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WHITE PAPER

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SEC Enforcement in Financial Reporting and Disclosure—2017 Mid-Year Update

Under the new administration, signs seem to point to a more favorable regulatory environment and possibly more balanced enforcement actions from the U.S. Securities and Exchange Commission. Investigations have slowed since January, and the SEC's new chairman has publicly stated that regulatory efforts must be carefully balanced with all three components of the agency's mission, which include investor protection, maintaining fair, orderly, and efficient markets and facilitating capital formation.

That noted, the SEC continues to bring cases involving improper accounting methods, and appears to be maintaining its recent practice of pursuing specific individuals in financial reporting cases. This Jones Day *White Paper* examines the SEC's enforcement activities through mid-2017, and provides insight as to where these actions might lead through the remainder of the year.

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We are pleased to present our annual mid-year update on financial reporting and issuer disclosure enforcement activity for 2017 and forecast for where activity might be headed for the remainder of the year. This update primarily focuses on the Securities and Exchange Commission's ("SEC" or "Commission") enforcement activity, but also discusses other relevant developments.

A SHIFTING ATTITUDE TOWARDS ENFORCEMENT

Under a new administration and new leadership in the first half of 2017, the SEC has made it abundantly clear that enforcement will take a new direction for the foreseeable future. For instance, as soon as Commissioner Michael Piwowar became acting chairman, he revoked delegated subpoena authority from senior enforcement officials and limited it to the enforcement director, which had the effect of slowing down some investigations. In addition, he froze rulemaking that was required by the 2010 Dodd-Frank Act and has openly remarked on multiple occasions about the need to ease existing regulations.

More recently, while discussing capital formation efforts before the Economic Club of New York, Chairman Jay Clayton provided one of the first insights into his perspective on the SEC and the "principles" he believes should "guide" the agency's future.¹

His first principle began with the SEC's three-part mission and noted the danger to investors, the markets, and the economy when the Commission "emphasize[s] one of the canons without being mindful of the others" This could be read as a desire to balance out the agency's post-financial crisis focus on enforcement with the other parts of the mission—maintaining fair, orderly, and efficient markets and facilitating capital formation.

For U.S.-listed public companies and those considering listing in the United States, Chairman Clayton offered hope for a more favorable regulatory environment. In his fourth principle, after describing how the SEC's disclosure-based regime provides benefits that often outweigh costs, Chairman Clayton emphasized how regulatory costs should be analyzed cumulatively, rather than incrementally as new regulations are imposed:

[T]he roughly 50 percent decline in the total number of U.S.-listed public companies over the last two decades forces us to question whether our analysis should be

cumulative as well as incremental. I believe it should be. As a data point, over this period, studies show the median word-count for SEC filings has more than doubled, yet readability of those documents is at an all-time low.

While there are many factors that drive the decision of whether to be a public company, increased disclosure and other burdens may render alternatives for raising capital, such as the private markets, increasingly attractive to companies that only a decade ago would have been all but certain candidates for the public markets. And, fewer small and medium-sized public companies may mean less liquid trading markets for those that remain public. Regardless of the cause, the reduction in the number of U.S.-listed public companies is a serious issue for our markets and the country more generally. To the extent companies are eschewing our public markets, the vast majority of Main Street investors will be unable to participate in their growth. The potential lasting effects of such an outcome to the economy and society are, in two words, not good.²

Chairman Clayton's principles also recognize that compliance with even existing regulations has significant costs that are most often borne by shareholders and customers, those whom the regulations are designed to protect. In discussing the need for the SEC to evolve with the markets, he recognized: "Companies spend significant resources building systems of compliance, hiring personnel to operate those systems, seeking legal advice concerning the design and effectiveness of those systems, and adapting the systems as regulations change. Shareholders and customers bear these costs, which is something that should not be taken lightly, lest we lose our credibility as regulators."³

Chairman Clayton, no doubt relying on his recent experience as a deal lawyer, emphasized that the Commission must consider that the "costs of a rule now often include the costs of demonstrating compliance":

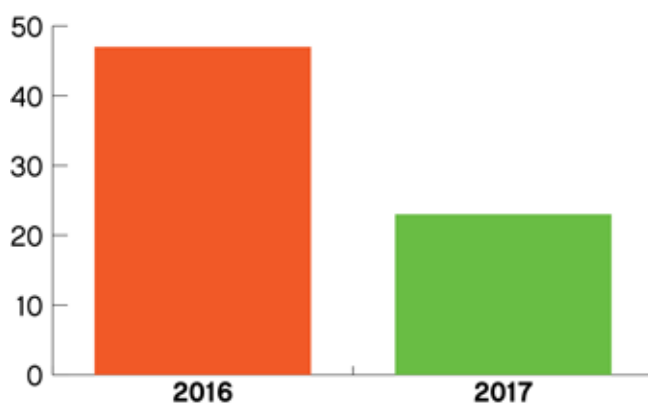
Vaguely worded rules can too easily lead to subpar compliance solutions or an overinvestment in control systems. We must recognize practical costs that are sure to arise. For example, when the SEC requires a Chief Executive Officer to make a certification that a specific requirement has been met, while he or she

retains ultimate responsibility, realistically, it should be expected that the responsibility will be supported through the chain of command in a demonstrable manner. This can be an expensive practice that goes well beyond a prudent management and control architecture; when third parties, such as auditors, outside counsel, and consultants, are involved, the costs—financial costs and, in many ways more important, the cost in terms of time—can skyrocket.⁴

