CITADEL

October 10, 2023

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

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

Dear Ms. Countryman:

We write to express our grave concerns with the Securities and Exchange Commission's (the "Commission") proposed rule regarding Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (the "Proposal").[1] For starters, the Proposal's name alone grossly misrepresents its ill-considered and over-expansive scope. Despite being advertised as narrowly focused on predictive data analytics, it would place reckless and unworkable restrictions on investment advisers' use of any technology in the investment process writ large. That said, even if it were more narrowly tailored, the Proposal remains poorly conceived and constructed. It would impair innovation, increase operational risk, and create a mountain of needless and costly documentation – all to the detriment of, and at the expense of, investors. Finally, the Proposal's requirements exceed the Commission's legal authority.

Over the past three decades, a wave of innovation has swept through the markets in response to new technologies and thoughtful regulation. This innovation has improved the experience of all investors, increased market efficiency and optimized the allocation of capital, in turn financing the groundbreaking companies and technology that have been vital ingredients to our global economic strength. Nowhere in the world has technological innovation benefited the markets and investors more than in the United States, where it has unleashed competition and expanded access to financial services.

The Proposal would alter this trajectory. Instead of fostering an environment that promotes technological innovation and competition, the Proposal would stifle it. While the Commission claims "the Proposal is intended to be technology neutral," that is only true in the sense that the Proposal is universally hostile to technology. Our comments in this letter focus on the Proposal's effects on private funds. However, we generally disagree with the fundamental premise of the Proposal: that existing regulatory frameworks do not adequately protect investors from an investment adviser's use of technology.

Substantively, the Proposal is overly broad, poorly designed, extremely vague, and creates enormous burdens each time an investment adviser uses technology.

[1] Conflicts of Interest Associated With the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53960 (Aug. 9, 2023).

First, the Proposal is disruptive and unworkable when applied to the management of private funds. The incredible breadth of the Proposal's definitions of "investor interaction" and "covered technology" would subject nearly every action that an adviser takes in the course of its day-to-day business to the proposed rule, from making portfolio management decisions on behalf of private funds it advises to answering due diligence questionnaires from prospective institutional investors. Further, the overbroad definition of "conflict of interest" would result in most of an adviser's "technologies" (again, as broadly defined) being wrongfully categorized as conflicted. Taken together, the scale of the review required by the proposal is unprecedented and impractical, resulting in significant disruptions to ordinary business operations. The costs of this compliance exercise would be massive and would provide no meaningful benefit to private fund investors.

The Proposal also breaks from decades of precedent by proposing to eliminate the ability of advisers to address potential conflicts of interest through disclosure, even for advisers to sophisticated investors in private funds. This radical change in approach is based on the Commission's baseless assertion that technology can be used to manipulate investor behavior, resulting in disclosure no longer serving as an effective mitigant. While this paternalistic view is flawed in many respects, the Commission's failure to consider different types of investors and levels of sophistication is inconsistent with prior Commission actions and the structure of the federal securities laws generally, and is arbitrary and capricious.

Second, the Commission's economic analysis is uninformed and deeply flawed. As with the rest of the Proposal, the Commission failed to analyze the economic effects of the Proposal as it relates to private funds. There is no analysis regarding the disparate impact the proposal would have on private funds or recognition that advisers to private funds use different technologies and employ different strategies than advisers to retail investors, which calls into question the articulated justifications for the proposal. The Commission's estimated costs are massively understated, and the purported benefits are unsupported and theoretical. The Commission's purported benefits are particularly weak given that existing regulations already require advisers to maintain reasonably designed policies, procedures, and controls to prevent violations of the federal securities laws (including an adviser's fiduciary duty) and Commission regulations thereunder, and these requirements already apply to the adviser's use of technology.[2] Regardless of whether these deficiencies were caused by carelessness or incognizance, the analysis clearly fails to comply with the Commission's statutory obligations.

Third, it is unclear if the Commission even intended the proposed rules to apply to private funds. Throughout the Proposal the Commission articulates concerns specific to retail investors, not sophisticated clients such as private funds, and the Commission failed to analyze or discuss the Proposal as it relates to the management of private funds at all. Also contributing to this ambiguity is the fact that, for broker-dealers, the rule is clearly limited to services provided to, and interactions with, retail investors. For investment advisers, however, the proposed rule appears to inexplicably apply to *all* of an adviser's clients, including private funds advised by the adviser. If the Commission intended the rule to apply to an adviser's management of private funds, this decision should have been fully discussed, and the costs of applying the rule to private funds should

[2] *See* Advisers Act Rule 206(4)-7.

