May 8, 2024

By E-mail (rule-comments@sec.gov)

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

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

Dear Ms. Countryman,

The New England Legal Foundation ("NELF") submits this letter in response to the U.S. Securities & Exchange Commission's ("Commission" or "SEC") proposed regulations under the Securities Exchange Act of 1934 ("Exchange Act") and Investment Advisers Act of 1940 ("Advisers Act") that purport to address conflicts of interest related to the use of "predictive data analytics" by broker-dealers and investment advisers ("the proposed PDA Rule").[1] As NELF explains herein, the proposed PDA Rule is unlawful and beyond the power of the Commission for at least three independent reasons:

1. The proposed PDA Rule is purportedly grounded in the Commission's authority to "examine and, where appropriate, promulgate rules prohibiting or restricting certain ... conflicts of interest." But the rule does not prohibit or restrict any "certain" conflict of interest. Rather, the rule categorically prohibits *all* conflicts of interest associated with a broad range of technologies, and unlawfully requires private parties, rather than the Commission, to identify these conflicts.

2. While the Commission has statutory authority to regulate "conflicts of interest," the proposed PDA rule's definition of "conflicts of interest" does not comport with the plain meaning of the term and is therefore beyond the power of the Commission to regulate.

3. The proposed PDA Rule violates the First Amendment of the United States Constitution by unduly restricting truthful disclosures of information without being tailored to a legitimate government interest.

Because the proposed rulemaking is unlawful, NELF urges the Commission not to move forward with the proposed PDA Rule.

[1] Conflicts of Interests Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53,960.

I. The Proposed PDA Rule Exceeds the Commission's Statutory Authority to Regulate Specific Conflicts of Interest.

Under section 15(*l*)(2) of the Exchange Act and section 211(h)(2) of the Advisers Act, the Commission has the authority to "examine and, 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."[2] This is the sole authority invoked by the Commission for the proposed PDA Rule.[3] Neighboring provisions of the Exchange Act and the Advisers Act require the Commission to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest."[4]

The statutory text is clear: the Commission must "examine … certain conflicts of interest," and, upon identifying a "certain … conflict[] of interest … that the Commission deems contrary to the public interest and the protection of investors," the Commission may then "promulgate rules prohibiting or restricting" *that* conflict of interest. In other words, the Commission must identify a specific (i.e., "certain") conflict of interest. Once the Commission identifies some specific conflict, it must then determine whether that conflict warrants regulation. Only after having done so may it then promulgate rules that apply to that conflict of interest. By contrast, general concerns about potential conflicts of interest are to be addressed by "simple and clear disclosures to investors" that the Commission is charged with facilitating.

The proposed PDA Rule does not comport with this statutory framework. The Commission does not identify *any* "certain" conflict of interest that is prohibited or restricted under the rule. Instead, the Commission seeks to impose a burdensome regulatory scheme under which private parties must "[e]valuate *any* use or reasonably foreseeable potential use of a covered technology … in *any* investor interaction to identify *any* conflict of interest associated with that use of potential use," identify the potential effect of any such conflict of interest, and "[e]liminate, or neutralize the effect of" any such conflict of interest if it would have the effect of putting the broker or adviser's interest ahead of the investor's interest.[5] Private parties would also be required to maintain "a written description of the process for evaluating any use (or reasonably foreseeable

[2] 15 U.S.C. § 78o(*l*)(2) (Exchange Act); *id.* § 80b-11(h)(2) (Advisers Act).

[3] *See* Proposing Release, 88 Fed. Reg. at 53,971.

[4] 15 U.S.C. §§ 78o(*l*)(1), 80b-11(h)(1).