It is too early to tell whether these principles will filter down to the 4600 people who carry out the agency's missions, but there is no doubt that Chairman Clayton is bringing a different perspective to the Commission. This could be good news for those who want less regulation or less burdensome regulation. From a financial reporting and compliance perspective, it could also signal the end of the focus on low level, technical violations that have not caused real investor harm. As the discussion below highlights, the SEC filed a number of internal controls/books and records cases in the first half of 2017, but nearly all of those investigations occurred under the prior leadership. Given Chairman Clayton's principles, the agency may not continue its focus on the type of nonfraud claims we have seen over the past few years.

Indeed, there may already be a discernible effect of the new approach on enforcement. New investigations and actions have slowed, and this is reflected in the qualitative and quantitative enforcement trends we are seeing thus far in 2017. For instance, about 30 percent of all new accounting and auditing enforcement actions during the first half of 2017 were announced before January 20, 2017. And over twice as many accounting and auditing enforcement actions were announced between February and June 2016 as compared to that same time period in 2017.

New Actions Down Over 50% from 2016
February to June



Not only have the number of actions dropped, but the penalty amounts have decreased, and the type of behavior targeted by the SEC has shifted away from technical accounting and disclosure issues (which often involve complex questions of accounting, finance, and management judgment) towards more overt, fraudulent actions like Ponzi schemes, affinity frauds, microcap fraud, “those who prey on retirees, and increasingly those who use new technologies to lie, cheat, and steal.” Indeed, while noting the SEC’s “strong and active enforcement” program, Chairman Clayton promised “to continue deploying significant resources to root out fraud and shady practices in the markets, particularly in areas where Main Street investors are most exposed.”⁵ This could be good news for those who want to see a moderation of the SEC’s use of negligence and strict liability theories of liability.

2017 ENFORCEMENT IN REVIEW

In 2017, the SEC continues to pursue a wide variety of accounting cases, including cases alleging failure to comply with generally accepted accounting principles (“GAAP”), improper revenue recognition, overstatement of assets, and insufficient internal controls.

IMPROPER ACCOUNTING

The SEC settled an action against a major automobile manufacturer for allegedly failing to properly identify certain loss contingencies in connection with a vehicle recall initiated by the company. According to the SEC, these losses stemmed from inadequate “internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with [GAAP].” According to SEC estimates, the unreported losses represented less than one percent of the company’s net income for 2013. The company was penalized \$1 million.

The SEC reached a settlement with a financial services company and an executive who served as the company’s executive vice president, chief investment officer, and treasurer for alleged books and records and internal accounting control violations related to “certain commercial loans and related swaps designated as accounting hedges [] under GAAP (ASC 815).” According to the SEC, the executive oversaw a practice

of altering calculations for hedge effectiveness such that its reported metrics were inconsistent with internal company policy and GAAP, although management in consultation with outside auditors determined that no financial restatement was required. In addition to a cease and desist order prohibiting future securities law violations, the company was penalized \$500,000, and the former executive was penalized \$20,000.⁶

The SEC filed an accounting fraud action in the Southern District of New York against a large Canadian oil producer and three company executives for misreporting and artificially reducing the company's operating expenses. The SEC's 82-page complaint detailed how the oil company's accounting staff allegedly "improperly reclassified hundreds of millions of dollars of operating expenses as capital expenditures or royalties," effectively misleading investors on metrics of operating efficiency and profitability. The SEC also alleged the defendants "took steps to conceal their scheme from others" within the company, as well as the company's independent auditor. The SEC is seeking civil penalties, disgorgement, and officer and director bars for the executives.⁷

The SEC filed a complaint against an information technology company and two of its executives for allegedly misleading investors through a fraudulent financial reporting scheme to hide the executives' siphoning of cash and stock from the company for the executives' personal benefit. The SEC's complaint detailed a host of violations allegedly committed by the company and its executives, including understating liabilities, inflating revenues and assets, lying to auditors, and forging and doctoring documents.⁸ The executives also face criminal charges.⁹

