# Arnold&Porter

Innovative. Integrated. Industry-Focused.

# US Regulation of AI in Financial Services

**Peter J. Schildkraut**
Co-Leader, TMT Industry Group
Arnold & Porter Kaye Scholer LLP

*City & Financial Global's Regulation and Risk Management of Artificial Intelligence in Financial Services Summit*
9 November 2021

# Peter J. Schildkraut

**Partner | Washington, DC | peter.schildkraut@arnoldporter.com**

Peter Schildkraut is a co-leader of Arnold & Porter's Technology, Media & Telecommunications industry team and provides strategic counsel on spectrum use, broadband, and other TMT regulatory matters.

He is the author of "AI Regulation: What You Need To Know To Stay Ahead of the Curve," among other writings on the regulation of artificial intelligence.

Mr. Schildkraut helps clients navigate the ever-changing opportunities and challenges of technology, policy, and law to achieve their business objectives at regulatory agencies, including the US Federal Communications Commission (FCC).

He represents clients in rulemakings and administrative litigation and advises them on regulatory compliance. He also assists them in all stages of transactions, large and small, including every major US communications transaction of AT&T Inc. (formerly SBC) since 1998.

Arnold & Porter

# Arnold & Porter Overview

## Who We Are

**100** Years of business acumen with a practical, forward-looking, and results-driven approach

**13** Offices in the Europe, US, and Asia

**123** Attorneys ranked in *Chambers Global, UK, Europe, USA*, *Latin America*, and *Asia-Pacific*

**94** Attorneys have held senior positions in European and US governments and international organizations

**133** Fortune 250 companies have chosen Arnold & Porter as outside counsel

## What We Offer

✓ Nearly 1,000 lawyers with an unyielding commitment to excellence and professionalism

✓ Exceptional depth of talent across the litigation, regulatory, and transactional spectrum

✓ Leading multidisciplinary practices in the financial services and life sciences industries

✓ Our London office has a well-established record for handling groundbreaking cases since opening in 1997

✓ Broad reach across geographic, cultural, commercial, and ideological borders

✓ One of the world's leading pro bono programs, with our attorneys performing more than 121,000 hours of pro bono work in 2020

## Our Services

- Antitrust & Competition
- Appellate & Supreme Court
- Bankruptcy & Restructuring
- Complex Litigation
- Corporate & Finance
- Environmental
- Financial Services Regulatory

- Government Contracts
- Intellectual Property
- International Arbitration
- International Trade
- Labor & Employment
- Legislative
- Life Sciences & Healthcare Regulatory

- Product Liability & Mass Tort
- Real Estate
- Securities Enforcement & Litigation
- Tax
- Telecommunications
- White Collar Defense

# Outline of Presentation

- US Financial Services Regulators and Laws Governing Use of AI
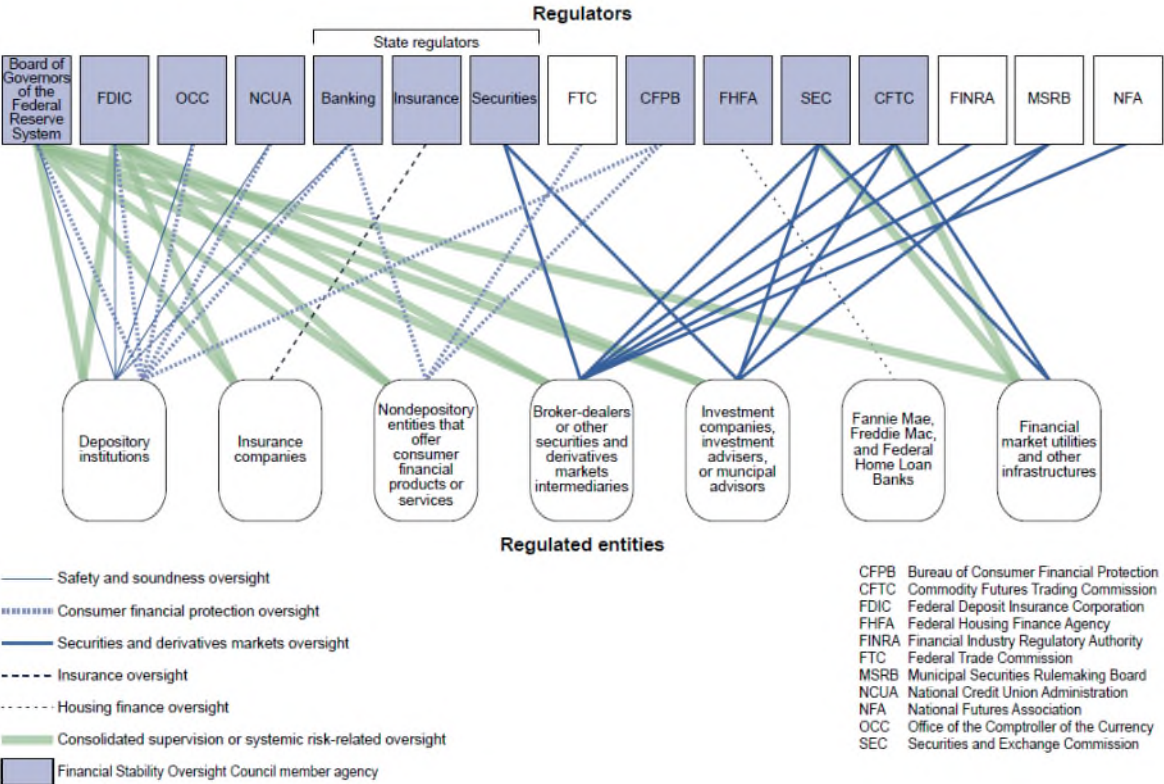- Key Principles and Compliance Considerations
- Questions

