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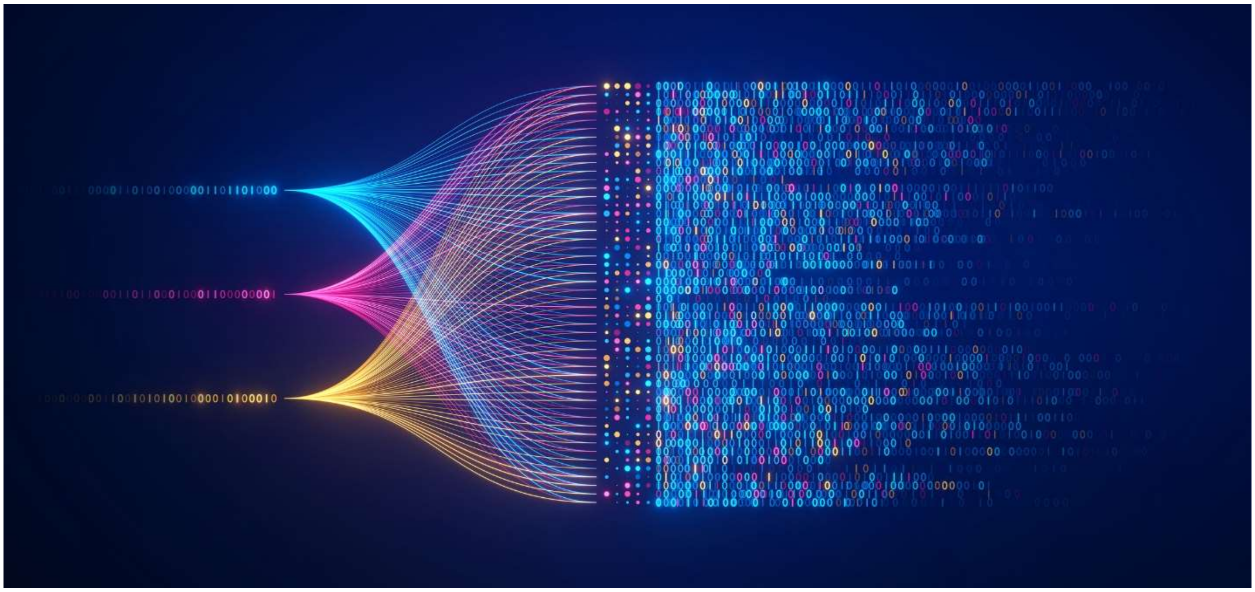
AI Is The New Green: The SEC's First-Ever Enforcement Actions Targeting AI Washing



Executive Summary

Artificial intelligence (AI) has emerged as a transformative technology across various industries, promising advancements in decision-making, automation, and data analysis. However, with the proliferation of AI comes the risk of misrepresentation and exaggeration by companies seeking to capitalize on its perceived benefits. Against this backdrop, the U.S. Securities and Exchange Commission (SEC) has intensified its scrutiny of companies making false or misleading statements about their use of AI, a practice commonly referred to as "AI washing." This article explores the recent, first-of-their-kind SEC enforcement actions targeting AI washing, and best practices for companies to mitigate enforcement risk.

What is AI Washing?

AI washing occurs when companies exaggerate or misrepresent their AI capabilities in order to attract investors or gain a competitive edge in the market. This deceptive practice can take various forms, including false claims about the sophistication of AI technology deployed, misleading statements about the impact of AI on business operations, or overstated promises about the benefits of AI-driven products or services. Similar to "greenwashing," where companies overstate their environmental credentials, AI washing undermines investor confidence and can lead to legal and regulatory consequences. (For more on greenwashing, see our recent article on the topic here.)

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Understanding the SEC's AI Washing Enforcement Actions

The SEC's enforcement actions against investment advisers Delphia (USA) Inc. ("Delphia") and Global Predictions Inc. ("Global Predictions") — with settled charges announced on March 18, 2024 — provide insight into the agency's approach to combating AI washing. In both cases, the SEC alleged violations of the antifraud provisions of the federal securities laws, as well as Marketing and Compliance Rules under the Investment Advisers Act of 1940. The Orders are available here and here.

In the case of Delphia, a Toronto-based robo-advisory firm, the SEC found that the company falsely claimed to use AI and machine learning to analyze client data and inform investment decisions. Specifically, Delphia misrepresented its use of "predictive algorithmic models" and "machine learning" in its Form ADV Part 2A, press releases, and website. Delphia claimed it used collected data to train its AI to "predict which companies and trends are about to make it big and invest in them before everyone else." Despite being aware of these misrepresentations following an examination by the SEC's Division of Examinations, Delphia failed to correct its disclosures and continued to make false and misleading statements to clients and investors.

Similarly, San Francisco-based Global Predictions was charged with making false statements about its AI capabilities, including claims of being the "first regulated AI financial advisor" and offering "[e]xpert AI-driven forecasts." The SEC found that these statements were misleading and lacked substantiation, constituting violations of the Advisers Act's antifraud provisions and the Marketing Rule.

Without admitting or denying these charges, Delphia agreed to pay a civil penalty of $225,000. Similarly, Global Predictions settled with the SEC by agreeing to pay a civil penalty of $175,000. Additionally, both companies agreed to be censured and to cease and desist from further violations as part of the settlements.

> "We find that Delphia and Global Predictions marketed to their clients and prospective clients that they were using AI in certain ways when, in fact, they were not.… We've seen time and again that when new technologies come along, they can create buzz from investors as well as false claims by those purporting to use those new technologies. Investment advisers should not mislead the public by saying they are using an AI model when they are not. Such AI washing hurts investors." — Gary Gensler, SEC Chair

Implications for Companies

The SEC's enforcement actions against Delphia and Global Predictions — the first-ever charging violations of the antifraud provisions of the federal securities law arising from AI-related statements — underscore the importance of accurate and truthful disclosures regarding AI use. Companies must ensure their statements about AI capabilities are substantiated and aligned with actual practices. Failure to do so can result in significant legal and regulatory consequences, including civil penalties, censure, and reputational damage.

Best Practices for Mitigating Enforcement Risk and Avoiding AI Washing

To mitigate the risk of enforcement actions related to AI washing, and related shareholder actions that invariably follow, companies should adopt robust compliance measures and internal controls, including:

- **Accurate Disclosures**: Companies should provide clear and accurate descriptions of their AI capabilities in regulatory filings, marketing materials, and communications with investors. Avoiding overstated claims and ensuring consistency in AI-related disclosures can help mitigate the risk of enforcement scrutiny. Communications and marketing teams should work closely with their legal and compliance partners to ensure any public statements regarding AI align with the reality of their AI systems' capabilities and performance.

- **Internal Review Processes**: Implementing rigorous review processes for AI-related disclosures can help identify and correct inaccuracies or exaggerations before they are disseminated to investors. This includes establishing clear policies and procedures for reviewing and approving marketing materials and regulatory filings.

- **Training and Education**: Providing training to employees involved in marketing and business development on the legal and regulatory requirements related to AI disclosures can enhance compliance and reduce the likelihood of misrepresentations. Educating staff on the risks of AI washing and the importance of accurate disclosure is essential for effective risk management.

Conclusion

Following its highly publicized crackdown on greenwashing, the SEC's recent enforcement actions highlight the agency's commitment to holding companies accountable for false or misleading statements about their AI capabilities. By adopting best practices for accurate disclosures, internal controls, and risk management, companies can mitigate the risk of enforcement actions and build investor trust in their AI-related initiatives.

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