

SEC clamps down on AI-washing

By *Anna Pinedo, Gonzalo Go* May 13, 2024



Public companies should be cautious of making misleading claims to avoid securities violation

Artificial intelligence (AI) plays an increasingly influential role for many financial services providers. AI not only provides sophisticated tools that sort and analyse vast amounts of real-time data from various sources, but also can predict market fluctuations using algorithms that track news, public sentiment, market and other data.

In fact, the perceived appeal of AI-related tools with investors and other constituencies may lead companies to make overly positive claims regarding their capabilities. The US Securities and Exchange Commission (SEC) has been on the lookout for “AI-washing,” wherein public companies or other regulated entities make misleading or false claims in an effort to benefit from investor interest in AI-related technologies.

Recently, SEC division of enforcement director Gurbir Grewal **reminded** the investment industry not to rush to make “claims about using AI in [their] investment processes to capitalise on growing

investor interest,” but, instead, to evaluate whether their representations are accurate or merely aspirational. Similarly, SEC Chair Gary Gensler **noted** that investment advisers, broker-dealers and public companies “should say what they’re doing and do what they’re saying” because AI-washing “may violate the securities laws”.

In March 2024, the SEC **penalised** two investment advisers for AI washing, violating the Investment Advisers Act of 1940 (Advisers Act) by misrepresenting their AI use. According to the SEC, the first investment adviser **committed** AI-washing by representing, over four years, that it used AI and machine learning “to analyse its retail clients’ spending and social media data to inform its investment advice when, in fact, no such data was being used in its investment process”.

Its robo-adviser business’ algorithms that were supposed to manage retail client portfolios based on individualised investment objectives and risk profiles never materialised. The client data it collected were neither used in its AI platform nor served as inputs to develop investing algorithms. The investment adviser had made a number of statements that specifically touted its use of AI, including, for example, the following:

- press release claims that it 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 ... personal data[;]”; that it “uses machine learning to analyse the collective data shared by its members to make intelligent investment decisions” and “[its] proprietary algorithms combine the data invested by its members with commercially available data, to make predictions across thousands of publicly traded companies up to two years into the future;” and
- website claims that it “turns [its clients’] data into an unfair investing advantage” and “put[s] collective data to work to make [its] artificial intelligence smarter so it can predict which companies and trends are about to make it big and invest in them before everyone else”.

These statements were considered material because they included representations to existing and future clients that the use of client data as inputs into its investing algorithms was a key differentiating characteristic from other advisers. The second investment adviser **violated** the Advisers Act through AI-washing as well. The adviser was alleged to have made false and misleading advertisements on its website and in other communications, including referring to itself as the “first regulated AI financial advisor” and claiming its interactive online AI platform yields “[e]xpert AI-driven forecasts”.

Of course, all of this comes against the backdrop of the controversy surrounding the SEC’s pending proposed rules relating to predictive data analytics and AI use by broker-dealers and investment advisers. The same concerns should be taken to heart by public companies. Public companies should consider the disclosures in their Exchange Act reports, proxy statements, and offering documents, as well as in their communications with investors and in social media communications. Director Grewal recently addressed “**proactive compliance**” against AI-washing. He discussed the importance of staying informed about emerging and heightened AI risks to one’s business and industry.

Many public companies already include AI-related risk disclosures in their filings, as well as address the impacts or potential impacts of AI on their products and services, as well as concerns related to legal and regulatory developments and uncertainties. However, as the director noted in his recent

comments, engaging with and collaborating with personnel across different business units is essential in order to understand how AI intersects with their activities, strategies and financial incentives. He also addressed the need for companies to update policies, procedures and internal controls in order to address and manage AI risks.

Clearly, AI-related disclosures will remain an area of focus for the SEC. Companies also should keep in mind that securities-related litigation claims also may be brought in respect of allegedly misleading or overly optimistic disclosures involving claims relating to AI use and technology.

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