LATHAM & WATKINS

Client Alert
Commentary

Latham & Watkins White Collar Defense & Investigations and Investment Funds Practices

March 25, 2024 | Number 3243

SEC Announces First-Ever Enforcement Actions for "AI Washing"

The actions are part of increased regulatory scrutiny on how companies, investment advisers, and other market participants are using AI and their related disclosures.

On March 18, 2024, the US Securities and Exchange Commission (SEC) announced two first-of-their kind settled enforcement actions with investment advisers Delphia (USA) Inc. (Delphia) and Global Predictions Inc. (Global Predictions) based on alleged false and misleading statements made about the firms' purported use of artificial intelligence (AI), including alleged violations of the Amended Marketing Rule.[1] The two firms agreed to settle the SEC's charges and pay a total of $400,000 in civil penalties.

The enforcement actions follow on the heels of reports that the SEC has initiated an AI "sweep" targeting investment advisers, and arrive amid a flurry of recent statements from US government regulators warning businesses about how they characterize their use of AI and promising more scrutiny of their public statements on that topic. Given the increasing and ever-expanding use of AI by businesses across industries and sectors, and what appears to be a concerted government effort to focus enforcement on AI applications, companies should exercise caution when messaging investors, customers, and the markets at large about their use of AI, and consider whether that messaging is consistent with how they are actually using this rapidly developing technology.

This Client Alert analyzes the enforcement actions, explains the larger enforcement trend taking place, and provides key takeaways for companies.

The SEC's Settled Enforcement Actions

The SEC charged Delphia, a former SEC-registered investment adviser based in Canada that operated a robo-adviser business, with making false and misleading statements about its "predictive algorithmic model." Delphia started its robo-advisory business in 2019 with the stated goal of developing algorithms to manage retail client portfolios based on their client's investment objectives and risk profiles.

Delphia told its clients that it would use its algorithm to make "more robust and accurate" investment decisions by inputting its clients' personal data, such as their banking information and social media accounts. Delphia also told its clients that their data was "helping [Delphia] train [its] algorithm for pursuing ever better returns." Delphia further claimed that it used machine learning (ML) to analyze its clients' collective data to make "intelligent investment decisions" by predicting "which companies and trends are about to make it big and invest[ing] in them before everyone else." Delphia advertised that it was "the first investment adviser to convert personal data into a renewable source of investable capital."

The SEC alleges that while Delphia may have *intended* to use AI and ML to inform its algorithm, it never actually did so. As such, the SEC found that Delphia had disseminated false and misleading statements about its AI and ML capabilities through its regulatory filings, advertisements, and social media, in violation of Section 206(2) of the Advisers Act and the Amended Marketing Rule.

The SEC separately charged Global Predictions, a San Francisco-based investment adviser that operates an interactive online platform designed to make investment allocation recommendations to users via a chatbot, with falsely claiming that it is the "first regulated AI financial advisor" and that it produced "[e]xpert AI driven forecasts" via its online algorithm. The SEC also found that Global Predictions made a number of other false and misleading statements, that its advisory contract contained terms that violated its fiduciary duty, and that it violated the Amended Marketing Rule, for reasons unrelated to its statements about its use of AI.

Of particular note, Global Predictions' advisory contract with retail investors permitted Global Predictions to amend the contract unilaterally. Global Predictions informed clients of certain material changes through an email blast that neither identified what changes had been made nor provided any mechanism for clients to provide or withhold informed consent to the changes prior to their effective date. The SEC found that Global Predictions' failure to provide advance notice of the material changes, and the fact that the contract permitted Global Predictions to change the terms unilaterally without advance notice to clients, violated the firm's fiduciary duty as an investment adviser.

For both enforcement actions, the SEC did not weigh in on whether the technology involved, if actually deployed, would constitute AI. Instead, the SEC alleged that these investment advisers never "developed the represented capabilities" (in the case of Delphia) and "could not substantiate" their claims about AI (in the case of Global Predictions). Without admitting or denying the findings, each firm agreed to an order finding that they had violated Sections 206(2) (which may rest on a finding of negligence, rather than scienter), 206(4) of the Advisers Act, the Amended Marketing Rule and Rule 206(4)-7. The firms further agreed to be censured, to cease and desist from future violations of the federal securities laws, and to pay civil penalties of $225,000 and $175,000, respectively.

The SEC's Public Statements

The SEC's efforts to publicize the enforcement actions appear intended to underscore its ongoing commitment to policing the use of AI by investment advisers, broker-dealers, issuers, and other market participants. As described below, the SEC's press release on the actions included clear warnings from the SEC's top leadership, including SEC Chair Gary Gensler and SEC Enforcement Director Gurbir Grewal, coupled with videos posted to X (formerly known as Twitter) that amplified their messages. The actions also come against the backdrop of the SEC's efforts to regulate investment advisers' use of AI through rulemaking.[2]

Chair Gensler framed AI as "the most transformative technology of our time." But he also warned that AI is the latest in a line of new technologies to "create buzz from investors as well as false claims by those purporting to use those new technologies." He emphasized that investment advisers, broker-dealers, and public companies should make sure they have a reasonable basis for the claims they make about, and the particular risks they face from, AI.

