REPORT

The Journal on the Law of Investment & Risk Management Products

Futures & Derivatives Law

February 2025 ▪ Volume 45 ▪ Issue 2

THE CFTC HITS PAUSE ON ARTIFICIAL INTELLIGENCE REGULATION

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On December 5, 2024, the U.S. Commodity Futures Trading Commission ("CFTC" or "Commission") issued a staff advisory on the use of artificial intelligence ("AI") in CFTC-regulated markets by registered entities and registrants ("the Advisory").[2] The Advisory sets forth certain requirements under the Commodity Exchange Act ("CEA") and other CFTC regulations that could be implicated by current and potential AI uses and risks, including requirements related to order processing and trade matching, market surveillance, system safeguards, member assessment and interaction, settlement, risk assessment and risk management, compliance and recordkeeping, and customer protection.

Although the CFTC has undertaken a thorough analysis of the risks and impact of AI on financial markets (including whether regulation is warranted), the Advisory does not create any new or amended rules or regulations. Instead, the Advisory "reminds" CFTC-regulated entities of their existing obligations under the CEA and CFTC regulations. The decision to not engage in a rulemaking reflects the CFTC Staff's understanding of the current and potential AI uses in the derivatives markets, informed by, among other things, responses to the Staff's January 25, 2024 request for comment; engagement with market participants and financial regulators; ongoing analysis undertaken by the former CFTC chairman's AI Task Force; and guidance issued by the Biden Administration. CFTC Commissioner Kristin Johnson lauded the CFTC's information-gathering efforts in particular and stated the Advisory is but the "latest step in what I hope will continue to be an ongoing discussion among each of these parties."[3] Of course, in issuing the Advisory, the CFTC may have also signaled its expectations under an anticipated regulatory-lite Trump Administration, which has already revoked the Biden Administration's Executive Order on the Safe, Secure and Trustworthy Development and Use of Artificial Intelligence.[4]

This article sets forth the CFTC's efforts to determine the impact of AI on its regulated markets as well as details of the Advisory and its implications for market participants, particularly as executive and legislative action will continue to shape views on AI regulation among the U.S. financial market regulators.

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I. AI and CFTC-Regulated Markets

AI is impacting the global economy and driving transformation in the financial marketplace. In the CFTC-regulated markets in particular, AI can improve efficiency, enhance performance and create opportunities for cost reduction.[5] For example, companies focused on efficiency and productivity can effectively use AI to streamline processes by automating repetitive tasks, which allows for humans to focus on more complex work. But AI is not new to financial market participants, including derivatives traders.

Use of technology to process data to inform or execute trading strategies, including algorithmic trading, began in the early 1980s. Specifically, algorithmic trading uses algorithms to automate the buying and selling of commodities and derivatives by capitalizing on certain programmable triggers such as contango, weather, supply and demand signals, geopolitical events, and other factors that may have a specific impact on the underlying commodity. When full optimized, these automatic trading systems can process large amounts of data in a matter of milliseconds, offering opportunities for improved market liquidity and more sophisticated trading strategies while humans are still kept "in the loop" to help inform and augment decision-making processes.

And because AI can quickly analyze large amounts of data, it can also recognize trends and patterns that humans may overlook, resulting in the ability to guard against the potential for system failures. Specifically, AI is often used in risk management and mitigation, including in the areas of compliance, surveillance and fraud detection, and back-testing trade strategies (also known as "RegTech"). This is because AI can pick up on certain patterns of anomalies across individuals or groups, including traders, employees or customers, in a way that human analysis may not detect.

These immense benefits are certainly impactful, but so too are the challenges and risks AI can pose if not properly managed, thereby resulting in significant harm to market participants.[6] The CFTC has thus undertaken various studies and analyses on the use of AI in trading applications, noting that the technology can, in worst-case scenarios, contribute to prohibited trading behavior or market disruptions, and that certain AI-based customer interactions may result in biases or deceptive communications.[7] Other AI risks identified by the CFTC include (1) lack of transparency or explainability of AI models' decision-making processes ("black box"); (2) the "poisoning" of real-world data sources encountered by the AI model; (3) mishandling of sensitive data; (4) fairness concerns, including AI system reproducing or compounding biases; (5) concentration risks; and (6) the potential to produce false or invalid outputs because of a reliance on inaccurate data to fill gaps or because of unknown reasons (called "hallucinations").[8]

While these risks seemed to push the CFTC toward the idea of creating a risk management framework, if not outright regulation, it also recognized that existing regulations already require registrants to manage risk generally and that some would even touch on AI-associated risks in particular. This seemingly follows certain blowback received by the CFTC's sister agency, the U.S. Securities and Exchange Commission ("SEC"), in the wake of its own proposed AI rules-namely, that the rule proposal would largely mirror existing SEC regulations, such as Regulation Best Interest.

