THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 57 No. 19 November 6, 2024

THE USE OF AI IN THE SECURITIES INDUSTRY: U.S. REGULATORY CONSIDERATIONS FOR BROKER-DEALERS AND SEC-REGISTERED INVESTMENT ADVISERS

In this article, the author explores the current U.S. regulatory environment with respect to the use of AI by U.S. broker-dealers and SEC-registered investment advisers and sets forth certain legal and compliance considerations.

By Jennifer D. Morton *

Long before the advent of artificial intelligence ("AI"), U.S. broker-dealers and SEC-registered investment advisers ("RIAs") deployed automated tools to facilitate communications with customers, assist with portfolio management, and support their operational functions, among other use cases. Broker-dealers employ virtual assistants to provide responses to basic customer inquiries, such as portfolio holdings, accounts balances, and market data,[1] and to develop investment strategies, including analyzing the success of specific features and marketing practices at influencing retail investor behavior.[2] RIAs use automated tools to supplement aspects of their advisory relationships with clients, including through the use of robo-advisers, to provide investors with computer-generated advice delivered through an application. Now they can do all that and more, using AI and machine-learning-based models to inform their investment decisions.[3]

Unsurprisingly, the use of AI in the securities industry has drawn attention from its regulators,[4] including the Financial Industry Regulatory Authority, Inc. ("FINRA"), an independent self-regulatory organization and principal regulator of U.S. broker-dealers, the U.S. Securities and Exchange Commission ("SEC"), which has supervisory jurisdiction over broker-dealers and RIAs.[5] While these regulators are still developing their

[1] Artificial Intelligence ("AI") in the Securities Industry, FINRA, at 6 (June 2020) *available at* https://www.finra.org/sites/default/files/2020-06/ai-report-061020.pdf.

[2] Rel No. 34-97990, at 16 (2023) *available at* https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf ("Proposing Release").

[3] *Id*. at 13.

[4] Note that the scope of this article does not capture the laws of the U.S. states and territories.

[5] The regulation of AI is also on the radar of the Biden Administration. In October 2023, in response to "the rapid speed at which AI capabilities are advancing," President Biden issued an Executive Order establishing standards for AI safety and security. Exec. Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence (2023) *available at* https://www.whitehouse.gov/briefing-room/presidential-actions/2023/10/30/executive-order-on-the-safe-secure-and-

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FORTHCOMING

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approach toward AI, they have already set forth sufficient guidance that financial firms must take note. FINRA has published multiple reports on the topic, while the SEC has proposed a comprehensive set of new rules ("Proposed SEC Rules") while simultaneously applying existing rules to perceived misuses of AI.

Broker-dealers and RIAs continue to allocate significant resources to the development and use of AI applications to create new products, increase revenues, maximize economic efficiencies, and improve the overall customer experience. As firms' use of AI increases, so does the risk of regulatory scrutiny. For this reason, when evaluating and adopting AI applications into their operations, it is important for firms to see it through the lens of the regulator, taking into consideration the principles set forth in current regulatory guidance, including conflicts of interests, data governance, customer privacy, recordkeeping, disclosure obligations, and supervisory control systems, with the goal of investor protection. In this regard, the following (1) summarizes FINRA's guidance with respect to broker-dealers' use of AI, (2) provides an overview of the SEC's regulatory posture with respect to AI, and (3) sets forth certain legal and compliance considerations given the current regulatory environment.

FINRA'S CURRENT REGULATORY FRAMEWORK

In 2020, FINRA published a report, "Artificial Intelligence ("AI") in the Securities Industry" (the "2020 FINRA Report")[6] that provides a comprehensive roadmap for member firms to consider when integrating AI into their existing supervisory and compliance programs. In particular, it highlights key compliance considerations for member firms' use of AI, which include: (1) updating the firms' model risk management programs to account for the use of AI, which correspond with the requirements set forth under FINRA Rule 3110 (Supervision);[7] (2) identifying and either reducing or eliminating data bias, which falls under FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), "to observe high standards of commercial honor and just and equitable principles of trade;"[8] (3) ensuring the protection of financial and personal customer information, noting that this is a "key responsibility and obligation of FINRA member firms,"[9] which corresponds with firms' obligations to comply with SEC Regulation S-P (Privacy of Consumer Financial Information and Safeguarding Personal Information)[10] and Regulation S-ID (Identity Theft Red Flags);[11] (4) the application of Reg BI and FINRA Rule 2111 (Suitability)[12] to recommendations generated by AI tools to retail investors and retail customers; and (5) increased cybersecurity risks associated with information firms take from new sources and related requirements set forth under FINRA guidance.[13] FINRA has also advised that member firms are responsible for the content of communications created using AI, including the applicable content standards in FINRA Rules 2210 (Communications with the Public)[14] and 2220 (Options

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trustworthy-development-and-use-of-artificial-intelligence. The Executive Order generally seeks to provide a framework to ensure the goals of justice, security, and opportunity within AI and, in this regard, sets forth guiding principles across different categories, including safety and security, innovation and competition, protecting privacy, and ensuring effective government use of AI.