have been fully evaluated in the Commission's cost-benefit analysis. If, by contrast, the proposed application was unintentional, it is clear evidence that the Proposal was not properly considered. Before proceeding the Commission must consider the effects of the Proposal on private funds and afford investment advisers to private funds a meaningful opportunity to comment on the Commission's analysis. Neglecting these statutory duties—failing to "apprise itself … of the economic consequences of a proposed regulation"—constitutes an arbitrary and capricious failure to consider statutorily required factors, in violation of the Administrative Procedure Act, 5 U.S.C. § 551 et seq.[3]

The Proposal also exceeds the Commission's statutory authority. The Commission purports to ground the Proposal in section 211(h) of the Investment Advisers Act of 1940 ("Advisers Act"), but section 211(h) concerns retail investors, not private funds. In any event, the Proposal is inconsistent with the plain text of section 211(h) in a multitude of other ways. Section 211(h) instructs the Commission to "examine" and, where appropriate, prohibit or restrict "certain" conflicts of interest. The Proposal does not restrict "certain" conflicts of interest, however; the Proposal sweeps in *all* purported "conflicts of interest." The Proposal, in fact, sweeps far beyond anything that could reasonably be called a "conflict of interest," redefining that term to include virtually any time an adviser has "an interest," even if it is *aligned* with the fund. That alone stretches section 211(h) beyond the breaking point.

The Proposal would harm investors and should be withdrawn in its entirety. Under the Administrative Procedure Act, "notice of a proposed rule must include sufficient detail on its content and bases in law and evidence to allow for meaningful and informed comment."[4] The Proposal fails to analyze or explain how the rule would apply to the management of private funds, depriving interested parties of the ability to comment on the Proposal's effects. To the extent the Commission moves forward with this rulemaking, at minimum, any new requirements under the Advisers Act should not apply to advisers of private funds.

---

[3] *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

[4] *Am. Med. Ass'n v. Reno*, 97 F.3d 1129, 1132 (D.C. Cir. 1995); see 5 U.S.C. § 553(b).

Table of Contents

I. The Proposal is Uniquely Disruptive and Illogical When Applied to Private Funds 5

A. The Proposed Definitions are Overbroad 5

B. The Proposed Requirements are Unworkable 6

C. The Proposal Eliminates the Ability of Firms to Disclose or Mitigate Potential Conflicts Through Full and Fair Disclosure 8

D. The Proposed Recordkeeping Requirements are Impermissibly Vague and Costly 9

II. The Commission's Cost Benefit Analysis is Deeply Flawed 10

III. The Commission Failed to Analyze the Proposal's Application to Private Funds 11

IV. The Proposal Exceeds the Commission's Statutory Authority 13

V. Conclusion 16

I. The Proposal is Uniquely Disruptive and Illogical When Applied to Private Funds

The Proposal would require investment advisers to evaluate the effects of "conflicts of interest" associated with an adviser's use (or reasonably foreseeable use) of "covered technologies" in "investor interactions," and eliminate or neutralize conflicts of interest that place the adviser's interest ahead of investors' interests. However, the incredible breadth of the Proposal's definitions of "investor interaction," and "covered technology" would subject nearly every action that an adviser takes in the course of its day-to-day business to the proposed rule. Further, the overbroad definition of "conflict of interest" would result in most of an adviser's "technologies" (as broadly defined) wrongfully categorized as conflicted. Taken together, the scope of the required review proposed by the Commission would not only be costly and ineffective, but unworkable. The Commission should abandon this flawed and reckless proposal, or at the very least return to the drawing board and re-propose it. The definitions of "investor interaction," "covered technology," and "conflict of interest" are core parts of the Proposal, but, as discussed below, the Commission cannot reasonably proceed with its unworkable definitions. This is not a problem the Commission could fix in a final rule; in order to be able to meaningfully comment on the Proposal, the public must have access to the core definitions in a "concrete and focused form."[5] Therefore, to proceed on this rulemaking, the Commission must, at the very least, re-propose with workable definitions.

A. The Proposed Definitions are Overbroad

First, the definition of "covered technology" lacks any rational basis and could be interpreted to capture any form of analysis used in connection with portfolio management. Specifically, the Proposal defines "covered technology" as "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."[6] This definition lacks any limiting principle, and appears to reclassify virtually every use of arithmetic in the investment management process as a "covered technology." Using "computational functions" to "forecast" "investment-related … outcomes" is at the core of any analyst's or portfolio manager's day-to-day job. But under the proposed definition, seemingly any form of fundamental analysis performed by an investment adviser, whether on a sheet of paper or an Excel spreadsheet, could be considered a covered technology.[7] For large private fund advisers that proposal could capture a truly immense number of analytical tools used in connection with an adviser's day to day management of advised funds.

The Commission's stated rationale for the Proposal cannot justify the sweeping definition of "covered technology" the Commission proposes. The Commission grounds this Proposal in claims about the supposedly uniquely powerful nature of new technologies such as artificial intelligence. The Commission is wrong on these matters, but even if it were not, the Commission has no logical basis to apply obligations targeted at those new technologies to the full range of "covered

---

[5] *Home Box Off., Inc. v. FCC*, 567 F.2d 9, 36 (D.C. Cir. 1977).

