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Artificial Intelligence Oversight: Implications for Mutual Fund Boards

By Dianne M. Descoteaux

Although artificial intelligence (AI) has been utilized in the investment management industry for decades, it is poised to present a sea change of investment, risk, compliance, and operational implications in the coming years due to the rapid pace of its development. Now, we are not just blithely taking advantage of convenient technology, such as predictive text or robo advisers, we are facing a potential regeneration and reconstruction of the industry as a whole. In the absence of omnibus federal legislation relating to AI, individual agencies are cobbling together rule proposals and guidance to attempt to mitigate potential risks.[1] In its 2024 Annual Regulatory Oversight Report, the Financial Industry Regulatory Authority (FINRA) noted that "while [AI] tools may present promising opportunities, their development has been marked by concerns about accuracy, privacy, bias and intellectual property, among others."[2]

US Securities and Exchange Commission (SEC) Chairman Gary Gensler, in remarks to Yale Law School on February 13, 2024, noted that while AI presents tremendous opportunities for humanity, it also raises a host of issues.[3] Indeed, the SEC has had a laser focus on the emergence of AI and emergent technologies recently, with SEC examiners currently conducting sweep examinations regarding the use of AI by investment advisers.[4] The sweep letter requests documentation on the management of potential AI-linked conflicts of interest as well as plans to address system failure, advertising that references AI and reporting on AI systems that cause legal or regulatory issues.[5] In the midst of this evolution, it is critical for mutual fund boards to quickly develop acumen in the uses and risks of AI within funds, as well as by their investment advisers and service providers, in order to ensure effective oversight.

Regulatory Background

An AI system is "an engineered or machine-based system that can, for a given set of objectives, generate outputs, such as predictions, recommendations, or decisions influencing real or virtual environments."[6] As AI develops, it is increasingly able to implement cognitive abilities similar to those of humans. Although AI may not be subject to a comprehensive regulatory regime in the United States currently, it is not an unregulated space. As background information for fund boards, in January 2021, Congress passed the National Artificial Intelligence Initiative Act of 2020, which has served to facilitate coordination across federal agencies to expedite AI research and establish a mission to advance and support the development of AI standards.[7] In addition, numerous proposed congressional bills are pending, including the Security, Accountability, Foundations, and Explainability (SAFE) Innovation framework proposed in June 2023 by Senator Schumer, which is designed to serve as a guidestone for Senate AI regulation initiatives.[8] In October 2023, the White House issued an Executive Order on Safe, Secure, and Trustworthy Artificial Intelligence (Executive

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Order).[9] The Executive Order seeks to develop a unified federal approach toward the safe and responsible development of AI.[10] The Executive Order invokes the statutory authority of the Defense Production Act and establishes a broad array of federal regulatory priorities and requests for agencies to promulgate their own standards and guidelines.[11]

With respect to regulations applicable to investment advisers and broker-dealers, SEC Chair Gary Gensler is well aware that AI is positioned to transform business and society, and he has been evaluating its implications for the financial services industry for years. If a few AI providers produce the models upon which numerous tech providers rely, this could create systemic as well as enterprise risk. In public remarks, Chair Gensler has discussed the importance of regulations concerning AI, especially with respect to fiduciary duties, and has confirmed that the SEC's Staff is actively focused on this area.[12] Both the SEC and FINRA have issued parameters for investment advisers regarding model governance relating to the use of AI.[13] In addition, last summer, the SEC proposed broad new rules under the Investment Advisers Act of 1940 (Advisers Act) and the Securities Exchange Act of 1934 (Exchange Act) that are designed to mitigate perceived conflicts of interest posed by the use of AI by investment advisers and broker-dealers (the predictive data analytics rules (PDA Rules)).[14] In particular, the PDA Rules would address conflicts of interest associated with advisers who leverage algorithms to predict and guide investor decisions through phone apps or web interfaces.[15] The SEC also proposed Advisers Act and Exchange Act rule amendments that would require firms to make and maintain certain records in accordance with the proposed new rules.[16]

