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WHITE PAPER

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SEC Enforcement in Financial Reporting and Disclosure: 2019 Year-End Update

We are pleased to present our annual year-end update on financial reporting and issuer disclosure enforcement activity for 2019. This *White Paper* focuses on the U.S. Securities and Exchange Commission's ("SEC") enforcement activity for the second half of 2019 but also discusses other recent developments, including relevant pending Supreme Court cases and SEC rulemaking activity. Overall, the agency has been active this year, driven largely by its continued focus on protecting "retail investors" and interest in naming individuals.

TABLE OF CONTENTS

INTRODUCTION . . . 1

ENFORCEMENT REVIEW . . . 3

- Accounting Fraud . . . 3
- Individual Accountability . . . 6
- Biotechnology Firms . . . 7
- Auditors and Audit Committees . . . 8
- American Depository Receipt Enforcement . . . 9

SCOTUS to REVIEW SEC'S DISGORGEMENT AUTHORITY . . . 9

DISCLOSURES: UPDATES ON REGULATION S-K AND A REGULATION FD ACTION . . . 9

PROXY FIRMS . . . 10

LAWYER CONTACTS . . . 11

ENDNOTES . . . 11

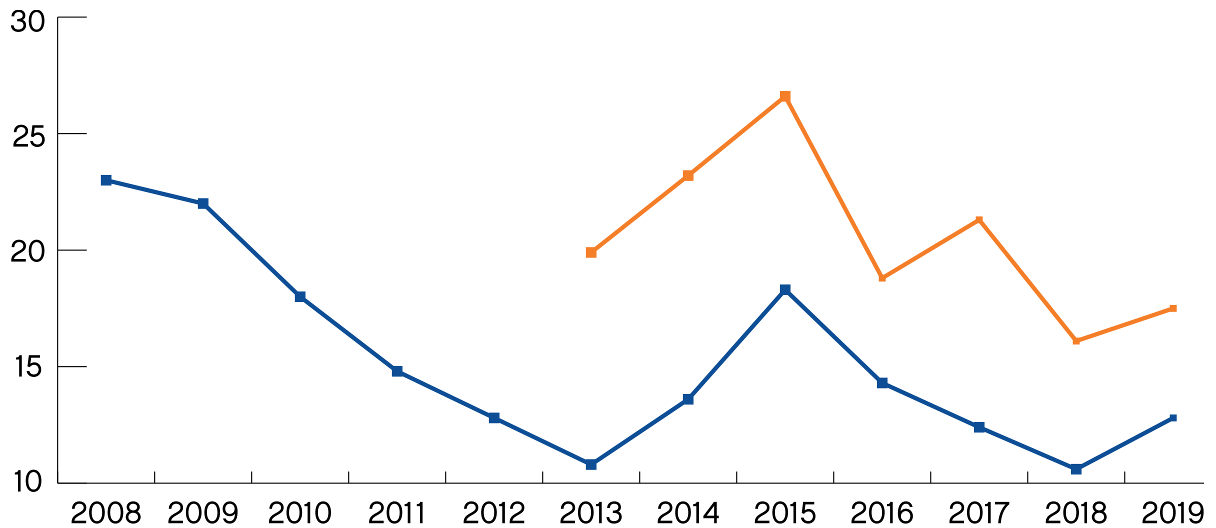
INTRODUCTION

The chairmanship of Jay Clayton continues to focus the SEC's enforcement program on main street investors and misconduct by individuals. And with the hiring freeze lifted, the suspension of appropriations over, an emphasis on faster investigations in response to *Kokesh*, and the resolution of administrative proceedings upended by the *Lucia* decision, the Commission is now firmly focused on its own agenda.

The continuing guideposts of main street investors and individual misconduct does not mean a focus merely on offering frauds but increasingly explains broader programmatic interests and sweeps. In the recent Enforcement Annual Report, the codirectors also included a lengthy section noting their interest in issuer disclosure and accounting matters. This discussion is worthy of note and signals intention to apply enforcement resources to issuer disclosure, financial fraud, and accounting matters. The codirectors noted a number of the matters we discuss below and, in the recent past, have grouped together otherwise small matters to highlight the need to remediate material weaknesses.

In fiscal year 2019 ("FY2019"), the number of cases in the issuer disclosure space remained essentially flat at 17% of "standalone" matters (compared with 16% in fiscal year 2018), and only 13% of overall matters in FY2019. These historically low numbers could account for why the codirectors signaled a focus in this area, as a financial crisis could expose the Enforcement Division to criticism if these numbers are interpreted as weakness or lack of interest in this space.

Issuer Reporting and Disclosure Actions as a Percent of Enforcement Actions



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
% of Total	23.0	22.0	18.0	14.8	12.8	10.8	13.6	18.3	14.3	12.4	10.6	12.8
% of Indep						19.9	23.2	26.6	18.8	21.3	16.1	17.5

In noting the focus on issuers and financial institutions, the codirectors also highlighted matters involving auditors and, in particular, auditor independence. The matters they highlight are summarized below. While the Enforcement Division also noted that often accounting matters involved actions against both the auditor and issuer, there did not seem to be a large number of these matters.