[6] Proposed Rule 211(h)(2)-4.

[7] Indeed, according to the Proposal, any spreadsheet that implements "financial modeling tools or calculations" to guide investment-related behavior would be a "covered technology." *See* Proposal at 53972.

technologies," which the Commission defines to include standard tools like Microsoft Excel. The mismatch between the Commission's stated rationale, on the one hand, and the Proposal's sweeping coverage, on the other, is itself arbitrary and capricious.

Second, the definition of "investor interaction" captures not only forms of "digital engagement" (i.e., pushes, nudges and other types of behavioral prompts that are directed to an individual investor), but also all discretionary management of portfolios.[8] When advisory clients provide an investment adviser with discretion, the client is, by definition, authorizing the adviser to act *without* interacting with the client. Defining investor interaction to include discretionary portfolio management is inconsistent with the plain English meaning of the phrase, and means that nearly every use of technology is considered to be in the context of an "investor interaction," thereby bringing it within scope of the proposed rule.

Third, the Commission's proposed new definition of "conflict of interest" is overbroad and illogical. Under the proposed rule, a "conflict of interest exists when an investment adviser uses a covered technology that takes into consideration *an interest* of the investment adviser."[9] This overbroad definition would classify basic uses of technologies as "conflicted" even in situations where an investor and an adviser's interests are aligned, or where the relevant technology explicitly puts the investor's interest ahead of the adviser's interest. For example, to the extent an adviser to a fund is compensated based on the performance of the fund, ostensibly the adviser would have "an interest" in every single investment decision, despite the fact that the fund and the adviser's motivations are aligned. This definition also conflicts with longstanding fiduciary principles and the SEC's own guidance, which make clear that conflicts of interest only exist where an adviser is inclined to place its own interest *ahead* of its clients.[10]

Applying the Proposal to private fund portfolio management will create significant impediments to and burdens on using any form of technology (as broadly defined) in an adviser's investment process. This will have profound, negative effects on the management of private funds, and on investor returns. By imposing unreasonable burdens on the use of analysis and technology, investors will face increased costs, greater inefficiencies, reduced returns, and less diversity in adviser product offerings.

B. The Proposed Requirements are Unworkable

The Proposal would require advisers to evaluate each "covered technology" to identify potential conflicts of interest, including by testing each covered technology prior to its implementation or material modification for potential conflicts of interest.[11] Advisers would be

---

[8] Proposed Rule 211(h)(2)-4 ("Investor interaction means engaging or communicating with an investor, *including by exercising discretion with respect to an investor's account*…") (emphasis added).

[9] Proposed Rule 211(h)(2)-4 (emphasis added).

[10] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers at 21 (June 5, 2019) ("Fiduciary Interpretation") ("The duty of loyalty requires that an adviser not subordinate its clients' interests to its own. In other words, an investment adviser must not place its own interest ahead of its client's interests") [internal citations omitted].

[11] Proposed Rule 211(h)(2)-4(b)(1).

required to document this review, along with a "written description of any material features of…any covered technology."[12] Requiring advisers to catalogue, analyze, and test every analytical tool that could fall under the proposed definition of "covered technology" would be completely impracticable. As described above, the proposed definition is likely to implicate an inordinate number of analytical tools used in connection with an adviser's portfolio management activities. This requirement would apply to all of an adviser's research, investment, trading, and risk management activities across a myriad of asset classes (e.g., equities, fixed income, commodities), thereby implicating a wide and varied array of analytical tools and methods. Even within a single asset class and within a single strategy, an adviser may use hundreds of different mathematical functions, models and projections to arrive at an investment thesis.

The overbroad definition of "conflict of interest" would further result in many of an adviser's "technologies" being wrongfully categorized as conflicted. In each case, the adviser would then be required to undertake additional review in order to determine whether any of the conflicts of interest result in placing the interest of the adviser ahead of the interest of investors, and if so, to eliminate or neutralize the effects of any conflict of interest.[13] The Proposal would, in practice, force advisers into proving the negative by requiring them to document why each purportedly conflicted technology does not, in fact, place their interests ahead of their clients. Once again, the scale of the review required by the Proposal is unprecedented and impractical. The costs of this compliance exercise would be massive, and provide no apparent benefits.

The Proposal would also create material impediments to adopting new, or modifying existing, covered technologies; delays that will harm investors. In addition to the requirements above, the Proposal would require advisers to analyze and test each covered technology prior to any material modification.[14] Even in instances where a change is not material, the Proposal would require a "record of each instance in which a *covered technology* was altered, overridden, or disabled, the reason for such action, and the date thereof…".[15] These onerous requirements will stifle technological innovation to the detriment of investors and U.S. capital markets.