# Arnold & Porter

Innovative. Integrated. Industry-Focused.

# US Financial Services Regulators and Laws Governing Use of AI

# *Dramatis Personae*: US Financial Regulators and Their Jurisdictions



Figure 2: U.S. Financial Regulatory Structure, 2016

**Interactive instructions:** Hover over regulators, entities, or legend items for an isolated view.

Regulators: Board of Governors of the Federal Reserve System, FDIC, OCC, NCUA, Banking, Insurance, Securities (State regulators), FTC, CFPB, FHFA, SEC, CFTC, FINRA, MSRB, NFA

Regulated entities: Depository institutions; Insurance companies; Nondepository entities that offer consumer financial products or services; Broker-dealers or other securities and derivatives markets intermediaries; Investment companies, investment advisers, or municipal advisors; Fannie Mae, Freddie Mac, and Federal Home Loan Banks; Financial market utilities and other infrastructures

Legend:
- Safety and soundness oversight
- Consumer financial protection oversight
- Securities and derivatives markets oversight
- Insurance oversight
- Housing finance oversight
- Consolidated supervision or systemic risk-related oversight
- Financial Stability Oversight Council member agency

CFPB  Bureau of Consumer Financial Protection
CFTC  Commodity Futures Trading Commission
FDIC  Federal Deposit Insurance Corporation
FHFA  Federal Housing Finance Agency
FINRA  Financial Industry Regulatory Authority
FTC  Federal Trade Commission
MSRB  Municipal Securities Rulemaking Board
NCUA  National Credit Union Administration
NFA  National Futures Association
OCC  Office of the Comptroller of the Currency
SEC  Securities and Exchange Commission

Source: GAO. | GAO-16-175

Note: This figure depicts the primary regulators in the U.S. financial regulatory structure, as well as their primary oversight responsibilities. "Regulators" generally refers to entities that have rulemaking, supervisory, and enforcement authorities over financial institutions or entities. There are additional agencies involved in regulating the financial markets, and there may be other possible regulatory connections than those depicted in this figure.

Arnold & Porter

# Federal AI Regulation Statute

- There isn't a US federal AI regulation statute.

- Proposed legislation:
    - The Algorithmic Accountability Act (last Congress) and similar bills would require companies to:
        - Assess impact of certain automated decision systems on accuracy, fairness, bias, discrimination, privacy, and security
        - Correct problems discovered through impact assessments
    - The Algorithmic Justice and Online Platform Transparency Act would:
        - Prohibit algorithms that discriminate based on protected characteristics or otherwise harm users
        - Require online platforms to take reasonable steps to ensure algorithms achieve their intended purposes
        - Mandate disclosures to users, recordkeeping, and reporting

- AI Bill of Rights?

**Arnold & Porter**

# Please Don't Draw the Wrong Conclusion

- The absence of a federal statute doesn't mean this is the Wild West where anything goes.

