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

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The financial services industry has long used technology, including artificial intelligence ("AI"), to assist in providing asset management services, personalize client interactions, enhance the level of client service, and manage compliance and risk functions, among other things. The emergence of generative AI has accelerated the exploration and adoption of this technology and has simultaneously increased the U.S. Securities and Exchange Commission's ("SEC") focus on addressing investor protection concerns that are heightened by the use of AI by investment advisers and broker-dealers.

SEC Chair Gary Gensler, in particular, has been keenly focused on potential conflicts of interests associated with the use of AI. "We live in an historic, transformational age with regard to predictive data analytics and the use of artificial intelligence," said Gensler in a statement on July 26, 2023.[1] "This also raises the possibilities that conflicts may arise to the extent, for example, that advisers and broker-dealers are optimizing to place their interests ahead of their investors' interests. Left unaddressed, I believe that investors exposed to conflicted investor interactions in such instances may lack the time-tested investor protections our laws and regulations provide."

Chair Gensler's more recent statements[2] also highlight what he views as some of the "inherent risks" associated with AI:

- AI models' decisions and outcomes are often unexplainable;

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[1] Gary Gensler, "Statement on Conflicts of Interest Related to Uses of Predictive Data Analytics" (July 26, 2023), available at: https://www.sec.gov/news/statement/gensler-statement-predictive-data-analytics-072623.

[2] Gary Gensler, "AI Finance, Movies, and the Law" Prepared Remarks before the Yale Law School (Feb. 13, 2024), available at: https://www.sec.gov/news/speech/gensler-ai-021324.

- AI may make biased decisions because the outcomes of its algorithms may be based on data that incorporates historical biases;
- The results of predictive models are not always accurate;
- The consolidation of AI platforms promotes network interconnectedness and monocultures that could lead to systemic risk;
- Current model risk management guidance has not been updated to reflect this new wave of data analytics;
- The use of AI may result in deceptive or manipulative practices, whether through intentional conduct or predictable harm;
- AI washing and other activities where public companies and financial intermediaries make inaccurate or misleading statements about their use of AI and its associated risks; and
- The risk that AI is hallucinating or otherwise generating recommendations or advice based on inaccurate information.

Many of these concerns were reflected, directly or indirectly, in the SEC's 2021 request for information and comment on how broker-dealers and investment advisers use digital engagement practices ("DEPs").[3] More recently, on July 26, 2023, the SEC proposed new rules intended to address certain conflicts of interests associated with the use of predictive data analytics ("PDAs") and similar technologies in investor interactions.[4] The PDA Proposal has been met with strong opposition from the industry due to the overly broad definitions and compliance obligations that are part of the Proposal, as well as the proposed approach of eliminating the ability to rely on disclosure to address conflicts of interest.[5]

The SEC's activity in this area is not limited to rulemaking. The SEC staff continues to focus on AI in its examination program. The SEC activity is occurring against the backdrop of significant legislative and executive branch attention to the regulation of AI[6] and other regulatory and self-regulatory agencies are also exploring the implications of AI in financial services.

1. SEC Request for Information on Digital Engagement Practices

On August 27, 2021, the SEC published a release requesting information and comments on broker-dealer and investment adviser use of DEPs when interacting with retail investors through digital

[3] *Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice*, Exchange Act Rel. No. 34-92766 (Aug. 27, 2021) [(the "DEP Request")], available at: https://www.sec.gov/rules/other/2021/34-92766.pdf.

[4] *Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers*, Advisers Act Rel. No. 6353 (July 26, 2023) [(the "PDA Proposal")], available at https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf.

[5] Letter from Gail C. Bernstein, Gen. Couns., and Sanjay Lamba, Assoc. Gen. Couns., Inv. Adviser Ass'n, to Vanessa A. Countryman, Sec'y, SEC, (Oct. 10, 2023), https://www.sec.gov/comments/s7-12-23/s71223-270339-652942.pdf.

[6] *See, e.g.*, *Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence*, E.O. 14110 of Oct. 30, 2023, available at: https://www.govinfo.gov/content/pkg/FR-2023-11-01/pdf/2023-24283.pdf.

platforms, as well as the analytical and technological tools and methods used in connection with such practices. DEPs are broadly defined in the DEP Request to include behavioral prompts, gamification, and other design elements or features for engaging with retail investors on digital platforms.[7] The Release also requested comments on investment adviser use of technology to develop and provide investment advice.