[6] 2020 FINRA Report, *supra* note 1, at 11.

[7] FINRA Rule 3110 *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/3110.

[8] FINRA Rule 2010 *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/2010.

[9] 2020 FINRA Report, *supra* note 1, at 15.

[10] 17 C.F.R. § 248.1 et. seq. *available at* https://www.govinfo.gov/content/pkg/CFR-2022-title17-vol5/pdf/CFR-2022-title17-vol5-sec248-1.pdf.

[11] 17 C.F.R. § 248.201 et. seq. *available at* https://www.govinfo.gov/content/pkg/CFR-2016-title17-vol4/pdf/CFR-2016-title17-vol4-sec248-201.pdf.

[12] FINRA Rule 2111 *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111.

[13] 2020 FINRA Report, *supra* note 1, at 18.

[14] FINRA Rule 2210 *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/2210.

Communications),[15] (and for funding portals, Rule 200(c) (Funding Portal Conduct)),[16] which generally require that communications be fair and balanced and prohibit the inclusion of false, misleading, promissory, or exaggerated statements or claims.

In its 2024 FINRA Annual Regulatory Oversight Report (the "2024 FINRA Report"), FINRA highlighted AI, including generative AI, as an emerging compliance risk for broker-dealers, and advised that broker-dealers should be mindful of how these technologies may implicate their existing regulatory obligations.[17] In particular, FINRA stated that the use of AI could implicate most aspects of a firm's regulatory obligations, including anti-money laundering, books and records, business continuity, customer protection, cybersecurity, model risk management, research, SEC Regulation Best Interest ("Reg BI")[18] and supervision.[19] Given the breadth of the scope of AI, regulatory compliance and customer protection would require the input from a team representing a broad variety of compliance specialties to update a firm's compliance program and corresponding internal controls.[20]

THE SEC'S EFFORTS

To date, the SEC has proposed rules intended to address potential conflicts of interest introduced by AI,[21] settled two enforcement actions against RIAs for alleged AI washing,[22] and senior members of SEC Staff have issued statements and provided remarks that discuss the potential risks to customers associated with firms' use of AI, each of which are described below.

Overview of Proposed SEC Rules

In his testimony before the U.S. Senate Subcommittee on Financial Services and General Government on June 13, 2024, Gary Gensler, Chair of the SEC, stated that, given the "robust" feedback the SEC has received in response to the Proposed SEC Rules, SEC Staff may "reopen or repropose" the Proposed SEC Rules altogether.[23] Notwithstanding this statement, some of the principles articulated in the Proposed SEC Rules could still serve as a basis for potential SEC enforcement or a new SEC rule, including identifying and mitigating conflicts of interests, establishing effective policies and procedures governing the firms' development and use of AI, and maintaining books and records evidencing the same.

According to the SEC, the Proposed SEC Rules are aimed at addressing conflicts of interest that may arise in connection with RIAs' or broker-dealers' use of predictive data analytics and similar technology, which would result in placing the firms' interests ahead of investors' interests.[24] Specifically, the Proposed SEC Rules are intended to address technologies that are designed (either intentionally or unintentionally) to consider firm-favorable information in a manner that outweighs investor interests. For example, an RIA that uses a model with an algorithm that only generates investment recommendations that would also satisfy a minimum amount of fees for the RIA would be viewed as a conflict of interest. The Proposed SEC Rules would also amend rules under the Exchange Act and the Investment Advisers Act of 1940, as amended ("Advisers Act") that would require firms to make and maintain certain records that, according to the SEC,

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[15] FINRA Rule 2220 *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/2220.

[16] FINRA Portal Rule 200(c) *available at* https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200.

[17] 2024 FINRA Annual Regulatory Oversight Report, FINRA, at 10 (Jan. 2024) *available at* https://www.finra.org/sites/default/files/2024-01/2024-annual-regulatory-oversight-report.pdf. FINRA also issued Regulatory Notice 24-09 reiterating some applicable regulations that members should consider when using generative AI and large language models. See FINRA Regulatory Notice 24-09 (June 27, 2024), *available at* https://www.finra.org/ rules-guidance/notices/24-09.

