October 10, 2023

Securities and Exchange Commission
Attn: Chairman Gary Gensler
100 F Street NE
Washington, DC 20549-1090

Dear Chairman Gensler,

As State Financial Officers, we write to express our opposition to the Securities and Exchange Commission's (the "SEC") proposed rules regarding Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers (the "Proposed Rules"). The Proposed Rules' burdensome requirements would drive up costs for investors, harm competition, and limit investor options. The SEC fails to justify the need to impose these costs and harms, and fails to explain why the Proposed Rules are necessary.

The Proposed Rules muddy broker-dealers and investment advisers' ("firms") existing legal duties by imposing several layers of costly bureaucracy on firms who use technology to better serve their clients, and at least some of these costs will be passed on to our state and to other investors in our states.[1] The Proposed Rules' overly prescriptive requirements, including restrictions on the use of third parties to assist with compliance, also would disproportionately affect smaller firms, reducing competition in the market and limiting investors' options.

The SEC justifies the Proposed Rules' significant costs and sweeping application based on its fear that new technology could create issues, but fails to provide any real-world examples or

[1] *See* Proposing Release at 87–88 ("[i]nvestment advisers using … technologies to provide investment advice are already required to consider whether they could cause the adviser consciously or unconsciously to render advice which is not disinterested").

evidence justifying this fear. Rather than focusing on its fears, the SEC should consider the facts: the Proposed Rules will result in higher costs and less competition for our states and for other investors in our states.

I. The Proposed Rules Impose Costly Bureaucracy, Resulting in Additional Costs for Investors

a. The Proposed Rules Will Impose Substantial Costs, Which Likely Will Be Passed on to Investors

The Proposed Rules' required testing would be extremely costly and time-consuming.[2] Under that process, the Proposed Rules would require that firms extensively analyze "*any* use or *reasonably foreseeable potential* use of a covered technology … in *any* investor interaction,"[3] even if the firm has no current intent to employ some of those uses.[4] The Proposed Rules also require firms to "periodically retest" the tool, with more frequent retesting for more complex tools.[5] Finally, the Proposed Rules require the creation of highly detailed written policies and procedures.[6]

Although the Proposed Rules appear to be aimed at more sophisticated tools such as machine learning, they would force testing costs for anything that is "analytical, technological, or computational."[7] For example, the SEC expressly notes that the Proposed Rules include tools such as "basic financial models contained in spreadsheets,"[8] and perhaps even more basic tools—as Commissioner Peirce warns, "it could result in countless hours of efforts to document why things like the simple desktop calculator do not have any conflicts of interest."[9] That needless expense will likely be passed on as a cost to our states and to other investors in our states.

The difficulty of the Proposed Rules' testing will only increase with the complexity level of the technology. As the release itself notes, even "one conflicted factor among thousands in the

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[2] Statement of Commissioner Peirce, https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623 (calling the process "uniquely onerous").
[3] Proposing Release at 230, 237 (emphases added).
[4] *See* Proposing Release at 60 ("any use or reasonably foreseeable potential use"); *id.* at 62 (stating that a firm must test all reasonably foreseeable uses "unless the firm has taken reasonable steps to prevent use of the technology in scenarios it has not approved").
[5] Proposing Release at 74 ("firms that use complex covered technologies generally should use testing methodologies and *frequencies that are tailored to this complexity*" (emphasis added)).
[6] Proposing Release at 41.
[7] Proposing Release at 230.
[8] Proposing Release at 62; *see id.* at 137 (Proposed Rules would cover "straightforward mathematical models such as those contained in spreadsheets").
[9] Statement of Commissioner Peirce, https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623; *see* Statement of Commissioner Uyeda, https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623 (same).

algorithm or data set" may violate the Proposed Rules,[10] and some software may literally be drawing from "millions of data points."[11] Yet the SEC warns that firms will be held responsible if they do not have "full visibility" into their systems,[12] and disallows the use of third-party consultants to perform the analysis, even though such an analysis may be well beyond a firm's capabilities.[13] Firms thus would have to undertake massive internal costs to use complex technologies, and those higher costs also will likely be passed along.

Therefore, despite the SEC's profession that the Proposed Rules are intended to be "technologically neutral,"[14] these rules clearly target more complex tools, regardless of the tools' benefits to investors. Investment technology is always advancing, and firms and investors today have more factors to analyze than ever before, but the SEC seems determined to stand in the way of progress.