For example, assume an investment analyst wants to enhance a model to optimize how it values certain securities. Under the proposed rule, before revising the model, it appears the adviser would first need to determine whether or not the modifications are material.[16] If they are material, the adviser would then need re-evaluate whether any use or "reasonably foreseeable potential use" involves a conflict of interest, which would include the requirement to test the technology for conflicts of interest prior to implementing any modification.[17] Given the broad definition of conflict, the adviser would then need to substantiate that the technology does not place its interest ahead of its clients.[18] The adviser would be required to document each step above, along with

[12] Proposed Rule 211(h)(2)-4(c)(1).

[13] Proposed Rule 211(h)(2)-4(b)(2).

[14] Proposed Rule 211(h)(2)-4(b)(1).

[15] Proposed Rule 204-2(a)(24)(vi).

[16] Proposed Rule 211(h)(2)-4(b)(1).

[17] Proposed Rule 211(h)(2)-4(b)(2).

[18] Proposed Rule 211(h)(2)-4(b)(2).

detailed descriptions of the testing performed and the changes made to the technology.[19] The costs associated with these requirements will be enormous, and the unnecessary delays in implementing changes could be harmful (including for example, to correct an error in a calculation or code).

C. The Proposal Eliminates the Ability of Firms to Disclose or Mitigate Potential Conflicts Through Full and Fair Disclosure

Breaking from decades of precedent and the Commission's own guidance,[20] the proposed rule would eliminate the ability of advisers to address potential conflicts of interest through disclosure. Instead, if an adviser determines that a conflict of interest associated with a covered technology places the interest of the investment adviser ahead of the interests of investors, the adviser would be required to "eliminate or neutralize" the effect of the conflict of interest.

With sweeping generalizations, the Commission asserts disclosure is no longer sufficient to mitigate potential conflicts of interest. Specifically, the Commission states: "disclosure may be ineffective in light of…the rate of investor interactions, the size of datasets, the complexity of the algorithms on which the PDA-like technology 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 variable, which could cause investors difficulty in understanding the disclosure."[21] First, this justification is inapplicable to the wide range of "covered technologies" swept into the Proposal. Second the Commission's failure to consider different investor types and levels of sophistication is inconsistent with prior Commission actions, the structure of the federal securities laws, and is arbitrary and capricious.

The Proposal directly contradicts the Commission's longstanding view that client sophistication is relevant when considering the effectiveness of disclosure. In the 2019 Fiduciary Interpretation, the Commission made clear that the scope of an adviser's fiduciary obligations differ for retail clients vs. sophisticated institutional clients with large portfolios, substantial knowledge, experience and analytical resources.[22] With regard to the specificity and effectiveness of disclosure, the Commission specifically acknowledged: "[f]ull and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[23] The Commission failed to justify the reversal of its longstanding position in now suggesting that disclosure is ineffective regardless of an investor's level of sophistication.

The Commission's failure to consider different investor types and levels of sophistication is also inconsistent with the structure of the federal securities laws. For example, Congress revised

---

[19] Proposed Rule 211(h)(2)-4(b)(1).

[20] Fiduciary Interpretation at 8.

[21] Proposal at 53967.

[22] Fiduciary Interpretation at 6.

[23] *Id.* at 25.

the Advisers Act to permit certain sophisticated investors (i.e., "qualified clients") to enter into advisory contracts with their investment advisers that provide performance-based compensation.[24] Congress has also found that certain "qualified purchasers" do not require the protections afforded by the Investment Company Act of 1940 because they are sophisticated investors able to "monitor for themselves such matters as management fees, transactions with affiliates, corporate governance, and leverage."[25] The Commission itself established the "qualified institutional buyer" standard for purposes of "identify[ing] a class of investors that can be conclusively assumed to be sophisticated and in little need of the protection afforded by the Securities Act's registration provisions."[26] Under the Proposal, irrespective of qualified client, qualified purchaser, or even a qualified institutional buyer status, the Commission has proposed to universally eliminate the ability of advisers to address potential conflicts of interest through full and fair disclosure. The Commission's failure to consider investor sophistication is arbitrary and capricious.

D. The Proposed Recordkeeping Requirements are Impermissibly Vague and Costly

While we assume that the Commission is not intending for advisers to prepare detailed records regarding their full suite of technology, the Commission failed to provide sufficient detail concerning the recordkeeping requirements in the Proposal. The Proposal would require investment advisers to maintain a list of all covered technologies,[27] written descriptions of "any material features of" covered technologies,[28] information about the adviser's evaluation of a covered technology's use,[29] and detailed information about the testing of covered technologies.[30] Taken to the extreme, these records could create a consolidated list of highly-sensitive information regarding an adviser's technology and investment operations.

