2023 - 2024 ASSOCIATION YEAR

CHAIR
Nicole F. Munro
nmunro@hudco.com

CHAIR-ELECT
Mac R. McCoy
macrmccoy@gmail.com

VICE-CHAIR
Norman M. Powell
npowell@ycst.com

SECRETARY
Heidi McNeil Staudenmaier
hstaudenmaier@swlaw.com

BUDGET OFICER
Thomas J. Walsh
twalsh@brodywilk.com

CONTENT OFFICER
Lisa R. Lifshitz
llifshitz@torkinmanes.com

DIVERSITY OFFICER
Sylvia Fung Chin
schin@whitecase.com

MEMBERSHIP OFFICERS
Michael F. Fleming
michael_fleming@uhg.com
Jonathan T. Rubens
rubens@mosconelaw.com

IMMEDIATE PAST CHAIR
James Schulwolf
jschulwolf@goodwin.com

SECTION DELEGATES TO THE ABA HOUSE OF DELEGATES
Jeannie Carmedelle Frey
Paul "Chip" L. Lion III
Barbara Mendel Mayden
Christopher J. Rockers

COUNCIL
Alison Manzer
Ankur D. Shah
Anna-Katrina S. Christakis
Christina Houston
Christopher P. Yates
Donald R. Kirk
E. Christopher Johnson
Garth Jacobson
Grace Pangilinan Powers
Jonice Gray Tucker
Kay Standridge Kress
Kimberly A. Lowe
Lisa R. Stark
Marlon Quintanilla Paz
R. Marshall Grodner
Monique D. Hayes
Peter M. Reyes, Jr.
Shazia Ahmad
Stuart M. Riback
Wilson Chu

BOARD OF GOVERNORS LIAISON
Aurora Abella-Austriaco

SECTION DIRECTOR
Susan Tobias
Susan.Tobias@americanbar.org

AMERICANBARASSOCIATION

Business Law Section

321 N. Clark Street
Chicago, IL 60654-7598
T: 312-988-5588 | F: 312-988-5578
businesslaw@americanbar.org
ababusinesslaw.org

October 18, 2023
Submitted via email to: rule-comments@sec.gov
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-0609

Re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker Dealers and Investment Advisers; Release No. 34-97990; Release No. IA-6353; File No. S7-12-23

Dear Ms. Countryman:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "**Committee**") of the Business Law Section (the "**Section**") of the American Bar Association (the "**ABA**") in response to the request for comments by the Securities and Exchange Commission (the "**SEC**" or the "**Commission**") with respect to its proposal to prohibit broker-dealers and investment advisers (together, **"regulated firms"**) from using "covered technologies" in connection with interactions with specified investors, unless the regulated firms have eliminated or neutralized certain conflicts of interest, as defined in the proposal. The Commission has proposed these rules under Section 15(l) of the Securities Exchange Act of 1934 (the "**Exchange Act**") ("**Rule 15l-2**") and under Section 211(h) of Investment Advisers Act of 1940 (the **"Advisers Act"**) ("**Rule 211(h)(2)-4**") (respectively and together, the "**Proposed Rules**").[1]

This letter was prepared by members of the Committee's Trading and Markets and Investment Company/Investment Adviser Subcommittees. The comments expressed in this letter represent the views of the Committee only and have not been reviewed or approved by the ABA's House of Delegates or Board of Governors and should not be construed as representing the official policy of the ABA. In addition, this letter does not represent the official position of the Section, nor does it necessarily reflect the views of all members of the Committee.

The Committee supports what we understand to be the Commission's overall effort to enhance investor protection by regulating the misuse of artificial intelligence ("**AI**") and predictive data analytics ("**PDA**") by regulated entities

[1] *See* SEC Release No. 34-97990 (July 26, 2023), 88 Fed. Reg. 53960 (Aug. 9, 2023) (the "**Proposing Release**"). The Proposing Release also proposes parallel changes to the broker-dealer books and records rules, Exchange Act Rules 17a-3 and 17a-4, and the investment adviser books and records rule, Advisers Act Rule 204-2 (the "recordkeeping proposals").

in ways that could materially mislead or manipulate clients and potential clients. We are, however, concerned that the Proposing Release, with its accompanying short comment period, proposes new rules that are not tailored to address the Commission's stated concerns in the Proposed Rules and is not sufficiently balanced and considered to avoid any overreaching and unintended harm to the healthy functioning of the affected market participants and investors.

In furtherance of these shared goals, the Committee would like to bring to the Commission's attention certain aspects of the Proposed Rules,– among others that could be elaborated in greater depth with more time – which we believe require additional time and attention by the Commission and the industry before these proposals are finalized.