[18] Securities Exchange Act ("Exchange Act") Rule 15I-1 *available at* https://www.sec.gov/news/statements/2018/annex-a-reg-bi-regtext.pdf.

[19] 2024 FINRA Report, *supra* note 17, at 10.

[20] *Id.*

[21] Proposing Release, *supra* note 2, at 42.

[22] Adv. Act Rel. No. 6573 (2024) *available at* https://www.sec.gov/files/litigation/admin/2024/ia-6573.pdf; Adv. Act Rel. No. 6574 (2024) *available at* https://www.sec.gov/files/litigation/admin/2024/ia-6574.pdf.

[23] A Review of the President's Fiscal Year 2025 Budget Requests for the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission: Hearing Before the Subcomm. on Fin. Servs. & Gen. Gov't, 118th Cong. (2024) (statement of Gary Gensler, Chair, U.S. Securities and Exchange Commission). The SEC also noted its consideration for reproposing the rules in its Spring 2024 Regulatory Agenda. See SEC Agency Rule List - Spring 2024, *available at*: https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202404&RIN=3235-AN14.

[24] Proposing Release, *supra* note 2, at 25.

would facilitate the Staff's examination and enforcement capabilities.

The Proposed SEC Rules generally require broker-dealers and RIAs to "eliminate or neutralize" the effect of conflicts of interest associated with its use of a "covered technology" in "investor interactions" that place the firm's or its associated person's interest ahead of "investors" interests.[25] Firms would be required to have written policies and procedures reasonably designed to prevent violations of, in the case of RIAs, or achieve compliance with, in the case of broker-dealers, the Proposed SEC Rules. Included in the policies and procedures would be written descriptions of the process for evaluating any use or potential use of a covered technology in any investor interaction and a written description of the process of determining how to eliminate or neutralize the effect of any conflicts of interest identified under the Proposed SEC Rules. Firms also would need to maintain books and records demonstrating compliance with the requirements of the Proposed SEC Rules.[26] Concern for the compliance challenges faced by broker-dealers and RIAs under the Proposed SEC Rules are amply demonstrated by the comments the SEC received from market participants. Such comments highlight some of the provisions that the SEC will most likely modify when it revisits the rules as they are currently drafted.

Commenters on the Proposed SEC Rules have asserted that there is already a robust standard for addressing similar conflicts generally under Reg BI for broker-dealers — highlighting the discrepancies between "conflict of interest" as defined under Reg BI and the Proposed SEC Rules, which leads to implementation challenges for firms subject to both standards.[27] Commenters have agreed that conflicts of interest that arise from RIA's use of a covered technology, that is determined to place the RIA's interest ahead of a client's, must be neutralized.[28] However, they note that the Proposed SEC Rules would constitute a departure from the SEC's prior position on dealing with conflicts of interest, which has historically permitted an RIA's conflicts to be addressed through disclosure and informed consent. Elimination or neutralization of a conflict of interest is far more difficult than disclosure and consent.[29]

A primary criticism of the Proposed SEC Rules is the scope of the definitions. For example, commenters found the definition of "covered technology"[30] to be overly broad and would include technologies and applications used in the day-to-day operations that are not generally associated with emerging technologies or predictive data analytics.[31] Moreover, given the

[25] *Id.*

[26] Firms' policies and procedures should be reviewed on an annual basis and include a description of the process for (1) evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction; and (2) determining conflicts of interest and how to eliminate or neutralize the effect. *Id.* at 131.

[27] Reg BI defines conflict of interest as an interest that might incline a firm or its associated persons (consciously or unconsciously) to make a recommendation or render advice that is not disinterested. The Proposed SEC Rules define conflict of interest as an interest that places or results in placing the firm's or its associated person's interest ahead of investors' interests. The ABA noted that as a result of the different definitions, firms would have to "(1) establish differing conflict handling processes for different rules that have significant overlap, which would be entirely impractical or (2) alternatively, seek to identify the lowest common

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denominator between the definitions." Letter from Jay H. Knight Chair of the Federal Regulation of Securities Committee of the American Bar Association, at 8 (Oct. 18, 2023) *available at* https://www.sec.gov/comments/s7-12-23/s71223-276240-670542.pdf.

[28] *Id.* at 5.

