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AI Washing Enforcement Continues, Highlighting Risks to Companies and Investors

02 July 2024

Last month, the U.S. Securities and Exchange Commission ("SEC") expanded its "war" on AI fraud to include private market participants, filing securities fraud charges against Ilit Raz, founder and former CEO of defunct AI recruitment startup Joonko. That same day, the DOJ unsealed an indictment against Raz detailing parallel criminal charges of securities fraud and wire fraud stemming from the same alleged scheme.

This is the latest salvo by the SEC in its response to allegedly fraudulent AI disclosures. SEC Chair Gary Gensler has been outspoken regarding the Commission's intent to combat AI washing – falsely claiming the use of AI or machine learning models or misrepresenting their application. But until the charges against Raz, the SEC's actions and rhetoric to fight AI washing had been limited to investment advisers, broker dealers, or companies raising money from the public.

The charges against Raz show that the SEC is reviewing any representations concerning AI technology that do not fairly or accurately describe its design or use, regardless of the identity or size of the market participant. Thus, any entity – from a startup to a Fortune 500 company – should approach disclosures, advertisements, other public statements, or any other representations to investors, regarding its use of AI with great care. Companies touting their AI use or capabilities must have a reasonable basis for these claims and ensure that any statements about their use of AI are not false or misleading.

The SEC's Complaint

Up until filing the June 11 action against Raz, the SEC had not yet filed a case to litigate its AI-washing theory. It settled charges in March 2024 against two investment advisers for making false and misleading statements about their purported use of AI, including claims that AI was used to inform investment decisions.

Like the earlier-settled actions, the SEC's action against Raz, filed as a securities fraud complaint in the Southern District of New York (SDNY), concerns basic misrepresentations. In announcing the charges, Gurbir S. Grewal, Director of the SEC's Division of Enforcement, described the scheme as an "old school" fraud using shiny new buzzwords like "artificial intelligence" and "automation."

At bottom, the fraud was that Joonko's platform did not work the way Raz said it did. The SEC's Complaint alleges that, to raise money for this purported AI venture, Raz made material misrepresentations about Joonko's business, including its customer and user base, its technology, and its revenues. These included fabricated testimonials about the effectiveness of its “automated technology.” Specifically, the SEC’s complaint called out Raz’s material misrepresentations about the platform, including Raz’s claims that the Company was offering an “automated recruiting solution” that used “seven different AI algorithms” and “machine learning to improve the matching process as candidates select the roles they’re interested in.” The SEC also said that investors “considered the state of Joonko’s technology important in deciding whether to invest.”

The DOJ Indictment

On the same day the SEC announced charges against Raz, the DOJ unsealed an indictment in the SDNY charging Raz with securities fraud and wire fraud. Although the indictment is suggestive of an AI-washing issue—namely that Raz made “false claims regarding central aspects of Joonko’s business” to induce investors to invest approximately $27 million in Joonko—the indictment does not reference any specific purported misrepresentations about the Company’s use of its AI technology as the SEC complaint does.

Instead, the indictment focuses on misrepresentations concerning the company’s revenue and the identity and number of its customers, which the SEC’s complaint also details. Specifically, the indictment calls out a forged bank statement and fictitious purchase orders, allegedly created by Raz. It remains to be seen how much the prosecution will focus on Raz’s purported misstatements about the underlying AI technology given that they are not specifically detailed.

Key Takeaways for Companies and Individuals

Chairman Gensler’s proclaimed “war” on AI fraud shows no signs of slowing down. Companies and individuals who exploit the fanfare around artificial intelligence to raise funds are firmly in regulators’ crosshairs and should therefore be careful, particularly when touting their AI technology in press releases, marketing and other investment materials, and in other statements to investors.

Companies should be careful with disclosures and statements. A recent review of public filings shows significant growth in the number of AI-related disclosures. Companies should approach any disclosures, advertisements, public statements, or any other representations to investors regarding their use of AI with great care, viewing them similarly to the way they prepare disclosures of other material risks. Companies should be sure their statements are consistent across communications, including investor presentations. Sellers should prepare, and be prepared to offer, clear and organized descriptions of the company’s use of AI.

Investors and buyers should conduct robust due diligence. Investors and buyers should take particular care to assess whether and how targets are managing AI risks and describing their own AI capabilities. Potential investors should examine the substance of statements that tout AI tools and consider engaging specialized expertise. Sellers should expect targeted questions in corporate transactions as well as representations that anchor company disclosures in the deal documentation.

Investors and buyers should carefully craft representations and warranties. They should consider whether and how these will cover intellectual property rights, privacy and dataset acquisition issues, and potential product use-related claims, among other related considerations.

Focus Remains on Individual Liability. These enforcement authorities appear to be affirming their position that the best way to effect corporate change is to hold individuals accountable. In the context of AI-related risk disclosures, SEC's Grewal has stated that "folks who operate in good faith and take reasonable steps are unlikely to hear from us." Companies operating in this space, and potential investors, should take steps to ensure this is not them.

If you have questions, reach out to our authors (David Rhinesmith, Bradley A. Marcus, Sarah Schaedler, and Jackson Hagen) or other members of the Orrick team.