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WHITE PAPER

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SEC Enforcement in Financial Reporting and Disclosure: Year-End 2021 Update

We are pleased to present our year-end update on financial reporting and issuer disclosure enforcement activity. This *White Paper* primarily focuses on the U.S. Securities and Exchange Commission's ("SEC") enforcement activity through the end of 2021 and discusses recent trends in SEC enforcement activity, as set out in the SEC Enforcement Division's Results for FY 2021.

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While the total number of enforcement actions brought by the SEC's Enforcement Division was the lowest it has been within the past five fiscal years,[1] and its 434 stand-alone enforcement actions initiated by Enforcement were lower in sum than the total number of such actions in any of FY 2016–FY 2020,[2] nothing can be read into these numbers, as the new chairman was not on board until April 2021, and the new director of Enforcement arrived at the end of July, two months before the end of the fiscal year.

matters that the SEC described as "first-of-their-kind."[5] For example, the SEC touted its achievements in bringing enforcement actions in cases involving DeFi technology and "against emerging threats in the crypto and SPAC spaces."[6]

The balance of this *White Paper* recaps several notable enforcement actions in the areas of financial reporting and public disclosure since the end of summer 2021.

Enforcement Actions Filed in Fiscal Years 2016 to 2021						
	FY 2021	FY 2020	FY 2019	FY 2018	FY 2017	FY 2016
Standalone Enforcement Actions	434	405	526	490	446	548
Follow-On Admin. Proceedings	143	180	210	210	196	195
Delinquent Filings	120	130	126	121	112	125
Total Actions	697	715	862	821	754	868

Far more telling of the direction of the Enforcement program are the pronouncements of the new chairman and director in speeches and testimony before Congress, and the Enforcement Division's Annual Report. In that report, the Enforcement Division articulated "Financial Fraud and Issuer Disclosure" as an ongoing priority, and we do not anticipate that the decrease in enforcement activity (both total and in the areas of general financial reporting and disclosure) in FY 2021 signals otherwise. Also of note, in all these pronouncements, the emphasis on conduct by individuals, and especially gatekeepers—which includes lawyers, auditors, and boards of directors—has been highlighted. Sanctions likely will be used to highlight the commission's focus on this conduct.

In the areas of financial reporting and disclosure, the SEC filed a total 70 enforcement actions that it primarily classified as "Issuer Reporting/Audit and Accounting," representing roughly 10% of enforcement activity for FY 2021.[3] This marks a roughly five percentage point decrease from FY 2020, in which Issuer Reporting/Audit and Accounting cases constituted 15% of enforcement activity.[4] Again, these numbers should not be read as directional.

Also as noted in its Enforcement Results Press Release for FY 2021, the Enforcement Division dedicated its resources and attention to several noteworthy initiatives and groundbreaking

FINANCIAL REPORTING CASES

On August 24, 2021, the SEC announced settled proceedings against a hospital service provider, its CFO, and its controller for accounting and disclosure violations that resulted in the company's reporting of inflated earnings per share. Specifically, the company did not report probable or reasonably estimable losses related to lawsuits, even when the company intended to settle the cases and had made estimates of the potential settlement costs. According to the SEC, the company's accountants erroneously determined that these loss contingencies did not have to be reported until the settlements were approved by a judge. Had the company reported accurately, it allegedly would have missed estimates and reported negative earnings per share. The SEC thus alleged that the company violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act") and Sections 13(a), 13(a)(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act of 1934 ("Exchange Act"); the former CFO violated Sections 17(a)(2) and (17)(a)(3) of the Securities Act and Exchange Act Rule 13b2-1 and caused the company's aforementioned alleged violations; and the Controller caused the company's aforementioned violations of the Exchange Act. Without admitting or denying fault, the company agreed to cease and desist from further violations and to pay $6 million in civil penalties. The company's CFO agreed to a ban prohibiting him from

practicing and appearing before the SEC as an accountant for two years, and to pay $50,000 in civil penalties. The company's controller agreed to cease and desist from further violations and to pay $10,000 in civil penalties.[7] This action was the third action resulting from the Enforcement Division's ongoing Earnings Per Share Initiative, which uses risk-based data analytics to uncover alleged accounting and disclosure violations.