[5] *See* Proposing Release, 88 Fed. Reg. at 53,971, 54,022–23 (emphasis added).

potential use) of a covered technology in an investor interaction," as well as written descriptions of the processes used to evaluate any conflicts of interest associated with such technology.[6]

This regulatory mandate exceeds the SEC's statutory authority in multiple different ways. *First*, while the SEC has regulatory authority to prohibit or restrict "certain" conflicts of interest, the Commission does not have regulatory authority to broadly prohibit all potential conflicts of interest. "Certain" is not the same as "any" or "all."[7] In providing the Commission statutory authority to regulate individual conflicts of interest by rule, Congress thus understood that the Commission would make individual, context-specific assessments as to what constitutes a conflict of interest, and which conflicts of interest are contrary to the public interest and the protection of investors. And under the Administrative Procedure Act, the Commission's individual assessments would be subject to public notice and comment.[8] By regulating in the aggregate, contrary to the statutory mandate, the Commission's proposed rule would circumvent the notice-and-comment rulemaking process.

Second, the SEC's approach here does not comport with section 15(*l*)(1) of the Exchange Act and section 211(h)(1) of the Advisers Act, which set forth a disclosure regime as the baseline framework for addressing conflicts of interest. Absent a rule governing a "certain" conflict of interest, these neighboring provisions require the SEC to "facilitate the provision of simple and clear disclosure to investors … including any material conflicts of interest." By creating a blanket rule governing *all* conflicts of interest that involve the technologies at issue, the proposed PDA Rule would undermine the disclosure regime that Congress devised, replacing it instead with a system of far-reaching regulatory oversight by the Commission that Congress did *not* authorize.[9] As the Supreme Court has explained, "the words of a statute must be read in their context and with

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[6] *See id.* at 53,971, 54,022–23 (emphasis added).

[7] *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 Convention is concerned with certain rules only, not with all the rules relating to international carriage by air." (alterations adopted)).

[8] *See* 5 U.S.C. § 553.

[9] *See* Commissioner Hester M. Peirce, *Through the Looking Glass: Conflicts of Interest Associated with the use of Predictive Data Analytics by Broker-Dealers and Investment Advisers Proposal* ("Peirce Statement"), https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623 (July 26, 2023) (observing that the release "does more than single out particular technologies for regulatory hazing" but "also rejects one of our primary regulatory tools—disclosure").

a view to their place in the overall statutory scheme."[10] The inconsistency between the proposed PDA Rule and the statutory scheme here demonstrates how far the rule departs from the SEC's limited statutory authorization.

Third, the Commission's statutory authority extends only to "prohibiting or restricting" conflicts of interest. Furthermore, the Commission can only exercise this authority after it "examine[s]" the "certain conflict of interest." Nothing in the statute authorizes the SEC to impose a burdensome prophylactic regime under which regulated entities (rather than the Commission) are required to identify potential conflicts of interest and devise written policies. This regime, as required by the proposed PDA Rule, goes beyond the Commission's discrete authority to prohibit or restrict conflicts of interest. An agency is a creature of statute and "literally has no power to act ... unless and until Congress confers power upon it."[11] And by requiring private parties to identify conflicts of interest, the Commission abandons its own statutory responsibility to "examine" a "certain" conflict of interest prior to promulgating regulations.

The requirements imposed by the proposed PDA Rule are burdensome. "For example, a firm might instruct firm personnel with sufficient knowledge of both the applicable programming language and the firm's regulatory obligations to review the source code of the technology, review documentation regarding how the technology works, and review the data considered by the covered technology (as well as how it is weighted)."[12] Congress did not give the Commission sweeping authority to require broker-dealers and/or investment advisers to review the source code of novel technologies to identify potential conflicts of interest. The statute contemplates that role to be fulfilled by the staff of the *Commission*.

Fourth, the proposed PDA Rule is so broad that it would impose significant burdens on regulated parties *even in cases where there is no conflict of interest*. Under the proposed rule, brokers and investment advisers are required to evaluate conflicts of interest anytime there is "any use or reasonably foreseeable *potential* use of a covered technology" (emphasis added) in any investor interaction.

