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Artificial Intelligence in Financial Services

Over the past decade, advances in technology have led to an unprecedented evolution in financial services. Every sector of the industry has benefited from new technologies and dramatically improved the customer experience. For example, the banking industry has migrated from bricks and mortar to robust digital platforms, providing consumers with seamless and efficient bill payment, loan applications, and access to credit. In today's capital markets, retail investors have access to investments on a smartphone with zero commissions, vastly enhanced access to investor education, low or no-cost investment advice, and 24/5 trading (or, in the case of some asset classes such as cryptocurrencies, 24/7 trading). In the housing markets, technological advances have streamlined the mortgage application process and opened new consumer access to credit from non-banks. Today, consumers enjoy immediate and frictionless payments at greatly reduced costs and can access a global payment footprint without high-cost intermediaries. And technology has given rise to a revolutionary new digital asset class that has unearthed the potential of distributed ledger technology to eliminate the friction and costs of multiple layers of intermediaries.

While these and other technological enhancements in the financial services space have fostered an unparalleled experience for consumers and investors, Artificial Intelligence ("AI") has the potential to be one of the most transformative technological advancements ever, reshaping how financial services companies interact with their customers and giving rise to a wide array of revolutionary new products and services. AI is transforming all sectors of the economy, from healthcare to manufacturing to national security. AI has the potential to transform the financial services industry in a similar fashion, delivering financial services like investment advice to a greater number of consumers in far more cost-effective and efficient ways. While there are clear risks posed by irresponsible uses of AI technologies, the federal government should avoid rushing to regulate AI in a manner that would stifle innovation and harm consumers and investors.

Benefits of AI in the Financial Services Industry

While the long-term impacts of AI on financial services are still evolving, there are already demonstrable benefits being realized today.

- *Increased Efficiency and Cost Savings*: AI-powered automation can streamline administrative back-office functions and reduce reliance on burdensome and costly intermediaries. In the wealth management space, for example, AI can automate manual, time-consuming steps such as streamlining paperwork, completing KYC/AML checks, and conducting quantitative analyses of a client's account to identify potential opportunities to enhance investment returns.

- *Improved Risk Management*: AI can assess vast amounts of data to more accurately identify potential risks in various financial scenarios, such assessing the creditworthiness of a loan applicant, ensuring that investment recommendations do not conflict with the investment objectives and risk tolerances of an investor, or the gauging the likelihood of a claim being made on an insurance policy. AI also has greatly enhanced the tools available to companies to monitor for potential fraud and to protect against cybersecurity incidents that could impact consumer accounts.

- *Product Innovation and Customer Experience*: AI is facilitating the development of new products and services that greatly enhance the customer experience. Financial services firms are using AI to develop customer-facing tools that allow clients to share information about their financial needs and objectives to obtain more targeted and tailored advice and services. AI is also now being harnessed to provide automated investment advice, substantially reducing costs and opening up access to investors who otherwise would not be able to afford professional advice.

- *Global Reach 24 Hours a Day / 7 Days a Week*: Advances in AI are fostering technology that eliminates geographical and temporal boundaries, allowing consumers to access markets across the globe at any time of the day. Today's retail investors have access to AI systems that can continuously monitor market conditions in countries across the globe, analyze vast amounts of data in real-time, and execute trades based on pre-programmed algorithms, allowing for rapid decision-making and execution even outside of regular market hours. AI eliminates the need for human intervention, allowing retail investors to trade around the clock, adapting to changing market dynamics as they occur.

- *Financial Inclusion*: Innovations in AI have been the most successful tools in promoting financial inclusion and democratizing the financial services space. AI is further breaking down traditional barriers to financial access, allowing previously underserved segments of the population to access financial services such as banking and investment accounts. And AI is transforming the manner in which financial education is made available to consumers and investors.

<u>U.S. Approach to AI in Financial Services Hinders Innovation and Competition</u>

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The Biden Administration's approach to AI in financial services has hindered innovation and stifled competition. Despite issuing an Executive Order[1] promoting the safe and responsible development of AI, the Administration generally has been hostile to advances in technology in financial services. To date, no legislative or regulatory framework has been established that would promote AI or serve as a guardrail for consumers and investors. To the contrary, the regulatory narrative has largely focused on the potential risks that AI could pose to the public, with the Financial Stability Oversight Council issuing warnings characterizing AI as a potential threat to financial stability.[2] The Securities and Exchange Commission under Chair Gary Gensler even attempted to rush a proposed rule that would have severely limited, if not altogether eliminated, the ability for broker-dealers and investment advisors to interact with their customers using technology – from basic spreadsheets and graphic design to future uses of advanced AI.[3]

<u>Opportunity to Promote the Development of AI in Financial Services</u>

A change in Administration presents an opportunity to focus not only on the potential risks AI could present, but also on AI's potential to transform the financial services industry in ways that greatly enhance the consumer experience, offer investors greater access to new markets and products, and democratize financial services for Americans from every socio-economic background. Rather than starting from the premise that AI is a threat that needs to be strictly contained, a new Administration has an opportunity to promote innovation and competition in the *responsible* development of AI-based tools that will lead to a positive transformation of the financial services experience. Specifically, the next Administration should focus on: (i) promoting the responsible use of AI in the financial markets it oversees; (ii) rejecting the misguided notion that AI is inherently risky and presents only a threat to consumers and financial stability; and (iii) engaging in detailed study and analysis of how AI technologies are developing, how consumers, investors, and market participants are using them, what the specific benefits and risks may be, and whether existing regulations are sufficient to address these risks.