Technology used by an investment firm is often its most valuable intellectual property and critical to its overall commercial success and viability. The Commission provides little detail regarding the descriptions the Proposal would require, including the level of detail advisers would be expected to provide regarding each technology. Even if the Commission only intended for advisers to maintain this information at a high-level, this information would likely be commercially sensitive, and the requirement would increase the risks of inadvertent disclosure.

[24] Section 205(e) of the Advisers. Section 205(e) provides that the Commission may determine that persons do not need the protections of section 205(a)(1) on the basis of such factors as "financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with [section 205]." Qualified clients generally include persons with a net worth of $2.2 million (excluding the value of the investor's primary residence).

[25] U.S. Sec. & Exch. Comm'n.,Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, 104-05 (May 1992) (emphasis added). Qualified purchasers generally include natural persons with $5 million or more in investments.

[26] See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Release No. 33-6806 (Oct. 25, 1988). Qualified institutional buyers generally include entities that own and invest on a discretionary basis at least $100 million in securities of unaffiliated issuers.

[27] Proposed Rule 204-2(a)(24)(i)(A).

[28] Proposed Rule 211(h)(2)-4(c)(1).

[29] Proposed Rule 204-2(a)(24)(i)(A)(2).

[30] Proposed Rule 204-2(a)(24)(i)(B).

The Commission should eliminate the proposed recordkeeping requirements in their entirety. While we are limited in our ability to comment on the precise contours of the requirement given the vagueness of the Proposal, even if we assume the Commission intended for these records to include cursory descriptions of an adviser's technology it could still create significant costs and intellectual property risks for investment advisers.

II. The Commission's Cost Benefit Analysis is Deeply Flawed

The Investment Advisers Act of 1940 requires the Commission to determine whether a rulemaking will "promote efficiency, competition, and capital formation."[31] The Commission's analysis here is clearly insufficient.

Notably, the Commissioner failed to analyze the effects of the Proposal on private funds. The only discussion specifically referencing private funds simply notes the number of private funds reported on Form PF and the number of registered investment advisers that list private funds on their Form ADV.[32] The Commission then concludes that "[b]ecause of the wide diversity of services and relationships offered by firms, we expect that the obligations imposed by the proposed rules would, accordingly, vary substantially."[33] There is no analysis regarding the disparate impact the proposal would have on private funds, for example, that advisers to private funds use different technologies and employ different strategies than advisers to retail investors, which may result in significantly different cost profiles. There is also no discussion of the purported benefits of the Proposal to private funds and their investors, of which there likely are none, given the comprehensive regulatory framework in place today. Existing regulations already require advisers to maintain reasonably designed policies, procedures, and controls to prevent violations of the federal securities laws (including an adviser's fiduciary duties) and Commission regulations thereunder, and these requirements already apply to an investment adviser's use of technology.[34]

The Proposal's quantitative analysis is similarly woefully inadequate and materially understates the costs. The Commission estimates that the *total costs* to initially comply with the Proposal for a "complex covered technology firm" will amount to $156,100. To arrive at this figure, the Commission estimates that it will initially take 100 hours to evaluate all of an adviser's covered technologies (with a total costs to the firm estimated at $44,600); 50 hours to determine which conflicts of interest require elimination or neutralization (total costs of $22,300); and 200 hours to eliminate or neutralize the effects of conflicts of interest (total costs of $89,200). Further, to arrive at the total ongoing annual costs, the Commission simply halves the initial estimate, estimating it will cost complex covered technology firms $78,050 a year to comply.

These estimates lack any rational basis and demonstrate a fundamental misunderstanding of the impact the rules would have. In reality, complying with the proposed rules (to the extent doing so is even possible) would require thousands of hours of legal, compliance, technology, and

---

[31] 15 U.S.C. § 80b-1.

[32] Proposal at 54000.

[33] *Id.*

[34] *See* Advisers Act Rule 206(4)-7.

business personnel attention and the creation of entirely new internal control frameworks to oversee compliance on an ongoing basis. Indeed, firms would need to hire dedicated compliance staff to evaluate changes to various analytical tools and other technologies that are used in the ordinary course of business. This is to say nothing of the costs associated with the additional frictions introduced with respect to a firm's use of technology generally and the impact of these delays on investment performance.

Finally, the Commission provides no quantitative analysis of purported benefits, relying only on baseless assertions. The Commission simply states that the requirement to eliminate or neutralize conflicts of interest "could enhance investor protection by eliminating or neutralizing the effects of certain conflicts of interest, particularly in the context of the increasing scope and scale of investor interactions made possible by new technologies and by firms' increased ability to influence investor behavior in interactions that may not be viewed as constituting a recommendation or investment advice."[35] Once again, this statement represents a fundamental misunderstanding of the Proposal, which not only captures interactions that do not constitute a recommendation or advice, but all discretionary portfolio management. Thus, it appears the Commission does not even attempt to identify purported benefits arising from subjecting private funds to this Proposal.

