts of interest in much narrower, and more traditionally understood terms. The Proposal notes that "To the extent that firms are using [Covered Technologies] to optimize for their own interests in a manner (intentionally or unintentionally) that places these interests ahead of investor interests, however, investors can suffer harm."[9] Elsewhere in the Proposal, and on multiple occasions, the Commission adopts the same formulation, noting, for example, that "Unless adequately addressed, the use of these [Covered] [T]echnologies may create or transmit conflicts of interest that place a firm's interests ahead of investors' interests."[10]

The Proposed Rule's overly narrow definition of a conflict of interest will create enormous difficulties for investment adviser and broker-dealer firms. The Proposal quite

[8] Proposed Rule § 275.211(h)(2)–4(a).

[9] Proposed Rule, 88 FR at 53,961.

[10] *Id.* at 53,962.

reasonably speaks of conflicts of interest as situations where the interests of an investment adviser or broker-dealer firm are placed ahead of investor interests — an outcome most financial industry participants would recognize as a conflict. Indeed, this is a standard the Commission has itself used in its Regulation Best Interest, where it defines a conflict of interest "as an interest that might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested."[11]

The Proposed Rule, by contrast, states that all that is required for a conflict of interest to exist is where a Covered Technology takes into account an interest of an investment adviser or a person associated with an investment adviser, even if in doing so the Covered Technology does not place the investment adviser's interest ahead of the investor's. The effect of this remarkably broad definition is that it would require investment advisers and broker-dealers to presumptively review as a conflict of interest, each and every situation in which the Covered Technology considers the interest of an adviser or a broker.

We ask the Commission to clarify what it means for a Covered Technology to consider the interest of an investment adviser or broker-dealer. In other words, what are the range of situations that an adviser or broker-dealer must review? The Proposal acknowledges that "In the case of many covered technologies, it may be readily apparent that, while the technology may take into account an interest of the firm, it does not result in the firm's interests being placed ahead of investors' interests."[12] If it is readily apparent that a technology takes into account the interest of the adviser but does not place it ahead of investor interests, there appears to be no reason why that situation should be considered to be a conflict of interest in the first place. And accordingly, if no real conflict exists, investment advisers should not be required to review such fictitious conflicts, thereby potentially incurring significant costs for themselves and their clients.

[11] *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 84 FR 33,318 at 33,325 (July 12, 2019).

[12] Proposed Rule, 88 FR at 53,982.

B. The Proposal Does Not Meaningfully Consider Disclosure and Mitigation as Alternatives to the Elimination of Conflicts

The Proposal cites four reasons for requiring adviser and broker-dealer firms to eliminate every single conflict caused by Covered Technology, irrespective of its gravity or rarity. These four justifications are as follows:

- Due to the inherent complexity and opacity of the Covered Technologies, conflicts of interest should be eliminated or their effects should be neutralized, rather than handled by other methods of addressing the conflicts, such as through disclosure and consent.[13]

- Reliance on scalable, complex, and opaque Covered Technologies can result in operational challenges or shortcomings.[14]

- Firms might have difficulty fully conveying the scope of conflicts of interest generated by the use of Covered Technologies. Disclosures may be too lengthy to be meaningful or actionable by investors, who may not know how to react to disclosures.[15]

- Disclosure of the full scope and dynamic nature of conflicts associated with Covered Technologies can potentially be too broad and unspecific to be useful to a particular investor or alternatively could entail too many disclosures to be useful to an investor.[16]

Each of these is a plausible reason for why disclosures may sometimes be an inappropriate tool to address conflicts posed by Covered Technologies, but none of these is remotely plausible as a reason for why disclosure is **never** an appropriate tool to address conflicts posed by Covered Technologies. The Proposal could, for instance, have suggested disclosure as a remedy for smaller firms or for simpler or rarer conflicts. In fact, the Commission's own Office of General Counsel specifically notes that formulating different

[13] *Id.* at 53,967.
[14] *Id.*
[15] *Id.* at 54,014.
[16] *Id.* at 54,006.

requirements for smaller and larger firms represents an important alternative regulatory approach for consideration[17] — but the Proposal considers no such alternative. The Commission's omission is all the more surprising given that it had posited disclosure as a default remedy for conflicts for both investment advisers and broker-dealers, as recently as 2019.[18] The Covered Technologies contemplated by the Proposed Rule were already in extensive use at the time the Commission accepted disclosure as a possible remedy for a very broad range of adviser and broker conflicts.[19]

