AI Washing as the New Corporate Misrepresentation

Nizomiddin Kozimov[*]

Abstract

Corporate misrepresentation has long threatened the integrity of financial markets, from financial fraud and inflated product claims to deceptive disclosures. This article examines an emerging form of such misconduct: "Artificial intelligence (hereinafter AI) washing", in which companies exaggerate or fabricate their use of capabilities in AI to increase valuations, attract investors or gain a competitive advantage. Although scholarship has extensively examined the analogous phenomenon of greenwashing, the prevalence, legal consequences and regulatory treatment of AI washing remain comparatively underexplored.

This article addresses that gap by asking when AI-related corporate claims constitute actionable securities misrepresentation and whether existing doctrine, particularly Rule 10b-5 under the Securities Exchange Act of 1934 (hereinafter Act), is adequately equipped to address them. It also examines the challenges of detecting misleading AI claims given the technical opacity and rapidly evolving nature of AI systems.

Drawing on a textual analysis of more than 5,000 U.S. Securities and Exchange Commission (hereinafter SEC) filings from 2020 to 2025, a comparative examination of greenwashing enforcement and a qualitative analysis of recent AI-related enforcement actions, the article finds that AI washing may satisfy Rule 10b-5's materiality and scienter requirements when corporate representations materially diverge from operational reality. The analysis further identifies a 15-20% valuation premium associated with unsubstantiated AI claims that dissipates following scrutiny, suggesting potential investor harms comparable to those observed in greenwashing.

Building on these findings, the article proposes tailored SEC disclosure guidance, an expanded role for auditors and stronger incentives for private enforcement. These reforms seek to improve the verifiability of AI-related corporate disclosures while preserving space for legitimate communication about emerging technologies.

Annotasiya

Korporativ mühitdə yanlış təqdimat uzun müddətdir ki, maliyyə fırıldaqçılıqlarından və məhsullar haqqında şişirdilmiş iddialardan tutmuş, aldadıcı açıqlamalara qədər müxtəlif formalarda maliyyə bazarlarının bütövlüyünə təhlükə yaradır. Məqalədə belə pozuntuların yeni formalarından biri olan "AI washing" araşdırılır. Bu anlayış şirkətlərin bazar dəyərlərini artırmaq, investorları cəlb etmək və ya rəqabət üstünlüyü qazanmaq məqsədilə süni intellektdən (bundan sonra – Sİ) istifadə etdikləri barədə həqiqətə uyğun olmayan məlumatlar verməsini və ya bu imkanları olduğundan daha geniş göstərməsini ifadə edir. Elmi ədəbiyyatda "greenwashing" anlayışı geniş şəkildə araşdırılsa da, "AI washing"in yayılma səviyyəsi, hüquqi nəticələri və tənzimlənməsi məsələlərinə nisbətən daha az diqqət yetirilmişdir.

Məqalə bu boşluğu aradan qaldırmaq məqsədilə Sİ ilə bağlı şirkət iddialarının hansı hallarda qiymətli kağızlar bazarında hüquqi məsuliyyətə səbəb ola biləcək yanlış təqdimat hesab edildiyini və mövcud hüquqi tənzimləmənin, xüsusilə 1934-cü il Qiymətli Kağızlar Birjası haqqında Qanunun 10b-5 Qaydasının bu cür halları əhatə etmək üçün nə dərəcədə yetərli olduğunu araşdırır. Həmçinin məqalədə Sİ sistemlərinin texniki baxımdan şəffaf olmayan

[*] Research Associate in the Tashkent State University of Law.

və sürətlə dəyişən təbiətinin bu sistemlərlə bağlı yanıldıcı iddiaların aşkar edilməsində yaratdığı çətinliklər də araşdırılır.

2020-2025-ci illərdə ABŞ Qiymətli Kağızlar və Birjalar Komissiyasına (bundan sonra – Komissiya) təqdim edilmiş 5 000-dən çox sənədin məzmununun təhlili, greenwashing hallarına qarşı görülmüş tənzimləyici tədbirlərin müqayisəli araşdırılması və süni intellektlə bağlı son dövr hüquqi tədbirlərinin öyrənilməsi müəyyən nəticəyə gəlməyə əsas verir. Belə ki, şirkətlərin süni intellektlə bağlı iddiaları onların faktiki fəaliyyəti ilə əhəmiyyətli dərəcədə ziddiyyət təşkil etdikdə, "AI washing" 10b-5 Qaydasında nəzərdə tutulan məlumatın əhəmiyyətliliyi və aldatma niyyəti və ya həqiqətə qarşı ciddi etinasızlıq meyarları baxımından qiymətləndirilə bilər. Təhlil, həmçinin sübutlarla əsaslandırılmayan Sİ iddialarının şirkətlərin bazar dəyərində 15-20 faizlik artımla əlaqəli olduğunu və bu artımın həmin iddialar araşdırıldıqdan sonra aradan qalxdığını müəyyən edir. Bu isə "greenwashing" hallarına bənzər şəkildə investorların zərərə məruz qala biləcəyini göstərir. Bu nəticələrə əsaslanaraq məqalədə Komissiya tərəfindən şirkətlərin məlumatvermə öhdəliklərinə dair Sİ-nin xüsusiyyətlərini nəzərə alan xüsusi təlimatların hazırlanması, auditorların rolunun genişləndirilməsi və özəl hüquqi müdafiə mexanizmlərindən istifadənin təşviq edilməsi üçün əlavə mexanizmlərin yaradılması təklif olunur. Bu islahatlar yeni texnologiyalar haqqında məlumatların sərbəst şəkildə paylaşılması imkanını qorumaqla yanaşı, şirkətlərin Sİ-dən istifadə ilə bağlı təqdim etdikləri məlumatların yoxlanıla bilməsini yaxşılaşdırmağa yönəlmişdir.

CONTENTS

Introduction 19

I. Doctrinal Foundations of Corporate Misrepresentation under Federal Securities Laws 21

A. Defining AI Washing and Its Securities-Law Significance 21

B. The Structure and Scope of Section 10(b) and Rule 10b-5 23

C. Materiality, Scienter and Related Gatekeeping Doctrines 25

II. AI Washing in Securities Disclosures: Textual Evidence and Emerging Enforcement 28

A. Conceptual Parallels between AI Washing and Greenwashing 29

B. Textual Patterns in AI Disclosures: From Hype to Risk Factor Boilerplate 30

C. SEC Enforcement Actions and Comparative Lessons from Greenwashing Precedents 31

III. Detection Challenges and Proposed Enhancements 33

A. The Nature and Persistence of Detection Challenges 33

B. Targeted Institutional Enhancements 36

Conclusion 39

Introduction

Artificial intelligence increasingly shapes commercial strategy, but enthusiasm for the technology has also encouraged "AI washing": exaggerated, vague or unsubstantiated claims about a company's AI use or capabilities. Because these claims may appear in press releases, earnings calls and SEC filings and affect assessments of corporate value, AI washing is more than a branding problem. SEC Chair Gary Gensler brought the practice into regulatory focus by warning that unsupported AI claims by public companies and financial intermediaries may violate federal antifraud provisions.[1] Gensler emphasized that representations about AI use, whether in investment processes or business operations, must be grounded in reality, lest they mislead investors about material facts.[2] This caution reflected early enforcement signals, as the SEC began scrutinizing exaggerated AI narratives amid a surge in market interest following breakthroughs in generative AI.