III. The Commission Failed to Analyze the Proposal's Application to Private Funds

Given the failure of the Commission to analyze or discuss the Proposal in the context of private funds, it is unclear if the Proposal was even intended to cover private funds. The Commission proposes to establish new requirements for broker-dealers and investment advisers when interacting with "investors"—but inexplicably appears to apply the rule to all of an investment adviser's clients (including sophisticated institutional investors) while only applying the rule to a broker-dealer's retail clients.

Specifically, for broker-dealers, the proposed rule would only apply when a broker-dealer is interacting with retail investors receiving services for "personal, family or household purposes."[36] For investment advisers, however, the Proposal would apply whenever the adviser is interacting with a prospective or current "*client*" (as well as directly with any prospective or current investor in a pooled investment vehicle).[37] Thus, it appears that all of an investment adviser's interactions with its institutional clients, including private funds, would be subject to the proposed rules.

The Commission provides no explanation for this significant difference, which materially expands the scope and burden of the Proposal for investment advisers. If the Commission did intend the rule to apply to advisers' management of private funds, this decision should have been fully discussed, and the costs of applying the rule to private funds should have been fully evaluated in the Commission's cost-benefit analysis. If this application was unintentional, it is clear evidence that the Proposal was not properly considered.

---

[35] *Id.* at 54006.

[36] Proposed Rule 15l-2(a).

[37] Proposed Rule 211(h)(2)-4.

Had the Commission considered private funds in the Proposal, it would have been obvious that the proposed rules are entirely inappropriate in the context of private funds. The theoretical harms the Commission alleges in the Proposal relate to retail investors—not to investment advisers managing private funds.

This is clear with respect to the Commission's stated concerns regarding the "scalability" of certain technologies, where the Commission notes "the advent and growth of services available on certain digital platforms, such as those offered by online brokerages and robo-advisers, have multiplied opportunities for *retail investors*, in particular, to invest and trade in securities, and in small amounts through fractional shares."[38] The Proposal continues to cite concerns specific to retail investors. The Commission states, for example "increased accessibility has been one of the key factors associated with the increase of *retail investor* participation in U.S. securities markets in recent years."[39] The Commission's list of digital engagement practices that contribute to the alleged scalability concerns also are specific to retail investors, including "behavioral prompts, differential marketing, [and] game-like features." Indeed, the Commission explicitly notes that these design elements or features are designed to engage "*retail investors* when using a firm's digital platforms for services such as trading, robo-advice, and financial education."[40] In the 239 page release the Proposal refers to "robo-advisers" more than 40 times. In contrast, the Proposal refers to private funds on only 5 occasions, none of which discuss the rule's application to private funds as "advisory clients" (e.g., exercising discretionary authority over a private fund client's portfolio).

The Commission's discussion of purported conflicts of interest is similarly focused on conflicts applicable to retail investors. The Commission argues that technologies that use predictive data analytics may encourage practices that are profitable for the broker-dealer or investment adviser at the expense of clients, including by encourage "excessive trading," "using trading strategies that carry additional risks (e.g., options trading and trading on margin)", and "trading in complex securities products that are more remunerative to the firm but post undue risk to the investor."[41] Once again, these purported concerns clearly relate to retail investors, not the management of private funds.

The Commission's failure to describe a market failure applicable to private funds stems from the fact that there is no failure or gap in regulation the Proposal would address. Advisers are already subject to comprehensive regulation under the Advisers Act. This includes the investment adviser's fiduciary duty, which comprises a duty of care and a duty of loyalty. As the Commission explained in 2019, this prohibits an investment adviser from placing its own interest ahead of the interests of its clients.[42] To meet its fiduciary obligations, advisers must eliminate or "expose through full and fair disclosure all conflicts of interest which might incline an investment adviser-

---

[38] Proposal at 53963.

[39] *Id.* at 53964.

[40] *Id.*

[41] *Id.* at 53968.

[42] Fiduciary Interpretation at 8.

consciously or unconsciously-to render advice which is not disinterested."[43] As described above, existing regulations also already require advisers to maintain reasonably designed policies, procedures, and controls to prevent violations of the federal securities laws and Commission regulations thereunder, and these requirements already apply to an investment adviser's use of technology.[44] Thus, existing rules already require advisers to analyze and eliminate or disclose conflicts of interest associated with the use of technology.

