Evolving Regulatory Oversight For AI And Asset Management

By **Cheryl Isaac, Jennifer Klass and Matthew Rogers** (August 5, 2024)

The emergence of generative artificial intelligence affects every sector of the financial services industry, including asset managers.

Increasingly, asset managers are exploring the use of AI to provide investment advisory services, execute trading strategies, engage in directed marketing efforts, personalize client interactions, enhance client service, manage compliance and risk functions, and enhance operational efficiency.

However, they do so against an evolving regulatory and legislative backdrop as the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission and Congress consider how to address potential investor protection and systemic risks associated with AI.

The U.S. Supreme Court's recent decision in Loper Bright Enterprises v. Raimondo could potentially affect the future of AI regulation. Historically, agencies have relied on Chevron deference to defend their authority to regulate emerging technologies. However, without this deference, agencies might encounter increased challenges when attempting to regulate areas where they lack explicit statutory authorization.

Given the nature of the legislative process, which may not keep pace with rapid technological advancements, agencies might opt to regulate through enforcement actions rather than formal rulemaking.

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SEC Proposed Regulation

In August 2023, the SEC proposed parallel rules for investment advisers and broker-dealers that would govern conflicts of interest associated with the use of predictive data analytics, or PDA, in investor interactions — PDA proposal — which marked the first significant rulemaking directly tackling AI.

The PDA proposal would require firms to eliminate or neutralize the impact of certain conflicts of interest in those cases where investment advisers and broker-dealers use technologies that "optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes."

The PDA proposal defines "covered technology" extremely broadly — the definition includes AI, machine learning, deep learning algorithms, neural networks, natural language processing and large language models — including generative pretrained transformers.

The PDA Proposal reflects SEC concerns that conflicts of interest incorporated into technology remain unidentified and unaddressed, that technology has the ability to rapidly transmit or scale conflicted actions across a firm's investor base, and that conflicts of

interest can arise from the data the technology uses (including investor data) and the inferences the technology makes in analyzing that data.[1]

The PDA proposal was widely criticized by industry commentators on a number of grounds, including that: (1) the proposed definitions within the rule proposal are vague and overbroad with the result that the PDA proposal would regulate a wide range of activities unrelated to the SEC's concerns about AI; (2) the existing regulatory framework is more than capable of addressing conflicts of interest relating to emerging technology; and (3) the implementation of the PDA proposal would be operationally infeasible and would impose unreasonable compliance costs.

Further, there was a question as to whether the SEC has the statutory authority to promulgate the PDA proposal, a concern that has been amplified by the recent decision of the U.S. Court of Appeals for the Fifth Circuit in National Association of Private Fund Managers v. SEC on June 5 that vacated the Private Fund Advisers Rule.

Commentators generally requested that the SEC withdraw the PDA proposal in its entirety and repropose a version that is more tailored to the SEC's policy concerns.

On March 7, the SEC's Investor Advisory Committee, which was established under the Dodd-Frank Act to advise the SEC on regulatory priorities, approved a series of recommendations, including that the SEC narrow the scope of the PDA proposal to "target the unique risks of predictive data analytics and artificial intelligence that interact directly with investors."

The committee also advocated a compromise under which the SEC would continue to permit investment advisers and broker-dealers to rely on the existing regulatory framework to define conflicts of interest and to permit firms to "eliminate, mitigate or disclose conflicts of interest," while at the same time acknowledging that disclosure may not be sufficient for certain "inherently opaque and complex PDA and AI technologies."

At this point, the debate continues, and the SEC has not yet taken further action on the PDA proposal.

In the meantime, we expect to see the SEC staff continue to rely on its examination and enforcement authority to address the use of AI by asset managers. Earlier this year in March, the SEC brought its first enforcement action against two investment advisers, Delphia (USA) Inc. and Global Predictions Inc., for "AI washing" — making false or misleading statements about the use of AI.

The CFTC's Approach to AI

In contrast with the SEC, the CFTC, which regulates U.S. derivatives markets, is in information-gathering mode.

On Jan. 25, CFTC staff issued a request for comment regarding the use of AI in CFTC-regulated derivatives markets. The request for comment aimed to gather insights on current and potential AI applications and the associated risks, in accordance with the Biden administration's executive order on the development and use of AI.

