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WHITE PAPER

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SEC Enforcement in Financial Reporting and Disclosure—2018 Mid-Year Update

Chairman Jay Clayton's vision for the Securities and Exchange Commission has largely shaped the first half of 2018, with policies and initiatives focused on the "main street investor" and combating clear cases of outright fraud. The number of highly technical and complex accounting and auditing enforcement actions continues to decline, but the robust control environments that companies have designed and implemented over the past several years continue to be as important today as they have ever been. In addition, corporate leaders should be aware of the SEC's evolving posture with respect to cybersecurity disclosures, whistleblower reports, and standards of professional conduct for broker-dealers.

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We are pleased to present our mid-year review of enforcement activity relating to financial reporting and issuer disclosures. As we have done in our prior mid-year updates, this review highlights key developments relating to the Securities and Exchange Commission ("SEC") for the first half of the year, with an eye toward emerging trends to watch for the remainder of 2018 and beyond.

Having completed a full year under the leadership of Chairman Jay Clayton, the SEC continues to tout its renewed emphasis on the "main street investor" or "Mr. and Ms. 401k." In its officials' speeches and publications, the SEC has reiterated the importance of: (i) ensuring that investors can get the information they need to make safe investment decisions; (ii) creating and enforcing standards of conduct for investment professionals that benefit retail investors; and (iii) having in place effective enforcement tools to accomplish these objectives. These guiding principles have been apparent in the SEC's activities with respect to blockchain technologies, equity market structure, shareholder engagement, the cost of financial services, the value of regulation, and changing standards of professional conduct.

Additionally, as highlighted in our prior issue, the enforcement environment now focuses less on technical accounting and disclosure issues (which frequently involve complex questions of accounting, finance, and management judgment) and more on clear-cut instances of fraud and misconduct. There remains, however, a clear emphasis on holding individual actors (company officers and auditors) accountable, although there is some reason to believe that the aggressive use of officer and director bars, and bars from appearing as an accountant before the Commission, may no longer be viewed as a requirement in every action. Nevertheless, statements by SEC officials echo the importance of these individuals' roles in preparing and submitting accurate financial statements, as well as the critical role of ongoing training and literacy for management and auditors alike.[1]

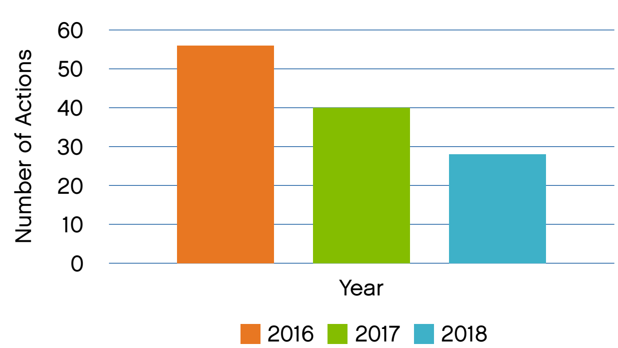
Public companies and their leadership should continue to evaluate investigative risks as they pertain to financial reporting and internal control effectiveness. The robust control environments that companies have designed and implemented over the past several years continue to be as important today as they have ever been.

2018 ENFORCEMENT REVIEW

The SEC's aggressive pursuit of complex accounting and auditing cases has continued to decrease, with only 27 actions brought in the first half of 2018, as compared to 56 actions brought in 2016 in the same timeframe. Chairman Clayton has made clear that enforcement actions now focus on the most "vulnerable members of the investing public" and on schemes such as "microcap 'pump and dump' frauds, Ponzi schemes, and the sales of unsuitable complex products."[2] Commissioner Peirce has likewise commented that in comparison to prior regimes, enforcement today should be: (i) less numbers-driven; (ii) more resource-conscious; (iii) more in line with larger strategic initiatives set forth by the Commission; (iv) more conscious of due process and constitutional concerns; and (v) more attentive to the types of penalties imposed. In fact, Commissioner Peirce's more measured philosophy toward enforcement has her voting against Enforcement Division recommendations at a 15 percent rate, which is higher than any other Commissioner's.[3]

In line with Commissioner Peirce's sentiments, Division of Enforcement Co-Director Steve Peikin has discussed ways for defense counsel and their clients to make the pre-enforcement Wells process more productive. Such considerations include a narrowed focus on key issues, less litigious negotiating tactics, and more thoughtful use of cooperation credits.[4]

Accounting and Auditing Enforcement Releases[5] **over First Half of Year**



Although the total number of actions and the accounting complexity of these cases has declined, the SEC continues to bring cases for improper professional conduct, improper revenue recognition, internal controls violations, overstatement of assets, and failure to comply with generally accepted accounting principles ("GAAP") or Public Company Accounting Oversight Board ("PCAOB") standards. Below is a recap of notable actions brought by the SEC in the first half of 2018.