The Commission Should Limit the Proposal to the Technologies that Actually Cause the Concerns Expressed in the Proposing Release

The Commission's proposed definition of "covered technologies" is overbroad, and it should limit the technologies subject to the Proposed Rules to those identified in the Proposing Release as actually presenting a risk to retail investors. The Proposing Release devotes a great deal of time and attention to the perceived potential for AI and PDA (what the Release refers to as "PDA-like" technologies) to harm retail investors.[2] However, for reasons the Proposing Release does not explain, the restrictions in the Proposed Rules apply to a much broader group of "covered technologies": "an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes in an investor interaction."[3] As Commissioner Peirce observed, this definition of "covered technologies" is broad enough to encompass simple spreadsheets or math formulas far removed from AI and PDA.[4] The Proposing Release does not justify the extreme overbreadth of the definition of "covered technologies" as compared to the limited types of AI and PDA technologies that may actually present the perceived harms that the Commission is trying to address. Particularly in light of the Administrative Procedure Act and First Amendment concerns that the Proposed Rules present (discussed

---

[2] Proposing Release at pages 12-21, 27-33.
[3] Proposing Release at pages 37-38. We recognize that Question 1 in the Proposing Release concerns the breadth of the definition of "covered technologies" and this section is designed to address that issue.
[4] Commissioner Hester 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) (https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623) (citing Proposing Release at pages 48-49: "Similarly, if a firm utilizes a spreadsheet that implements financial modeling tools or calculations, such as correlation matrices, algorithms, or other computational functions, to reflect historical correlations between economic business cycles and the market returns of certain asset classes in order to optimize asset allocation recommendations to investors, the model contained in that spreadsheet would be a covered technology because the use of such financial modeling tool is directly intended to guide investment-related behavior.")

below), the Commission should tailor its Proposed Rules to the technologies that actually present investor protection concerns.

The Proposing Release expresses some concern that AI technologies are rapidly evolving and thus may be difficult to define, and this may be the motivating factor behind the exceptionally broad definition of "covered technologies".[5] But there are recognized and well-accepted industry definitions of AI and PDA. The Commission should consider definitions that are actually linked to the anticipated harms that it describes. For example, the European Union defines "artificial intelligence" in the proposed EU Artificial Intelligence Act.[6] The International Committee for Information Technology Standards, a private sector standard-setting organization, also has developed a proposed standard to define artificial intelligence.[7] Similarly, the National Institute of Standards and Technology, an agency of the U.S. Department of Commerce, has developed a risk management framework for artificial intelligence.[8] There are similar industry definitions for predictive data analytics.[9]

We reserve judgment as to whether the Commission has adequately justified the Proposed Rules as to AI and PDA. But it clearly has not justified applying the Proposed Rules to ordinary technology such as spreadsheets that do not constitute AI or PDA under any conceivable definition. If, as the Proposing Release indicates, the Commission is concerned about AI and PDA, then it should adopt definitions tailored to those concerns. The Commission should not adopt its proposed definition of "covered technologies", which encompasses types of technologies that have long been used without any record (or reasonable prediction) of abuse.

The Commission Should Not Reject Disclosure as an Approach to Conflicts of Interest, as its Proposed "Eliminate or Neutralize" Standard Would Require

The Proposed Rules would impose an entirely new requirement not found in, nor grounded in, the Securities Exchange Act of 1934 or the Investment Advisers Act of 1940. Regardless of the degree of disclosure to investors or clients and the sophistication of those investors or clients, under

---

[5] *See, e.g.,* Proposing Release at page 10 ("PDA-like technologies may have the capacity to process data, scale outcomes from analysis of data, and evolve at rapid rates") and 16 ("The rate at which PDA-like technologies continues to evolve is increasing").

[6] *See* https://www.artificial-intelligence-act.com/#:~:text='Artificial%20intelligence%20system'%20(AI,logic%2D%20and%20knowledge%20based%20approaches%2C (last visited Sept. 26, 2023).

[7] *See* https://standards.incits.org/apps/group_public/project/details.php?project_id=4054 (last visited Sept. 26, 2023).

[8] *See* https://www.nist.gov/itl/ai-risk-management-framework (last visited Sept. 26, 2023).

[9] *See, e.g.,* Gartner Glossary, https://www.gartner.com/en/information-technology/glossary/predictive-modeling (last visited Sept. 26, 2023); SAS Analytics Insights, https://www.sas.com/en_us/insights/analytics/predictive-analytics.html#:~:text=Predictive%20analytics%20is%20the%20use,will%20happen%20in%20the%20future (last visited Sept. 26, 2023); IBM, https://www.ibm.com/topics/predictive-analytics (last visited Sept. 26, 2023).

the Proposed Rules firms would be required to "eliminate or neutralize" any conflicts of interest viewed as placing the interests of the firm ahead of its investors or clients. The Proposing Release assumes that such conflicts cannot be adequately addressed by disclosure, but it does not support this assumption. Instead, disclosure is replaced by the novel concept of "eliminating or "neutralizing" a conflict, without an explanation as to how this is consistent with existing law or how it would work in practice.

