

April 10, 2024

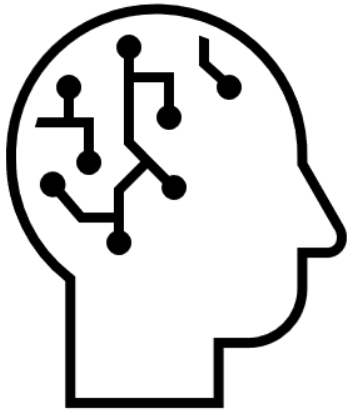
Artificial Intelligence for Asset Managers – The Compliance and Regulatory Path Ahead

Presenters

Agenda

- Definition of artificial intelligence
- Key risks of generative AI
- SEC rule proposal
- CFTC request for comment
- Congressional perspective
- Best practices for AI governance

What is the difference between AI and Generative AI?



ChatGPT

AI, or Artificial Intelligence, refers to the broader field of computer science focused on creating systems that can perform tasks that typically require human intelligence. This can include tasks like learning, problem-solving, perception, and language understanding.

Generative AI, on the other hand, specifically refers to a subset of AI techniques that involve generating new data or content. This can include generating images, text, music, or other forms of media. Generative AI often utilizes techniques like neural networks, deep learning, and reinforcement learning to create new content that is realistic and coherent, mimicking the patterns and structures found in the training data it has been exposed to.

Key Risks of Generative AI

- Lack of transparency and explainability
- Hallucinations and inaccurate information
- Consolidation of AI models
- Market manipulation and fraud
- Data quality
- Bias
- Data privacy and security
- IP and copyright infringement

SEC Rule Proposal

- On July 26, 2023, the SEC proposed new rules intended to address certain conflicts of interests associated with the use of covered technology in investor interactions
- “**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
- “**Covered Technology**” means:
 - 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
- “**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

