

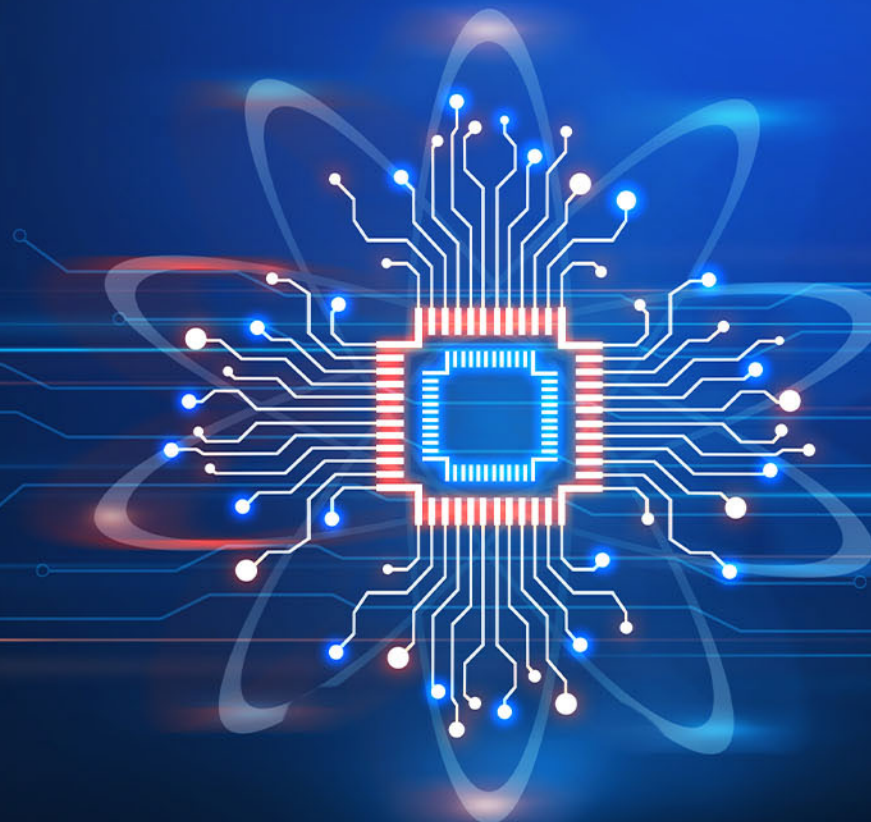
# The Age of AI: SEC Focus on AI

Josh Newville, Partner

Bob Pommer, Partner

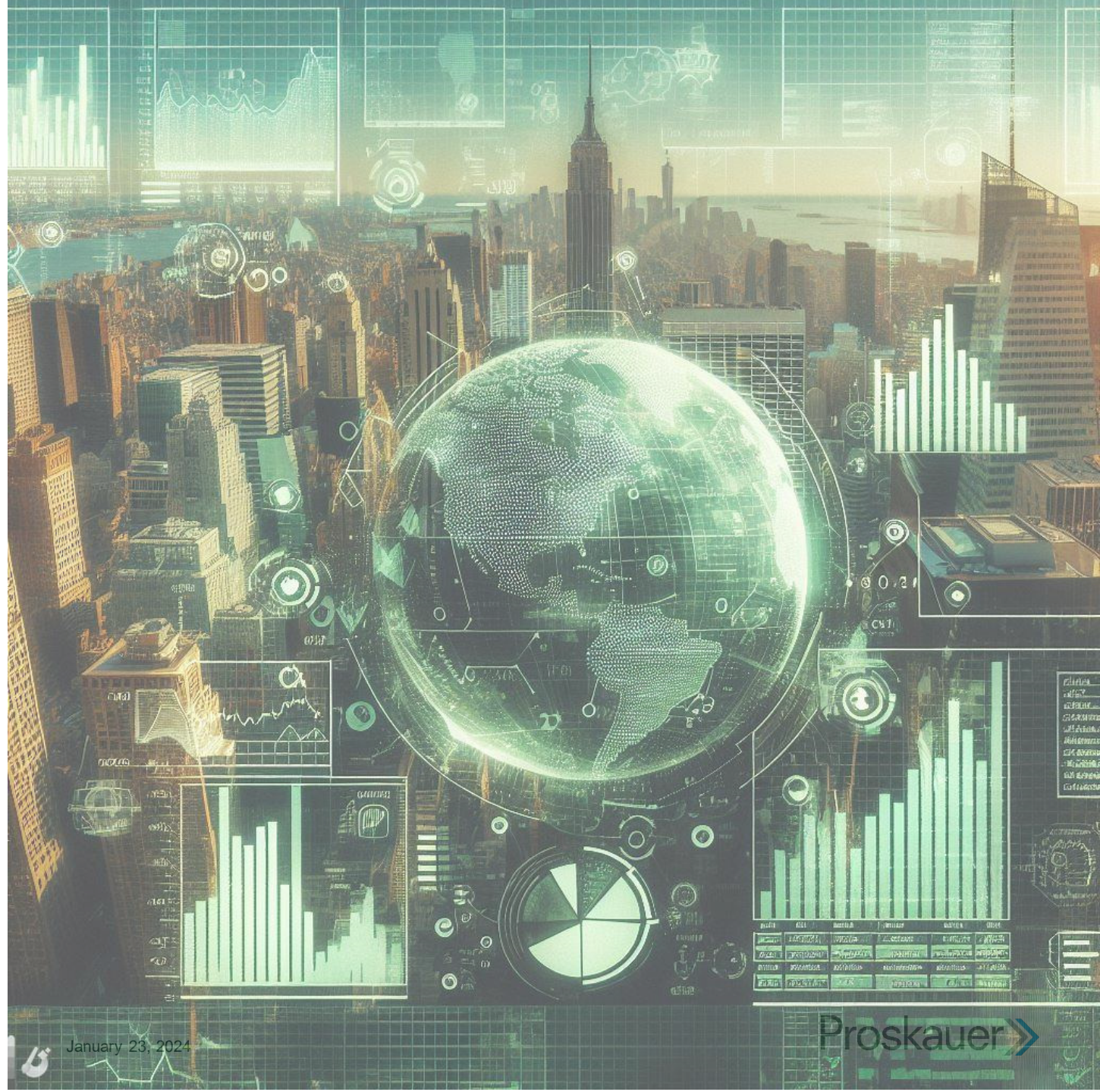
Rob Sutton, Partner

January 23, 2024

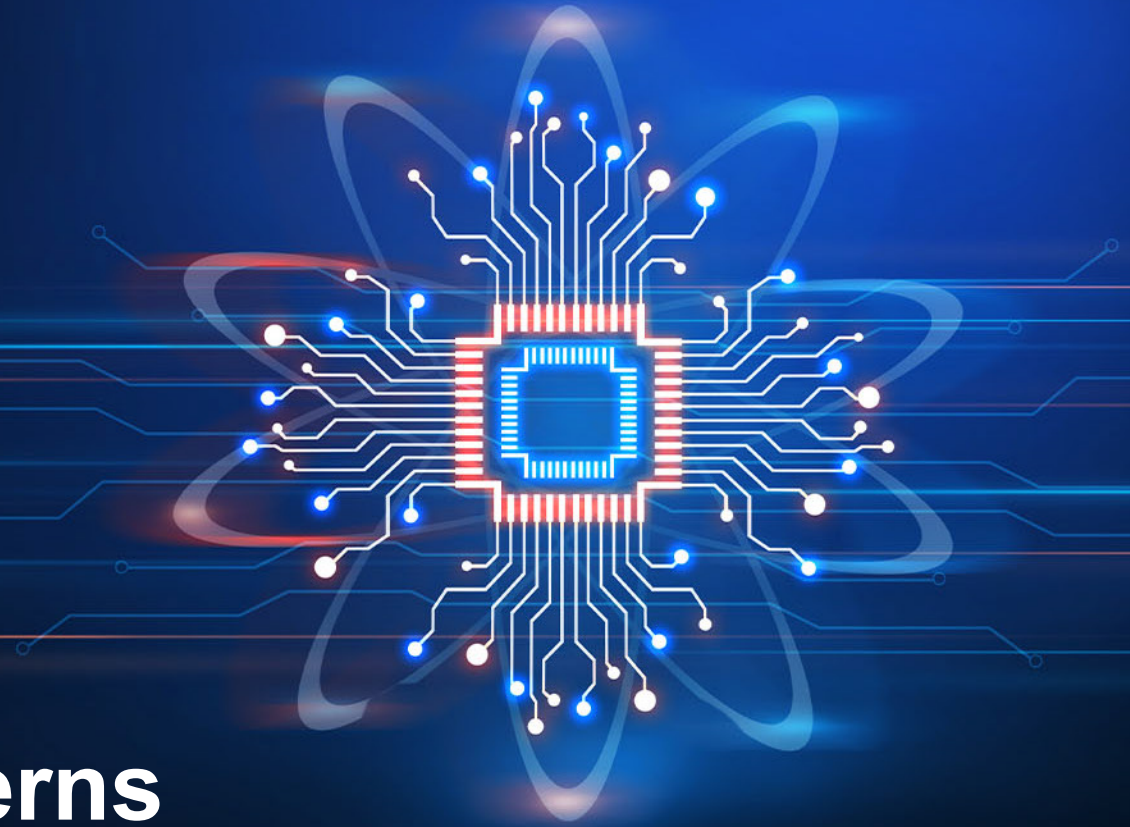


# Agenda

- **Speeches:** The SEC's Latest AI Concerns
- **Rulemaking:** Proposed Predictive Analytics Rules
- **Exams:** AI Sweep and Exam Priority Focus of 2024
- **Enforcement:** AI Washing and Other Areas of Potential Scrutiny



# Speeches: The SEC's Latest AI Concerns



# The SEC and AI

RISK & COMPLIANCE JOURNAL

## Next Financial Crisis Could Come From AI, SEC Chair Says

Gary Gensler sounded a cautious note on the technology that joined skepticism from other U.S. officials

By Richard Vander  
May 16, 2023 4:47

↪ 📌 AA

### AI-caused financial crisis ‘nearly unavoidable’ without regulation: SEC chief

BY JULIA SHAPERO - 10/16/23 3:24 PM ET



Greg Nash

Securities and Exchange Commission Chairman Gary Gensler answers questions during a House Financial Services Committee oversight hearing of the SEC on Tuesday, April 18, 2023.

The head of the Securities and Exchange Commission (SEC) warned that a financial crisis caused by artificial intelligence (AI) is “nearly unavoidable” in the next decade without further regulation of the rapidly advancing technology.

“It’s a hard financial stability issue to address because most of our regulation is about individual institutions, individual banks, individual money market funds, individual brokers; it’s just in the nature of what we do.”

