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Artificial Intelligence

# AI for IAs: How Artificial Intelligence Will Impact Investment Advisers

AI has the potential to be used for portfolio management, customer service, compliance, investor communications, and fraud detection, though RIAs should review emerging rules regulating AI

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The use of artificial intelligence and machine learning technology solutions ("AI") is becoming increasingly common in all industries, including the registered investment adviser ("RIA") space. [A recent survey](#) by AI platform Totumai and market research firm 8 Acre Perspective found that 12% of RIAs currently use AI technology in their businesses and 48% plan to use the technology at some point, which means there is a realistic expectation that 60% of RIAs will be using AI in the near future. Among other use-cases, AI has the potential to be used by RIAs for portfolio management, customer service, compliance, investor communications, and fraud detection.

While regulators are not likely to prohibit the use of AI in the industry, they are likely to closely monitor and regulate specific applications and use-cases, which is why it is essential for RIAs to understand these emerging rules and regulatory frameworks so they can appropriately leverage the many benefits of AI while ensuring their business

remains compliant with these new rules of the road. DWT has recently launched a series of webinars titled "[AI Across Industries](#)" that has gone in-depth on the legal issues surrounding the use of AI.

## Rules of the Road

The SEC maintains that their rules are platform and technology neutral, so it is important to remember that although the technology may be new, many existing rules may apply. Additionally, we expect more new proposed rules in this area (like those discussed below), so RIAs must ensure their use of AI complies with the existing, and emerging, regulatory framework.

### Disclosures

First and foremost, RIAs must disclose their use of AI in their investment management business under Section 206 of the Investment Advisers Act of 1940 ("Advisers Act"). Disclosure is the bedrock of SEC regulation and will be the first place regulators or examiners will look when reviewing the use of AI in the industry. RIAs must ensure that they are fully and fairly disclosing how and where AI is being used in their investment management business. Additionally, it is essential for RIAs to actually understand the technology and be able to explain how the technology works to both clients and regulators. In March, the outgoing director of the SEC's Investment Management Division, William Birdthistle, spoke at the Investment Advisers Association Conference where he suggested that "it is simply not good enough that, for many advisers, their understanding of AI is that information goes into a black box, 'magic happens' and something comes out." RIAs must take ownership of AI if they are to incorporate it in their business, and, as RIAs, they must properly disclose use of AI to their clients and the SEC in furtherance of their fiduciary duty. This can be a fine line to walk for many RIAs who attempt to keep a competitive edge in limiting any disclosure of how they run their business while maintaining compliance with the rules.

- *We recommend that at a minimum RIAs should disclose the use of AI in their investment management business in their ADV brochures, client agreements, and in communications where AI is being leveraged.*

### Division of Investment Management 2017 Guidance on "Robo-Advisers"

In February 2017, the SEC's Investment Management Division provided guidance on the use of automated advisers, also known as "robo-advisers" ("[2017 Guidance](#)"). SEC staff noted in the 2017 Guidance that "Robo-advisers, like all registered investment advisers, are subject to the substantive and fiduciary obligations of the Advisers Act. Because robo-advisers rely on algorithms, provide advisory services over the internet, and may offer limited, if any, direct human interaction to their clients, their unique business

models may raise certain considerations when seeking to comply with the Advisers Act". This point reaffirms the concept that even as technology changes, the existing regulatory framework will continue to apply in many instances.

The 2017 Guidance focuses on three distinct areas that robo-advisers must address:

- The substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers;
- The obligation to obtain information from clients to support the robo-adviser's duty to provide suitable advice; and
- The adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated advice.

If a RIA is using AI to automate their investment advice, it is very likely they would be considered a robo-adviser. Firms who are currently using or plan to use an AI solution to support their advisory services should consider the above three areas to ensure compliance with the Advisers Act. Opponents of the SEC's proposed Predictive Data Analytics Rule, discussed below, often argue that the Rule is unnecessary because the SEC has given RIAs guidance in this space through the 2017 Guidance.

The 2017 Guidance includes robo-adviser specific disclosure requirements which requires them to include the following information in disclosures:

- A description of the business model and related algorithms (including the assumptions and limitations of the algorithm used to manage client accounts);
- The scope of the automated advisory services;
- A description of when (if ever) a client will have human interaction;
- The reliance on questionnaires for the robo-adviser to gather client information;
- A description of the particular risks inherent in the use of an algorithm to manage client accounts;
- A description of any involvement by a third party in the development, management, or ownership of the algorithm used to manage client accounts;
- An explanation of any fees the client will be charged directly by the robo-adviser, and of any other costs that the client may bear either directly or indirectly; and

- An explanation of how and when a client should update information that he or she has provided to the robo-adviser.

*We recommend that RIAs familiarize themselves with the 2017 Guidance and incorporate these principles in their compliance program if they will be using AI in their investment management business.*

## The New Marketing Rule

The SEC's new Marketing Rule 206(4)(1) under the Advisers Act (the "[Marketing Rule](#)") also impacts how RIAs will use AI. DWT has [analyzed](#) how RIAs are complying with the new Marketing Rule. RIAs who are using or intend to use AI in their business and market themselves as such must be very careful to assure compliance with the Marketing Rule. Recently, in March 2024, the SEC separately charged a [former](#) and [current](#) RIA with making false and misleading statements about their use of artificial intelligence. In both cases, the RIAs held themselves out and promoted themselves as leveraging AI when in fact they did not have the ability or technology to do so – a concept now known as "AI Washing." RIAs must ensure that they are following the Marketing Rule disclosure requirements at all times, including when discussing AI, and most importantly say what they do, and do what they say.

## The Proposed Predictive Data Analytics Rule

In July 2023, SEC Chair Gary Gensler announced the Commission would propose new requirements to address risks to investors from conflicts of interest associated with the use of predictive data analytics by Broker-Dealers and RIAs, through the proposed "[Predictive Data Analytics Rule](#)." The Rule would cover a broad range of technology that includes not just AI, but also any other "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" (Covered Technology).<sup>[1]</sup> The rule would also require RIAs to: (i) identify conflicts of interests when using certain technology in interactions with investors; and (ii) adopt policies and procedures that eliminate or neutralize (rather than disclose or mitigate) those conflicts of interests.<sup>[2]</sup>

The proposed Predictive Data Analytics Rule has been [criticized by the industry](#) as being overly broad and unnecessary given previous guidance (such as the 2017 Guidance discussed above). Despite industry objections, both Chair Gensler and former IM Director Birdthistle support the proposal. The Rule has not been finalized, and we expect more discourse surrounding the costs and benefits of adopting the rule, but the expectation at this point is that it will be finalized in some form in the near future. Either way, the SEC has made it clear they intend to closely scrutinize the use of AI in the industry, so it is imperative that RIAs stay current with changing regulations if they

intend to use AI or any other Covered Technology to make predictions, manage portfolios, provide investment advice, or use chatbot technologies to communicate with investors and make investment decisions.

## Conclusion

AI is here to stay. As regulators and the industry grapple with the intended and unintended consequences of harnessing AI, it is imperative that RIAs understand both the technology and the rules. The SEC will continue to scrutinize RIAs who use (or say they use) AI in their investment management business in examinations and enforcement proceedings. DWT's [AI team](#) can assist you in staying current and compliant as the regulatory landscape shifts.

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[1] *Id.*

[2] *Id.* at 40.

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