In 2019 the Commission explicitly defined the fiduciary duties owed to investment advisory clients. With respect to conflicts of interest, an adviser's duty to its clients is to "eliminate, or at least to disclose" the conflict.[10] In defining this standard, the Commission specifically rejected a one-size-fits-all approach, noting that the facts and circumstances will dictate the appropriate approach based on the contours of the advisory relationship. Similarly, in Regulation Best Interest, the Commission required broker-dealers to "address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest".[11]

The Commission reiterated this disclosure-based standard in adopting the Private Funds Advisers Rules less than two months ago:

> To satisfy its fiduciary duty, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser to provide advice that is not disinterested (emphasis supplied). Full and fair disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent.[12]

The Proposing Release does not provide support for this change of approach. We believe that a change in a regulated firm's standard of conduct with respect to certain technologies should not be undertaken without further study and consideration.

The Proposing Release's requirement to "eliminate or neutralize" conflicts of interest effectively would swallow the disclosure-based approaches that have governed broker-dealer and investment adviser regulation for more than 80 years, at least for any broker-dealer or

[10] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Inv. Adv. Act Rel. No. 5248 at page 6 (June 5, 2019) ("Investment Adviser Fiduciary Interpretation") (available at https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf).
[11] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exch. Act Rel. No. 86031 at page 1 (Jun 5, 2019) (the "Regulation Best Interest Adopting Release") (available at https://www.sec.gov/files/rules/final/2019/34-86031.pdf). As discussed further below, Regulation Best Interest applies a flat ban to a carefully defined set of conflicts of interest concerning sales contests, but this ban does not support the much broader prohibitions in the Proposed Rules here.
[12] Private Fund Advisers, Inv. Adv. Rel. No. 6383 at page 248 (Aug. 23, 2023) (available at https://www.sec.gov/files/rules/final/2023/ia-6383.pdf).

investment adviser that uses technology to serve or communicate with clients (which is to say, effectively all of them). We observe that any investment adviser that manages assets for more than a single client necessarily has potential conflicts of interest (between those clients), and any investment adviser that sets and charges fees to their clients necessarily has potential conflicts of interest between the clients' interests and the adviser's interests. Similarly, any broker-dealer that charges transaction-based compensation (such as commissions or mark-ups) or that receives transaction-based revenues from third parties (such as Rule 12b-1 fees, administrative service fees, payment for order flow, or exchange fee rebates), necessarily has potential conflicts of interest with clients. In other words, all investment advisers and broker-dealers have potential conflicts of interest with their clients. Indeed, as the SEC staff stated in an FAQ just last year:

> **Do all broker-dealers and investment advisers have conflicts of interest?**
>
> Yes. All broker-dealers, investment advisers, and financial professionals have at least some conflicts of interest with their retail investors. Specifically, they have an economic incentive to recommend products, services, or account types that provide more revenue or other benefits for the firm or its financial professionals, even if such recommendations or advice are not in the best interest of the retail investor. This can create substantial conflicts of interest for both firms and financial professionals.[13]

Regulation Best Interest, the Investment Adviser Fiduciary Interpretation and the recent Staff Bulletin on Conflicts of Interest all provide extensive guidance about how to disclose and mitigate conflicts of interest. Under the Proposing Release, all of that guidance is simply thrown out of the window. It is no longer sufficient to disclose or mitigate conflicts; they must be "eliminated or neutralized".

We observe that the Proposal is stunningly broad, covering any type of interaction with virtually any customer.[14] Chairman Gensler gives as an example in his statement accompanying the rule the use of color in an

---

[13] Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest, Question 1 (Aug. 3, 2022) (citation omitted) ("Staff Bulletin on Conflicts of Interest") (available at https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest); *accord*, Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (Oct. 18, 2019) (available at https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation); *see also* Regulation Best Interest Adopting Release at n. 6 (noting that, like many principal-agent relationships, broker-dealers' and investment advisers' relationships with retail investors have inherent conflicts of interest).

[14] The broker-dealer proposal affects interactions with natural person customers (consistent with Regulation Best Interest), while the investment adviser proposal affects all clients and all investors in pooled vehicles (inconsistent with the Investment Adviser Fiduciary Interpretation, which only affects investment advisory clients and potential clients, and not investors in pooled vehicles). Having multiple overlapping rules with different affected groups of clients will make compliance more difficult and expensive.

investor-facing website.[15] If a broker-dealer or investment adviser concludes that clients prefer some website color combinations (and thus might benefit the firm by trading more or bringing in more assets for management), does that mean that the firm must "eliminate or neutralize" those color combinations? Broker-dealers and investment advisers regularly test user interfaces to make them more intuitive and user-friendly – is this process a conflict of interest that must be eliminated or neutralized, simply because customers might use a better interface to do more business with the firm? We suggest that such a result would be so absurd and impossible to justify that it could not be what the Commission reasonably could intend.