If the Commission is implicitly admitting it was wrong to give the guidance it did in 2019, then the Commission must expressly reconsider its previous interpretations and regulations accordingly. But the Commission appears to stand by its earlier releases, noting that "[t]he proposed conflicts rules thus **supplement, rather than supplant**, existing regulatory obligations related to conflicts of interest, laying out particular steps a firm must take to address conflicts of interest arising specifically from the use of [C]overed [T]echnologies in investor interactions."[20] (Emphasis added.) If this Proposed Rule is merely intended to supplement rather than supplant, it should not entirely remove two sets of remedies (i.e., disclosure and mitigation) as potential tools to address a large number of conflicts. It would seem that the Proposed Rule effectively narrows the scope of prior Commission guidance and regulation, perhaps most notably in the context of Regulation Best Interest.

Were the Rule to be adopted in its proposed form, its net effect would be to largely repeal Regulation Best Interest if a broker is confronted by a conflict posed by a Covered Technology. As we discuss below, the Commission has already published multiple pronouncements[21] that

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[17] OGC Memorandum at 9.

[18] ***See***, ***generally***, *Fiduciary Interpretation*, 84 FR at 33,676; and *Regulation Best Interest* 84 FR at 33,325 (July 12, 2019).

[19] If the Proposal's treatment of disclosure is inexplicable, its treatment of mitigation as a potential remedy is odder still. The Proposal appears to have not even considered mitigation as a potential remedy for conflicts posed by Covered Technology. The Proposal asks whether mitigation should be considered as a remedy, but never considers it in any detail, despite the fact that mitigation is a key element of Regulation Best Interest.

[20] Proposed Rule, 88 FR at 53,977.

[21] For a more detailed discussion, please see Section I.C.1 below, "*The Inflexible Elimination Requirement Contradicts the Commission's Requirements in Similar Situations".*

make it clear that disclosure, rather than elimination, is the adviser's default remedy for a conflict of interest. If the Commission proposes to depart from this well-established position, or if the Commission is proposing the implied repeal of its previous guidance and regulations, the Commission must make its intention plain. Broker-dealers and investment advisers should not be left to guess which of the Commission's prior regulations and guidance remain in effect, and which would effectively be replaced by the Proposed Rule.

C. The Commission Admits that Many Covered Technologies and their Conflicts of Interest Can be Simple — but Unjustifiably Requires Elimination or Neutralization in Every Case

The Proposal notes in a number of places that Covered Technologies can be complex and opaque,[22] or that they can operate on opaque biases,[23] or that the inferences made by Covered Technologies can be opaque to investors and firms.[24] However the Proposal is also careful to note in each instance that such opacity is not universally true of all Covered Technologies, and may only be true in some instances. In fact, the Proposal goes on to note that "…for the use of **certain complex and opaque technologies,** the proposed conflicts rules could enhance investor protection and address some of the unique challenges posed by conflicts of interest in the use of covered technologies in investor interactions."[25] (Emphasis added). In other words,

[22] Proposed Rule, 88 FR at 53,967, noting that "…reliance on scalable, complex, and opaque PDA-like technologies can result in operational challenges or shortcomings."

[23] *Id.* at 53,968, noting that "AI and other similar technology are only as good as the data upon which it is based. Corrupted or mislabeled data, biased data, or data from unknown sources, can undermine data quality, leading to skewed outcomes with opaque biases as well as unintended failures."

[24] *Id.* at 53,998, noting that "The capabilities of these technological advances—including the data the technology uses (including any investor data) and the inferences the technology makes (including in analyzing investor data, other data, securities, or other assets)—may be opaque to investors and firms. ***See also*** Proposed Rule, 88 FR at 54,007 noting that "These conflicts of interest are exacerbated by firms' use of certain covered technologies because the technologies that firms use may be complex and opaque to investors, who may not have the knowledge or time to understand how firms' use of these technologies may generate conflicts of interest in their interactions with investors."

[25] *Id.* at 54,007.

the Proposal admits that the Covered Technologies are not universally or inevitably opaque or complex.

