

September 12, 2024

Via Online Submission

European Commission
Directorate-General For Financial Stability, Financial Services and Capital Markets Union
1049 Bruxelles/Brussels
Belgium

Re: EC TARGETED CONSULTATION ON ARTIFICIAL INTELLIGENCE IN THE FINANCIAL SECTOR

Dear Sir/Madam,

MFA¹ appreciates the opportunity to represent the views of the global alternative investment industry in this written response to the European Commission's ("EC") targeted consultation on artificial intelligence in the financial sector ("**Consultation Paper**").² We have set out our responses to the relevant questions of the Consultation Paper in the Annex hereto.

MFA acknowledges the value of the EC's thoughtful and consultative approach by issuing this Consultation Paper, which reflects the EC's desire to constructively engage with various market participants regarding the role of potential new technologies, including AI. We particularly appreciate that the Consultation Paper is not intended "to lead to policy work that would generate new duplicative requirements in relation to the use of AI by the financial sector, or to new requirements that have the potential to stifle AI innovation."³

¹ Managed Funds Association ("**MFA**"), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member fund managers, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over €2.9 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

² European Commission, Targeted Consultation on Artificial Intelligence in the Financial Sector (June 18, 2024), available at: https://finance.ec.europa.eu/document/download/054d25f5-0065-488a-96fb-2bb628c74e6f_en?filename=2024-ai-financial-sector-consultation-document_en.pdf.

³ *Id.* at 3.

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MFA believes existing financial regulatory frameworks are well-designed to address the current and potential uses of AI in the alternative asset management industry because the rules regulate activities and avoid regulating specific technological tools. We support technology neutral frameworks that address specific activities rather than technologies as being the most appropriate regulatory approach to AI. While use cases for AI are still evolving, the technology has demonstrated the potential to unlock important efficiencies and yield benefits. As a result, while regulators must ensure their regulatory frameworks are adequate to govern the marketplace as it exists today, we urge regulators to avoid any potential actions that could unintentionally stymie the development of new technological tools that could augment human capabilities and ultimately amplify benefits to investors.

In summary, we submit the following four high-level recommendations we believe the EC should carefully consider in connection with the use of AI in the financial sector:

- Alternative asset managers use AI to enhance existing processes and procedures
- Fiduciary duty and other existing regulations already sufficiently address potential concerns posed by the use of AI tools
- Past attempts to regulate specific technologies confirm that regulators should remain technology neutral and prioritize regulating activities
- Potential use cases for AI are still developing and could unlock important benefits

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MFA appreciates the opportunity to provide these comments to the EC in response to the Consultation Paper. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Matthew Daigler (mdaigler@mfaalts.org), Rob Hailey (rhailey@mfaalts.org), or the undersigned (jflores@mfaalts.org).

Respectfully submitted,

/s/ Jillien Flores

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ANNEX

Part 2: QUESTIONS RELATED TO SPECIFIC USE CASES IN FINANCIAL SERVICES

Question ASSET MANAGEMENT 1. For which use case(s) are you using/considering using AI?

MFA Response

Alternative Asset Managers Use AI to Enhance Existing Processes and Procedures

The alternative investment industry is using AI the same way many other industries are: to enhance existing standard processes and procedures, such as research and analysis, risk management, portfolio optimisation, fraud detection, and compliance. AI is not the sole input for investment decisions but rather is one of the many tools alternative asset managers use. For example, tools such as natural language processing may empower personnel to query, synthesise, and analyse large data sets, allowing personnel to perform certain functions in a more efficient manner. As with any automation, a human is always involved.

An infamous story of a U.S. lawyer who submitted legal briefs drafted by AI that cited nonexistent precedents underscores why AI is only one part of investment decision making, and why humans are always in the loop. In his reprimand in the case, Judge P. Kevin Castel noted that “[t]echnological advances are commonplace and there is nothing inherently improper about using a reliable artificial intelligence tool for assistance.... But existing rules impose a gatekeeping role on attorneys to ensure the accuracy of their filings.”⁴ New technological advances will always be incorporated into existing processes. As technology improves standard processes, oversight procedures are adapted as appropriate. It is laudable for regulators to continue analysing and reviewing how new technologies fit within the existing regulatory framework. Current regulations such as the fiduciary duty standard continue to effectively capture new technologies, as discussed further below.

