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LAWFLASH

SEC CHARGES INVESTMENT ADVISERS WITH MAKING FALSE AND MISLEADING STATEMENTS ABOUT THEIR USE OF AI

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On March 18, the US Securities and Exchange Commission (SEC) announced the first AI-related settled actions against two investment advisers—*Delphia (USA) Inc.* and *Global Predictions Inc.*—for making false and misleading statements about their purported use of artificial intelligence (AI), a practice the SEC refers to as “AI washing.” The advisers were also charged with violating the Marketing Rule under the Investment Advisers Act of 1940 (the Advisers Act). SEC Chair Gary Gensler previously analogized “AI washing” to “greenwashing” (referring to misleading statements about how eco-friendly a company is) and cautioned businesses to ensure they are not misleading the public about their AI use.[1]

As Chair Gensler said in a statement following the settlements, “everyone may be talking about AI, but when it comes to investment advisers, broker dealers, and public companies, they should make sure that what they say to investors is true.”[2] Without admitting or denying the charges, Delphia and Global Predictions agreed to pay a \$225,000 and \$175,000 civil penalty, respectively, to settle with the SEC. These matters reinforce the SEC’s focus on AI (not only for investment advisers, but other registrants and public companies as well) and these are likely to be the first of many AI washing cases we’ll see from the SEC’s Division of Enforcement.

While the SEC has proposed new rules regarding data analytics and AI, similar to the Commission’s track record regarding ESG, the Division of Enforcement does not have to wait until those rules go into effect in order to bring AI-related actions. For example, and as these matters make clear, the Marketing Rule (and general fiduciary duty principles) already applies and can lead to Enforcement activity regarding the use of AI.

IN THE MATTER OF DELPHIA (USA) INC.

The SEC asserted that between 2019 and 2023, Delphia made multiple false and misleading statements relating to its purported use of AI and machine learning to analyze its retail clients’ spending and social media data to inform its investment advice. The SEC alleges that although Delphia “intended” to use AI and machine learning to collect data from clients as inputs into its algorithms (and did in fact collect “certain client data intermittently”), it never actually “accomplished [its] goal” or otherwise used the data in its investing algorithms.[3]

The SEC pointed to multiple allegedly false and misleading statements concerning AI and machine learning across Delphia's Form ADV Part 2A brochures, press releases, website content, and client communications. For example, in a 2022 press release, Delphia stated that its "proprietary algorithms . . . make predictions across thousands of publicly traded companies up to two years into the future." [4] Their website also said that Delphia "put[s] collective data to work to make our artificial intelligence smarter so it can predict which companies and trends are about to make it big and invest in them before everyone else." [5]

The SEC concluded these statements were false and misleading because Delphia had not developed the represented capabilities. They were deemed material because Delphia was representing "to current and prospective clients that its use of client data as inputs into its investing algorithms was a key differentiating characteristic from other advisers." [6] Notably, the SEC's Division of Examinations had previously identified these statements as problematic and Delphia took certain corrective actions, such as updating its Form ADV in August 2021 to state that it currently does not use client data to make investment decisions for its clients. However, Delphia continued making similar statements in subsequent social media posts, client communications, and a press release. As a result, the SEC found that Delphia violated Section 206(2) of the Advisers Act (a key negligence-based antifraud provision for investment advisers) for making false and misleading statements concerning its use of AI, machine learning client data.

The SEC also charged Delphia with violations of Section 206(4) of the Advisers Act and Rules 206(4)-1 and 206(4)-7 thereunder (the Marketing Rule and Compliance Rule) for failure to adopt and implement policies and procedures—namely a social media policy—necessary to ensure that Delphia's advertisements were accurate and did not contain false or misleading statements. While Delphia had a number of individuals involved in its advertising review and approval process, the SEC found that it lacked a clear process that enabled everyone to understand their respective roles and responsibilities.

IN THE MATTER OF GLOBAL PREDICTIONS INC.

As with Delphia, the SEC charged Global Predictions with violations of Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-1 and 206(4)-7 thereunder in connection with allegedly false and misleading statements about its use of AI and the services it offered. For example, Global Predictions stated on its website that its technology incorporated "[e]xpert AI-driven forecasts." [7] According to the SEC, it did not do so.

The adviser's website, social media sites, and client communications also described Global Predictions as the "first regulated AI financial advisor," but Global Predictions was unable to "produce documents to substantiate" that claim. [8] Notably, however, many of the allegedly false and misleading statements made by Global Predictions, as well as other instances of misconduct (e.g., an allegedly improper hedge clause) are not related to AI. The SEC nonetheless chose to announce the Global Predictions matter with Delphia, both under an "AI washing" headline, likely to reinforce the SEC's focus on the use of AI and send a message to the industry.

KEY TAKEAWAYS

- AI is a clear priority across the Commission, as exemplified by the following:
 - The Division of Examinations pointed to it within its 2024 priorities report
 - The SEC's Office of Investor Education and Advocacy issued an investor alert in January 2024 regarding potential frauds associated with AI

- The Commission has **proposed rulemaking** regarding predictive data analytics and AI
- AI has been the topic of several speeches and statements by SEC leadership[9] (including most recently by Director of Enforcement Gurbir Grewal at this year's Securities Industry and Financial Markets Association meeting)
- We have heard anecdotally of firms receiving real-time inquiries from the SEC staff about the firms' AI-related public announcements
- The Division of Enforcement has made a point to announce two settled actions about the use of AI on the same day
- Marketing Rule compliance also continues to be a clear priority of the Commission and given the broad scope of that rule, is a means for the SEC to bring cases across a wide array of topics, including AI and ESG.
- Investment advisers, broker dealers, and public companies should consider reviewing and reassessing their policies, procedures, marketing material and public-facing statements and disclosures about their use of AI to avoid getting caught in the SEC's crosshairs
- The Division of Enforcement doesn't need to wait for the Commission to finalize rules specific to data analytics and AI to bring enforcement actions that are AI-related. Among other things, general fiduciary duty principles and the Marketing Rule already apply and can serve as the basis for an enforcement action related to a registered entity's purported use of AI. For those entities not registered with the Commission, the antifraud sections of the Exchange Act and the Securities Act can be used to pursue entities and individuals who the Commission believes are making misleading claims about AI.
- As with ESG disclosures, when it comes to the use of AI, entities need to ensure that they do what they say and say what they do and have processes in place to ensure that such statements are consistent across all platforms, including social media

CONTACTS

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[1] Gary Gensler, SEC Chairman, “AI, Finance, Movies, and the Law” Prepared Remarks before the Yale Law School (Feb. 13, 2024).

[2] Gary Gensler, SEC Chairman, Chair Gary Gensler on AI Washing (Mar. 18, 2024).

[3] *In the Matter of Delphia (USA) Inc.*, Investment Advisers Act Release No. 6573, AP File No. 3-21894 (Mar. 18, 2024) (Order Instituting Cease-and-Desist Procedures Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Finds, and Imposing a Cease-and-Desist Order).

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *In the Matter of Global Predictions, Inc.*, Investment Advisers Act Release No. 6574, AP File No. 3-21895 (Mar. 18, 2024) (Order Instituting Cease-and-Desist Procedures Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Finds, and Imposing a Cease-and-Desist Order).

[8] *Id.*

[9] See, e.g., Gary Gensler, SEC Chairman, Office Hours with Gary Gensler Transcript: AI (Feb. 14, 2024).