We do not dispute that some Covered Technologies may be complex. Nor do we disagree that the workings, biases, or inferences of Covered Technologies may sometimes be opaque. We disagree strongly, however, that all Covered Technology necessarily operates in a complex or opaque manner or that such complexity or opacity is inherent in all Covered Technology. Indeed, even the Commission does not necessarily disagree with our view — for example, the Proposed Rule acknowledges that "The proposed definition would include widely used and bespoke technologies, future and existing technologies, sophisticated and **relatively simple technologies**, and ones that are both developed or maintained at a firm or licensed from third parties."[26] (Emphasis added.) It is clear, then, that some Covered Technology may be inherently simple, and that the conflicts of interest posed by the use of such Covered Technologies may also be simple, rather than complex — and the Commission acknowledges as much elsewhere in the Proposed Rule.[27]

The Proposed Rule consistently notes that the term "Covered Technologies" encompasses a wide range of technologies, ranging from simple spreadsheets[28] to complex AI tools. The Commission repeatedly admits that many conflicts posed by Covered Technologies may be neither complex nor opaque. Yet, even after these obvious admissions, the Commission nevertheless insists that conflicts posed by Covered Technologies are necessarily so opaque that they must always be eliminated and never, in any instance, addressed by disclosure or any other means short of elimination or neutralization.

The Commission notes that disclosure may be "ineffective" because of "the rate of investor interactions, the size of the datasets, the complexity of the algorithms on which the [C]overed [T]echnology is based, and the ability of the technology to learn investor preferences or behavior, which could entail providing disclosure that is lengthy, highly technical, and

[26] *Id.* at 53,972.
[27] *Id.* at 53,977.
[28] *Id.*

variable, which could cause investors difficulty in understanding the disclosure."[29] As we discuss elsewhere in this letter, this proposed approach is entirely inconsistent with how the Commission has usually required broker-dealers and investment advisers to address conflicts. As we discuss below, the Commission has never before adopted so inflexible a requirement on the basis of such scant evidence.

We would also note that the Commission never previously appears to have considered the length and complexity of disclosure as a reason for mandating less disclosure — for example, in the context of disclosures made on a Form S-1, pursuant to Regulation S-K. The Federal securities laws are a disclosure-based regime that presume the investing public can make informed decisions, and the SEC has invested substantial resources in providing guidance around disclosures in plain English.[30] Nor has the Commission, in its relatively recent adopting release for Regulation Best Interest, ever considered disclosure to be an inherently unsuitable approach even for complex products.[31] Disclosure in the context of the Federal securities laws is too fundamentally important a remedy to be entirely discarded for conflicts caused by a wide swathe of technologies. Further, as we discuss below, the Commission has already identified disclosure, rather than elimination, as the default remedy by which advisers should address conflicts of interest.

1. *The Inflexible Elimination Requirement Contradicts the Commission's Requirements in Similar Situations*

The Proposed Rule acknowledges that "[e]xisting obligations already restrict firms from placing their interests ahead of customers, clients, or investors in certain contexts, such as when providing investment advice or recommendations, including as a result of conflicting interests related to their use of covered technologies." In fact, as recently as 2019, the Commission issued

[29] *Id.* at 53,967.

[30] ***See, e.g.***, SEC Office of Investor Assistance and Education, A Plain English Handbook: How to create clear SEC disclosure documents, available at https://www.sec.gov/pdf/handbook.pdf.

[31] Notably, in its adopting release, the SEC expressly retained disclosure as a method of addressing conflicts even after considering in some detail the academic literature regarding the limits of effectiveness of disclosure as a remedy. ***See***, *Regulation Best Interest*, 84 FR at 33,433.

an interpretation regarding the fiduciary duties of investment advisers which specifically notes that "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."[32] (Emphasis added.) Elsewhere in the same interpretation, the Commission expressly clarifies that "In all of these cases where an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser should either **eliminate** the conflict or adequately **mitigate** (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible."[33] (Emphasis in the original). The Commission's statement speaks for itself — it is disclosure, not elimination, that is the default remedy for a conflict of interest. Mitigation or elimination are required only where a conflict of interest cannot be adequately addressed through disclosure.

