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Commentary

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# CFTC Issues Staff Advisory on the Use of Artificial Intelligence in CFTC-Regulated Markets

***As AI use proliferates, the advisory reminds CFTC-regulated entities of their existing obligations and the CFTC's intention to monitor for ongoing risks.***

On December 5, 2024, the staff of the Commodity Futures Trading Commission's (CFTC) Divisions of Clearing and Risk, Data, Market Oversight, and Market Participants published an advisory on the use of artificial intelligence (AI) in CFTC-regulated derivatives markets (the Advisory).[1] As the development and adoption of AI products, services, and systems continue to accelerate, the Advisory reminds market participants of their existing obligations — which the Staff describes as "technology-neutral" — under the Commodity Exchange Act (CEA) and the CFTC Rules thereunder. As an advisory, the Staff's pronouncement does not create any new rules or obligations but sheds light on the Staff's expectations for the agency's regulated entities.

The Advisory relied in part on comments received in response to the CFTC's January 25, 2024, Request for Comment (RFC) on the current and potential uses and risks of AI. The RFC was itself driven by President Biden's October 30, 2023, Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence (for more information, see this Latham Client Alert).

The CFTC's new Advisory does not purport to address exhaustively all statutory and regulatory requirements under the CEA and CFTC Rules that may be implicated by AI. Nonetheless, the Advisory underscores that CFTC-regulated market participants are expected to "assess the risks of using AI and update policies, procedures, controls, and systems" in light of all existing applicable obligations and give due consideration to the unique risks in using AI in the derivatives markets.

This Alert provides a roadmap of the Advisory and places it in the broader context of evolving regulatory expectations for use of AI in financial markets.

## Key Takeaways From the CFTC Advisory

The Staff's guidance highlights the following observations and developments:

- The Staff is closely tracking the development and implementation of rapidly-evolving AI technology, and monitoring AI's potential benefits and risks.

- The Staff expects CFTC-regulated market participants to assess AI risks and update policies, procedures, controls, and systems, as appropriate, under existing laws and regulations.

- The Staff expects CFTC-regulated market participants to adhere to all applicable laws and regulations whether the AI products, services, and solutions in question are developed internally or procured from a third party.

- While the Advisory does not introduce any new obligations, the Staff noted that it may "incorporate AI as a topic of discussion in its routine oversight activities such as examinations."

- The Staff also noted that it may develop future guidance or recommend that the CFTC propose new regulations in response to new developments in technology or risks.

## AI Under the CEA and CFTC Rules

By its own terms, the Advisory provides a non-exhaustive list of existing requirements under the CEA and CFTC Rules that may potentially be implicated by the use of AI. The Advisory addresses two broad categories of participants in CFTC-regulated markets:

- Registered entities:[2] trading organizations like designated contract markets (DCMs) and swap execution facilities (SEFs), derivatives clearing organizations (DCOs), and swap data repositories (SDRs)

- Registrants:[3] market intermediaries like futures commission merchants (FCMs), introducing brokers (IBs), swap dealers (SDs), commodity pool operators (CPOs), and commodity trading advisors (CTAs)

With respect to each of these categories, the Advisory identifies examples of potential AI use cases and their implications for existing requirements under the CEA and CFTC Rules.

### Registered Entities: DCMs, SEFs, and SDRs

- **Order Processing and Trade Matching.** The Staff notes that such entities may leverage AI in the order processing and trade matching function, such as by using the analytic and predictive capabilities of AI to anticipate trades, optimize allocation of system resources, and reduce post-trade message latencies. The Advisory cautions that when employing AI for these purposes, entities remain subject to existing requirements, such as the DCM core principle to provide a competitive, open, and efficient market and mechanism for executing transactions that protect the price discovery process of trading.

- **Market Surveillance.** The Staff expects that such entities may also leverage AI's analytic capabilities to monitor, detect, and flag certain trade execution patterns, trade anomalies, or instances of potential abusive trading practices (e.g., front-running or wash trading). When employing AI for these purposes, entities remain subject to the requirements of the DCM and SEF core principles, including to maintain compliance staff and resources sufficient to conduct effective audit trail reviews, trade practice surveillance, market surveillance, and real-time market monitoring.

- **System Safeguards.** The Staff also recognizes that such entities may leverage both internal and third-party AI solutions. In either case, the Advisory cautions that registered entities must maintain the required risk analysis and oversight with respect to their operations and automated systems, and follow generally accepted standards and best practices in the development, operation, reliability, security, and capacity of the AI system. This includes notifying Staff of material planned changes to automated systems that may impact the reliability, security, or adequate scalable capacity of such systems.