OVERSTATING ASSETS

The SEC filed an action against a publicly-traded company and a former executive who served as the company's CEO, chairman, and principal financial and accounting officer for allegedly overstating the company's assets. The SEC also brought an action against the former executive's long-time friend and business associate for aiding and abetting the violations. According to the SEC, the company materially understated liabilities by selling nonperforming, indebted companies to a new shell company that was formed and controlled by the former executive's friend. The SEC also alleged

that the former executive concealed the nature of these transactions from the company's auditors. The former executive's friend agreed to settle the claims against him in exchange for three-year officer-and-director and penny-stock bars and a \$25,000 civil penalty. The claims against the other defendants remain pending.¹⁰

The SEC alleged that two former executives of a publicly-traded wire and cable company fraudulently concealed accounting errors at the company's Brazilian subsidiary. According to the SEC, the company's former CEO and CFO allegedly became aware of and did not disclose overstatements of the company's inventory balance in excess of \$40 million as well as an inventory theft scheme by the subsidiary's employees, ultimately resulting in a restatement of its financials. The SEC further alleged that the executives directed employees to destroy documents and conceal accounting problems from internal auditors. The SEC also filed an action against a former executive of the subsidiary for allegedly aiding and abetting the other executives' fraud. The former senior vice president agreed to cooperate with the SEC and consented to a final judgment against him. The company previously agreed to pay a \$6.5 million civil penalty to settle allegations related to inventory accounting errors. The claims against the other two executives remain pending.

IMPROPER REVENUE RECOGNITION

The SEC reached settlements with a medical device company and four of its former executives for various alleged revenue recognition failures. According to the SEC, the alleged misconduct included improperly recognizing revenue associated with several distribution contracts entered into by its largest subsidiary and with various extracontractual agreements at another subsidiary. The SEC also alleged that the company lacked adequate "internal accounting controls over its distributor revenue recognition and had a culture of setting aggressive internal sales targets and imposing pressure to meet those sales targets." The company restated its financials in connection with the alleged misconduct. The CFOs of the company and its largest subsidiary, the president of its largest subsidiary, and the vice president of global sales and development were penalized \$40,885, \$20,000, \$25,000, and \$40,000, respectively. The company was penalized \$8.25 million. On the same day, the

company settled an action for alleged FCPA violations in connection with allegedly improper payments to doctors employed by a foreign government. The company agreed to disgorge \$2.928 million and to pay a civil penalty of the same amount.

The SEC reached a settlement with a semiconductor company and its former CFO and principal accounting officer in public administrative and cease-and-desist proceedings for allegedly engaging in various practices to artificially inflate revenue to meet publicly-announced targets in the two-and-half year period following its initial public offering. According to the SEC, suspicions by both inside and outside auditors triggered an internal investigation, which revealed revenue recognition practices that failed to comply with GAAP. Among other things, the company allegedly “improperly recognized revenue on ‘sales’ of nonexistent or unfinished products.” The SEC also alleged the company failed to maintain internal controls over financial reporting, including by failing to “maintain a control environment that effectively emphasized (i) an attitude of integrity and ethics against the pressure to achieve sales, gross margin and other financial targets, (ii) adherence to US GAAP, (iii) utilization of the whistleblower program, and (iv) prevention or detection of undisclosed business practices involving the circumvention of internal controls under the management team in place during the relevant period.” The company self-reported the revenue recognition problems and revised its financial statements to reduce reported revenue by \$121 million such that the company’s “previously reported net profit was restated to a net loss,” after which the company’s stock price fell by 50 percent. The company was fined \$3 million, while the former CFO was fined \$135,000 and was indefinitely barred from acting as an officer or director and practicing accounting before the SEC.¹¹

The SEC settled an action against a major Mexican residential construction company for allegedly overstating revenue by approximately \$3.3 billion (or 355 percent) during a three-year period by inflating sales numbers. The SEC discovered the fraudulent scheme using satellite imagery to illustrate its allegations that the company had not even broken ground on many of the homes for which it reported revenue. The company began cooperating with the SEC after experiencing a change in ownership and agreed to a five-year U.S. securities-offering ban. The SEC has not brought claims against individuals in connection with the alleged scheme, but the SEC’s investigation is ongoing.¹²

NON-GAAP METRICS—STILL A FOCUS?

As we noted in the 2016 year-end recap, the SEC, under former Chair Mary Jo White, began reviewing non-GAAP accounting metrics in financial disclosures with greater scrutiny and increased frequency. It is likely too early to determine whether non-GAAP metrics remain a priority issue under Chairman Jay Clayton, but the first six months of 2017 have only featured a handful of actions related to non-GAAP issues, and the only notable new cases were filed before the new administration took office.

