

Understanding SEC's Focus Amid Lack Of Final AI Rules

By **Daniel Michael, David Simon and Merin Cherian** (February 20, 2024, 5:55 PM EST)

Last year, the U.S. Securities and Exchange Commission proposed ambitious rules relating to artificial intelligence that have drawn significant commentary and criticism.

It is unlikely that changes in the law are imminent, but recent steps taken by the SEC indicate that it is not content to wait for those changes before addressing AI-related problems and risks that it perceives.

This month alone, the SEC filed an enforcement action charging an investment adviser with allegedly making false claims about the use of AI in an investment strategy,[1] and SEC Chair Gary Gensler gave a speech promising "war" on AI fraud.[2]

While the SEC's proposed rules raise the bar in the areas of conflicts of interest, disclosures, and policies and procedures, existing provisions of the federal securities laws address each of these areas. Given the lengthy process for rulemaking, it is likely that the SEC has launched these initiatives with an eye to these existing provisions.

Understanding how the SEC may be approaching its existing regulatory authority can help firms that develop and use AI stay ahead of regulatory developments.

The SEC's Focus on AI

Following significant technological developments in recent years, AI — which includes machine learning, deep learning and generative AI — has become a tool used by many broker-dealers and investment advisers.

Firms currently use programs leveraging AI in various ways, such as to forecast the price movements of certain investment products, program robo-advisers to assist in automated planning and investment services, address basic client questions via virtual assistants, aid in risk management, anticipate cyber threats, and bolster compliance efforts by enhancing surveillance capabilities.

The SEC is paying attention. Reiterating concerns he expressed while he was a professor at the Massachusetts Institute of Technology's Sloan School of Management, Gensler has stated that AI poses risks to individual investors as well as to the financial system generally.

For example, according to Gensler, AI models' decisions and outcomes are often unpredictable, making it difficult to determine whether the models may be placing the interests of the firms developing them ahead of those of firm clients.[3]

To address these and other risks, the SEC has proposed broad new rules that would govern how broker-dealers and investment advisers can use AI.[4] The rules, if adopted in their current form,



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would prevent firms from using predictive data analytics, or PDA, which includes AI and other technologies, in a manner that creates conflicts of interest that place a firm's interests ahead of those of its customers and clients.

Specifically, the rules as proposed require that broker-dealers and investment advisers:

- Evaluate the PDA they use and identify and eliminate or neutralize any related conflicts of interest that could place the firm's interests ahead of those of its customers or clients;
- Adopt, implement and maintain written policies and procedures to come into compliance with the proposed rules; and
- Comply with recordkeeping requirements by maintaining records of evaluations done on PDA, including when the technology was implemented and materially modified, the date of any testing and any actual or potential conflicts of interest identified.

Commentators have noted that these proposed rules, if adopted in their current form, would present new challenges to firms relying on AI models.[5] The rules would apply to technology beyond AI and to interactions with not just individual investors but also institutional investors and even prospective investors.[6]

In addition, the requirement to eliminate and neutralize conflicts of interest goes beyond how the federal securities laws typically deal with conflicts, which is by mandating full and fair disclosure. To satisfy this requirement, the proposed rules state that firms must evaluate and document all conflicts of interest that may arise by using AI.

Gensler's own remarks in 2020 when he was an MIT professor indicate this is no easy task: "[I]f deep learning predictions were explainable, they wouldn't be used in the first place." [7] How broker-dealers and investment advisers can fully document the conflicts that may arise from these unexplainable predictions is not clear.

Given these challenges, the proposed rules have been met with industry pushback. Some firms have argued that the rules in their current form would require them to stop using PDA technologies, would risk industry consolidation and would put U.S. investors at a competitive disadvantage in the global market.[8]

Efforts outside of rulemaking suggest that the SEC is not content to wait until these rules are adopted before addressing problems and risks it perceives related to AI technologies.

Around the time the SEC proposed its rules on PDA, the SEC's Division of Examinations launched an AI-related sweep, requesting that firms provide, among other things, a description of their AI models and techniques, the source and providers of their data, AI-related policies and procedures, and marketing documents that disclose the firm's use of AI.[9]

The Division of Enforcement is also involved. After Gensler cautioned firms against "AI washing," which is the practice of making false AI-related claims that he likened to greenwashing, a senior SEC enforcement official confirmed that the agency has active investigations in this area.[10]

Earlier this month, the SEC filed a settled **enforcement action** against Rockwell Capital Management LLC and its founder for, among other things, allegedly misrepresenting that the investment adviser would use a "multi-faceted investment strategy using unique, proprietary tools," which included AI and machine learning models that could predict price behavior.[11]

Also, this month, Gensler gave a speech reiterating a statement made by the SEC's first chair, Joseph Kennedy, that the SEC "will make war without quarter on any who sell securities by fraud or misinterpretation" and noting that "bad actors have a new tool, AI, to exploit the public." [12]

Gensler's comments, however, went beyond fraudulent conduct. He warned companies against failing to test technology before deploying it or failing to put in place appropriate guardrails.[13]

The Existing Regulatory Framework and AI

In the absence of final AI rules, the SEC's efforts indicate that it is considering using existing regulatory provisions to address risks the SEC apparently perceives with respect to AI.

Fixing a problem in an operational AI model can be challenging because subsequent machine learning by the model may have been influenced by the problem in ways that are difficult to see and trace. Consequently, an awareness of the regulatory landscape is crucial so that problems can be avoided or, at least, minimized in the first instance.

AI Development

Current regulatory provisions could apply to both the inputs and outputs of AI models. As to inputs, AI models that use datasets that the firm may not have the authority to use or that may be nonpublic could implicate insider trading laws and other provisions, such as the requirement that investment advisers establish and enforce policies and procedures to prevent the misuse of material nonpublic information. A robust understanding of the origin of data used by AI models may help firms navigate these requirements.