Financial Reporting and Issuer Disclosure Matters

- The SEC brought settled actions against a public energy storage and power delivery company and three of its executives—the company's chief executive officer, corporate controller, and senior vice president of sales—arising from an alleged accounting fraud scheme whereby the executives improperly recognized more than $19 million in revenue from future quarters to inflate the company's sales so they would better align with analysts' expectations. Specifically, the SEC claimed that the company recognized revenue that was neither fixed nor determinable, in violation of GAAP. The company allegedly engaged in several tactics to prematurely record revenue and thus inflate sales, such as: "customer side deals with contingent payment terms and full right of return; channel stuffing; extending payment terms; falsifying purchase orders and third-party confirmations; and by instructing certain distributors to order product they neither wanted nor needed at quarter-end." Further, the company purportedly did not have sufficient internal accounting controls to identify and properly account for its revenue. This resulted in the accounting department ignoring and missing red flags that should have alerted them to departures in their material revenue. The SEC's settlement included a cease and desist order, a $2.8 million civil penalty for the company, a director and officer bar for the senior vice president of sales, and various monetary penalties for the officers.[6]

- The SEC brought actions against six accountants of a public accounting firm, two of whom were former PCAOB accountants, for the use of unauthorized, confidential information relating to the PCAOB's inspection program to benefit themselves and the firm. According to the SEC, a former PCAOB employee took sensitive inspections documents to the firm to use as a resource in his new job when he was recruited to serve in their Professional Practice group. He then allegedly elicited inspection planning information, inspection guides and manuals, and drafts of confidential inspection comment forms. This information was purportedly used by the firm, which had previously experienced audit deficiency findings, to prepare for PCAOB audits and inspections and to alert the firm of planned inspections. Further, the SEC alleged that three partners at the firm encouraged the sharing of this confidential information with various colleagues and an outside contractor so that the company could implement revisions to documents to avoid deficiency findings by the PCAOB. The former PCAOB employee who accepted a role in the Professional Practice group settled the action with the SEC, which ordered the employee to cease and desist from further violations of the PCAOB Ethics Code, denied the employee the privilege of appearing or practicing before the SEC, and scheduled a hearing to determine whether disgorgement or civil penalties are necessary. The claims against the other accountants remain pending.[7]

- The SEC brought a settled action against a public accounting firm's South African branch for improper conduct while auditing a Canadian corporation and the accounting firm's Zimbabwe branch, which was not registered with the PCAOB. The SEC alleged that the South African firm claimed in its financial statements that it had conducted its audits of the Canadian corporation in compliance with the standards of the PCAOB, but the firm failed to make an inquiry under AU 543[8] into the professional reputation and independence of the Zimbabwe branch and to follow up with the branch when it discovered the firm was not registered with the PCAOB. The South African branch was censured, required to cease and desist from further violations of Rule 2-02 of Regulation S-X, and received a civil penalty of $100,000. The Zimbabwe branch was ordered to cease and desist from further violations of the Sarbanes-Oxley Act § 102 and ordered to pay disgorgement of $129,410 with prejudgment interest amounting to $11,895.33.[9]

- In a related action, the SEC brought a settled action against a private accounting firm's Zimbabwe branch for its role in the auditing of a Canadian corporation without being registered with the PCAOB. The SEC alleged that the Zimbabwe firm prepared audit reports after auditing most of the corporation's revenue for six years without being registered with the PCAOB under U.S. securities laws and PCAOB rules. The SEC found the branch in violation of the

Sarbanes-Oxley Act § 102 and ordered the firm to cease and desist from further violations and to pay disgorgement of $83,077.84 and prejudgment interest of $15,979.50.[10]

- In another related action, the SEC brought a settled action against a public Canadian accounting firm for improper conduct while auditing a Canadian corporation. The SEC claimed that the firm's use of work from another independent auditor—the private accounting firm located in Zimbabwe—failed to comply with the PCAOB's auditing standards. Further, the SEC alleged that the firm failed to perform an analysis under AU 543 to determine whether it could serve as the corporation's principal auditor and use the work of the independent auditor when that independent auditor played a substantial role in the preparation of the audit. The SEC ordered the firm to cease and desist from violating Rule 2-02 of Regulation S-X, censured the firm, and ordered the firm to pay a $50,000 civil money penalty.[11]

- The SEC settled an action against the CEO of a Las Vegas-based hemp oil company for inflating the company's assets on its balance sheet. The SEC alleged that the company materially overstated its total assets in quarterly reports for the first and second quarters of 2013 by reporting its purchase of another hemp-related company for $35 million, even though the CEO knew that the purported purchase price was substantially inflated. The complaint alleged that the company agreed to the purported purchase only because it could pay for the acquisition primarily with its own shares, which the CEO believed to have little value at the time. The CEO was permanently enjoined from future violations of the Exchange Act and was ordered to pay a $40,000 civil money penalty and to reimburse the company $10,000.[12]

- The SEC brought a settled action against a large accounting firm for improper professional conduct while performing the audit of a fund. According to the SEC, the schedule of investments contained in the auditor's report failed to separately record the fair value of the oil and gas royalty interests held by the fund, as required by GAAP. The complaint states that the firm did not use adequate procedures during the audit, took steps to conceal that fact, improperly delegated tasks, and failed to review required paperwork. The SEC censured the firm and imposed remedial sanctions including an internal review and evaluation of all the firm's work, mandatory training, and reporting to the SEC Enforcement Division.[13]

- The SEC brought a settled action against a small accounting firm and its president for improper professional conduct while acting as the accountant and auditor of a public company. The SEC alleged that the president of the company made unauthorized withdrawals of $457,058 and executed a $250,000 backdated promissory note to himself. The accountant and firm were allegedly aware of this practice, facilitated the execution of the promissory note, and did not consult with the board regarding the president's actions. Furthermore, the complaint stated that the company's Forms 10-Q and 10-K for that year and the two following years made misleading and false representations as to the president's compensation, the date of the promissory note, and the president's ability to pay it back. The SEC enjoined the accounting firm from further violations of various sections of the Securities Act and barred the firm and the accountant from practicing before the SEC. The SEC also disgorged $22,500 from the firm and the accountant, plus prejudgment interest of $2,643, and imposed a civil money penalty of $45,000 on both, jointly and severally.[14]