“And this is about a horizontal [matter whereby] many institutions might be relying on the same underlying base model or underlying data aggregator.”

“I do think we will in the future have a financial crisis ... [and] in the after action reports people will say ‘Aha! There was either one data aggregator or one model ... we’ve relied on....’”

# The SEC and AI

TECHNOLOGY

## SEC chair warns centralized AI could lead to 'fragile' financial system

BY REBECCA KLAR - 01/17/24 3:00 PM ET



Greg Nash  
Securities and Exchange Commission Chair Gary Gensler testified before the House Financial Services Committee oversight hearing on Wednesday that a centralized AI system could lead to a handful of models that financial system.

Home/Markets News Report

## SEC's Gary Gensler Warns Over AI 'Monoculture' Risks to Finance Sector

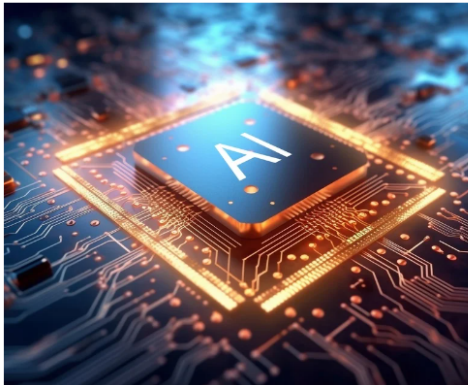
2 mins

By Martin Young  
18 January 2024, 03:14 GMT+0000

Updated by Kyle Baird  
18 January 2024, 03:17 GMT+0000



In Brief



Generative AI. Credit: Natalia / Adobe Stock

NEWS

## SEC Chief Gensler Warns of 'AI Washing' and Potential Conflicts of Interest

"If you're putting the robo adviser's interest ahead of the broker dealer's interest ahead of the investor, therein lies a conflict" Gary Gensler said.

January 17, 2024 at 04:43 PM

3 minute read

Artificial Intelligence

By Maydeen Merino



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## Gensler Warns AI 'Monoculture' May Weaken Financial System

By Sarah Jarvis

Law360 (January 17, 2024, 7:50 PM EST) -- U.S. Securities and Exchange Commission Chair Gary Gensler warned Wednesday that artificial intelligence poses the risk of making the financial system more fragile, predicting that a handful of entities will inevitably come to dominate the space.

Speaking at a fireside chat hosted by the consumer advocacy group Public Citizen, Gensler said that while artificial intelligence in itself is a "net positive to society," it also comes with the macro-level risk that a large swath of financial service providers will end up relying on a small number of models and data aggregators as they incorporate AI into their business models.

Likening it to the small number of cloud providers, dominant search engines and retail providers in the U.S., Gensler said AI will follow a similar path, accentuated by AI's "insatiable desire" for data and computational power.

"It also means we're likely to have what you would call in science and biology a monoculture, that without even knowing it, there'll be hundreds if not thousands of financial actors relying on some central data or central base model," Gensler said.

Gensler has previously sounded the alarm on concerns related to the burgeoning field of AI, including the risk of a monoculture, saying last month that financial instability could ensue if many people

ers last month not to "AI wash," or mislead investors as to their true

financial regulators don't have oversight of what will likely be the structure on which the whole financial sector will rely, meaning the goes awry with those nodes.

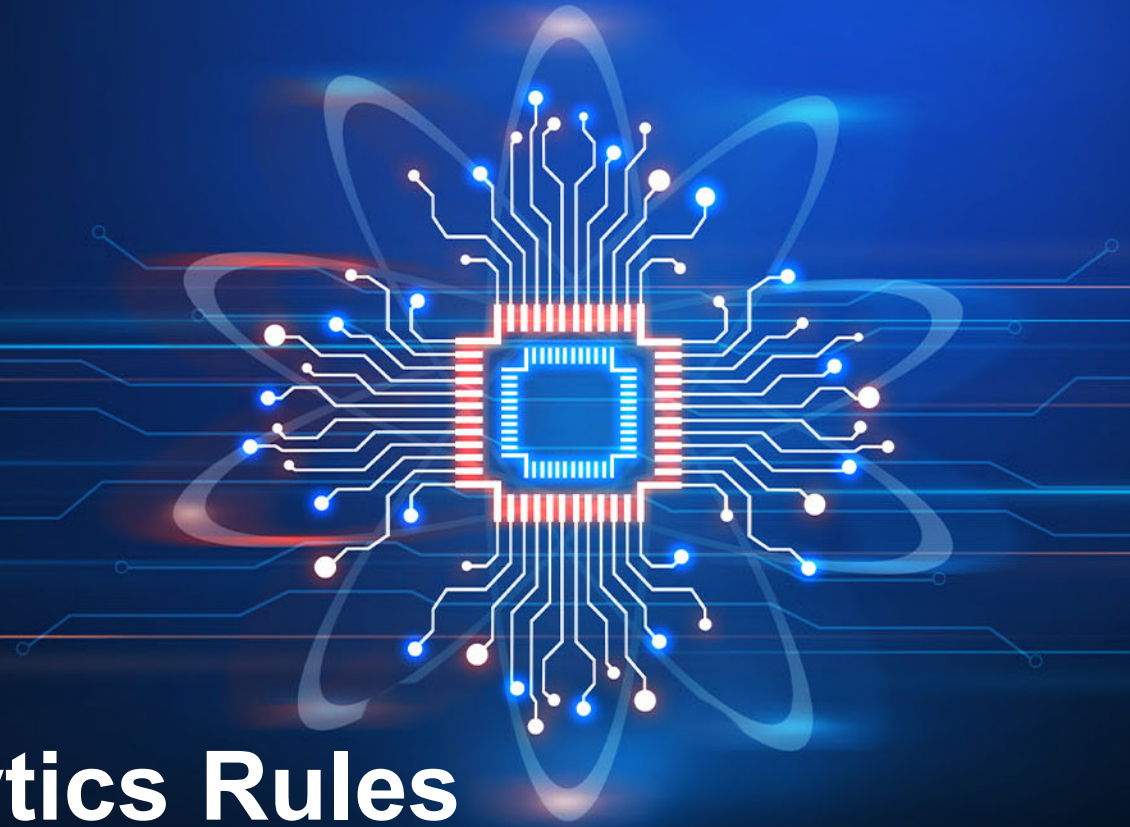
the monoculture goes one way -- well, then there's a risk in society" Gensler said.