Based on the public statement that Chair Gensler issued in connection with the DEP Request[8], it is clear that he was particularly focused on addressing investor protection concerns where the use of DEPs:

- Actually lead to statistically significant changes in investor behavior or change decision-making such that a firm is making a recommendation (under Reg BI) or providing investment advice; and
- Create conflicts of interest by directing investors to securities, investment strategies, or services that generate higher fees or third-party revenue for the firm or may not be appropriate for a retail investor.

According to the SEC, the purpose of the DEP Request was to, among other things, collect information that the SEC could use to access existing regulations and consider whether rulemaking might be necessary. Two years later on July 26, 2023, the SEC proposed rules governing conflicts of interest associated with the use of predictive data analytics.

2. SEC Proposal on Conflicts of Interest Associated with Predictive Data Analytics

The PDA Proposal would create parallel rules for broker-dealers and investment advisers - Rule 15l-2 under the Securities Exchange Act of 1934 ("Exchange Act") and Rule 211(h)(2)-4 under the Investment Advisers Act of 1940 ("Advisers Act") - that would govern conflicts of interest in covered technology used in investor interactions. The PDA Proposal reflects SEC concerns that conflicts 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 can arise from the data the technology uses (including investor data) and the inferences the technology makes in analyzing that data. Ultimately, the wide-ranging PDA Proposal would require firms to implement detailed policies and procedures to identify and "eliminate or neutralize" the effects of such conflicts of interest.

If adopted as proposed, the PDA Proposal would require firms using "covered technologies" in "investor interactions" to:

- Evaluate any use or reasonably foreseeable potential use of a covered technology by the firm or its associated persons in an investor interaction to determine whether there is a conflict of interest associated with that use or potential use;

[7] The DEP Request specially identified the following DEPs: social networking tools; games, streaks, and other contests with prizes; points, badges, and leaderboards; push notifications; celebrations for trading; visual cues; ideas presented at order placement; subscription and membership tiers; and catboats.

[8] Chair Gary Gensler, *Statement on Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches*, Aug. 27, 2021, available at: https://www.sec.gov/news/public-statement/gensler-dep-request-comment.

- Determine if the conflict of interest places the interests of the firm and its associated persons ahead of the interests of investors;
- "Eliminate or neutralize" the effect of conflicts associated with the use of technologies that place the firm's or its associated person's interest ahead of investors' interests; and
- Adopt written policies and procedures, implement comprehensive controls, and generate detailed records to memorialize compliance with the proposed conflicts rule.

The concepts of covered technologies and investor interactions are defined broadly and would potentially capture almost every interaction with prospective and existing investors. Even more troublesome, however, seems to be the SEC's position that the rapid acceleration, complexity, and scalability of PDA-like technology makes disclosure an ineffective means of mitigating the related risks. In other words, firms would not have the option to disclose conflicts of interest and rely on informed consent under investment adviser concepts of fiduciary duty (IA Fiduciary Duty) or to disclose, mitigate, or eliminate conflicts of interest as set forth under Regulation Best Interest (Reg BI). Rather, in the event of a conflict of interest that places the firms' interest ahead of investors, the only option would be to "eliminate or neutralize" such conflict.

(a) Covered Technology

The definition of a "covered technology" refers to any 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. Examples of investment-related behaviors or outcomes include buying, selling or holding securities, making referrals, and increasing trading volume and/or frequency. While the proposed definition of covered technology includes technology licensed from third parties, it *excludes* technologies designed purely to inform investors (e.g., a website that shows investor's current account balance and past performance), and information related to non-securities products (e.g., whether an investor would be approved for a credit card, or basic customer service support).

The proposed definition would capture design elements, features, or communications and advertisements that "nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors." According to the PDA Proposal, this covers "PDA-like" technologies such as AI, machine learning, deep learning algorithms, neural networks, natural language processing, large language models (including generative pre-trained transformers), and other technologies that make use of historical or real-time data, lookup tables, or correlation matrices among others.

(b) Investor

The PDA Proposal would define "investor" differently for broker-dealers and investment advisers. The proposed definition of "investor" for broker-dealers comes from the definition of "retail investor" under Form CRS and is limited to "any natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." The proposed definition for investment advisers is broader and would not be limited to retail investors. Rather, the proposed definition of an investor for investment advisers would include all current and prospective clients, as well as all investors in any investment company or private fund (exempt under

section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940) advised by the investment adviser. This means that the Proposed Rule would apply to investor interactions with investors in both private funds and registered funds.