- The SEC brought a settled action against a pharmaceutical company, its former CFO, and former controller based on violations of financial reporting, books and records, and internal accounting controls. The complaint stated that the company had material weaknesses in its internal controls surrounding the company's gross-to-net reserve accounts and estimates during 2014. In 2016, the company allegedly restated its financial statements and disclosed that such weaknesses had resulted in a 7 percent overstatement of the company's net revenue and a 136 percent overstatement of income. The complaint also identified the CFO and controller as having supervisory responsibility over such controls and charged them with control-person liability. The company consented to a permanent injunction from further violations of various sections of the Exchange Act, and each individual agreed to pay a $20,000 civil money penalty.[15]

- The SEC brought a settled action against one of the world's largest internet media companies for allegedly failing to disclose a massive breach of its user database in its public filings for nearly two years. According to the SEC, the company learned of a 2014 data breach affecting more than 500 million of its user accounts that resulted in the theft, unauthorized access, and acquisition of users' data. The company allegedly made materially misleading statements in its annual and quarterly reports when it claimed that it faced risk only from future data breaches, when one had already occurred. The SEC alleged that, in connection with a proposed sale of its operating business, the company made affirmative representations denying the existence of any significant data breaches. When the company did disclose the data breach, its stock price decreased by 3 percent, and the proposed purchase price decreased by 7.25 percent. The company was permanently enjoined from violating various laws and ordered to pay a civil money penalty of $35 million.[16]

- The SEC brought a settled action against the former CEO of an energy company for "hiding more than $10 million in personal loans that he obtained from company vendors and a candidate for [the company's] board." According to the SEC's complaint, the former executive extracted $7.5 million in loans from a vendor in exchange for business contracts, as well another $3 million loan from a portfolio manager who was appointed to the company's board weeks after issuing the loan. Furthermore, the SEC alleged that the CEO received executive compensation in the form of first-class travel, legal expenses for personal matters, and donations to preferred charities. None of these loans or executive compensation perks were publicly disclosed. As part of the settlement, the CEO must pay a $180,000 penalty and is barred from serving as an officer or director for five years.

- In a related matter, the SEC also brought settled actions against the individual board member for failure to disclose the loan to the CEO and investment adviser that allegedly put in place an activist plan to place the individual on the board.[17] In its complaint, the SEC alleged that the board member failed to disclose the loan with the CEO and any conflicts of interest that would compromise the candidate's independence as a board member. The SEC also claimed that the investment adviser "could no longer certify that it was a passive investor in [the issuer's] securities and, therefore, was no longer eligible to rely on Rule 13d-1(c) to report its beneficial ownership in a Schedule 13G filing" and failed to file a Schedule 13D until 45 days after it incurred an obligation to do so. As part of its settlement, the board member must pay a $100,000 penalty, and the investment adviser must pay a $160,000 penalty.[18]

- The SEC brought a settled action against the administrative services provider of a manufactured housing company for violating Exchange Act Rule 14e-2 by failing to respond to a tender offer. Specifically, the SEC alleged that the manufactured housing company received three tender offers between 2007 and 2016, and the administrative services provider failed to respond to the offers by filing a Schedule 14D-9 or providing the information required by a Schedule 14D-9 through any other means. The SEC claimed that the administrative service provider's failure caused the company to violate Exchange Act Rule 14e-2. As part of the settlement, the service provider will pay a $50,000 civil penalty to the SEC.[19]

- The SEC brought a settled action against a global engineering and construction company for allegedly inflating its "backlog" metrics. According to the SEC's press release, the company "improperly included $459 million in its publicly disclosed backlog for a pipe fabrication and modular assembly contract in Canada, even though [the company] had not actually received—and the counterparty was not obligated to provide—any orders under the contract." In addition to the alleged overstatement, the SEC also claimed that the company had deficient accounting controls and made books and records violations. The company was ordered to pay a $2.5 million civil penalty.[20]

- The SEC brought a settled action against a major manufacturer for failing to disclose certain executive perquisites in its annual proxy statements. Specifically, the SEC alleged that the company failed to "ensure that approximately $3 million in executive perquisites were adequately evaluated and disclosed as 'other compensation' in the Compensation Discussion & Analysis (CD&A) section of the annual proxy statements." Such benefits included personal use of company aircraft, among other expenses. Furthermore, the SEC claimed that company policy did not follow or properly implement the Commission's standard for when to disclose an executive benefit. The settlement requires the company to retain an independent consultant to monitor the company's policies and disclosures relating to perquisities, as well as pay a $1.75 million civil penalty. [21]

- The SEC bought a settled actions against a plastic pipe and drainage manufacturer and its CFO for materially misstating its financial results following its IPO in 2013. The SEC specifically claimed that the company overstated its income before taxes by 20 percent, 5 percent, and 90 percent in three consecutive years. Furthermore, the SEC noted the CFO's alleged role in these misstatements, alleging that the CFO "directed or approved unsupported journal entries to inventory, cost of goods sold, and other accounts that resulted in overstated Company earnings." As a result of these purported violations, the company will pay a civil penalty of $1 million, and the CFO will pay a $100,000 penalty and is barred from practicing before the SEC as an accountant.[22]