A significant area of note is the focus on accelerating the pace of investigations. The Enforcement Division has brought the timing down to just under 24 months for the average length of an investigation and continues to try to reduce the length of investigations in issuer disclosure cases, where the average age of investigation is currently 37 months. Concluding investigations more rapidly is certainly to the benefit of issuers, but the key questions are: How will these generally complex investigations be resolved more quickly? Will enforcement staff seek formal orders earlier at the expense of a voluntary exchange of information? Will it be at the expense of the issuer's ability to advocate their positions? The Enforcement Division highlighted two matters that were brought more quickly, one where the company self-reported and one where the SEC was able to essentially duplicate a matter already investigated and brought by another regulator. Both matters reflected instances in which the conduct was neither identified by nor primarily investigated by Commission staff and therefore may not be easily replicated.

In a continued effort to encourage more self-reporting, the Enforcement Division recently attempted to provide additional transparency on the benefits of cooperating, and especially self-reporting. The Enforcement Division highlighted one matter where self-reporting led to no penalty, and another matter where cooperation and extensive remediation, but apparently not self-reporting, led to a lower penalty. Self-reporting remains a difficult decision that must be carefully considered. It is made all the more difficult because the composition of the SEC changes over time, and thus the view of the SEC on how to reward self-reporting may change from administration to administration. For instance, at one point in time, self-reporting could lead to no enforcement matter being brought, and now the benefit appears to be no penalty. Nonetheless, every Commission has sought to encourage self-reporting by providing some benefit to those who do so, and there are other considerations that factor into the self-reporting equation (e.g., the possible existence of whistleblowers).

The Commission is also affording more transparency to its own processes as it now reveals for many—especially settled—district court actions, the vote of its Commissioners. The Commission already discloses its votes on administrative proceedings, but in recent years has made this information much more readily available and, since June 2019, has posted on its website the votes in district court matters. As enforcement matters are all voted on in closed Commission meetings, this gives the public its only real insight into these votes. And the votes will be interesting to watch as Commissioner Allison Lee comes fully onboard, and Commissioner Robert Jackson is replaced.

Two matters identified in the annual report present particularly troubling issues if they become trends. First is the matter where the issuer allegedly violated the law for failing to disclose, and accrue for, an ongoing nonpublic Department of Justice ("DOJ") investigation. It is generally considered to be a judgment call as to whether an issuer should disclose the existence of regulatory or law enforcement investigation, with the standard being whether there was a settlement that included terms that were probable and reasonably estimable. This standard does not appear to have been met in this matter. Potentially, however, the SEC's real focus was not the DOJ investigation status, but rather that the Food and Drug Administration ("FDA") had told the issuer it could no longer call its main product a "generic" device rather than a "branded" device. At best, this matter muddles the appropriate standard that issuers and their counsel should provide in these judgment-laden situations.

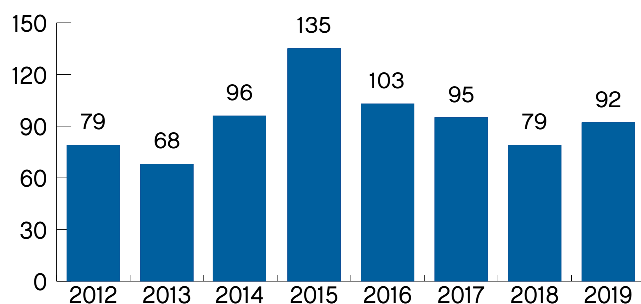
The second is one in which the Commission alleges the defendant's Wells Submission failed to express remorse or an acknowledgment of wrongdoing. The compliant does not call the defendant's document a Wells Submission, but from the description, this is what it appears to be. Wells Submissions have always been viewed as an opportunity to express the defendant's view of the facts and the law to the Commission—in other words, an advocacy piece. While it is clear the SEC views any statements made in such submissions as admissions that can be used in court, the mere *fact* that a defendant advocates for its legal or factual position has not previously been used publicly against a defendant. While this may have been based on the individual facts and circumstances of this particular matter, an SEC positional shift here could undercut a defendant's ability to defend itself prior to the filing of a formal complaint.

Finally, as we note the anticipated Supreme Court decision in *Liu,* determining whether the SEC may seek disgorgement in district court actions and SEC rulemaking in the proxy space will be developments to watch in the coming months.

ENFORCEMENT REVIEW

The second half of 2019 saw the Enforcement Division's continued focus on the protection the "retail investor" but also showed steady attention being paid to financial reporting and disclosure matters. The number of such actions stayed fairly consistent in 2019:[1]

Issuer Disclosure and Enforcement Actions (No FCPA)



We characterize the following notable enforcement actions into five groups: (i) accounting and disclosure fraud; (ii) individual accountability; (iii) biotechnology firms; (iv) scrutiny of auditors; and (v) American depository receipt enforcement.

Accounting Fraud

- The SEC charged a semiconductor company with violating the antifraud and reporting provisions of the securities laws, alleging that the company pulled sales scheduled for future quarters into the current quarter to close the gap between their actual and publicly forecasted guidance.[2] Specifically, the amounts pulled in for Q4 2015 and Q1 2016 totaled $24 million and $64 million, respectively. According to the SEC, the semiconductor company also misleadingly lauded its Q4 2015 financial results and falsely stated that it met public earnings guidance for Q1 2016.[3]

  In consideration of settlement, the semiconductor company agreed to cease and desist from further violations and to pay $5.5 million in penalties.[4]

- The SEC settled charges against a bank holding company and two of its officers stemming from the company's reporting, recordkeeping, and internal control failures in connection with its commercial loan portfolio. Between 2012 and 2014, the company allegedly failed to properly classify certain loans and take appropriate charges for individually impaired loans, resulting in the company materially understating its Allowance for Loan and Lease Losses and its Provision for Loan and Lease Losses in periodic reports filed with the Commission. During this same time period, the holding company also allegedly failed to devise or maintain internal accounting controls for credit file maintenance. As a result of these failures, the bank holding company restated its financial results and financial statements for prior years, as for example, its Provision for Loan and Lease Losses for the company's fiscal years 2010 through 2013 was understated by an aggregate amount of approximately $138.6 million.