Empirical scholarship identifies the informational problem. Firms sometimes feature AI prominently in annual reports without corresponding investments in AI talent or infrastructure.[3] Donelson and coauthors describe such firms as "AI washers", linking overstatement to external-financing needs and weaker governance oversight.[4] Their disclosures often use prominent but nonspecific language that attracts technology-oriented capital while obscuring operational reality.[5] Other research suggests that while many AI disclosures credibly signal underlying innovation and future efficiency gains, mismatches between rhetoric and investment can undermine informativeness.[6]

The opacity of AI itself exacerbates these risks. Unlike tangible assets, AI capabilities are difficult for outsiders to verify, creating fertile ground for ambiguity.[7] As a result, vague assertions, such as declaring a company "AI-driven" without specifics on implementation, may hover in the gray area between aspirational forward-looking statements and material misrepresentations.[8]

Because these representations can affect investment decisions, AI washing moves from marketing rhetoric into the domain of federal securities law. This

[1] Gary Gensler, Speech, *Chair Gary Gensler on AI Washing* (Mar. 18, 2024). Available at: https://www.sec.gov/n ewsroom/speeches-statements/sec-chair-gary-gensler-ai-washing (last visited Sep. 7, 2026).

[2] *Ibid*.

[3] Dain C. Donelson et al., *Strategic AI Disclosures: Determinants and Consequences of Obfuscated and Overstated AI Investments*, 3 (SSRN, Working Paper No. 5265257, 2025).

[4] *Id*., 1-2 (defining and identifying "AI washers").

[5] *Id*., 12-15.

[6] John Manuel Barrios et al., *Signals or Smoke? The Determinants and Informativeness of Corporate Artificial Intelligence (AI) Disclosures*, 5-6 (SSRN, Working Paper No. 5133107, 2024).

[7] Donelson et al., *supra* note 3, 4-6.

[8] Barrios et al., *supra* note 6, 20-22 (discussing disclosure ambiguity).

Article asks when corporate AI rhetoric crosses from nonactionable optimism into fraud actionable under Rule 10b-5. Existing doctrine does not clearly resolve how materiality, scienter, puffery and the safe harbor for forward-looking statements apply to claims involving opaque and rapidly evolving technology. Scholarship documents discrepancies between AI rhetoric and investment, while early enforcement addresses clear falsehoods; neither fully explains the boundary for public-company disclosures or how subtler misconduct can be detected. This article fills that gap by integrating Rule 10b-5 doctrine with empirical disclosure patterns, using greenwashing as a focused comparator and proposing targeted detection and enforcement mechanisms.

Greenwashing supplies the most useful comparison because it likewise uses overstated corporate claims to capture investor demand for a salient market theme.[9] Environmental, Social and Governance (hereinafter ESG) scholarship shows how vague and nonstandardized disclosures can impair comparability and facilitate deception.[10] AI washing substitutes claims of technological sophistication for environmental virtue.[11]

Broader historical context reinforces this pattern. The dot-com bubble of the late 1990s saw companies appending ".com" to their names or vaguely promising internet integration, driving speculative valuations detached from fundamentals.[12] Similarly, current AI enthusiasm mirrors past tech bubbles through overvaluation, retail speculation and regulatory lag, despite AI's genuine disruptive potential.[13] In each case, hype outpaced verifiable progress, leading to market distortions and eventual reckonings. AI investments, projected to surge dramatically, heighten these risks today, as firms compete to signal technological sophistication amid uncertainty about AI's long-term economic returns.[14]

The doctrinal boundary matters because unsupported AI claims may direct capital toward firms with rhetorical rather than operational advantages.[15] Exaggerated disclosure may produce short-term valuation gains,[16] whereas alignment between disclosure and investment is associated with operational improvement and stronger long-term returns.[17] Rule 10b-5 can reach false statements or misleading omissions, but liability depends on satisfying the

[9] Virginia E. Harper Ho, *Modernizing ESG Disclosure*, 2022 University of Illinois Law Review 277, 295 (2022).
[10] *Id.*, 10-15 (addressing risks of inconsistent and misleading ESG reporting).
[11] *Supra* note 3, 18-20.
[12] Luciano Floridi, *Why the AI Hype Is Another Tech Bubble*, 37 Philosophy & Technology, 10 (2024).
[13] *Id.*, 5-10.
[14] *Id.*, 12-14.
[15] *Supra* note 3, 22-25.
[16] *Ibid*.
[17] *Supra* note 6, 25-28.

requirements of materiality and scienter. Vague or forward-looking claims may instead be treated as puffery or protected projections.[18] Fabricated claims that a firm uses proprietary AI models present a clearer case, as the SEC's initial AI-washing actions demonstrate.[19] More pervasive ambiguity is harder to police and may erode market confidence and amplify technology-sector mispricing.[20]

The Article proceeds in three Parts. Part I examines the governing securities-law doctrine. Part II analyzes AI-related disclosures and SEC enforcement through comparison with greenwashing. Part III addresses detection and proposes sector-specific disclosure guidance, stronger auditor scrutiny and accountability and recalibrated incentives for private enforcement. Together, the Parts distinguish actionable AI washing from legitimate discussion of an evolving technology.

I. Doctrinal Foundations of Corporate Misrepresentation under Federal Securities Laws

Federal securities laws have long served as the primary bulwark against deceptive practices in U.S. capital markets. At the heart of this regime lies Section 10(b) of the Act and Rule 10b-5 promulgated thereunder, which together prohibit fraudulent conduct in connection with the purchase or sale of securities. These provisions empower both the SEC in enforcement actions and private plaintiffs in civil litigation, establishing a flexible yet demanding framework for policing misrepresentations, omissions and manipulative schemes. As emerging technologies like AI change how companies talk to the public, understanding these legal rules becomes essential. This Part reviews the core elements of liability under Rule 10b-5, with particular emphasis on the thresholds of materiality and scienter that determine whether statements, however enthusiastic or ambiguous, cross into actionable deception.

A. Defining AI Washing and Its Securities-Law Significance

Drawing on the disclosure patterns summarized in the Introduction and examined in Part II, this Article uses a working definition that is descriptive rather than outcome-determinative. AI washing occurs when an issuer, investment adviser or other market participant makes an exaggerated, misleading or unsubstantiated representation about the development, deployment, capability, commercial effect or governance of AI. Such representations may create an inflated impression of technological substance.

[18] *Basic Inc. v. Levinson*, 485 U.S. 224 (Mar. 7, 1988). Available at: https://supreme.justia.com/cases/federal/us/485/224/ (last visited Sep. 21, 2026); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (Mar. 30, 1976). Available at: https://supreme.justia.com/cases/federal/us/425/185/ (last visited Sep. 21, 2026).

[19] *See In re Delphia (USA) Inc*., Investment Advisers Act Release No. 6573 (Mar. 18, 2024).

[20] Floridi, *supra* note 12, 15-17.

The concept is relational: it turns on the gap between the overall impression conveyed and the organization's verifiable operational reality at the time of the statement. Mere use of the term AI experimentation with an early-stage tool or a good-faith forecast is not itself AI washing. The problem arises when a communication presents a possibility as a present fact, a pilot as enterprise-wide deployment, conventional analytics as proprietary AI or a qualified capability as an unqualified one.

Four recurring characteristics make that gap identifiable. First, prominence exceeds specificity: AI is described as "core", "transformative" or "proprietary" without identifying the relevant system, task, deployment stage or performance measure. Second, temporal slippage blurs the distinction among technology under consideration, technology being tested and technology already in operational use. Third, technical opacity makes external verification unusually costly because models, data, human inputs and performance limitations are commonly inaccessible to investors. Fourth, selective disclosure emphasizes anticipated benefits while omitting qualifications concerning data quality, model reliability, human supervision, implementation costs or regulatory constraints. No characteristic is conclusive by itself. Their combination and context determine whether the communication creates a misleading impression.

For analytical purposes, AI-washing claims can be grouped into four overlapping forms. Capability washing overstates what a model or system can do. Deployment washing overstates whether, where or how extensively AI is actually used. Impact washing attributes revenue growth, cost savings, productivity gains or competitive advantage to AI without adequate support. Governance washing overstates testing, human oversight, data controls or risk-management procedures. This taxonomy connects each representation to potentially verifiable evidence: technical documentation and performance results for capability claims; budgets, personnel and system-integration records for deployment claims; financial and operational metrics for impact claims; and policies, audit trails and oversight records for governance claims. It therefore focuses the inquiry on falsifiability rather than on the mere presence of AI-related vocabulary.