[29] Rel. No. IA-5248 (June 5, 2019) *available at* https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf (noting that "[t]he fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."). *See also* Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflict of Interest (Aug. 3, 2022) *available at* https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest (stating that "[i]nvestment advisers must fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent" and "the staff believes that the adviser should eliminate the conflict [only] if the client cannot provide informed consent.").

[30] The Proposed SEC Rules define "covered technology" to mean 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 in an investor interaction." According to the SEC, "covered technology" captures existing and future technologies, given rapid development of technology.

[31] Letter from SIFMA re: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, SIFMA, at 10 (Oct. 10, 2023) *available at* https://www.sec.gov/comments/s7-12-23/s71223-271819-

potential tools and technologies that may fall within the definition of "covered technologies,"[32] firms would likely need to identify all client-facing technologies and programs to evaluate whether any conflicts of interest are present. This process is likely to complicate the offering of existing tools offered to customers and may be costly for firms. Further, firms with less resources may also be forced to use external consultants and compliance experts to assess their compliance programs.

In addition, the SEC Proposed Rules broadly define "investor interaction" to include: "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. However, the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support."[33] Unlike Reg BI, which applies when a firm makes a recommendation in securities or an investment strategy involving securities to a retail customer, "investor interaction" as currently defined in the SEC Proposed Rules, applies to any activity by a broker-dealer or RIA that involves an investor, not just a recommendation. According to the SEC, the term is not intended to capture communications that qualify as recommendations, but that have the effect of "guiding or directing investors to take an investment-related action."[34]

Further, the proposed definition of "investor" varies for broker-dealers and investment advisers. For broker-dealers, "investor" includes "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family, or household purposes."[35] The definition of "investor" for investment advisers, however, would include "a client or prospective client, and any current or prospective investor in a pooled investment vehicle advised by the investment adviser."[36] The differing definitions would particularly affect firms that are dually-registered as broker-dealers and RIAs. Indeed, to the extent that the same covered technology is used by a firm both in its capacity as a broker-dealer and an RIA, such covered technology would be subject to the Proposed SEC Rules. On the other hand, a firm that is solely registered as a broker-dealer might be able to exclude certain technologies from the requirements of the Proposed SEC Rules on the basis that such technology is exclusively used for institutional investor interactions. Furthermore, dually-registered firms would need to be aware of the new recordkeeping requirements under both the Exchange Act and Advisers Act.

Members of Congress have also urged the SEC to reconsider the difference in the definition of "investor" for broker-dealers and RIAs, noting that "there may be instances where institutional investors are better equipped to understand the complexities of certain technologies and, in such cases, disclosure may be sufficient."[37] Further, it has been noted that, although a conflict of interest may exist in connection with a firm's use of AI, the resulting recommendation may be beneficial to investors and therefore elimination of the conflict may not be necessary.[38]

As noted above, in the Senate hearing on June 13, 2024, Chair Gensler expressed that the SEC will reconsider the Proposed SEC Rules, in light of the extensive comments the SEC received in response to the same.[39] Chair Gensler also commented that AI may

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655302.pdf (noting that the definitions in the Proposed SEC Rules are "vague and overbroad, encompassing a wide range of commercial activities and uses of technology that have no nexus to the concerns raised" by the Proposing Release).

[32] The broad scope of this definition has drawn criticism from both the industry and SEC Commissioners. For example, in his statement on the Proposed SEC Rules, Commissioner Mark T. Uyeda stated that "this proposal goes far beyond to encompass nearly everything. In this regard, consider that the proposed rules cover anything that is either analytical, technological, or computational." 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 (July 26, 2023) *available at* https://www.sec.gov/news/statement/uyeda-statement-predictive-data-analytics-072623.

[33] Proposing Release, *supra* note 2, at 230.

[34] *Id*. at 53.

[35] *Id* at 49; this proposed definition is consistent with the definition of "retail customer" under Reg BI.

[36] *Id*. at 49–50.

[37] Letter from Brad Sherman, Member of Congress, Ranking Member, Subcommittee on Capital Markets and Bill Foster, Member of Congress, Ranking Member, Subcommittee on Financial Institutions and Monetary Policy (Apr. 26, 2024) *available at* https://www.sec.gov/comments/s7-12-23/s71223-464851-1230694.pdf.

[38] *Id*.

