AI, Behavioral Prompts, and Other Emerging Technology – Risk Governance and Conflicts Management

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Agenda

- SEC Proposal on Conflicts of Interest Associated with the Use of Predictive Data Analytics (SEC PDA Proposal)

- SEC examinations and enforcement inquiries on use of AI by investment advisers

- Generative Artificial Intelligence

  - ✓ Applications

  - ✓ Compliance

  - ✓ Risk Governance

What is the SEC concerned about?

"AI, Finance, Movies, and the Law" by SEC Chair Gensler

- System-wide risk
- Deceptive or manipulative practices
- AI washing
- Hallucinations
- Conflicts

SEC PDA Proposal

The Proposal would require:

- A firm to **eliminate or neutralize** the effect of conflicts of interest associated with the firm's use of **covered technologies** in investor interactions that place the firm's or its associated person's interest ahead of investors' interests;

- A firm that has **any investor interaction** using covered technology to have **written policies and procedures** reasonably designed to prevent violations of (in the case of investment advisers) or achieve compliance with (in the case of broker-dealers) the proposed rules; and
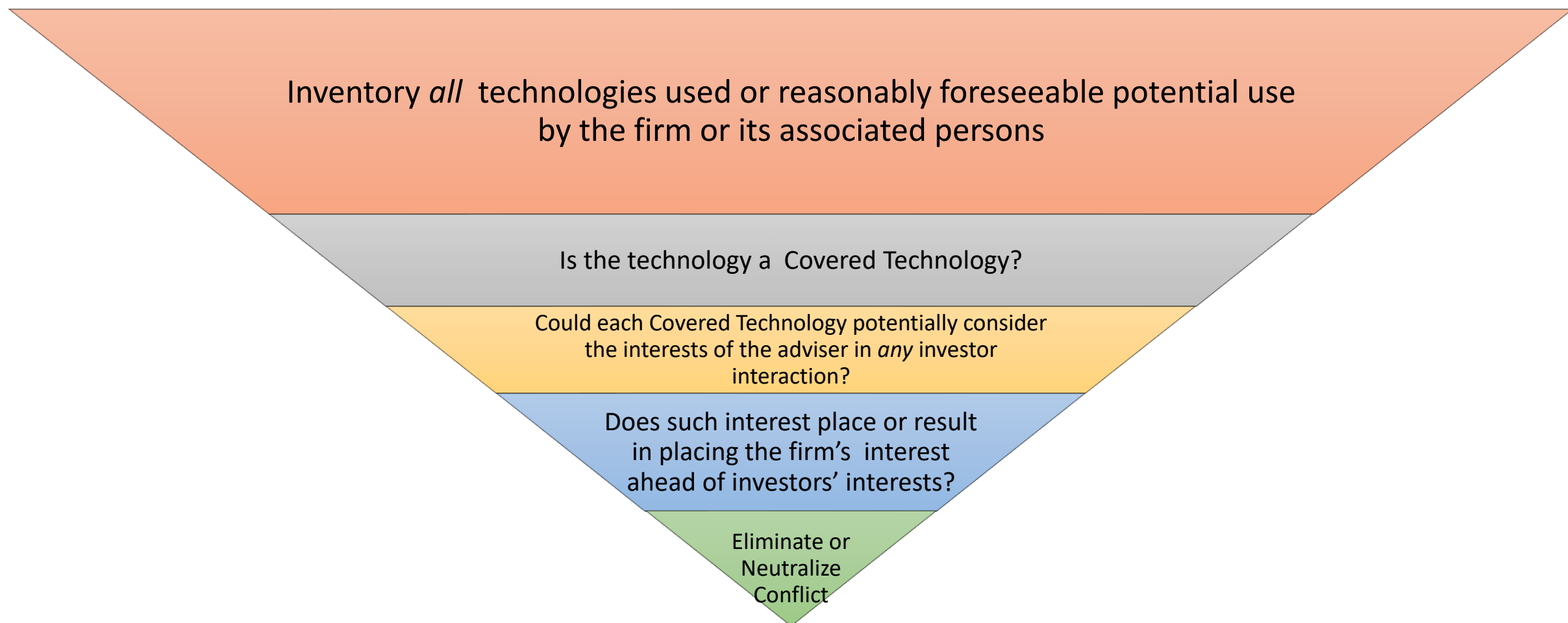
- **Recordkeeping** related to the proposed rules.

SEC PDA Proposal

Covered Technology

- Means "[a]n 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."

- Captures "PDA-like technologies," such as artificial intelligence (AI), including machine learning, deep learning, neural networks, natural language processing (NLP), or large language models (including generative pre-trained transformers or "GPT"), as well as other technologies that make use of historical or real-time data, lookup tables, or correlation matrices.

SEC PDA Proposal Funnel

Inventory *all* technologies used or reasonably foreseeable potential use by the firm or its associated persons

Is the technology a Covered Technology?