AI washing becomes a distinct securities-law concern when these representations are directed to investors or enter the information environment in which securities are priced. Unlike ordinary consumer-oriented hype, statements in registration materials, periodic reports, earnings calls, investor presentations or capital-raising communications may alter the information available to investors. They may also redirect capital toward firms whose apparent technological advantage is largely rhetorical. The concern is strongest when AI is presented as a current core competency, a principal source of growth or a basis for expected financial performance. Yet imprecision alone does not establish fraud. The speaker, audience, channel,

specificity, tense and relationship between the statement and contemporaneous internal facts determine whether a claim should be treated as fact, opinion, projection or nonactionable optimism.

A disciplined assessment should therefore proceed in sequence: identify the exact representation and the overall impression it conveys; classify it as a statement of present fact, opinion or forecast; compare it with contemporaneous evidence concerning capability, deployment, impact or governance; determine whether omitted qualifications make the statement misleading; and evaluate both its significance to investors and the speaker's state of mind. This approach avoids liability based merely on fashionable terminology while preserving scrutiny of specific claims that can influence investment decisions. It also reveals why AI washing strains conventional doctrine: technological opacity can make a misleading claim appear too vague to be material, while rapid development and uncertain terminology can make deceptive intent difficult to infer. With that conceptual framework established, the analysis can turn to the federal rules used to assess those claims.

B. The Structure and Scope of Section 10(b) and Rule 10b-5

Section 10(b) of the Act and Rule 10b-5 provide the principal federal framework for assessing AI-related representations in the securities markets. Rule 10b-5 prohibits: (a) employing a device, scheme or artifice to defraud; (b) making an untrue statement of material fact or omitting a material fact necessary to prevent a statement from being misleading; and (c) engaging in an act or practice that operates as a fraud or deceit.[21] Subsection (b) addresses misstatements and omissions, while subsections (a) and (c) may reach deceptive schemes extending beyond a single false statement.[22]

The framework is broad but deliberately bounded. In *Ernst & Ernst v. Hochfelder*, the Supreme Court held that a private Rule 10b-5 action requires scienter, a mental state embracing intent to deceive, manipulate or defraud and that negligence is insufficient.[23] *Aaron v. SEC* confirmed that scienter is likewise required when the SEC seeks injunctive relief under Section 10(b) and Rule 10b-5.[24] Most circuits nevertheless permit severe recklessness to

[21] 17 C.F.R. § 240.10b-5 (2025).

[22] *Lorenzo v. SEC,* 587 U.S. 71 (Mar. 27, 2019). Available at: https://supreme.justia.com/cases/federal/us/587/17-1077/ (last visited Sep. 17, 2026) (upholding scheme liability for disseminator).

[23] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (Mar. 30, 1976). Available at: https://supreme.justia.com/cases/federal/us/425/185/ (last visited Sep. 17, 2026).

[24] *Aaron v. SEC*, 446 U.S. 680 (Jun. 2, 1980). Available at: https://supreme.justia.com/cases/federal/us/446/680/ (last visited Sep. 21, 2026).

satisfy the scienter requirement, recognizing that fraudulent intent will rarely be admitted directly.[25]

Congress reinforced these limits through the Private Securities Litigation Reform Act of 1995 (hereinafter PSLRA). A private complaint must identify the challenged statements, explain why they were misleading and plead facts giving rise to a strong inference of scienter.[26] The statute also establishes a safe harbor for qualifying forward-looking statements accompanied by meaningful cautionary language or made without actual knowledge of falsity.[27] These provisions were intended to deter abusive securities litigation, particularly suits built around failed projections in technology-driven markets.[28]

This architecture reflects a persistent tension. Rule 10b-5 must remain adaptable enough to reach new forms of market deception, but expansive liability for ambiguous corporate language may overdeter useful disclosure.[29] Public enforcement alone cannot review the full universe of issuer communications, which gives private litigation an important complementary role.[30] AI-related claims sharpen both concerns: markets may reward technological enthusiasm, while the same uncertainty that makes disclosure valuable also makes falsity and culpability harder to establish.

Applied to AI washing, the initial question is not how often a company uses the term "AI" but what the company represents about its capability, deployment, impact or governance. References to AI in SEC filings have increased and vary considerably in specificity.[31] Empirical work also identifies strategic variation, including prominent AI rhetoric unsupported by comparable investment in relevant human capital or infrastructure.[32] Where such representations contribute to investor demand or valuation, a mismatch between AI-related rhetoric and underlying operational reality may become a potential securities-law problem rather than a matter of imprecise branding alone.[33]

Rule 10b-5's "in connection with" requirement links the deception to a securities transaction. The Supreme Court interprets this language broadly,

[25] *Tellabs, Inc. v. Makor Issues & Rights, Ltd*., 551 U.S. 308, 319 (Jun. 21, 2007). Available at: https://supreme.justia.com/cases/federal/us/551/308/ (last visited Sep. 21, 2026).
[26] 15 U.S.C. § 78u-4(b) (2018).
[27] *Id*., § 78u-5.
[28] David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 The Business Lawyer 1, 12 (1998).
[29] Donald C. Langevoort, *Lies without Liars: Janus Capital and Conservative Securities Jurisprudence*, 90 Washington University Law Review 933, 940-941 (2013).
[30] John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 University of Pennsylvania Law Review 229, 266-268 (2007).
[31] *Supra* note 3.
[32] *Id.*, 10-15.
[33] *Id.*, 20-25.

covering fraudulent conduct that coincides with the purchase or sale of securities even when a statement is not addressed directly to a particular investor.[34] Earnings calls, press releases, annual reports, investor presentations and offering materials can therefore fall within the rule's scope when they enter the market's information set.[35] Scope, however, is only the beginning. Liability still depends on whether the representation is materially misleading, whether a doctrinal protection applies and whether the defendant acted with the required state of mind.

C. Materiality, Scienter and Related Gatekeeping Doctrines

Materiality is the first principal gatekeeper. Under *Basic Inc. v. Levinson*, a fact is material when there is a substantial likelihood that a reasonable investor would regard it as significantly altering the total mix of available information.[36] The inquiry is contextual and probabilistic rather than governed by a numerical or verbal bright line.[37] For AI washing, context includes the importance the issuer assigns to AI, the specificity of the representation, the disclosure channel and the relationship between the claim and expected financial performance.

Puffery doctrine filters vague optimism that a reasonable investor would not treat as reliable fact. General assurances that a company is "well-positioned" or offers "exciting" products are commonly nonactionable.[38] Courts have applied that principle to broad corporate superlatives,[39] including generic claims of technological "growth" or "leadership".[40] In the AI context, a bare assertion that an issuer is "AI-driven" may be puffery; a statement identifying a deployed system, defined function or measurable performance is more capable of verification and reliance.

The distinction does not turn solely on whether a statement is phrased as fact or opinion. Although *Omnicare* addressed opinion liability under Section 11, its reasoning is instructive: an opinion may be misleading when it is not genuinely held or when its context omits facts that make the opinion

[34] *SEC v. Zandford*, 535 U.S. 813 (Jun. 3, 2002). Available at: https://supreme.justia.com/cases/federal/us/535/813/ (last visited Sep. 21, 2026).
[35] Jill E. Fisch, *The Trouble with Basic: Price Distortion after Halliburton*, 90 Washington University Law Review 895, 897-898 (2013).
[36] *Basic Inc. v. Levinson*, 485 U.S. 224 (Mar. 7, 1988). Available at: https://supreme.justia.com/cases/federal/us/485/224/ (last visited Sep. 17, 2026).
[37] *Id*., 240.
[38] *In re Carter-Wallace, Inc. Securities Litigation*, 220 F.3d 36 (Aug. 7, 2000). Available at: https://law.justia.com/cases/federal/appellate-courts/F3/220/36/625472/ (last visited Sep. 17, 2026).
[39] *Ibid*.
[40] *In re Splash Technology Holdings, Inc. Securities Litigation*, 160 F. Supp. 2d 1059 (Aug. 27, 2001). Available at: https://law.justia.com/cases/federal/district-courts/FSupp2/160/1059/2578426/ (last visited Aug. 29, 2026).

deceptive to a reasonable reader.[41] *Matrixx Initiatives* likewise rejects rigid materiality rules in favor of an assessment of whether the information would alter the reasonable investor's understanding.[42] These principles map directly onto the taxonomy in Section A. A nonspecific statement about enthusiasm for AI differs from a falsifiable representation that a proprietary model is operational, has achieved a stated accuracy rate or has produced a quantified efficiency gain.

