



Insights - Alert

SEC Director of Enforcement Warns of a 'Perfect Storm' Developing Around AI

04/18/2024 | 3 minute read

Key Takeaways

- Director of Enforcement of the U.S. Securities and Exchange Commission (SEC or Commission) Gurbir Grewal warns of the risks surrounding artificial intelligence (AI) related disclosures and puts investment advisers and public companies on notice that disclosures related to AI may be necessary and must not be materially false or misleading.
- Grewal advocates for “proactive compliance,” which requires education, engagement and execution.
- The SEC is expected to increase its enforcement efforts and scrutiny of AI-related disclosures.

On April 15, Grewal spoke at the Program on Corporate Compliance and Enforcement Spring Conference and warned there is a “perfect storm . . . brewing around AI.” Framing the discussion on lessons learned from recent frauds and “perfect storms” in the crypto market and special-purpose acquisition companies, Director Grewal cautioned that “perfect storms of risk” often stem from heightened investor interest in quickly developing

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technologies. He cautioned individuals and companies against capitalizing on FOMO, or the “fear of missing out.”

Drawing on enforcement cases based on environmental, social and governance (ESG) disclosures as instructive, Grewal says that increased investor interest in ESG has led to financial incentives for companies to exaggerate or misstate their ESG activities or products. He believes the same thing is occurring with AI. The SEC has already settled charges related to AI-related disclosures. Grewal warns that as investor interest in AI technology rises and investors increasingly believe that faster adoption of AI is important to the value of companies, the SEC will be more heavily scrutinizing potentially false and/or misleading information.

Grewal indicates that the recent AI actions should put regulated entities and persons on notice that “AI-washing” may violate the federal securities laws. He also highlights that public company disclosures related to AI may also violate the federal securities laws. This is becoming a more significant issue as AI-related disclosures by public companies increase. For example, companies should identify whether disclosure is necessary due to being in the business of developing AI applications, use of AI in their operations, or potential security or competitive risks related to AI.

With regard to individual liability, Grewal referenced the SEC’s approach to cybersecurity disclosure actions as instructive. Specifically, the SEC looks at “what a person actually knew or should have known; what the person actually did or did not do; and how that measures up to the standards of our statutes, rules, and regulations.” He indicated that those who act in good faith and take reasonable steps are unlikely to face an enforcement action.

To ensure compliance with securities law requirements, Grewal advocates for “proactive compliance,” which requires education, engagement and execution.

1. Education. Stay informed on AI risks related to the specific business, enforcement actions, the impact of AI-related issues on other companies and relevant speeches, such as a recent speech by SEC Chair Gary Gensler discussing AI risks, conflicts of interest related to AI and AI hallucinations.
2. Engagement. Speak with personnel to understand how AI intersects with the various business units, including activities, strategies, risks, incentives, etc. Identify AI-related disclosures and ensure they are accurate.
3. Execution. Update policies, procedures and internal controls to ensure they are adequate and bespoke to the company.



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Conclusion

As the use of AI technology increases, investment firms, public companies and individuals alike must be aware of the risks pertaining to AI-related disclosures. Misrepresenting AI-related information and capabilities can violate federal securities laws. As AI-related disclosures increase, the SEC is expected to ramp up its scrutiny of how this evolving technology is disclosed.

BakerHostetler's attorneys have extensive experience helping clients with these issues through their work on our Capital Markets and Securities, Corporate Governance, and Securities Enforcement Defense teams. These teams are comprised of many experienced individuals, including partners who served in the SEC's Division of Corporation Finance, Division of Enforcement and Office of the General Counsel. Please feel free to contact any of our experienced professionals if you have questions about this alert.

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