- The SEC brought a settled action against a telecommunications equipment manufacturer and three of its executives (CEO, CFO, and director of contract fulfillment and sales operations) for allegedly inflating reported revenues in the company's Middle East, Africa, and Europe regions in the fourth quarter of 2012 and first quarter of 2013. According to the SEC, the defendants improperly recognized revenue "despite entering into undisclosed side agreements that relieved customers of payment obligations" and inflated "unit prices of products to hit revenue targets with the agreement that [the company] would subsequently repay the inflated amounts to the customer as marketing development fees." Altogether, the SEC claims that the revenue was "overstated by 66 percent in the fourth quarter of 2012 and 38 percent in the first quarter of 2013." The settlement, which has not yet been approved, contemplates civil monetary penalties between $10,000 and $40,000 as well as officer and director bars for the CFO and CEO.[23]

A FOCUS ON DECREASED REGULATION

Over the past several months, we have observed a change in the regulatory environment as it pertains to small company capital formation through IPOs. Several SEC Commissioners have publicly identified various root causes for the scarcity of small-company IPOs, from an excessive Middle Market IPO tax to limited access to the benefits to Regulation A.[24] In addition, the Treasury recently issued a report[25] stating that cost of securities litigation is one of the reasons for fewer IPOs, which has sparked discussion of whether the SEC should begin allowing companies to bind investors to mandatory arbitration of post-IPO disputes.[26]

Several Commissioners have also commented on what they perceive as a burdensome regulatory environment. For example, Commissioner Peirce consistently advocates for more streamlined regulation with less onerous compliance mandates in order to reduce the cost of financial instruments, increase participation in the market, and improve clarity of rules. She argues that the SEC should undertake a review of its regulations and consider whether the SEC should be regulating at all in each area.[27] She opposes Dodd-Frank and increased auditor attestation of internal controls for small companies, advocates dedicating resources to domestic issues while limiting international regulatory alignment efforts, and supports decreasing the length and complexity of disclosures and investor information.[28]

Prior to his departure, Commissioner Piwowar also advocated for decreasing the regulatory burden for small companies and opposed the formulation of a new fiduciary-duty standard for investment advisors as being derived solely from common law and therefore outside the authority of the SEC.[29]

One of the concrete measures undertaken in this arena was the SEC's rollback of the Volcker Rule by amending the Dodd-Frank Act.[30] The Volcker Rule prohibited banks from using customer deposits for certain types of speculative investments.[31] Commissioner Peirce and Chairman Clayton viewed the Volcker Rule as imposing an exceedingly complex regulatory framework.[32] They believed the new amendments are tailored to the size and risk profile of various firms and provide greater clarity and simplicity.[33]

REACHING THE "MAIN STREET" INVESTOR

The focus on the "main street" investor has prompted various goals and initiatives from the SEC, including the following:

- **Transaction Fee Pilot Program**. The SEC is considering a program to gather data to help "meaningfully analyze the effects of exchange fees and rebates on order routing behavior, execution quality, and … market structure generally."[34] According to Chairman Clayton, the aim is for the data to enable the

SEC to make more informed and data-driven regulatory decisions to better serve all retail investors.

- **Public Reporting of Fund Liquidity Information**. The SEC adopted a new rule amending Forms N-PORT and N-1A by rescinding "the requirement that certain open-end funds disclose aggregate liquidity classification information about their portfolios."[35] The new requirement instead compels the disclosure of information surrounding a fund's liquidity risk management programs and how effective they are. Furthermore, the rule amends Form N-PORT "to require reporting of holdings of cash and cash equivalents."[36]

- **Share Class Selection Disclosure Initiative Program**. The SEC announced this program to address harm to investors caused when investment advisers put their clients into higher-fee mutual fund share classes when lower- or no-fee classes are available. The goal of the new program, which is being run by the SEC's Asset Management Unit, is to return as much money to harmed investors as soon as possible. The program, which had a deadline of June 12, 2018, sought to incentivize self-reporting by offering standardized settlement terms that would result in disgorgement, or the return of money, to impacted investors with no penalties assessed against the self-reporting firm.

- **Proposed Elimination of Dual-Class Ownership Structures**. Commissioners Stein and Jackson have stated that dual-class ownership structures are "undemocratic" and protect managers from the discipline of the market.[37] Rather than permit dual-class ownership perpetually, Commissioner Jackson has asked that the SEC consider a rule that would set standards for sunset provisions to better empower and engage shareholders.[38]

- **Enhanced Accounting and Disclosure Standards**. This year, companies will also have to adhere to various other accounting and disclosure standards intended to enhance the information available to investors, including: (i) new revenue recognition standards issued by FASB and IASB; (ii) income tax reform passed in December 2017; and (iii) enhanced communication requirements relating to stock held in other companies. The Commission has also commented on the role of non-GAAP measures in supplementing and providing investors and auditors with "useful information regarding how management monitors performance and can facilitate analysis."[39] In addition, at least one report suggests that SEC enforcement officials are investigating whether companies are subtly bumping up earnings results, with the SEC seeming to rely on research suggesting that the number "4" appears at an abnormally low rate in the tenths place of companies' earnings-per-share numbers.[40] If true, this is likely the work of the Financial Reporting and Audit Group.

Officials have also forecasted other areas that may see initiatives and programs in the coming months. One area to note comes from a comment made at the SEC's annual conference SEC Speaks by PLI regarding corporate sustainability disclosures. This is an area that has thus far not been subject to a great deal of Division of Enforcement scrutiny, and rightly so, given the lack of meaningful disclosure guidance. But sustainability and ESG disclosures have been the subject of significant investor, activist, public, and academic interest in the past few years. We will have more to say on this topic in an upcoming publication.