Faced with this clear precedent, the Proposal chooses a curious justification for the Proposed Rule. Disclosure is never enough, and the elimination of all conflicts of interest created by the Covered Technologies is required, the Proposal states, "[d]ue to the inherent complexity and opacity of these technologies as well as their potential for scaling..."[34] However, as we discuss above, this characterization of Covered Technologies as complex or opaque is not universally true, and the Commission itself admits that much Covered Technology may be simple and/or transparent. There is, therefore, no reason for the Commission to assume that disclosure can never be an effective remedy for any conflict of interest posed by the use of a Covered Technology in an investor interaction. In other words, there is no reason for the Commission to depart from the rule it recognized as recently as 2019 — namely, that investment advisers are required to eliminate or neutralize conflicts only where disclosure would be an inadequate remedy. There is no reason for the Commission to simply presume, seemingly on the basis of no evidence, that all Covered Technologies and every single conflict they produce are so complex

[32] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 84 FR 33,669, 33,676 (July 12, 2019). ***See***, ***more generally***, section II.C. ("Fiduciary Interpretation") (describing an adviser's fiduciary duties to its clients).

[33] *Id.* at 33,677.

[34] Proposed Rule, 88 FR at 53,967.

that disclosure will never suffice. The Proposed Rule provides no evidence whatsoever in support of this sweeping, unwarranted and inflexible presumption against disclosure.

2. The Commission's Existing Regulations and Guidance Make the Proposed Rule Unnecessary

The Proposal recognizes that "investment advisers today are subject to a number of laws, rules, and regulations which indirectly address the oversight of the way an adviser relies on and uses technology in its interactions with advisory clients."[35] We disagree that this oversight is only "indirect." As the Commission also notes, among other things

- an investment adviser's fiduciary duty requires it to take steps to protect client interests, which would include steps to provide investment advice that it reasonably believes is in the best interest of the client regardless of whether the adviser is using a Covered Technology in an investor interaction;[36]

- investment advisers are subject to the antifraud provisions found in section 206 of the under the Investment Advisers Act, 1940 (the "Advisers Act"), which prohibits fraud or deceit upon any client or prospective client;[37]

- investment advisers are subject to Rule 206(4)–8 under the Advisers Act, which makes it unlawful for any investment adviser to a pooled investment vehicle to engage in fraud or deceit upon any investor or prospective investor in the pooled investment vehicle;[38]

[35] *Id.* at 54,019.

[36] 84 FR 33,669, noting also that "Under its duty of loyalty, an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict." ***See*** 84 FR 33,671.

[37] 15 U.S. Code § 80b–6.

[38] 17 CFR § 275.206(4)-8.

- investment advisers are subject to the Advisers Act Compliance Rule, requiring advisers to adopt, implement, and annually review written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder;[39]

- investment advisers are subject to Rule 206(4)–1 under the Advisers Act, which prohibits advisers from disseminating advertisements that violate that rule, including making untrue statements of material fact or misleading omissions and discussing any potential benefits connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits.[40]

In light of these rigorous and well-established requirements, it is unclear what the Proposed Rule adds, beyond making compliance more complex and difficult to understand for investment advisers. The Proposal claims that "investment advisers do not have specific obligations under the Advisers Act or any of its rules to **eliminate, or neutralize** the effect of, conflicts of interest promptly after the adviser identifies, or reasonably should have identified, such conflict of interest." (Emphasis added.) The Proposal's claim that advisers have no duty to eliminate or neutralize any conflicts of interest is plainly incorrect — it contradicts the Commission's own earlier statement that "Under its duty of loyalty, an investment adviser must eliminate **or** make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict." (Emphasis added.) The Commission has consistently recognized that disclosure is one of several methods of addressing a conflict of interest and may, under the appropriate circumstances, be the optimal way of addressing a specific conflict or type of conflict.

As the Commission has itself observed, investment advisers are under a duty to eliminate conflicts where disclosure would be inadequate. What the Proposed Rule does is to instead unduly narrow and re-shape an investment adviser's fiduciary duty, removing disclosure as a suitable remedy for a large number of conflicts, for no discernible reason.

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[39] 17 CFR § 275.206(4)-7.

[40] 17 CFR § 275.206(4)-1.

