Securities Regulation Daily Wrap Up, AI NEWS: CFTC seeks input on AI uses and risks for regulated derivatives markets, (Jan 29, 2024)

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Separately, the Commission warns the investment public to be wary of scammers who claim they can generate outsized returns using AI-assisted technology.

The CFTC's Divisions of Market Oversight, Clearing and Risk, Market Participants, and Data and the Office of Technology Innovation have issued a request for comment (RFC) on current and potential uses and risks of artificial intelligence (AI) in CFTC-regulated derivatives markets. The RFC seeks the public's input on the definition of AI and its applications, including its use in trading, risk management, compliance, cybersecurity, recordkeeping, data processing and analytics, and customer interactions.

The CFTC said the request is part of a broader staff effort to monitor the adoption of AI, including machine learning and other uses of automation in CFTC-regulated markets, and was prompted, in part, by AI-related guidance issued by the White House. The administration issued an Executive Order on October 30, 2023, "Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence," that encouraged federal agencies, including the CFTC, to consider using their authorities to protect American consumers from fraud, discrimination and threats to privacy, and to address other risks that may arise from the use of AI.

The CFTC's request "allows us to better align our supervisory oversight and evaluate the need for future regulation, guidance, or other Commission action," said CFTC Chairman Rostin Behnam in a statement. In addition, it will further support the CFTC "as we strategically identify the highest priorities and return-on-investment projects with AI use cases internally," he said.

Also commenting on the RFC release, Commissioner Kristin Johnson noted that while there were potential benefits to developing and deploying AI in derivatives markets, there also were notable risks, "including risks relating to market safety, customer protection, governance, data privacy, mitigation of bias, and cybersecurity, among other issues."

Focus on regulated markets. The RFC specifically asks for feedback about AI use in CFTC-regulated markets and avoids broader queries about AI, dividing its 20 questions between current and potential uses of AI, including its scope and its risks to CFTC-regulated entities: derivatives clearing organizations, futures commission merchants, swap dealers, swap execution facilities, designated contract markets, and other derivatives market participants. Consistent with the definition used in the Executive Order, the CFTC's request refers to AI as "a machine-based system that can, for a given set of human-defined objectives, make predictions, recommendations or decisions influencing real or virtual environments."

The use of algorithms and other advanced programming have a long history in financial services, and such applications have evolved to incorporate AI, the CFTC noted in its release. "While it may be difficult to draw a precise boundary between algorithms and AI, it is evident that use of AI has already gained a significant foothold in financial services, including derivatives markets." AI was used for trading as early as 2017.

Further, "a recent publication by the International Organization of Securities Commissions found that market intermediaries are deploying AI and machine learning for uses including advisory and support services, client identification and monitoring (including compliance with know-your-customer obligations), and risk management," the CFTC said.

"I applaud the staff's efforts to improve the Commission's understanding of the use of AI technologies by market participants as well as the potential for the Commission to rely on AI in conducting supervisory oversight," said the

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CCFTC's Johnson. "The comments that the Commission will receive in response to the RFC will enable the Commission to evaluate the need for any formal guidance and possibly rulemakings regarding the integration of AI in CFTC-regulated markets."

Customer advisory issued. In a related action, the CFTC last week also published a customer advisory that warned investors of the emergence of AI scams, titled: "AI Won't Turn Trading Bots into Money Machines."

The advisory warned investors that "fraudsters are exploiting public interest in artificial intelligence (AI) to tout automated trading algorithms, trade signal strategies, and crypto-asset trading schemes that promise unreasonably high or guaranteed returns." However, "AI technology can't predict the future or sudden market changes," the CFTC said.

"Dubious claims have been made about algorithms that automatically place trades, known as 'bots,' and algorithms that provide buy and sell signals to subscribers, among others," the Commission said. It cited the case of Mirror Trading International (MTI) as an example. MTI was found liable for fraud in September 2023 in connection with retail foreign currency transactions, fraud by a commodity pool operator, registration violations and failure to comply with commodity pool operator regulations.

Through MTI, Cornelius Johannes Steynberg, a citizen of the Republic of South Africa, stole more than $1.7 billion in bitcoin from at least 23,000 people in a Ponzi scheme that used websites, Facebook, Instagram and YouTube accounts. Steynberg told customers that for as little as $100 in bitcoin, they could buy into a commodity pool that he falsely claimed used a proprietary "bot" trading program that guaranteed at least a 10 percent monthly return by trading foreign currencies.

Before trusting trading platforms that claim AI-created algorithms can generate huge returns, the CFTC said, investors should research the background of the company or trade, research the history of the trading website by checking the age of the domain registration, get a second opinion, and know the risks and fees associated with the underlying assets.

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