The "eliminate or neutralize" standard would make it effectively impossible for some regulated firms to pursue business models that are expressly permitted in Regulation Best Interest and the Investment Adviser Fiduciary Interpretation. For example, Regulation Best Interest specifically permits a broker-dealer (for example, a distributor to a specific fund adviser) to have a limited product set, so long as it discloses the conflicts of interest presented by that limited product set to investors.[16] But under the Proposed Rules here, that broker-dealer must "eliminate or neutralize" that conflict of interest if it uses any "covered technology". For example, it would appear that such a limited-purpose broker-dealer could not have a website tool that allowed customers to search or sort its available products (because such a tool would encourage investors to buy the products sponsored by the broker-dealer's affiliate). We suggest that the Commission has not justified an initiative that would put at a severe competitive disadvantage a business model that, just four years ago, the Commission found was permissible (even beneficial) to provide more choices to investors.

Soft dollars provide another concrete example of this issue. As the Commission has stated, investment advisers' "[u]se of client commissions to pay for research and brokerage services presents money managers with significant conflicts of interest".[17] However, Section 28(e) of the Exchange Act clearly and unambiguously permits investment advisers to use client commission revenue to obtain research and brokerage services for the benefit of clients. For years, the Commission has given guidance to investment advisers about how to mitigate and disclose these soft dollar conflicts of interest. But under the Proposal, if the investment adviser uses any kind of technology to manage client assets, including research services

---

[15] Chair Gary Gensler, Statement on Conflicts of Interest Related to Uses of Predictive Data Analytics (July 26, 2023) ("For instance, my mom used to dress my identical twin brother, Rob, in red, and me in green. Today, I might not react as favorably to green prompts. You see, it was a bit Rob-red, Gary-green, but it was a little overused in my youth.") (available at https://www.sec.gov/news/statement/gensler-statement-predictive-data-analytics-072623#:~:text=Similarly%2C%20I%20believe%20that%20investors,to%20providing%20advice%20or%20recommendations).

[16] *See* Regulation Best Interest Adopting Release at page 313.

[17] Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 at page 3 (July 18, 2006) (available at https://www.sec.gov/files/rules/interp/2006/34-54165.pdf).

such as market data feeds and brokerage services such as order management systems, it is no longer sufficient to mitigate and disclose the inherent conflicts of interest presented by soft dollar usage. Instead, under the Proposal, those conflicts must be "eliminated or neutralized" – a standard impossible to meet without abandoning those (expressly permitted) technologies altogether. In short, with respect to soft dollar usage, the Proposal's "eliminate or neutralize standard" is directly contrary to the clear statutory intent of Section 28(e) of the Exchange Act. We submit the "eliminate or neutralize" standard is inconsistent with the Exchange Act and the Investment Advisers Act more generally.

The Proposal's Application in the Absence of a Recommendation Is Inconsistent with the Investment Adviser Fiduciary Interpretation and Regulation Best Interest

Even apart from the "eliminate or mitigate" issue discussed above, the Proposal is inconsistent with Regulation Best Interest for broker-dealers, and the Investment Adviser Fiduciary Interpretation, in a variety of ways that introduce substantial concerns.

First, the Proposal explicitly applies even in the absence of a recommendation by the broker-dealer or the provision of investment advice by the investment adviser.[18] The Commission has not explained or justified this radical departure from traditional principles it reaffirmed just four years ago. Both Regulation Best Interest and the Investment Adviser Fiduciary Interpretation impose substantive obligations on broker-dealers and investment advisers, respectively, to disclose conflicts of interest associated with their recommendations or provision of investment advice.[19] In this regard, and as discussed above, the proposed requirement to eliminate or neutralize conflicts is a drastic departure from the option to disclose conflicts of interest and rely on informed consent under the Investment Adviser Fiduciary Interpretation or to disclose or mitigate eliminate conflicts of interest under Regulation Best Interest. The Proposal directly rejects the concept under the federal securities laws of disclosure-based regimes providing investor protection as well as fair and efficient markets. Coupled with the ambiguities discussed above, firms would be forced to consider

[18] *See* Proposing Release at page 43 ("This could include providing investment advice or recommendations, but it also encompasses design elements, features, or communications that nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors").