The SEC noted that the proposed rules applicable to investment advisers and broker-dealers are a response to the acceleration of the adoption and use of newer technologies by firms, such as predictive data analytics and AI, which has increased the risk that such technologies may be used in a way that could place firms' interests ahead of investors' interests.[17] It appears that the SEC is concerned that a firm could utilize AI in its communications with investors in a manner that benefits the firm but is to the detriment of the investor. Much to the chagrin of registrants and legal practitioners, the proposed rules approach conflicts from a different perspective than the frameworks set forth in Regulation Best Interest (Reg BI) and the SEC's 2019 interpretation regarding the fiduciary duties of investment advisers (the Fiduciary Interpretation).[18] If adopted substantially as proposed, the PDA Rules would have a considerable impact on AI service providers, as well as the regulatory landscape for investment advisers. Notably, the SEC is not waiting until rule adoption to focus on AI in its examination priorities.[19]

With respect to current regulations that may have an impact on funds and board oversight directly, boards should be mindful that the investment adviser prohibition against fraudulent conduct is applicable in the AI space as well.[20] In particular, this antifraud prohibition is applicable to AI fund disclosure as well as with respect to the manner in which AI is incorporated in fund investment strategies and processes. With respect to board oversight of compliance programs, investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, and boards may wish to ask if any adviser compliance policies have been updated to reflect the incorporation or oversight of AI processes, if applicable.[21] Boards may also wish to inquire about adviser processes to safeguard customer records and data.[22] In addition, boards may seek to obtain ongoing updates regarding relevant AI regulations as they evolve over time.

AI Overview

The financial services industry has utilized AI for years—for everything from robo-advisor chatbots to summarizing fund performance to data trends and fraud detection. Boards would benefit from developing an understanding of key terminology utilized in AI, including machine learning, deep learning, large language models, and generative AI. Although there are no universal definitions of key AI terms, standard understandings of key terms in the AI space include the following:

- AI. Broadly speaking, AI generally refers to applications of technology to perform tasks that resemble human cognitive function and is generally defined as "the capability of a machine to imitate intelligent human behavior."[23]
- Machine Learning. A method that helps machines aggregate and learn from data in order to make decisions. In supervised machine learning, models are trained with labeled input data, and in unsupervised machine learning, models are fed large amounts of data and algorithms are designed to identify any underlying meaningful patterns without any preconceived notion of the output.[24]
- Deep Learning. A type of machine learning that uses artificial neural networks, in which algorithms process large amounts of data through multiple layers of learning in a manner inspired by the structure and function of the human brain.[25]
- Generative AI. Algorithms, such as ChatGPT, that can be used to create new content, including audio, code, images, text, simulations, and videos.[26]

While both AI and machine learning have existed for decades, it is the rapid evolution of "generative AI," such as ChatGPT, that has prompted a considerable groundswell of global attention and scrutiny. When boards are evaluating the use of AI by investment advisers and fund service providers, they may wish to consider inquiring about what types of AI are used in each instance and what the attendant risks of such uses are.

Board Assessment of Scope of Utilization of AI

Given the rapid pace with which AI is evolving and its impact on many aspects of the financial services industry, fund board members have a wide range of factors that they may wish to consider with respect to their fiduciary duty and oversight obligations as they relate to the use of AI across their fund platforms. As AI continues to evolve, it is important that boards develop an understanding of key terminology used in AI, the primary ways in which AI is used in the financial services industry, and the potential impact it may have on services provided to funds. Boards should consider inquiring about the uses of AI by investment advisers and fund service providers. Advisers and service providers utilizing AI should be able to explain in plain English to boards how and why they are using each type of AI, as well as their monitoring and oversight processes. Boards may also seek to inquire about fund management's view regarding the potential for AI to disrupt the financial services industry as a whole as well as the products that they oversee.