The SEC reached a settlement with an advertising, marketing, and communications company concerning alleged disclosure failings with respect both to executive compensation and certain non-GAAP financial measures. According to the SEC, an internal investigation revealed that the company had failed to disclose over \$20 million in compensation to its former chairman and CEO. In addition, the SEC alleged that, despite having agreed to comply with non-GAAP financial measure disclosure rules in prior communications with the SEC, the company failed “to afford equal or greater prominence to GAAP measures in earnings release presentations containing non-GAAP financial measures” and failed to reconcile a non-GAAP metric to GAAP revenue. The SEC claimed to have credited substantial remedial efforts undertaken by the company beginning with its internal investigation and including replacing certain executives, reclaiming the undisclosed compensation from its former chairman and CEO, adding three more independent directors to its board, and establishing new internal control and compliance policies. The company was penalized \$1.5 million.¹³

A jury found the former CFO of a real estate investment fund guilty of securities fraud, filing false SEC reports, filing false certifications, and a related count of conspiracy.¹⁴ According to the SEC’s complaint in a parallel civil suit, the ex-CFO misrepresented the fund’s performance by manipulating a non-GAAP financial metric, known as Adjusted Funds From Operations (“AFFO”). Specifically, he was allegedly involved in a scheme that “involved adding false amounts or a ‘plug’ to several figures without any basis ... in an internal spreadsheet that the Company used to calculate AFFO and AFFO per share.”¹⁵ The former CFO awaits sentencing.

INTERNAL CONTROLS

Under former Chair White, the SEC showed great interest in bringing enforcement actions that centered on internal controls failures. In 2017, the SEC continues to pursue enforcement actions against companies with allegedly deficient internal controls.

The SEC reached a settlement with an environmental solutions company and its former CFO for allegedly filing false and misleading financial statements. According to the SEC, the company failed to record a material loss contingency from an adverse arbitration ruling, recognized revenues prematurely, improperly accounted for warranty accruals, improperly consolidated a joint venture on its balance sheets, and overstated a subsidiary's revenues. The SEC also alleged several inadequacies in the company's internal accounting controls and internal controls over financial reporting, such as ineffective risk assessment and monitoring, insufficient technical accounting expertise, inadequate management review, and ineffective information technology controls. The former CFO agreed to pay disgorgement and a civil penalty (totaling \$238,692) and to five-year officer-and-director and SEC-accountant bars. The company consented to a \$500,000 civil penalty.

The SEC settled a civil action against a military technology company for alleged books and records and internal accounting control violations at one of its subsidiaries. According to the SEC, the subsidiary improperly recognized \$17.9 million of revenue from invoices generated for disputed claims in connection with a U.S. Army contract. An internal investigation allegedly revealed that these invoices were never transmitted to the U.S. Army, failing to comply with internal corporate policy and GAAP and causing the company to revise four years worth of financial statements. The SEC also alleged the internal investigation revealed inadequacies in the company's internal controls over financial reporting, including "inadequate execution of existing controls around the annual review and approval of contract (revenue arrangement) estimates" and "intentional override of numerous transactional and monitoring" controls at the subsidiary. The company was penalized \$1.6 million.¹⁶ Subsequently, the SEC settled an action against the subsidiary's former president and filed an additional action against an executive who served as both the company's former vice president and senior director of finance. According to the SEC, the former

president relied on the former vice president's representations as an accountant that recognizing revenue in connection with the untransmitted invoices was proper and that senior management had approved of doing so. The SEC also alleged that the former president recklessly disregarded certain indicia that the revenue recognition was improper. The former president settled with the SEC and was penalized \$25,000.¹⁷ The action against the former vice president is pending.¹⁸

The SEC settled with an international food, beverage, and snack company for alleged books and records and internal accounting control violations at a foreign subsidiary that was part of a recent acquisition. According to the SEC, the subsidiary also "did not devise and maintain an adequate system of internal accounting controls sufficient to provide reasonable assurances that access to assets and transactions were executed in accordance with management's authorization." The SEC also alleged that the subsidiary did not implement adequate FCPA compliance controls. The acquirer agreed to pay a \$13 million penalty.¹⁹

The SEC settled an action against an international oil transportation company and its former CFO for an alleged decade-long failure to record material federal income tax liabilities despite red flags that credit agreements with its foreign subsidiaries could trigger tax consequences. The SEC also alleged that the company had "deficient or nonexistent internal accounting controls" to ensure that the company "properly reported its tax liabilities." As a result, the company revised twelve-and-a-half years worth of financial statements to reflect over \$500 million of additional losses (which would have increased its net losses by about 265 percent). After discovery of the alleged reporting failure, the company filed for bankruptcy. According to the SEC, the former CFO became aware of significant indicia of unreported tax consequences and negligently misled an internal auditor through his representations about the company's tax liabilities. The company and former CFO were fined \$5 million and \$75,000, respectively.²⁰

CONTINUED EMPHASIS ON INDIVIDUAL LIABILITY

The SEC's recent practice of naming individuals in financial reporting cases continues in 2017.