[19] *See* Regulation Best Interest Adopting Release at page 1 (broker-dealer must "act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer"); see id. at page 299 ("Nor does Regulation Best Interest apply to self-directed or otherwise unsolicited transactions by a retail customer, whether or not he or she also receives separate recommendations from the broker-dealer"). *Compare* Investment Adviser Fiduciary Interpretation at page 8 ("in our view, the duty of care requires an investment adviser to provide investment advice in the best interest of its client, based on the client's objectives. 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.")

eliminating or neutralizing conflicts where disclosure or mitigation alone would be sufficient under Regulation Best Interest or the Investment Adviser Fiduciary Interpretation, a discrepancy for which the Proposal fails to provide a reasonable justification. Nothing in the Proposing Release provides any evidence that the disclosure-based principles in Regulation Best Interest or the Investment Adviser Fiduciary Interpretation, adopted only four years ago, have failed or demonstrated themselves to be inadequate.[20]

Further, the Proposal provides a new definition of "conflict of interest"—an interest that places or results in placing the firm's or its associated person's interest ahead of investors' interests. This definition differs from the meaning of the term under Regulation Best Interest and the Investment Adviser Fiduciary Interpretation—an interest that might incline a firm or its associated persons (consciously or unconsciously) to make a recommendation or render advice that is not disinterested. However, the Proposal fails to explain the extent to which the definitions differ and whether there are interests that could be conflicts under the Proposal but not under Regulation Best Interest or the Investment Adviser Fiduciary Interpretation. This ambiguity and inconsistency would result in firms being forced either (1) to establish differing conflict handling processes for different rules that have significant overlap, which would be entirely impractical, or (2) alternatively, seek to identify the lowest common denominator between the definitions.

We are concerned that these ambiguities and inconsistencies in the Proposal suggest that Commission has not thoroughly vetted the interplay between the Proposed Rules and Regulation Best Interest and the Investment Adviser Fiduciary Interpretation, as well as the unintended and impractical consequences that may or would result. The Commission should review these areas and other aspects of the Proposal that could impact the application of Regulation Best Interest and the Investment Adviser Fiduciary Interpretation for further consideration, and reassess the need for the Proposed Rules to address areas already covered by substantive regulations.

As the Supreme Court has stated, while an agency is permitted to change its interpretation of the statutes in administers, it must provide a convincingly reasoned explanation for any such change of course:

> To be sure, the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it is changing position. An agency may not, for

[20] The Proposing Release, at pages 30-31, cites a single case in which a regulated firm allegedly used a "PDA-like" technology inappropriately, but as it concedes, that case involved an alleged failure of disclosure actionable under existing law and rules. That single case certainly does not demonstrate a need for the wholesale abandonment of disclosure-based principles in the Proposed Rules.

> example, depart from a prior policy sub silentio or simply disregard rules that are still on the books.

FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009). The Proposed Rules do not satisfy this standard – the Commission has not justified its departure from the disclosure-based regulatory scheme it announced in 2019 in Regulation Best Interest and the Investment Adviser Fiduciary Interpretation.

The Proposal also inappropriately omits any concept of materiality. In the Investment Adviser Fiduciary Interpretation, the Commission used the term "material" or "materiality" more than 30 times to describe the standard for conflicts of interest that an investment adviser must disclose or mitigate.[21] Similarly, Regulation Best Interest requires broker-dealers to "address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose *material* facts about conflicts of interest[.]"[22] The Proposing Release here is inconsistent with the Investment Adviser Fiduciary Interpretation and Regulation Best Interest because it lacks such a materiality standard. Further, the Proposing Release is completely silent about this drastic departure from standard federal securities law principles. The Proposed Rules should be amended to apply a materiality standard. The failure of the Proposing Release to discuss this issue violates the Supreme Court's *Fox Television* standard quoted above.[23]

The Statutory Provisions on Which the Commission Relies, Sections 211(h) of the Investment Advisers Act and 15(l) of the Exchange Act, Do Not In Fact Provide Sufficient Authority for the Proposal

The Proposed Rules would prohibit regulated firms from using any tool, method, or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes in any customer communication or engagement in a way that benefits the broker-dealer or registered investment adviser. As discussed above, virtually every broker-dealer and investment adviser activity can be characterized as some combination of technology, methods, and/or processes and thus a "covered technology" under the Proposed Rules. Virtually every business activity involves customer communication or engagement. Virtually all technology, methods, and processes that regulated firms use in some way optimize for investment-related behaviors or outcomes. The practical effect of the Proposed Rules would be to ban regulated firms from pursuing their own interests unless they can demonstrate a greater benefit to customers. Accordingly, the applicability of the new obligations and prohibitions to

---

[21] *Cf. SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 194 (1963) ("Failure to disclose **material** facts must be deemed fraud or deceit within its intended meaning") (emphasis supplied).
[22] Regulation Best Interest Adopting Release at page 5 (emphasis supplied).
[23] *See FCC v. Fox Television Stations, Inc.,* 556 U.S. at 515 (agency may not depart from a prior policy sub silento).

regulated firms' activities would be, for practical purposes, unbounded. It is far from clear that the Commission has the statutory rulemaking authority to impose such strict obligations and prohibitions on such a staggeringly broad range of activity.