Investment Adviser Use of AI

If advisers use AI as part of a fund's investment strategy, boards should request that management provide information regarding its use, as well as related compliance policies and procedures. Boards may also seek to obtain information about other ways in which AI is used by the investment adviser, such as to create operational efficiencies. With respect to funds with an AI strategy component, AI should be optimized in favor of the investor's best interests in light of the fiduciary duty that investment advisers owe to clients. Funds that utilize AI in their investment strategy should have carefully crafted strategy and risk disclosure[27] that does not constitute "AI washing," the practice of overinflating AI claims in a

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similar fashion to greenwashing in the environmental, social, and governance (ESG) context.[28]

With respect to AI use generally, advisers should be able to explain how they are using AI in the context of portfolio management, digital engagement practices, and other applications. Boards may inquire about how AI models operate, how they are tested on an ongoing basis, and the type of data underlying each model. They may also consider inquiring about the periodic review of model output and how it compares to anticipated results. Boards may also consider the potential for AI to disrupt each fund's peer landscape. Investment advisers should be able to explain to the board their analysis with respect to AI and the competitive landscape prospectively.

Fund Service Provider Use of AI

Boards may also seek to inquire whether advisers have conducted an assessment of service provider AI uses and risks as part of their firm's vendor management and outsourcing processes. It may be prudent to request that service providers explain in plain English how they are using each type of AI and what risk policies have been adopted or are being considered with respect to AI use and limitations. If a vendor informs fund management or the board that AI is prohibited, the vendor should be able to demonstrate how this is tested on an ongoing basis. Boards may wish to inquire about the ability of vendors to resist new and more complex threats posed by AI, as well as if the use of proprietary data or customer data for AI applications is reviewed on an ongoing basis for compliance with applicable privacy laws. Boards should be cognizant that AI may also be utilized as a tool for fund service provider selection, as AI can analyze large amounts of aggregated data and provide critical information on patterns and trends in vendor performance, pricing, and other selected factors.

Compliance Policies and Procedures and Risk Assessments

With respect to compliance oversight, boards should inquire whether compliance teams have AI policies and procedures in place and if fund compliance is monitoring the AI procedures of fund service providers for which they have oversight on an ongoing basis. Fund policies and procedures generally describe how vendor oversight is managed. Boards may request an inventory of AI uses, as well as whether a risk/benefit analysis has been conducted. The compliance team should be able to describe their process for ongoing testing and monitoring of any AI policies and how they are updated as needed. In some instances, AI itself may be used to bolster compliance processes and make routine compliance tasks more efficient. AI can easily aggregate data, recognize patterns, and create content, and this could enable compliance personnel to focus on items that require judgment and analysis. Compliance may advise the board that additional training may be needed in order to consider how processes would be modified by AI and how they could be tested. If carefully evaluated and monitored, the use of AI in compliance testing and processes could be a tremendous benefit, alleviating the enormous burdens on compliance teams with limited personnel, resources, and budgets. In many cases, AI technology may already be deeply embedded in compliance processes, and firms may just need to assess its current and prospective uses and risks. Boards and firms are likely to be particularly cognizant of the potential risks of generative AI, which could have a much greater risk of unintended consequences.

Boards may also seek to inquire whether AI has been incorporated into compliance risk assessments. If so, such risk assessments may include an evaluation of AI in each compliance testing category for which it is relevant and could also include detailed information, such as the degree of risk of each use, as well as potential mitigating risk factors. In addition to an inventory of AI uses, fund compliance may also wish to develop an inventory of the numerous risks associated with AI. Boards may wish to inquire about specific AI risks. For example, one critical risk to evaluate is the oversight of data. Questions to consider asking include:

- How is data procured?
- Is there any inherent bias with respect to data?
- What assumptions are relied upon in machine learning applications?
- What is the process for identifying and correcting errors in data?
- How is data protected?
- How are data rights and privacy monitored?