The SEC settled an action against three former executives at a commercial construction company after alleging that the company's subsidiary failed to comply with GAAP when it prematurely recognized revenue in connection with its most lucrative contract. According to the SEC, the subsidiary's former president knowingly or recklessly relied upon advice given by the other two executives concerning proper application of the percentage-of-completion accounting method to recognize revenue. The SEC also alleged that the subsidiary's former president and controller both failed to comply with GAAP by improperly recognizing revenue and failing to confirm the accuracy of certain invoices. The SEC pointed to alleged weaknesses relating to internal accounting controls and internal controls over financial reporting, including entity-level monitoring, internal audit monitoring, and revenue and cost recognition controls, as well as failing to maintain sufficiently experienced accounting personnel. According to the SEC, the company experienced a 50 percent drop in its stock price the day after it revised its financial statements, causing it ultimately to delist its stock and file for bankruptcy. The company's former CAO and controller and the subsidiary's former controller both received SEC-accountant bars and were fined \$75,000 and \$25,000, respectively. The subsidiary's former president was ordered to pay \$35,000 in disgorgement and a \$125,000 penalty.²¹

The SEC settled claims against two executives of a freight forwarding and logistics company for failing to include adequate information in the Management's Discussion & Analysis ("MD&A") section of the company's Form 10-Q. Beginning in fiscal year 2013, the company began experiencing a "liquidity crisis," including a backlog of receivables and an inability to meet its debt covenants. Despite trends suggesting that these liquidity issues were imminent, the executives did not include such forecasts in the Form 10-Q preceding the company's "liquidity crisis." In particular, the SEC pointed to the executives' failure to comply with Regulation S-K Item 303, which "requires registrants to disclose in the MD&A sections of required periodic filings 'any known trends or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.'" Each of the executives agreed to pay a \$40,000 civil penalty to settle the action.²²

The SEC brought an action against two former executives of a computer network testing company for alleged financial

reporting violations and for aiding and abetting the company's violations. According to the SEC, the former CFO and director of accounting prematurely recognized revenue from sales, contravening both GAAP and company policy. The SEC alleged that the company artificially split its software and professional services into separate purchase orders, which gave the allegedly false appearance that customers were buying professional services in stand-alone sales rather than as components of the software sales. The SEC further alleged that this scheme "exploited a material weakness in the company's internal controls over financial reporting," which "had not been designed to identify and assess [split purchase orders] and their revenue recognition accounting impact." The SEC's complaint also claimed that the executives took "affirmative steps" to mislead the company's auditors. The SEC separately settled claims against the company and its former CEO. The company agreed to pay a \$750,000 civil penalty, while the former CEO agreed to pay a \$100,000 penalty and to a five-year officer-and-director bar. The claims against the former CFO and director of accounting remain pending.²³

The SEC brought an action against two former executives at a credit card processing company for alleged accounting fraud. According to the SEC, the company's former COO and senior vice president of sales and marketing reimbursed themselves for phony personal credit-card payments, conspired with vendors to overstate invoices, and disguised other corporate funds diverted to themselves as legitimate forms of compensation. The SEC also filed suit against three other executives who allegedly received kickbacks for falsifying books and records to conceal the alleged fraudulent activity. Parallel criminal charges were brought against the company's former COO and senior vice president of sales and marketing. All claims remain pending.²⁴

The SEC filed suit in the Eastern District of Texas against a capital funding company and its chief executive for operating an illegal real estate mortgage scheme that allegedly defrauded investors.²⁵ In its complaint, the SEC alleged that investor funds were improperly used to pay for: (i) the executive's personal luxury expenses; (ii) high-risk securities trading and investments in various businesses; and (iii) referral fees to a concert promoter. According to the SEC, the promoter provided no services or consideration in exchange for the funds it received, and the company's use of investor funds expressly contradicted promises made by the company. The

SEC is seeking injunctive relief, civil penalties, and disgorgement with prejudice interest.

LIMITING DISGORGEMENT PENALTIES

The Supreme Court's decision in *Kokesh v. SEC* made clear that a significant enforcement tool—disgorgement of profits—is subject to the five-year statute of limitations provision under 28 U.S.C. § 2462 because it operates like other financial penalties used by the SEC. The ruling, which resolved a circuit split, has several implications for enforcement actions moving forward. First, companies and individuals facing disgorgement for conduct outside the five-year limitations period have strong grounds to resist such sanctions. However, the SEC may push for higher penalty amounts to compensate for the limits on its disgorgement claims. Second, we might anticipate faster-moving proceedings and more aggressive timelines with respect to document requests, testimony, and Wells notices. Third, and perhaps most significantly, the existence of disgorgement as a sanction might be in the balance. Not only does the language of the decision question the legitimacy of disgorgement as a remedy in SEC federal court actions, but it might revive arguments relating to double jeopardy in the context of criminal fines imposed by the Department of Justice in parallel proceedings.