This is particularly burdensome given the incredibly broad definition of "covered technology" employed by the Commission, which includes any "analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that

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[10] *Home Depot U.S.A., Inc. v. Jackson*, 139 S. Ct. 1743, 1748 (2019) (quoting *Davis v. Mich. Dep't of Treasury*, 489 U.S. 803, 809 (1989)).

[11] *New York v. FERC*, 535 U.S. 1, 18 (quoting *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986)).

[12] Proposing Release, 88 Fed. Reg. at 53,977.

optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes."[13] Even "a spreadsheet that implements financial modeling tools or calculations ... in order to optimize asset allocation recommendations to investors" would trigger the regulatory requirements.[14] As Commissioner Peirce has explained, "spreadsheets, commonly used software, math formulas, statistical tools, and AI trained on all manner of datasets could fall within the ambit of this rulemaking."[15]

Furthermore, the rules actually *prohibit* using covered technologies if they are not sufficiently transparent for firms to evaluate how they operate, even without a finding that the covered technologies actually create conflicts of interest. As the proposed PDA Rule explains, "firms would only be able to continue using [these technologies] where all requirements of the proposed conflicts rules are met."[16] And, "as a practical matter, firms that use such covered technologies likely may not meet the requirements [of the proposed PDA Rule] where they are unable to identify all conflicts of interest associated with the use of such covered technology."[17]

This is unlawful. While the Commission has rulemaking authority over certain conflicts of interest, it does not have any statutory authority to impose regulatory burdens or proscribe private conduct where no conflict of interest exists. Nor does the Commission have any statutory authority to prohibit firms from using new technologies absent even an identified conflict of interest. The mere potential for misuse—inherent in virtually any technology—is not sufficient ground for the Commission to exercise its circumscribed regulatory power.

II. The Proposed PDA Rule Adopts an Unlawful Definition of "Conflict of Interest."

Under the proposed PDA Rule, a conflict of interest exists "when a firm uses a covered technology that takes into consideration an interest of the firm or its associated persons."[18] As the rule further explains, "if a covered technology considers *any* firm-favorable information in an investor interaction or information favorable to a firm's associated persons, the firm should evaluate the conflict."[19] Indeed, "when covered technology takes into account the profits or

[13] *See id.* at 54,021–23.

[14] *Id.* at 53,972.

[15] Peirce Statement.

[16] *Id.* at 53,978.

[17] *Id.*

[18] *Id.* at 53,981.

[19] *Id.* at 53,982.

revenues of the firm, that would be a conflict of interest under the proposal regardless of whether the firm places its interests ahead of investor interests."[20] And the proposed rule also defines "interest" so broadly that simply "incentivizing increased trading activity or opening of options or margin accounts" qualifies as a conflict of interest "if increased trading or opening of such accounts would cause the firm to experience higher profits."[21] Under this approach, any use of technology to make a broker-dealer or an adviser more attractive from a user's perspective qualifies, implausibly, as a conflict of interest.

This approach does not comport with the plain meaning of the phrase "conflict of interest."[22] As Black's Law Dictionary explains, a "conflict of interest" is a "real or seeming incompatibility between one's private interests and one's public or fiduciary duties."[23] A "conflict of interest" therefore requires not only that an entity's "private interests" are implicated, but that there is some "incompatibility" between these private interests and the entity's fiduciary duties. The Commission's definition does not require any such incompatibility. Any technology that takes into account, even indirectly, increased trading or opening of accounts, for instance, would qualify as a conflict of interest even if such trading or opening of accounts is aligned with customers' interests. As the Commission itself acknowledges, this definition "is broader than how economists usually define 'conflicts of interest.'"[24] "To permit an agency to expand its power in the face of a congressional limitation on its jurisdiction would be to grant to the agency power to override Congress."[25]

The Commission appears to recognize that this definition does not correspond with the plain meaning of a "conflict of interest," by requiring that conflicts be eliminated or neutralized when "such conflict of interest places or results in placing the firm's or its associated person's interest ahead of investors' interests."[26] But the proposed PDA Rule does not limit its regulatory scope to such conflicts. Rather, any "conflict of interest" under the rule's much broader definition requires the party to engage in a determination as to whether the conflict needs to be eliminated or

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[20] *Id.* at 53,982.