[39] A Review of the President's Fiscal Year 2025 Budget Requests for the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission: Hearing Before the Subcomm. on Fin. Servs. & Gen. Gov't, 118th Cong. (2024) (statement of Gary Gensler, Chair, U.S. Securities and Exchange Commission).

increase insider trading concerns, noting that predictive data analytics will raise new challenges on how people are using information and blur the line of what constitutes material nonpublic information. He warned, "fraud is fraud, regardless of whether it's a human doing it or it's a computer doing it."[40]

In addition to the Proposed SEC Rules, the SEC has addressed firms' use of AI technologies through enforcement, signaling to the market that it will not wait for final SEC rules governing AI before asserting its compliance expectations to market participants.

Recent SEC Enforcement Actions

In a February 2024 speech, Chair Gensler advised that investors could suffer financial harm if broker-dealers and RIAs, in using predictive data analytics technology, put their interests ahead of their investors' interests, which is a primary concern of the Proposed SEC Rules.[41] He also said that broker-dealers should not give investment advice or recommendations based on inaccurate or incomplete information that may be embedded in AI tools.[42] He warned that "investment advisers and broker-dealers should not mislead the public by saying they are using an AI model when they are not, nor say they are using an AI model in a particular way but do not do so. Such AI washing, whether it's by companies raising money or financial intermediaries, such as investment advisers and broker-dealers, may violate the securities laws."[43]

A month later, in March 2024, the SEC settled charges against two RIAs for making allegedly false and misleading statements about their purported use of AI to conduct their advisory businesses, including overstating the firms' technology capabilities in their website, press releases and public filings. One firm claimed it "put[s] collective data to work to make [its] artificial intelligence smarter so it can predict which companies and trends are about to make it big and invest in them before everyone else."[44] The other claimed it incorporates "expert AI-driven forecasts."[45] As a result, the SEC found that the firms violated section 206(2) of the Advisers Act, which makes it unlawful for any RIA, directly or indirectly, to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," rule 206(4)-1 (*i.e.*, the Marketing Rule) and rule 206(4)-7, which requires that RIAs implement policies and procedures designed to prevent violations of the Advisers Act.[46] The firms were subject to censure and fines of $175,000 and $225,000.[47] It is clear that recent enforcement actions demonstrate that the SEC will apply existing SEC rules to a RIA's use of and claims regarding AI. RIAs should therefore consider how its compliance programs may be affected when deploying new technologies.[48]

The enforcement actions evidence that the SEC is not only interested in how firms use emerging technologies in their businesses, but also how such use is being characterized to the public. Therefore, firms should assess how they are currently representing their use of technologies like AI and have procedures in place to ensure that such representations do not become stale or inaccurate. Accordingly, a firm should consider reviewing its websites, press releases, public filings, conferences materials, public appearances, and related activities.

Director Grewal's Proactive Compliance Approach

Consistent with Chair Gensler's statements regarding AI washing, in an April 2024 speech, Director Grewal compared AI washing with greenwashing in the ESG space and emphasized that market participants, including SEC-reporting companies and investment firms, must ensure that their representations regarding their use of AI

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[40] *Id.*

[41] Chair 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.

[42] *Id.*

[43] *Id.*

[44] Adv. Act Rel. No. 6573 (2024) *available at* https://www.sec.gov/files/litigation/admin/2024/ia-6573.pdf.

[45] Adv. Act Rel. No. 6574 (2024) *available at* https://www.sec.gov/files/litigation/admin/2024/ia-6574.pdf.

[46] Adv. Act Rel. No. 6573 (2024) *available at* https://www.sec.gov/files/litigation/admin/2024/ia-6573.pdf ; Adv. Act Rel. No. 6574 (2024) *available at* https://www.sec.gov/files/litigation/admin/2024/ia-6574.pdf.

[47] *Id.*

[48] Director Grewal remarked that the two SEC enforcement actions "should serve notice to the investment industry that if you claim to use AI in your investment processes, you must ensure that your representations aren't false [or] they aren't misleading." SEC Enforcement Director Gurbir Grewal on AI Washing, *available at* https://x.com/SECGov/status/1769697224613597285.

are not materially false or misleading.[49] Director Grewal also discussed general principles for market participants to comply with securities laws as they relate to AI, which he referred to as "proactive compliance".[50] These principles center around the ideas of education, engagement, and execution. Broker-dealers and RIAs can refer to these principles as they incorporate AI in their compliance programs.

Interestingly, as part of the "education" prong, Director Grewal explained that market participants should review current and future AI-related enforcement actions, and speeches like Chair Gensler's speech referenced above, which highlight other ways in which a firm's AI may implicate the federal securities laws. As a practical matter, firms should ensure that their AI disclosures, including the potential performance of AI applications when they take into consideration customer data, are accurate and not misleading.