The Proposed Rules would discourage use of technology,[15] as firms either take on more costs to use complex technology, or retreat to "relatively simple" technology to reduce costs and liability.[16]This will have the likely effect of harming investors – specifically retail investors – who are often the beneficiaries of this technology. It's not hard to imagine what that might look like: longer wait times for small investors to interact with their broker and less sophisticated automation used in determining investment options. Both are stated benefits of this technology currently. As Commissioner Peirce stated: "Let us be honest about what we are doing here: banning technologies we do not like."[17]

b. The Proposed Rules Will Disadvantage Smaller Firms, Discourage Technology Use, and Decrease Competition

As noted above, under the Proposed Rules, firms must conduct expensive and difficult analyses of virtually all technology. Firms must conduct this testing regardless of whether the firm developed the tool itself or bought it from a third party.[18] The latter case potentially presents even more testing challenges, as a purchase of a software product does not necessarily grant the purchaser any insights into the software's internal operation or development. In such situations, the Proposed Rules would demand that firms either (1) analyze the source code or documentation that is "sufficiently detailed as to how the technology works,"[19] or (2) not use

[10] Proposing Release at 81.
[11] Proposing Release at 65.
[12] Proposing Release at 60, 65–66.
[13] *See* Proposing Release at 72 (asking for comments on whether to allow the use of third-party consultants).
[14] Proposing Release at 39.
[15] Proposing Release at 188.
[16] Proposing Release at 115.
[17] Statement of Commissioner Peirce, https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623.
[18] Proposing Release at 44–45.
[19] *See* Proposing Release at 63, 64.

the software at all.[20] And as noted above, firms cannot hire third parties to assist, and would have to try to undergo this analysis on their own.[21]

All of this would place a heavier burden on smaller firms, which are more likely to rely on third-party software or third-party consultants than to have that expertise in-house.[22] As the SEC admits, the Proposed Rules could make it "challenging for smaller firms to compete with larger firms utilizing covered technologies."[23]

c. The Proposed Rules Will Hurt Investors

The result of the Proposed Rules will be harm to investors in three primary ways. First, investors will face higher costs due to firms passing along some or all of the costs to conduct onerous testing. Second, investors will miss out on technological tools that firms elect not to use due to the high cost of testing such tools. Third, investors also will have fewer choices, as competition decreases due to the Proposed Rules not only will reduce existing market participants' use of technologies that could benefit consumers, they will also create competitive barriers for small firms or possible market entrants.

II. The Proposed Rules Fail to Justify Their Added Expense and Difficulty

One would expect that the Proposed Rules' burdensome and expensive testing requirements must be justified based on prior incidents where those requirements would have helped. But, as others have put it, any such evidence is "strikingly absent,"[24] replaced instead with the speculation of the SEC that a problem *could* arise in the future,[25] or concern about firms *intentionally* leading investors astray.[26]

For example, the SEC notes that it recently brought an enforcement action against an adviser who allegedly pre-set its robo-adviser portfolios to hold a certain percent of assets in cash in order to benefit the adviser's affiliate.[27] The SEC's example defeats its point, as it shows

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[20] *See* Proposing Release at 65 ("a firm's lack of visibility [into a covered technology] would not absolve it of the responsibility"); *id.* at 121 ("it would be impossible for firms to use such covered technologies … where they are unable to identify all conflicts of interest associated with the use of such covered technology").
[21] *See* Proposing Release at 72 (asking whether the Proposed Rules should be changed to allow the use of third-party consultants).
[22] *See* Proposing Release at 97.
[23] Proposing Release at 193; *see id.* ("larger firms with a larger client or customer base may have a competitive advantage over smaller firms" under the Proposed Rules); *id.* at 194 ("smaller firms who may struggle to absorb these additional costs").
[24] Hardy Callcott, et al., *SEC's New Rules on Use of Data Analytics by Broker-Dealers and Investment Advisers* (Aug. 26, 2023), https://corpgov.law.harvard.edu/2023/08/26/secs-new-rules-on-use-of-data-analytics-by-broker-dealers-and-investment-advisers/.
[25] *See, e.g.*, Proposing Release at 25 ("can lead to outcomes"); *id.* at 30 ("could have the effect").
[26] *See, e.g.*, Proposing Release at 20 n.56 (expressing concern about the intentional programming of advisory tools to favor the firm); *id.* at 25–26 (firms could "inappropriately steer investors toward complex and risky securities").
[27] Proposing Release at 30–31.

that the SEC "already ha[s] the ability to pursue bad actors."[28] Indeed, the SEC brought an enforcement action against that adviser for willfully violating the Investment Advisers Act, and obtained over $45 million in disgorgement for affected investors, plus a $135 million civil penalty.[29] In contrast, the SEC does not list any actual examples of past conduct that would not already be addressed by the current rules.

Advancements in investment technologies have benefited investors in the past,[30] and new technologies subject to traditional safeguards are likely to do the same. Even the SEC admits that the use of these new technologies "can bring benefits in market access, efficiency, and returns."[31] But these benefits would be dramatically reduced by the Proposed Rules, which would increase the cost and discourage the use of such technologies.[32]

III. The Proposed Rules Do Not Promote Efficiency, Competition, or Capital Formation

The SEC has a statutory duty to "promote efficiency, competition, and capital formation" when it proposes rules,[33] but the Proposed Rules here would do the opposite.

a. The Proposed Rules Would Decrease Efficiency

As discussed above, the rules would impose significant costs on the use of all kinds of technologies. The onerous testing regime imposed by the Proposed Rules is certain to increase costs, consume firm time and resources, and discourage the use of technology, thus decreasing efficiency by increasing costs to investors and removing technologies that benefit investors.