Could each Covered Technology potentially consider the interests of the adviser in *any* investor interaction?

Does such interest place or result in placing the firm's interest ahead of investors' interests?

Eliminate or Neutralize Conflict

The IAA's Position: *Withdraw the PDA Proposal!*

The SEC PDA Proposal would:

- Effectively replace ***fiduciary duty principles*** for managing conflicts of interest with an unproven regulation

- Unnecessarily duplicate principles-based regulations that already govern interactions with investors

- Impose costly and burdensome compliance, testing, and recordkeeping obligations that are operationally infeasible due to overly expansive defined terms covering virtually every tool used in almost every interaction between an adviser and investors, including both existing and prospective clients;

- Stifle innovation and the beneficial use of emerging technology, contrary to the interests of investors; and

- Severely underestimate the significant economic impact, including the cumulative costs and burdens that would be imposed on advisers, particularly smaller advisers.

SEC Inquiries on Use of "AI"

Examinations:

"….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, but is not limited to, 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, whereas (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." [emphasis added]
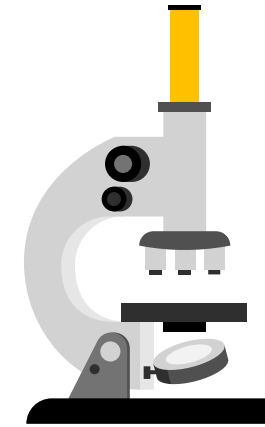
Enforcement:

"….software programs that utilize deep and machine learning to analyze large amounts of data and define new rules based on connections among data points that are not usually made by humans to learn form the data and connections for making trading decisions. The software programs may autonomously execute trading decisions or may assist staff in making trading decisions."

SEC Inquiries on Use of AI

Examinations:

- AI disclosures and marketing
- Marketing and promotion
- Description of AI models and techniques
- List of algorithmic trading signals and associated models
- Data sources and providers
- Compliance policies and procedures
- Conflicts of interest policies
- Contingency plans
- Client profile documents
- Data security
- Performance evaluation reports
- Incident reports
- Data Acquisition Errors and Adjustments
- Model validation reports
- Staffing, training and education

Enforcement:

- AI disclosures
- Compliance policies and procedures
- Staffing, training and education
- Algorithmic models and trading signals
- Data sources, use and profitability

Generative Artificial Intelligence
What is Gen AI?

"Generative AI is a form of artificial intelligence in which models are trained to generate new original content based on natural language input. In other words, you can describe a desired output in normal everyday language, and the model can respond by creating appropriate text, image, or even code output." - *Microsoft*
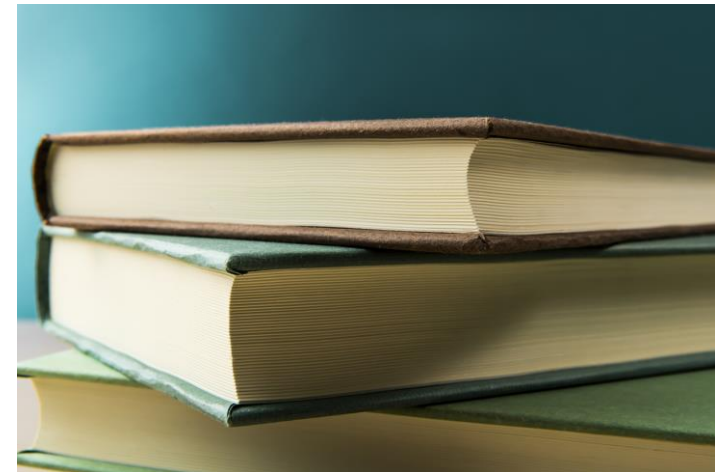
Generative Artificial Intelligence
Existing applicable regulations and guidance for advisers

- Fiduciary duty (including risk management and mitigation)

- 2017 SEC Staff Guidance on Robo Advisers

- Marketing Rule

- Compliance Program Rule

- Recordkeeping Rule

Generative Artificial Intelligence
Applications

Back office administrative

Compliance

Trade operations

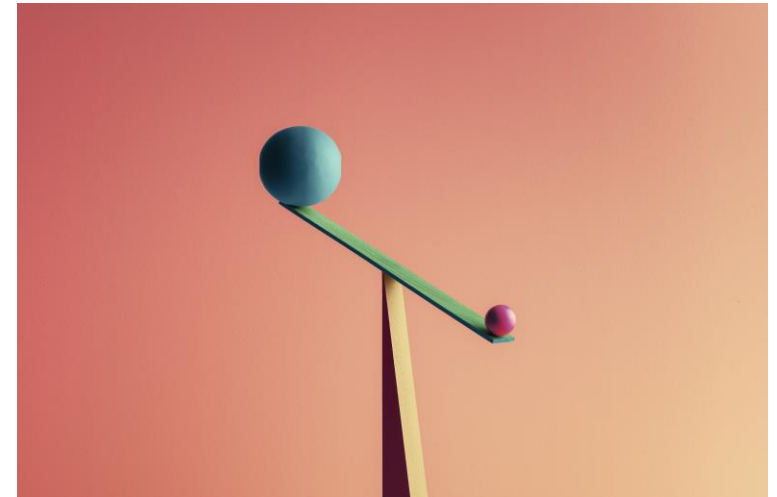Investment advice and portfolio management