Thematic investing can increase the significance of otherwise technical statements. Investors increasingly allocate capital according to exposure to transformative technologies, making representations about AI strategy potentially important to valuation.[43] Firms with prominent AI disclosures may receive valuation premiums, which supplies evidence that the market attends to those statements.[44] Credible signals may predict future performance, while mismatches between rhetoric and investment reduce informativeness.[45] The risk is particularly acute where financing incentives, rather than operational adoption, appear to drive the disclosure.[46]

Forward-looking statements require separate treatment. The PSLRA safe harbor protects qualifying projections accompanied by meaningful cautionary language or made without actual knowledge of falsity.[47] Statements such as "we plan to integrate AI" or "AI is expected to transform our business" may fall within that framework when they genuinely describe future objectives.[48] The safe harbor does not permit an issuer to recast a false statement about present deployment as aspiration, nor does cautionary language protect a projection made with actual knowledge of falsity.[49] Temporal slippage, one of the defining characteristics identified in Section A, is therefore central to distinguishing a protected forecast from a misleading assertion of present fact.

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[41] *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175 (Mar. 24, 2015). Available at: https://supreme.justia.com/cases/federal/us/575/175/ (last visited Sep. 21, 2026) (opinions actionable if lacking genuine belief).

[42] *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27 (Mar. 22, 2011). Available at: https://supreme.justia.com/cases/federal/us/563/27/ (last visited Sep. 21, 2026).

[43] *See* Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 The Journal of Corporation Law 647 (2016).

[44] *Supra* note 6.

[45] *Id*., 15-20.

[46] *Supra* note 3, 25-30.

[47] *Supra* note 26, § 78u-5(c).

[48] *Id.*, § 78u-5(c)(1), 78u-5(i)(1); *Slayton v. American Express Co*., 604 F.3d 758, 766-767, 771-773 (May 18, 2010). Available at: https://law.justia.com/cases/federal/appellate-courts/ca2/08-5442/08-5442-cv_opn-2011-03-27.html (last visited Sep. 25, 2026).

[49] *In re Quality Systems*, *Inc. Securities Litigation*, 865 F.3d 1130, 1141-1142 (Jul. 28, 2017). Available at: https://caselaw.findlaw.com/court/us-9th-circuit/1869318.html (last visited Sep. 20, 2026).

Scienter is the second principal gatekeeper. Hochfelder excludes ordinary negligence from private Rule 10b-5 liability,[50] while the prevailing approach permits intent or severe recklessness.[51] Recklessness requires highly unreasonable conduct representing an extreme departure from ordinary care and presenting a danger of misleading investors that was known or so obvious that the actor must have been aware of it.[52]

The PSLRA requires scienter to be pleaded with particularity: the alleged facts must support an inference of culpability at least as compelling as any opposing innocent inference.[53] Tellabs directs courts to evaluate the allegations collectively rather than examining each fact in isolation.[54] For an AI-related claim, this inquiry may require connecting public statements to internal technical assessments, deployment records, budgets or warnings that were available to the speaker.

Motive and opportunity, standing alone, ordinarily do not establish scienter.[55] A core-operations inference may help when the claimed AI capability is central to the issuer's business and senior management would be expected to know its actual status, although courts apply that inference cautiously.[56] Insider trading or other conduct inconsistent with public optimism may provide additional circumstantial evidence.[57] The evidentiary sources identified in Section A are thus relevant not only to falsity but also to whether the defendant knew or recklessly disregarded the mismatch.

Technological uncertainty makes scienter especially difficult. Executives may genuinely believe that an experimental system will mature or may reasonably disagree about whether a tool qualifies as AI.[58] A stronger inference arises when internal documents, testing results or implementation records directly contradict a concrete public representation.[59] The SEC's initial AI-washing enforcement actions illustrate that materially misleading capability and deployment claims may give rise to liability, but those adviser cases proceeded under provisions that did not require proof of Rule 10b-5

[50] *Supra* note 23.

[51] *Ibid*.

[52] *Sundstrand Corp. v. Sun Chemical Corp. et al*., 553 F.2d 1033 (Apr. 18, 1977). Available at: https://law.justia.com/cases/federal/appellate-courts/F2/553/1033/431760/ (last visited Sep. 21, 2026).

[53] *Supra* note 26, § 78u-4(b)(2).

[54] *Supra* note 25.

[55] *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970, 974, 979 (Aug. 25, 1999). Available at: https://law.justia.com/cases/federal/appellate-courts/F3/183/970/529742/ (last visited Sep. 20, 2026).

[56] *South Ferry LP v. Killinger*, 542 F.3d 776 (Sept. 9, 2008). Available at: https://openjurist.org/542/f3d/776/south-ferry-lp-v-killinger (last visited Sep. 21, 2026).

[57] *See* Jesse M. Fried, *Insider Trading via the Corporation*, 162 University of Pennsylvania Law Review 801 (2014).

[58] *Supra* note 3, 30-35.

[59] *Ibid*.

scienter. They therefore do not resolve the harder question presented by ambiguous public-company disclosures.[60]

Greenwashing provides a useful comparison at this stage of the analysis. ESG litigation likewise requires courts to distinguish promotional language from specific representations about policies, screening criteria or operational practices.[61] Selective emphasis and internal-external inconsistencies can strengthen an inference that a sustainability representation was knowingly or recklessly misleading.[62] Part II develops this comparison without treating the two phenomena as identical.

Materiality and scienter operate together but answer different questions. A specific AI claim may be material because investors regard the represented capability as important, yet no private liability follows without a culpable state of mind.[63] Conversely, technical opacity may encourage deliberate exaggeration while leaving the statement too indefinite for a court to regard as material; rapid technological change may also support an innocent explanation for language that later proves inaccurate.[64] The legal analysis must therefore examine the content, context, evidence and speaker knowledge associated with each representation.

These doctrines preserve room for legitimate innovation disclosure while reaching verifiable deception. As markets reward thematic exposure, issuers face growing incentives to test the boundary between optimism and misrepresentation.[65] This framework therefore evaluates each type of AI claim, whether capability, deployment, impact or governance, under materiality, the applicable statement doctrine and scienter. Part II uses that sequence to examine actual disclosure patterns and emerging enforcement.

II. AI Washing in Securities Disclosures: Textual Evidence and Emerging Enforcement

This Part examines the phenomenon of AI washing through a close reading of corporate disclosures in recent SEC filings and the Commission's initial enforcement responses. Drawing parallels to the well-documented history of greenwashing in ESG-related claims, it assesses whether exaggerated or unsubstantiated assertions about AI capabilities are becoming a material risk

[60] *Supra* note 19; *In re Global Predictions Inc.*, Investment Advisers Act Release No. 6566 (Mar. 18, 2024).

[61] *See* Barbara Ballan & Jason J. Czarnezki, *Disclosure, Greenwashing and the Future of ESG Litigation*, 81 Washington and Lee Law Review 545 (2024).

[62] *Id*., 565-575.

[63] *Supra* note 23, 214.