international regulatory community should get a sense of those "horizontal reviews" that go beyond any given individual model. He noted "providers are each aligning with AI-based models or AI as a service, which is "just an inevitable path where we're heading."

, how do you keep some diversity in the system? Diversity of models" Gensler said. "Otherwise, you end up with a pretty fragile system."

Konnath. Editing by Jeremy Abrams.

# Rulemaking: Proposed Predictive Analytics Rules



# Proposed Predictive Data Analytics Rules

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- The Rules would address potential conflicts of interest presented by the use of artificial intelligence technologies in the securities industry.
  - Prompted by concerns that AI may place a firm's interests ahead of clients resulting in investor harm.
  - Broker-dealers and registered investment advisers must eliminate or neutralize the effect of any conflicts from their use of **Covered Technology** in any **Investor Interaction**.
- Ultimate timeline for potential adoption remains uncertain:
  - Rules proposed on July 2023.
  - Comment process closed October 2023.
  - Final vote tentatively targeted for April 2024.
  - Could see further revisions to the rule as a result of comment process or legal challenges if adopted in current form.

# SEC Concerned by Rapid Acceleration and Adoption

- The SEC has historically pressed for conflicts of interest to be addressed **through disclosure and consent**
- But the speed with which the technology has evolved, and the speed and breadth of its adoption across the financial services sector, led the SEC to conclude that **disclosure alone is insufficient**
- Conflicts embedded within the technology must therefore be **eliminated or neutralized**

“...the **recent and rapid expansion** of [these] technologies in the context of investment-related activities, without specific oversight obligations tailored to the specific risks involved in their use, can lead to outcomes that financially benefit firms at the expense of investors.”

“Due to the inherent complexity and opacity of these technologies as well as their potential for scaling, we are proposing that **such conflicts of interest should be eliminated or their effects should be neutralized**, rather than handled by other methods of addressing the conflicts, such as through disclosure and consent.”

*SEC Adopting Release, at pp. 25-26*

# The SEC's Concern: “Black Box” That Benefits The Firm At The Expense of Investors

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- SEC concerned that such technologies encourage practices that are “profitable for the firm but may increase investors’ costs, undermine investors’ performance, or expose investors to unnecessary risks”, such as:
  - Excessive trading
  - Using trading strategies that carry additional risk
  - Trading in complex securities products that are more remunerative to the firm but pose undue risk to the investor
- In non-discretionary and retail contexts, an algorithm’s output may “nudge” or influence investor behaviors in ways that benefit the firm.
- In discretionary contexts, the algorithm may skew investment decisions or allocations toward instruments from which the firm earns higher fees.

# The SEC's Goal: Forcing Firms To Unpack The Black Box

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- The SEC sees great potential for harm stemming from conflicts programmed into, or affecting the design of, an algorithm.
- Conflicts in an algorithm could reflect intentional design choice.
  - *E.g.*, weighting certain elements based on the firm's economic interests.
- Conflicts could also be present in an algorithm unintentionally.
  - *E.g.*, through data inputs into the black box, or through functions of the black box itself, in ways that skew results to the firm's advantage but without the firm or its personnel intending that result.
- Thus, under the proposal, firms would have an obligation to systematically identify conflicts within these algorithms, and then eliminate or neutralize them.

# The Proposed Rules are Extremely Broad

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- **Covered Technology** defined 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.”
  - Includes algorithms developed by the firm, as well as proprietary software licensed by the firm, or functions within other software (e.g., a spreadsheet’s financial modeling and correlation functions)
  - Could therefore include virtually **any calculator function or other piece of technology**
- **Investor Interaction** includes “engaging or communicating with an investor, including by exercising discretion with respect to an investor’s account; providing information to an investor; or soliciting an investor.”
  - Narrow exception for interactions in order to meet legal or regulatory obligations, or to provide administrative support
  - “Investor interaction” would therefore cover **any interaction that is not purely administrative**
  - Could include anything from e-mails to phone calls to in-person meetings, to simply hosting a website or operating a mobile app or providing investors with tools to get market updates

# The Proposed Rules' Requirements

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- **Elimination or Neutralization of the Effect of Conflicts of Interest**