On August 25, 2021, the SEC initiated proceedings against the former CEO of a technology company, alleging that he made false statements with respect to the company's growth in terms of customer acquisition and financial performance. According to the SEC, the former CEO engaged in a fraudulent scheme by which he more than tripled the company's valuation by doctoring the company's financials and sales metrics. Specifically, the former CEO prematurely recognized revenue from contemplated customer deals before they were executed and by falsifying or fabricating supporting invoices. The SEC thus alleged that the former CEO violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The SEC is seeking injunctive relief, a civil penalty, and an officer-and-director bar against the former CEO. Additionally, the U.S. Attorney's Office for the Northern District of California has announced parallel criminal charges against the former CEO.[8]

On September 2, 2021, the SEC announced settled proceedings against a telecommunications company arising from alleged accounting and disclosure fraud that materially overstated revenues over a two-year period. Specifically, the SEC alleged the company and its executives ordered recognition of revenue based on nonbinding purchase orders prior to product shipment, in violation of GAAP. According to the SEC, the company should have met all of its performance obligations under each purchase order before recognizing revenue, and the company had inadequate internal accounting controls to determine whether the obligations had been met. The SEC further alleged that former company executives knowingly or recklessly authorized or accepted decisions to improperly recognize revenue and directed employees to encourage customers to sign audit confirmations through false statements about the confirmations' purposes. Finally, the SEC alleged the company allegedly improperly recognized millions in revenue from an unsigned, mid-negotiation purchase order. Thus, the SEC alleged that the company violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as various reporting, books and records, and internal accounting control provisions of the Exchange Act and rules thereunder. To settle the charges, the company agreed to cease and desist from further violations of the charged provisions and to pay a $500,000 penalty. The SEC's order specifically acknowledged the company's cooperation in the investigation and the remedial measures it took in response, including restatement of its financial results for 2018 and the first half of 2019.[9]

On September 3, 2021, the SEC announced settled proceedings against a food and beverage manufacturing company for engaging in an expense management scheme that resulted in the restatement of several years of financial reporting, as well as the company's former COO and CPO for misconduct related to the accounting scheme. Specifically, the SEC alleged that the company negotiated and maintained false and misleading supplier contracts in order to prematurely recognize cost savings. In sum, the company allegedly recognized unearned discounts from suppliers and then touted this practice to investors as "cost savings." The SEC further alleged that the company's former COO and CPO received warning signs of the company's misconduct. Rather than addressing these signs, the COO allegedly pressured procurement to deliver unrealistic savings targets and improperly approved financial statements. Moreover, the CPO allegedly approved several improper supplier contracts and certified financial statements when the misconduct allegedly occurred. According to the SEC, the company's procurement division lacked adequate internal controls, and the former COO should have known that his failure to properly address warning signs caused the company's internal accounting control failures.

The SEC alleged that the company violated Sections 17(a)(2) and (3) of the Securities Act; Section 13(a) of the Exchange Act, Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder; and the books and records and internal accounting controls provisions of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. The SEC also alleged that the former COO violated Sections 17(a)(2) and (3) of the Securities Act and the books and records and internal accounting controls provisions of Exchange Act Section 13(b)(5) and Rule 13b2-1 thereunder; failed to provide the company's accountants with accurate information in violation of Exchange Act Rule 13b2-2(a); and caused the company's reporting, books and records, and internal accounting controls violations. The SEC's complaint against the CPO

alleges violations of Sections 17(a)(2) and (3) of the Securities Act, failure to provide accurate information to accountants in violation of Exchange Act Rule 13b2-2(a), and violations of the books and records and internal accounting controls provisions of Exchange Act Section 13(b)(5) and Rule 13b2-1 thereunder. To settle the claims against them, the company agreed to cease and desist from future violations of the provisions they allegedly violated and pay a civil penalty of $62 million, whereas the former COO agreed to cease and desist from future violations, pay disgorgement and prejudgment interest of $14,211.31, and pay a civil penalty of $300,000. And, the former CPO agreed to injunctive relief, a civil penalty of $100,000, and an order barring him from serving as an officer or director of a public company for five years.[10]

On September 27, 2021, the SEC instituted public administrative proceedings against several c-suite executives of a Mexico-based homebuilding company, temporarily suspending them from appearing or practicing before the Commission as accountants. The proceedings arise from the executives' alleged participation in a multibillion-dollar accounting fraud scheme involving overstatement of the company's revenue in three annual reports filed with the SEC.[11] The SEC previously obtained a default judgment against the executives in the United States District Court for the Southern District of California. Those proceedings are described in our Summer 2021 Update.