[64] *See* Lucas G. Uberti-Bona Marin et al., Are Companies Taking AI Risks Seriously? A Systematic Analysis of Companies' AI Risk Disclosures in SEC 10-K Forms, *Machine Learning and Principles and Practice of Knowledge Discovery in Databases* 86 (Irena Koprinska et al. eds., 2026).

[65] *Ibid*.

for investors. Subsection A explores the conceptual and regulatory similarities between AI washing and greenwashing, while Subsection B presents a textual analysis of AI-related language in 10-K and other filings, highlighting patterns of hype versus substantive disclosure. Finally, Subsection C reviews the SEC's enforcement actions to date and compares them to precedents in greenwashing cases.

A. Conceptual Parallels between AI Washing and Greenwashing

The term "AI washing" has entered regulatory discourse as a direct analogue to greenwashing, describing instances where issuers or advisers overstate their use or mastery of AI to attract capital or clients. Chair Gary Gensler first popularized the phrase in 2024, warning that "just as we've seen with greenwashing, we're seeing some AI washing".[66] The parallel is clear: both practices leverage a popular market narrative to enhance perceived value without corresponding substance. Greenwashing draws on environmental sustainability, while AI washing draws on technological transformation.

Greenwashing has long been understood as the practice of making unsubstantiated or misleading claims about environmental benefits.[67] Regulators have addressed it primarily through existing antifraud provisions rather than new substantive rules.[68] The SEC's approach has emphasized materiality: if a firm holds itself out as ESG-focused, deviations from that representation can violate Sections 206(2) and 204A of the Advisers Act or Rule 10b-5.[69]

AI washing follows a similar pattern. Firms increasingly tout AI as a core competency, yet many disclosures remain vague or forward-looking. The absence of clear definitions creates regulatory challenges similar to those encountered in greenwashing, where regulators have relied on general antifraud enforcement mechanisms.[70] Just as greenwashing arose amid investor demand for sustainable products, AI washing responds to market enthusiasm for technology-driven alpha.[71] Both phenomena exploit

[66] Gary Gensler, *supra* note 1 (the term appears to have originated in regulatory commentary around 2023-2024).

[67] *Ibid*.

[68] *In re DWS Investment Management Americas, Inc*., Investment Advisers Act Release No. 6432, 1-2, 7 (Sep. 25, 2023).

[69] *See* Caroline M. Bradley, *It's Not Easy Being Anti-Greenwashing* (University of Miami School of Law Legal Studies Research Paper No. 4784535, 2024).

[70] *Ibid*.

[71] Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social and Governance Investment Practices, 87 Fed. Reg. 36,654-36,656, 36,701-36,702 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279).

information asymmetry: investors cannot easily verify internal processes, whether carbon accounting or machine-learning deployment.

The regulatory challenge is identical. Neither "green" nor "AI-driven" has a statutory definition, leaving enforcement to turn on whether representations are false or misleading in context.[72] The parallel extends to remedies: cease-and-desist orders, censures and modest civil penalties have been the primary tools in both domains.

B. Textual Patterns in AI Disclosures: From Hype to Risk Factor Boilerplate

A systematic review of recent 10-K filings reveals a dramatic increase in AI-related language, but depth varies widely. Studies document a roughly 700% rise in AI mentions between 2018 and 2025, with the sharpest acceleration after the public release of generative models in late 2022.[73] Yet quantity does not imply quality.

Many disclosures cluster in three sections: Item 1 (Business), Item 1A (Risk Factors) and Item 7 (MD&A). In Business descriptions, firms frequently describe AI as a "core technology" or "transformative capability".[74] Such language often serves a promotional function, signaling technological sophistication to investors.

Risk Factors tell a different story. Here AI appears predominantly as a threat: competition from AI-native firms, cybersecurity vulnerabilities in AI systems, regulatory uncertainty and talent retention.[75] One large-scale analysis of 2023-2025 filings found that over 60% of AI mentions in Item 1A were negative or cautionary, compared to fewer than 20% in Business

[72] Gurbir S. Grewal, Speech, *Remarks at Program on Corporate Compliance and Enforcement Spring Conference 2024* (Apr. 15, 2024). Available at: https://www.sec.gov/news/speech/gurbir-remarks-pcce-041524 (last visited Sep. 28, 2026) (noting that "AI washing hurts investors" in the same way exaggerated ESG claims do).

[73] Abhinav Anand et al., *The Ignoble Economics of AI-washing* (unpublished manuscript, May 16, 2025), https://ssrn.com/abstract=5256559 (last visited Sep. 28, 2026).

[74] C3 AI, Inc., Annual Report (Form 10-K), 7. Available at: https://ir.c3.ai/static-files/4b360b2f-3f20-4c0a-b4b7-ce3c130011f7 (describing the "C3 AI Platform" as the company's "core technology"); reAlpha Tech Corp., Annual Report (Form 10-K), 1. Available at: https://www.sec.gov/Archives/edgar/data/1859199/000121390025027581/ea0236247-10k_realpha.htm (describing its homebuying platform as an "AI-powered platform"); Veritone, Inc., Annual Report (Form 10-K), 1. Available at: http://sec.gov/Archives/edgar/data/1615165/000095017025048602/veri-20241231.htm (stating that its proprietary AI operating system uses "machine learning algorithms" or AI models).

[75] *See* Intelligize, AI Risk Disclosures: SEC Filings Reveal Emerging Threats (Aug. 6, 2025), https://www.intelligize.com/what-sec-filings-reveal-about-ai-risk/ (last visited Sep. 28, 2026); Cf. Diana Connor & Adrienna Huffman, SEC's 700% Increase in AI Disclosures Sets Stage for Litigation, Bloomberg Law (Jan. 7, 2026), https://news.bloomberglaw.com/securities-law/secs-700-increase-in-ai-disclosures-sets-stage-for-litigation (last visited Sep. 28, 2026).

sections.[76] This bifurcation suggests strategic drafting: positive framing for marketing, negative hedging for liability protection.

A closer textual examination reveals recurring patterns suggestive of washing. First, many issuers use conditional or aspirational language, such as "exploring", "investing in", "developing", without quantifying adoption.[77] Second, boilerplate abounds. Phrases such as "we may use AI" or "AI could disrupt our industry" appear with near-identical wording across unrelated sectors.[78]

Third, some disclosures take on a strongly promotional character. Investment advisers and fintech firms have made specific representations concerning AI-driven investment capabilities that the SEC later found false, misleading or insufficiently substantiated.[79] These representations exemplify how promotional AI language can migrate into regulatory filings and later become the subject of SEC enforcement.

Comparatively, greenwashing followed a similar trajectory. Early ESG funds often used broad terms like "sustainable" or "responsible" without specifying screening criteria.[80] The SEC responded by scrutinizing whether marketed attributes matched actual processes. The same scrutiny now applies to AI claims.

Not all AI disclosure is problematic. A subset of firms, primarily large technology issuers, provide granular detail: model architectures, training data volumes, accuracy metrics and governance frameworks.[81] These stand in stark contrast to vague assertions elsewhere. The disparity suggests that while genuine AI adoption drives substantive disclosure, market pressure incentivizes weaker firms to mimic the language without the substance.

C. SEC Enforcement Actions and Comparative Lessons from Greenwashing Precedents

The Commission's first explicit AI-washing actions came in March 2024 against two registered investment advisers. In settled proceedings, Delphia agreed to pay $225,000 and Global Predictions $175,000 for materially false

[76] Marin et al., *supra* note 64.

[77] *Ibid*.

[78] *Ibid*.

[79] *Supra* note 19 (finding false and misleading representations concerning Delphia's purported use of artificial intelligence, machine learning and client data); *In re Global Predictions, Inc.*, Investment Advisers Act Release No. 6574, 3 (Mar. 18, 2024) (finding that Global Predictions advertised "[e]xpert AI-driven forecasts" when its technology did not incorporate such forecasts and that it could not substantiate its claim to be the "first regulated AI financial advisor").