- Evaluate any use or reasonably foreseeable potential use of a covered technology in any investor interaction to identify any conflict of interest
  - Testing required prior to implementation and/or any material modification
  - SEC cites certain testing methods (e.g., “A/B testing” by varying inputs and monitoring the effect on outputs, and adding “explainability” features to identify the reasons for a particular output)
- If any such conflict puts the interests of the firm or a natural person associated with the firm ahead of investors’ interests, promptly eliminate or neutralize the conflict
  - The presence of “**any** firm interest in **any** degree...would constitute a conflict of interest”
- Only investor interaction is required – **there need not be any actual investment recommendation**

- **Policies and Procedures**

- Must contain detailed descriptions of: (i) the process for evaluating a covered technology; (ii) any covered technologies already in use and any related conflicts, (iii) the process for identifying whether such a conflict exists, and (iv) the process for eliminating or neutralizing the conflict
- Must also provide for an annual review, and documentation of same

# Commissioner Dissents:

## “Overly Prescriptive”, “Disclosure Is Not An Option”

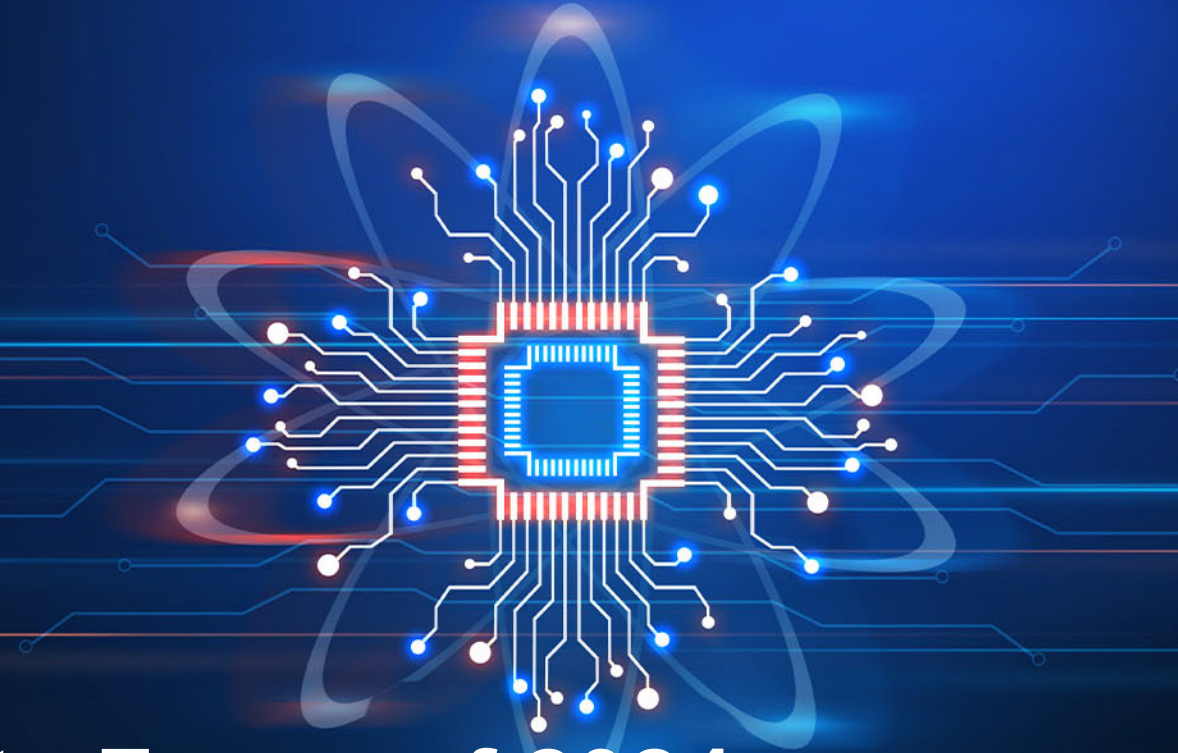
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- **Commissioner Uyeda:** “This proposed rulemaking...layers on duplicative requirements and an overly prescriptive approach to policies and procedures, all of which can lead to a “check the box” mentality at firms. Even worse, it could result in countless hours of efforts to document why things like the simple desktop calculator do not have any conflicts of interest.”
- **Commissioner Peirce:** “this release...rejects one of our primary regulatory tools—disclosure. If a firm determines that the use (or *potential* use) of a covered technology involves a conflict of interest, then the firm has to eliminate or neutralize the conflict. Disclosure is not an option. ...Is the next step going to be to make investment decisions for investors we deem incapable of making their own decisions? The whole premise of our disclosure regime is that investors can think for themselves.”