With respect to the "engagement" prong, he advised that companies and firms should engage with their personnel to learn about the different ways AI intersects with their activities, business strategies, corresponding potential risks, and financial incentives. After performing that diligence, they should effectively "execute" the learnings generated by such diligence by (1) updating their policies, procedures, and internal controls, which should be bespoke to each firm, (2) adopting them, and (3) implementing them, emphasizing that effective execution is where many firms "fall short."[51]

LOOKING AHEAD: PRACTICAL CONSIDERATIONS

Given the guidance described above, it is clear that the SEC and FINRA are already regulating firms' use of AI applications, which will expand as the underlying technology supporting the AI applications continues to grow. In this regard, applying a proactive compliance approach, firms should continue to evaluate and update their compliance programs and internal controls to incorporate FINRA's and the SEC's guidance, including the principles and themes set forth in (1) the 2020 FINRA Report, in the case of broker-dealers, (2) SEC enforcement actions, (3) speeches and statements given by SEC Staff, and (4) the Proposed SEC Rules, notwithstanding the SEC's expected recalibration of the rules, and any new rule proposals. In particular, firms may consider taking the following steps:

- establishing an internal governance structure (e.g., task force, working group, center of excellence) that reviews, shares, and builds expertise related to the use of AI across their organizations;
- employing a cross-disciplinary team of supervisory personnel who have expertise in AI and increasing training required for the use of AI applications;
- updating model risk management programs to address challenges AI applications may pose, including those related to data integrity and customer privacy, and performing periodic stress testing;
- reviewing the underlying dataset used in AI applications for potential bias and verifying the source of data, especially data obtained from external sources;
- evaluating the use and treatment of customer data to ensure that they comply with applicable privacy rules and regulations;
- establishing reasonable procedures and internal controls governing the supervision and governance of their use of AI applications;
- employing effective supervision over third-party vendors that support their AI applications to ensure they satisfy or exceed the cybersecurity protocols expected by the firm;
- carefully reviewing firms' disclosures (e.g., websites, press releases, public filings, conference materials, and public appearances) to ensure that they accurately describe (1) the firm's actual use of an AI model, (2) the treatment of customer data in connection with such model, (3) the limits and risks of using results generated by such AI model, and (4) in the case of RIAs, compare such disclosures with their policies and procedures governing compliance with the Marketing Rule and make required amendments;
- engaging with firm personnel to identify the firm's use of AI applications throughout its operations (especially those that interact with customers), and to analyze the outputs generated by the application to see if any result places the firm's interest ahead of its customers, including outcomes that are based on factors that are favorable for the RIA or broker-

[49] Gurbir S. Grewal, Remarks at Program on Corporate Compliance and Enforcement Spring Conference (Apr. 15, 2024) *available at* https://www.sec.gov/news/speech/gurbir-remarks-pcce-041524.

[50] *Id.*

[51] *Id.*

dealer, such as the revenue generated by a particular course of action;

- instructing firm personnel with sufficient knowledge of both the applicable programming language and the firm's regulatory obligations to review the source code of the technology, review documentation regarding how the technology works, and review the data considered by the covered technology (as well as how it is weighted) to identify potential conflicts of interest;
- building "explainability" features into the technology to give the AI model the capacity to explain why it reached a particular outcome, recommendation, or prediction in order to eliminate or mitigate conflicts of interest;
- establishing and executing policies and procedures to cover testing and ongoing monitoring of each AI application prior to its implementation or material modification, to determine whether the application operates as intended and the use of such covered technology is associated with a conflict of interest;
- amending internal policies and procedures, and controls to incorporate the firm's learning from internal reviews and regulatory guidance, and employing the same; and
- maintaining books and records that (1) capture the additional records generated by the firm's use of AI applications in accordance with applicable recordkeeping rules, (2) demonstrate that the firm has taken the steps necessary to implement its amended policies and procedures, and internal controls that govern its use of AI, and (3) evidence mitigative practices against conflicts of interest that the firm has taken.

As a general matter, firms should continue to communicate with its regulators, directly and/or through trade organizations, to ensure that they are current on all regulatory developments governing AI that are relevant to their business operations. Finally, firms should work with in-house or outside counsel, together with their compliance, risk, operations personnel, and business teams as they continue to navigate the U.S. regulatory environment governing their use of AI to ensure they employ a holistic approach to their legal, supervisory, and compliance programs. ■

The Review of Securities & Commodities Regulation