  Pursuant to the settlement agreement, the company consented to a cease-and-desist order and agreed to pay a $1.4 million penalty. Both officers agreed to pay a $50,000 penalty.[5]

- The SEC filed a settled action against an international automotive manufacturer, its former CEO, and one of its former director for charges related to financial disclosures that omitted more than $140 million to be paid to the former CEO in retirement. Specifically, the SEC alleged that company personnel deceived the company's CFO and devised payment structures for the former CEO's postretirement compensation, such as entering into secret contracts, backdating letters to grant interest in the company's Long Term Incentive Plan, and changing the calculation of the former CEO's pension allowance to provide for benefits.[6]

  In consideration of settlement the company agreed to pay $15 million, while the former CEO agreed to pay $1 million and the former director agreed to pay $100,000. The CEO also consented to a 10-year officer and director bar, while the director agreed to a five-year bar and a five-year suspension from practicing or appearing before the Commission as an attorney.

- The SEC charged a publicly traded global information and media analytics firm and its former CEO with overstating

revenue by approximately $50 million by engaging in a fraudulent scheme by which the company entered into nonmonetary transactions to increase its reported revenue. Through these transactions, the company and a counterparty would allegedly exchange sets of data without cash consideration, and the company recognized revenue on the basis of the fair value of the data it delivered, which was allegedly increased to inflate revenue.[7]

The Commission also alleged that the company and former CEO made false and misleading public disclosures regarding the company's clientele and flagship product and that the CEO lied to the company's internal accountants and outside auditors.[8] Amidst these allegations, the SEC stated that the firm's "ineffectual corporate culture resulted in, among other material weaknesses, sales practices designed to maximize and manage the timing of revenue recognition, inadequate accountability for recording transactions in accordance with GAAP, and insufficient internal controls to limit the ability of management to exercise influence" over financial reporting.[9]

To settle the charges, the company and the former CEO agreed to cease-and-desist from future violations of the antifraud provisions of the federal securities laws and to pay monetary penalties of $5 million and $700,000, respectively. In settling with the company, the Commission considered the company's cooperation and extensive remedial acts. The former CEO also agreed to reimburse the company $2.1 million in profits from the sale of stock and incentive-based compensation pursuant to Section 304(a) of the Sarbanes-Oxley Act and to the entry of a 10-year officer and director bar against him.[10]

- The SEC brought a settled action against a paint and coatings manufacturer after the company allegedly made fraudulent misstatements in the company's financial statements intended to bridge the gap between actual and projected earnings. Specifically, the SEC alleged that the manufacturer failed to properly record expense accruals and misclassified certain income, leading to inflated published financial results for 2016 and fiscal 2017 and certain quarters therein. The manufacturer restated its financials for the relevant periods on June 28, 2018, and disclosed 14 instances of accounting misconduct. It also identified a material weakness in internal controls over financial reporting.[11]

  The manufacturer agreed to settle charges that it violated the antifraud, reporting, books and records, and internal accounting controls provisions of the securities laws. However, in light of the manufacturer's self-reporting and remediation efforts, the SEC afforded the company significant cooperation credit and imposed no monetary penalties in consideration of the settlement.[12]

- The SEC brought a settled action against a publicly traded real estate investment trust in the United States District Court for the Southern District of New York, alleging that it manipulated and falsely reported non-GAAP performance measures— specifically, its Same Property Net Operating Income ("SP NOI") Growth Rate in its annual and quarterly filings. To manipulate SP NOI, the company allegedly (i) selectively recognized income; (ii) incorporated lease termination income into SP NOI, despite claiming that the income was excluded from the calculation; and (iii) reduced the SP NOI for the previous reporting period in order to make the current quarter's growth rate appear more significant. According to the SEC, certain of the defendants referred to this process as "making the sausage."[13]

  The SEC's complaint charged the investment trust with violations of Sections 10(b) and 13(a) of the Exchange Act and Rule 100(b) of Regulation G of the Exchange Act. In consideration of settlement, the investment trust agreed to pay a $7 million penalty and comply with certain undertakings, including retention of an independent consultant to review controls relating to calculation and disclosure of non-GAAP measures such as SP NOI.[14]

  The SEC also charged four former senior executives of the investment trust with aiding and abetting the investment trust's violations and sought permanent injunctions against future violations, disgorgement and penalties, and officer and director bars against the individual defendants. The U.S. Attorney's Office for the Southern District of New York also announced parallel criminal charges against the individual defendants.[15]

- In another matter where the SEC alleged misrepresentations regarding performance indicators, the SEC charged a Michigan-based automaker and its parent company with misleading investors about the number of new vehicles sold each month to customers in the United States.

