BEACON POLICY ADVISORS
1701 Pennsylvania Ave, NW
Suite 200
Washington, DC 20006
beaconpa.com
SPOTLIGHT REPORT

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Gensler's AI Ambitions

What's Happening: Securities and Exchange Commission (SEC) Chair Gary Gensler has consistently expressed concern about AI's risks to financial stability.

Why It Matters: Gensler's recurrent warnings preview potential regulatory ambitions. **His focus on AI goes beyond the SEC's traditional purview to target this emerging technology's impact on the financial services sector, which is relevant not only for Wall Street but also for Big Tech. There is a possibility that SEC action on AI use in the context of investing could have an upstream impact on tech firms' development of their AI products.** While the SEC has not acted on AI beyond a proposed rule on predictive analytics, Gensler is laying the groundwork to claim a seat at the table for the SEC in discussions over regulation of AI writ large. **President Biden's executive order (EO) on AI nods to Gensler's concern about the impact of AI on financial stability.** It does not mention the SEC by name but encourages independent regulatory agencies to leverage their authority to address AI fraud, discrimination, and risks to privacy as well as "other risks that may arise from the use of AI, including risks to financial stability." The EO goes on to encourage rulemaking on due diligence, explainability, and transparency for AI systems. Biden's EO focused more on broader AI safety and security risks, but the inclusion of financial stability suggests that Gensler's point of view has found a receptive ear in the White House. **Gensler is not alone in his concerns about AI.** Federal Reserve Board Governor Lisa Cook argued in a November speech at Duke University that the impact of AI on financial stability requires greater attention. "The potential widespread adoption of powerful new AI, especially generative-AI applications, inevitably raises questions about potential benefits and risks to the stability of the financial system as a whole," she said. The Financial Stability Oversight Council (FSOC), which includes Gensler, Secretary of the Treasury Janet Yellen, and Federal Reserve Chair Jay Powell, addressed AI as a risk to financial stability in a December report. Senate Banking, Housing, and Urban Affairs Committee Chair Sherrod Brown (D-OH) may be an important congressional ally for Gensler. In a committee hearing last fall, Brown mentioned similar worries about AI's impact on the financial services sector. "At a minimum, the rules that apply to the rest of our financial system should apply to these new technologies," he said. Brown's remarks provide important political backing for any effort to rein in the use of AI by Wall Street.

What's Next: The SEC will likely aim to finalize its predictive analytics rule by the end of this spring to reduce the risk of vulnerability to a Congressional Review Act repeal under potential unified Republican control of the federal government after this November's elections. The SEC's investor advisory committee, which tabled proposed negative feedback on the rule last month, has its next meeting scheduled in March, where it could reconsider the proposal. **With only a year left in Biden's term, more ambitious regulatory efforts by Gensler on AI will depend on a Biden victory this November.**

Gensler on AI

AI has been an area of interest for Gensler since before he took office as SEC chair in 2021 and before ChatGPT made AI a household name in late 2022. In 2020, Gensler co-authored a paper with Lily Bailey, now special assistant to the SEC's chief of staff, titled "Deep Learning and Financial Stability." The paper raises alarms about common use of data sets, model design, inadequate regulation, coordination due to algorithms, and herding behavior. **Gensler and Bailey also outlined policy recommendations that could inform an SEC regulatory agenda of AI.** A speech from Gensler in 2021 lays out several potential challenges that AI could pose for financial markets and gives a sense that this rulemaking may be the first of several. The SEC chair has increasingly voiced concerns about this emerging technology in recent months as AI has become a dominant topic. In a July speech at the National Press Club and in recent interviews, Gensler outlined some of his concerns with AI and its potential to pose risks to financial stability.

