

ARTIFICIAL INTELLIGENCE STAYS IN THE SEC'S CROSS-HAIRS

CHARGES INCLUDE ALLEGATIONS AGAINST AUDIT COMMITTEE CHAIR AND CFO FOR FAILURES AS GATEKEEPERS

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WHAT HAPPENED

As news stories about AI have surged, so have enforcement actions by the SEC alleging fraudulent statements about AI capabilities. Recent targets have included:

- An investment advisor for making false and misleading statements about its use of AI to perform automated trading for client accounts.
- The founder and CEO of a start-up for false and misleading statements about the company's AI humanoid robot and hologram assistant products.
- The CEO, the CFO and the audit committee (AC) chair of an emerging growth company for misstating the capabilities of an AI-powered software product in order to recognize revenue leading up to an IPO.

Without admitting or denying the SEC's findings, the defendants in the first two cases agreed to cease and desist orders or permanent injunctions, as well as civil penalties. The charges against the CFO and AC chair in the third case remain pending. However, the CEO consented to injunctions from future violations while litigating appropriate remedies. He also pled guilty to parallel criminal charges.

TAKEAWAYS

AI washing. An SEC official [recently cautioned](#): "As AI becomes more popular in the investing space, we will continue to be vigilant and pursue those who lie about their firms' technological capabilities and engage in 'AI washing'."

As discussed in our [June 20, 2024 post](#): "[c]ompanies should exercise care to ensure that any discussion of AI is supported with internal documentation and balanced in presentation, with

appropriate consideration of risks and limitations.”

In particular, companies should follow recent SEC staff guidance, outlined in our [August 16, 2024 post](#):

- Clearly define what the company means by AI and how it could improve the company’s results of operations, financial condition, and future prospects.
- Provide tailored, rather than boilerplate disclosures, commensurate with AI’s materiality to the company, about material risks and the impact AI is reasonably likely to have on its business and financial results.
- Focus on the company’s current or proposed use of AI rather than generic buzz not relating to its business.
- Establish a reasonable basis for each claim when discussing AI prospects.

Gatekeeping. The proceedings against gatekeepers such as the AC chair and the CFO serve as warnings they need to:

- Conduct “meaningful” investigations of, and appropriately respond to, red or yellow flags.
 - Don’t rely on assurances from potentially conflicted officers or staff, even the CEO.
- Maintain transparency when communicating with independent auditors.
 - Don’t hide the ball on potentially material issues.
- Continually evaluate senior leadership and whether they establish a healthy tone and culture for the organization.

In the related [announcement](#), an SEC official stated: “This case should send an important signal to gatekeepers like CFOs and audit committee members that the SEC and the investing public expect responsible behavior when critical issues are brought to their attention.”

Regulatory focus on AI. This SEC focus on companies’ use and discussions about AI fits within the Department of Justice’s recent amendments to its Evaluation of Corporate Compliance Programs. See BCLP’s Sept. 30, 2024 alert: [DOJ Updates Criteria for Review of Corporate Compliance Programs, Emphasizing AI Issues](#) Those amendments called for companies to manage risks, both in their businesses and in their compliance programs, created by the use of AI.

DEEPER DIVE

Purported use of AI by investment advisor to perform automated trading

According to the [SEC Order](#):

Itai Liptz, owner and CEO of Rimar LLC and Rimar USA, with the help of Clifford Boro, a Rimar USA board member, raised nearly \$4 million from 45 investors in an offering of [SAFEs](#) in Rimar USA, representing potential future equity interests issuable upon achievement of certain trigger events.

The purpose of the offering was development of Rimar LLC, an investment adviser subsidiary of Rimar USA, that purported to use AI to perform automated trading for advisory client accounts in a range of products including equities, futures, and crypto assets.

False statements. According to the SEC, Liptz and Boro exaggerated the company's capabilities, misrepresenting Rimar LLC as having:

- An AI-driven platform for trading stock, crypto assets, and other products. But the firm had no trading application at all at the time of the offering and had never had a trading platform for stock or crypto assets.
- An extensive infrastructure of coders and data processing capabilities. But those operations belonged to unaffiliated entities in which neither the company nor its principals had any ownership interest.

Additionally, Liptz and Boro made misleading statements about the amount of assets under management and prior performance of their client accounts. Further, Liptz used a portion of the proceeds for personal expenses.