II THE PROPOSAL DOES NOT ADEQUATELY ASSESS THE SIGNIFICANT COSTS TO SMALLER FIRMS, ESPECIALLY SMALLER AI FIRMS

Section 553 of the Administrative Procedure Act requires the Commission to provide the public with a meaningful opportunity to comment on the content of any rule that the Commission proposes, amends, or adopts.[41] The Commission is also required by Section 202(c) of the Advisers Act to consider or determine whether a rule is necessary or appropriate in the public interest, and to consider, whether the action will promote investor protection, efficiency, competition, and capital formation.[42] The Commission's Office of General Counsel notes that "High-quality economic analysis is an essential part of SEC rulemaking" and that "the basic elements of a good regulatory economic analysis" include (1) the identification of alternative regulatory approaches; and (2) an evaluation of the qualitative and quantitative benefits and costs of the proposed action and the main alternatives identified by the analysis.[43]

It is therefore unfortunate that the Proposal's consideration of economic costs and benefits and regulatory alternatives ranges from the superficial to the incomplete. In particular, the Proposal freely admits to missing vital quantitative data, makes unsupported assumptions about costs and alternatives, and seems to consider all firms that use Covered Technologies as an undifferentiated mass. We are especially concerned that the Commission's analysis appears to take no account of the significant challenges faced by smaller AI firms, at a time when permitting such small firms to compete on an even playing field is a matter not just of economic fairness, but of vital national interest. We elaborate on our concerns, and the Proposal's omissions and unjustifiable assumptions further below. Among other things, we note that

- The Proposal is plainly unsuitable for addressing minor conflicts arising in large data sets for AI firms in general, and smaller AI firms in particular.

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[41] 5 U.S.C. § 553.

[42] 15 U.S.C. 80b-2(c).

[43] OGC Memorandum at 1.

- The Proposal appears to ignore the patterns of technology and infrastructure ownership in the AI industry, and the costs of technology for smaller AI firms.

- The Proposal does not consider the efficiencies that accrue to advisers and brokers from using AI in their work flows (including but not limited to portfolio management, analysis, risk management, investor relations).

A. The Proposal is Plainly Unsuitable for Addressing Minor Conflicts Arising in Large Data Sets

The Proposed Rule requires that firms test each Covered Technology prior to its implementation and periodically thereafter, to determine whether such Covered Technology is associated with a conflict of interest. The Proposal notes "firms might need to hire dedicated personnel" to comply with these requirements, and acknowledges that firms which have conflicts more deeply embedded in their Covered Technologies would likely bear greater costs than those that do not.[44] However, what the Proposal does not appear to recognize is that firms that have fewer conflicts, or that identify only minor conflicts would also likely bear greater costs, particularly if these conflicts appeared sporadically among a wide range of test results.

Firms using AI applications to generate high accuracy results face the particular problem of rare situations, sometimes called a "tail." While any given situation may be rare on its own, there may be many rare situations in aggregate. As instances get rarer, the level of investment needed to handle them can increase very significantly, and a firm's ability to automate the ability to spot such rare instances may be limited.[45] Many AI-based startups initially use humans in order to perform key tasks with accuracy early on, with the expectation that these tasks will be handled by AI in the longer term. In reality, AI will likely only be able to process the more common use cases, with humans managing the long "tail" of cases that occur less frequently.

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[44] Proposed Rule, 88 FR at 53,980.

[45] Martin Casado & Sarah Wang, The Economic Case for Generative AI and Foundation Models, (Aug. 3, 2023) available at *https://a16z.com/the-economic-case-for-generative-ai-and-foundation-models/*.

The Proposal appears to recognize that "training models often require substantial computational resources and human feedback during the training process," and that therefore "testing of opaque systems could entail significant costs, which could entail the need to either hire dedicated personnel, or allocate the time of existing personnel."[46] What the Proposal does not consider are cases where conflicts occur so rarely, or are so minor as to make their identification time-consuming and very expensive. The Proposal makes no attempt to analyze or evaluate whether the elimination of these very rare, or relatively insignificant conflicts provide sufficient benefit to investors to justify the expending of very significant resources, including by smaller firms.

The Proposal briefly considers whether to provide an exclusion from testing for technologies that consider large datasets where firms have no reason to believe the dataset favors the interests of the firm.[47] Even though this would clearly reduce costs, the Commission appears to have decided not to provide any such exclusion because it claims this alternative could result in a regime where firms "only reasonably believe" their Covered Technologies do not have conflicts of interest, rather than one where firms have tested for conflicts in their Covered Technologies. The Proposal does not explain why a reasonable belief that there are no conflicts of interest is not sufficient or why the elimination of all conflicts is so vital to be placed even above the economic viability of smaller firms that use AI. Investor protection is an important part of the Commission's mission, but it is a goal that must be balanced against other parts of the Commission's mission, including the need to facilitate capital formation.