[21] *Id.* at 53,982.

[22] *See BP Am. Prod. Co. v. Burton*, 549 U.S. 84, 91 (2006) ("Unless otherwise defined, statutory terms are generally interpreted in accordance with their ordinary meaning.").

[23] *Conflict of interest*, Black's Law Dictionary (11th ed. 2019).

[24] Proposing Release, 88 Fed. Reg. at 53,998 n.232.

[25] *La. Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374–75 (1986).

[26] Proposal, 88 Fed. Reg. at 53,971.

neutralized. But the Commission does not have statutory authority to regulate hypothetical conflicts of interest, and thus requiring parties to engage in this determination absent an actual conflict of interest is unlawful.

III. The Proposed PDA Rule Violates the First Amendment.

The Free Speech Clause of the First Amendment provides that "Congress shall make no law … abridging the freedom of speech."[27] The proposed PDA Rule burdens the communication of truthful information to investors and thereby directly targets protected speech. And the rule is not remotely tailored to the government's interest in preventing actual conflicts of interest. Accordingly, the proposed PDA Rule is unconstitutional.

As the Supreme Court has explained, "[a]n individual's right to speak is implicated when information he or she possesses is subjected to 'restraints on the way in which the information might be used' or disseminated."[28] This is true even where "the burdened speech results from an economic motive."[29] That is precisely what the proposed PDA Rule does: if a broker-dealer or investment adviser collects information by use of a covered technology, the entity may not then use such information in an "investor interaction" without triggering the burdensome requirements of the rule.

The proposed PDA Rule is likely subject to strict scrutiny as a content-based restriction on speech.[30] The rule applies whenever a firm uses covered technology "in an investor interaction," which is defined to include most communication to investors but does not include "interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support."[31] And the rule applies only to speech that implicates a covered technology. Both of these features discriminate on the basis of content: a recommendation to an investor triggers the regulatory restrictions of the rule, but assisting the investor with her account does not. And explaining to an investor that an algorithm recommends a certain investment triggers the rule, but explaining that the adviser personally recommends an investment does not.

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[27] U.S. Const. amend. I.

[28] *Sorrell v. IMS Health Inc.*, 564 U.S. 552, 568 (2011) (quoting *Seattle Times Co. v. Rhinehart*, 467 U.S. 20, 32 (1984)).

[29] *Id.* at 567.

[30] *See NIFLA v. Becerra*, 585 U.S. 755, 767 (2018) (even professional speech is subject to "the rule that content-based regulations of speech are subject to strict scrutiny").

[31] Proposing Release, 88 Fed. Reg. at 53,975.

The proposed PDA Rule cannot satisfy the requirements of strict scrutiny—that it be narrowly tailored to a compelling government interest[32]—and hence the rule is unconstitutional.

Even if the proposed PDA Rule could be understood as a content-neutral restriction on speech, however, it still would violate the First Amendment. To survive intermediate scrutiny, the regulation must be "narrowly tailored to serve a significant governmental interest" and must "leave open ample alternative channels for communication of the information."[33] In other words, the government may not "regulate expression in such a manner that the substantial portion of the burden on speech does not serve to advance its goals."[34]

The proposed PDA Rule does not meet this test. While the Commission may have an interest in regulating actual conflicts, the proposed PDA Rule burdens a vast amount of speech that is not even implicated by that interest. As explained above, the regulatory requirements of the rule are triggered any time a broker-dealer or investment adviser uses a covered technology in any investor interaction—regardless of whether the investor interaction has any likelihood of generating an actual conflict of interest.