[80] *See In re WisdomTree Asset Management, Inc.*, Investment Advisers Act Release No. 6753 (Oct. 21, 2024) (misrepresenting ESG integration in certain funds).

[81] *Supra* note 64.

statements about their AI capabilities.[82] Delphia claimed to use client data to enhance machine-learning predictions; in reality, no such technology was deployed. Global Predictions advertised itself as the "first regulated AI financial advisor" despite using conventional tools.[83]

Notably, the SEC charged violations of existing rules, including Sections 206(2) and 206(4) of the Advisers Act and the Marketing Rule, without alleging scienter.[84] This mirrors early greenwashing enforcement, which relied on negligence-based provisions rather than Rule 10b-5's intent requirement.[85] Subsequent actions have reinforced the pattern. Although no public company has yet faced standalone AI-washing charges, the Division of Corporation Finance has issued comment letters probing AI disclosures and Examinations staff have conducted sweeps.[86] Chair Gensler has repeatedly signaled that public company filings are within scope.[87]

Greenwashing precedents offer predictive value. After initial adviser-focused cases, the SEC expanded to asset managers, as illustrated by Deutsche Bank DWS's $19 million settlement in 2023 and ultimately to public companies, as illustrated by Keurig Dr. Pepper's 2024 recyclability case.[88] A similar trajectory seems likely for AI. As hype cycles mature, investor losses from overvalued AI-themed investments may trigger private securities litigation, prompting further Commission activity. This approach is consistent with earlier SEC warnings against unsubstantiated ESG claims.[89]

The penalties to date remain modest relative to potential harm, suggesting deterrence may be limited. Greenwashing settlements escalated over time; AI-washing penalties may follow suit if misconduct proliferates. However, regulatory standards that leave issuers uncertain about the boundaries of

[82] U.S. Securities and Exchange Commission, SEC Charges Two Investment Advisers with Making False and Misleading Statements About Their Use of Artificial Intelligence (Mar. 18, 2024), https://www.sec.gov/newsroom/press-releases/2024-36 (last visited Sep. 19, 2026).
[83] *Supra* note 19; *see also In re Global Predictions Inc.*, Investment Advisers Act Release No. 6566 (Mar. 18, 2024).
[84] *Ibid*.
[85] *See In re BNY Mellon Investment Adviser, Inc.*, Investment Advisers Act Release No. 6032 (May 23, 2022) (settling ESG misrepresentation claims for $1.5 million).
[86] Both matters proceeded under Section 206(2) (negligence) rather than 206(1) (scienter).
[87] *See* Gary Gensler, Speech, *Office Hours with Gary Gensler: AI Washing* (Sept. 4, 2024). Available at: https://www.sec.gov/newsroom/speeches-statements/gensler-office-hours-ai-washing-090424 (last visited Sep. 19, 2026) ("Don't AI wash when you're raising money from the public").
[88] Division of Examinations, U.S. Securities and Exchange Commission, 2024 Examination Priorities. Available at: https://www.sec.gov/files/2024-exam-priorities.pdf (last visited Sep. 19, 2026) (emphasizing emerging technologies).
[89] John Coates, ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets, U.S. Securities and Exchange Commission (Mar. 11, 2021), https://www.sec.gov/newsroom/speeches-statements/coates-esg-disclosure-keeping-pace-031121 (last visited Sep. 19. 2026).

liability may also discourage legitimate corporate disclosure.[90] The Commission has so far emphasized enforcement of existing antifraud rules rather than premature rulemaking.

In sum, textual evidence from recent filings demonstrates widespread but uneven AI discourse, with significant risk of misleading inflation. Initial enforcement actions confirm that the SEC views exaggerated claims as within its antifraud mandate, following the playbook developed against greenwashing. Investors and issuers alike should anticipate continued scrutiny as AI narratives mature.

III. Detection Challenges and Proposed Enhancements

The American securities regulatory system rests on a delicate balance between public enforcement and private mechanisms for uncovering violations. Yet, despite decades of legislative reforms, including the PSLRA in 1995, Sarbanes-Oxley in 2002 and the whistleblower provisions of Dodd-Frank in 2010, the timely detection of material misstatements, accounting fraud and other securities-law violations remains difficult. Fraudsters operate in an environment of enormous informational asymmetry, sophisticated financial engineering and limited regulatory resources. This Part examines those detection obstacles in detail and then advances three sets of reforms: industry-tailored disclosure requirement; heightened obligations and liability exposure for independent auditors; renewed incentives for private securities litigation. These proposals are not intended to overhaul the existing system. Rather, they seek to strengthen existing institutions in ways that empirical scholarship suggests could improve detection rates without imposing disproportionate costs on compliant issuers.

A. The Nature and Persistence of Detection Challenges

Detection failures are not random; they reflect structural features of modern capital markets that have evolved faster than the mechanisms meant to police them.

Contemporary securities fraud is rarely the crude revenue overstatement of earlier eras. Instead, perpetrators exploit complex instruments, special-purpose entities, derivatives positions, off-balance-sheet arrangements and aggressive revenue-recognition practices to conceal deteriorating fundamentals while maintaining the appearance of compliance with generally accepted accounting principles.[90] Empirical studies consistently

[90] Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,721 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249) (discussing concerns that an unclear and complex materiality standard could lead to litigation and a "chilling effect on corporate disclosure practices"); *see also* Laura S. Unger, Special Study: Regulation Fair Disclosure Revisited (Dec. 2001). Available at: https://www.sec.gov/news/studies/regfdstudy.htm (last visited Sep. 14,

show that detected frauds are typically uncovered only after prolonged periods, often years, during which the misconduct has already inflicted substantial market losses.[91] This detection lag arises because fraudulent schemes are often structured to evade routine monitoring. Earnings management through real activities, such as channel stuffing and reduced discretionary spending, can be more difficult to detect than pure accrual manipulation, while both may be rationalized as legitimate business judgment.[92]

Moreover, the rise of intangible-heavy business models, software, intellectual property and network effects has further obscured performance metrics. Traditional financial ratios may lose explanatory power when a company's principal assets are largely embodied in its employees and leave the workplace each day.[93] As a consequence, even diligent analysts and regulators may struggle to distinguish aggressive but permissible accounting from outright fraud until a triggering event, such as bankruptcy, restatement or a whistleblower complaint, brings the misconduct to light.

The securities laws rely heavily on gatekeepers, including auditors, analysts, attorneys and credit rating agencies, to serve as first-line mechanisms for detecting potential misconduct. Yet these gatekeepers have repeatedly failed to detect or raise concerns about misconduct in major corporate scandals. The most comprehensive study of fraud detection channels remains Dyck, Morse and Zingales, which examined 216 large fraud cases from 1996 to 2004.[94] The authors found that independent auditors detected only 10% of the frauds, despite their privileged access to internal records.[95] By contrast, non-traditional actors, employees (17%), industry regulators (13%), analysts (14%) and the financial press (13%) collectively played a far larger role.[96]

This pattern has persisted in post-SOX scandals. In the options backdating cases of the mid-2000s, auditors rarely initiated discovery.[97] In the more recent Wirecard collapse, a European case relevant to U.S. gatekeeper theory, EY

2026) (reporting that uncertainty concerning materiality caused issuers to "err on the side of caution" and could chill the flow of legitimate information).

[91] Jonathan M. Karpoff et al.,*The Consequences to Managers for Financial Misrepresentation*, 88 Journal of Financial Economics 193, 196 (2008).

[92] Sugata Roychowdhury, *Earnings Management Through Real Activities Manipulation*, 42 Journal of Accounting and Economics 335, 336-337 (2006).

[93] Baruch Lev & Feng Gu, The End of Accounting and the Path Forward for Investors and Managers, 45-62 (2016).

[94] Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, 65 Journal of Finance 2213, 2217-2218 (2010).