Gensler recognizes the possibilities afforded by AI but is not exactly an AI optimist. "This is the most transformative technology of this generation," he told Bloomberg in August. "There's a 'there' there—we can get to crypto later. We're taking so much of what we humans do on a daily basis and automating it." **In his July speech, Gensler acknowledged the positives of AI but put more emphasis on the potential risks.** He highlighted how AI outputs may be unexplainable, could produce unfair outcomes based on biased data, and could create false predictions. He raised concerns about charging consumers excessively high prices, conflicts of interest between platforms and their users, deception, privacy, and intellectual property. He also flagged concerns about AI market dominance and effects on financial stability. This speech provides key insight into Gensler's perspective on AI. While he referenced the technology's beneficial potential, he devoted more of his speech to the risks, suggesting that he would not be the type to back a light-touch regulatory approach to AI. He concluded by saying that "within our current authorities, we're focused on protecting against both the micro and macro challenges that I've discussed."

Corporate Concentration and Fair Markets

In his July speech, Gensler raised the alarm about corporate concentration in the AI space. "We've seen in our economy how one or a small number of tech platforms can come to dominate a field. There are a number of reasons we may see the same with AI platforms," he said. **Gensler argued that economies of scale and data network effects are likely to contribute to concentration of competitive advantage in a small number of base models.** AI systems depend on data inputs and significant computing power, creating a positive feedback loop. The better your data, the better your AI model will be, and the better your AI model, the easier it will be to retain users and source more data. Speaking to MarketWatch in late October, Gensler cited cloud computing and internet search as services dominated by one or two big tech companies and expressed concern that AI would follow these pathways. These concerns align with President Biden's 2021 executive order on competition in the US economy, which called on agencies including the SEC to promote fair competition through policies such as taking action against unfair or deceptive behavior, proposing rules to strengthen competition (e.g., facilitating market entry), and supporting market transparency.

Gensler also argued in his remarks that widespread reliance on a handful of AI base models could make the financial system more fragile. This builds on the argument Gensler made in his 2020 paper that greater use of deep learning in financial services risked increasing uniformity of data and models and network interconnectedness. He noted that developments in generative AI in the years since the paper's publication made this issue more salient.

Gensler also flagged issues relating to market fairness. He raised the question of data privacy and intellectual property ownership in the age of AI, given that AI systems rely on a large volume of data for training purposes. Data collected on users goes into strengthening the models, creating value for companies. Moreover, Gensler suggested that the companies controlling dominant AI models could extract greater economic rents from consumers given their foothold in the market. Gensler said that he "believe[s] we closely have to assess this so that we can continue to promote competition, transparency, and fair access to markets." **Not only does AI raise the big-picture risk of financial fragility, according to Gensler, it also brings to bear issues of fairness and competition.**

Financial Stability

Gensler has voiced alarm that common use of the same AI base model could cause herding behavior and deepen interconnectedness in the financial system, eroding stability and heightening the risk of a crisis. He elaborated on his concerns about AI and financial stability in an October interview with the Financial Times. The SEC chair said that an AI-triggered financial crisis was "nearly unavoidable" in the next 10 years if regulators do not act. He highlighted AI's "economics of networks" as a reason. This claim may be seen as hyperbolic but illustrates the depth of his concern. "I do think we will in the future have a financial crisis . . .[and] in the after action reports people will say 'Aha! There was either one data aggregator or one model . . . we've relied on.' Maybe it's in the mortgage market. Maybe it's in some sector of the equity market," he said. The spark could come from any part of the economy, in Gensler's view, that depends on a shared foundation model. "A growing issue is that [AI] could lead to a risk in the whole system," Gensler told Marketwatch. "As many financial actors rely on one or just two or three models in the middle … you create a monoculture, you create herding." This may particularly be the case if a problem in a model gets magnified through widespread use in the financial system.