The Proposal does not appear to have considered any other alternatives that might allow for an exclusion of testing of large data sets, especially where firms have no reason to believe the dataset favors the interests of the firm, or believe that the dataset confers no significant advantage. For example, the Proposal does not consider whether, in situations involving rare or minor conflicts, disclosure or even steps towards mitigation might be a reasonable and cost-effective remedy. The Proposal makes no attempt to evaluate whether, in these relatively benign situations of little to no conflict, there might be significant economic benefits in permitting firms to forego testing in favor of full and fair disclosure and informed consent. Instead, the Proposal

[46] Proposed Rule, 88 FR at 54,009.

[47] *Id*. at 54,013.

requires in such situations, as it does in all situations without exception, that firms identify and eliminate all conflicts, not matter the costs and harms to itself, to its investors or to the asset management industry more generally.

Courts have noted that the Commission is required to consider reasonable alternatives raised during a rulemaking. Such alternatives include those that are "neither frivolous nor out of bounds." "'[W]here a party raises facially reasonable alternatives ... the agency must either consider those alternatives or give some reason...for declining to do so.'"[48] Here, however, the Proposal give no evidence that it has considered even the most obvious alternatives, i.e. disclosure and mitigation, in the context of testing large datasets.

B. The Proposal Appears to Ignore Technology and Infrastructure Ownership Patterns in AI, and Costs of Technology for Smaller Firms

Many small firms face difficulties in accessing the essential ingredients for modern AI research, namely, "compute" (i.e. the computational resources required for AI systems to perform tasks, such as processing data, training machine learning models, and making predictions) and unique proprietary large datasets.[49] The National Security Commission on Artificial Intelligence notes, in its 2021 report,[50] that "AI startups have difficulty affording the cost of compute resources and data for training sophisticated machine learning models."[51] Recent innovations in chip design and cloud computing have also given large firms significant advantages — for example, big, well-entrenched firms like Amazon, Apple, Google, and Tesla are increasingly engaged in specialized chip design. AI research has moved into a computing era where general purpose chips do not exponentially improve with time — this situation benefits only a smaller group of organizations that can design specialized chips and write specific

[48] *Chamber of Commerce v. SEC*, 412 F.3d 133 at 144 (quoting *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 51 (1983)).

[49] Nur Ahmed & Muntasir Wahed, *The De-democratization of AI: Deep Learning and the Compute Divide in Artificial Intelligence Research*, available at https://doi.org/10.48550/arXiv.2010.15581.

[50] National Security Commission on Artificial Intelligence, *Final Report*, (2021) at 187, available at https://assets.foleon.com/eu-west-2/uploads-7e3kk3/48187/nscai_full_report_digital.04d6b124173c.pdf.

[51] Ahmed & Wahed, *The De-democratization of AI*.

software for the hardware. Finally, large firms have quality proprietary datasets that contribute to better training datasets which produce highly accurate deep learning models.[52] Recent research suggests that large firms like Facebook, Google, and Amazon have an advantage in AI research due to their proprietary data.[53]

It is in light of this economic background that we must consider the likely impact of the Proposed Rule among small firms that deploy AI. Apparently ignoring this somewhat bleak economic background of relatively high costs and technological concentration among large firms, the Proposal makes the following optimistic observations, again seemingly on the basis of no empirical evidence:

- Where the Proposed Rule results in more costly development, testing, and documentation, third-party providers of Covered Technology may incur costs.

- Competition between third-party providers might drive down the costs of compliance for firms.

- Firms with bargaining power might also seek to pass on certain compliance costs to third-party providers, for instance by seeking assurances that the Covered Technology provided by the third party would not generate conflicts of interest between the firm and the investor.

- Competition between third-party providers might pass some or all of these costs on to advisers and brokers in product prices and service fees, or may reduce expenses significantly, and such advisers and brokers in turn may pass some or all of these costs on to investors.[54]

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[52] N.C. Thompson & S. Spanuth, S. *The Decline of Computers as a General Purpose Technology*. *MIT Initiative on the Digital Economy Research Brief* (Vol. 1), available at http://ide.mit.edu/publications/decline-computers-general-purpose-technology-0.