Violations and remedies. The SEC charged the conduct violated antifraud provisions of the Securities Act, the Exchange Act, and the Investment Advisers Act.

Without admitting or denying the findings, the defendants consented to the entry orders finding antifraud violations and to cease and desist from future violations. Liptz consented to pay disgorgement and prejudgment interest totaling \$213,611, to pay a \$250,000 civil penalty, and to be subject to an investment company prohibition and associational bar with the right to reapply in five years. Boro agreed to pay a \$60,000 civil penalty. Rimar LLC consented to be censured.

Start-up exaggerated the capabilities of humanoid AI robot and hologram assistant products

According to an [SEC Litigation Release](#):

False statements. From February 2022 through March 2023, Destiny Robotics Corp., an AI and robotics start-up company, and Megi Kavtaradze, its founder and CEO, raised \$141,000 from investors by claiming to be developing the world's first humanoid AI robot at-home assistant and companion for delivery by 2023. In truth, the robot would have been much less sophisticated and capable than what was described to investors and the company had no realistic prospect of

delivering the robot by 2023. The SEC also alleged that they falsely described Kavtaradze's qualifications and failed to disclose his personal relationship with the lead investor, while touting his endorsement of the company. Additionally, they failed to disclose that Kavtaradze used some investor funds for personal expenses.

Violations and remedies. The SEC charged the company and Kavtaradze with violating the antifraud provisions of the Securities Act. Without admitting or denying the allegations, the defendants consented to the entry of judgments which permanently enjoin them from violating the charges. In addition, Kavtaradze agreed to pay disgorgement of \$12,990 plus prejudgment interest of \$1,394.06, and a civil penalty of \$50,000.

AI-powered tool to detect fraud in the digital advertising industry misrepresented in IPO

According to SEC complaints filed against [Paul D. Roberts](#) and [Joshua A. Weiss](#) and [Grainne M. Coen](#):

False statements. Shortly before an IPO, Roberts, the chair, CEO, and president of Kubient, Inc., fabricated reports that the company had successfully tested its flagship product, "Kubient Artificial Intelligence," a software program that purportedly detected real-time fraud using AI during digital advertising auctions. As digital advertising is typically priced based on numbers of views, the software purported to detect when those views are not by humans but by software programs designed to inflate those numbers to increase the price of the advertising.

Roberts fabricated analyses for two customers as a beta test without actually obtaining their data to analyze. He then lied to the independent auditor about the revenue, which the company improperly recognized because it did not perform any services. The false reports allowed Kubient to recognize \$1.3 million in revenue, representing 94% of total revenue leading up to the IPO. The fraudulent revenue represented over 74% at the time of the secondary offering and approximately 45% for all of 2020.

Kubient raised approximately \$33 million in the two stock offerings using offering materials that touted the misrepresentations about the success of the tests and the revenue.

Gatekeeping failures. The SEC alleged that Weiss, the former CFO, and Coen, the former audit committee chair, failed as gatekeepers through inaction and omissions.

- On the launch date of Kubient's secondary stock offering, only four months after the IPO, an employee tried to notify both the CFO and AC chair that the tests had not been performed.
- Instead of investigating, the two discussed the issue with the CEO and outside counsel, with the CEO emailing the two customers and offering to retest their data. The customers

responded they were satisfied with the existing reports, which they didn't realize had been fabricated.

- The independent auditors were not notified about the issue.
- After the secondary offering, the Audit Committee met to discuss the issue but did not notify or invite the independent auditor.
- No minutes were prepared for that meeting and the company omitted it from the list of meetings provided to the independent auditor.

In addition, during the next audit, the CFO represented that the financials conformed with GAAP and that he was not aware of any risks of material misstatements. The AC Chair affirmed that the committee had no knowledge of any fraud or suspected fraud.

Violations and remedies. The SEC charged Roberts, Weiss, and Coen with violating the antifraud and other provisions of the federal securities laws and lying to auditors. The complaints seek injunctions, officer-and-director bars, disgorgement of ill-gotten gains, civil penalties, and other relief against each of the defendants.

In a partial settlement, Roberts consented to injunctions from future violations of the charged provisions while agreeing to litigate the appropriate remedies. In a parallel criminal matter, the U.S. Attorney's Office for the Southern District of New York [announced](#) charges against, and a guilty plea by, Roberts.

RELATED PRACTICE AREAS

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MEET THE TEAM



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