Even more important than taking proactive steps to establish a regulatory framework governing the use of AI in financial services, regulators should avoid acting too soon, when the development of a particular AI technology is still nascent, and where regulation could lead to entrenching dominant players, stifling innovation, or erecting barriers to entry. An example of regulators acting too soon is the SEC's Predictive Data Analytics proposal, which would require broker-dealers and investment advisers who use AI or other predictive data tools to eliminate or

[1] Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence (Oct. 30, 2023) (link).
[2] FSOC 2023 Annual Report (Dec. 13, 2023) ("For the first time, the Council has identified the use of AI in financial services as a vulnerability in the financial system. [The] use of AI can introduce certain risks, including safety-and-soundness risks like cyber and model risks.") (link).
[3] U.S. Securities and Exchange Commission, Proposal: Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broke Dealers and Investment Advisers (July 26, 2023) (link).

neutralize all "conflicts of interest" arising from the use of such tools, regardless of the costs or feasibility of doing so. The proposal defines "conflict of interest" broadly to include any instance where a covered technology takes into account any "firm-favorable information in an investor interaction," even where a firm does not place its interests ahead of the interests of investors. This definition is far too expansive and would essentially shut access off for a wide range of investors from getting recommendations and advice that would otherwise benefit them and help them make responsible investment decisions.

Rather than attempting to regulate a new technology prematurely and in an overly broad manner as the SEC has done, regulators instead should take an approach that primarily focuses on engaging in a data-driven analysis of the developing technology, understanding how users are deploying and benefitting from the technology, and developing a federal policy approach to regulation that will allow technology to develop in a way that offers consumers the protections they need, but also allows technology to continue to enhance the experience of participants in our financial markets. To this end, regulators should follow the lead of the Commodity Futures Trading Commission, which issued a wide-ranging request for comment on the use of AI in CFTC-regulated markets.[4] It is critical for regulators to first become educated on the potential benefits and risks of a new technology rather than rushing to put up guardrails that deprive our markets from the enhancements to the investor experience that can flow from technological innovation.

Regulators should also keep in mind that regulations in the U.S. traditionally have not been technology-specific, and instead are elastic to apply to new and developing technologies over time. The existing U.S. legal system already has robust antitrust laws, civil and constitutional rights and protections against discrimination, consumer and investor protection laws, and laws that protect the integrity of our financial system. There is no basis to think that existing laws do not apply to new and developing technologies or are insufficient to regulate such technologies.

Concrete steps that regulators can take to promote the use of AI in financial services during the next Administration include:

- *Innovation Hubs*: Under the supervision of a centralized office (e.g., White House or Treasury) to ensure consistency, mandate the establishment of Innovation Hubs within individual agencies and give their staff authority to engage in the rulemaking process to promote technology. While several agencies have established units dedicated to innovation and technology in recent years, they lack any real authority and play only a minor advisory role. A change in Administration presents an opportunity to mandate that

[4] CFTC Staff Releases Request for Comment on the Use of Artificial Intelligence in CFTC-Regulated Markets (Jan. 25, 2024) (link).

these bodies have a role in shaping policy and participating in the rulemaking process. The development of AI-focused policy initiatives should be a priority for these units.

- *Regulatory Sandboxes*: Promote the use of so-called regulatory sandboxes for certain technology initiatives, including developments in AI. A regulatory sandbox is a form of pilot program that permits market participants to test and experiment with new and innovative products, services, or activities under the supervision of a regulator for a limited timeframe. The UK Financial Conduct Authority Sandbox, the EU DLT Pilot Regime, and EU Blockchain Regulatory Sandbox are models that have been successfully deployed in Europe. Regulatory sandboxes only exist at the state level in the U.S. A new Administration offers the opportunity to expand the use of regulatory sandboxes within federal government agencies. These programs not only spur innovation and competition in the private sector but also are highly useful tools in educating regulators on the benefits and risks of developing technologies and can help shape policy. Regulatory sandboxes dedicated to AI technology should be established by key financial services regulators such as the SEC, CFTC, and bank regulators.

- *Funding and Staffing*: Dedicate more staffing and funding to study the use of AI technology in financial services to determine how best to regulate to both protect consumers and promote innovation. Regulators should include AI funding as part of their appropriations budget requests. Regulators should also consider appointing personnel who are dedicated to AI initiatives, such as a Chief AI Officer.

- *Interagency Working Groups*: Develop interagency working groups to coordinate the development of regulatory initiatives related to AI technology in financial services. It is critical that regulators take a whole of government approach to the regulation of AI. Especially in the financial services space, where market participants are subject to overlapping regulation by nearly a dozen different agencies, interagency working groups can play an important role in ensuring that individual regulators stay appropriately in their own lanes while working together to create a framework that does not subject market participants to burdensome and duplicative regulation that could stifle innovation.

- *Advisory Committees*: Establish AI technology-focused advisory committees within individual agencies, composed of private sector experts who can share real-world use cases and experience to inform intelligent, data-driven regulation. Most agencies already have advisory committees that provide expertise to help educate policymakers. Given the transformative potential that AI presents, financial services regulators should form dedicated advisory committees focused on AI technology to assist in shaping regulatory policy in this space.

- *Consumer and Investor Education*: Prioritize consumer and investor education about the potential risks *and* benefits that individual technologies present to the marketplace. To date, AI-focused educational materials from financial services regulators have concentrated only on the potential risks that AI technology could present. A new Administration presents an opportunity to also educate the public about the benefits of AI and to encourage consumers and investors to responsibly use the technology to enhance their experience in the financial markets.