(c) Investor Interaction

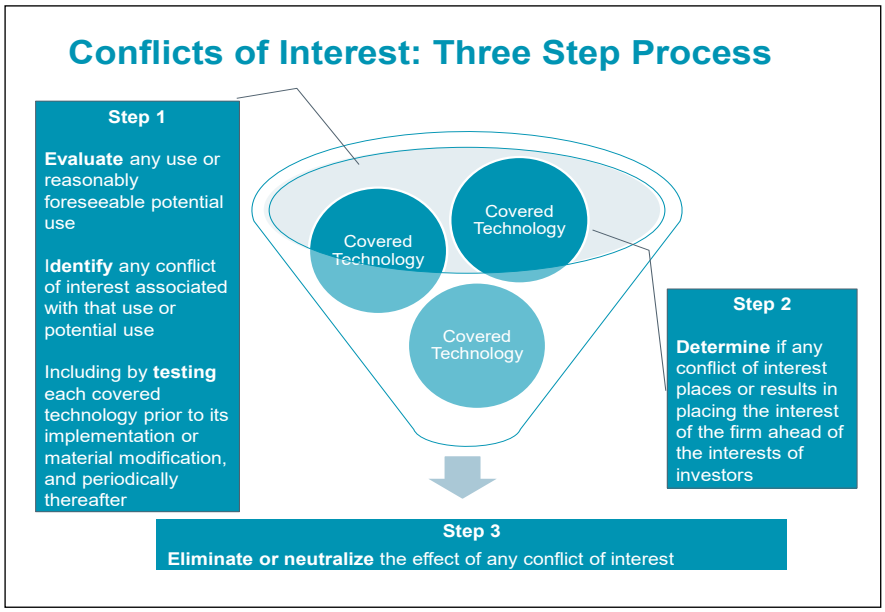
"Investor interaction" means engaging or communicating with an investor, including by exercising discretion with respect to an investor's account, providing information to an investor, or soliciting an investor. The only express exception to the proposed definition would be interactions solely for purposes of meeting legal or regulatory obligations, or providing clerical, ministerial or general administrative support. Further, the "use" of a covered technology in an investor interaction can occur directly through the covered technology itself, or indirectly when an associated person communicates results generated by the technology to an investor.

As drafted, the proposed definition would capture a firm's correspondence, dissemination, or conveyance of information to, or solicitation of, investors in any form, including in-person or electronically via websites, smartphones, chatbots, emails, text messages and other online or digital tools platforms.

(d) Conflicts of Interest

A conflict of interest exists when a firm uses a covered technology that takes into consideration an interest of the firm, or an associated person of the firm. The term is defined broadly to capture situations where a covered technology considers *any* favorable information about the firm or associated person in an investor interaction. Importantly, the proposed definition does not depend on whether there is an actual conflict between the interests of the firm (or its associated persons) and the client, or whether the conflict places the interest of the firm or its associated persons ahead of investors' interest. Instead, the definition sets up a three-step process under which firms would:

- Evaluate any use or reasonably foreseeable potential use of a covered technology in any investor interaction to identify any conflict of interest, including through testing the covered technology prior to its implementation or material modification, or periodically thereafter.
- Determine if any conflict of interest places or results in placing the interests of the firm ahead of the interests of investors.
- Eliminate or neutralize the effect of any conflict of interest that places the interests of the firm ahead of the interest of the investors, promptly after the firm determines or reasonably should have determined that the conflict of interest placed the interests of the firm ahead of the interests of the investors. Under the PDA Proposal, disclosure is not an option to address possible conflicts of interest.



(e) Policies and Procedures Requirement

Under the PDA Proposal, firms must implement policies and procedures reasonably designed to prevent violations of the proposed rules, which must include:

- A written description of the process for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction, and any material features (including conflicts of interest) prior to implementation or material modification, which must be updated periodically;
- A written description of the process for determining whether any conflict of interest results in an investor interaction that places firm interests ahead of investors' interests;
- A written description of the process for eliminating or neutralizing the effect of any conflict of interest; and
- An annual review of the adequacy of the policies and procedures and the effectiveness of their implementation.

(f) Recordkeeping Amendments

The SEC also proposed amendments to the Advisers Act and Exchange Act books and records rules in order to require firms to maintain and preserve extensive written communications that would evidence and memorialize each step of the process described above. Specifically, investment advisers and broker-dealers would be required to retain the following:

- Written documentation of the evaluation conducted, including a list of all covered technologies, evaluation of intended use vs. actual use, description of any testing, methods used to conduct testing, conflicts of interest identified, modifications or restrictions placed on the covered technology as a result of the testing;

- Written documentation of each determination of a conflict of interest, including rationale for the determination;
- Written documentation of each elimination or neutralization of a conflict;
- Written policies and procedures, including date of last review;
- A record of disclosures made to investors regarding the firm's use of a covered technology; and
- A record of each instance when a covered technology was altered, overridden or disabled and the reason for such action.

