April 12, 2024

Via Electronic Submission

Vanessa A. Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 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:

MFA[1] appreciates the opportunity to submit additional information to the Securities and Exchange Commission (the "**Commission**") in response to the Commission's request for comments on the above-referenced proposal (the "**Proposal**")[2]. This submission supplements MFA's comment letter dated October 10, 2023[3], and is in furtherance of meetings that we and our members have had with Commissioners and staff of the Commission on the Proposal.

In light of our serious concerns regarding the Proposal as expressed in our comment letter, including the inadequacy of the Proposal's cost-benefit analysis[4], MFA asked the economic consulting firm NERA to undertake an assessment of the Proposal's potential economic impact. We are submitting to the Proposal's comment file a copy of NERA's report, which highlights expected economic ramifications for the private funds and broader investment management industry as well as some of the material gaps in the cost-

[1] Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] *See* Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53,960 (Aug. 9, 2023).

[3] Managed Funds Association Comment Letter re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers [File No. S7-12-23] (Oct. 10, 2023), available at https://www.sec.gov/comments/s7-12-23/s71223-269979-652482.pdf.

[4] *See id.* at pp. 8-13.

benefit analysis included in the proposing release. We request that the Commission keep in mind the economic analysis in this report as it considers public comments on the Proposal.

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We appreciate the opportunity to provide these additional materials to the Commission. If the staff have questions or comments, please do not hesitate to contact Matthew Daigler, Vice President and Senior Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

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April 11, 2024

[1] Jianghao Liu is a Senior Consultant in NERA's Securities and Finance Practice and focuses on market manipulation, securities class actions, and complex investment and trading strategy analysis. Mr. Liu has presented economic analysis to regulatory agencies and conducted statistical analyses involving a wide range of financial products, including equities, fixed-income instruments, futures, and options. Mr. Liu received his BA in economics and BS in business administration from the University of California, Berkeley, and his MA in quantitative methods in the social sciences from Columbia University.

[2] Dr. Patrick Conroy is a Senior Managing Director in NERA's Securities and Finance Practice and specializes in economic analysis of securities and finance issues. Dr. Conroy has provided evidence in US federal district and state court proceedings, and in European, Asian, and Latin American venues. In addition, he has provided opinions at various arbitrations and mediations. Dr. Conroy served as Chair of NERA's Securities and Finance Practice for a six-year term. Prior to joining NERA, Dr. Conroy was an economist at the US Securities and Exchange Commission where he conducted research on ECNs, foreign securities, IPOs, underwriting, mutual funds, and securities fraud, and provided support for policy areas such as market microstructure and market regulation. Dr. Conroy received his BA in foreign policy from American University and his Ph.D. in economics from the University of Miami.

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INTRODUCTION AND SUMMARY OF OPINIONS

We have been asked by MFA[3] to assess the potential economic impact of the Securities and Exchange Commission's ("**SEC**" or the "**Commission**") proposed rule regarding purported conflicts of interest associated with the use of predictive data analytics ("**PDA**") by broker-dealers and investment advisers ("**Proposal**").[4] The Proposal seeks to address purported conflicts of interest in broker-dealer and investment adviser interactions with investors through the use of technology, and also proposes amendments to require firms to maintain records in accordance with the conflicts rules.

1. Based on our analysis, we have reached the following opinions:

The Proposal, if enacted, will have serious ramifications for the private funds and general investment management industry, including reduced technological innovation and efficiency, and substantial compliance costs that may force firms to close or consolidate. All of this would likely result in a decrease in competition and in the number and variety of investment opportunities available to investors.

The SEC has not conducted a sufficient economic analysis in connection with the Proposal. Many of the direct costs appear to be substantially underestimated based on a review of relevant regulations, while <u>none of the indirect costs have been quantified</u>. The wide range of outcomes and other indirect costs are acknowledged but not quantified by the SEC in the Proposal, which introduces uncertainty for investment advisers that would be detrimental to the industry.

A proper economic analysis of indirect costs is crucial to understanding the potential effects of regulations and to avoid unintended consequences. The benefits – and the associated costs to the

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[3] Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member fund managers, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[4] Securities and Exchange Commission, "Conflicts of Conflicts of Interest Associated With the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers," *Federal Register* 88, no. 152 (August 2023): 53960, https://www.federalregister.gov/documents/2023/08/09/2023-16377/conflicts-of-interest-associated-with-the-use-of-predictive-data-analytics-by-broker-dealers-and. ("**Proposal**")

industry of chilling the development and use of technology – must be considered and quantified when evaluating the magnitude and extent of potential outcomes.

