AI Financial Risk, Rules

Cite
S. 3554, the Financial Artificial Intelligence Risk Reduction Act (FAIRR Act)

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Impact Assessment

- FSOC would be forced to reckon with AI's potential financial risk, accelerating activity-and-practice standards federal regulators could then quickly implement if they chose to do so.
- Publicly-traded entities using AI would need to ensure AI-model validity or create new risk-management protocols to mitigate this risk.
- Mandatory AI scenario analyses would be likely for all federally-regulated financial institutions.

Overview

Bipartisan Senate legislation has been introduced to press FSOC to do more than highlight artificial intelligence (AI) as a potential threat to financial stability. The measure instead requires the Council to undertake a rapid study of AI's financial stability risk and report to Congress on conclusions that must then be advanced through FSOC designation and federal-agency action. The bill also gives the SEC more authority to address at least some of the risks its chairman has identified that may be posed by predictive analytics, including AI. New AI-related stress testing would also be likely.

Impact

Financial regulators have been talking about AI since the banking agencies proposed initial steps to address its risks in 2021,[1] but little has been done beyond that despite the fears most recently expressed at the end-2023 FSOC meeting and in its

[1] See **AI**, *Financial Services Management*, April 5, 2021.

annual report.[2] This legislation would force FSOC to take a firmer, quicker stand on AI risks and what needs to be done about them, echoing President Biden's order to FSOC in his AI executive order.[3]

However, FSOC does not have direct authority to set AI-related standards. Instead, it has the power – recently clarified and updated – to designate nonbank SIFIs[4] or identify systemic or economic-justice risks that warrant action via the Council's activity-and-practice authority that puts federal agencies on notice to take action if they concur with the Council.[5]

The Senate legislation focuses on this activity-and-practice authority, pressing FSOC to use it quickly following the identification of AI risks and regulatory gaps. What comes of this will then depend on what member federal agencies do, but several have made it clear that they fear AI's implications and may well speed up action they can also take without FSOC request under their own authority to do so. The bill is also focused on AI's ability to create false representations of voice or other media, an issue Senate Banking Chairman Brown (D-OH) and committee Democrats have pressed CFPB Director to address.

The resilience concerns expressed by federal regulators and the Biden order are also and more directly addressed in a directive to the President's Working Group on Financial Markets (PWG) to look at AI's implications for financial-system resilience evidenced by mandatory scenario analyses. Internal-control improvements are also likely to be sparked by the bill's revision to securities law increasing liability for AI-related model risk in the absence of policies and procedures to mitigate it. These would presumably involve both table-top exercises and requirements of regulated entities akin to the climate-risk scenarios required in recent inter-agency climate-risk principles.[6] Regulated entities would thus need to ramp up their own risk-management protocols with it comes to AI not only to ensure they are resilient, but also ready to comply with scenario-analysis mandates.

As noted, the bill also addresses SEC Chair Gensler's frequently-expressed view that AI threatens securities-market integrity, investor protection, and financial stability. The Commission is likely to make rapid use of this power if granted not only to promulgate rules beyond those already under consideration, but also to reach media, tech-platform, cloud-service, generative-AI, or other entities not expressly within its current enforcement authority.

What's Next

S. 3554 was introduced on December 18 by Sens. Warner (D-VA) and Kennedy (R-LA). Senate Banking Chairman Brown included AI in his 2024 committee agenda,

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2 See *Client Report* **FSOC29**, December 18, 2023.

3 See *Client Report* **AI3**, October 31, 2023.

4 See **SIFI37**, *Financial Services Management*, November 13, 2023.

5 See **SYSTEMIC98**, *Financial Services Management,* November 9, 2023.

6 See **CLIMATE17**, *Financial Services Management*, November 1, 2023.

but whether he plans to do more than review it through hearings remains to be seen. There is no companion legislation in the House.

However, there is also bipartisan agreement that AI requires a new regulatory framework. Even if measures such as this specific to finance do not advance on their own, they are likely to be incorporated into omnibus AI legislation if this advances in 2024.

Analysis

A. Definitions FSOC Deliberations and Actions

As noted, the bill requires the Council to go beyond its recent report to actively coordinate with member agencies, specifying that it should (but apparently need not) also order an OFR report on AI risks related to financial institutions and their third-party providers looking at risks posed by false representations of events or persons and any other acts or practices that threaten financial stability.

In addition, FSOC would need within 180 days of enactment to complete a consultation and report back to Congress on AI threats and identify specific regulatory and supervisory gaps that adversely affect each Council member agency's ability to address these risks. FSOC is also directed to make "specific recommendations" about how best to address these risks with particular attention to cyber-security.

FSOC is also to identify opportunities for using AI in financial regulation and supervision, here mandating that AI use by the agencies be transparent and disclosed to those each agency using AI governs.

The bill also seeks to force Congress' hand by requiring Senate Banking and HFSC within thirty days to give FSOC their comments and recommendations. With Congress' feedback in hand, FSOC would need to make the activity-and-practice recommendations to member agencies described above, with the Congressional Review Act applying to any rules the agencies then implement.

B. Scenario-Based Exercises

The President's Working Group on Financial Markets is directed to work with the industry and other governmental agencies to begin AI-related scenario analyses testing financial-market resilience to AI-related challenges. The PWG is also to make recommendations based on the results of these scenario analyses, with no deadline set either for the analyses or this report.

C. Third-Party Service Providers

Transmission The bill also gives the NCUA and FHFA authority over providers of AI and other services akin to that of the banking agencies.[7]

D. Securities Law

These are amended to clarify provider/user liability for AI-model use to make liability parallel to that a person would have for acts or practices and/or model failures that

7 See **VENDOR10**, *Financial Services Management*, June 9, 2023.

do not rely on AI. Liability could be reduced or eliminated if the person established policies or procedures for AI use and took steps to design prudent AI applications. AI-provider warranties related to model failure could not be waived for purposes of securities-law violation.

The bill also gives the SEC authority to impose treble penalties for securities-law violations related to "machine-manipulated media" – i.e., AI- or other machine-generated or manipulated video, audio, or other images or representations.

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