On October 15, 2021, the SEC announced settled charges against a chemical products development company for allegedly materially overstating its royalty revenues and for related alleged internal accounting controls violations. Specifically, the SEC alleged that during Q1 and Q2 2018, the company improperly recognized royalty revenues from a customer that used one of the company's chemicals to manufacture certain products. According to the SEC, company executives received information from the customer that was material for the company to consider when estimating its royalty revenue. However, the executives allegedly failed to share this information with the company's accounting personnel, who prepared the company's financial statements, leading to the company reporting overstated royalty revenues for those quarters. Moreover, the SEC alleged that the company failed to devise internal accounting controls sufficient to provide reasonable assurance that relevant information was communicated to the company's accounting staff, and also that the company lacked resources within its finance and accounting function to provide reasonable assurance that the company properly accounted for significant transactions like its royalty arrangements. Thus, the SEC alleged that the company violated the reporting, internal controls, and books and records provisions of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 13a-11 and 13a-13 thereunder. The company agreed to cease and desist from further violations and to pay a $300,000 penalty.[12]

On November 4, 2021, the SEC announced that the former CEO of a technology company, against whom the SEC is engaged in ongoing litigation, was sentenced to 13 years in prison in a parallel criminal case. The SEC's complaint, which is based on the same misconduct alleged in the criminal complaint, alleges that the former CEO falsely inflated nearly all of the company's revenue (in one year, 99% of the reported revenue came from fraudulent sales) by using straw buyers and forged contract documents. Additionally, the SEC alleges that the former CEO used the fraudulent SEC filings to raise millions from investors in a private securities offering, by which he personally enriched himself with $1.3 million in compensation from the company. The SEC's complaint charges him with violating Section 17(a) of the Securities Act, Sections 10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5, 13a-14, 13b2-1, and 13b2-2. The complaint also alleges that the former CEO aided and abetted the technology company's violations of Sections 13(a), and 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Exchange Act Rules 12b-20, 13a-1, and 13a-13. The SEC is seeking permanent injunctive relief, disgorgement plus prejudgment interest, civil penalties, an officer-director bar, and a reimbursement order under Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX").[13]

On December 6, 2021, the SEC brought a settled action against a dialysis service provider and three of its former executives for allegedly participating in a revenue manipulation scheme that resulted in the restatement of several years of financial reporting. According to the complaint, the company allegedly improperly manipulated certain revenue topside adjustments to embellish its financial performance, and defendants misled the company's auditor to prevent discovery of those improper adjustments. As a result of these practices, the company overstated net income by more than 30% for 2017, and by more than 200% for the first three quarters of 2018. Accordingly, the SEC alleged that defendants violated and/or aided and abetted violations of Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) of the Exchange

Act and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, 13a-14, 13b2-1, 13b2-2 thereunder, as well as Section 304(a) of SOX. Without admitting or denying the allegations, the company agreed to settle by consenting to a permanent injunction and $2 million civil penalty.

On December 15, 2021, the SEC announced that a brand management company had agreed to entry of a final judgment against it. The SEC's complaint, discussed in our 2020 Year-End edition, alleged that the company failed to properly assess its goodwill for potential impairment after several months of declining stock prices and a steep drop in early November 2016. According to the complaint, the company ignored objective evidence that it would fail the first step of its impairment testing. Instead, the company performed a qualitative analysis that omitted its internal impairment calculation and numerous other negative developments in the company's business. Thus, the company allegedly concluded, unreasonably, that goodwill was not impaired. By avoiding impairment to its goodwill, the company allegedly inflated its income from operations, created a false impression of its financial condition, and misstated its financial statements and reports for almost a year, and the company allegedly continued to improperly account for its goodwill for three more quarters before belatedly impairing all of its goodwill in 2017. Without admitting or denying the allegations of the complaint, the company agreed to be permanently enjoined from future violations of the antifraud provision of Section 17(a)(3) of the Securities Act as well as certain reporting, books and records, and internal control provisions under Exchange Act. The SEC refrained from imposing a monetary penalty as a condition of settlement, given the company's financial condition in bankruptcy.[14]

DISCLOSURE FRAUD CASES

On August 16, 2021, the SEC announced settled proceedings against a publishing company. The SEC alleged that the company materially misled investors when it failed to disclose information relevant to a September 2018 data breach that included birth dates, email addresses, usernames, and passwords belonging to consumers. The company allegedly became aware of the breach in March 2019 and completed its review of the breach in July 2019, but did not disclose the breach to the public or those affected. Instead, in its Form 6-K for the period covering January–June 2019, the company identified a breach as a *potential* threat, but failed to disclose that a breach had occurred or the nature or extent of the breach. On July 31, 2019, after being contacted by a member of the media, the company posted a statement on its website that acknowledged the breach but downplayed its seriousness. The SEC thus alleged that the company violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 13(a) of the Exchange Act and Rules 12b-20, 13a-15(a), and 13a-16 thereunder. Without admitting or denying the SEC's findings, the company agreed to cease and desist from committing violations of these provisions and to pay a $1 million civil penalty.[15]