3. Draft Recommendation of the SEC Investor Advisory Committee's Disclosure Subcommittee Regarding Digital Engagement Practices

During its December 7, 2023 meeting, the Disclosure Subcommittee of the SEC's Investor Advisory Committee ("IAC") discussed draft recommendations relating to the PDA Proposal.[9] Although they are still in draft form, the IAC Recommendations echoed what many of the industry comment letters reflected, which is that while there is an appreciation that the SEC is trying to address investor protection concerns relating to emerging technology, the Proposal may "negatively impact the very investors that the [Proposal] is intended to protect." Specifically, the IAC Recommendations state that "efforts by firms to comply with the current formulation of 'covered technologies' combined with the current formulation of 'investor interactions' could have unintended adverse impacts on investors by overly curtailing access to valuable information, tools, and assistance, and impeding the adoption of new, beneficial technologies." The IAC ultimately set forth the following proposed recommendations.

- Narrow the scope of the PDA Proposal to target the unique risks of predictive data analytics and artificial intelligence that interact directly with investors;
- Build upon the existing regulatory framework which requires firms to "eliminate, mitigate or disclose conflicts of interest" while recognizing that for certain inherently opaque and complex PDA and AI technologies, disclosure is not sufficient and the SEC should use the existing definition of conflicts under Regulation Best Interest and the Adviser Fiduciary Duty Interpretation;
- Rely on existing regulations and principles to improve the oversight of DEPs by clarifying the definition of what constitutes a recommendation;
- The Commission and FINRA should bring the full weight of their enforcement authority against DEPs that are determined to be abusive, misleading, and manipulative; and

[9] *Draft Recommendation of the SEC Investor Advisory Committee's Disclosure Subcommittee Regarding Digital Engagement Practices* at 5, SEC, (Nov. 17, 2023) https://www.sec.gov/files/20231117-recommendation-use-dep.pdf ("IAC Recommendation").

- The Commission and FINRA should promote investor education in connection with the use of DEPs.[10]

The IAC is currently scheduled to discuss a recommendation regarding DEPs at its upcoming meeting on March 7, 2024.

4. SEC Examination Activity

The SEC Division of Examinations highlighted AI as a priority in its 2024 Examination Priorities noting that "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."[11] The Division of Examinations has also been requesting various information from investment advisers relating to their use of AI such as:

- Disclosure and marketing documents provided to clients where the use of AI by the adviser is stated or referred to specifically in the disclosure;
- A written description of all distinct AI-based models and techniques developed and implemented by the adviser to manage client portfolios, make investment decisions, or generate trading signals;
- The underlying data sources used by AI systems and any data source providers with which the adviser contracts, along with "in-house" alternative data sources;
- Written compliance and operational policies and procedures concerning the supervision of AI systems;
- A list of all supervised persons responsible for developing, implementing, operating, managing, and supervising AI systems and a list of internal committees with specific AI-related responsibilities; and
- Documents outlining how potential conflicts of interest related to AI outputs are managed.

As the above list indicates, the SEC staff is focused both on the way investment advisers market their AI capabilities (and, in particular, so-called "AI washing") as well as the substantive controls around the use of AI and any related conflicts of interest.

5. FINRA 2020 Report on AI in the Securities Industry

In addition to the SEC, FINRA has long focused on the potential impact of AI in the securities industry. In July 2018, FINRA requested comments from broker-dealers on the potential challenges associated with

[10] The SEC Office of Investor Education and Advocacy, NASAA and FINRA recently issued a joint investor alert relating to artificial intelligence and investment fraud. *See Artificial Intelligence (AI) and Investment Fraud: Investor Alert* (Jan. 25, 2024), available at: https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/artificial-intelligence-fraud.