EMPHASIS ON IPOs AND CAPITAL FORMATION

In his opening remarks at the SEC-NYU Dialogue on Securities Market Regulation, Commissioner Piowar commented on the importance of initial public offerings to both public and private markets and the economic need to revitalize the dwindling IPO market: “[M]aking public capital markets more attractive to business while providing appropriate safeguards for investors will be a priority for the Commission In a nutshell, a robust IPO market encourages entrepreneurship, facilitates growth, creates jobs, and fosters innovation, while providing attractive opportunities for investors to increase their wealth and mitigate risk.”

In particular, Piowar discussed regulatory changes that have contributed to the downward trends in IPOs, including the Sarbanes-Oxley Act's regulatory burdens on smaller public companies. In an effort to revitalize the IPO market, Piowar cited to modifications in Title I of the JOBS Act that “provided

an IPO on-ramp for emerging growth companies, allowing them to use scaled disclosure for a certain period of time.”²⁶

In another effort to facilitate capital formation, the SEC announced that it will accept voluntary draft registration statements relating to initial public offerings from all issuers for nonpublic review beginning July 10, 2017.²⁷ The announcement extends a benefit to larger companies not otherwise covered by the JOBS Act. Chairman Clayton noted that the SEC is “striving for efficiency in [its] processes to encourage more companies to consider going public,” and the SEC hopes that the confidential, nonpublic review process will reduce “the potential for lengthy exposure to market fluctuations that can adversely affect the offering process and harm existing public shareholders.”²⁸ In addition, while discussing capital formation efforts before the Economic Club of New York, Chairman Clayton encouraged companies to take advantage of Rule 3-13 of Regulation S-X to “request modifications” to overly-burdensome financial reporting obligations.²⁹

Cautioning that too much advocacy and research around increasing IPOs focuses on the supply-side, investor advocate Rick Fleming spoke on the importance of “understand[ing] the demand side of the equation.” Fleming identified several trends that he believed to be decreasing demand for IPOs. In particular, Fleming pointed to a statistical association between the increasing proportion of institutional stock ownership and dwindling IPOs, affecting smaller companies most severely. According to Fleming, this association can be explained by liquidity concerns of institutional investors, which become particularly salient for smaller companies. In addition, Fleming pointed to the comparative advantages of private equity and venture capital over IPOs for smaller companies. Arguing, however, that deterrent illiquidity creates a vicious cycle that discourages investment, Fleming advocated that policymakers should therefore do more to increase demand for shares in smaller companies.³⁰

INVESTOR PROTECTIONS

Speaking at the North American Securities Administrators Association (NASAA) Section 19(d) Conference, Commissioner Piowar highlighted the SEC's renewed emphasis on capital formation through its regulatory mission under new Chairman Clayton. In particular, Piowar stressed the importance of

“state and federal regulators work[ing] together to support the businesses that seek to engage in [exempt small] offerings while also protecting investors,” and extolled the NASAA information-sharing agreement as exemplifying such endeavors. In the investor-protection context, Piwowar made cautionary remarks about the use of the unfortunately-named SAFEs (simple agreements for future equity), themselves designed for sophisticated investors, in Regulatory Crowdfunding offerings aimed at retail investors. Indeed, Piwowar warned that “[i]ntermediaries face a real challenge in educating potential investors about this high-risk, complex, and nonstandard security when the security itself is entitled ‘SAFE.’” In addition, with respect to auditor independence, Piwowar underscored his internal directive to SEC staff to “work on amendments to the Loan Provision designed to address unnecessary compliance issues and instead focus attention on lending relationships that actually threaten auditor independence.”³¹

Speaking at the same conference as Commissioner Piwowar, Commissioner Kara Stein advocated for an adaptive regulatory approach. In particular, Stein suggested that “[t]he discussions on emerging trends in fintech, robo-advice, and cybersecurity highlight how critical adaptation is to our regulatory roles.” Stein also emphasized “the importance of communication and coordination” and highlighted the “need for high-quality data and data analytics.”³²

On the issue of cybersecurity, Chairman Clayton recently expressed a quite practical and nuanced view of the SEC’s role when public companies are attacked:

Public companies have a clear obligation to disclose material information about cyber risks and cyber events. I expect them to take this requirement seriously. I also recognize that the cyber space has many bad actors, including nation states that have resources far beyond anything a single company can muster. Being a victim of a cyber penetration is not, in itself, an excuse. But, I think we need to be cautious about punishing responsible companies who nevertheless are victims of sophisticated cyber penetrations. Said another way, the SEC needs to have a broad perspective and bring proportionality to this area that affects not only investors, companies, and our markets, but our national security and our future.³³

Chairman Clayton’s view that the SEC should “have a broad perspective and bring proportionality” when companies and firms are victims of cyber attacks is a welcome sign. The SEC has thus far done a good job of avoiding piling on (by bringing an enforcement action) following cybersecurity breaches, and Chairman Clayton’s view suggests that approach may continue.