Enforcement Director Grewal posted a video to X, stating, "If you claim to use AI in your investment processes, you must ensure that your representations aren't false and they aren't misleading." In the press release, Enforcement Director Grewal also offered a word of warning to public companies, cautioning them to "remain vigilant about similar misstatements" related to their adoption and use of AI that may be material to individuals' investing decisions.

Both SEC leaders referred to Delphia's and Global Prediction's conduct as "AI washing," or relying on deceptive or inaccurate claims to exploit investors' heightened interest in this burgeoning area of technology. This term harks back to the SEC's previously announced focus on "greenwashing," or exploiting investor interest in environmental, social, and governance (ESG) topics by making exaggerated or false claims about ESG practices.

A Larger Enforcement Trend

The SEC enforcement actions are part of a larger enforcement trend focusing on AI-related risks. In his remarks at the 39th National Institute on White Collar Crime earlier this month, Enforcement Director Grewal identified five categories of risk related to AI: (1) AI washing; (2) the use of AI in fraud or market manipulation; (3) conflicts that may arise from AI technology prioritizing advisers' interests over their clients' interest; (4) the risk of "hallucination" or mistakes by AI technology in investor or offering materials; and (5) the systemic risks arising from a large number of people making investment decisions based on the same data sets from a few big AI players. Prior to the recent emphasis by Enforcement Director Grewal, the SEC announced it was focusing on AI in its 2024 Examination Priorities, in which it highlighted the establishment of specialized teams within its examination programs to address the risks posed by AI and other emerging financial technology.

The SEC is not alone in telegraphing a greater focus on enforcement related to AI. US Deputy Attorney General Lisa Monaco recently highlighted AI as an enforcement priority for the US Department of Justice (DOJ) in her keynote remarks at the American Bar Association's 39th National Institute on White Collar Crime. She stated that "where AI is deliberately misused to make a white-collar crime significantly more serious, our prosecutors will be seeking stiffer sentences, for individual and corporate defendants alike."

Deputy Attorney General Monaco also announced that, moving forward, DOJ prosecutors will "assess a company's ability to manage AI-related risks as part of its overall compliance efforts." To this end, she announced that she has directed the DOJ Criminal Division to "incorporate assessment of disruptive technology risks — including risks associated with AI — into its guidance on Evaluation of Corporate Compliance Programs." Finally, Deputy Attorney General Monaco spoke about a new initiative called "Justice AI," which brings together stakeholders across industry, academia, law enforcement, and civil society to address the impacts of AI. She noted that the DOJ would use these conversations to inform the DOJ's AI policy, including regarding corporate compliance issues.

All these initiatives are in addition to the DOJ's appointment of a Chief Science and Technology Advisor, and the creation of the Disruptive Technology Strike Force, a joint venture by the DOJ and the US Department of Commerce to investigate and prosecute violations of export laws and protect advanced technologies, including AI, from adverse use.

The DOJ's focus on AI technology extends to US Attorneys' offices as well. For example, on March 19, 2024, the US Attorney for the Northern District of California, Ismail J. Ramsey, announced that prosecutors in his office will target AI tech startups that defraud investors with a "fake it till you make it" strategy before they go public.

The Federal Trade Commission (FTC) likewise has recently announced a number of initiatives related to AI. In November 2023, the FTC approved an omnibus resolution authorizing the use of compulsory process in nonpublic investigations involving products and services that use, or claim to detect, AI. This resolution streamlined the FTC staff's ability to issue civil investigative demands and pursue investigations related to AI. At the FTC's recent Summit on Artificial Intelligence, the Director of the Bureau of Consumer Protection, Samuel Levine, emphasized the FTC's proactive approach to protecting consumers from AI-related harms, including fraudulent marketing tactics and privacy invasions that may occur through data collection. FTC Chair Lina Khan has warned companies that they "should be on notice that systems that bolster fraud or perpetuate unlawful bias [via AI] can violate the FTC Act," as do "exaggerated, deceptive claims about the capabilities of their AI tools." The FTC also recently proposed new protections to ban impersonation of individuals via AI.

Key Takeaways

AI is poised to become an indispensable tool with the power to be used in various ways across industries and sectors. As the SEC, DOJ, FTC, and other government regulators bring intense focus to bear on companies' and firms' use of AI, companies should take care regarding their public disclosures to investors and marketing to consumers about their AI capabilities, including considering whether those disclosures accurately reflect the state of their AI capabilities and whether they can be substantiated if called into question.

The SEC enforcement actions against Delphia and Global Predictions illustrate the types of AI-related misstatement cases the SEC stands ready to bring under existing rules and regulations. More generally, the SEC's pursuit of these actions reflects the Commission's commitment to closely scrutinizing AI-related disclosures and public statements, including statements made outside of required SEC filings. Companies and firms should expect their AI-related disclosures — no matter how or where made — to attract considerable scrutiny.

If you have questions about this Client Alert, please contact a member of our White Collar Defense & Investigations and Investment Funds Practices or the Latham lawyer with whom you normally consult.

You Might Also Be Interested In

FTC Sharpens Its AI Agenda With Novel Impersonation Rulemaking

DOJ Announces New Whistleblower Program

FTC Refines Road Map for AI Enforcement

Endnotes

[1] Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the Advisers Act).

[2] https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf.