The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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ICI Draft Letter on SEC Proposal Regarding Conflicts of Interest Raised by Broker-Dealers' and Advisers' Use of Predictive Data Analytics: Your Comments Requested by September 26

[35441]

September 19, 2023

TO: Investment Adviser and Broker-Dealer Standards of Conduct Working Group
Retail SMA Advisory Committee
SEC Rules Committee RE: ICI Draft Letter on SEC Proposal Regarding Conflicts of Interest Raised by Broker-Dealers' and Advisers' Use of Predictive Data Analytics - Your Comments Requested by September 26

On July 26, the SEC proposed sweeping new regulatory requirements to address purported risks to investors from conflicts of interest associated with the use of "covered technologies" by investment advisers and broker-dealers (collectively, "firms"). Proposed rules 15l-2 under the Securities Exchange Act of 1934 ("Exchange Act") applicable to broker-dealers and 211(h)(2)-4 under the Investment Advisers Act of 1940 ("Advisers Act") applicable to registered investment advisers (together, the "Proposed Rules" or the "Proposed Conflicts Rules") would require firms to evaluate their use of predictive data analytics and other covered technologies in connection with investor interactions and to eliminate or "neutralize" certain conflicts of interest associated with such use. The Commission also proposes amendments to rules under the Exchange Act and Advisers Act that would require firms to make and maintain certain records in accordance with the Proposed Conflicts Rules.[1]

ICI has drafted a comment letter, which is attached and summarized below. Please provide your written comments on our draft letter to Sarah Bessin (sarah.bessin@ici.org) and Mitra Surrell (mitra.surrell@ici.org) no later than Tuesday, September 26. We apologize for the short deadline, but comments are due to the SEC on October 10, and we plan to circulate a "fatal flaw" draft for your final review early the week of October 2.

ICI's letter urges the SEC to abandon these flawed rules. The Proposed Rules are ill-conceived and unnecessary and would have detrimental consequences for the very

investors the SEC intends to protect. In the guise of addressing unique risks raised by investment advisers' and broker-dealers' use of certain technologies, the Commission proposes to fundamentally change well-established legal principles that govern how firms' and their representatives' conflicts of interest must be addressed. The Proposed Rules raise Constitutional issues by unduly restricting firms' ability to communicate with investors. The Commission has not adequately demonstrated the existence of a problem that would justify such a radical change in regulation, nor has it provided sufficient public notice of its intent to do so. Furthermore, the Proposed Rules exceed the Commission's statutory authority and violate the Administrative Procedure Act (APA). The letter explains that the Commission has failed to adequately analyze the tremendous costs of this vague, flawed, and wide-ranging proposal for market participants and investors, which would outweigh any potential benefits.

Specifically, the letter explains that the SEC should promptly withdraw the Proposed Conflicts Rules for the following reasons:

- The Commission has provided no evidence that the Proposed Conflicts Rules are needed; the Proposed Rules are vague, unworkable, overreaching, substantively flawed and would harm the very investors the Commission purports to protect by stifling innovation, restricting financial education, and limiting access to affordable advice;
- Existing Standards of Conduct[2] for advisers and broker-dealers fully and appropriately address the SEC's concerns regarding conflicts of interest, as supported by Appendix A;
- The Proposed Rules violate the First Amendment by unduly limiting, without adequate justification, how firms communicate with investors and potential investors;
- The Proposed Rules exceed the Commission's statutory authority; and
- The Proposed Rules violate the APA. In the guise of addressing concerns raised by new technologies, the Commission seeks to change existing regulation without appropriate notice and comment. As discussed in Appendix B,[3] the rules are arbitrary and capricious. The Commission's economic analysis is fundamentally flawed, as it does not identify or analyze the costs and benefits of such a radical change to existing legal standards. By not being forthright about its intentions with these Proposed Rules, the Commission fails to adequately identify or consider the Proposal's costs and burdens, which overwhelmingly outweigh any potential benefits.

The letter explains that existing Standards of Conduct include well-developed principles for addressing conflicts of interest that can be readily tailored to new technologies and other market developments. The Commission should seek to promote a regulatory environment that encourages technological innovation that benefits investors and markets, rather than proposing rules that would have a severely chilling effect on technological innovation. The Commission therefore should first carefully identify the problem to be solved and tailor a solution proportionate to any concerns it identifies. If the Commission believes there may be gaps in how firms are applying existing Standards of Conduct to artificial intelligence (AI) and other new technologies, the Commission should clearly articulate its concerns and engage with market participants to better understand their use of technology how firms currently manage conflicts of interest. Following that inquiry, we would encourage the Commission to provide guidance or examples regarding how the Standards of Conduct apply to the use of AI and other sophisticated technologies under well-settled existing regulations and the current Standards of Conduct. This approach would be similar to the approach the SEC took in 2017 when its staff issued guidance regarding the application of fiduciary duty and other existing legal obligations to the activities of robo-advisers.

ICI's comments focus on the Proposed Rules' implications for (i) registered investment advisers, in their capacity as advisers to registered investment companies and separately managed accounts; (ii) registered investment companies, including mutual funds, exchange-traded funds, and closed-end funds (together, "funds") and their investors; and (iii) registered broker-dealers that sell fund shares. Our perspective reflects the important role each of these entities plays in helping retail investors achieve their investment goals.

Sarah A. Bessin
Deputy General Counsel - Markets, SMAs & CITs

Mitra Surrell
Associate General Counsel, Markets, SMAs, & CITs

Notes

[1] For a summary of the Proposal, please see ICI Memorandum No. 35390 (Aug. 2, 2023), available at https://www.ici.org/memo35390.

[2] Regulation Best Interest ("Reg BI") and the fiduciary duty applicable to investment advisers ("IA Fiduciary Standard," collectively, the "Standards of Conduct").

[3] ICI will include an Appendix B to the letter, which will be an economic analysis prepared by ICI's Research Department. We are not circulating Appendix B today, but plan to include a copy, for your information, when we circulate our "fatal flaw" draft of the comment letter.
