GUIDE

How Financial Firms Are Moving Forward with AI

The state of AI in financial services and implications for your firm

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Introduction

Business and technology move fast. It wasn't too long ago when easy access to artificial intelligence (AI) was viewed more as a cliché plot device in science fiction. Now, AI is touted in nearly every business technology.

Even financial services firms — organizations that are bound by regulations and known for being cautious technology adopters — are warming up to AI. Some have even actively deployed them in specific use cases. (Many are already using AI, albeit unknowingly. More on that later.)

In this guide, we examine the state of AI in financial services and how firms can take advantage of the technology's benefits while staying compliant to their regulatory obligations.

What do regulators say?

The permitted use of AI in financial services is gaining increasing clarity as regulators share their perspectives and insights to upcoming rule changes.

"What we're hearing from different regulators about AI is that there's a lot of risk involved," says Tiffany Magri, regulatory compliance advisor at Smarsh. "But regulators also recognize a lot of opportunities and how to integrate it meaningfully with either clients or within a firm's operational or compliance structure."

One of the biggest regulatory impacts to AI is the passing of the EU AI Act. The European Union set up a structure around AI from a risk perspective. Higher risk areas will require more oversight, accountability, transparency and human elements.

"Firms will need to make sure they can follow the risk structures appropriately, or we will see some high fines," says Magri. "The financial consequences are pretty robust in the EU Act."

Across the pond, FINRA recently released an AI FAQ discussing the inclusion of AI-generated communications. If firms communicate with the public, whether that's retail, institutional or other, firms must apply proper guardrails and procedures.

The SEC also provided several public comments about generative AI, with Chairman Gensler warning of its potential to impact "financial market stability" given its ability to attract fraud and "conflicts of interest."

"It's really a more proactive approach that they've proposed in terms of eliminating conflicts," says Matt Cohen, partner at Kirkland & Ellis. "The proposed rules basically say that when you're using predictive data analytics in investor interactions, you have to adopt policies and procedures to identify and determine conflicts that would result in putting the firm's interests ahead of clients, and then eliminate or neutralize those conflicts."

Define: investor interactions

Broadly defined as communications with prospective clients and marketing, which includes exercising investment discretion over investor accounts.

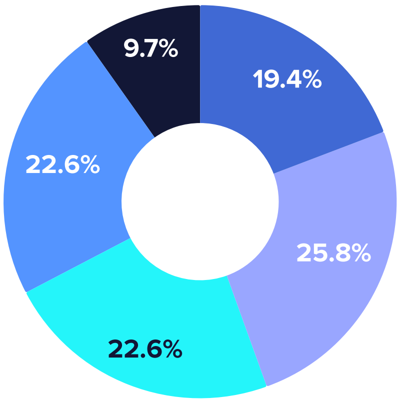
What can firms expect from regulators?

It is almost certain that financial regulators will issue additional regulatory guidance. We can also safely assume that data privacy authorities and U.S. federal and international government bodies will continue to address these and other common areas of concern, including model explainability, data privacy protections, and model risk management.

"The SEC, in particular, has had a rather ambitious rulemaking agenda, but I think this will stay near the top of their list," says Cohen.

There's room for AI in financial services

Firms are cautiously warming up to using AI-created content in their business operations.



Where Are You Currently Focused on AI-enabled Communications Tools?

- **Prohibiting use of ChatGPT and similar models**
- **Assessing how AI might be used by specific applications and processes**
- **Doing due diligence on existing tools to understand how they use AI**
- **Piloting or deploying solutions in limited capacity**
- **Supporting enterprise-level AI tools for specific apps (e.g., conduct surveillance)**

Survey of attendees of recent Smarsh webinar, How AI is Increasing Supervision Data Volumes

While prohibiting AI tools like ChatGPT still hovers near 20%, this is a far cry from a year-and-a-half ago.

"I would say that that is a rather big number, but I think it was a lot bigger 12-18 months ago," says Cohen. "I think 12-18 months ago, outright prohibition was the default approach that most firms were taking."

The reason for this change? Firms needed to meet the needs and demands of their employees.

Internal stakeholders, business teams, marketing, and investment teams want to explore the use of AI to help the business. With employees finding innovative ways to boost productivity, firms now must examine their policies and procedures and take a risk-based approach that allows their employees to use AI to some extent.