Firms may wish to consider the US Department of Commerce's National Institute of Standards and Technology Artificial Intelligence Risk Management Framework (AIRMF), which was issued in January 2023 and was created to develop standards for trustworthy use of AI.[29] The AIRMF proposed numerous criteria that can be tested in evaluating AI risk, including whether it is valid and reliable, safe and secure, resilient, accountable and transparent, explainable and interpretable, privacy-enhanced, and fair with harmful bias managed.[30]

Cybersecurity Considerations

Although the rapid evolution of AI poses new and complex threats, AI technology can also present a distinct advantage through its incorporation into cybersecurity protocols for threat detection, classification, and incident response. AI has an unprecedented ability to analyze large amounts of data and can be used to help management detect emerging threats and implement preventive measures. Boards may inquire whether management has evaluated or updated cybersecurity controls to incorporate AI as a tool to enhance risk management. Management may be asked to provide boards with information on any IT budget adjustments or investments considered to enhance cybersecurity controls in light of evolving threats. Boards may also wish to inquire about any training measures fund management is considering with respect to the use of AI in cybersecurity controls.

Whether or not it incorporates AI, cybersecurity controls should be evaluated to determine their adequacy in light of evolving AI threats, including social engineering, privacy implications, malicious code, and denial of service attacks. AI also has the potential to optimize cyberattacks, such as ransomware and phishing. Directors should inquire whether fund management has a process in place to audit the firm's cybersecurity controls periodically. Firms should assess AI risks on an ongoing basis, review cybersecurity protocols in light of new threats, and update them as needed. If cybersecurity vendors are utilized, fund management should be able to provide information about their ability to assess and counter AI risks. As AI tools become less expensive and more prevalent, the risks associated with their pervasiveness are likely to increase, and the extent, scope, and risks associated with each use should be assessed. If firms are utilizing AI in their cybersecurity controls, these protocols should be reviewed on an ongoing basis to ensure that any AI-powered tool has not been the subject of an attack or data manipulation, and firms should invest in encryption and access control to protect from such attacks. To protect privacy, personal information should not be shared with an AI tool. In addition, boards may seek to ask fund management whether an AI incident response plan has been developed.

Conclusion

It is apparent that the financial industry's use and reliance on AI will only escalate over time, as well as the regulatory focus on its use. Boards should continue to assess the use by fund advisers and service providers of AI tools and monitor them on an ongoing basis to assess whether the internal policies and procedures of fund investment advisers and service providers continue to develop with the pace of AI enhancements. Boards should be mindful of the AI risks of fraud, market manipulation, conflicts of interest, deception, privacy considerations, and inherent bias. In order to navigate the forthcoming transformational shift in the financial services industry fomented by AI, boards would be prudent to exercise diligent oversight over fund adviser and service provider use of AI and assess whether

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safeguards have been put in place to ensure that regulatory requirements are met and investor interests are protected.

Ms. Descoteaux is Senior Counsel for the Mutual Fund Directors Forum.

NOTES

1 On July 26, 2023, the SEC proposed the regulation of "predictive data analytics" by registered investment advisers and broker-dealers. *See Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers,* SEC Rel. Nos. 34-97990; IA-6353 (July 26, 2023), 88 Fed. Reg. 53960 (August 9, 2023), available at *https://www.sec.gov/rules/2023/07/s7-12-23#34-97990* (the PDA Proposing Release).

2 *See* FINRA, 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*.

3 Gary Gensler, Chair, SEC, AI, Finance, Movies and the Law: Prepared Remarks Before the Yale Law School (February 13, 2024), available at *https://www.sec.gov/news/speech/gensler-ai-021324*. Gensler noted systemic financial risk, opportunities for deception or manipulation, and deception, conflicts, and inflated AI claims as potential AI risks that may require systemic or policy interventions.

4 Richard Vanderford, "SEC Probes Investment Advisers Use of AI," *Wall Street Journal* (December 10, 2023), available at *https://www.wsj.com/articles/sec-probes-investment-advisers-use-of-ai-48485279*. The AI sweep examination appears to be a means for the SEC to update the inventory of knowledge it derived from its 2021 request for comment from investment advisers and broker-dealers relating to digital engagement practices in the context of advisers' use of technology to provide investment advice, features designed to engage with retail investors on digital platforms, and analytical and technological tools and methods used in digital engagement practices. *See 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 Release No. 34-92766, 86 Fed. Reg. 49067 (September 1, 2021).

5 *Id*.