The SEC acknowledges all of these real-world effects,[34] yet it contends that that the Proposed Rules would nonetheless *increase* efficiency because they would "provid[e] investors with greater confidence" and stop investors from doing their own analyses on the technologies used.[35] These hypothetical improvements in efficiency are unsupported by any evidence, and rely solely on the assumption that investors are just as worried about technology as the SEC is. The SEC also ignores the fact that investors that have concerns about new technology can choose firms that do not use such technology.

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[28] Statement of Commissioner Peirce, https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623; *see* Statement of Commissioner Uyeda, https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623 (noting that the Proposed Rules are "unnecessary" under the current framework); Proposing Release at 87–88.

[29] In re. Charles Schwab & Co., Inc., et al., Exchange Act Release No. 95087 (June 13, 2022) (settled order), https://www.sec.gov/files/litigation/admin/2022/34-95087.pdf.

[30] Proposing Release at 12.

[31] Proposing Release at 6.

[32] *See, e.g.*, Proposing Release at 188.

[33] 15 USCA § 78c; Proposing Release at 142–43.

[34] *See, e.g.*, Proposing Release at 182–190 (listing direct and indirect costs to firms); *id.* at 194–195 (listing impacts on technology use).

[35] Proposing Release at 191.

b. The Proposed Rules Would Decrease Competition

Similarly, though the SEC acknowledges that the Proposed Rules would decrease technology use and disproportionately affect smaller firms,[36] it concludes that the Proposed Rules would *increase* competition.[37] Once again, the SEC invokes its hoped-for boost in investor confidence to support this conclusion.[38] The SEC also argues that investors would "put additional weight on key factors" such as fees.[39] Though the SEC provides no support for this statement, in one sense it is true—if firms are limited from competing with different technologies that benefit investors, investors will be forced to more heavily weight other factors such as fees. However, reducing the areas in which firms can compete would be a net loss to competition.

Under the Proposed Rules, firms must consider that creating newer, more sophisticated tools will result in additional costs for testing and retesting, as well as additional potential liability.[40] This will "slow down the rate at which firms update existing or develop or adopt new technologies," "slow the overall rate of updates," and "reduce the quality or increase the cost of the technology or service for investors."[41] Investors such as our states will not only pay more (both due to increased testing costs and decreased competition), they will be prevented from choosing beneficial technological tools.

c. The Proposed Rules Would Decrease Capital Formation

The SEC does not contend that the Proposed Rules would benefit capital formation. It invokes investor confidence, but admits that costs may outweigh those gains.[42] It notes that the Proposed Rules may "result in increased fees for investors or deter firms from using covered technologies in investor interaction," both of which would hinder capital formation.[43] The SEC also acknowledges that the Proposed Rules "could be particularly problematic for smaller firms who may struggle to absorb these additional costs."[44] Finally, the SEC states that capital formation "could be hindered" if the "costs of the technology are too high and firms avoid using certain covered technologies that benefit investors."[45]

The SEC's concerns as to capital formation are correct, except that all of these effects are virtually certain to follow from the Proposed Rules, rather than just possible.

IV. The Proposed Rules Should Be Resubmitted If Substantially Changed

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[36] *See, e.g.*, Proposing Release at 193–194 (listing impacts on smaller firms).
[37] Proposing Release at 193.
[38] Proposing Release at 193.
[39] Proposing Release at 193.
[40] *See* Proposing Release at 60.
[41] *See* Proposing Release at 188, 190.
[42] Proposing Release at 194.
[43] Proposing Release at 194.
[44] Proposing Release at 194.
[45] Proposing Release at 195.

Commissioner Uyeda has expressed concern about "the pattern of recent Commission proposals in which somewhat outlandish components were included, which drew the attention and focus of commenters," only to have the SEC "pivot[] to a different approach at final rule adoption, the details of which had never been fully previewed to the public."[46] As discussed above, the Proposed Rules raise serious concerns and impose significant costs. If the SEC elects to take a different approach to this issue and make substantial changes to the Proposed Rules, it should resubmit the proposal.

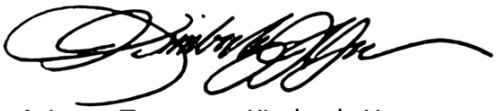
V. Conclusion

The Proposed Rules' approach of imposing extensive costs for unclear and uncertain benefits is unnecessary, unhelpful, and unjustified. The SEC should not adopt the Proposed Rules.

Thank you for the opportunity to provide comments.

Respectfully submitted,

Alaska Commissioner of Revenue Adam Crum



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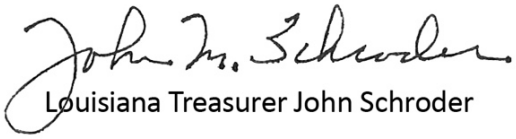

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[46] Statement of Commissioner Uyeda, https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623

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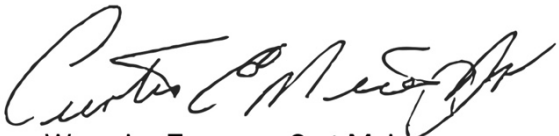

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