Between 2012 and 2016, the company allegedly issued monthly press releases falsely reporting new vehicle sales and emphasizing a "streak" of monthly year-over-year sales growth, when the growth streak was actually broken in September 2013. According to the SEC, in months when the growth streak would have ended, the company made payments to dealers to report fake vehicle sales and reported prior unreported actual sales as if they had recently occurred a practice internally referred to as taking sales from the "cookie jar."[16]

To settle charges that it violated antifraud, reporting, books and records, and internal accounting controls provisions of the securities laws, the company and its parent agreed to cease and desist from committing or causing future violations of these provisions and to pay a civil penalty of $40 million jointly and severally.[17]

- The SEC charged a publicly traded pharmaceutical company with failing to timely disclose or accrue for potential liability relating to a DOJ investigation as to whether the company severely overcharged Medicaid with respect to the company's flagship product. Specifically, the SEC alleged that the pharmaceutical company improperly failed to disclose or record an accrual for a loss before October 2016, when it announced a $465 million settlement with the DOJ. Furthermore, the pharmaceutical company allegedly classified the product as a "generic" rather than a "branded" drug, which resulted in the company paying much lower rebates that it should have. [18]

  As a result, the Commission claimed that the pharmaceutical company had violated the antifraud (Sections 17(a)(2) and (3) of the Securities Act), reporting, books and records, and internal accounting controls provisions of the securities laws. To settle the charges, the pharmaceutical company agreed to pay a $30 million penalty and to the entry of an order enjoining it from future violations.[19]

- The SEC charged a producer of specialty hydrocarbon products with including material misstatements in its earnings release. The producer allegedly implemented a new enterprise resource planning ("ERP") system which resulted in certain "disruptions." For example, the new ERP system inhibited the company's ability to maintain effective internal controls and meet reporting deadlines. The SEC's order found that the producer was seven weeks late filing its Q3 2017 financial results, in which it reported two material weaknesses in Internal Control Over Financial Reporting ("ICFR"). Further, on March 8, 2018, the producer announced its 2017 financial results, but disclosed 11 days later that it expected those results to differ from what it had reported on March 8. Ultimately, the producer issued a press release on April 2, 2018, which indicated that the producer had underreported the company's net loss by 18%.[20]

  The producer consented to the entry of the SEC's order finding that it had violated the reporting provisions of the securities laws and further agreed to pay a penalty of $250,000.[21]

- The SEC charged a brand-management company and its former executives with fraud after allegedly devising a scheme to recognize false revenue and manipulate earnings. According to the complaint against the company, the company entered into transactions to hide the "distressed financial condition" of two licensees whose licensing royalty payments were effectively uncollectable and failed to recognize impairment charges for three of its brands over the course of multiple years. The complaint alleges that, in sum, the company's fraudulent accounting practices led the company to overstate its net income by hundreds of millions of dollars between 2013 and 2015. To settle charges that it violated the antifraud (Section 17(a) of the Securities Act and Sections 10(b) of the Exchange Act), reporting, books and records, and internal accounting controls provisions of the securities laws, the company agreed to injunctive relief and to pay a $5.5 million penalty.[22]

  Separately, the SEC alleged that the former CEO and former COO—after realizing that substantial profits on the company's stock sales were fraudulently derived—deleted emails and caused the company to make false and misleading statements in response to an SEC inquiry. The SEC charged the former CEO with violating Sections 10(b) of the Exchange Act and Section 17(a) of the Securities Act, Section 304(a) of the Sarbanes-Oxley Act of 2002, lying to auditors and aiding and abetting certain of the company's violations of the reporting and controls violations. The Commission also charged the former COO with similar violations. The former COO is cooperating with the SEC and consented to injunctive relief, a permanent officer and

director bar, disgorgement and prejudgment interest of more than $147,000, and monetary penalties of an amount to be determined a later date. Litigation against the former CEO is ongoing. Additionally, the U.S. Attorney's Office for the Southern District of New York announced parallel criminal charges against the former CEO and the former COO, to which the former COO pleaded guilty.[23]

Finally, the SEC also alleged the company's former CFO failed to recognize losses from the company's "distressed" licensees, failed to disclose secret transactions intended to temporarily augment the licensees' finances, and failed to properly test for impairment. The SEC charged the former CFO with willful violations of Securities Act Sections 17(a)(2) and (3) and Exchange Act Rules 13b2-1 and 13b2-2 and causing certain of the company's violations. To settle those charges, the former CFO agreed to disgorgement and prejudgment interest of nearly $50,000 and to pay a $150,000 monetary penalty. He also agreed to entry of an order suspending him from appearing and practicing before the SEC as an accountant for three years, after which he may apply for reinstatement.[24]

- The SEC brought a settled action against an insurance company arising from two errors in its accounting for reserves associated with its annuities businesses. The insurance company allegedly improperly released reserves for certain annuity benefits, which resulted in the company reporting inflated income. After determining that it maintained flawed processes for locating and contacting unresponsive annuitants, the company increased reserves by $510 million as of year-end 2017. Additionally, the insurance company also allegedly overstated reserves and understated income relating to variable annuity guarantees assumed by its subsidiary. In response, the insurance company reduced reserves by $896 million as of year-end 2017.[25]

  As a condition of the settlement, the insurance company agreed to cease and desist from committing or causing future violations the books and records and internal control provisions and agreed to pay a civil penalty of $10 million.[26]

- The SEC brought settled charges against a data storage company for internal accounting controls violations resulting in chronic revenue recognition errors over a two-year timespan. According to the SEC, the company recognized revenue from dozens of transactions without meeting the revenue recognition criteria required under GAAP. This occurred because the company's sales personnel—without management's knowledge—added terms to third-party transactions that inhibited the company's revenue recognition ability under GAAP. The SEC further alleged that accounting personnel left these errors unchecked for almost three years because accounting personnel responsible for revenue recognition determinations were either ignorant of these extra terms or lacked the sophistication required to analyze these extra terms under GAAP.[27]

  Accordingly, the SEC charged the data storage company with violations of reporting, books and records, and internal accounting provisions of the Exchange Act. To settle these charges, these company agreed to pay a $1 million penalty and to cease and desist from future violations.