Company Stock Buyback Programs

Stock buyback programs have been common for years and are often demanded by shareholders. Recently, however, Commissioner Jackson commented on the "unprecedented volume" of executives' stock buybacks and called for an "open comment period to reexamine our rules in this area to make sure they protect American companies, employees, and investors."[41] Commissioner Jackson's concern is that executives are using stock buyback programs to "cash out" of company shares they receive as executive compensation, which, in his mind, suggests they are focusing on short-term stock trading rather than long-term value creation.[42] He notes, however that even if this is true, such trading is "not necessarily illegal."[43]

Despite such assurances of legality, however, a recent settlement involving a broker-dealer engaged to execute company stock buybacks pursuant to announced buyback plans suggests that the Division of Enforcement may also be interested in this area. The broker settled for allegedly failing to maintain information barriers between the trading and execution desk and other parts of its firm and some of its clients, which raises the possibility of additional enforcement interest in this area. Nevertheless, Commissioner Jackson's speech and the enforcement action provide a reminder for companies to ensure they are erecting information barriers of their own around their buyback programs.

KEEPING PACE WITH TECHNOLOGICAL CHANGE

Cybersecurity and Related Disclosures

Cybersecurity also continues to be a priority for the SEC. The SEC previously announced the creation of its Cyber Unit to combat the risks associated with cyber-related crimes and is continuing to assess new areas where it can regulate cybersecurity. Commissioner Robert J. Jackson Jr. discussed the rising threat of cybersecurity in a recent speech and stated that he believed increased cooperation between the SEC and corporate counsel could aid in combatting this threat. The Commissioner called for: (i) increased disclosure to shareholders from corporations in 8-K filings of cyberattacks; (ii) discretion from senior management in not trading securities before nonpublic information is released and the development of internal plans for when nonpublic information is released by hackers; and (iii) the use of experts to create internal corporate controls that ensure any cybersecurity risks or incidents are reported up the corporate ladder.[44]

Additionally, the SEC issued an interpretive release to public companies that guides companies on preparing public disclosure regarding cybersecurity risks and incidents.[45] The SEC expects public companies to: (i) implement comprehensive cybersecurity policies allowing for accurate and timely disclosure of material cybersecurity risks and events; and (ii) prohibit insider trading based on selective disclosure of cyber risks or incidents.[46]

With respect to disclosures, the SEC has made clear that companies are required to report cybersecurity risks under existing federal securities reporting laws, including in Form 10-K annual reports and Form 10-Q quarterly reports.[47] The Commission's handling of a large-scale data breach involving an internet media company,[48] and the ensuing $35 million penalty, proves instructive here. Key takeaways from this case include: (i) companies must not only disclose risks of potential future data breaches but also major ones that have already occurred; (ii) good-faith exercises of judgment about a cyber threat or data breach disclosure will not be second-guessed; and (iii) companies must promptly investigate and make a reasoned decision on whether or not to disclose a data breach. The penalized company's failure in these three areas likely resulted in the massive fine levied against the company.[49]

With respect to insider trading and cybersecurity, an insider trading action relating to a major credit reporting company in 2017 sheds lights on how the SEC might proceed in this area. On June 28, 2018, the SEC filed an insider trading case against a former company employee for allegedly trading company stock while knowing material nonpublic information about the company's cybersecurity incident. The U.S. Attorney's Office for the Northern District of Georgia brought criminal charges against the individual as well.

The case highlights the need for companies to be wary on how they internally disclose incidents of this nature and who becomes privy to this information. In addition to caution with internal disclosures, a company might also consider trading blackouts that restrict employee stock trading altogether. In any event, the SEC's actions here demonstrate that it will scrutinize how a company will both internally and externally respond when faced with a cybersecurity crisis.[50]

Initial Coin Offerings

For several months now, the SEC has actively monitored initial coin offerings ("ICOs") and has even brought an ICO fraud action involving a court-appointed receiver.[51] But the SEC is grappling with whether and how cryptocurrency assets qualify as a "security." As the Supreme Court has stated in *SEC v. Howey*, determining what constitutes a security is not a bright-line rule.[52] Rather, facts and circumstances determine "whether a particular transaction involves an investment of money in a common enterprise and with the expectation of profits that are expected to arise substantially from the efforts of a third party."[53] According to the SEC's understanding of *Howey*, "an instrument marketed and sold to the general public rather than to specific users of a network may weigh heavily on the expectation-of-profits prong of the *Howey* analysis."[54]

With this new form of currency becoming more popular, Chairman Clayton has stated that he supports revisiting the SEC's frameworks and policies to allow for more effective and efficient enforcement of these currencies in the digital era.[55]

Technology as a Tool

In addition to enhancing the cybersecurity measures and disclosures adopted by registrants, the SEC is also seeking ways to detect potential market misconduct through machine-learning methods. For instance, the SEC has recently proposed a rule requiring registrants to file their reports in Inline XBRL. According to the Commission's deputy chief economist, Inline-XBRL standardized data "can be combined with other relevant financial information and market participant actions to establish patterns that may warrant further inquiry[,]" which "can ultimately lead to predictions about potential future registrant behavior."[56]

The SEC has also showed support for the modernizing of disclosure delivery. The SEC adopted Rule 30e-3 granting registered management companies and certain registered unit investment trusts ("UITs") the option of publishing shareholder reports and other specified documents online. Should a company rely on Rule 30e-3, they will need to provide paper versions of their reports only upon request by shareholders. The majority of the Commissioners applauded this rule as a cost-effective, environmentally friendly proposal that could benefit Main Street investors. Chairman Clayton stated that this rule is "only the beginning of the Commission exploring the ways that electronic documents can be more interactive…."[57] A company may begin relying on the rule on January 1, 2021.