The Proposing Release cites Section 211(h)(2) of the Advisers Act and Section 15(l)(2) of the Exchange Act for its new definition of conflicts of interest as taking into consideration a regulated firm's self-interest and the accompanying new mandates to eliminate or neutralize such conflicts. Congress added these provisions to the Investment Advisers Act and Exchange Act, respectively, by enacting Section 913(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" and "Section 913(h)," respectively). Specifically, the Proposing Release relies on Section 913(h)'s provision that the Commission shall "where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors"[24] as its authority for the Proposed Rules.

The Proposed Rules' overbreadth and deviation from existing frameworks appear to exceed Section 913(h)'s statutory language, the apparent intent of the Dodd-Frank Act, and the context of the applicable statutory schemes. The language in both Section 211(h)(2) of the Advisers Act and Section 15(l)(2) of the Exchange Act on its face empowers the Commission to prohibit or restrict not all conflicts of interest, but rather only "certain" conflicts of interests. By defining "conflict of interest" as effectively any system, method, or process that considers the interests of a regulated firm or its associated persons, the Proposed Rules effectively eliminate the statutory limitation on the Commission's authority that the Dodd-Frank Act intended by enacting the word "certain." In relying on these sections to promulgate such unbounded prohibitions, restrictions, and obligations in the Proposed Rules, the Commission effectively treats the word "certain" as if it had no meaning. This approach contravenes established principles of statutory construction. Case law has established that legislative use of the term "certain" has a limiting effect.[25] The overbroad prohibitions, restrictions, and obligations of the Proposed Rules contravene any limiting effect of the term "certain" in the statute. At a minimum, the Commission should repropose the rule addressing directly how the effective ban on virtually all conceivable conflicts of interests that might arise in the pursuit of regulated firms' business objectives comports with the limitation on its authority inherent in the Dodd-Frank Act's use of

---

[24] *See* Proposing Release at footnote 117 and accompanying text.

[25] *See El Al Israel Airlines, Ltd. v. Tsui Yan Tseng*, 525 U.S. 155, 173 (1999) ("Inclusion of the word 'certain' in the [Warsaw] Convention's title . . . accurately indicated that the [C]onvention is concerned with certain rules only, not with all the rules relating to international carriage by air") (second alteration in original) (internal quotation marks omitted).

the term "certain." Similarly, in issuing the Proposed Rules, the Commission also appears to have ignored or treated as mere surplusage the qualifying phrase "where appropriate." This phrase effectively requires that the Commission make a showing that there is some sort of foreseeable abuse that necessitates the breadth of the prohibition or restriction authorized and that the scope of the prohibition or restriction will be suitably tailored to remedy such abuse. The Proposing Release makes no such showing.

To provide further context for the limiting terms "certain" and "where appropriate," the Commission should look (as the courts will look) at the relevant context in Section 913(h). This provision gives the Commission authority to regulate "sales practices, conflicts of interest, and compensation schemes" when that Commission finds them to be "contrary to the public interest and the protection of investors." The longstanding statutory analysis tools of *ejusdem generis* and *noscitur a sociis* counsel that the authority to regulate "sales practices" should be interpreted consistently with the authority to regulate "compensation schemes."[26] The particular harm with which Section 913(h) was concerned was undisclosed sales contests which created potential conflicts of interest with respect to sales representative compensation.[27] And this is exactly how the Commission interpreted Section 913(h) in Regulation Best Interest, in which the Commission banned certain types of broker-dealer sales contests, sales quotas, bonuses and non-cash compensation, for a specific security or type of security in a limited period of time.[28] The Commission's interpretation of its Section 913(h) authority close in time to its adoption is deserving of weight when seeking to understand the intended scope of that authority. Nothing in Regulation Best Interest suggested this Section 913(h) authority extended to issues like regulated firms' use of technology completely unrelated to sales contests or representative compensation.[29] The Proposing Release here does not explain or justify its radically different interpretation of Section 913(h) today.

The statutory language of Section 211(h)(2) to the Advisers Act and Section 15(l)(2) of the Exchange Act also must be understood in relation to

---

[26] *See Yates v. United States*, 574 U.S. 528 (2015) (applying *ejusdem generis* and *noscitur a sociis* canons of statutory interpretation to Sarbanes-Oxley Act).
[27] For example, the Dodd-Frank Act clearly intended to give the Commission authority to ban the notorious penny-stock firm "stock of the day" promotions made infamous in the movie "The Wolf of Wall Street."
[28] *See* Regulation Best Interest Adopting Release at pages 16, 41-42 and 61-62. The Commission staff similarly addressed investment adviser representative compensation conflicts in Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (Oct. 18, 2019) (available at https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation). Again, this focus on sales compensation helps inform the intended scope of Section 913(h).
[29] Notably, when the State of Massachusetts Securities Division adopted a fiduciary duty rule for broker-dealers after Regulation Best Interest, it banned all sales contests, without limiting that ban to contests relating to a specific security or class of securities, and whether or not the sales contest was for a limited period of time. *See* Massachusetts Fiduciary Rule Adopting Release (Feb. 21, 2020) (available at https://www.sec.state.ma.us/divisions/securities/enforcement/adopting-release.htm). We believe this rule helps give color concerning the issues under consideration in Section 913(h).