Gensler has also raised some challenges for federal regulators in addressing AI's risks to financial stability. He told the FT that the SEC faces difficulties in this area because models are used broadly across organizations, making individual enforcement actions a less effective means of addressing a systemic issue. "It's a hard financial stability issue to address because most of our regulation is about individual institutions, individual banks, individual money market funds, individual brokers; it's just in the nature of what we do. And this is about a horizontal [matter whereby] many institutions might be relying on the same underlying base model or underlying data aggregator," he said. The SEC's traditional tools may fall short in addressing the problem as Gensler sees it. Gensler highlighted another issue in his Marketwatch interview: AI's risk to the financial system cuts across the jurisdiction of many regulators. It's "a cross-entity issue," Gensler said, and "that's the challenge for these new technologies." AI has relevance for securities trading but also for commodities trading (regulated by the Commodity Futures Trading Commission) and banks (regulated by the Office of the Comptroller of the Currency, Federal Reserve, and Federal Deposit Insurance Corporation). Coordinating across agencies has challenges, which are likely to be amplified in the case of an emerging and rapidly developing technology.

Proposed Rule on Predictive Analytics

The most notable action taken by the SEC on AI thus far is a proposed rule on predictive analytics. Issued in July, the proposed rule focuses on the use of individual AI systems, not base models. Broker-dealers and investment advisors would be required to assess the use of predictive analytic technology for conflicts of interest and eliminate or neutralize any that arise from its use. They would also have to have written compliance policies in effect and keep records relating to the rule. The agency's fact sheet released alongside the proposed rule takes a broad approach to defining the scope of the technology covered. It says that it "includes a firm's use of analytical, technological, or computational functions, algorithms, models, correlation matrices, or similar methods or processes that optimize for, predict, guide, forecast or direct investment-related behaviors or outcomes of an investor." It's possible that the rule when finalized may take a different tack or be scaled down. "We live in an historic, transformational age with regard to predictive data analytics, and the use of artificial intelligence," Gensler said in a press release. "This raises possibilities that conflicts may arise to the extent that advisers or brokers are optimizing to place their interests ahead of their investors' interests."

The SEC is also probing investment advisors' use of AI. The sweep reportedly includes inquiries into marketing related to AI, algorithmic models used in portfolio management, AI providers, and compliance training. The investigation could lead to enforcement actions or potentially inform future rulemaking.

Republican Pushback

The SEC's proposed predictive analytics rule is encountering opposition from Republicans. In the open commission meeting to vote on the predictive analytics rule, Republican SEC Commissioner Mark Uyeda pointed out that this would even capture "a spreadsheet that embeds a financial model." **Even if concerns about the scope of the rule are addressed, the rule is likely still objectionable to industry participants and could be subject to lawsuits.** In a September Senate Banking Committee SEC oversight hearing, GOP senators attacked Gensler's predictive analytics proposal. Senator Tim Scott (R-SC), the top Republican on the committee, criticized it as an overreach of the SEC's authority. "Despite it being labeled a rule on artificial intelligence, your power grab to regulate emerging technologies, even Excel spreadsheets, is beyond the SEC's scope and will ultimately stifle innovation," Scott said. In September, Senators Mike Rounds (R-SD) and Bill Hagerty (R-TN) and Reps. Ann Wagner (R-MO) and French Hill (R-AR) sent Gensler a letter challenging the agency's proposed predictive analytics rule. They argued that the measure is too broad, making compliance burdensome for broker-dealers and investment advisors, and that the economic analysis failed to fully take into account the benefits of technology use in the sector and the costs of compliance. They also argued that the rule would conflict with the Trump-era Regulation Best Interest rule for broker-dealers. In their letter, the lawmakers stated that "if the SEC intends to assume the role of a technology regulator, it should seek explicit authority from Congress." This line of attack previews potential litigation against any SEC regulation of AI under the "major questions" doctrine.

First applied in a Supreme Court majority opinion in *West Virginia v. Environmental Protection Agency* (2021), this doctrine holds that agencies must have authority explicitly delegated from Congress to make rules on matters of great political or economic significance. **Any effort by Gensler to regulate AI could be vulnerable to a legal challenge on the basis of the major questions doctrine.** The Supreme Court's 6-3 conservative majority may be sympathetic to such an argument. Republicans' fierce opposition to the predictive analytics rule suggests that any broader AI regulatory push by Gensler would also face resistance.