KEY SUPREME COURT DEVELOPMENTS

Whistleblower Retaliation

As previewed in our January 2018 update, the Supreme Court decided *Digital Realty Trust v. Somers*.[58] Reversing the Ninth Circuit, the Court held that the Dodd-Frank Act does not prohibit retaliation against internal whistleblowers who have not reported concerns about securities law violations to the SEC but who have reported them internally to their company. This case resolved a circuit split between the Ninth and Fifth Circuits and effectively mandates that whistleblowers report to the SEC if they want to take full advantage of Rule 21F–2 of the Dodd-Frank anti-retaliation protections under § 78u–6(a)(6). The Court reasoned that the "core objective" of the whistleblower program is "to motivate people who know of securities law violations to tell the SEC."[59]

We might expect this case to cause an increase in the number of whistleblowers who report to the SEC from the outset because the decision strongly incentivizes them to do so to take advantage of the anti-retaliation protections. That provides even more reason for companies to take whistleblower allegations with utmost seriousness from the very beginning.

Disgorgement Penalties

In *Kokesh v. SEC*, the Supreme Court ruled that disgorgement is a penalty and is governed by the five-year statute of limitations set forth in 28 U.S.C. § 2462. The SEC has seen this ruling impact cases on three fronts. First, defendants from prior settlements are now challenging their settlement agreements based on issues raised by *Kokesh*. According to the SEC, the courts have rejected these arguments and refused to set aside properly negotiated agreements. Second, the SEC has reopened certain cases where the alleged misconduct resulted in ill-gotten gains received both inside and outside the limitations period, in order to recalculate the correct amount of damages that occurred within the five-year limitations period. Third, defendants have attempted to expand *Kokesh* by asserting that disgorgement is no longer a remedy or that *Kokesh* applies to other relief such as injunctions.[60]

Chairman Clayton views the *Kokesh* developments as problematic, because according to the SEC, "if the fraud is well-concealed and stretches beyond the five-year limitations period applicable to penalties, it is likely that [the SEC] will not have the ability to recover funds invested by [] retail investors more than five years ago."[61] Accordingly, Chairman Clayton has testified before Congress asking for legislation to address these issues.[62]

Appointment of Administrative Law Judges

In June 2018, the Supreme Court issued a decision in *Lucia v. SEC*, holding that administrative law judges ("ALJs") are inferior officers subject to the Appointments Clause.[63] Accordingly, the Court reversed the D.C. Circuit's 2016 holding that ALJs are employees and ordered that Lucia receive a new trial by a constitutionally appointed ALJ. All SEC ALJs are now deemed "Officers of the United States" under the Constitution's Appointments Clause, Art. II, §2, cl. 2, and must now be appointed by the President, a court, or a department head. It is important to note that the case does not fully resolve constitutional challenges to SEC ALJs, as these ALJs still have multiple layers of protection from removal by the President.[64] However, the President recently issued an Executive Order seeking, among other things, to make the selection of ALJs more directly accountable to agency heads, who are themselves appointed by the President.[65]

Item 303 of Regulation S-K

In June 2018, the Supreme Court dismissed *Leidos v. Indiana Public Retirement System*, a securities case centering on whether Item 303 of SEC Regulation S-K creates an enforceable duty to disclose under Section 10(b) and Rule 10b-5. Item

303 currently requires several disclosures in public filings, including "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." Although the parties settled the dispute and thus had the case dismissed, the Supreme Court's granting of certiorari signals an interest in the issue.[66]

NEW STANDARDS OF PROFESSIONAL CONDUCT

Another development beyond the financial reporting and disclosure realm, but still worthy of note, is the SEC's proposal of new standards of professional conduct, known as Regulation Best Interest. Under the proposal, "a broker-dealer would be required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer." The proposed regulation outlines three specific obligations for broker-dealers:

- "Disclosure obligation: disclose to the retail customer the key facts about the relationship, including material conflicts of interest.
- "Care obligation: exercise reasonable diligence, care, skill, and prudence, to (i) understand the product; (ii) have a reasonable basis to believe that the product is in the retail customer's best interest; and (iii) have a reasonable basis to believe that a series of transactions is in the retail customer's best interest.
- "Conflict of interest obligation: establish, maintain and enforce policies and procedures reasonably designed to identify and then at a minimum to disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives; other material conflicts of interest must be at least disclosed."[67]

The proposal also calls for investment advisers and broker-dealers to complete a short-form disclosure that "highlight[s] key differences in the principal types of services offered, the legal standards of conduct that apply to each, the fees a customer might pay, and certain conflicts of interest that may exist."[68]

The Commissioners have expressed both support and criticism for the proposal as written. For example, Commissioner Peirce praised the proposed regulation for its attempt to protect retail investors from misleading and predatory conduct of investment professionals but criticized the new regulation for lacking clarity, imposing costs on broker-dealers, and going beyond the authority of the SEC.[69] She argued for clearer rules that encourage brokers to provide a better product, rather than just tailor their offerings to limit their exposure.[70]

LAWYER CONTACTS

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ENDNOTES

1 Wesley Bricker, Chief Accountant, "Remarks before the Institute of Management Accountant's 2018 Annual Conference and Expo: 'Advancing the Purpose and Promise of Those Involved in Financial Reporting'" (June 19, 2018). *See also* Wesley Bricker, Chief Accountant, "Remarks to the Institute of Chartered Accountants in England and Wales: 'The intersection of financial reporting and innovation'" (June 6, 2018). This focus on senior management and "tone at the top" extends to other areas of SEC enforcement not discussed in detail in this update, such as anticorruption compliance. *See* Roman Darmer, Henry Klehm, and Joshua Roseman, "Ten Board Questions on Anticorruption Compliance" (July/Aug. 2018).