6 National Institute of Standards and Technology, U.S. Department of Commerce, Artificial Intelligence Risk Management Framework (AI RMF 1.0), NIST Trustworthy and Responsible AI (January 26, 2023), available at *https://doi.org/10.6028/NIST.AI.100-1, https://tsapps.nist.gov/publication/get_pdf.cfm?pub_id=936225*.

7 *See* National Defense Authorization Act for Fiscal Year 2021 [Public Law 116-617, § 5002(3)].

8 *See* Chuck Schumer, Majority Leader, U.S. Senate, Remarks of Sen. Chuck Schumer, Launches SAFE Innovation in the AI Age at CSIS (June 21, 2023), available at *https://www.csis.org/analysis/sen-chuck-schumer-launches-safe-innovation-ai-age-csis*. The SAFE Framework has two components: a set of high-level principles meant to guide the development of AI legislation and a series of forums with AI experts. The five policy principles are designed to encourage domestic AI innovation while ensuring adequate guardrails to protect national security, democracy, and public safety.

9 *See* Presidential Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence (October 30, 2023), available at *https://www.whitehouse.gov/briefing-room/presidential-actions/2023/10/30/executive-order-on-the-safe-secure-and-trustworthy-development-and-use-of-artificial-intelligence/*.

10 *Id*.

11 *Id*.

12 *See* Mulholland, Paul, "SEC's Gensler Confirms AI is Regulatory Priority," Plan Adviser (May 13, 2023), available at *https://www.planadviser.com/secs-gensler-confirms-ai-regulatory-priority/*.

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

14 *See* PDA Proposing Release, *supra* n.1.

15 *Id*.

16 The SEC proposed new Rule 151-2 under the Exchange Act and new Rule 211(h)(2)-4 under the Advisers Act, as well as proposed recordkeeping rule amendments to Exchange Act Rule 17a-3 and Rule 17a-4 and Advisers Act Rule 204-2. *Id*.

17 *Id*.

18 *See* FINRA, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Rel. No. 86031, 84 Fed. Reg. 33318 (June 5, 2019), available at *https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf*, and SEC, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248, 84 Fed. Reg. 33669 (June 5, 2019), available at *https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.*

19 *See* U.S. Securities and Exchange Commission, 2024 Examination Priorities, U.S. SEC Division of Examinations (October 15, 2023), available at *https://www.sec.gov/files/2024-exam-priorities.pdf*. The SEC's 2024 Examination Priorities noted that the SEC has "established specialized teams within our different examination programs, allowing us to better address emerging issues and risks associated with crypto assets, financial technology, such as artificial intelligence, and cybersecurity, among others."

20 *See* 15 U.S.C. § 80b-6.

21 *See Compliance Programs of Investment Companies and Investment Advisers*, Release No. IA-2204, 68 FR 74713 (December 24, 2003).

22 *See Privacy of Consumer Financial Information (Regulation S-P)*, Exchange Act Release No. 42974, 65 FR 40333 (June 22, 2000).

23 *See supra* n.10.

24 *Id*.

25 *Id*.

26 *See* McKinsey and Company, "What Is Generative AI?" (January 19, 2023), available at *https://www.mckinsey.com/featured-insights/mckinsey-explainers/what-is-generative-ai#/.*

27 Chair Gensler has stated that as AI disclosures by SEC registrants increase, registrants should ensure that claims about prospects should have a reasonable basis, and investors should be told that basis. He noted that "When disclosing material risks about AI—and a company may face multiple risks, including operational, legal, and competitive—investors benefit from disclosures particularized to the company, not from boilerplate language." *See supra* n.3.

28 *Id*. Chair Gensler noted: "Investment advisers or broker-dealers also 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 not do so. Such AI washing, whether it is by companies raising money or financial intermediaries, such as investment advisers and broker-dealers, may violate the securities laws."

29 *See supra* n.6.

30 *Id*. Note that Chair Gensler has cautioned that while current model risk management guidance, "generally written prior to this new wave of data analytics—will need to be updated, it won't be sufficient. The challenges to financial stability that AI may pose in the future will require new thinking on system-wide or macro-prudential policy interventions." *See supra* n.3.

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