Accordingly, at least for now, the CFTC has fallen on the side of demurring from regulation and instead has issued its Staff Advisory to remind market participants of their ongoing obligations under relevant rules and regulations. Whether a rulemaking occurs in the future is unclear, especially given the likelihood of the Trump administration reversing Biden-era rules and policy statements with respect to fintech. In the interim, the below synopsis of the CFTC's Staff Advisory should provide clarification on the agency's stance on AI regulation for the immediate future.

II. CFTC Regulations Implicating AI

While the CFTC noted in its Staff Advisory that the below regulations do not comprise an exhaustive list, discussion of such requirements serves as a helpful reminder to CFTC-regulated entities that choose to deploy AI or other technology, either directly or through a third-party service provider. That said, ongoing compliance reviews are recommended to ensure that policies and procedures factor in the evolving technological landscape and how such changes may be impacted by CFTC regulations.

Designated Contract Markets ("DCMs"), Swap Execution Facilities ("SEFs") and Swap Data Repositories ("SDRs")

The Advisory reminds DCMs, SEFs and SDRs of requirements related to:

- Order Processing and Trade Matching—DCMs, SEFs and SDRs may use AI to process orders or match trades, including as AI relates to the preparation of message data at the time of execution (e.g., a DCM may use AI to anticipate trades to allocate system resources and reduce post-trade message latencies). The Advisory specifically notes that DCMs must continue to provide competitive, open and efficient markets and mechanisms for executing transactions that protect the price discovery process of trading in the centralized market of the DCM, irrespective of their use of AI, consistent with DCM Core Principle 9, which governs the execution of transactions.

- Market Surveillance—DCMs, SEFs and SDRs may use AI to detect abusive trading practices, investigate rule violations and monitor markets in real time. The Advisory reminds DCMs and SEFs of their responsibility to maintain compliance staff and resources sufficient to conduct effective audit trail reviews, trade practice surveillance, market surveillance and real-time marketing monitoring consistent with DCM Core Principles 2, 4 and 12 and SEF Core Principles 2, 3 and 4.

- System Safeguards—AI may be developed by some DCMs, SEFs and SDRs internally, while others may procure AI-based products and services from third parties. In either instance, the Advisory reminds DCMs, SEFs and SDRs to follow generally accepted standards and best practices with respect to the development, operation, reliability, security and capacity of the AI system, including maintaining appropriate controls consistent with DCM Core Principle 20, SEF Core Principle 14 and § 49.24 for SDRs.

Derivatives Clearing Organizations ("DCOs")

While DCOs that employ AI must continue to comply with regulatory requirements, the CFTC recognizes that some DCOs may develop their own AI solutions internally while others will procure such products and services from third parties. In both instances, DCOs must follow industry best practices concerning the development, operation and security of those systems using AI. That said, the use of AI may also implicate the following:

- Member Assessment and Interaction—DCOs may use AI in connection with the review of its clearing members' compliance with DCO rules and to support communications with its members. The Advisory notes that AI chatbots may have access to external or internal datasets that may be comprised of member information. The Advisory reminds DCOs that Core Principle C (concerning participant admission and continuing eligibility) and Core Principle D (concerning monitoring credit exposure) continue to apply.

- Settlement—DCOs may use AI for settlement, including to facilitate netting or offset of positions as AI works to validate data, mine data anomalies prior to settlement or identify failed trades. The Advisory reminds DCOs that Core

Principle E (concerning the timely completion of settlement, the limitation of exposure of the DCO to settlement bank risks, and the ability to permit netting or offset arrangements) continues to apply.

- System Safeguards—DCOs may use AI to support the detection of and/or response to cyber intrusions and identification of cyber vulnerabilities and hardening defenses. The Advisory reminds DCOs that Core Principle B (concerning the collateral that will be used to meet the financial resource requirements), Core Principle D (concerning risk management activities) and Core Principle I (concerning system safeguards and operational risk) continue to apply in the event that DCOs use AI. These core principles and their related regulations apply even if a DCO relies on a third-party service provider for the provision of the AI. The CFTC also reminds DCOs of their obligation to provide CFTC Staff with advance notice of all material planned changes to automated systems that could impact the reliability, security or capacity of those automated systems, and all changes to the DCO's program of risk analysis and oversight.