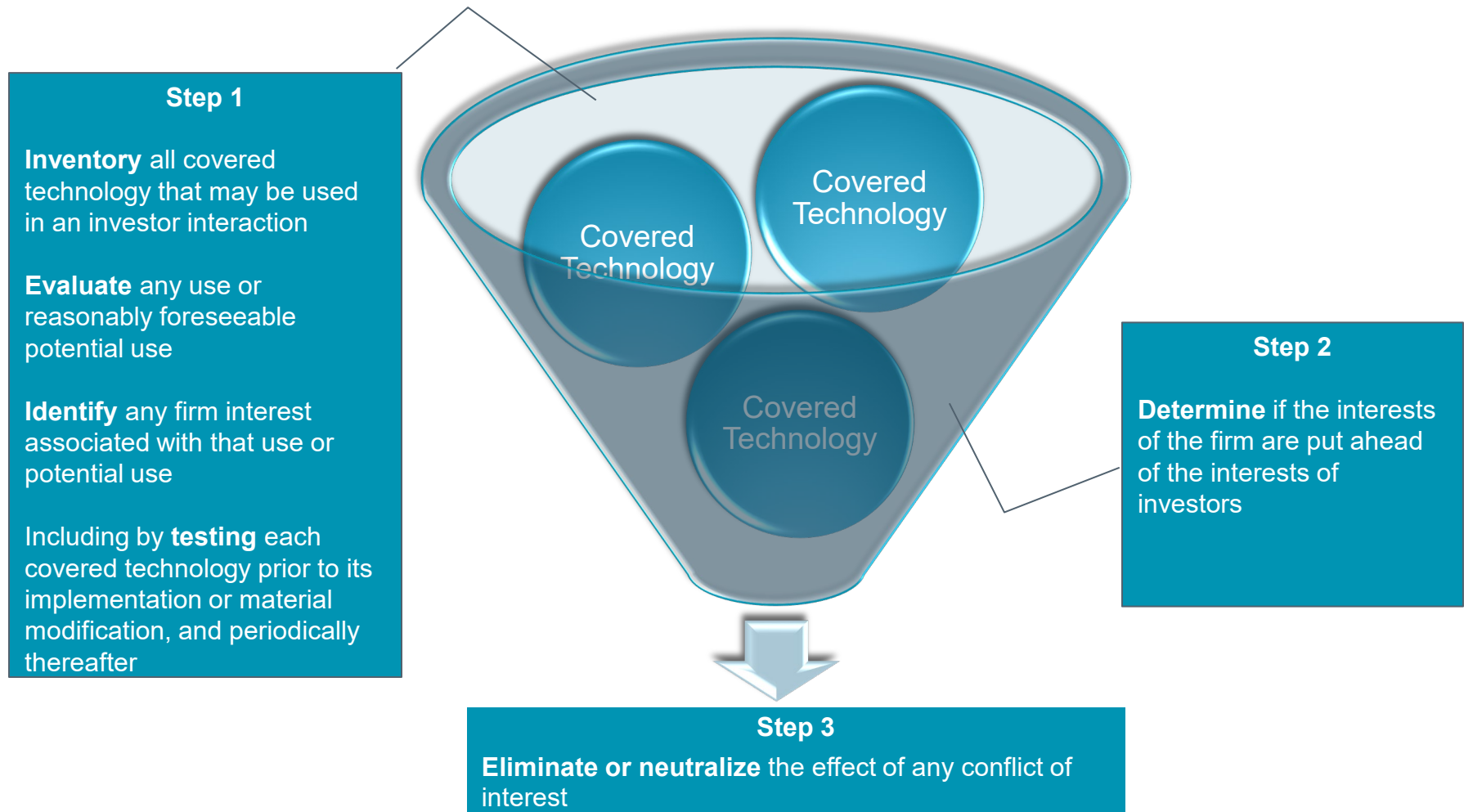
SEC Rule Proposal

- Definition of covered technology would capture design elements, features, or communications and advertisements that “nudge, prompt, cue, solicit, or influence investment-related behaviors or outcomes from investors”
- Definition designed to cover “PDA-like” technologies:
 - Artificial intelligence
 - Machine learning
 - Deep learning algorithms
 - Neural networks
 - Natural language processing
 - Large language models (including generative pre-trained transformers)
 - Other technologies that make use of historical or real-time data, lookup tables, or correlation matrices among others

SEC Rule Proposal

- The proposal would require firms using “covered technologies” in “investor interactions” to:
 - Evaluate any use or reasonably foreseeable potential use of a covered technology in an investor interaction to determine whether there is a conflict of interest
 - 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 the conflicts
 - Adopt written policies and procedures, implement comprehensive controls, and generate detailed records to memorialize compliance with the proposed conflicts rule

SEC Rule Proposal



Select Industry Comments

There are existing rules that extensively regulate recommendations and advice, as well as investor interactions through the use of technology (or otherwise)

The existing regulatory framework has proven capable of addressing conflicts of interest relating to emerging business practices and technology

The proposed definitions are vague and overbroad with the result that the proposed rules will regulate a wide range of activities that are unrelated to the concerns raised by the SEC

The SEC lacks the statutory authority to promulgate the proposed rules

The requirements of the proposed rules would impose unreasonable costs on firms and investors

The proposed rules would stifle innovation and the beneficial use of emerging technology, contrary to the interests of investors

The implementation of the proposed rules are operationally infeasible given the overly expansive defined terms

The SEC significantly underestimates the economic impact of the proposed rules, including the cumulative impact that would be imposed on firms based on the active rulemaking agenda

CFTC Request for Comment

- On January 25, 2024, CFTC issued a request for comment on the use of AI in CFTC-regulated derivatives markets, including:
 - The proper definition of AI, and how broadly or narrowly it should be defined
 - 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
 - The risks of AI

Congressional Perspective

- House Task Force on AI
- House Financial Services Committee – Working Group on AI
 - What can the US Congress learn from the EU’s actions?
 - How will use of AI affect the denial process for individuals?
 - What does “investment advisory” mean in the context of AI?
 - How will AI make BSA/AML reviews more effective?
 - How will potential China outbound investment restrictions affect the development of AI?

Best Practices for AI Governance

- Definition of AI
- Governance committee
 - AI inventory and prioritization
 - Using AI for business purposes
- Model risk management
 - Data sources
 - Review AI models for explainability
 - Testing
 - Verification of output

Best Practices for AI Governance

- Conflicts assessment
- Disclosure
 - Explanation of risks and limitations
 - Form ADV risk factors
- Marketing and advertising
- Training
- Books and records
- Service providers and vendor management

The image features a blue bokeh background with a central orange band. The bokeh consists of numerous out-of-focus light spots in various shades of blue and white, creating a shimmering effect. The orange band is a solid, horizontal strip that spans the width of the image, providing a high-contrast background for the text.

Questions?

K&L GATES