[53] J. Traub, J-A Quiané-Ruiz, Z. Kaoudi, & V. Markl, V., *Agora: Towards An Open Ecosystem for Democratizing Data Science & Artificial Intelligence, 2–7*, available at http://arxiv.org/abs/1909.03026.

[54] Proposed Rule, 88 FR at 54,011.

The Proposal cites no evidence, and provides no support of any kind for these optimistic forecasts. There is plenty of evidence to the contrary, as we cite above, indicating a significant bias in existing AI markets towards large and well-entrenched tech firms. The inflexible, unnuanced Proposed Rule makes no concession for a firm's size, the gravity or seriousness of its conflicts or the nature of the Covered Technology that it deploys. It will, we fear, likely entrench large AI firms even further in their positions of privilege.

Remarkably, the Proposal appears to recognize the significant ill-effects it could have on competition, citing the barriers to entry that the Rule might create, and the advantages that might accrue to large firms. Yet again, however, the Proposal appears to conclude on an inexplicably positive note, claiming that

> "These competitive effects might be mitigated to the extent that firms are using technologies licensed from third party providers. Third party technology providers might compete with each other to lower the cost of compliance, compared to the case where firms bore the costs of compliance internally. Moreover, to the extent that firms have bargaining power over third party providers, they may be able to shift some of the compliance burden onto these providers. To the extent that third party providers develop the ability to lower compliance costs through competition, smaller firms may also experience reduced compliance costs."[55]

And yet again, the Proposal cites no evidence in support of these Pollyannaish projections, nor even any substantive reason why these mitigating effects are in any way likely to materialize. The drafters of the Proposal may well be hopeful for increased competition among AI service providers, but hope cannot be a substitute for a well-researched economic analysis.

[55] *Id.* at 54,012.

C. The Proposal Does Not Adequately Consider the Efficiencies that Accrue to Advisers and Brokers from Using AI

The Proposal repeatedly recognizes the central role played by AI in a number of advisory and brokerage firms. It notes, for example that "Organizations, including firms in the securities industry, are using AI in a multitude of ways, including responding to customer inquiries, automating back-office processes, quality control, risk management, client identification and monitoring, selection of trading algorithms, and portfolio management."[56] However, the Proposal makes no attempt to consider, in any detail, how the Proposed Rule might impede efficiency or slow down technological innovation. The Proposal perfunctorily considers the likely effects of the Proposed Rule on efficiency, competition and capital formation, but this "analysis" merely consists of listing speculative and generic advances in efficiency from the Rule against potential harms.[57] These abstract contemplations, apparently ungrounded in any data, cannot be sufficient to discharge the Commission's duty to consider the impact of the Proposed Rule on efficiency, competition and capital formation.

The Commission's Office of General Counsel states that "The economic consequences of proposed rules (potential costs and benefits including effects on efficiency, competition, and capital formation) should be measured against a baseline, which is the best assessment of how the world would look in the absence of the proposed action."[58] The SEC's Office of General Counsel goes on to note that "It is important to clearly describe the assumptions that underlie the description of the relevant baseline and **to detail those aspects of the baseline specification that are uncertain**. Defining the baseline typically involves identifying and describing the market(s) and participants affected by the proposed rule."[59] (Emphasis added). The Proposal provides no detail regarding the baseline, i.e., the extent to which firms use AI in advisory and brokerage functions. Nor does it make any attempt to determine the extent to which that baseline may be changed by the Rule. Instead, the Proposal restricts itself to general observations of limited utility such as speculating that "the compliance costs of the proposed

[56] *Id*. at 53,965.
[57] *Id*. at 54,011.
[58] OGC Memorandum at 6.
[59] *Id*. at 7.

conflicts rules could dissuade some firms from using covered technologies in investor interactions."[60]

We also note with disappointment the Proposal's suggestion that firms may simply have to abandon the use of advanced technologies if they cannot comply with the Proposed Rule.[61] In this context, we note the Commission's observation in 2019 that an investment adviser's fiduciary obligation requires that it consider the "investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit—to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client."[62] We think this fiduciary duty likely extends to using the optimal technology available to exercise an investment choice or determine an investment strategy. To the extent the Proposed Rule may force advisers to abandon the use of otherwise optimal technologies, the Rule will likely impede advisers in the effective performance of their fiduciary duty.