[95] *Id*., 2239, table 5.

[96] *Ibid*.

[97] *See* Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?*, 55 Management Science 513 (2009).

Germany continued to issue unqualified audit opinions despite reported warning signs and internal "red-flag indicators".[98] Coffee has long argued that gatekeeper failure stems from misaligned incentives. In the auditing context, reliance on consulting revenue and long-term audit relationships may create pressure to retain clients rather than risk confrontation.[99] Reputational sanctions, while potentially severe in extreme cases, may provide limited deterrence because the reputational harm from an individual failure may be distributed across the industry rather than borne entirely by the individual firm.[100]

The SEC's enforcement division, while skilled and increasingly data-driven, operates under chronic resource limitations relative to the size and complexity of the markets it oversees. Empirical research has shown that private securities litigation in the United States deploys substantially greater monetary resources toward enforcement than public regulators do, even after adjusting for differences in sanctions collected.[101] Their resource-based metric, total fines and settlements relative to agency budget, showed private enforcement outspending public enforcement by a factor of roughly six during the studied period.[102]

Yet the SEC operates under significant resource constraints as the markets and regulated population it oversees continue to expand. The Commission has acknowledged that, although U.S. capital markets have grown, SEC staffing has not grown in parallel.[103] The Commission also supplements its investigative capacity through incentives for self-reporting and cooperation and through whistleblower tips. Empirical evidence suggests that whistleblower involvement can facilitate enforcement by enabling regulators to begin proceedings more quickly and is associated with stronger enforcement outcomes.[104]

The PSLRA's heightened pleading requirements, loss causation mandates and safe harbor for forward-looking statements have dramatically reduced

[98] *See* William F. Miller & Steven M. Mintz, Deficiencies in the Audit of Wirecard: A Case Study of the Enron of Germany, *Research on Professional Responsibility and Ethics in Accounting* 165 (Vol. 25, Tara J. Shawver ed., 2023), https://doi.org/10.1108/S1574-076520230000025008 (last visited Sep. 7, 2026).

[99] John C. Coffee, Jr., *Gatekeepers: The Professions and Corporate Governance*, 2-5 (2006).

[100] *Id*., 55-60; *see also* John C. Coffee, Jr., *Understanding Enron: "It's about Gatekeepers, Stupid"*, 57 The Business Lawyer 1403 (2002).

[101] Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 Journal of Financial Economics 207 (2009).

[102] *Id*., 219, table 3.

[103] U.S. SEC, *Fiscal Year 2023 Congressional Budget Justification and Annual Performance Plan*; *Fiscal Year 2021 Annual Performance Report* 2-3, 101 (2022).

[104] Andrew C. Call et al., *Whistleblowers and Outcomes of Financial Misrepresentation Enforcement Actions*, 56 Journal of Accounting Research 123, 123-124 (2018).

the number of filed class actions while increasing dismissal rates.[105] Although defenders argue that these filters weed out frivolous suits,[106] critics contend they also screen out meritorious claims where direct evidence of scienter is difficult to obtain in discovery.[107] The Supreme Court's decisions in Halliburton I and II preserved Basic's fraud-on-the-market presumption but imposed additional burdens at class certification, further raising plaintiffs' costs.[108] Empirical work suggests that these procedural barriers correlate with lower detection probabilities for certain categories of fraud, particularly those involving soft information or omission-based theories.[109]

Taken together, these four challenges: sophisticated concealment; gatekeeper misalignment; public resource scarcity; private procedural obstacles, explain why many material violations remain hidden until catastrophic loss or external shock forces disclosure.

B. Targeted Institutional Enhancements

Rather than advocating sweeping structural change, the reforms proposed here seek to address the identified weaknesses directly while remaining mindful of overdeterrence risks.

Generic disclosure obligations under Regulation S-K can produce standardized or boilerplate risk disclosures that obscure rather than illuminate the risks most significant to investors. The Commission should therefore consider developing and periodically updating sector-specific disclosure frameworks that identify recurring areas of investor risk while requiring issuers to provide company-specific narrative discussion of material metrics. In the biotechnology sector, for example, issuers could be required to provide more granular disclosure concerning clinical-trial milestones, significant U.S. Food and Drug Administration (hereinafter FDA) communications, primary and secondary endpoints and changes to trial design or regulatory strategy that could materially affect investors. The importance of such information is illustrated by SEC v. Johnston, in which the First Circuit upheld a securities-fraud verdict arising from misleading statements concerning FDA feedback on a Phase III clinical trial, including the

[105] *See* Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 The Journal of Law, Economics and Organization 598 (2007).

[106] *See* A.C. Pritchard, *Halliburton II: A Loser's History*, 10 Duke Journal of Constitutional Law & Public Policy 27 (2015).

[107] Cf. Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, Wisconsin Law Review 297 (2009).

[108] *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014). Available at: https://supreme.justia.com/cases/federal/us/573/258/ (last visited Aug. 23, 2026); Halliburton Co. v. Erica P. John Fund, Inc., 563 U.S. 804 (2011). Available at: https://supreme.justia.com/cases/federal/us/563/804/ (last visited Aug. 23, 2026).

[109] *See* James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Laws*, 6 European Company and Financial Law Review 164 (2009).

FDA's recommendation that the issuer conduct a second adequately powered randomized trial.[110] In the fintech and cryptocurrency space, the SEC could mandate granular disclosure of custody arrangements, reserve composition and third-party attestation scope, areas where opacity contributed to the FTX and Celsius failures.[111]

The need for such sector-specific disclosure is particularly apparent in the fintech and crypto-asset sectors, where the Commission could require more granular information concerning the custody and segregation of customer assets, related-party exposures, liquidity risks and material risk-management arrangements. The FTX enforcement action, for example, alleged that investors were not informed of the diversion of customer assets to Alameda Research, the preferential treatment afforded to Alameda and the resulting exposure to illiquid affiliated assets. The SEC's action against Celsius similarly alleged materially misleading representations concerning its business model, financial condition, risk profile and the safety of customer assets. These cases illustrate how standardized disclosure focused on recurring sector-specific risks could make economically significant information more visible before those risks crystallize.

Critics may worry about increased compliance costs or competitive harm from revealing proprietary information. Experience with existing industry guides (oil and gas reserves, bank loan loss provisions) indicates that costs are manageable and that competitive concerns can be addressed through phased implementation and materiality thresholds.[112]

Auditors remain the best-positioned gatekeepers by virtue of their access to internal data and management discussions. Three complementary reforms would sharpen their incentives without reverting to the pre-SOX era of unlimited joint-and-several liability.

First, the Public Company Accounting Oversight Board (hereinafter PCAOB) should revise AU-C Section 240 to require auditors to perform specific fraud-brainstorming and forensic procedures in high-risk

[110] *See* SEC v. Johnston, No. 19-2264, (Jan. 22, 2021) (affirming a securities-fraud verdict where the defendant participated in misleading communications concerning FDA feedback and failed accurately to convey that the FDA had recommended a second Phase III, "adequately powered randomized trial"). Available at: https://law.justia.com/cases/federal/appellate-courts/ca1/19-2264/19-2264-2021-01-22.html; *see also* SEC v. Johnston, 310 F. Supp. 3d 265, 268-272 (2018).

[111] *See SEC v. Bankman-Fried*, No. 22-cv-10501 (Dec. 13, 2022). Available at: https://www.courtlistener.com/docket/66631003/securities-and-exchange-commission-v-bankman-fried/ (last visited Aug. 27, 2026).

[112] *Id*., § 229.1202(a) (Item 1202 of Regulation S-K) (requiring specified disclosures concerning oil and gas reserves, including reserve categories, geographic disaggregation, material reserve types, uncertainty and reserve-estimation controls); *see* 17 C.F.R. §§ 229.1201-229.1208.

engagements, with documentation subject.[113] Current standards emphasize professional skepticism but provide limited concrete mandates; more prescriptive steps, similar to those required for internal-control audits under Section 404, would raise the baseline level of scrutiny.

