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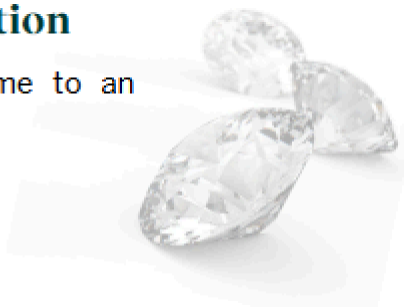
Quarterly Newsletter

Q1 2024 Newsletter

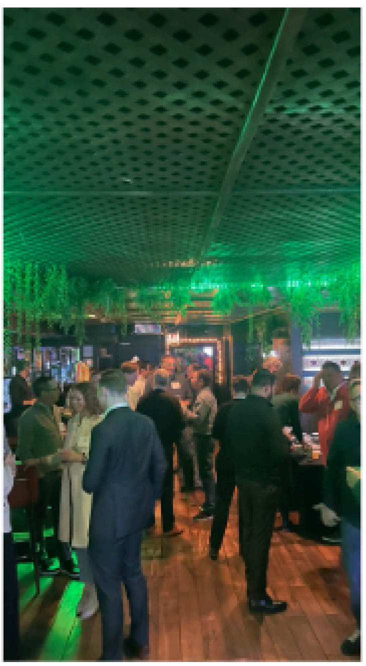
Brain Teaser Question



Which U.S. state is home to an active diamond mine?

Answer at the end!

March Madness



PINE had a fun night in Chicago kicking off March Madness with our amazing partners!

Last quarter, we had the opportunity to connect with colleagues outside the office and celebrate the spirit of competition.

A huge thank you to all of our partners Cohen & Company, Ultimus Fund Solutions, & Faegre Drinker who joined us for the event.

IN THIS ISSUE

I. Navigating the Gray Area: AI and Investment Adviser Compliance in the Absence of Formal Regulation

In March 2024 the SEC settled charges against two investment advisers for making false and misleading statements about their purported use of artificial intelligence (AI).[1] While no formal regulation has come about, or is likely imminent, these charges indicate the SEC is ready to address the risks of AI and its growing presence in the industry. After all, existing provisions of the federal securities laws address potential issues related to fraud, conflicts of interest, disclosures, and policies and procedures that may be relevant to the use of AI by Investment Advisers.

A major question looming over market participants that currently use AI, or plan to use AI, is how to address the risks associated with artificial intelligence and ultimately comply with the current regulatory framework. As Artificial Intelligence can be used in various modalities, creating policies and procedures and monitoring conflicts of interest associated with the broad landscape of AI can be difficult. As a starting point, Investment Advisers can benefit from having an understanding of the modalities of AI in general, the ways in which AI is currently used at their firms, and the intended uses of AI at their firms.

AI is a broad category defined by IBM as “technology that enables computers and machines to simulate human intelligence and problem-solving capabilities”[2] and by Stanford Professor John McCarthy as “the science and engineering of making intelligent machines”.[3] These definitions leave firms with the task of differentiating between services like Grammarly and the use of algorithmic trading in their policies and procedures, disclosures, and overall business. AI is not a one-size-fits-all landscape and should not be treated as such.

Each modality of AI can present unique challenges related to conflicts of interest and investor harm. As a baseline, keeping a record of each AI technology used and the intended purpose(s) can assist compliance teams in monitoring for potential conflicts of interest, providing appropriate disclosures, and maintaining compliance with securities laws. As noted by the SEC, if market participants claim to use AI in investment processes, they need to ensure that the representations they make are not false or misleading and remain vigilant about misstatements that may be material to individuals’ investing decisions.[4]

II. The SEC Expands the Definition of “Dealer” – Referred to as “Practically Limitless” in Scope

On February 6, 2024, the Securities and Exchange Commission expanded its definition of “dealer” under the Securities Exchange Act of 1934 (the Exchange Act) by providing quantitative standards to the phrase “as part of a regular business.” Before the change, the definition excluded a trader who “buys or sells securities…for such person’s own account… but **not** as a part of regular business.”

This expansion codifies quantitative measures which identify activities tied to roles that provide significant liquidity into the markets and are deemed “**part of a regular business**”. At a high level, the new activities brought into scope and likely to trigger registration as a dealer with the SEC are:

- Regularly express trading interest at or near the best available prices for both sides of the market for the same security, in a manner accessible to other market participants; or
- Earning revenue primarily from capturing bid-ask spreads or from incentives provided by trading venues to supply liquidity.

These newly defined standards will capture hedge funds and principal trading firms whose activities, historically, did not count as securities dealers. The expansion of “dealer” stems from the SEC taking note of market participants who provide a great portion of liquidity to government securities markets and equities and operate in a mostly unregulated space. This includes those dealer-like activities done by individuals who would not have triggered registration with the SEC nor FINRA (or other self-regulatory organizations) as a dealer under the old wording of the rule.

Arguably, in light of the Sam Bankman-Fried scheme, the lack of regulatory oversight in the cryptocurrency markets, and emerging fin-tech operations like decentralized finance, this newly adopted definition aims to bring formerly unregulated market participants into the fold. But has the SEC gone too far? This adoption has been met with a lot of criticism. The DeFi Education Fund views the stricter oversight as “misguided” and called the approach “impractical and innovation-stifling.”