2 Jay Clayton, Chairman, SEC, "Remarks on the Establishment of the Task Force on Market Integrity and Consumer Fraud" (July 11, 2018).

3 Hester M. Peirce, Commissioner, SEC, "The Why Behind the No: Remarks at the 50th Annual Rocky Mountain Securities Conference" (May 11, 2018).

4 Steven Peikin, Co-Director, Division of Enforcement, SEC, "Keynote Address at the New York City Bar Association's 7th Annual White Collar Crime Institute" (May 9, 2018).

5 SEC, "Accounting and Auditing Enforcement Releases Archive." Per the SEC's disclaimer, their list "only highlights certain actions and is not meant to be a complete and exhaustive compilation of all of the actions that fall into this category." *Id.*

6 Exchange Act Release No. 10472 (March 27, 2018).

7 Exchange Act Release No. 82556 & No. 82557 (January 22, 2018). The action against a former PCAOB employee was unusual for the SEC, but the alleged use of confidential PCAOB inspection documents created circumstances warranting an enforcement action, per the SEC.

8 PCAOB AU Sec. 543, Part of Audit Performed by Other Independent Auditors, establishes requirements that apply when an auditor of an issuer's financial statements "use[s] the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in [that issuer's] financial statements." *See* AU 543.01.

9 Exchange Act Release No. 82862 & No. 82869 (Mar. 13, 2018).

10 Exchange Act Release No. 82861 (Mar. 13, 2018).

11 Exchange Act Release No. 82859 (Mar. 13, 2018).

12 Exchange Act Release No. 83391 (June 6, 2018).

13 Exchange Act Release No. 83428 (June 14, 2018).

14 Exchange Act Release No. 10482 (Apr. 12, 2018).

15 Exchange Act Release No. 24082 (March 26, 2018).

16 Exchange Act Release No. 10485 (Apr. 24, 2018).

17 "SEC Charges Oil Company CEO, Board Member With Hiding Personal Loans" (July 16, 2018).

18 *Id.*; Exchange Act Release No. 83637 (July 16, 2018).

19 Exchange Act Release No. 83627 (July 13, 2018).

20 "SEC Charges KBR for Inflating Key Performance Metric and Accounting Controls Deficiencies" (July 2, 2018).

21 Exchange Act Release No. 83581 (July 2, 2018).

22 Exchange Act Release No. 83612 (July 10, 2018).

23 "SEC Charges California Company and Three Executives with Accounting Fraud" (July 2, 2018).

24 Hester M. Peirce, Commissioner, SEC, "Tossing Fish and Catching Capital: Remarks at the 38th Annual Northwest Securities Institute CLE at the Washington State Bar Association" (May 4, 2018); Robert J. Jackson, Jr., Commissioner, SEC, "The Middle-Market IPO Tax" (April 25, 2018); Michael S. Piwowar and Hester M. Peirce, Commissioners, SEC, "Letter of Commissioners Piwowar and Peirce on Regulation A Offering Amount Limitation" (Apr. 11, 2018).

25 U.S. Dep't of the Treasury, "A Financial System that Creates Economic Opportunities. Capital Markets Report to President Donald J. Trump Executive Order 13772 on Core Principles for Regulating the United States Financial System" (Oct. 2017).

26 Investor Advocate Rick Fleming stated that mandatory arbitration would strip away the rights of shareholders in a "draconian" manner and he thus urged the Commission to reject any proposals for mandatory arbitration. Rick Fleming, Investor Advocate, "Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders" (Feb. 24, 2018). Commissioner Jackson further stated that he believed shareholder lawsuits served the public and Commission best as they bring more enforcement actions than the SEC can and grant the public judge-made, transparent law. Robert J. Jackson, Jr., Commissioner, SEC, "Keeping Shareholders on the Beat: A Call for a Considered Conversation About Mandatory Arbitration" (Feb. 26, 2018).

27 Hester M. Peirce, Commissioner, SEC, "Remarks before the SIFMA Equity Market Structure Conference" (Apr. 18, 2018).

28 Hester M. Peirce, Commissioner, SEC, "Optional Internet Availability of Investment Company and Shareholder Reports" (June 5, 2018); Hester M. Peirce, Commissioner, SEC, "The Why Behind the No: Remarks at the 50th Annual Rocky Mountain Securities Conference" (May 11, 2018); Hester M. Peirce, Commissioner, SEC, "Tossing Fish and Catching Capital: Remarks at the 38th Annual Northwest Securities Institute CLE at the Washington State Bar Association" (May 4, 2018); Hester M. Peirce, Commissioner, SEC, "Statement at the Open Meeting on Standards of Conduct for Investment Professionals" (Apr. 18, 2018); Hester M. Peirce, Commissioner, SEC, "International Organizations: Learning from the Past to Build for the Future" (Apr. 11, 2018).

29 Michael S. Piwowar, Commissioner, SEC, "Statement at Open Meeting on Form CRS, Proposed Regulation Best Interest and Notice of Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (Apr. 18, 2018); Michael S. Piwowar and Hester M. Peirce, Commissioners, SEC, "Letter of Commissioners Piwowar and Peirce on Regulation A Offering Amount Limitation" (Apr. 11, 2018). Commissioner Piwowar left the SEC on July 7, 2018.