OVERVIEW OF THE PROPOSAL AND ASSOCIATED IMPACT

The Proposal would require investment advisers and broker-dealers to eliminate, or neutralize the effect of, certain purported "conflicts of interest" associated with their uses of "covered technology" in "investor interactions." Each term is defined extremely broadly in the proposal without any support that these proposed definitions are based on existing uses in securities laws or common industry understanding of the applicable terms. The proposal also defines "investor" differently as between the proposed rules applicable to investment advisers and those applicable to broker-dealers. While the proposed broker-dealer rule limits the definition of "investor" to certain natural persons receiving services "primarily for personal, family, or household purposes" (i.e., "retail investors");[5] the proposed investment adviser rule would apply to *all* of an investment adviser's clients, including pooled investment vehicles (such as private funds) open only to sophisticated investors.[6] For both investment advisers and broker-dealers, the rule would apply broadly to any "analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process" used for optimizing, predicting, guiding, forecasting, or directing investment decisions and outcomes.[7] This includes technologies ranging from simple Excel spreadsheets to artificial intelligence, encompassing a broad range of mathematical and computational processes on which investment advisers rely for their day-to-day operations. Additionally, the Proposal would expand recordkeeping requirements for applicable registered firms.[8]

In addition to covering a broad range of "technologies" (as broadly defined), the rule would cover a wide variety of activities. For example, the proposal would redefine a "conflict of interest" to include any use of a covered technology that "takes into consideration of an interest of the investment adviser," capturing situations where an investor's and adviser's interest are

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[5] Proposed Exchange Act Rule 15l-2(a).

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

[7] Proposing Release, p. 53960. See summary: "The Securities and Exchange Commission (''Commission'' or ''SEC'') is proposing new rules (''proposed conflicts rules'') under the Securities Exchange Act of 1934 (''Exchange Act'') and the Investment Advisers Act of 1940 (''Advisers Act'') to eliminate, or neutralize the effect of, certain conflicts of interest associated with broker-dealers' or investment advisers' interactions with investors through these firms' use of technologies that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes."

[8] Proposing Release, p. 53960. See summary: "The Commission is also proposing 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."

aligned, or where the adviser's interest have no actual influence on the outcome.[9] As such, the Proposal would effectively encompass all activities involving any covered technology as defined in the proposal. The breadth of definitions such as "investor interaction" and "covered technology" would also subject virtually every action an adviser takes in the course of its day-to-day business to the Proposal. These include portfolio management, responding to investor due diligence, and investment analysis. Moreover, the broad definition of "conflict of interest" would result in most of an adviser's "technologies," which are also broadly defined, being wrongfully categorized as conflicted without further clarification of the specific details. Taken together, the scale of the review required by the proposal can be especially burdensome and impractical, resulting in significant disruptions to ordinary business operations.

The term "investor" for purposes of the investment adviser proposal includes non-natural person advisory clients open only to sophisticated investors, such as private funds and pension funds, without acknowledging that the federal securities laws and the Commission have long recognized substantial differences between these parties and retail clients with respect to their "knowledge, experience, and analytical resources."[10] Here, the Proposal fails to consider existing regulatory requirements applicable to investment advisers, including rules already addressing potential conflicts of interest, resulting in unnecessary burdens on the affected parties. For example, "investor interactions" pursuant to the proposed investment adviser rule would include investment advisers providing discretionary portfolio management to private funds, a basic advisory function that falls within the core of an adviser's existing fiduciary duties. Smaller advisers would be particularly impacted, as they typically lack resources devoted specifically to compliance, and would be detracted from their actual interactions with investors.

The testing and recordkeeping requirements would impose significant burdens on investment advisers. The Proposal appears to require constant testing and evaluation of modifications to technologies involved in an adviser's day-to-day operations. This could cause significant delays to the improvement of investment processes or optimization of ordinary investment research and analysis, delays that will harm investors. The Proposal would require documentation of all evaluations performed pursuant to the Proposal. The documentation also covers descriptions of

[9] Proposed Advisers Act Rule 211(h)(2)-4(a).