Arnold & Porter

# Express Regulation of AI by the States

- California, Colorado, and Virginia privacy statutes restrict the development and use of AI in connection with individuals and their personal data—like the GDPR:
  - Right to explanation of the significance and anticipated consequences of the AI output for individual
  - Right not to be subject to fully automated decisions with significant effects on individual
  - Right of rectification
  - Right to be forgotten
  - Right to explanation of use of personal data in "profiling" or other automated decision-making (California only)

- Another California law targets intentionally deceitful use of chatbots masquerading as real people to incentivize a purchase or sale of goods or services.

- Illinois regulates private-sector use of certain facial-recognition and other biometric-identification technologies.

- Illinois also regulates use of AI to vet video interviews with job applicants.

# Generally Applicable Laws

- Federal Equal Credit Opportunity Act ("ECOA") prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, age, or because the applicant receives public assistance.

- State antidiscrimination laws (e.g., NY) contain similar provisions.

- Federal Fair Credit Reporting Act ("FCRA") requires:
  - Disclosures to potential employees, tenants, borrowers, and others regarding credit or background checks
  - Further disclosures if the report will lead to an adverse action

- SEC has found "robo-advisers" made false statements about investment products and published misleading ads, violating federal Investment Advisers Act of 1940.

- FTC Act proscribes unfair methods of competition and unfair or deceptive commercial practices.

- The Dodd-Frank Act prohibits unfair, deceptive, or abusive acts and practices by providers of consumer financial products or services and by those providing material services to them.

**Arnold & Porter**

# Filling the Federal Regulatory Vacuum

- OCC, Fed, FDIC, CFPB, and NCUA joint RFI on financial institutions' use of AI/ML included questions about:
    - Explainability
    - Risks from broader or more-intensive data processing and usage
    - Overfitting to training data
    - Cybersecurity risk
    - Dynamic updating
    - AI use by community institutions (problems of lack of scale)
    - Oversight of third-party developers/providers
    - Fair lending

- OCC, Fed, and FDIC guidance for community banking organizations on due diligence for relationships with fintech companies

**Arnold&Porter**

# Filling the Federal Regulatory Vacuum Continued

- CFPB Director Rohit Chopra has emphasized disparate-impact analysis "to root . . . out" hidden discrimination under ECOA.

- FTC focus on algorithmic bias, especially in credit

> *"As an enforcer, I will see self-testing [for unlawful credit discrimination] as a strong sign of good-faith efforts at legal compliance, and I will see a lack of self-testing as indifference to alarming credit disparities."*
> *— FTC Comm'r Rebecca Kelly Slaughter*

- Equal Employment Opportunity Commission emphasis on AI use in employment decisions

Arnold & Porter

# Key Principles and Compliance Considerations

# Key Principles

- Be careful not to make misleading statements

- Avoid disparate impacts on protected classes

- "AI did it" is, by and large, not an affirmative defense.

- Probability is not certainty: Properly designed, trained, and functioning AI systems will make mistakes.
  - *Res ipsa loquitur* and other inferences of liability
  - Defense is demonstrating proper design, training, and functioning (through testing)

**Arnold & Porter**

# Compliance Considerations

- Audit AI projects for compliance with applicable privacy laws

- Assess the risks posed by each AI system developed, procured, or deployed
  - Use a checklist
  - Extent of assessment should be proportionate to the potential degree of harm

- Mitigate risks through explanation
  - Enables appeal or acceptance
  - Required for adverse actions under FCRA
  - Explaining black-box AI predictions

- Mitigate bias
  - Diversity as an issue-spotting aid
  - Consider bias impact statements
  - If you notice *prima facie* disparities, rectify them or identify a lawful basis for them.
  - Monitor for "model drift" and retrain on fresh data when necessary

Arnold & Porter

# Compliance Considerations Continued

- Third-party developers and vendors
    - Procurement contracts should address access to information about system design, operation, and results by client and its customers.
    - Clients should ensure vendors' risk assessment and mitigation processes are as rigorous as their own.

- Revisit existing compliance structures; are they well-suited to oversee the development, procurement, and use of AI?

- Corporate boards
    - Does the board have a duty to monitor AI regulatory compliance?
    - If so, does it have the expertise?

- Explainability facilitates oversight, but inquire into the bases for explanations.

- Reevaluate document-retention policies for AI

Arnold & Porter

**Arnold & Porter**
Innovative. Integrated. Industry-Focused.

# Questions?

# Thank You!