Start with exploring potential use cases

From a macro perspective, there are new use cases arriving every day. Firms must ask how they can adopt these use cases for:

- Document summarization
- Third-party document review
- Addressing meeting instances that are documented in Copilot summaries

“It’s that plethora of use cases that we see firms wrestling with,” says Robert Cruz, “trying to put the right controls in place to deal with the variety of outcomes that you could see based upon the way a particular use case is defined.”

Bottom line: How is this going to benefit the firm? That’s the big question that must be answered when looking at new use cases. Anything that is client-facing requires quite a bit of oversight when it comes to compliance, so it’s important that firms also ensure they have the necessary back-end structure for any new use case they want to adopt.

How to move forward with AI

Cohen argues that, from a broad perspective, the general principles of current codes of ethics and other policies already apply to the use of AI.

“You cannot share material non-public information with others,” says Cohen, “and that would include putting it into an AI or similar system that’s publicly available or available to the provider.”

While there’s some existing policies that can be applied, there’s still a need for more specificities to move forward with AI. While prohibition was the prevailing policy, there was also a rollout process that educated employees on what fell inside and outside the scope of that prohibition rule — which is how many people were able to initially implement AI use.

Now, people have a much better handle of the implications of AI and how their firm needs to use it. For any firm that has been on the prohibition side of AI, the first step is to lean into more flexibility around AI use. Cohen advises firms to gain an understanding of the different groups and stakeholders, and how they would like to use AI.

“How does IR want to use it?” asks Cohen, “How do investment analysts want to use it? Having those conversations with key stakeholders on the team is critical in terms of crafting a policy that is tailored to your firm.”

To achieve flexibility, some firms have implemented a pre-clearance requirement, which means that a new AI system must be pre-cleared through the CCO. For example, if a firm is only allowing “closed systems,” which means they do not use information from the firm to train the public algorithm, the pre-clearance requirement ensures that vital prerequisite is met.

Additionally, firms cannot get sucked into AI use cases and forget about the human component.

“You still need that human element,” says Tiffany, “and we still must make sure we have the knowledge base around AI and its applications. Humans must be the ones to ask: Do we understand the capabilities? Can we supervise it? Can we locate the red flags in this new technology within our firm?”

At the end of the day, if you’re going to move forward with AI, your people need to gain internal expertise on AI capabilities and implications, even if you’re relying on external assistance for oversight and supervision.

Key takeaways

Protect your firm: Firms are prioritizing operational and compliance usage of AI systems first, followed by client-facing usage. Overall, they’re trying to create some structure and better decision-making from the perspective of the business.

Train your staff: As with any policy, there’s no way to monitor with 100% certainty. So, what do people do? They train. Periodically they obtain certifications regarding compliance from their team in either annual or quarterly compliance certifications.

Future-proof your policies: Some of the technologies you already have in use at your firm may have recently integrated AI functionality, so AI may be in your current systems already. Whether you’re aware or not, continuing to use those systems without monitoring that AI integration is putting your firm at risk right now. When setting up policies, procedures, and oversight, consider how current systems may change in the future and how to handle them through periodic review processes.

Explain your AI use: Explainability is going to be another major risk. Firms must understand their inputs and outputs using AI. You must not only train your staff on this, but you must also be able to explain your usage to a regulator at some point.

“We have seen some regulatory actions from the U.S. Federal Trade Commission and the Consumer Financial Protection Bureau take action against firms making false and misleading claims about what they were actually doing around AI (also known as AI-washing). Make sure when you’re making claims about AI, you don’t get caught up too much in the hype or the trends of what’s going on. Do what you say you’re going to do and don’t make those claims without proper backup or justification.”

- Tiffany Magri, Senior Regulatory Advisor, Smarsh

Conclusion

This all comes back to off-channel communications.

"Timewise, maybe it's convenient that firms have already established and expanded these processes to deal with off-channel communications," says Cruz, "If you have Copilot and Teams but you don't have a policy defining how they can be used, you potentially have another off-channel exposure to address. The work that's been done over the past two years to get those processes in place now can be extended and leveraged for this question about how AI is going to be evaluated."

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