[10] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669, 33671 (Jul. 12, 2019).

all testing done, including testing dates, methods used to conduct the testing, and "any actual or reasonably foreseeable potential conflicts of interest identified as a result of the testing."[11] Additionally, firms would also be required to document and maintain records of instances where "a covered technology was altered, overridden, or disabled." Thus, any "alteration," however miniscule, would result in a required record under the Proposal.

In short, the vagueness as well as the breadth of the defined terms in the SEC's proposal would have a chilling effect on firms' uses of an expansive range of technologies and associated activities that are already being utilized. Such a broad-ranging rule would have costly effects on the private funds industry and beyond. The recordkeeping requirements could involve the documentation and potential disclosure of highly sensitive and proprietary information, exposing investment advisers to increased risk of data leakage and other indirect costs such as enhancing cybersecurity practices and increased litigation risk associated with intellectual property and cybersecurity breaches.

[11] Proposing Release, p. 53996.

THE PROPOSAL'S ECONOMIC ANALYSIS IS FLAWED

The SEC's cost-benefit analysis associated with the Proposal falls far short of what would be necessary for market participants to properly evaluate its economic impact. The SEC quantifies only the most general impact of expected direct costs, making no attempt to estimate indirect costs or any potential benefits. Besides potential loss of revenue, none of the indirect costs were quantified in the Proposal.

The Commission Failed to Reasonably Consider Direct Costs

The SEC failed to undertake an adequate cost-benefit analysis of the Proposal, as evidenced by the lack of particularized analysis by investor type, each of which requires distinct considerations on risk and operations. For example, the Proposing Release notes that "50,554 private funds were reported on Form PF, and 5,620 registered investment advisers listed private funds on their Form ADV,"[12] but places no considerations on the variety of business models, technologies, and clients when estimating costs and benefits for private funds.

The Proposing Release also does not distinguish between retail investors, institutional investors, and private funds when assessing how benefits may be less impactful, if at all, in the context of more sophisticated entities. This is because these entities have different levels of financial knowledge, resources, and risk tolerance. For instance, retail investors generally have limited financial knowledge and resources compared to institutional investors and private funds. They may rely more on public information and may not have access to the same level of research and analysis. Therefore, the benefits provided to retail investors may have a more significant impact on their ability to make informed investment decisions and protect their interests.

Additionally, institutional investors and private funds are presumed to have a higher level of financial sophistication and experience. They may have dedicated investment teams, access to specialized research, and the ability to conduct in-depth due diligence. The impact of benefits on these entities may be less significant as they have the resources and expertise to navigate the investment landscape and assess risks effectively. By distinguishing between retail investors, institutional investors, and private funds, the SEC should tailor the benefits and regulatory requirements to address the specific needs and characteristics of each entity. This approach

[12] Proposing Release, p. 54000.

ensures that the benefits provided are appropriate and effective in promoting investor protection, market integrity, and overall financial stability.

In terms of direct costs, the SEC estimates that the total costs to initially comply with the Proposal for a “complex covered technology firm” will amount to $156,100.[13] To arrive at this figure, the SEC estimates that it will initially take 100 hours to evaluate all of an adviser’s covered technologies (with a total cost 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). To arrive at the total ongoing annual costs, the SEC halves the initial estimate, estimating it will cost complex covered technology firms $78,050 a year to comply.

It is essential to recognize the limitations of cost estimates that fail to consider discretionary portfolio management or private fund business models. Ignoring these factors can lead to inaccurate and incomplete assessments of the true costs involved. Discretionary portfolio management involves active decision-making and personalized investment strategies, which often come with higher fees due to the expertise and resources required. Similarly, private fund business models operate differently from traditional retail investment models, with unique fee structures and investment strategies. Failing to account for these factors can result in misleading cost estimates that do not accurately reflect the true expenses incurred by investors.

As discussed in the Proposal, some of the direct costs include: evaluating the applicable “technology” and any new or updated use of such technology; determining whether such use could potentially create a conflict of interest as defined in the rule; arriving at a further determination as to whether the conflict would need to be eliminated or neutralized and if so, how to accomplish this; and creating and maintaining records comprising detailed descriptions of each applicable technology and use. Although the SEC presents its estimates of direct costs as complete and exhaustive, its analysis lacks consideration of real-world examples and the practical effects that compliance would have on advisers.