⁴ *Mata v. Avianca, Inc.*, 22-cv-1461 (PKC) (S.D.N.Y. Jun. 22, 2023).

Question ASSET MANAGEMENT 2. What are the opportunities that AI brings to your use case?

MFA Response

Potential Use Cases for AI Are Still Developing and Could Unlock Important Benefits

MFA’s membership consists of market participants that use many different forms and types of technological tools to maximize business efficiencies, reduce costs for fund investors, decrease operational risks, and optimize regulatory compliance. While use cases for AI are still evolving and generative AI, in particular, is still in its infancy, the technology has demonstrated the potential to unlock important efficiencies and yield benefits for investors. Accordingly, MFA believes regulators should not pursue a reactive or proscriptive approach that could impede innovation and should instead carefully consider how best to responsibly capture the potential benefits of AI within its existing control framework. Given the recent entry into force of the EU’s Artificial Intelligence Act (“**AI Act**”), and with implementation of numerous provisions taking place over the next two to three years, policymakers should consider perspectives from stakeholders and individual Member States about the workability of the recent regulatory framework before proceeding with proscriptive financial services-oriented AI legislation.

Question ASSET MANAGEMENT 3. What are the main challenges and risks that AI brings to your use case (e.g. discrimination, opacity of the AI application developed, difficult to control/supervise it, etc.)?

MFA Response:

One risk posed by AI has to do with the potential for information leakage. Investment management firms’ value-adding fundamental research is the intellectual work product of the firm. Information forms the inputs into every investor’s decision-making process, and no two investment theses are identical, creating the depth and breadth of liquidity that facilitate thriving and competitive capital markets. Investors protect their intellectual property, and alternative asset managers have significant concerns about information leakage when using open-source AI models. To mitigate this, models are often placed in internal sandboxes before being trained on proprietary data, preventing proprietary information and processes from being incorporated into the publicly-available version.

Question ASSET MANAGEMENT 4. What is the main barrier to developing AI in your use case (e.g. lack of skills and resources, readiness of the technology, high regulatory costs for compliance with the relevant frameworks, etc.)?

MFA Response

Many of our members trade in EU markets and offer investment products to EU investors. While regulators must ensure their regulatory frameworks are adequate to govern the marketplace as it exists today, it is critical that regulators avoid any potential actions that could unintentionally stymie the development of new technological tools that could augment human capabilities and ultimately amplify benefits to investors. We believe that existing regulations in the EU and other major markets already sufficiently address potential concerns posed by the use of AI tools.

In the EU, MFA members are governed by the Alternative Investment Fund Managers Directive (“**AIFMD**”) and by the Markets in Financial Instruments Directive/Regulation (“**MiFID/MiFIR**”). Both AIFMD and MiFID/MiFIR have undergone recent legislative reviews that ultimately improve transparency and strengthen EU capital markets. Alternative investment funds in the EU are also supervised by the European Securities and Markets Authority (“**ESMA**”) and by National Competent Authorities (“**NCA**s”). In the United States, MFA’s membership consists of registered investment advisers (“**RIAs**”), subject to regulation by the Securities and Exchange Commission (“**SEC**”) as fiduciaries, and who, in many cases, are also commodity pool operators (“**CPO**s”) and commodity trading advisors (“**CTAs**”), subject to regulation by the Commodity Futures Trading Commission (“**CFTC**”).

In the EU, AIFMD and MiFID/MiFIR generally adopt a principles-based approach to regulation. This approach sets out broad objectives that firms must achieve, such as ensuring transparency and market integrity, without prescribing specific methods or technologies to be used. By embracing a technology-neutral stance, AIFMD and MiFID/MiFIR can more readily adapt to the rapidly evolving technological landscape. AIFMD and MiFID/MiFIR’s focus on principles and outcomes grants firms the flexibility to select the most appropriate and efficient technologies while still meeting regulatory objectives. For example, MiFID mandates that firms maintain records of transactions and communications, but the means to achieve this is left to the discretion of the firms. As discussed in ESMA’s Public Statement on AI and investment services,⁵ firms’ use of AI in the provision of investment services is already subject to a number of requirements, given the

⁵ See ESMA, ‘Public Statement on the use of Artificial Intelligence (AI) in the provision of retail investment services’ (ESMA35-335435667-5924, 30 May 2024), available at: https://www.esma.europa.eu/sites/default/files/2024-05/ESMA35-335435667-5924_Public_Statement_on_AI_and_investment_services.pdf.