the provisions they immediately follow, namely Sections 211(h)(1) and 15(l)(1), respectively. Those provisions require the Commission to "facilitate the provision of simple and clear disclosures to investors." Importantly, the provision requiring the Commission to facilitate the long-established core way for regulated firms to address conflicts of interest under the federal securities laws – *i.e.*, simple and clear disclosures – is not limited the way that Sections 211(h)(2) and 15(l)(2) limit the Commission's authority to prohibit or restrict conflicts of interest with the terms "certain" and "where appropriate." Nothing in Section 913(h) suggests authority to "eliminate or neutralize" conflicts of interest even when they are disclosed in simple and clear terms. The plain language of Section 913(h) on its face, therefore, establishes a framework that grants the Commission only limited authority to prohibit and restrict specific types of compensation-related conflicts within the larger area of authority to foster simple and clear disclosure about conflicts. The Proposed Rules turn this framework on its head by creating a vast new area of conflicts prohibition no matter how simply and clearly they are disclosed. If the Dodd-Frank Act intended such a result, it would have made a clear statement to that effect.

The Proposed Rules exceed not just the statutory authority established in the plain meaning of Section 913(h) but also the overall structure and intent of the Dodd-Frank Act. Specifically, the entire overarching purpose of Section 913, including Section 913(h), is to *harmonize* the then-existing and differing obligations of broker-dealers and investment advisers. The purpose was not to impose an entirely new regime on all regulated firms. Understood in this context, the Dodd-Frank Act granted the Commission new powers to prohibit and restrict conflicts of interest "where appropriate" to harmonize divergent standards. For example, if a particular action was permissible for a broker-dealer but impermissible for an investment adviser, then Section 913(h) authorizes the Commission to apply the investment adviser standard to broker-dealers by restricting or prohibiting the action. As discussed above, longstanding Commission and court interpretations of the Investment Advisers Act impose a fiduciary duty standard that requires regulated firms to disclose fully and fairly all material conflicts of interest. However, nothing in the text or history of the Dodd-Frank Act provides the authority to require the "elimination or neutralization" of conflicts no matter how clearly they are disclosed. The prohibitions and restrictions in the Proposed Rules, by contrast, go far beyond what is appropriate to harmonize regulated firms' obligations where they diverge.

Finally, the Proposed Rules' deviation from conflicts of interest requirements under existing law contravenes the limits on the Commission's authority inherent in the overall statutory scheme. The federal securities laws have always relied on informed disclosure and mitigation as the primary

methods for addressing conflicts of interest.[30] The federal securities laws have traditionally imposed different standards on investment advisers and broker-dealers. In Section 913(h), the Dodd-Frank Act directed the Commission to review whether in some cases the standards applied to broker-dealers should be harmonized with the investment advisers' longstanding standard. But in so doing, the Dodd-Frank Act did not authorize the Commission to *create* in whole cloth an entirely new standard that is more stringent than any that either broker-dealers or investment advisers have ever had to meet. If the Dodd-Frank Act intended such a sea change, then surely it would not have labeled Section 913(h) "Other Matters." As other commenters have argued, it is illogical to conclude that the Dodd-Frank Act buried such a momentous directive to replace the key elements of the regimes for addressing regulated firms' conflicts of interest in a miscellaneous matters subsection within the larger harmonization mandate.[31] For all of these reasons, Sections 211(h)(2) of the Advisers Act and 15(l)(2) of the Exchange Act simply do not provide the Commission with sufficient statutory authority to adopt the Proposed Rules.

As Now Written, the Proposed Rules Would Not Survive Scrutiny under the First Amendment

As explained above, the Proposed Rules would forbid broker-dealers and investment advisers from communicating with clients and potential clients using "covered technologies" unless the broker-dealers and investment advisers have "eliminated or neutralized" conflicts of interest in connection with those covered technologies. The Proposing Release is clear that full and fair disclosure of conflicts is insufficient to meet this standard: "we are proposing that such 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."[32] In other words, the Proposed Rules broadly forbids speech that (because it is fully disclosed) is not misleading. Such regulations would be inconsistent with the First Amendment and would not survive judicial scrutiny.