[13] Proposing Release, p. 54009.

The Proposal also makes no attempt to incorporate direct qualitative costs by fund type, including for private funds.[14] Even the estimation of direct costs is geared towards advisers to retail clients and is lacking in economic support for the expected number of hours or costs for each task, with no clear explanation of how initial and ongoing estimated costs are reasonable given current market conditions.

As just one example of how expansive the Proposal is, investment advisers have been using spreadsheets and Excel models for decades, tools that would now be subject to stringent compliance requirements. Such requirements would halt even routine work by investment advisers if substantial compliance costs and mitigation steps are required before firms can continue using even their most basic tools.

To illustrate how the Proposal may limit new technologies that are beneficial to both firms and investors, consider a firm that is considering deploying PDA to enhance research capabilities and risk management, calibrate trading strategies, and automate certain processes in reporting functions. As these uses would fall under investor interactions, they would be covered by the proposed rule and the firm would have to undergo a lengthy review process to neutralize conflicts of interest and to document that process. Compliance with the rule's proposed documentation and recordkeeping requirements could also raise significant concerns regarding protection of proprietary information against unauthorized access. Balancing such protection with the increased compliance requirements would create a double burden for the firm, such that the firm might forgo an automated system that would increase efficiency, ease of use for their customers, and revenue generation for their funds (and, accordingly, their investors).

Under the Proposal, investment advisers who routinely perform fundamental and technical analysis when optimizing investment models would be required to test if these functions or any foreseeable use may result in conflicts of interest and evaluate if any features are material, thus requiring written documentation. When implementing changes or enhancements to the investment strategy, or any other "covered technology," an investment adviser would further need to assess for material modifications. Given the lack of clarity on materiality thresholds and relevant exceptions, as well as the complexities associated with investment models, advisers will

[14] Proposing Release, p. 54000: "Because 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."

spend considerable time evaluating their actions while keeping track of compliance costs, detracting from their day-to-day business functions of client interactions and providing investment services. In turn, increased time spent on compliance can lead to reduced returns for investors due to new delays in investment analysis and management.

The Commission Failed to Reasonably Consider Indirect Costs

Exhibit 1 lists 13 other indirect costs that would need to be considered and analyzed in more detail. Costs 2 through 8 summarize indirect costs that are listed in the proposal, and costs 9 through 14 represent additional indirect costs that were not discussed in the proposal. While not an exhaustive list, these items highlight the risks and costs to investment advisers that can substantially affect their business operations, hinder their ability to incorporate technological advancements, and provide innovative solutions to investors. Some of these costs are also new and emerging, and as such require additional time for data collection before an economic analysis can be conducted.

Exhibit 1. Summary of Costs for Investment Advisers

No. (1)	Cost Item (2)	Quantified in Proposal (3)	Not Quantified in Proposal (4)
Costs Discussed in Proposal			
1	Direct costs - policies & procedures, written descriptions, annual review, and recordkeeping requirements.	✓	
2	Loss of revenue associated with eliminating/neutralizing technology, or decision not to employ certain beneficial technology due to concerns about cost and/or compliance.		✓
3	Less informed investment decisions for investors and investment managers due to elimination of certain technology.		✓
4	Decreased efficiency resulting from modifications to comply with proposed rule, reduction in updates to existing technology, and delayed/canceled introduction of new technology.		✓
5	Increased cost for investors due to firms passing on compliance costs, expenses, and fees from third-party providers.		✓
6	Decreased innovation from reduced frequency of updates and reduction in introduction of new technologies.		✓
7	Reduced competition due to barriers to entry for new firms and existing firms being priced out from high compliance costs.		✓
8	Decreased capital formation if firms are unable to absorb additional costs and avoid using beneficial technologies.		✓
Additional Costs Not Discussed in Proposal			
9	Risk of intellectual property (IP) leakage stemming from disclosure requirements.		✓
10	Data security requirements, including storage and security related costs.		✓
11	Costs associated with potential security breach such as data recovery, business disruption, and reputational damage.		✓
12	Additional expenses such as data/technology sourcing, research and development, increased direct communication with clients, and customer acquisition costs.		✓
13	Potential litigation costs, such as IP leakage lawsuits and cybersecurity incidents.		✓
14	Unforseen costs due to interactions with other rules and regulations.		✓

Notes and Sources:

Data are from Securities and Exchange Commission, "Conflicts of Conflicts of Interest Associated With the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers," Federal Register 88, no. 152 (August 2023): 53960, https://www.federalregister.gov/documents/2023/08/09/2023-16377/conflicts-of-interest-associated-with-the-use-of-predictive-data-analytics-by-broker-dealers-and.

