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ANALYSIS

SEC's Crackdown on AI Washing Has Broad Implications

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By Benjamin Daniels, Jennifer Driscoll and Sabrina Galli | May 10, 2024 at 10:00 AM



Artificial intelligence (AI) is everywhere, and the U.S. Securities and Exchange Commission (SEC) is making sure companies do not exaggerate their AI capabilities.

The SEC warned in December 2023 that it would not tolerate “AI washing,” a marketing tactic where companies overstate their AI capabilities or technology to trick investors. In January 2024, the SEC, North American Securities Administrators Association (NASAA) and Financial Industry Regulatory Authority (FINRA) jointly issued an “Investor Alert” about increases in investment fraud involving AI and other emerging technologies.

The SEC has now announced that it has settled its first enforcement actions involving AI. Two investment advisors, Delphia (USA) Inc. and Global Predictions Inc., recently agreed to pay civil fines to the SEC for misstatements about AI technology. This signals a new era of SEC enforcement.

Pre-AI Misstatements About Technology

Overstating technological innovation is nothing new. In the past, companies have engaged in what is sometimes called a “black box” scheme, where a company promises software or technological innovation but refuses to disclose details of the invention. The companies will repeatedly promise that the technology will launch soon but miss deadlines with only vague updates on progress. Eventually, the scheme falls apart as investors become disenchanted with the lack of production, or there is a revelation that the technology does not exist. The SEC and courts have made clear that this is a form of misstatement actionable under federal securities laws.

The best-known example is Theranos. The company and its officers made several misleading statements about the development of portable testing machines that only required a little blood to perform medical testing. Based on those statements—and falsified results—the company raised more than \$700 million and was valued at a peak of \$10 billion. The company’s scheme eventually fell apart because of delays in research and development and an exposé in the Wall Street Journal.

The SEC filed civil fraud charges against Theranos, its CEO Elizabeth Holmes, and its former president for engaging in a “years-long fraud” and violating several federal securities laws. The Department of Justice (DOJ) indicted and convicted the officers for wire fraud, and investors brought civil class actions against the company and its officers.

SEC Policies and Warnings

The SEC seems to be concerned that a similar scheme is possible in industries involving AI. The SEC has put public companies and investors on notice that statements about their AI use and capabilities must comply with securities laws and regulations.

At the Messenger AI Summit in December 2023, SEC Chair Gary Gensler warned that false or misleading claims about the role of AI in a company's business may violate rules governing "full, fair, and truthful" disclosures. In remarks delivered that same month to the Financial Stability Oversight Council, Gensler hailed the transformative nature of AI but again cautioned that the technology was vulnerable to misuse "by bad actors to deceive people in the market."

In January 2024, the SEC (along with FINRA and other agencies) followed with an investor alert warning about an increase in fraud involving the purported use of AI. The agencies noted that while the rise of new technologies creates investment opportunities, it can also attract fraudsters who want to capitalize on the unsettled markets. The agencies identified certain red flags, including "unregistered/unlicensed investment platforms claiming to use AI," "high-pressure sales tactics by unregistered individuals," "promises of quick profits," and "using AI-generated information to...predict changes in the stock market's direction or in the price of a security."

They noted that micro- or nano-cap stocks are particularly vulnerable to investment schemes because they often involve limited public information about management, products, services and finances.

AI-Washing Cases

In March 2024, the SEC announced that it settled two enforcement actions against investment advisors for making false statements about their use of AI technology.

First, the SEC targeted Delphia, which had issued several statements about its use of AI. According to the SEC, Delphia represented that it "used artificial intelligence and machine learning to analyze its retail clients' spending and social media data to inform its investment advice." The company's brochures promised that its investment advice was "powered by the insights it makes when individuals...connect their social media, banking, and other accounts," which was fed into "a predictive algorithmic model" for the selection of "stocks, ETFs and options[.]"

A later press release stated that Delphia was "the first investment adviser to convert personal data into a renewable source of investable capital...that will allow consumers to invest in the stock market using their personal data."

Finally, its website said that it "put 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."

The SEC found that these statements were false and misleading because Delphia did not have the claimed AI and machine-learning capabilities. The firm also violated the Marketing Rule, which prohibits a registered investment adviser from distributing any advertisement that includes any untrue statement of material fact. Delphia was ordered to cease and desist from any further violations, was censured, and agreed to pay a civil penalty of \$225,000.

Second, the SEC targeted Global Predictions, which had issued similar statements. The company's website said it was the "first regulated AI financial advisor." Its emails and social media claimed that its platform had "expert AI-driven forecasts," had more than \$6 billion of assets, and was "outperforming IMF forecasts by 34%."

The SEC order found that the statements were false and misleading and that the company had also violated the Marketing Rule by claiming that Global Predictions offered tax-loss harvesting services and included an impermissible liability hedge clause in the advisory contract. Global Predictions was ordered to cease and desist from any further violations, was censured, and agreed to pay a civil penalty of \$175,000.

Takeaways

The SEC's recent crackdown seems aimed at companies with specific traits. As the Investor Advisory foreshadows, the SEC will pay increased attention to all statements about AI or predictive technology, whether in promotional materials, websites, or emails to potential investors. Right now, however, it appears the SEC is giving extra scrutiny to microcap companies, investment advisors, and promoters. The SEC believes those entities are more likely to be involved in pump-and-dump schemes or other investment fraud that capitalizes on limited public information. The SEC appears to focus on companies that seem more intent on attracting investors rather than developing technology.

Companies that do not fall into those buckets must still scrutinize their statements about predictive technology. Along with including standard language that identifies forward-looking statements, companies in this area should be careful about how they tout their predictive technology and the details they provide about it. Currently, the SEC seems focused on companies with little or no technology to support their public statements. However, the SEC might begin scrutinizing the accuracy of statements about the degree of development of the technology. This will be fact-specific, so companies may wish to consult experienced counsel whenever issuing statements about predictive technology.

Finally, companies should also remember that the SEC is considering rules for predictive data analytics. In July 2023, the SEC issued a press release about the new proposed rules intended to “help protect investors from conflicts of interest—and require that, regardless of the technology used, firms meet their obligations not to place their own interests ahead of investors’ interests.” These proposed rules would require firms to either “eliminate or neutralize the effect of conflicts of interest associated with the firm’s use of covered technologies.” The rules would also impose recordkeeping requirements.

The rules are currently in the public comment period. Until they are acted on, companies will remain mindful of this evolving area of federal securities law and carefully vet what they disclose in their disclosures, advertisements, websites or social media.

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