- The SEC charged a nutrition company with defrauding investors by inaccurately describing its business model and operations in China. Allegedly, the nutrition company told its investors that it used a business model in China that was distinct from its global business model when, in reality, the two models were quite similar.[28] In addition, the SEC alleged that an executive asserted that company personnel would "have supporting documents that will somehow magically support" work hours on invoices. [29]Without admitting or denying the SEC's findings that the nutrition company had violated antifraud and reporting provisions of the federal securities laws, the nutrition company agreed to pay a $20 million penalty.[30]

Individual Accountability

The SEC continued its trend of holding individual senior-level officers and directors accountable and brought several financial reporting and disclosure actions against individuals in the second half of 2019:

- The SEC charged senior managers of a healthcare company with engaging in a scheme to overstate the healthcare company's revenues. According to the SEC's complaint, the managers' conduct included recognizing fictitious revenue, severe overbilling and subsequent crediting in later quarters, authorization of fraudulent sales

practices, and concealing discounts from the company's finance department. These practices allegedly caused the company to misreport its financials in its various filings with the Commission.[31]

While charges varied among the individual participants in the scheme, the SEC—for example—specifically charged one senior manager with violations of the antifraud provisions Securities Act and Exchange Act, the internal controls and books and records provisions of the Exchange Act, and the lying to auditors provision of Rule 13b2-2 of the Exchange Act. The SEC also alleged that the senior manager willfully aided and abetted and caused certain of a company principal's violations of the antifraud provisions of the Securities Act and the Exchange Act, and that the manager willfully aided and abetted and caused the company's violations of the periodic reporting provisions of the Exchange Act, the internal controls and books and records provisions of the Exchange Act Sections, and Regulation Fair Disclosure ("Regulation FD"). To settle these charges, the senior manager agreed to a five-year officer and director bar, to pay a $80,000 civil penalty, and to a five-year suspension from appearing or practicing before the SEC as an accountant.[32]

- The SEC charged two former senior executives of a trucking company for participating in a scheme by which the company reported inflated income and earnings per share. The SEC's complaint alleged that the executives sought to conceal losses by buying and selling trucks at inflated prices, in some cases at double or triple their fair market value. The executives also allegedly caused the company to overstate its pretax income, net income, and earnings per share in public filings in 2016. Finally, the complaint alleged that the executives lied to the company's auditor by claiming that the truck prices were "determined and evaluated independently," and by covering up their roles in negotiating and approving the transactions.[33]

  The executives were charged with violating various antifraud provisions of the Securities Act and the Exchange Act, lying to auditors, and aiding and abetting the company's books and records and reporting violations. The Commission seeks permanent injunctions, monetary penalties, and officer and director bars against the defendants. The U.S. Attorney's Office for the Southern District of Indiana and the DOJ filed parallel criminal charges.[34]

Biotechnology Firms

Whether a matter of coincidence or a concerted effort by the Commission, there notably were multiple enforcement actions commenced against biotechnology firms in the latter half of 2019:

- The SEC filed a settled action against a biotechnology firm, charging the company with failing to maintain ICFR reporting for 12 consecutive annual reporting periods. According to the SEC, in each of its Forms 10-K during that period, the company disclosed material weaknesses, many of which recurred annually and which the company did not sufficiently address. The company also repeatedly disclosed that it lacked internal controls to guarantee that all material transactions and developments impacting its financial statements were reflected and properly recorded. In its most recent Form 10-K for Fiscal 2018, the company allegedly continued its trend by disclosing material weaknesses, including two newly identified weaknesses. In addition, the company allegedly failed to timely file its Form 10-K for 16 consecutive years.[35]

  The SEC charged the biotechnology firm with violating the internal control provisions of the Exchange Act. As a term of settlement, the biotechnology firm agreed to pay civil penalties of $250,000.[36]

- The SEC also brought a settled action against a biotechnology firm for allegedly misstating the company's revenue and attempting to cover up misconduct. Specifically, the SEC alleged that from 2013 to 2017, the biotechnology firm improperly recognized revenue because its former CEO and former COO entered into undisclosed agreements with distributors, which allowed distributors to return product or which made distributors' payment obligations contingent on sales to end users. The former CEO and former COO, along with the company's former CFO, allegedly covered up these side agreements for years, even after the company's controller raised concerns about its accounting for specific transactions. The SEC also alleged that the former CEO, former COO, and former CFO misled outside auditors, the company's audit committee, and outside counsel with respect to these transactions.[37]

The SEC's complaint charged the biotechnology firm with violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. The complaint also alleged that the company violated certain reporting and recordkeeping provisions of the Exchange Act, and that the former CEO, the former COO, and the former CFO aided and abetted these violations. Further, the complaint alleges that the former CEO, the former COO, and the former CFO directly violated Exchange Act Section 13(b)(5).[38]

