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Technology

How to Apply Alt Data Best Practices to AI Systems

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Given recent acceleration of developments in artificial intelligence (AI), regulators and authorities globally have begun to examine the use of AI in various industries, including by investment advisers in connection with trading and investment decisions. Although the SEC has proposed a rule focused on conflicts of interest created by the use of predictive data analytics (PDA), including AI, (PDA Rule), U.S. regulators have yet to provide firm guidance on the application of existing regulations to advisers' use of AI in connection with trading and investment activities. In the absence of such guidance, advisers should consider adopting AI policies and procedures that focus on insider trading concerns and are consistent with current best practices for alternative data (alt data) use.

This article describes how advisers' use of AI has evolved, discusses the applicable regulatory framework and explains how to apply alt data best practices to AI systems.

See this two-part series on the SEC's proposed PDA Rule: "Proposal Background and Overview" (Sep. 14, 2023); and "Issues and Implications for Hedge Fund Managers" (Sep. 28, 2023).

Evolution of Advisers' Use of AI

The use of computers to automate and accelerate tasks in connection with investment decisions and trading activities has evolved over time, from basic computing systems for algorithmic and high-frequency trading, to machine learning tools capable of analyzing large data sets and providing actionable insights. More recently, machine learning has advanced to create a new category of deep learning methods requiring minimal human intervention and allowing the AI system to self-train its components and discover useful improvements independently. The "deep" in "deep learning" refers to the use of multiple layers of a neural network in such systems. Examples of deep learning systems include generative AI systems that have gained a lot of popular attention for their ability to generate essays, articles, works of art and videos.

See "Understanding and Mitigating Risks of Using ChatGPT and Other AI Systems" (Jul. 6, 2023).

With these new deep learning methods, AI capabilities appear to have effectively advanced from an elementary level of handling ministerial tasks to a graduate school level of demonstrating creative

abilities. Defining AI broadly – which regulators tend to do – this technology can be seen as a continuation of the longstanding use of automated trading/investment systems in the financial industry. However, as a matter of common industry usage, AI is viewed as only recently emerging in the form of these deep learning methods.

See "AI Widely Used by Hedge Funds, AIMA Study Finds" (Apr. 25, 2024); and "Driven by AI, Private Funds' Use of Alternative Data Continues to Grow, Survey Finds" (Feb. 15, 2024).

Regulatory Framework

White House

President Biden issued an Executive Order in connection with the development and use of AI in October 2023. The Executive Order provides guidance for federal agencies in developing their individual regulatory standards for the use of AI. It urges those agencies to play an active role in this area through the promulgation of new rulemaking and/or guidance on the application of existing rules to AI.

For more on the Executive Order, see "Recent Developments in Privacy, Cybersecurity and AI Regulation" (Mar. 28, 2024).

CFTC

Earlier this year, the CFTC solicited comments on the use of AI and any necessary guardrails that may be advisable in the near future, signaling its consideration of new regulations in this area. In May 2024, the CFTC's Technology Advisory Committee released its Report on Responsible AI in Financial Markets, which:

- highlights the importance of establishing guardrails for the use of AI applications and tools; and
- recommends a framework for the CFTC to further evaluate these issues and develop such guardrails.

See "Evaluating the CFTC's Actions in 2023 and the Outlook for 2024" (Jun. 20, 2024).

SEC

PDA Rule

In August 2023, the SEC proposed the PDA Rule, which is broadly drafted and covers basic algorithmic systems along with newer machine and deep learning systems. If enacted, the PDA Rule would require advisers to identify and take steps to address conflicts of interest arising from their use of PDA, including AI systems.

However, in recent remarks, SEC Chair Gary Gensler acknowledged that the SEC received robust comments on the proposed PDA Rule. As a result, the SEC has indicated, as part of its regulatory agenda, that it is likely to repropose the rule in a revised form with another opportunity for the industry to comment on it.

See "What's Next for the SEC and CFTC? A Look at the Latest Reg Flex Agendas" (Aug. 15, 2024).

Gensler has explained that AI is not just a new communications tool (like radio, TV and the internet) but is a tool for predictive analytics. He highlighted the risks posed by AI, including fraud, market manipulation, conflicts of interest and improper disclosure to investors and clients.

Investor Alert

In addition, in January 2024, the SEC published an investor alert warning retail investors of the dangers of AI, urging caution in using AI-generated information to make investment decisions or predict stock prices due to hallucination risks and other similar issues.