As the Commission has also acknowledged, investors in private funds that are exempt from registration under Section 3(c)(7) of the Investment Company Act of 1940 are sophisticated and, by definition, need to meet certain qualification standards. That was the framework intentionally set forth by Congress. This entire regulatory framework and exemption availability is based on the premise that such investors are capable of understanding the risks that an investment in a private fund may pose, provided that the adviser shares with them full and fair disclosure as they make their investment determination(s). Advisers are required to do so both in their Form ADV brochures and in their fund offering memoranda, and to the extent that an adviser provides any advertisement to a prospective investor, such advertisement must comply with all of the requirements and prohibitions set forth in the Commission's newly adopted Rule 206(4)-1 (the "Marketing Rule"). The Commission has failed to identify any reason why this set of requirements and obligations—combined with its examination regime and ability to impose penalties on bad actors—is insufficient.

Before proceeding the Commission must consider the effects of the Proposal on private funds, and afford investment advisers to private funds a meaningful opportunity to comment on the Commission's analysis. Neglecting these statutory duties—failing to "apprise itself … of the economic consequences of a proposed regulation"—constitutes an arbitrary and capricious failure to consider statutorily required factors, in violation of the Administrative Procedure Act, 5 U.S.C. § 551 et seq.[45]

IV. The Proposal Exceeds the Commission's Statutory Authority

The Proposal also exceeds the Commission's statutory authority. The Commission has "no power to act … unless and until Congress authorizes it to do so by statute."[46] Here, the Commission claims authority to regulate virtually any aspect of a private fund adviser's use of technology under section 211(h) of the Advisers Act. That section has no application here.

First, section 211(h) is not applicable to private fund advisers. Congress, in the securities laws, drew a sharp distinction between private funds, on the one hand, and registered investment companies, on the other. Registered investment companies serve ordinary retail investors and are governed by prescriptive regulations concerning almost every aspect of the companies'

[43] *Id.* at 22.

[44] *See* Advisers Act Rule 206(4)-7.

[45] *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

[46] *FEC v. Cruz*, 142 S. Ct. 1638, 1649 (2022).

operations.[47] Private funds, in contrast, generally serve "qualified purchasers"[48]—"high[ly]" "sophisticat[ed]" investors whom Congress presumed to be in a position "to evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage[,] and redemption or withdrawal rights."[49] Congress, consequently, exempted private funds from the type of prescriptive regulations applicable to registered investment companies,[50] and nothing in section 211(h) changes that dynamic.

Congress enacted section 211(h) as part of section 913 of the Dodd-Frank Act.[51] Section 913 does not mention private fund advisers. Instead, it mentions "retail customers" repeatedly. Section 913 instructs the Commission to "study" the "effectiveness of existing legal or regulatory standards of care for brokers, dealers, [and] investment advisers" with respect to the provision of "personalized investment advice and recommendations about securities to retail customers."[52] And it further authorizes the Commission to set a new standard of care with respect to "personalized investment advice about securities to a retail customer."[53] In a paragraph at the end of section 913, titled "Other Matters," Congress also adopts what is now codified at section 211(h), which authorizes the Commission to prohibit certain "sales practices, conflicts of interest, and compensation schemes."[54] But that provision, like all of section 913, is, in context, referring to retail customers. It is not plausible that Congress hid in the "mousehole[]"[55] of an ancillary provision on "Other Matters," buried in a section of Dodd-Frank focused exclusively on retail customers, a broad, heretofore unrecognized power, to regulate virtually every use of technology by a private fund adviser which does not serve retail customers. Congress does not "hide elephants in mouseholes."[56]

Other textual clues highlight the implausibility of the Commission's current reading of section 211(h), as applied to private fund advisers. For one, Title IV of Dodd-Frank focuses exclusively on "private fund advisers."[57] Accordingly, if Congress wanted to authorize the Commission to broadly regulate private fund advisers' use of technology, Congress would have placed that authority in Title IV, not in section 913. Further, section 211(h) is not, as is the Proposal, focused on just "conflicts of interest"; section 211(h) is focused on "sales practices, conflicts of interest,

---

[47] *See, e.g.*, 15 U.S.C. §§ 80a-1 to -64.

[48] *Id.* § 80a-3(c)(7)(A).

[49] Private Investment Companies, 61 Fed. Reg. 68,100, 68,102 (Dec. 26, 1996) (citing S. Rep. No. 104-293, at 10 (1996)).

[50] *See* 15 U.S.C. § 80a-3(c)(1), (c)(7).

[51] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1824 (2010).

[52] *Id.*

[53] *Id.* at 1828.

[54] *Id.* (codified at 15 U.S.C. § 80b-11(h)(2)).

[55] *Whitman v. American Trucking Ass'ns, Inc.*, 531 U.S. 457, 468 (2001).

[56] *Id.*

[57] 124 Stat. at 1570.

and compensation schemes."[58] These linked phrases have a "related meaning[]."[59] They refer to the structural incentives, such as sales quotas and the like, that may encourage an adviser to push an investor, through aggressive cold-calling, for example, into an unsuitable transaction.[60] This has nothing to do with private funds.