### Registered Entities: DCOs

- **System Safeguards.** The Staff expects that DCOs may leverage AI to identify cybersecurity vulnerabilities, detect and respond to cyber intrusions, or evaluate and update legacy and new computer code. In doing so, DCOs should consider how AI impacts the functionality, reliability, and resilience of their computer systems. The Advisory also cautions that DCOs must continue to meet the requirements of the DCO core principles regarding collateral and financial resource requirements, risk management activities, and system safeguards and operational risk. Finally, the Advisory reminds DCOs of the requirement to notify the Staff of material planned changes to automated systems that may impact the reliability, security, or adequate scalable capacity of such systems and material changes to the entity's risk analysis and oversight program.

- **Member Assessment and Interaction.** The Staff notes that DCOs may seek to use AI to communicate and interact with clearing members (e.g., through AI chatbots) or to assess clearing members' compliance with DCO rules. The Advisory cautions that, in doing so, DCOs should continue to maintain compliance with the DCO core principles regarding participant admission and continuing eligibility and monitoring credit exposure from the perspective of the DCO to its members.

- **Settlement.** The Advisory identifies that DCOs may leverage AI to support settlement by validating data, facilitating netting or offset of positions, identifying data anomalies, or detecting failed trades. When employing AI for these purposes, DCOs must maintain compliance with the DCO core principles regarding timely completion of settlement, the limitation on exposure of the DCO to settlement bank risks, and the ability to permit netting or offset arrangements.

### Registrants: FCMs, SDs, CPOs, CTAs, IBs, RFEDs, and Associated Persons

- **Risk Assessment and Risk Management.** The Staff identified that registrants may leverage AI to calculate and collect initial and variation margin for uncleared swaps. The Advisory cautions that if an SD is employing AI for purposes of regulatory margin requirements, SDs must still ensure adequate risk management consistent with requirements under the CEA and CFTC Rules.

- **Compliance and Recordkeeping.** The Staff recognized that registrants may seek to leverage AI to support the creation and preparation of financial information and risk disclosures provided to the CFTC, NFA, or the registrants' customers. For example, a CPO might seek to use generative AI in preparing its disclosure documents. The Advisory cautions that when employing AI for these purposes, entities must ensure that such information and disclosures are compliant with the applicable requirements of the CEA and CFTC Rules.

- **Customer Protection.** Many of the requirements of the CEA and CFTC Rules applicable to registrants focus on customer protection, such as requirements relating to proper segregation of customer funds. The Advisory reminds registrants such as FCMs that may be considering the use of AI to account for segregated funds to ensure that they remain compliant with all applicable provisions of the CEA and CFTC Rules pertaining to customer protection.

## Supporting Comments

The Advisory comes in the context of the CFTC's ongoing focus on AI. In a separate public comment, CFTC Chairman Rostin Behnam called the Advisory "a measured first step" that is "emblematic of the CFTC's technology-neutral approach." He noted that the CFTC is undergoing an "internal transformation . . . to build a forward-looking AI culture," including the appointment of a chief artificial intelligence officer to implement an AI and data analytics strategy that enhances the CFTC's ability to monitor risk, ensure compliance, and deter unlawful trading. As AI becomes increasingly integrated into market operations, the CFTC Staff plans to monitor potential AI risks that may require regulatory attention and encourages ongoing dialogue with stakeholders about AI's risks and benefits.

Commissioner Kristin N. Johnson strongly supported the Advisory and the CFTC's efforts to explore guardrails around AI risks. She said that it "is an important step in developing a pathway for the Commission and our markets to consider emerging risks associated with generative AI and other innovative approaches that must be effectively stress tested to ensure global market integrity, market stability, and the Commission's efforts to carry out its statutory mandate." Like Chairman Behnam, Commissioner Johnson described the Advisory as a reminder of the "technology neutral" nature of existing obligations under the CEA and CFTC Rules. She also observed that such obligations apply broadly, regardless of the sophistication of novel technologies.

Notably, Commissioner Johnson also advocated that the CFTC take additional steps to balance the opportunities and risks of AI, including:

- increasing resources dedicated to enabling several CFTC divisions to address innovative trading, clearing, and settlement technologies;
- creating an AI Fraud Task Force within the Division of Enforcement;
- gathering information from market participants about their use of AI technologies, as well as engaging in an "open dialogue" on the implications of integrating AI in global derivatives markets;
- creating an interagency task force among market and prudential regulators focused on understanding the implications of integrating more complex AI models into regulated markets; and
- adopting enhanced penalties to deter bad actors from intentionally using AI technologies to engage in fraud, market manipulation, or evasion of CFTC regulations.

## Key Takeaways for Registrants and Registered Entities

CFTC-regulated market participants should consider the risks that the adoption of AI introduces to their risk management systems. In light of the existing regulatory obligations of CFTC registrants, such firms should work with counsel to establish robust governance frameworks and develop comprehensive policies and procedures to ensure responsible implementation. In evaluating or implementing governance structures, firms may wish to consider accountability for AI oversight along with relevant ethical considerations, risk management, and compliance with regulatory obligations.