30 Economic Growth, Regulatory Relief, and Consumer Protection Act, PL 115-174, May 24, 2018, 132 Stat 1296.

31 *Id.*

32 *See* Jay Clayton, Chairman, SEC, "Statement at Open Meeting on Inter-Agency Proposal for Amendments to the Volcker Rule" (June 5, 2018); Hester M. Peirce, Commissioner, SEC, "Statement at Open Meeting on Amendments to the Volcker Rule" (June 5, 2018).

33 *Id.*

34 Jay Clayton, Chairman, SEC, "Proposed Rule to Conduct a Transaction Fee Pilot in NMS Stocks" (March 14, 2018).

35 Hester M. Peirce, Commissioner, SEC, "Statement on Proposed Amendments to Public Reporting of Fund Liquidity Information" (Mar. 14, 2018).

36 *Id.*

37 Kara M. Stein, Commissioner, SEC, "'Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance' Remarks at Stanford University" (Feb. 13, 2018); Robert J. Jackson, Jr., Commissioner, SEC, "Perpetual Dual-Class Stock: The Case Against Corporate Royalty" (Feb. 15, 2018).

38 Robert J. Jackson, Jr., Commissioner, SEC, "Perpetual Dual-Class Stock: The Case Against Corporate Royalty" (Feb. 15, 2018).

39 Wesley Bricker, Chief Accountant, SEC, "Remarks before the 2018 Baruch College Financial Reporting Conference: 'Working Together to Advance Financial Reporting'" (Apr. 3, 2018).

40 Dave Michaels, *The Wall Street Journal*, SEC Probes Whether Companies Rounded Up Earnings Per Share (June 22, 2018).

41 Robert J. Jackson, Commissioner, SEC, "Stock Buybacks and Corporate Cashouts" (June 11, 2018).

42 *Id*. ("[T] here is clear evidence that a substantial number of corporate executives today use buybacks as a chance to cash out the shares of the company they received as executive pay. We give stock to corporate managers to convince them to create the kind of long-term value that benefits American companies and the workers and communities they serve. Instead, what we are seeing is that executives are using buybacks as a chance to cash out their compensation at investor expense.").

43 *Id*. ("Now, let's be clear: this trading is not necessarily illegal. But it is troubling, because it is yet another piece of evidence that executives are spending more time on short-term stock trading than long-term value creation.").

44 Robert J. Jackson, Jr., Commissioner, SEC, "Corporate Governance: On the Front Lines of America's Cyber War" (Mar. 15, 2018).

45 SEC, "Commission Statement and Guidance on Public Company Cybersecurity Disclosures" (Feb. 26, 2018).

46 *Id.*

47 *Id.*

48 Exchange Act Release No. 10485 (Apr. 24, 2018).

49 For more information, *see* the May 17, 2018, Jones Day *Commentary* on this issue.

50 Jones Day, "The Perils of Well-Intentioned Deception: Insider Trading Case Highlights Challenges Facing Public Companies" (July 2018).

51 SEC, "SEC Obtains Emergency Order Halting Fraudulent Coin Offering Scheme" (May 29, 2018).

52 328 U.S. 293 (1946).

53 Jones Day, "SEC Provides Framework to Determine if Digital Assets are Securities" (June 2018).

54 *See* William Hinman, Director, Division of Corporate Finance, SEC, "Digital Asset Transactions: When Howey Met Gary (Plastic)" (June 14, 2018).

55 Jay Clayton, Chairman, SEC and J. Christopher Giancarlo, CFTC Chairman, "Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: Regulators are Looking at Cryptocurrency" (Jan. 25, 2018).

56 Scott Bauguess, Deputy Chief Economist and Deputy Director, Division of Economic and Risk Analysis, SEC, "The Role of Machine Readability in an AI World" (May 3, 2018).

57 Jay Clayton, Chairman, SEC, "Statement on Investment Company Design, Delivery and Disclosures Rulemaking Package" (June 5, 2018).

58 138 S.Ct. 767 (2018).

59 *Id.*

60 Steve Peikin, Co-Director, Division of Enforcement, SEC, "Keynote Address at the New York City Bar Association's 7th Annual White Collar Crime Institute" (May 9, 2018).

61 SEC, "Testimony on 'Oversight of the U.S. Securities and Exchange Commission'" (June 21, 2018).

62 *Id.*

63 *Lucia v. SEC*, 138 S. Ct. 2044 (2018).

64 Jones Day, "U.S. Supreme Court Holds SEC's Staff Appointments for Administrative Law Judge Unconstitutional" (June 2018).

65 Executive Order Excepting Administrative Law Judges from the Competitive Service (July 10, 2018).

66 Jones Day, "Supreme Court Dismisses Important Securities Case on Issue Likely to Arise Again" (June 2018).

67 SEC, "SEC Proposes to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Investment Professionals" (Apr. 18, 2018).

68 *Id.*

69 *See* Hester M. Peirce, Commissioner, SEC, "Statement at the Open Meeting on Standards of Conduct for Investment Professionals" (Apr. 18, 2018); Michael S. Piwowar, Commissioner, SEC, "Statement at Open Meeting on Form CRS, Proposed Regulation Best Interest and Notice of Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (Apr. 18, 2018).

70 *See* Hester M. Peirce, Commissioner, SEC, "Statement at the Open Meeting on Standards of Conduct for Investment Professionals" (Apr. 18, 2018).