Some direct costs can also lead to secondary indirect costs. For instance, increased data costs associated with storing and maintaining records to ensure compliance can be considerable for smaller firms that do not already have these facilities in place. These data storage and infrastructure costs will also lead to increased security expenses. Moreover, firms will incur additional costs developing and sourcing data for new tools, as they will need to review any new products developed prior to allowing employees or investors to use them.

As indirect costs can be several times larger than direct costs, additional work is required to isolate the effects of specific indirect costs. For instance, there are economic models that can provide a framework to quantify the loss of revenue associated with reduced access to PDA technologies. One could also examine increases in revenue and other relevant metrics from earlier adoptions of other technologies, testing the hypothesis that hinderances in technological advancement and reductions in usage of existing technologies would have an adverse effect on firm performance. The increased costs to investors can be quantified in a similar fashion, such as through an analysis of similar regulations and survey data.

Other indirect costs that have seemingly been omitted from the Proposal cost-benefit analysis include the risk of intellectual property ("**IP**") leakage and cybersecurity incidents. In recent years, data privacy has come under increased scrutiny, along with its associated costs. There has been an increased number of lawsuits concerning cybersecurity and data protection, with litigation expected to continue to increase.[15,16] IP leakage represents a major risk of these cybersecurity incidents, which can have a significant cost for firms.[17] Indeed, BakerHostetler reported that 25% of cybersecurity incidents involved either the theft of data/exfiltration (24%) or the theft of trade secrets (1%).[18]

In summary, the Proposal fails to consider the magnitude and extent of costs that would arise from its adoption and does not provide any justification that expected benefits would outweigh costs. A proper analysis requires accounting for both direct and indirect costs, as well as the application of well-supported economic models to measure, or at least to estimate, the magnitude

[15] BakerHostetler. Reassess & Recalibrate: 2023 Sata Security Incident Response Report.

[16] Norton Rose Fulbright, 2023 Annual Litigation Trends Summary.

[17] Gelinne, J.P. et al. (2016). The hidden costs of an IP breach: Cyber theft and the loss of intellectual property. Deloitte Insights.

[18] BakerHostetler. Reassess & Recalibrate: 2023 Sata Security Incident Response Report, p. 6.

of these costs. In addition to potentially prohibitive costs that could force investment advisers to shut down or consolidate, the impact on innovation and competition would result in further uncertainty that would be detrimental for the private funds and broader investment industry.

CONCLUSION

The Proposal raises significant concerns regarding its broad scope and potential substantial negative impact on the private funds industry and beyond.

The rule's coverage of a wide range of technologies and activities, including both advanced systems and simple tools like spreadsheets, creates compliance burdens that may hinder routine work and innovation among investment advisers and broker-dealers.

The vagueness of defined terms in the proposal further exacerbates the potential negative effects, as firms would need to undergo lengthy review processes and implement costly mitigation steps to ensure compliance.

The recordkeeping requirements pose additional challenges, including the disclosure of sensitive and proprietary information, increased cybersecurity risks, and potential litigation risks.

Finally, the compliance review process and the need to neutralize purported conflicts of interest may discourage the implementation of automated systems that could enhance efficiency and improve outcomes for both firms and investors.

The SEC only quantifies the impact of certain expected direct costs, without considering indirect costs or absence of potential benefits. This lack of quantitative analysis of potential market failures and inadequate economic justification raises concerns about the proposed rule. Furthermore, the estimation of direct costs is unsupported by economic evidence, with no clear explanation of the reasonableness of the estimated hours and costs.

Other indirect costs related to data storage, security expenses, and the development of new tools can considerably affect the business operations of investment advisers, hinder their technological advancements, and limit their ability to provide innovative solutions to private fund investors. Economic models can be used to quantify the loss of revenue, increased costs to investors, and the impact on firm performance. In addition, the risk of intellectual property leakage and cybersecurity incidents have become increasingly prevalent in recent years.

An actual cost-benefit analysis would specifically calculate both the magnitude and extent of these costs. No such analysis is presented here by the SEC.