Second, even *if* section 211(h) could be applied to private fund advisers, section 211(h), by its plain terms, cannot sustain the Proposal anyway. Section 211(h) authorizes the Commission 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."[61] The Proposal, however, does not restrict or prohibit "*certain*" conflicts of interest; it addresses "*all* conflicts of interests" connected to the use of technology.[62] "All" is the opposite of "certain."[63] Under section 211(h), the Commission must "examine" and, "where appropriate," prohibit or restrict "certain" conflicts of interest; the Commission cannot just swipe at "*any* conflict of interest," without further specification.[64] As the Commission itself recently acknowledged, the word "certain" in section 211(h) "indicates that [this section] does not apply to all sales practices, conflicts of interest and compensation schemes, but rather only those that, after examination, the Commission deems contrary to the public interest and protection of investors."[65] The Proposal's reach to "*all* conflicts of interest"[66] exceeds the Commission's own understanding of its authority.

Third, even if the Proposal applied to "certain" conflicts of interest, it does not "prohibit[]" or "restrict[]" them. The power to prohibit or restrict implies a negative power—a power to restrain or ban a particular conflict of interest. The Proposal goes well beyond that. It requires private fund advisers to "evaluate" the use of technology and "[d]etermine" whether that use creates a conflict of interest.[67] It further requires the advisers to "adopt and implement written policies and procedures" to carry out the above.[68] That is not *banning* a particular conflict of interest—one the

[58] 15 U.S.C. § 80b-11(h)(2).

[59] *Third Nat'l Bank in Nashville v. Impac Ltd., Inc.*, 432 U.S. 312, 322 (1977).

[60] *See, e.g.*, Regulation Best Interest, 84 Fed. Reg. 33318, 33454 (July 12, 2019) (explaining that "conflicts of interest associated" with certain sales practices, such as "sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time," "may create high-pressure situations for the associated persons of the broker-dealer to recommend a specific security over another").

[61] 15 U.S.C. §§ 78o(l)(2), 80b-11(h)(2) (emphasis added).

[62] Proposal at 53978 (emphasis added).

[63] *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." (ellipsis in original)).

[64] Proposal at 53978 (emphasis added).

[65] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance, 88 Fed. Reg. 63206, 63216 (Sept. 14, 2023).

[66] Proposal at 53978 (emphasis added).

[67] *Id.* at 54023.

[68] *Id.*

Commission itself "examined";[69] it is forcing private fund advisers to go out and themselves identify and "examine" potential conflicts of interest, exactly what Congress told the Commission to do in the first instance. If Congress wanted to require private fund advisers to develop their own "written policies and procedures" for identifying conflicts of interests, Congress knew how to say that,[70] but it did not. Congress instructed *the Commission* to identify the conflicts of interest that are prohibited, and the Proposal here does not do that.

Finally, the Proposal does not regulate "conflicts of interest," at least within any recognizable meaning of that phrase. In what the Commission calls a "broad definition of conflict of interest,"[71] the Proposal addresses any scenario (involving technology) where a private fund adviser "takes into consideration an interest" of its own.[72] That is not—and has never been—the meaning of the phrase "conflict of interest." Everyone "takes into consideration" one's interests. A "conflict of interest," a term of art, arises in the context of a fiduciary relationship, where there is an "incompatibility" between the interests of the fiduciary and its responsibility to the principal[73]—think a lawyer representing two sides of the same case. Here, the Proposal sweeps in *any* scenario in which an adviser has "an interest," even if that interest is aligned with the entity the adviser is advising, and even if the interest has nothing to do with the adviser's duties as an investment adviser. The Commission cannot bulldoze the meaning of "conflicts of interest" in the name of regulating it.

For any of the above reasons, the Commission's Proposal far exceeds its statutory authority, and the Commission should abandon the Proposal with respect to private fund advisers for this reason alone.

V. Conclusion

The Proposal would harm investors and should be withdrawn in its entirety. Under the Administrative Procedure Act, "notice of a proposed rule must include sufficient detail on its content and bases in law and evidence to allow for meaningful and informed comment."[74] The Proposal fails to analyze or explain how the rule would apply to the management of private funds, depriving interested parties of the ability to comment on the Proposal's effects. To the extent the Commission moves forward with this rulemaking, at minimum, any new requirements under the Advisers Act should not apply to advisers of private funds.

---

[69] 15 U.S.C. § 80b-11(h)(2).

[70] *Id.* § 80b-4a.

[71] Proposal at 53982.

[72] *Id.* at 54023.

[73] Black's Law Dictionary (11th ed. 2019) (defining conflict of interest).

[74] Am. Med. Ass'n v. Reno, 97 F.3d 1129, 1132 (D.C. Cir. 1995); see 5 U.S.C. § 553(b).

*   *   *   *   *   *   *   *   *   *

Please feel free to contact the undersigned with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger
Managing Director
Global Head of Government & Regulatory Policy