

SEC Targets "AI Washing" With Two New Settled Cases

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Investigations + White Collar Defense Securities Enforcement and Securities Litigation

Client Alert

On March 18, 2024, the SEC announced—in videos posted on YouTube and Twitter—regulatory actions against two investment advisers for “AI washing,” a practice defined by the SEC as “making false artificial intelligence-related claims.” Coming on the heels of the SEC proposing new rules in 2023 for investment advisers and broker-dealers using “predictive data analytics,” and the SEC’s joint alert with the Financial Industry Regulatory Authority (FINRA) and the North American Securities Administrators Association (NASAA) flagging concerns about increasing investment frauds involving the use of artificial intelligence, it is clear that the SEC will be focused on artificial intelligence in the months ahead.

Indeed, SEC Enforcement Director Gurbir Grewal confirmed as much in remarks made at the annual gathering of securities practitioners hosted by the Securities Industry and Financial Markets Association (SIFMA), where he called attention to the AI washing cases on the very day they were announced. Given widespread reports in 2023 that the SEC launched a sweep of investment advisers to gather information regarding their use of artificial intelligence, we expect additional AI-related cases to follow. Just as the SEC announced its focus on the ESG space by bringing “greenwashing” cases based on precedent established in other contexts, the Commission has now applied similar precedent to remind regulated entities that representations about the use of AI will face scrutiny.

Case Details

The allegations supporting the Commission’s settled findings were not particularly complicated or novel but for their application in the AI context. The settled charges were brought against investment advisers Delphia (USA) Inc. (“Delphia”), and Global Predictions Inc. (“Global Predictions”), for allegedly making false and misleading statements about their use of AI technology. In both cases, the SEC alleged the firms misled investors about the use of AI in their investment processes, in violation of negligence-based antifraud provisions and the Marketing Rule of the Investment Advisors Act. From 2019 to 2023, Toronto-based Delphia allegedly claimed it used its collective data to make its AI smarter to “predict which companies and trends are about to make it big,” and in 2023, San Francisco-based “deep tech company” Global Predictions allegedly claimed to be the first regulated AI financial adviser. But neither company could substantiate its boasts about utilizing AI to serve investors.[1]

To settle the SEC charges, Delphia agreed to pay \$225,000 and Global Predictions agreed to pay \$175,000 in civil penalties without admitting or denying the charges.

Key Takeaways

In the words of SEC Chair Gary Gensler, who has called AI “the most transformative technology of our time fully on par with the Internet”: “Public companies should make sure they have a reasonable basis for the claims they make and yes, the particular risks they face about their AI use, and investors should be told that basis.” Director Grewal has added: “History teaches us that as AI continues to develop, firms will rush to capitalize on investor interest by promoting their supposed use of AI. But some of these claims may come before the firms actually develop the technology or the strategy. Or maybe they’ll fail altogether on implementing the technology or strategy[.]”

With that in mind:

- **Pay special attention to boasts about AI use.** The SEC clearly intends to focus on your AI representations. Use Director Grewal’s statements as a guide. Are your statements too aspirational? Have you tested your competencies sufficiently? Are you employing AI in the precise ways you say you are?
- **Consider how investors might (mis)understand your AI-related representations.** The language around AI is evolving rapidly. Disclosures should keep pace with how the public uses new terms and phrases.

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- **Understand your AI.** The SEC is not likely to limit investigations to affirmative misrepresentations. The next frontier may be to question when companies violate the securities laws by omitting material statements regarding reliance on AI. To that end, be sure to understand the role AI plays in your business and consider, with counsel, whether that role should be disclosed.

In short, the SEC's newly settled actions likely represent a new wave of AI-focused cases that will not wait for the adoption or implementation of new rules or regulations, and companies employing AI should pay extra attention to AI-related disclosures, knowing the SEC certainly will do so.

[1] The SEC also alleged that Global Predictions included liability disclaimer language, commonly referred to as a "hedge clause," in its advisory contract with clients, which created the misleading impression that clients had waived non-waivable causes of action against Global Predictions provided by state or federal law, and made false and misleading disclosures to clients regarding its advisory services.

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