---

[30] Indeed, Chairman Gensler repeatedly has made this very point about how the federal securities laws rely on disclosure, not merit regulation. *See* Chairman Gary Gensler, Remarks before the Financial Stability Oversight Council (July 28, 2023) (available at https://www.sec.gov/news/speech/gensler-remarks-fsoc-climate-072823):

> In response to the Great Depression and fraudulent practices of the time, President Roosevelt and Congress came together to enact the federal securities laws in which they established a basic bargain in our markets. Investors get to decide which risks to take, so long as public companies raising money from the public make what Roosevelt called "complete and truthful disclosure."
>
> The SEC was assigned an important role regarding that basic bargain and public disclosure. Under the securities laws, though, the SEC is merit neutral. Investors get to decide what investments they make and risks they take based upon those disclosures. The SEC focuses on the disclosures about, not the merits of, the investment.

[31] *See Whitman v. American Truckers*, 531 U.S. 457, 468 (2001) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes.").

[32] Proposing Release at page 26.

We can presume that a regulated firm's speech using covered technologies constitutes "commercial speech" and therefore must satisfy the U.S. Supreme Court's test for regulation of commercial speech in *Central Hudson Gas & Electric Co. v. Public Service Comm.*, 447 U.S. 557 (1980).[33] In Central Hudson, the Court applied a four-part test:

> For commercial speech to come within that provision, it at least must concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest.[34]

The Proposed Rules seek to forbid speech by regulated firms concerning their lawful activities, even if the asserted conflicts of interest at issue are fully disclosed, and the speech is not misleading. We can assume that a court might deem that the Commission's asserted interest (avoiding some harm to investors, the precise nature of which is not clear from the Proposing Release) is substantial. But a flat ban on such speech does not directly advance the government interest asserted, and is substantially overbroad and thus is not appropriately tailored to the interest at issue.

A federal district court recently analyzed a closely analogous statute and found that it violated the *Central Hudson* test. The court in *NetChoice, LLC v. Bonta*, No. 22-cv-08861-BLF (N.D. Cal. Sept. 18, 2023) (available at https://images.law.com/contrib/content/uploads/documents/403/93175/gov.uscourts.cand_.406140.74.0.pdf) reviewed the California Age-Appropriate Design Code Act (the "CAADCA"), a statute intended to protect minors when they access the internet. In relevant part, the CAADCA restricted the use of "dark patterns" which the court described as "design features that 'nudge' individuals into making certain decisions". Slip op. at 32.[35] The court found protection of minors to be a "substantial" government interest. But the *NetChoice* court held that the "dark patterns" provisions of the CAADCA did not directly advance the state's interest because they were not causally connected to the purported harm, and were not narrowly tailored because they could chill speech that did not present the asserted harms. As a result, the court found that the plaintiffs opposing the statute had demonstrated a likelihood of success on the merits of their First Amendment

[33] We observe that at least five current Supreme Court justices have called into question whether the "intermediate scrutiny" test generally ascribed from *Central Hudson* is still good law. *See Matal v. Tam*, 137 S. Ct. 1744, 1746-47 (2017) (Alito, J., plurality opinion) (commercial speech restrictions "must be narrowly drawn"), *id*. at 1769 (Thomas, J., concurring in part and concurring in judgment) ("strict scrutiny applies" to commercial speech restrictions).

[34] 447 U.S. at 566.

[35] *Compare* Proposing Release at page 33: arguing for need to regulate "design elements, features, or communications that nudge or prompt certain or more immediate action by an investor".

arguments, and the court enjoined enforcement of the "dark patterns" provisions of the CAADCA. Slip op. at 33-34.[36]

The *NetChoice* ruling would doom the Proposed Rules here: the Proposed Rules would forbid use of covered technologies to provide accurate and non-misleading speech (for example, "most active" and "largest mover" stock lists) to all investors, including to investors not susceptible to being "nudged", even if the regulated entity fully disclosed the fact that it could benefit financially if investors used those lists to trade. The Proposed Rules do not employ the logical less restrictive means of regulation (full disclosure). We urge the Commission to reconsider the breadth of the Proposed Rules in light of recent First Amendment jurisprudence permitting non-misleading commercial speech.

Conclusion

We greatly appreciate the opportunity to provide comments with respect to this important rule-making effort and thank the Commission staff for its efforts and thoughtful approach to the issues addressed by the Proposed Rules. Members of the Drafting Committee are available to meet and discuss these matters with the Commission staff and to respond to any questions.

Very truly yours,

/s/ Jay H. Knight

Jay H. Knight
Chair of the Federal Regulation of
Securities Committee

Drafting Committee:

W. Hardy Callcott (chair)
Marc Elovitz
Steve Ganis
Gavin Meyers
Jeffrey L. Robins

[36] Here, the Proposal would permit exactly the same speech when made without using a covered technology (for example recommending a margin account, or recommending trading to rebalance an account) that would be forbidden when using a covered technology. We submit this type of channel-based restriction always violates Supreme Court First Amendment precedent. *See Sorrell v. IMS Health Inc*., 564 U.S. 552 (2011) (striking down Vermont statute forbidding use of data-mining technology to tailor individualized marketing messages about drug prescriptions to doctors and pharmacists).