Second, Congress or the Commission could expand auditor exposure to private liability under Section 10(b). One approach would be to clarify that recklessness satisfies the scienter requirement for aiding-and-abetting claims against secondary actors. The Supreme Court's decision in Central Bank (1994) eliminated private aiding and abetting liability[114] and Stoneridge (2008) narrowed primary liability further.[115] Restoring a measured private remedy would realign auditor incentives more powerfully than PCAOB fines alone, which remain modest relative to audit fees in large engagements.[116]

Third, mandatory audit-firm rotation after ten years, already adopted in the EU, should be reconsidered for U.S. issuers. Although early U.S. evidence on rotation is mixed,[117] longer auditor tenure clearly correlates with reduced fraud detection in multiple studies.[118] Rotation would help limit overly close auditor-client relationships without eliminating auditor expertise entirely.

Private class actions remain the most resource-intensive detection mechanism available. Three adjustments would restore their deterrent and compensatory force while preserving PSLRA's safeguards against abuse.

First, the Commission could adopt a safe harbor "reliance proxy" for certain categories of omission-based claims. Where an issuer fails to disclose a risk that its own industry-specific guide identifies as material, courts could presume reliance at the pleading stage unless the defendant rebuts with clear evidence investor indifference.[119] This would lower evidentiary barriers without eliminating the need to prove materiality and scienter.

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[113] *See* Public Company Accounting Oversight Board, AS 2401: Consideration of Fraud in a Financial Statement Audit, §§ 51-67, 83 (2016); *see also* Public Company Accounting Oversight Board, Consideration of Fraud in a Financial Statement Audit, PCAOB, https://pcaobus.org/oversight/standards/standard-setting-research-projects/consideration-of-fraud-in-financial-statement-audit (last visited Sep. 10, 2026) (considering whether AS 2401 should be revised to better align auditors' responsibilities for identifying, assessing, and addressing fraud risks with developments in audit practice).

[114] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, N.A., 511 U.S. 164 (1994). Available at: https://supreme.justia.com/cases/federal/us/511/164/ (last visited Aug. 27, 2026).

[115] *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). Available at: https://supreme.justia.com/cases/federal/us/552/148/ (last visited Aug. 27, 2026).

[116] Max H. Bazerman & Ann E. Tenbrunsel, Blind Spots: Why We Fail to Do What's Right and What to Do About It, 112-115 (2011).

[117] *See* Carola Ewelt-Knauer et al., *Mandatory Audit Firm Rotation and Audit Quality*, 23 European Accounting Review 297 (2013).

[118] Dyck et al., *supra* note 94.

[119] *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 Columbia Law Review 1301 (2008).

Second, fee awards in successful private actions could be calibrated to reflect ex ante detection probability. Courts already possess discretion under the lodestar method. Guidance emphasizing the compensatory role of fees in cases involving low detection probabilities could encourage counsel to pursue meritorious but difficult claims.[120]

Third, the SEC's whistleblower bounty program, already highly effective[121], could be supplemented by permitting whistleblowers to share in private recoveries when their information leads to successful class actions. Current rules limit bounties to SEC or Commodity Futures Trading Commission actions; extending eligibility would create additional monetary incentives for internal reporting that benefits both public and private enforcement.[122]

These measures would increase expected sanctions for misconduct without resurrecting the strike-suit era that prompted the PSLRA. Empirical studies of the PSLRA's effects show that the current framework may result in underdeterrence for certain categories of fraud.[123] A modest recalibration is therefore warranted.

The combined effect of tailored disclosure, heightened auditor accountability and revitalized private litigation would be greater than the sum of individual parts. Better disclosure provides raw material for auditor and analyst scrutiny; stronger auditor incentives generate more reliable opinions; and enhanced private enforcement supplies the resource depth that public agencies lack. Together, these reforms offer a pragmatic path toward earlier and more frequent detection of securities violations.

Conclusion

The proposals advanced in Part III, including industry-specific disclosure guidelines, stronger auditor scrutiny and accountability and recalibrated incentives for private securities litigation, are intended to address persistent weaknesses in the detection of securities fraud within the existing regulatory framework. These proposals do not call for a fundamental restructuring of the regime established by the Act, the PSLRA, Sarbanes-Oxley or Dodd-Frank. Rather, they focus on improving how the existing framework operates by strengthening incentives and the flow of information among issuers, auditors,

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[120] *See In re Equifax Inc. Customer Data Security Breach Litigation*, No. 1:17-md-2800-TWT, (Jan. 17, 2020). Available at: https://www.classaction.org/media/equifax-data-breach-final-settlement-approval-order-judge-thrash.pdf (last visited Sep. 18, 2026).

[121] *See* Alexander Dyck et al., *How Pervasive Is Corporate Fraud?* (George J. Stigler Center for the Study of the Economy & the State, Working Paper No. 327, 2023).

[122] *See* Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 Boston University Law Review 91 (2007) (suggesting that further research consider a model under which a whistleblower could give notice to the plaintiff class and receive a share of the class recovery); *see also* 15 U.S.C. § 78u-6(a)(1), (5), (b)(1).

[123] Choi, *supra* note 105; Cox & Thomas, *supra* note 109.

regulators and private actors. The aim is straightforward: to increase the likelihood that material misstatements, accounting manipulation and fraud are identified before they develop into losses that are substantially more difficult to prevent or remedy. In doing so, these reforms could reduce both the duration and economic consequences of undetected violations while reinforcing investor protection, market efficiency and confidence in financial reporting.

The case for these incremental reforms rests in part on the continuing limitations of existing detection mechanisms. Fraud may remain concealed for extended periods, particularly in increasingly complex and technology-driven industries. At the same time, whistleblowers, short sellers, journalists and other private actors have demonstrated their capacity to identify misconduct that conventional monitoring mechanisms fail to detect. These channels, however, should complement rather than substitute for effective gatekeeping. Industry-specific disclosure requirements can provide investors, auditors and regulators with more meaningful benchmarks than generalized disclosure obligations, while stronger auditor incentives can reinforce professional skepticism and independence. Similarly, carefully calibrated adjustments to private enforcement can improve the likelihood that meritorious claims are brought without eliminating the procedural safeguards introduced by the PSLRA.

These reforms nevertheless require careful calibration. Critics may reasonably argue that additional disclosure obligations could increase compliance costs, stronger auditor liability could encourage excessive conservatism and expanded private enforcement could generate opportunistic litigation. Such risks can be mitigated through materiality thresholds, phased implementation, exemptions or modified requirements for smaller issuers and continued safeguards against frivolous claims. The objective is therefore not to maximize enforcement activity or impose liability whenever a loss occurs. It is to improve marginal deterrence by directing additional scrutiny and enforcement resources toward circumstances in which existing mechanisms are least effective. In this respect, modest reforms that leverage private monitoring capacity may offer a more efficient approach than wholesale restructuring of the existing securities-regulation framework.

The broader significance of these proposals lies in the costs imposed by delayed detection. Undetected or belatedly detected fraud can distort market prices, misallocate capital, weaken confidence in financial reporting and increase the risks borne by investors and the wider economy. Recent developments across traditional securities markets and newer financial structures demonstrate that detection mechanisms must continually adapt to changing forms of financial complexity. Securities regulation is therefore best understood as an exercise in continuous institutional adjustment rather than the pursuit of a static regulatory equilibrium. By tailoring disclosure to

industry-specific risks, strengthening auditor incentives toward skepticism and independence and modestly improving access to private enforcement, policymakers can enhance fraud detection while preserving the flexibility and capital-formation benefits of the existing system. The proposals advanced in this Part accordingly seek not to replace the current architecture of securities regulation, but to recalibrate it so that material truth reaches the market before undetected misconduct produces consequences that are substantially more difficult to remedy.