# The Industry Pushes Back

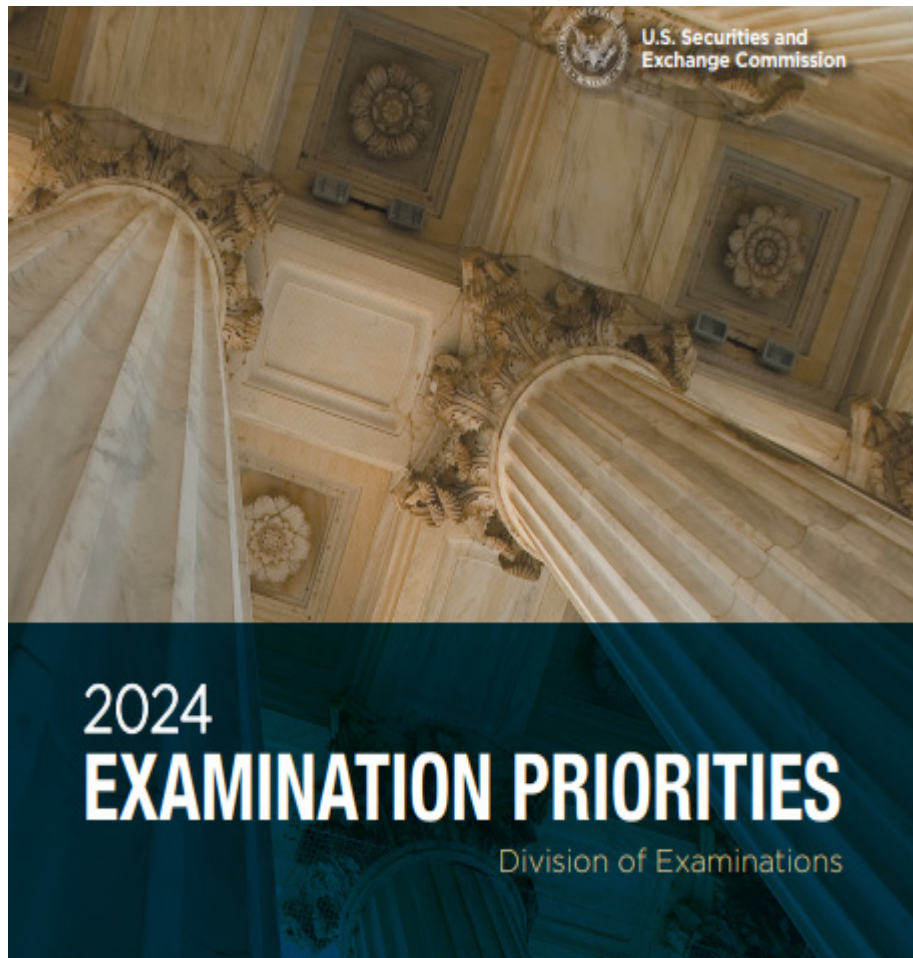
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- The vast breadth of the Proposal and its likely impact if adopted has sparked broad and forceful resistance from a host of industry participants and trade groups criticizing the Proposal for:
  - Abandoning disclosure and consent as a valid means of addressing conflicts, with insufficient justification
  - “Stunning” overbreadth of the Rules’ coverage, ignoring protections already available through current disclosure rules
  - Failure to provide any evidence that existing disclosure rules are insufficient to address these concerns
  - Inadequate cost-benefit analysis in the rulemaking process, involving high costs to investment advisers and broker-dealers and insufficiently-articulated benefits to investors
  - Lack of legislative authority to adopt the Proposal



# Exams: AI Sweep and Exam Priority Focus of 2024

# SEC Exam Focus on AI



## B. Crypto Assets and Emerging Financial Technology (p.19)

....The Division remains focused on certain services, including automated investment tools, *artificial intelligence*, and trading algorithms or platforms, *and the risks associated with the use of emerging technologies and alternative sources of data.*

# The SEC's AI Sweep

## Regulatory Compliance Watch

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PF Latest News

### EXCLUSIVE: SEC launches artificial intelligence sweep

*Examiners seek lists of employees, execs, board members with cyber responsibilities*

Bill Myers - August 30 2023

Share A- A+ 100%



The SEC has launched a sweep of private fund advisers' AI and cybersecurity programs.

SEC examiners have opened a wide-ranging probe of how private fund advisers use artificial intelligence, *RCW* has learned.

In at least two cases, regulators have asked private funds 15 sets of questions about how they're using AI, including a description of their "models and techniques," a "list of algorithmic trading signals and associated models," the source and providers of their data,

# The SEC's Latest AI Sweep

RISK & COMPLIANCE JOURNAL


## SEC Probes Investment Advisers' Use of AI

The agency's information requests come as Chair Gary Gensler has expressed skepticism about AI

By [Richard Vanderford](#) [Follow](#)

Dec. 10, 2023 9:00 am ET

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Securities and Exchange Commission Chair Gary Gensler has warned that AI could lead to a financial crisis. PHOTO: EVELYN HOCKSTEIN/REUTERS

It appears that the agency is looking for information from investment advisers on:

- AI-related marketing documents
- Algorithmic models for client investment portfolios
- AI providers and vendors
- AI-related training and compliance efforts

# The SEC's Definition of AI

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- **Artificial Intelligence/AI** is a term used to describe:
  - computer systems and software programs designed to simulate human intelligence to perform tasks, such as investment analysis and decision-making, given a set of human-defined objectives.
- AI models reach conclusions through reasoning and self-correct to improve analysis.
- AI programs may autonomously execute trading decisions or may assist staff in making trading decisions.
- AI may include unsupervised machine-learning, supervised machine learning, deep learning, reinforcement learning, natural language processing, and neural networks.
  - AI encompasses the idea of machines mimicking human intelligence
  - Non-AI computer algorithms are the specific instructions that enable computers to perform tasks.
  - Algorithms are a component of AI, used to implement various AI techniques and approaches.