Policies should address AI-specific risks, such as data privacy, model transparency, and bias mitigation, while ensuring alignment with existing internal controls. Procedures for regular testing, monitoring, and validation of AI systems may be essential as well to maintain accuracy and reliability over time. Additionally, firms should consider targeted training for staff to enhance understanding of AI technologies and their implications, fostering a culture of responsible innovation. Regular audits and updates to frameworks and policies help firms adapt to evolving regulatory expectations and technological advancements.

## Areas to Watch as a New Administration Charts Its Course on AI Policy

### Unaddressed Recommendations From the May 2024 Report

The Advisory builds on prior attention to the potential uses of AI in CFTC-regulated derivatives markets. In May 2024, the CFTC Subcommittee on Emerging and Evolving Technologies released a Report on Responsible AI in Financial Markets outlining five key recommendations to ensure the responsible use of AI in these markets. The recommendations aimed to enhance understanding, establish governance frameworks, and ensure alignment with broader regulatory efforts. They included (i) hosting public roundtables to gather insights on AI technologies and their applications; (ii) adopting a risk management framework aligned with the National Institute of Standards and Technology's guidelines to assess AI model efficiency and potential harms; (iii) creating an inventory of existing AI-related regulations to conduct a gap analysis for compliance needs; (iv) aligning CFTC AI policies with other federal agencies for consistency and cooperation; and (v) building internal technical expertise by engaging staff in domestic and international AI dialogues.

The new Advisory, as well as the CFTC's appointment of a Chief AI Officer earlier this year, underscore the agency's ongoing focus on AI and its commitment to developing internal technical expertise, as outlined in the May 2024 Report. But the CFTC has not yet taken specific actions to implement several of its recommendations. In 2025, the unaddressed recommendations may present opportunities for the CFTC to enhance its oversight and guidance on AI in financial markets.

### Open Questions for AI Enforcement

As the CFTC continues to navigate the integration of AI into market operations, questions remain about how its enforcement rules will adapt to AI-driven trading decisions. The current framework, as outlined in the Advisory, emphasizes technology-neutral obligations under the CEA and CFTC Rules. But the existing enforcement paradigm may be a poor fit for the unique attributes of AI, such as its potential for autonomous decision-making and the opacity of AI systems.

Latham's 2023 article highlighted these potential gaps, noting that traditional enforcement mechanisms may not be well-suited to issues like embedded bias in AI and AI-driven trading that resembles market manipulation. As a new administration takes over, it will be crucial to monitor how the CFTC addresses these challenges, and whether it follows a more prescriptive or principles-based approach in AI-related enforcement.

## AI in Global Financial Markets: A Focus of Lawmakers and Regulators

Beyond the CFTC, lawmakers and regulators across the US, the EU, and the UK are increasingly focused on the benefits and risks of AI in financial markets.

### SEC Developments

The Securities and Exchange Commission's (SEC) Enforcement Division has continued its emphasis on "AI washing," or making false or misleading statements about the use of AI,[4] while the SEC's Division of Examinations has announced that AI will be an examination priority in 2025.

In March 2024, the SEC announced that it settled two first-of-their kind enforcement actions with investment advisers for AI washing. The enforcement actions followed reports that the SEC had initiated an AI "sweep" targeting investment advisers and arrived amid a flurry of statements from US regulators cautioning businesses about how they characterize their use of AI and signaling increased scrutiny on public statements related to AI. The SEC has since charged more investment advisers with AI washing.

In October 2024, the SEC Division of Examinations published its exam priorities for the 2025 fiscal year, which include a focus on compliance policies and procedures, as well as investor disclosures for investment advisers that integrate AI into advisory operations. How the SEC will approach these issues in the new administration remains to be seen. However, given the ever-expanding use of AI across industries and sectors, companies are reviewing their communications with investors, customers, and the public regarding their use of AI, and should consider the extent to which their compliance policies and procedures sufficiently address AI risks. (For more information, see this Latham Client Alert.)

## DOJ Developments

The Department of Justice (DOJ) continues its emphasis on AI enforcement and has updated its corporate compliance evaluation guidelines to include an evaluation of a company's use of AI. Federal prosecutors have charged at least two cases involving the use of AI to commit fraud (see here and here).

Federal prosecutors have also charged the founders of multiple artificial intelligence companies with fraud, although the charges have generally focused on financial misrepresentations rather than AI washing (see here, here, here, and here).

In February 2024, the DOJ announced that it would seek harsher penalties for individuals who use AI to commit crimes. And in September 2024, the DOJ updated its compliance guidance, the Evaluation of Corporate Compliance Programs (ECCP), to highlight that when prosecutors assess the effectiveness of a company's compliance program as part of a corporate investigation, they will include an assessment of the company's use of AI and data analytics.