technology-neutral basis of the MiFID/MiFIR framework. Examples include transparency with clients on the use of AI tools in the provision of investment services, governance, risk management, and staff training frameworks reflecting the firm's use of AI, and, where AI tools are used in investment decision-making processes, controls to ensure firms continue to meet their existing product governance and suitability obligations.⁶ The same principles apply in the context of corresponding regulatory requirements applicable to alternative investment fund managers under AIFMD. This flexibility afforded by a technology-neutral framework not only fosters innovation but also ensures that regulatory standards are upheld across diverse technological platforms. AI should not necessitate a departure from this approach which is well-suited to accommodate new technologies.

In the United States, existing regulatory frameworks already apply to RIAs' use of new technologies. Recent advancements in AI have not fundamentally changed or required wholesale revisions to the core tenets of regulatory and compliance frameworks. As a result, as new potential use cases for AI are considered, existing control frameworks remain the proper mechanism for oversight of activities that involve the use of such tools. Existing regulatory frameworks applicable to alternative investment funds' research, risk management, financial reporting, and customer protection sufficiently address existing and emerging risks related to AI.⁷

The Investment Advisers Act of 1940 (“**Advisers Act**”) and rules thereunder impose a broad fiduciary duty on RIAs to act in the best interest of their clients, which includes both a duty of care and a duty of loyalty. RIAs are subject to, among other things, a prohibition on principal trading and requirements to adopt and implement reasonably-designed policies and procedures to ensure compliance with the Advisers Act and rules thereunder (including rules related to portfolio management and trading practices) and to adopt and enforce a written code of ethics reflecting the adviser's fiduciary duty to its clients. In addition, when an RIA directs an investment fund to trade through a broker-dealer to access a market, SEC Rule 15c3-5 applies, which requires risk management controls for broker-dealers with market access. Thus, many controls are in place both at the RIA and the RIA's broker-dealer before an order is exposed to the public markets. Moreover, MFA members that are also CFTC registrants are required to be members of the National Futures Association (“**NFA**”). Historically, the CFTC has relied upon NFA, a self-regulatory organization and the only registered futures association under Section 17 of the Commodity Exchange Act (“**CEA**”), to set forth and enforce its own rules that establish, among other things, training standards and proficiency testing, minimum standards governing the sales

⁶ In addition, firms are subject to appropriate controls to prevent their trading systems from contributing to a disorderly market or functioning in any way contrary to the EU Market Abuse Regulation or the rules of any trading venue to which the trading system is connected.

⁷ See 7 U.S.C. § 21(p).

practices of its members and associated persons, as well as special supervisory guidelines to protect the public interest relating to the solicitation of new futures or options accounts.⁸ All told, NFA’s existing regulatory framework is a complementary balance between the CFTC’s principles-based approach and NFA’s more prescriptive approach. AI, as merely one of many new and emerging technological tools,⁹ should not necessitate altering this dynamic.

Regulators Should Remain Technology Neutral and Prioritise Regulating Activities

MFA believes that regulators should avoid regulating specific technological tools. Instead, regulators should embrace a flexible approach to regulatory oversight that is premised on the understanding that the markets are ever-evolving.¹⁰ For example, the CFTC generally has not strayed from this paradigm even in the face of rapid and widespread adoption of once-new technological tools such as the internet and electronic trading.¹¹ This approach has served the

⁸ As a result, in addition to CFTC rules, registrants are also subject to NFA rules that apply to regulated activities where AI technologies may be deployed. As one example, NFA-registered MFA members are already subject to rules governing supervision, such as NFA Rule 2-9, which “places a continuing responsibility on every Member futures commission merchant . . . , [CTA], [CPO], and introducing broker . . . to diligently supervise its employees and agents in *all aspects* of their commodity interest activities.” NFA Interpretive Notice 9074, available at:

<https://www.nfa.futures.org/rulebooksql/rules.aspx?Section=9&RuleID=9074> (last visited Apr. 23, 2024).