Futures Commission Merchants ("FCMs"), Swap Dealers ("SDs"), Commodity Pool Operators ("CPOs"), Commodity Trading Advisors ("CTAs"), Introducing Brokers ("IBs"), Retail Foreign Exchange Dealers ("RFEDs") and Associated Persons ("APs")

CFTC Staff also identified the following examples of where AI may be used:

- Risk Assessment and Risk Management—CFTC Staff expects FCMs, SDs, CPOs, CTAs, IBs, RFEDs and APs may use AI for the calculation and collection of initial and variation margin for unclear swaps. Even when using AI, these categories of registrants are still required to confirm the adequate performance of their systems to ensure that risk is properly managed consistent with CFTC regulations.

- Compliance and Recordkeeping—CFTC Staff monitors these categories of registrants for compliance with CFTC regulations, including with respect to recordkeeping and disclosure. Accordingly, the Staff recognizes that they may use AI, specifically generative AI, to support the accuracy and timeliness of financial information and risk disclosures provided to the CFTC pursuant to recordkeeping, disclosure and financial reporting obligations. The Advisory reminds these registrants that they remain responsible for ensuring such information and disclosures are compliant with applicable statutory and regulatory requirements.

- Customer Protection—The Advisory notes that a significant number of CFTC regulations are related to consumer protection and will still apply if FCMs use AI, including to account for segregated funds.

III. CFTC AI-Related Initiatives

In understanding that the U.S. financial markets are largely data-driven, the increasing availability and development of technology to address and power the financial services industry necessarily merited an examination of these impacts, particularly as they have become more relevant in CFTC-regulated markets. As stated above, the CFTC has taken several actions aimed at helping the Commission and market participants assess the risks of AI to ensuring its responsible use. The Staff Advisory was certainly not issued in spite of these efforts; rather, perhaps, it serves as somewhat of a placeholder as these endeavors continue to crystallize.

For example, on January 25, 2024, the CFTC issued a request for public comment on the use of AI in CFTC-regulated markets, seeking input on the risks of AI, the definition of AI and the potential applications of AI, including risk management, trading, compliance, recordkeeping, data processing and analytics, customer interactions, and cybersecurity. In her statement published concurrent with the request for comment, Commissioner Johnson lauded the CFTC's steps to engage the public regarding AI integration in CFTC-regulated markets, noting that federal regulators "cannot stand still," as countermeasures may be necessary to address the new challenges AI will create.[9] This is particularly fundamental given that "[a]pplications of AI in financial markets are only increasing."[10]

Additionally, on May 1, 2024, the CFTC announced the designation of Ted Kaouk, Ph.D. as the agency's first chief AI officer. For his part, Kaouk feels rather optimistic about the CFTC's approach to AI and how it can be used to uncover fraud and market abuse. In an August 2024 interview, Kaouk stated that the CFTC wants to "send a strong signal to bad actors that misconduct will be identified and punished," noting that he "personally feel[s] that [the CFTC] can harness that data to develop and deploy sophisticated analytics and AI capabilities."[11]

The following day, the CFTC's Technology Advisory Committee, which was launched in 1999 to explore the intersection of technology, law and policy in CFTC-regulated markets, released its Report on Responsible AI in Financial Markets, with five main recommendations to the CFTC,[12] including, relevant here, a recommendation to evaluate existing regulations related to AI. In parallel, Commissioner Johnson announced the CFTC's agenda for assessing risks associated with the integration of AI in financial markets,[13] which included a "principles-based regulatory framework" that in part focuses on considering existing regulations and whether certain key AI-related risks are addressed by those existing risk-management requirements.

IV. What Lies Ahead

The Advisory comes after many years of focus by the CFTC on the impact of emerging technologies and is the most significant AI-related communication since the January 2024 Request for Comment. In issuing the guidance, the CFTC expects that regulated entities will, at the very least, use the Advisory to assess the risks of using AI and to update policies, procedures, controls and systems according to already applicable CFTC statutory and regulatory requirements. Acting CFTC Chair Caroline Pham will likely continue to adhere to these sentiments, having previously acknowledged "the importance of utilizing existing risk governance frameworks and risk management disciplines to identify, measure, monitor, and control merging risks and new technologies."[14]