[11] *SEC Division of Examinations, 2024 Examination Priorities* (Oct. 16, 2023), available at: https://www.sec.gov/files/2024-exam-priorities.pdf.

using and supervising AI.[12] Based on the feedback it received in response to this request, FINRA, through its Office of Financial Innovation, undertook a "broad review of the use of AI in the securities industry to better understand the varied applications of the technology, their associated challenges, and the measures taken by broker-dealers to address those challenges." This review culminated in a 2020 report on AI in the securities industry.[13] Among other things, the FINRA AI Report detailed the following regulatory challenges relating to the use of AI:

(a) Model Risk Management

FINRA suggested that firms employing AI update their model risk management frameworks to take into consideration the complexity of AI models. For example, by conducting upfront and ongoing tests based on scenario testing and new datasets, maintaining a detailed inventory of all AI models and assigning risk ratings, and developing model performance benchmarks and ongoing monitoring and reporting processes to ensure the models perform as intended. The FINRA AI Report also focused on model explainability - the degree to which machine learning models explain the underlying assumptions and factors considered in making a prediction, as opposed to operating as "black boxes."

(b) Data Governance

The FINRA AI Report emphasized controls around data given the large amounts of data that AI applications use to train and retrain models, conduct analyses, identify patterns, and make predictions. The FINRA AI Report recommended that firms have a process for reviewing the underlying dataset for any potential built-in biases. The report also highlighted the need to review the legitimacy and authoritativeness of data sources, focus on the integration of that data into firm systems, develop and test data security controls, and measure the effectiveness of data governance programs.

(c) Consumer Privacy

Customer privacy is a general area of concern for regulators, but that concern is heightened in the case of AI applications that collect personally identifiable information ("PII"), monitor customer activities (e.g., website or app usage, geospacial location, and social media activity), or record written, voice, or video communications with customers. According to the FINRA AI Report, firms should update their written policies and procedures on customer data privacy to address how customer data and information is being collected, used and shared in connection with AI applications.

(d) Supervisory Control Systems

The FINRA AI Report also focused on the supervision and governance of AI applications under FINRA Rule 3110. In particular, it recommended that firms consider the need to enhance supervisory controls to: establish a cross functional technology governance structure to oversee the development, testing,

[12] *FINRA Requests Comment on Financial Technology Innovation in the Broker-Dealer Industry*, Special Notice (July 30, 2018), available at: https://www.finra.org/sites/default/files/Special-Notice-073018.pdf.

[13] *Artificial Intelligence in the Securities Industry*, FINRA Report (June 2020), available at: https://www.finra.org/sites/default/files/2020-06/ai-report-061020.pdf [(the "FINRA AI Report")].

and implementation of AI-based applications; conduct extensive testing of AI applications across their lifecycle; establish back-up or contingency plans (often part of disaster recovery or business continuity plans) in the event an AI-based application fails; and review and verify personal registrations, particularly as AI blends technology, operations, trading, and portfolio management functions.

6. 2024 FINRA Annual Regulatory Oversight Report

In its most recent annual report[14], FINRA again cautioned firms to be thoughtful about how the use of new technologies, including generative AI tools, could impact their regulatory obligations. According to FINRA, "[t]he use of AI tools could implicate virtually every aspect of a member firm's regulatory obligations, and firms should consider these broad implications before deploying such technologies." In particular, FINRA highlighted regulatory obligations relating to: anti-money laundering, books and records, business continuity, communications with the public, customer information protection, cybersecurity, model risk management (including testing, data integrity and governance, and explainability), research, SEC Reg BI, supervision, and vendor management.

7. CFTC Request for Comment on the Use of AI in CFTC-Regulated Markets

In addition to the SEC, the Biden Executive Order has prompted other regulatory agencies to consider the impact of AI in financial services. On January 25, 2024, the Commodity Futures Trading Commission ("CFTC") issued a request for comment on the use of AI in CFTC-regulated derivatives markets.[15] The CTFC requested comment on, among other things:

- The proper definition of AI, and how broadly or narrowly it should be defined with respect to automated trading strategies and CFTC-regulated markets;
- The application of AI in trading, risk management, compliance, cybersecurity, recordkeeping, data processing, analytics, and customer interactions;
- The role of third parties in developing AI technologies; and
- The risks of AI, including those related to market manipulation, fraud, governance, explainability, data quality, concentration, mitigation of bias, privacy and confidentiality, and general customer protection.

Comments on the CFTC request will be accepted through April 24, 2024.

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[14] *2024 FINRA Annual Regulatory Oversight Report* (January 2024), available at: https://www.finra.org/sites/default/files/2024-01/2024-annual-regulatory-oversight-report.pdf.

[15] *Request for Comment on the Use of Artificial Intelligence in CFTC-Regulated Markets*, CTFC Release (January 25, 2024), available at: https://www.cftc.gov/PressRoom/PressReleases/8853-24.