NFA also has issued numerous Interpretive Notices under Rule 2-9 further setting forth detailed supervisory guidelines as applied to activities that involve the use of certain technologies, including but not limited to CPO control systems (*see id.*), information systems security programs (*see* NFA Interpretive Notice 9070, available at: <https://www.nfa.futures.org/rulebooksql/rules.aspx?Section=9&RuleID=9070> (Apr. 23, 2024), and automated order-routing systems (*see* NFA Interpretive Notice 9046, available at: <https://www.nfa.futures.org/rulebooksql/rules.aspx?Section=9&RuleID=9046> (Apr. 23, 2024)).

⁹ As the EC is aware, much like other novel technological tools that have emerged in the recent past, AI is merely a tool. AI tools may support human decision-making in the investment process and enhance efficiency and productivity, but AI tools should not be a stand-in for ultimate human decision-making.

¹⁰ *See* Regulation Automated Trading; Withdrawal, 85 Fed. Reg. 42755, 42757 (July 15, 2020) (“The markets we regulate are changing. To maintain our regulatory functions, the CFTC must either halt that change or change our agency. Swimming against the tide of developments like electronic markets is not an option, nor should it be. The markets exist to serve the needs of market participants, not the regulator. *If a technological change improves the functioning of the markets, we should embrace it.*”) (emphasis added).

¹¹ By contrast, in addressing the use of “predictive data analytics,” the SEC eschewed the “technology-neutral” approach it claims to employ in favor of proposing a regime so sweeping and restrictive that it would shut down not only innovation and technological advancement but also some registrants themselves. *See* Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53960 (Aug. 9, 2023); *see also* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa

markets well and has laid the groundwork for thriving and resilient derivatives markets in the United States because registrants are not burdened by cumbersome or soon-to-be anachronistic rules. Alternative asset managers operate globally deploying a diverse range of investment strategies, and therefore, MFA encourages the EC to consider the importance of interoperable, flexible, principles-based frameworks in the context of AI technologies and corresponding regulations.

It is instructive to consider the CFTC’s determination to withdraw the proposed Regulation AT Notice for Proposed Rulemakings (“**NPRMs**”), when it decided “not to proceed with detailed prescriptive requirements.”¹² When the CFTC attempted to regulate a specific technology (*i.e.*, automated trading), it encountered tremendous challenges drafting proposed rules “just right” and ended up withdrawing its initiative in its entirety and solely deferring to existing rules and regulations.¹³ Through this rulemaking initiative and process, the CFTC ultimately realized that the markets it regulates and the technological tools used by its market participants are constantly changing.¹⁴ Similarly, the CFTC changed the definition of storage media recordkeepers could employ under CFTC Rule 1.31 from “optical disk” to “electronic storage media”¹⁵ and then again to “electronic regulatory records”¹⁶ in order to “modernize and make technology neutral the form and manner in which regulatory records must be kept.”¹⁷ In light of experiences such as these, we encourage regulators to maintain a commitment to remain technology neutral and avoid putting in

Countryman, Secretary, SEC (Oct. 10, 2023), available at: <https://www.mfaalts.org/wp-content/uploads/2023/10/MFA-Comment-Letter-to-SEC-on-Conflicts-of-Int-PDA-Proposal-101023.pdf>.

¹² *See* note 10, *supra*, at 42756 (“In light of feedback the [CFTC] received in response to the Regulation AT NPRMs, and upon further consideration, the [CFTC] has determined to withdraw the pending Regulation AT NPRMs, to specifically reject the policy responses listed above as means of addressing the perceived risk underlying the Regulation AT NPRMs. *Furthermore, the [CFTC] has determined not to proceed with detailed, prescriptive requirements such as those contained within the Regulation AT NPRMs.* Finally, the [CFTC] has decided not to pursue regulatory proposals that would require additional classes of market participants to become registrants or compel market participants to divulge their source code and other intellectual property absent a subpoena.”) (emphasis added).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Recordkeeping, 64 Fed. Reg. 28735 (May 27, 1999) (changing the term “optical disk” to “electronic storage media”).

¹⁶ Recordkeeping, 82 Fed. Reg. 24479 (May 30, 2017) (again changing the term “electronic storage media” to “electronic regulatory records”).

¹⁷ *Id.*

place regulations tied to technological terms and concepts that will quickly become outdated and out of step with the marketplace.

Attempting to regulate any one specific technology over another could unintentionally stifle innovation, reduce returns to investors, and potentially circumscribe the ability of smaller and emerging managers to remain nimble and agile in an ever-competitive market.