SEC Commissioner Mark T. Uyeda, in his published statement, called this a continuation of “the Commission’s war on private funds” and referred to the scope of this definition as “practically limitless.” He stated, “This rulemaking targets proprietary trading funds (PTFs), private funds, and others who make money by buying low and selling high in the Treasury market while creating additional regulatory confusion for other markets, including crypto-asset securities.”

To boot, the rule is fraught with ambiguity as the SEC does not dig into the intricacies of many aspects of these new standards. What does the frequency of expressing trading interest need to be to be considered *regular* business? Although the SEC states that for a market as liquid as U.S. treasuries, “expressing trading interest on both sides of the market for the same security as part of an investment strategy,” even as a one-off, would not rise to the level of *regularity*. This begs the question – when would it? Unfortunately, it seems only enforcement actions will tell.

Further confusion lies in the cryptocurrency world. As one example, the definition of “dealer” in this niche space will need to go so far as to draw “distinctions between software coders, the software itself,” and those operating the software to provide liquidity, according to Goodwin Law’s article on the topic.

Under Chairman Gensler, the SEC has been a rulemaking machine, and perhaps the best outcome we can hope for with this new definition is measurable clarity, if only minute, in the rule of law under the new standards for the dealers operating in traditional market participant roles. This also goes for those in emerging and innovating markets through the new scope of the word “dealer.” Reach out to PINE to see if this will impact you.

III. Excel Power Query for Financial Professionals

Microsoft Excel has been a data analysis tool utilized by financial professionals for decades. The introduction of Power Query within Excel in 2010 has greatly improved the capabilities and efficiencies for users. Power Query is a powerful data transformation tool that empowers professionals to automate file retrieval, as well as clean and process data in a tool that is powerful while also being simple to use.

One key benefit of Power Query is its ability to automate data cleaning and preparation. Conventional Excel formula-based approaches can be time-consuming and error-prone. However, Power Query allows users to create reusable data transformation steps that can be utilized across varying data sets and shared with users that create companywide efficiencies. The time savings and reduction of formula errors ensure consistency and accuracy in data analysis which is invaluable.

Datasets are often updated frequently, and Power Query allows users to automatically refresh queries to ensure the most current information is being utilized. This eliminates the need for manual updates, greatly improving efficiency and human error, and reduces the risk of working with outdated information. Power Query even allows users to combine data from multiple sources and different formats. For example, Power Query provides Excel connection to web-based data, text files, CSV files, and Excel files on a company's SharePoint. The ability for Excel to connect to varying datasets and merge data into a single, unified dataset eliminates the need for manual, time-consuming data manipulation.

Power Query is useful for standardizing data formatting. Financial data is often messy and inconsistent, which can complicate analyses. Power Query provides a wide range of data transformation tools, such as data type conversions and custom formatting that can be used to clean and standardize datasets. Power Query greatly simplifies data transformations, which allows users to perform complex data manipulations with a couple of clicks.

Power Query's user interface ("UI") is simple to use, so anyone can utilize and experience the benefits of this powerful tool. There are various tools and windows to help users troubleshoot and investigate different functions with Power Query. Clicking buttons within Power Query's UI automatically generates an M-code for users to edit in the advanced editor. The advanced editor provides users the ability to create complex and powerful queries using M-code. The M-Code language is relatively easy to learn, and Microsoft provides various tools to assist users. Goodly is an exceptionally helpful resource for learning Power Query (https://goodly.co.in/tag/power-query/).

Overall, the evolution of Excel as a data analysis tool has been greatly enhanced by the introduction of Power Query. This powerful data transformation tool revolutionizes the way financial professionals manage and analyze data. Its automation capabilities streamline processes, reducing time-consuming manual tasks and minimizing the risk of errors. By providing the means to automate data cleaning, refresh queries, and standardize formatting, Power Query ensures consistency and accuracy in analyses, even with frequently updated datasets. Its user-friendly interface and accessibility make it a valuable asset for professionals across industries. As we continue to leverage the capabilities of Power Query, we anticipate further advancements in data analysis efficiency and effectiveness.

Daryn Levesque - COO!

Education - MBA with a specialty in Finance from the Van Loan School at Endicott College; active FINRA Series 7, 24, 63, and 99 registrations.

Prior Experience - Almost 10 years at ACA Foreside, first managing the mutual fund operations team then the ETP trade desk; various roles in business development and management before that.

PINE is excited to welcome Daryn as our Director & Chief Operating Officer for PINE Distributors LLC! Daryn brings years of experience and expertise!

Get to Know Daryn!
We asked Daryn a few questions to hopefully give our readers some insight into his background and personality.

1. Why did you join PINE?
The opportunity to work with a small group focused on client success while building a new service line for the firm.

2. What is your favorite movie?
Office Space

3. What are some of your favorite weekend activities?
Mountain biking, house work, reading, & family time.

Brain Teaser Answer 💡

Crater of Diamonds is one of the only places in the world where the public can search for real diamonds in their original volcanic source, bringing people from all over the world to Murfreesboro, **Arkansas**.

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