Client communications and support

Marketing

Generative Artificial Intelligence
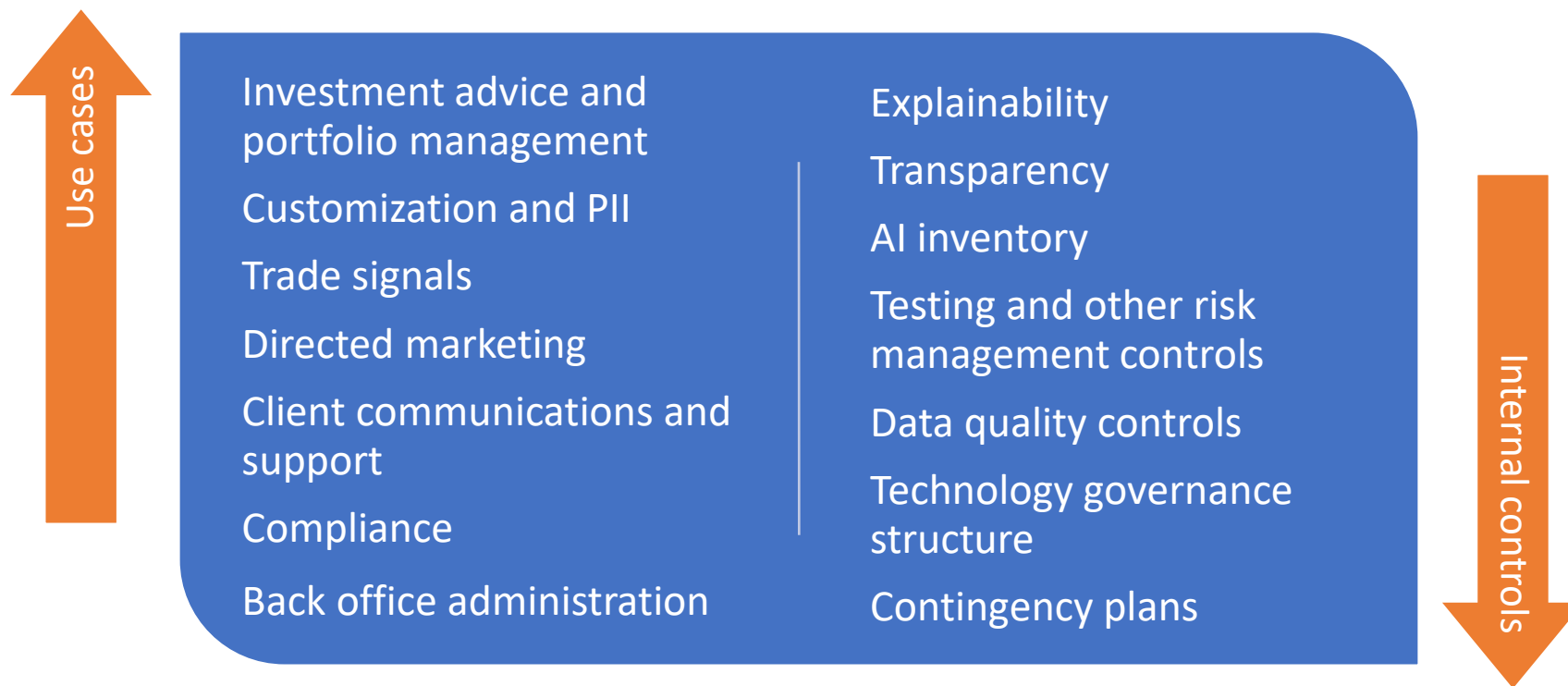*What are the risks?*

- Data privacy and security

- Transparency and explainability

- Dependency on data quality and availability/accuracy ("hallucinations")

- Use of copyrighted source material

- Bias

- User perception/trust issues

Generative Artificial Intelligence

Relationship between use cases and controls to mitigate risk

Use cases

- Investment advice and portfolio management
- Customization and PII
- Trade signals
- Directed marketing
- Client communications and support
- Compliance
- Back office administration

- Explainability
- Transparency
- AI inventory
- Testing and other risk management controls
- Data quality controls
- Technology governance structure
- Contingency plans

Internal controls

Questions?