In his keynote address at the 2017 Journal of Accounting and Public Policy (JAPP) Conference, Chief Accountant Wesley Bricker emphasized the important role that academic research does and should play in the SEC’s rulemaking and regulatory oversight, focusing particularly on “the interaction between regulatory institutions and accounting.” In particular, Bricker advocated for further academic exploration into financial accounting standards, ICFR and internal governance generally, auditing, investment decision-making, and disclosures.³⁴

WHISTLEBLOWER PROTECTIONS UNDER DODD-FRANK

In the next term, the U.S. Supreme Court will review whether the Dodd-Frank Act prohibits retaliation against internal whistleblowers who have not reported concerns about securities law violations to the SEC. The case comes from the Ninth Circuit, which held that a former executive could sue the company for alleged retaliation against him under subdivision (iii) of Section 21F of the Dodd-Frank Act.³⁵ This subdivision prohibits employers from discriminating against a whistleblower who makes disclosures that are required or protected by Sarbanes-Oxley. In 2015, the Second Circuit found that the antiretaliation provision is ambiguous and courts should defer to the SEC about its purview.³⁶ In contrast, the Fifth Circuit held in 2013 that Dodd-Frank protections extend only to those whistleblowers who report to the SEC.³⁷ The Supreme Court’s decision in the upcoming term will likely resolve this circuit split and clarify the class of individuals eligible to receive protection as whistleblowers under Dodd-Frank.

The chief of the SEC’s Office of the Whistleblower, Jane Norberg, recently suggested that the program would continue as it had under previous Chair Mary Jo White.³⁸ She noted that the SEC would continue to take in tips and review severance and employment agreements to monitor whether employees are discouraged from reporting violations to the SEC. In addition,

Chief Norberg stated that the agency already brought three enforcement actions against companies for retaliation, and that the agency's own view on the case before the Supreme Court is that internal whistleblowers who have yet to report to the SEC are indeed protected. In developing and updating their compliance programs, companies should monitor this Supreme Court case and consider the SEC's scrutiny and recent enforcement actions against companies with policies that are perceived to discourage employees from reporting problems directly to the government, such as severance or confidentiality agreements that limit an employee's ability to disclose information or monetary rewards from whistleblower programs.³⁹

NEW PCAOB AUDIT DISCLOSURE RULE TAKES EFFECT

A PCAOB rule requiring audit firms to disclose the names of each audit engagement partner, as well as the names of other firms that took part in the audit, became effective June 30, 2017. This information will be a required disclosure on a new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, and will be publically available.⁴⁰ This rule was first discussed in July 2009, and then considered at an open meeting on December 15, 2015. The PCAOB Chief Auditor Martin Baumann stated that the new enhanced disclosure “will provide investors and other financial statement users with the information they have continued to request ... giving the market valuable information, while responding to concerns raised by accounting firms and others about the unintended consequences of such a disclosure in the auditor's report.”⁴¹ The standard filing deadline for Form AP will be 35 days after the date the auditor's report is first included in an SEC filing.⁴²

SEC IN-HOUSE JUDGES

On June 26, 2017, the D.C. Circuit became the first appellate court to uphold the SEC's in-house courts on constitutional grounds when it deadlocked on a challenge that the in-house judges were hired in violation of the Appointments Clause.⁴³ Petitioner Raymond J. Lucia, a former investment adviser, challenged a ruling from an administrative law judge that barred him from the industry and imposed a six-figure penalty. A D.C. Circuit panel ruled in August 2016 that the appointments were constitutional.⁴⁴ Following Lucia's appeal of that decision, the

full court heard oral arguments in May. The court subsequently issued a one-page per curiam order on June 26, 2017, stating that the court was divided and would decline to review the ruling en banc. This ruling has created a circuit split given the Tenth Circuit's ruling in December 2016 that the ALJ hiring process is unconstitutional. In *Bandimere v. SEC*, the Tenth Circuit held that the ALJ hiring process violates the Appointments Clause because the judges are neither appointed by the president nor by the agency's commissioners.⁴⁵ The SEC has stayed all administrative proceedings that could be reviewed by the Tenth Circuit until it determines whether to appeal the *Bandimere* decision to the Supreme Court.

ARTIFICIAL INTELLIGENCE AND RISK ASSESSMENT BY REGULATORS

In a recent address at the Annual Operational Risk North America Conference, Scott Bauguess, Acting Director of the Division of Economic and Risk Analysis (“DERA”), discussed the ways in which major advances in machine learning and artificial intelligence have improved the ability of regulators to monitor markets for potential misconduct.⁴⁶ The SEC now employs topic modeling and other cluster analysis techniques that identify both common and outlier behaviors in the market. These analyses can quickly and easily identify trends that may prompt further investigation by SEC staff. In addition to market monitoring, DERA uses predictive modeling algorithms to analyze investment adviser filings. DERA's models are five times better than random methods at identifying troublesome language in these filings that could merit a referral to enforcement. While the models can also generate false positives, SEC staff is aware of this risk and critically examines and evaluates the model outputs. Human examinations of the outputs can be used to refine the algorithm or “train” it to understand what language is most likely indicative of possible fraud or misconduct. Bauguess noted that the “demonstrated ability of these machine learning algorithms to guide staff to high risk areas ... enables the deployment of limited resources to areas of the market that are most susceptible to possible violative conduct.” While Bauguess was careful to point out that “machine learning predication cannot—and should not—be the sole basis of an enforcement action,” companies and individuals should expect the SEC to continue to utilize artificial intelligence and predictive modeling to enhance its monitoring and enforcement as this technology evolves.