The biotechnology firm agreed to pay a $1.5 million penalty while litigation against the three former officers remains pending. The SEC seeks permanent injunctions, disgorgement plus interest, penalties, and officer and director bars against all three former officers, and also seeks clawback of bonuses and other incentive-derived compensation paid to the former CEO and the former CFO.[39]

- The SEC also obtained final judgments against a biotechnology firm and five former executives and consultants for defrauding investors out of $26 million. The complaint alleged that the company offered and sold unregistered securities for more than six years and misrepresented that the company was not paying its directors and officers when, in reality, the company's largest expense was executive compensation. The final judgment (i) permanently enjoined all defendants from violating the antifraud provisions of the Securities Act and the Securities Exchange Act, and certain individual defendants from violating Section 15(a) of the Exchange Act and Section 5 of the Securities Act; (ii) permanently barred certain individual defendants from serving in senior positions at public companies; and (iii) ordered defendants to pay disgorgement and penalties totaling more than $44 million.[40]

Auditors and Audit Committees

As in prior years, the SEC took some notable actions on matters involving auditing and auditors.

First, the SEC proposed rules to modernize the auditor independence rules first adopted in 2000 and then revised in 2003. The proposed amendments "primarily focus on fact patterns presented to Commission staff through consultations that involve a relationship with, or services provided to, an entity that has little or no relationship with the entity under audit, and no relationship to the engagement team conducting the audit."[41] Of perhaps most relevance are the proposed rules designed to alleviate, in certain situations, auditor independence concerns where an investment fund has multiple investments in portfolio companies and the different companies are working with affiliated auditors, typically foreign affiliates, of the same firm. The proposed rules also introduce "a transition framework to address inadvertent independence violations that only arise as a result of merger and acquisition transactions." The comment period for the rules remain open for 60 days following publication of the proposing release in the Federal Register.

The SEC's chairman, chief accountant, and director of the Division of Corporation Finance released a statement ahead of the 2019 calendar year-end financial reporting season offering "key reminders regarding oversight responsibilities."[42] The statement offered general reminders on such areas as tone at the top; auditor independence; implementing new generally accepted accounting principles (e.g., new revenue and lease standards); ICFR; and communications to the audit committee from the auditors. It also offered more specific reminders on non-GAAP measures; reference rate reform (LIBOR); and critical audit matters from the audit committee perspective. On reference rate reform—the process of discontinuation and transition to an alternative reference rate away from LIBOR—the statement "encouraged audit committees to understand management's plan to identify and address the risks associated with reference rate reform, and specifically, the impact on accounting and financial reporting and any related issues associated with financial products and contracts that reference LIBOR." The entire reminder is worthy of review by audit committee members and management.

Finally, the SEC brought two audit independence matters against auditors and audit firms that are worth mention:

- The SEC charged a public accounting firm with violating auditor independence rules with respect to more than 100 audits. Specifically, the SEC alleged that the accounting firm represented that it was "independent" of audit clients when, in fact, the firm was also providing nonaudit services or engaging in employment relationships with at least 15 of the firm's audit clients.[43]

Accordingly, the SEC found that the accounting firm violated the auditor independence provisions of the federal

securities laws and caused audit clients to violate their independent audit obligations. The accounting firm agreed to an order to cease and desist from future independence violations, to pay a $950,000 penalty, and to retain and independent consultant to evaluate its control for complying with independence requirements for nonaudit services.[44]

- The SEC brought settled charges against a major accounting firm and one of its partners for alleged violations of the SEC's auditor independence rules. According to the Commission, the firm was retained by an audit client—during an audit engagement—to design and implement financial reporting software and perform certain management tasks.[45]

  In response to the charges, the firm agreed to pay disgorgement of $3,830,213, plus prejudgment interest of $613,842 and a civil money penalty of $3.5 million, and to be censured. The firm also agreed to a series of specific undertakings by which the firm must review its current quality controls for complying with auditor independence requirements and assessing its provision of nonaudit services. The partner agreed to pay a civil money penalty of $25,000 and to be suspended from appearing or practicing before the Commission, with a right to apply for reinstatement after four years.[46]

American Depository Receipt Enforcement

The SEC charged two financial institutions with improperly handling prereleased American Depositary Receipts ("ADRs"). Both financial institutions improperly obtained prereleased ADRs when they should have known that the prerelease transactions were not backed by the required foreign shares.[47] With respect to the first financial institution, the SEC's order found that it violated Section 17(a)(3) of the Securities Act of 1933 and failed to reasonably supervise its securities lending personnel. Without admitting or denying the SEC's findings, the financial institution agreed to disgorgement and penalties totaling almost $650,000. With respect to the second financial institution, the SEC's order found that it failed to reasonably supervise its securities lending personnel, and without admitting or denying the SEC's findings, the financial institution agreed to disgorgement and penalties totaling over $3.9 million.[48]

These actions raised the total number of financial institutions charged by the SEC during its ongoing investigation into ADR prerelease practices to 13.[49]

SCOTUS TO REVIEW SEC'S DISGORGEMENT AUTHORITY

As evident from the actions described in Section II above, disgorgement is a crucial securities enforcement tool. However, the SEC's authority to seek disgorgement in district court actions has come under fire as the Supreme Court granted certiorari to review whether the SEC has proper authority to obtain disgorgement in district court actions as a remedy for securities violations.[50] A decision that the SEC does not have disgorgement authority in district court actions would have a significant impact on securities enforcement practice, as Courts of Appeals have consistently upheld disgorgement for nearly five decades, and since 2015, the SEC has obtained more than $2.5 billion from disgorgement annually.[51]