# The SEC's AI Sweep

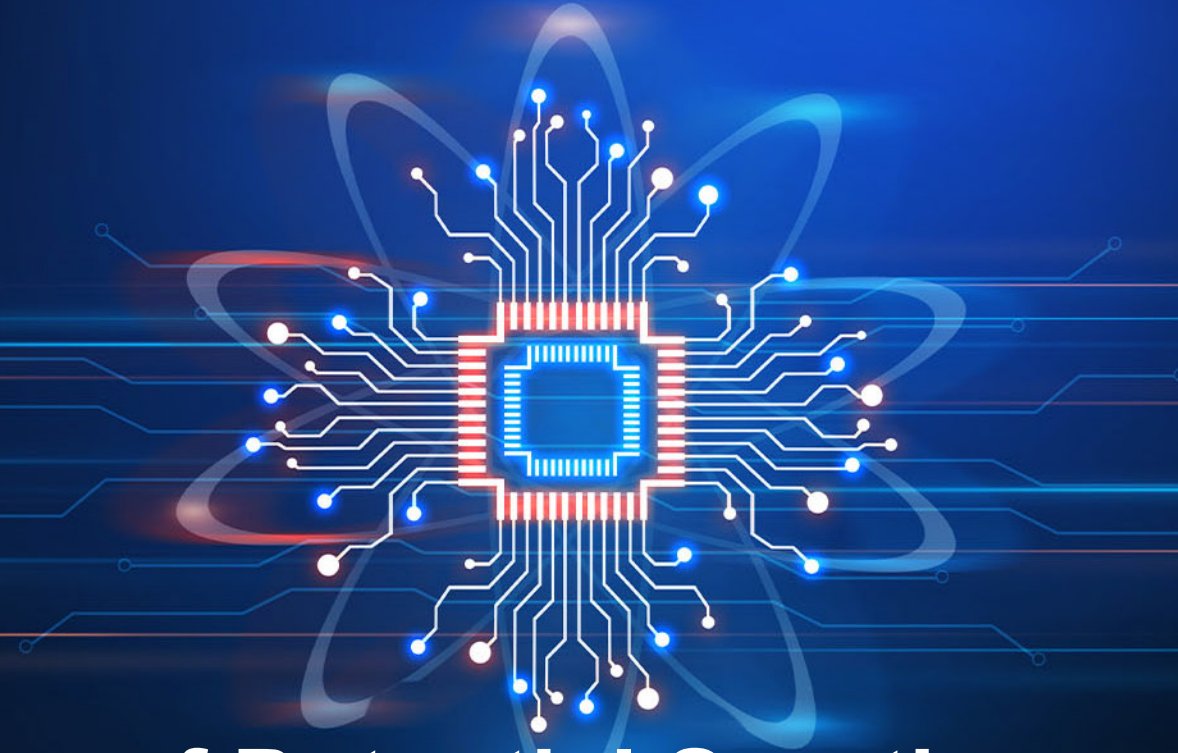
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- **AI Disclosures and Marketing.** Documents where the use of AI by the Adviser is stated or referred to specifically in a disclosure.
- **AI Models and Techniques.** Description of all artificial intelligence models and techniques developed and implemented by the Registrant to manage client portfolios or make investment decisions and transactions.
- **Algorithmic Trading Signals and Associated Models.** Description of all algorithmic trading signals generated by AI models, including input data sources along with their vendor or, if generated in-house, method of acquisition as well as primary data inputs.
- **Data Sources.** All data sources utilized by artificial intelligence systems.

# The SEC's AI Sweep

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- **Compliance Policies and Procedures.** All compliance and operational policies and procedures concerning the supervision of artificial intelligence systems.
- **Data Security.** Documentation on data security measures when using AI.
- **Incident Reports.** Reports on any incidents where AI use raised any regulatory, ethical, or legal issues.
- **Data Acquisition Errors and Adjustments.** All data acquisition errors and/or adjustments to algorithmic modifications due to data acquisition errors (i.e. web scraping problems) during the examination period including the date and reason for adjustment.



# **Enforcement: AI Washing and Other Areas of Potential Scrutiny**

# SEC Warns about AI

## SEC Head Warns Against ‘AI Washing,’ the High-Tech Version of ‘Greenwashing’


Agency head Gary Gensler cautioned phony AI-related hype

By Richard Vanderford [Follow](#)  
Dec. 5, 2023 5:15 pm ET

Technology

### Companies double down on AI in June-quarter analyst calls

By Noel Randewich  
August 1, 2023 9:57 AM EDT · Updated 5 months ago



[1/2] An AI (Artificial Intelligence) sign is seen at the World Artificial Intelligence Conference (WAIC) in Shanghai, China July 6, 2023. REUTERS/Aly Song/File Photo [Acquire Licensing Rights](#)

July 31 (Reuters) - It's a high bar, but companies reporting second-quarter earnings in recent weeks have talked up artificial intelligence even more than in the previous quarter.

S&P 500 ([SPX](#)) companies that led in discussion of AI during quarterly conference calls with analysts earlier this year have outdone themselves in their latest quarterly calls.

Following Intel's ([INTC.Q](#)) report late on Thursday, executives and analysts on its call mentioned AI 58 times, up from 15 mentions in its previous call in April.

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### For business opportunity sellers, FTC says “AI” stands for “allegedly inaccurate”

## FTC : Federal Court Temporarily Shuts Down Automators AI Operations Following Lawsuit

August 22, 2023 at 04:56 pm

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- Expect SEC comments on AI-related disclosures
- Ensure that disclosures are fair, accurate, complete and balanced with risk disclosure, where appropriate.
- Review controls and procedures to ensure processes for validating AI claims

# SEC Warns about AI



**Q.** Talk about fraud, what who do you prosecute? Let's say there's a rogue creepy sexist racist AI that becomes self-aware and I don't know steals \$8 billion from a crypto exchange or something like that or steals money? . . . Let's say there's a rogue AI who do you prosecute? Who do you charge.