Insider Trading

We view material nonpublic information (MNPI) concerns as of paramount importance to advisers as they undertake to use AI systems in connection with their trading and other investment activities. For example, recent SEC actions demonstrate the SEC's willingness to take a broad interpretation of MNPI and insider trading:

- *Panuwat*: The *Panuwat* case shows the SEC's willingness to pursue so-called "shadow trading" as an insider trading theory, accusing Panuwat of failing to comply with his employer's broadly worded insider trading policy, which barred using MNPI to trade in a competitor's securities.
- *App Annie*: The SEC's September 2021 settlement with alt data vendor App Annie found that misrepresentations and deceptive practices amount to a violation of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Among other things, the SEC argued that App Annie made misrepresentations to its trading firm customers that its product did not contain MNPI and that it had effective internal controls to prevent it from selling MNPI.
- *Ares Management*: The SEC's May 2020 settlement with Ares Management, LLC related to a supervisory failure around MNPI issues. Ares' compliance policies failed to account for the special circumstances presented by having an employee serve on a public portfolio company's board while that employee continued to participate in trading decisions regarding the portfolio company. Although the SEC did not charge Ares with insider trading, the regulator did accuse it of failing to make adequate inquiries about its possession and use of MNPI.

See "SEC Focus on Private Fund Managers: Alternative Data and 'Shadow Trading' (Part One of Two)" (Dec. 2, 2021); and "SEC Action Against Alternative Data Vendor Is Warning to Fund Managers" (Oct. 14, 2021).

In addition, an April 2022 risk alert from the SEC's Division of Examinations highlighted policies and procedures around the use of alt data as a common area of deficiency in complying with Section 204A of the Investment Advisers Act of 1940 (Advisers Act) and Rule 204A-1 thereunder. Specifically, the alert notes that exam staff found that some advisers' policies and procedures were not reasonably designed to address the receipt of MNPI from alt data sources. The alert cites three concerns in this area:

1. *Inadequate Due Diligence*: Advisers' due diligence of alt data providers was "ad hoc and inconsistent," and they failed to memorialize and/or follow their due diligence processes.
2. *Data Provenance*: Advisers did not have policies and procedures for assessing "terms, conditions, or legal obligations related to the collection or provision of the data" and for responding to red flags about data sources.
3. *Inconsistent Implementation*: Advisers applied their policies and procedures inconsistently, including:
    - not applying due diligence processes to all data providers;
    - failing to have a system to determine when initial due diligence should be refreshed, either because of the passage of time or a change in the provider's data collection practices; and
    - being unable to demonstrate, "such as by documentation," that they had followed their policies and procedures.

See "Risk Alert Cites Compliance Issues Regarding Advisers' Handling of MNPI" (May 19, 2022).

Applying Alt Data Best Practices to AI Systems

The foregoing MNPI and insider trading enforcement actions, plus the SEC's 2022 risk alert, provide the background for industry best practices that have emerged around the onboarding of alt data vendors. Absent specific AI guidance from regulators and legislators, and due to the independent operational nature of newer AI systems along with their extensive use of alt data, these alternative data best practices – along with the SEC's proposed rule on the oversight of third-party service providers to which key functions have been outsourced (Oversight Proposal) – provide a framework that advisers should consider using as guidance for developing best practices with respect to the use of AI systems.

As a best practice, many firms have adopted detailed policies and procedures regarding the onboarding and ongoing use of alt data, including, of paramount importance, thorough due diligence of the sources and restrictions applicable to data sets to assess MNPI risks. Firms also pay careful attention to contractual provisions applicable to such data sets. Advisers can adapt these alt data best practices to their AI policies and procedures; vendor due diligence; and contract provisions.

See this two-part series on the Oversight Proposal: "New Rules for Advisers That Outsource Key Functions" (Dec. 8, 2022); and "A Solution in Search of a Problem?" (Dec. 22, 2022).

Policies and Procedures

Best practices for alt data policies and procedures should cover the onboarding of new sources of alt data, including due diligence of alt data vendors (discussed in more detail below) and data provenance. The onboarding process should also be performed for internal web scraping or other directly acquired data not involving a third-party vendor. For AI policies and procedures, advisers' onboarding procedures should also include an appropriately detailed understanding of the technical operation of the AI system, along with evaluation of the provenance of all data used to train the AI system and data expected to be used as an input or for training on an ongoing basis.

In addition, advisers should develop supervisory policies and procedures that anticipate specific MNPI scenarios and outline tailored responses to those scenarios. Those procedures should outline expectations of the vendor due diligence process and specify contract negotiation standards to guide the formalization of those vendor relationships. For AI systems, it may be important to anticipate scenarios in which only limited information on training data may be available or when training data includes broad swathes of the internet. It may be reasonable to consider the MNPI risk in such scenarios to be low despite the limited ability to inquire into the provenance of such training data.

For more on MNPI policies and procedures, see "SEC Charges Broker-Dealer Over Information Barrier Failures" (May 9, 2024).