That said, given the time and resources spent on examining AI's impact on CFTC-regulated markets, some believe the Advisory lacks impact. This is, perhaps, by design: while it is certain that AI technology will continue to be a priority for the CFTC, how this runs in parallel with the views of the Trump Administration is less clear. Specifically, President Trump not only followed through on the Republican Party's promise to repeal President Biden's 2023 executive order concerning AI risk but also, just 24 hours into his second term, announced the Stargate Initiative, a $500 billion private sector deal to expand AI's footprint. This joint venture of OpenAI, Oracle and SoftBank seeks to build out data centers and the electricity generation needed to power the development of AI, ultimately exhibiting this administration's anticipation of AI expansion. Before taking office, President Trump also announced a first-of-its-kind "White House A.I. & Crypto Czar," which is perhaps a further indication of the Administration's technology-friendly approach.

Additionally, the Trump Administration's stance on regulation will see some sort of recalibration of priorities, where, in the case of the CFTC, we should see a decrease in focus on "technical" violations of law in favor of more "ordinary" enforcement. This ultimately means a complete reversal on "regulation by enforcement"-seen as a hallmark of administrative agencies in the Biden era-which will involve a shift from perceived compliance issues to prosecuting matters involving market-wide concerns like manipulation and fraud.

What is clear, however, is that compliance remains key. Companies using or contemplating the use of AI are advised to establish a concrete framework and plan that allow teams to understand what is permitted and what is not in deploying and using AI. Such policies and procedures should communicate to employees what is required or prohibited under applicable laws, including those promulgated by the CFTC, and should be regularly reviewed and amended as regulations emerge and technology evolves. Even if oversight and regulation become more business-friendly, such shifts will not detract from fundamental obligations under law, including those enumerated in the Staff Advisory.

ENDNOTES:

[2]U.S. Commodity Fut. Trad. Comm'n, Staff Advisory, Letter No. 24-17, *Use of Artificial Intelligence in CFTC-Regulated Markets* (Dec. 5, 2024), *available at* https://www.cftc.gov/csl/24-17/download.

[3]U.S. Commodity Fut. Trad. Comm'n., Public Statements and Remarks, *Statement of Commissioner Kristin N. Johnson on Future-Proofing Financial Markets: Assessing the Integration of Artificial Intelligence in Global Derivatives Markets* (Dec. 5, 2024), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/johnsonstatement120524.

[4]The White House, *Initial Rescissions of Harmful Executive Orders and Actions* (Jan. 20, 2025), *available at* https://www.whitehouse.gov/presidential-actions/2025/01/initial-rescissions-of-harmful-executive-orders-and-actions/.

[5]U.S. Commodity Fut. Trad. Comm'n, *Request for Comment on the Use of Artificial Intelligence in CFTC-Regulated Markets* (Jan. 25, 2024), p. 2, *available at* https://www.cftc.gov/media/10156/AI_RFC_012524/download.

[6]*Id.* at 6.

[7]*Id.*

[8]U.S. Commodity Fut. Trad. Comm'n, *CFTC Technology Advisory Committee Advances Report and Recommendations to the CFTC on Responsible Artificial Intelligence in Financial Markets* (May 2, 2024), *available at* https://www.cftc.gov/PressRoom/PressReleases/8905-24.

[9]U.S. Commodity Fut. Trad. Comm'n, Public Statements & Remarks, *Commissioner Kristin N. Johnson Statement on the CFTC RFC on AI: Building a Regulatory Framework for AI In Financial Markets* (Jan. 25, 2024), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/johnsonstatement012524.

[10]*Id.*

[11]FEDSCOOP, *CFTC wants to transform enforcement work through AI and data 'marathon'* (Aug. 14, 2024), *available at* https://fedscoop.com/cftc-ai-data-ted-kaouk-derivatives-regulator-enforcement/.

[12] U.S. Commodity Fut. Trad. Comm'n, Rel. No. 8905-24, *CFTC Technology Advisory Committee Advances Report and Recommendations to the CFTC on Responsible Artificial Intelligence in Financial Markets* (May 2, 2014), *available at* https://www.cftc.gov/PressRoom/PressReleases/8905-24.

[13]U.S. Commodity Fut. Trad. Comm'n, Public Statements & Remarks, *Statement of Commissioner Kristin N. Johnson: Articulating an Agenda for Regulating AI* (May 2, 2014), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/johnsonstatement050224.

[14]U.S. Commodity Fut. Trad. Comm'n, Public Statements & Remarks, *Opening Statement of Caroline D. Pham before the Technology Advisory Committee* (May 2, 2014), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement050224.