If the Supreme Court finds that the SEC does not have disgorgement authority in district court litigation, the SEC will still be able to obtain disgorgement in administrative proceedings.[52] Further, the SEC would still be able to obtain civil monetary penalties in district court litigation.[53] And, while Congress could override a decision limiting the SEC's disgorgement authority, the very question of the SEC's disgorgement authority may lead to an uptick in administrative—rather than district court—litigation.[54] Indeed, in the short-term, such a ruling against the SEC would severely limit the SEC's enforcement power and could have implications on the enforcement powers of other federal agencies.[55]

DISCLOSURES: UPDATES ON REGULATION S-K AND A REGULATION FD ACTION

On August 8, 2019, the SEC proposed amendments to disclosures made under Regulation S-K.[56] The purpose of the proposed amendments is to modernize and increase readability of disclosure documents while also discouraging disclosure of repetitive and nonmaterial information.[57] The primary changes would be made to the description of the general development of the business, the description of smaller reporting companies, the narrative description of the business, legal proceedings, and risk factor disclosures (Items 101(a), 101(h), 101(c), 103, and 105, respectively).[58]

Across each of the amendments, there is a shift towards principles-based disclosure by creating a more flexible approach

that will encourage registrants to exercise judgment in evaluating what disclosures to provide.[59]

While potential changes to Regulation S-K came in the form of proposed amendments, the SEC revisited Regulation FD through a recent enforcement action. Indeed, this enforcement action was the first standalone Regulation FD enforcement action since 2013.

On August 20, 2019, the SEC charged a pharmaceutical company with violations of Regulation FD based on its sharing of material, nonpublic information with research analysts, without also revealing the same information to the broader public. Specifically, the SEC alleged that in 2017, the pharmaceutical company twice selectively shared material information with analysts about the company's interaction with the FDA. Furthermore, the SEC alleged that the pharmaceutical company lacked policies and procedures designed to ensure compliance with Regulation FD at the time of the alleged violations. To settle the charges against it, the pharmaceutical company agreed to cease and desist from future violations of Regulation FD and Section 13(a) of the Exchange Act, and to pay $200,000 in monetary penalties.[60]

PROXY FIRMS

On August 21, 2019, the SEC voted to adopt new guidance that addresses how investment advisors should conduct their engagement of proxy firms in a way that is compliant with federal law. The Commission adopted two items, which clarify how investment advisors should engage with the proxy firms they hire and how these proxy firms can avoid liability.

The first item, addressed to investment advisors, puts the onus on investment advisors to institutionalize policies and procedures that "are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients."[61] Specifically, the guidance discusses (i) how an investment adviser and its client may agree upon the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of the client; (ii) what steps and investment adviser can take to demonstrate its proxy-voting determinations are in the client's best interest and consistent with the adviser's proxy-voting policies and procedures; (iii) what advisers should consider when retaining a proxy advisory firm to assist with carrying out their obligations; (iv) what steps and investment advisers should consider if they become aware of deficiencies in a proxy advisory firm's analysis on which the investment advisor might rely; (v) how an investment advisor can critically evaluate its relationship with a proxy advisory firm; and (vi) when an investment adviser who has assumed voting authority on behalf of a client must vote every possible proxy available to a client.

The second item, addressed to proxy firms, clarified that because proxy voting advice generally constitutes a solicitation under the federal proxy rules, the antifraud provisions apply to proxy voting advice given by proxy firms.[62] The guidance further clarified that the antifraud provisions extend not only to the voting recommendation itself, but also to any "opinions, reasons, recommendations, or beliefs that are disclosed as part of a solicitation[.]"[63] To round out its updated guidance, the SEC also advised proxy firms to explain their methodologies for each particular matter, disclose the sources of their information, and disclose any material conflicts of interest.[64]

Then, on November 5, 2019, the SEC proposed rule amendments to the federal proxy rules to "enhance the quality of the disclosure about material conflicts of interest that proxy voting advice businesses provide their clients."[65] According to SEC Chairman Jay Clayton, "[these] proposals are rooted in key principles of our federal securities laws—disclosure of material conflicts of interest and constructive shareholder-issuer engagement—and benefit from the considerable experience of the staff and the feedback the Commission has received for more than a decade. These proposals recognize the important role proxy voting advice businesses play in our markets and would benefit our Main Street investors—who, more and more, invest through funds where the asset managers rely on the advice, services and reports of proxy voting advice businesses."[66]

The proposed amendments include:

- Amendments to the definition of "solicit" and "solicitation" under Exchange Act Rule 14a-1(l) to "specify the circumstances when a person who furnishes proxy voting advice will be deemed to be engaged in a solicitation subject to the proxy rules" and "codify the Commission's view that voting advice provided in response to an unprompted request would not constitute a solicitation."[67]

- Amendments to the exemptions outlined under Exchange Act Rule 14a-2(b) such that proxy firms would be required to disclose material conflicts of interest, give registrants and other soliciting persons an opportunity to review and give feedback on proxy voting advice before it is issued, and allow registrants and certain other soliciting persons to request that proxy firms include a hyperlink to the registrant or soliciting person's views on the proxy voting advice the proxy firm is offering.[68]
- Amendments to Exchange Act Rule 14a-9 to include examples of when the failure to disclose certain information in proxy advice could be misleading.[69]

The proposed amendments are subject to a 60-day public comment period.[70]

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ENDNOTES

1 The data below is taken from the Division of Enforcement 2019 Annual Report and uses actions from the SEC's fiscal year, which runs from October 1, 2018, to September 30, 2019. The actions discussed throughout this update include SEC actions during the second half of *calendar* year 2019.