Vendor Due Diligence

Alt data vendors should complete a due diligence questionnaire (DDQ) or an equivalent document as the first step in the process. In addition to data sources and consents/permissions, an AI DDQ should include detailed questions on the sources of intellectual property (IP) and technology used to create the AI system. Any internally created AI systems should be diligenced in a comparable manner.

Although the use of alt data has typically been one directional, with minimal flows of confidential information from the adviser to the vendor, AI systems raise concerns around the use and disclosure of the advisers' and their investors' confidential information by the AI system. Therefore, a careful evaluation of the use and disclosure of such confidential information by the AI system, including whether it will be used to train AI systems released to third parties, is required.

As a follow up to the DDQ, it is recommended that advisers conduct a due diligence call with the vendor to:

- follow up on any questionable items or red flags in the DDQ;
- confirm the vendor's understanding of the importance of compliance and MNPI issues;
- inquire as to any SEC or other governmental inquiries; third-party complaints from data sources; and any breach of a duty to any third party or pursuant to legislation;
- discuss in detail data provenance; and
- request copies of underlying contracts (or excerpts thereof), consents, consumer disclosures, etc.

For AI vendors, this call may be of particular importance in gaining additional insight into the operation of the AI system.

Advisers should pay close attention to international vendors and the use of data gathered internationally. International laws and regulations – including in areas such as data privacy, data security and price-sensitive information versus MNPI distinctions – should be considered and may require consultation with local counsel. These same concerns are relevant with respect to AI due diligence, particularly in light of the E.U.'s AI Act, which took effect August 1, 2024.

All due diligence procedures should be documented. For example, the outlines of the due diligence call and the matters discussed therein should be memorialized and retained. This should be equally applicable with respect to diligence of AI systems.

Periodic re-diligence (at renewal or at least biannually) should confirm the absence of material changes to the DDQ or data provenance. Advisers should also conduct a renewed diligence exercise after becoming aware of a material change in data provenance or the emergence of red flags with respect to the vendor. Because of the rapid evolution of AI systems and the regulatory landscape, advisers should consider conducting a diligence refresh quarterly or every six months.

See this two-part series on best practices for using alt data: "Data Gathering and Managing Data Providers" (Feb. 6, 2020); and "Mitigating Regulatory and Other Risks" (Feb. 13, 2020); as well as "Best Practices for Due Diligence by Hedge Fund Managers on Research Providers" (Mar. 14, 2013).

Contracts

When negotiating a contract with an alt data provider, advisers should obtain representations and warranties around data provenance to the extent possible, including a duty to update/inform the adviser in the event of material changes or a breach. Advisers should avoid accepting a mere indemnity in lieu of representations and warranties.

Those terms are equally applicable with respect to license agreements for AI systems, which should also cover IP rights in the software underlying the AI system itself. License agreements for AI systems should also ensure adequate confidentiality and use protections for the adviser's and its investors' confidential information, which may include restrictions on the use of such information to train the AI system.

A duty to notify of an adverse event (*i.e.*, an SEC inquiry/investigation or third-party claims for breach of a duty) should ideally be included in any agreement. This notice allows the adviser to conduct further due diligence and to restrict use of the data set, if appropriate. This duty is equally applicable in license agreements for AI systems, especially when the AI system is integral to trading decisions because it allows an adviser to suspend use of the AI system for trading purposes if necessary.

Advisers should avoid autorenewals to allow for re-diligence at each renewal. Advisers may consider opt-out rights and short-term contracts with respect to AI systems, particularly in light of the rapidly advancing technology. However, if an AI system is heavily integrated into an adviser's operations, it may be advisable to obtain long-term renewal rights or lengthy notice periods for

nonrenewal. Advisers should also approach free or limited trials in license agreements for AI systems with caution as the terms may not provide adequate representations/warranties or allow for trading use of the data.

See "Hedge Fund-Specific Issues in Portfolio Management Software Agreements and Other Vendor Agreements" (Aug. 4, 2011).

Conclusion

In the absence of express guidance from the SEC and CFTC, advisers contemplating the use of AI systems for investment and trading decisions should consider adopting policies and procedures for the onboarding and use of AI systems derived from those widely used with respect to alt data. As AI continues to evolve and regulators work on their response, those policies and procedures should provide a useful framework that can be modified as appropriate to keep up with the inevitable continuing technological advances and regulatory developments.

See this four-part AI compliance playbook: "Traditional Risk Controls for Cutting-Edge Algorithms" (Sep. 29, 2022); "Seven Questions to Ask Before Regulators or Reporters Do" (Oct. 6, 2022); "Understanding Algorithm Audits" (Oct. 13, 2022); and "Adapting the Three Lines Framework for AI Innovations" (Oct. 20, 2022).

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