III The Commission Should Withdraw and Re-Consider the Proposed Rule

For the reasons we discuss earlier, we believe the Commission should withdraw the Proposed Rule and engage in further study on the extent to which adviser and broker firms are deploying AI-based solutions, and the extent to which such deployment is generating conflicts. The Commission could, for example, seek to undertake a further concept release on these conflicts specifically, and the ways in which they are unlike the traditional conflicts that have

[60] Proposed Rule, 88 FR at 54,011.

[61] Proposed Rule, 88 FR at 53,978, noting that "The proposed conflicts rules would apply to these covered technologies, and firms would only be able to continue using them where all requirements of the proposed conflicts rules are met, including the requirements of the evaluation, identification, testing, determination, and elimination or neutralization sections."

[62] *Fiduciary Interpretation*, 84 FR at 33,674.

arisen in the asset management industry.[63] We would ask the Commission to first undertake and review a suitable study of this type to determine whether all conflicts posed by AI could be appropriately disclosed or mitigated.

If the Commission concludes, as we think it should, that AI-generated conflicts may be suitably addressed by disclosure and/or mitigation, then the Commission must consider whether the Proposed Rule is required at all. This position, namely that conflicts may on occasion be suitably addressed by disclosure and/or mitigation, and on occasion by elimination, is precisely the requirement that advisers and brokers are subject to under current regulation, and it is doubtful what a repetition of this requirement, specifically in the context of Covered Technologies, would add anything in terms of regulatory clarity.

If the Commission decides following further study to re-issue the Proposed Rule, we would strongly urge the Commission to create exemptions for firms deploying AI in specific functions of advisory and brokerage services, especially where such firms have good reason to believe that the technologies in question do not pose material conflicts. We would also urge the Commission to adopt a more standard, easily comprehensible definition of when a conflict actually exists, and to provide a rigorous economic study, consistent with its obligations under the Administrative Procedure Act and the Advisers Act, of the impact of the Proposed Rule on firms using AI, on competition, and on efficiency.

[63] We are aware, of course, of the Commission's *Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches*, 86 FR 49,067 (Sept. 1, 2021), but we note also that this document focused on digital engagement practices and "gamification", rather than AI. We strongly believe that the impact of AI on advisory and brokerage services merits its own study, and we would note FINRA's instructive study in this regard. **See** FINRA, *Artificial Intelligence in the Securities Industry*, (June 2020), available at https://www.finra.org/sites/default/files/2020-06/ai-report-061020.pdf.

CONCLUSION

a16z appreciates the opportunity to share its perspective on the Proposed Rule. AI in the United States is at an inflection point, and regulatory interventions must consider their likely impact on this emerging and essential industry and its utility to the nation. A critical part of this analysis must fully consider the impact of rulemaking on firms that develop or use AI. As the National Security Commission for Artificial Intelligence puts it, "We worry that only a few big companies and powerful states will have the resources to make the biggest AI breakthroughs. Despite the diffusion of open-source tools, the needs for computing power and troves of data to improve algorithms are soaring at the cutting edge of innovation. The Federal government must partner with U.S. companies to preserve American leadership and to support development of diverse AI applications that advance the national interest in the broadest sense."[64]

One of the founders of our firm proposes a simple plan for AI firms:

"Startup AI companies should be allowed to build AI as fast and aggressively as they can. They should neither confront government-granted protection of big companies, nor should they receive government assistance. They should simply be allowed to compete. If and as startups don't succeed, their presence in the market will also continuously motivate big companies to be their best – our economies and societies win either way."[65]

We could put it no better ourselves. Unfortunately, we fear that the Proposed Rule, instead of enabling firms to compete, will stifle their ability to do so. We share with the Commission the goals of competition, innovation, and efficiency without sacrificing investor protection. It is in the hope of progress towards those goals that we offer these criticisms of the Proposed Rule.

[64] NSCAI Final Report at 4.

[65] Marc Andreessen, *Why AI Will Save the World*, available at https://a16z.com/ai-will-save-the-world/.

Respectfully submitted,
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