These restrictions are exceptionally burdensome. An investor interaction involving covered technology occurs whenever such technology is used for "providing investment advice or recommendations" as well as "to proactively provide curated research reports on particular investment products, because the use of such technology has been shown to guide or influence investment-related behaviors or outcomes."[35] "Similarly, using algorithmic-based tools, such as investment analysis tools, to provide tailored investment recommendations to investors would fall under the proposed definition of covered technology because the use of such tools is directly intended to guide investment-related behavior."[36]

Indeed, the proposed PDA Rule is not even limited to recommendations, but instead "would capture firm communications that may not rise to the level of a recommendation, yet are nonetheless designed to, or have the effect of, guiding or directing investors to take an investment-

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[32] *See NIFLA*, 585 U.S. at 766 (content-based laws are "presumptively unconstitutional and may be justified only if the government proves that they are narrowly tailored to serve compelling state interests" (quoting *Reed v. Town of Gilbert*, 576 U.S. 155, 163 (2015)).

[33] *Ward v. Rock Against Racism*, 491 U.S. 781, 791 (1989).

[34] *Id.* at 798–99.

[35] Proposing Release, 88 Fed. Reg. at 53,972.

[36] *Id.*

related action."[37] For instance, the rule applies to contexts such as a firm's "use of research pages or 'electronic libraries' to provide investors with the ability to obtain or request research reports, news, quotes, and charts from a firm-created website; or firm's use of technologies to generate emails to investors as part of a firm-run email communication subscription that investors can sign up for and customize, and which alerts investors to news such as news affecting the securities in the investor's portfolio or on the investor's 'watch list.'"[38]

The effect of this is that whenever a broker-dealer or investment adviser uses any of a wide variety of technologies and seeks to communicate information derived from that use to an investor—even indirectly by providing investors with a research report or a subscription email—the use triggers burdensome regulatory requirements. In Commissioner Peirce's words: "Let us be honest about what we are doing here: banning technologies we do not like."[39] The effect is a far-reaching regulatory regime that burdens many categories of speech as a precautionary measure in order to target the far more limited category of speech that implicates an actual conflict of interest. The First Amendment does not permit this sort of overbroad regulation.

Nor does the proposed PDA Rule leave open ample alternative channels for communication of the information at issue. Indeed, as noted, the rule targets not just recommendations but also indirect communications, such as a firm-created website that posts "research reports, news, quotes, and charts." And because the definition of "covered technology" in the proposed PDA Rule is so broad, there often will be no alternative way for the investment adviser or broker-dealer even to gather the relevant information.

These constitutional deficiencies are particularly striking given that the Commission had far less restrictive alternatives before it. As Congress contemplated, the Commission could have promulgated rules restricting actual, identified conflicts of interest. Or the Commission could have relied on the disclosure regime to address conflicts of interest generally. But it was unconstitutional for the Commission to expand Congress's specific statutory mandate into a broad restriction on speech associated with these technologies.

Because the proposed PDA Rule is both unlawful and unconstitutional, NELF urges the Commission not to proceed with the Rule.

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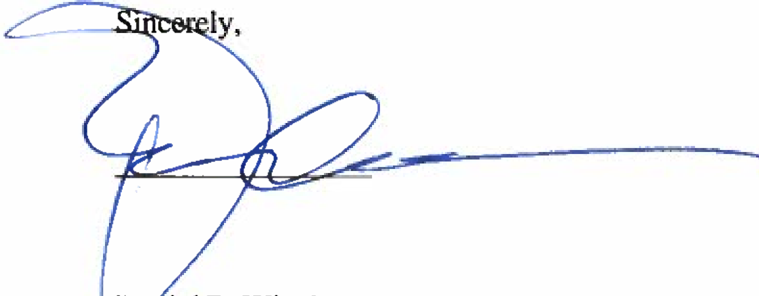
[37] *Id.* at 53,975.

[38] *Id.*

[39] Peirce Statement.

Sincerely,



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