## Potential Legislation

Even more recently, on November 27, 2024, Ranking Member Maxine Waters of the House Financial Services Committee introduced a bill for a Responsible AI Disclosure Act. If enacted, the bill would require various US financial regulators (including the Federal Reserve, the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the National Credit Union Administration, and the SEC) to:

- conduct a study and issue a report to Congress on how the companies they oversee categorize AI data and train AI models, along with recommendations on whether existing federal statutes and regulations should be revised with regard to disclosures and standardized descriptions of AI systems; and
- if a covered agency determines it appropriate and within the agency's existing authority, require entities regulated by the relevant agency to report to the agency and disclose to the public how the entity uses and trains AI models.

## Global Developments

In parallel with these US initiatives, EU and UK regulators are also actively addressing the implications of AI in financial markets. The EU AI Act, the world's first comprehensive AI law, establishes a regulatory framework that classifies AI systems based on risk levels, imposing stringent regulations on high-risk systems, such as those aiding in legal interpretation or application of the law, while banning those deemed to pose unacceptable risks, such as manipulative AI and social scoring systems. Adopted by the European Parliament in March 2024 and approved by the Council in May 2024, the EU AI Act will be fully applicable 24 months after its entry into force, with some provisions, like the ban on unacceptable risk AI systems, taking effect sooner.

Coinciding with the Council's approval of the EU AI Act in May 2024, the European Securities and Markets Authority (ESMA) also issued formal guidance on the use of AI in retail financial services, emphasizing the importance of transparency, accountability, and compliance with existing regulations, in this case MiFID II. Like the CFTC's "technology-neutral" approach, ESMA's guidance underscores the need for firms to integrate AI responsibly while maintaining effective governance structures and risk management practices. Both regulators highlight the potential benefits of AI, such as enhanced operational efficiency, while cautioning against its potential risks, such as overreliance and data privacy concerns.

Building on these efforts, the UK Financial Conduct Authority (FCA) launched a series of collaborative projects in October 2024 to explore the integration of AI technologies within the financial sector. In doing so, the FCA emphasized the need to deepen understanding of the risks and opportunities that AI brings to the market to inform the development of a robust and practical regulatory framework. These global developments reflect a broader international effort to ensure rapidly developing AI technologies are harnessed effectively within the financial sector, safeguarding market integrity and investor protection.

## Conclusion

The financial services industry has been at the forefront of adopting AI, leveraging its capabilities for algorithmic trading, fraud detection and prevention, customer relationship management, predictive analytics, and credit risk management. This rapid technological advancement has outpaced regulatory frameworks, leading to a pressing need for fresh guidance and potential regulatory updates. Although various existing aspects of the CEA and CFTC Rules may already extend to AI activities or particular applications or uses of AI, additional CFTC rulemaking or Staff guidance may ultimately be needed to target AI-specific risks. That said, the Advisory makes clear that the CFTC has been tracking the development of AI technology and AI's potential benefits and risks, as well as regulated entities' and registrants' ongoing compliance with current CFTC Rules and regulations.

While cognizant of the risks, the CFTC and Staff appear enthusiastic about the prospects of AI in financial markets. The agency's latest Advisory hopefully signals that it will pursue a balanced and informed approach to regulation and oversight of this transformational technology. Welcoming new technology, while implementing heightened vigilance where appropriate, can ensure that AI innovation in CFTC-regulated markets has both the space and guardrails to flourish.

Latham & Watkins will continue to monitor developments in this area.

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**Endnotes**

[1] The Advisory addresses "artificial intelligence" within the meaning set forth in the Biden Executive Order and as defined in 15 U.S.C. § 9401(3): "a machine-based system that can, for a given set of human-defined objectives, make predictions, recommendations, or decisions influencing real or virtual environments. Artificial intelligence systems use machine- and human-based inputs to perceive real and virtual environments; abstract such perceptions into models through analysis in an automated manner; and use model inference to formulate options for information or action."

[2] The term "registered entity" is used in the Advisory as defined in 7 U.S.C. § 1a(40), which references designated contract markets (DCMs), derivatives clearing organizations (DCOs), swap execution facilities (SEFs), and swap data repositories (SDRs).

[3] The term "registrant" is used in the Advisory as defined in 17 C.F.R. § 1.3 to include commodity pool operators (CPOs); commodity trading advisors (CTAs); futures commission merchants (FCMs); introducing brokers (IBs); leverage transaction merchants; floor brokers; floor traders; major swap participants (MSPs); retail foreign exchange dealers (RFEDs); or swap dealers (SDs), or an associated person of any of the foregoing other than an associated person of an SD or MSP.

[4] The FTC is also focused on AI washing. In September 2024, it announced five enforcement actions against companies for AI washing, in a sweep that it called "Operation AI Comply."