2 "SEC Charges Silicon Valley-Based Issuer With Misleading Disclosure Violations" (Sept. 16, 2019).

3 *Id.*

4 *Id.*

5 Accounting and Auditing Enforcement Release No. 4081 (Sept. 20, 2019).

6 "SEC Charges Nissan, Former CEO, and Former Director with Fraudulently Concealing from Investors More than $140 Million of Compensation and Retirement Benefits" (Sept. 23, 2019).

7 "SEC Charges Comscore Inc. and Former CEO with Accounting and Disclosure Fraud" (Sept. 24, 2019).

8 *Id.*

9 Accounting and Auditing Release No. 4091 (Sept. 24, 2019).

10 *Id.*

11 "SEC Charges PPG Industries with Fraudulent Financial Reporting (Sept. 26, 2019).

12 *Id.*

13 "SEC Charges Brixmor Property Group Inc. and Former Senior Executives with Accounting Fraud" (Aug. 1, 2019).

14 Accounting and Auditing Release No. 4061 (Aug. 1, 2019).

15 "SEC Charges Brixmor Property Group Inc. and Former Senior Executives with Accounting Fraud" (Aug. 1, 2019).

16 "Automaker to Pay $40 Million for Misleading Investors"

(Sept. 27, 2019).

17 *Id.*

18 "Mylan to Pay $30 Million for Disclosure and Accounting Failure Relating to EpiPen" (Sept. 27, 2019)

19 *Id.*

20 Accounting and Auditing Enforcement Release No. 4102 (Nov. 25, 2019).

21 *Id.*

22 Litigation Release No. 24682 (Dec. 5, 2019).

23 *Id.*

24 *Id.*

25 Exchange Act Release No. 87793 (Dec. 18, 2019).

26 *Id.*

27 "SEC Charges Quantum with Internal Accounting Controls Failures" (Dec. 20, 2019).

28 "Herbalife to Pay $20 Million for Misleading Investors" (Sept. 27, 2019).

29 Exchange Act Release No. 87131 (Sept. 27, 2019).

30 "Herbalife to Pay $20 Million for Misleading Investors" (Sept. 27, 2019).

31 Accounting and Auditing Enforcement Release No. 4070 (Sept.5, 2019); Accounting and Auditing Enforcement Release No. 4071 (Sept. 6, 2019).

32 "SEC Charges Former Healthcare Executive in Fraudulent Scheme to Inflate Financial Results" (Sept. 6, 2019).

33 Litigation Release No. 24683 (Dec. 5, 2019).

34 *Id.*

35 Accounting and Auditing Enforcement Release No. 4099 (Oct. 10, 2019).

36 *Id.*

37 Litigation Release No. 24678 (Nov. 26, 2019).

38 Section 13(b)(5) of the Exchange act provides: "No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2)."

39 Litigation Release No. 24678 (Nov. 26, 2019).

40 Litigation Release No. 24592 (Sept. 10, 2012).

41 "SEC Proposes to Codify Certain Consultations and Modernize Auditor Independence Rules" (Dec. 30, 2019).

42 "Statement on Role of Audit Committees in Financial Reporting and Key Reminders Regarding Oversight Responsibilities" (Dec. 30, 2019).

43 "RSM US LLP Charged With Violating Auditor Independence Rules" (Aug. 27, 2019).

44 *Id.*

45 "SEC Charges PwC LLP With Violating Auditor Independence Rules and Engaging in Improper Professional Conduct" (Sept. 23, 2019)

46 *Id.*

47 "Cantor Fitzgerald and BMO Capital Charged for Improper Handling of ADRs" (Aug. 16, 2019).

48 *Id.*

49 *Id.*

50 Jones Day *Commentary*, "Supreme Court to Review SEC's Authority to Obtain Disgorgement" (Nov. 2019).

51 *Id*.

52 Jones Day *Commentary*, "Supreme Court to Review SEC's Authority to Obtain Disgorgement" (Nov. 2019).

53 *Id*.

54 *Id*.

55 *Id*.

56 U.S. Securities and Exchange Commission, "SEC Proposes to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K" (Aug. 8, 2019).

57 *Id*.

58 Jones Day *Commentary*, "SEC Proposes to Modernize Certain Disclosures Under Regulation S-K" (Sept. 2019).

59 *Id.*

60 "SEC Charges TherapeuticsMD With Regulation FD Violations" (Aug. 20, 2019).

61 "SEC Clarifies Investment Advisers' Proxy Voting Responsibilities and Application of Proxy Rules to Voting Advice" (Aug. 21, 2019).

62 Release No. 34-86721 (Aug. 21, 2019).

63 *Id.*

64 *Id.*

65 "SEC Proposes Rule Amendments to Improve Accuracy and Transparency of Proxy Voting Advice" (Nov. 5, 2019).

66 *Id.*

67 *Id.*

68 *Id.*

69 *Id.*

70 *Id.*

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