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ENDNOTES

- 1 Jay Clayton, Chairman, SEC, “Remarks at the Economic Club of New York” (July 12, 2017).
- 2 *Id.* (Principle #4).
- 3 *Id.* (Principle #5).
- 4 *Id.* (Principle #7).
- 5 *Id.*
- 6 Exchange Act Release No. 79,844 (Jan. 19, 2017).
- 7 Civil Action No. 17-cv-4866 (S.D.N.Y. June 28, 2017).
- 8 Civil Action No. 17-cv-4883 (N.D. Ill. June 29, 2017).
- 9 Criminal Action No. 16-cr-772 (N.D. Ill. July 6, 2017) (both executives entered not guilty pleas on July 6, 2017).
- 10 Litigation Release No. 23,855 (June 8, 2017).
- 11 Exchange Act Release No. 80,564 (May 1, 2017).
- 12 Litigation Release No. 23,765 (Mar. 3, 2017).
- 13 Exchange Act Release No. 79,823 (Jan. 18, 2017).
- 14 Criminal Action No. 16-cr-595 (S.D.N.Y. June 30, 2017).
- 15 Civil Action No. 16-cv-7003 (S.D.N.Y. Sept. 8, 2016).
- 16 Exchange Act Release No. 79,772 (Jan. 11, 2017).
- 17 Exchange Act Release No. 80,547 (Apr. 28, 2017).
- 18 Exchange Act Release No. 80,548 (Apr. 28, 2017).
- 19 Exchange Act Release No. 79,753 (Jan. 6, 2017).
- 20 Exchange Act Release No. 79,857 (Jan. 23, 2017).
- 21 Exchange Act Release No. 80,901 (June 9, 2017).
- 22 Exchange Act Release No. 80,947 (June 15, 2017).
- 23 Litigation Release No. 23,741 (Feb. 3, 2017).
- 24 Litigation Release No. 23,775 (Mar. 10, 2017).
- 25 Litigation Release No. 23,838 (May 22, 2017).
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- 31 Michael S. Piwowar, SEC Commissioner, “Opening Remarks at 2017 SEC/NASAA Annual Section 19(d) Conference” (May 9, 2017).
- 32 Kara M. Stein, SEC Commissioner, “Closing Remarks at 2017 SEC/NASAA Annual Section 19(d) Conference” (May 9, 2017).
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- 35 See *Somers v. Digital Realty Trust Inc.*, 850 F.3d 1045, 1047 (9th Cir. 2017), cert. granted, 85 U.S.L.W. 3594 (U.S. June 26, 2017) (No. 16-1276).
- 36 *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145, 155 (2d Cir. 2015).
- 37 *Asadi v. G.E. Energy (USA), L.L.C.*, 720 F.3d 620, 630 (5th Cir. 2013).
- 38 Jane Norberg, Chief, Office of the Whistleblower, “Corporate Whistleblowing in 2017” (June 28, 2017).
- 39 See e.g., Exchange Act Release No. 79,804 (Jan. 17, 2017).
- 40 PCAOB, “Staff Guidance Form AP, Auditor Reporting of Certain Audit Participants and Related Voluntary Audit Report Disclosure Under AS 3101, Reports on Audited Financial Statements” (Feb. 16, 2017).

- 41 PCAOB, "[PCAOB Adopts Rules Requiring Disclosure of the Engagement Partner and Other Audit Firms Participating in an Audit](#)" (Dec. 15, 2015).
- 42 PCAOB Release No. 2015-008 (Dec. 15, 2015).
- 43 *Raymond J. Lucia Cos. v. Sec. & Exch. Comm'n*, No. 15-1345, 2017 WL 2727019, at *1 (D.C. Cir. June 26, 2017).
- 44 *Raymond J. Lucia Cos. v. Sec. & Exch. Comm'n*, 832 F.3d 277, 281 (D.C. Cir. 2016), *reh'g en banc granted, judgment vacated* (Feb. 16, 2017), *on reh'g en banc*, No. 15-1345, 2017 WL 2727019 (D.C. Cir. June 26, 2017).
- 45 *Bandimere v. Sec. & Exch. Comm'n*, 844 F.3d 1168 (10th Cir. 2016).
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