AI outputs may implicate the fiduciary duty owed by investment advisers or the obligations owed by broker-dealers under Regulation Best Interest. While these requirements do not go as far as the proposed rules to require that conflicts of interest be eliminated, they do require that firms take steps to identify and disclose those conflicts.

Firms will need to consider, for example, whether AI models used in making securities recommendations might run afoul of these requirements if they fail to take into account reasonably available alternatives. And, while there is no existing requirement that firms demonstrate how their AI models make decisions, the SEC, under current regulatory requirements, needs only to demonstrate that a conflict of interest exists — which it can do from a pattern of investment recommendations — and does not need to show how or why it exists.

AI Disclosures

As Gensler's warnings against AI washing demonstrate, the SEC is focused on disclosures concerning AI technology that do not fairly or accurately describe the design or use of the technology. Given the SEC's broad authority to pursue inaccurate disclosures, the agency's focus likely extends beyond broker-dealers and investment advisers to public issuers and others.

If companies choose to make disclosures on the AI models they use, they should seek to not only accurately disclose how AI is being developed and deployed, but also monitor the models to timely identify any drift over time based on the training scenarios provided, which may render previous disclosures outdated. Even disclosures not specifically related to AI may be impacted.

For example, the use of AI in risk management — such as technology that semi-automates the review of risk limit breaches or modifies that review based on training scenarios and other information it obtains — may be inconsistent with disclosures about risk management controls and processes that were drafted with a more static approach in mind.

AI Compliance

While the proposed AI rules mandate the design and implementation of AI-related policies, investment advisers are already required to have and implement policies and procedures designed to prevent violations of the federal securities laws, and broker-dealer supervisory requirements take into account whether they have policies and procedures that would reasonably be expected to prevent violations.

The request by the Division of Examination for AI-related policies and procedures suggests the SEC is interested in assessing whether a firm's compliance program is specifically focused on the possible regulatory risks that using AI models may pose.

AI Data Protection

Under SEC rules such as Regulations S-P and S-ID, broker-dealers, investment advisers and investment companies must take certain steps to safeguard client information and appropriately respond to red flags related to possible identity theft. Firms should, therefore, take steps to ensure that any AI models that have access to customer information are properly safeguarded and surveilled for indicia of cyber threats.

And, conversely, AI models deployed by third parties may use the information that a broker-dealer or investment adviser makes available online. Vulnerabilities in a firm's network architecture may allow for access to more information than the firm intended and possibly implicate its obligation to safeguard customer and other nonpublic information.

Conclusion

AI has already demonstrated that it can revolutionize many aspects of financial services, and rapid developments with the technology suggest even more significant uses ahead.

The SEC's ongoing efforts related to this technology indicate that the agency may not be content to wait until it adopts rules specifically designed to address AI, and an understanding of the existing regulatory landscape will help firms anticipate and avoid pitfalls.

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[1] Press Release, SEC Charges Founder of American Bitcoin Academy Online Crypto Course with Fraud Targeting Students, SEC (Feb. 2, 2024), <https://www.sec.gov/news/press-release/2024-13>.

[2] Jessica Corso, SEC's Gensler Promises 'War' on AI Fraud, Law360 (Feb. 13, 2024); <https://www.law360.com/securities/articles/1797350/sec-s-gensler-promises-war-on-ai-fraud>.

[3] Gary Gensler, "Isaac Newton to AI" Remarks before the National Press Club, SEC (July 17, 2023), <https://www.sec.gov/news/speech/gensler-isaac-newton-ai-remarks-07-17-2023>.

[4] Conflicts of Interests Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 152 (proposed July 26, 2023) (to be codified at 17 C.F.R. pts. 240, 275). The SEC has not yet announced a date for voting on a final rule.

[5] See, e.g., Ken Kumayama et al., SEC Proposes New Conflicts of Interest Rule for Use of AI by Broker-Dealers and Investment Advisers, Skadden (Aug. 10, 2023), <https://www.skadden.com/insights/publications/2023/08/sec-proposes-new-conflicts>.

[6] Id.; see also Commissioner Hester M. Peirce, Through the Looking Glass: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers Proposal, SEC (July 26, 2023), <https://www.sec.gov/news/statement/peirce-statement-predictive-data-analytics-072623>; Commissioner Mark T. Uyeda, Statement on the Proposals re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, SEC (July 26, 2023), <https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623>.

[7] Gary Gensler and Lily Bailey, Deep Learning and Financial Stability, MIT Sloan School of Management (Nov. 1, 2020), <https://mitsloan.mit.edu/shared/ods/documents?PublicationDocumentID=7644>.

[8] See, e.g., Virtu Financial, Comment Letter on Proposed Rule on Conflicts of Interest Associated with the Use of PDA (Oct. 10, 2023), <https://www.sec.gov/comments/s7-12-23/s71223-269879-652322.pdf>.

[9] Bill Myers, SEC launches AI sweep, Private Funds CFO (Aug. 30, 2023), https://www.privatefundscfo.com/sec-launches-ai-sweep/?utm_source=linkedin&utm_medium=post&utm_campaign=pfco_paywall_mktg.

[10] Richard Vanderford, SEC Head Warns Against 'AI Washing,' the High-Tech Version of 'Greenwashing', The Wall Street Journal (Dec. 5, 2023), <https://www.wsj.com/articles/sec-head-warns-against-ai-washing-the-high-tech-version-of-greenwashing-6ff60da9>.

[11] See fn 1.

[12] See fn. 2.

[13] Id.