Joining other regulators in exploring AI's impact, the CFTC sought public input on several issues, including the definition of artificial intelligence, the regulator's role in trading and

market operations, third-party involvement, and associated risks such as market manipulation and data quality.

A number of themes emerged from the comments submitted to the CFTC, most notably that (1) activities and outcomes should be regulated, rather than the technology, and (2) the agency's existing, principles-based approach works well. Market participants advocated for a definition of AI that is narrow enough not to encompass all technologies, yet broad enough not to inhibit the development of AI capabilities.

Multiple commenters also noted that the CFTC may not need to promulgate any new rules at all, because existing CFTC and National Futures Association rules already apply to a variety of AI uses and may be adequate as is.

Following the close of the request for comment period, on May 1, the CFTC announced its first chief artificial intelligence officer, Ted Kaouk. The next day, the CFTC's technology advisory committee held AI Day, in which both public and private sector participants presented to the CFTC — and public — on a variety of AI-related issues.

Importantly, a subcommittee of the committee issued a report and a number of recommendations, including that the CFTC host a public roundtable discussion to explore key technical and policy considerations on the use of AI in financial markets, and for the CFTC to inventory existing regulations to determine whether any clarity or additional rulemakings related to AI are necessary.

Each of these initiatives demonstrates the CFTC's willingness to engage with market participants, and a desire to better understand the technology and the markets it regulates before taking any next steps. Importantly, they also raise some good questions about the sufficiency of existing CFTC regulations, particularly when viewed in tandem with the National Futures Association's compliance rules — which apply to certain CFTC registrants — as well as the rules of derivatives exchanges, which apply to any entity trading on any such exchange.

Collectively, the CFTC and the various self-regulatory organizations mandate that vast swaths of derivatives market participants have a duty to supervise their agents, including any technological applications that they use, such as AI models.

Likewise, the CFTC, National Futures Association and derivatives exchanges already prohibit fraud and market manipulation, and a market participant will be subject to a potential disciplinary action whether or not the misconduct was by a human trader or an AI model.

All of this is to say that, even without new or expanded regulations, the CFTC has existing tools for policing the use of AI.

Congressional Approach to AI

Leaders of both parties in Congress recognize the disruptive and transformational nature of AI and have shown a willingness to learn first and legislate second.

Inside the Beltway, there was some surprise that the European Union acted so quickly in passing their Artificial Intelligence Act this year. Though that legislation ostensibly applies to Europe, it will affect multinational companies outside its borders.

Perhaps cognizant that the U.S. was in danger of losing its leadership position on AI, House

Speaker Mike Johnson, R-La., and House Minority Leader Hakeem Jeffries, D-N.Y., established a bipartisan House Task Force on Artificial Intelligence earlier this year. Specific to the financial services industry, the House Financial Services Committee Chairman Patrick McHenry, R-N.C. and ranking member Maxine Waters, D-Calif., formed a committee-led Working Group on Artificial Intelligence with a broad mandate to investigate how AI affects the industry and workforce.

Rep. French Hill, R-Ark., leads the working group and has spent this spring soliciting input from the private sector as well as government regulators with hearings expected in a few weeks. Hill wants to ensure that the U.S. remains the innovation leader, while creating a more inclusive financial system with the use of AI. His working group will also address many of the directives in President Joe Biden's 2023 executive order on AI.

On the U.S. Senate side of Capitol Hill, senators from both parties led by Senate Majority Leader Chuck Schumer, D-N.Y., released a road map of AI proposals earlier this year. This work product is the culmination of a series of AI briefings and education sessions. These proposals have recommended legislation mandating financial services providers to utilize accurate and representative data in their AI models. It also encourages Congress to provide regulators with appropriate enforcement tools as more industry participants will be using AI.

While Congress is working to learn more about AI, it is unlikely that there will be major legislation focused on AI in the financial services industry in the near term — however, this deliberative approach sets the stage for the possibility of a more comprehensive approach to AI that would be ready early in next year's 119th Congress.

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[1] AI, Behavioral Prompts, and Other Emerging Technology - Risk Governance and Conflicts Management (sec.gov). https://www.sec.gov/files/outline-iaa-conference-ai-behavioral-prompts.pdf.