Impact on Financial Services and Capital Markets

Gensler's broad proposal for the agency's predictive analytics rules shows how expansively he views the SEC's ability to regulate AI and similar products. This is likely the first of further rulemakings, but how many he can pursue likely depends on whether President Biden is re-elected for a second term. Only in the most recent semi-annual regulatory agenda issued by the Biden administration was AI explicitly mentioned in the entry on this rulemaking, reflecting the technology being a newer focus at the SEC. The scope of the final predictive analytics rule will also shape this decision. If it is narrowed from its original proposal, as has been the trend for Gensler's proposed rules, this could leave the door open to similar regulations to be proposed in the future. This could effectively result in creating the wide-ranging regulatory framework that Gensler envisioned in this initial proposal but being done through a series of rulemakings rather than just one.

The positive outlook for financial services companies and capital markets is that it is more likely that the agency views rulemakings as a way to regulate AI than enforcement actions. For the SEC to start pursuing court cases, there would have to be a belief that current behaviors are covered by existing regulations and in violation of them. By choosing to pursue a rulemaking first, the SEC has essentially acknowledged that current rules are inadequate to cover AI, so lawsuits from the SEC are unlikely to emerge until regulations are finalized. Cases alleging algorithmic bias could still occur at other agencies, though, like the Consumer Financial Protection Bureau, where there is more of a focus on models used to determine, for example, home loans.

From Gensler's public remarks on AI in financial services, his concerns seem primarily to be big-picture issues, such as market concentration. Notably, his comments suggest this is not a risk that exists today but could emerge in the future. Given this dynamic, it is more likely that rulemaking will again be the way forward for Gensler to ensure that it does not become a danger. Any regulations to address or prevent perilous levels of market concentration will likely first focus on reporting requirements, with only some of the information required to be publicly disclosed. This would give the SEC the ability to identify consolidation trends in advance and act as needed. A more aggressive approach could be favored, though, if there is a significant increase in the use of AI or a financial crisis linked to AI.

If the relationship between AI and financial services evolves faster than the SEC can keep up, there also will be an increased risk of enforcement actions. Gensler has used enforcement as a quicker means to police industry, but, as previously mentioned, this requires grounding in existing securities law. As much as industry members may believe these rules should not apply to them, Gensler's experience with the digital assets industry shows that where there is a will, there is a way.

The reality is that Gensler is still in the early stages of trying to get the SEC to grapple with AI. As such, expect his priorities and agenda to evolve and become more refined in the coming months. The chair will likely be responsive to issues raised by allied lawmakers and stakeholders. Following these individuals and groups could serve as a preview for the areas Gensler will scrutinize more. Although it will likely not be a perfect correlation, Gensler has appeared reasonably aligned with these entities, making them valuable proxies to identify what issues will be next on Gensler's radar.

Impact on AI Companies

Gensler's focus on AI is relevant not only for the financial services sector but also for firms that develop AI models. Any regulatory effort to address perceived risks of AI to the financial system could encompass Silicon Valley as well as Wall Street. Updated rules on the part of the SEC won't fully address the issue "if everybody's relying on a base model and the base model is sitting not at the broker dealer, but it's sitting at one of the big tech companies," Gensler told the FT. He also highlighted cloud providers, which often offer AI services. While the SEC has not acted on AI beyond the predictive analytics rule, Gensler is laying the groundwork to claim a seat at the table for the SEC in discussions over regulation of AI writ large. His perspective comes from the impact of this emerging technology on financial markets but has the potential for ripple effects much further beyond the markets. **There is a possibility that SEC action could have an upstream impact that forces the creators of these products, the AI tech firms themselves such as Microsoft, OpenAI, and Anthropic, to adjust them so that they are still accessible to these clients and in compliance with the SEC.** While the SEC may not be generally considered a traditional stakeholder when it comes to emerging technologies like AI, Gensler is working to ensure that his agency is in the regulatory mix.

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