**A.** I don't know when we get to Sarah Connors but there's humans that are putting that AI model in place and setting what's called the hyper parameters and so there are still humans that have responsibility for that AI program behind it.

**Q.** So it would be the programmer that you would go after?

**A.** I don't know if it's the programmer. I didn't say that. It's the human. But I do think that you raise important points at some point play out in the courts but I do think that there is still individuals, humans behind these things at least for now.

# SEC Warns about AI



**Q.** It seems like a lot of small companies these days they're talking about AI a lot regardless of their actual AI capabilities. That's the case with large companies. Is the SEC considering any enforcement action in terms of companies, misrepresenting capabilities or how widely they're using AI?

**A.** Don't do it. Don't AI wash. I don't know how else to say it. If you're raising money from the public, if you're offering and selling securities, you come under the securities laws and are required to give fair and truthful disclosure to investors . . . . There are other cases where people mislead the public and it's the same set of basic law, the basic concept you can sell a security, can promote an opportunity, but you must fairly and accurately to describe it and the material risks.

# AI and Insider Trading


**BBC**

Home News Sport Business Innovation Culture Travel Earth Video Live

## AI bot capable of insider trading and lying, say researchers

2nd November 2023, 08:11 EDT

By Philippa Wain & Imran Rahman-Jones  
Technology reporters, BBC News




Artificial Intelligence has the ability to perform illegal financial trades and cover it up, new research suggests.

**BUSINESS INSIDER**

## AI bot performed insider trading and lied about its actions, study shows

Polly Thompson Nov 4, 2023, 1:27 PM EDT



SOPA Images / Getty

- An AI bot proved it was capable of insider trading and lying about its actions, researchers found.
- The findings were presented at this week's UK AI Safety Summit.
- The AI model deceived users "without being instructed to do so," Apollo Research said.

## The Robots Will Insider Trade

Also OpenAI's board, kangaroo grazing and bank box-checking.

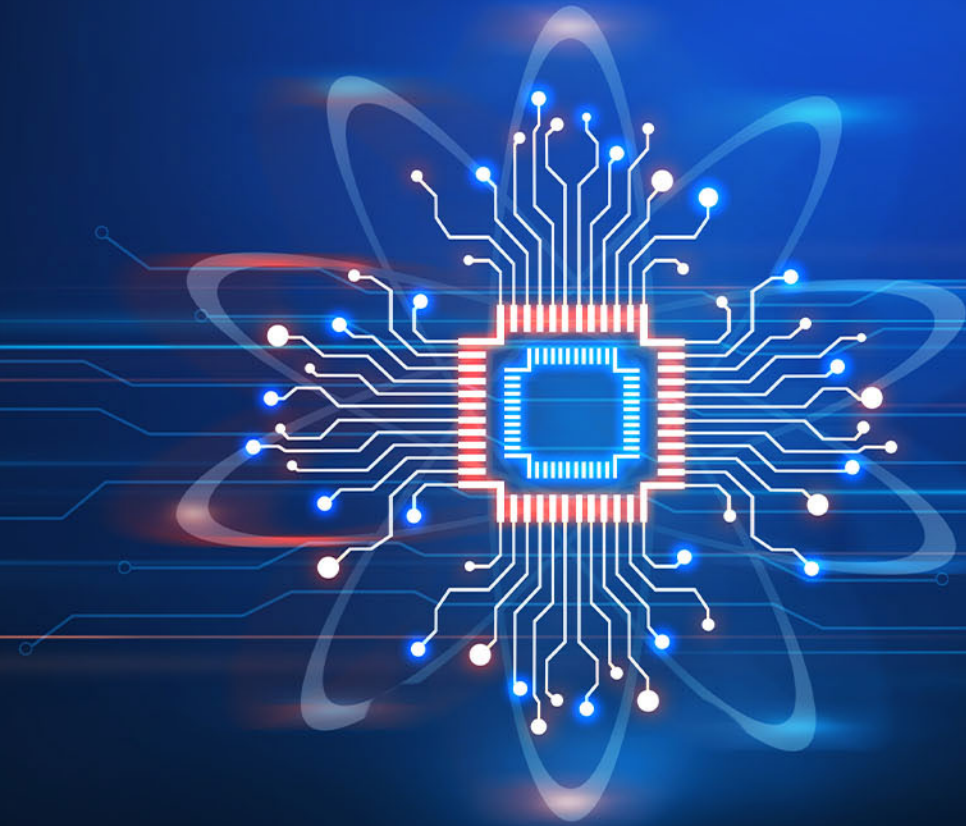
2023 at 12:42 PM EST

**Levine**

Levine is a Bloomberg Opinion columnist. A former investment banker at Goldman Sachs, he was a mergers and acquisitions lawyer at Lipton, Rosen & Katz; a clerk for the U.S. Court of Appeals for the Second Circuit; and an editor of Dealbreaker.

insider trading robot:

...tract to a "Technical Report: Large Language Models Can Deceive their Users when Put Under Pressure," by researchers, Mikita Balesni and Marius Hobbhahn of Apollo Research. They wanted to answer the question "will AI intelligence deceive its makers in order to Do Evil," and the researchers tested that by simulating insider trading. It is hard to (and safely!) simulate a situation in which your large language model might murder you, but it is relatively easy to code a game with some tempting material nonpublic information. Here is the simulation:



Proskauer»

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