On August 17, 2021, the SEC initiated proceedings against a pharmaceutical company and its CEO for allegedly making false and misleading statements about certain disinfectant products offered by the company. Specifically, the company falsely claimed that its disinfectants were CDC approved or EPA registered in conjunction with claims concerning the products' effectiveness in killing the COVID-19 virus. Allegedly, however, the products were neither CDC approved nor EPA registered for any use. Thus, the company and its CEO are accused of violating the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The SEC is seeking permanent injunctions, disgorgement, prejudgment interest, and civil penalties against both the company and its CEO. The SEC is also seeking officer and director and penny stock bars against the CEO.[16]

On September 7, 2021, the SEC announced that a final judgment had been entered against former executives of a now-bankrupt renewable energy services company. The former executives were charged with allegedly defrauding investors by materially misrepresenting the company's relationship with a key customer, the scope of its business operations, and the company's financial condition. Specifically, the former executives led investors to believe the company had obtained contracts for seven heat-and-power plants and had the ability to open and run these plants. Allegedly, however, the company had contracts for only two plants and was able to perform on only one contract. Without admitting or denying the allegations against them, the executives consented to entry of final judgments resulting in injunctive relief for various respective violations of the Securities Act and Exchange Act, officer and director and penny stock bars, and civil penalties totaling $605,000. In a separate proceeding, one of the former executives consented to an SEC order prohibiting him from appearing or practicing as an accountant before the Commission.[17]

On November 24, 2021, the SEC announced final judgments against two former executives of a plastics manufacturer. According to the complaint, filed in the United States District Court for the Southern District of Indiana, the former executives allegedly engaged in a scheme to conceal that the company's core business model was a sham in connection with the company's acquisition by another manufacturer. Allegedly, executives routinely lied to customers, falsified certifications, hid the company's fraudulent practices, and made further misrepresentations to the company that acquired it. These allegations are set out in further detail in our Mid-Year 2019 edition. Pursuant to the final judgment, the former executives were permanently enjoined from violating Section 17(a) of the Securities Act and the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. They were also barred from serving as officers or directors of a public company and ordered to pay disgorgement with prejudgment interest totaling more than $2.5 million. In parallel criminal litigation, both of the executives pleaded guilty to charges of securities fraud and money laundering, and one of the executives pleaded guilty to making false statements to federal agents.[18]

On December 3, 2021, the SEC announced that it obtained a final judgment against the former chairman and CEO of an energy company for allegedly making materially misleading disclosures in the company's public filings. The SEC's complaint alleged that the former chairman and CEO made materially misleading disclosures that falsely represented to the public that the company had a CFO when, in fact, the company had no such executive. Specifically, the SEC asserted that the former CEO had repeatedly affixed the nonexistent, purported CFO's signature to the company's periodic reports and SOX certifications. The final judgment permanently enjoins the former CEO from violating the antifraud provisions of Section 17(a)(1) and (3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, permanently bars the former CEO from serving as an officer and director of a public company, and includes a permanent penny stock bar. The final judgment also orders the former CEO to pay a civil penalty in the amount of $350,000.[19]

On December, 3, 2021, the SEC announced that a default judgment was entered against a microcap company in the Eastern District of New York. In its complaint, the SEC alleged that the microcap company's CEO caused the company to issue a press release announcing a smartphone the company purportedly developed, which inflated the volume and price of the company's stock. However, the CEO allegedly knew that the smartphone actually did not exist, and the CEO allegedly received kickbacks from a stock promoter during the months leading up to the issuance this false press release. The default judgment against the company imposed a monetary penalty of $150,000 and permanently enjoined the company from further violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[20] Discussion of the final consent judgment against the CEO can be found in our Summer 2021 edition.

On December 21, 2021, the SEC announced settled proceedings against a publicly traded company that manufactures vehicles, pursuant to which the company agreed to pay $125 million to settle. According to the SEC, the company allegedly defrauded investors by misleading them about its products, technical advancements, and commercial prospects. The settlement followed the SEC's action against the company's founder and former CEO and executive chairman. The SEC stated that the company is responsible for both the CEO's statements and for other deceptions that construed the reality of the company's business and technology. Allegedly, before the company even manufactured any products, the CEO launched a public relations campaign to inflate the company's stock price. Specifically, the CEO made statements in tweets and media appearances that gave the impression the company had reached certain product and technological milestones. For example, the SEC's order finds the CEO misled investors about the company's technological advancements, in-house production capabilities, hydrogen production, truck reservations and orders, and financial outlook. Additionally, the order finds the company misrepresented or omitted material facts regarding the time to refuel its prototype vehicles, the state of its headquarters' hydrogen station, the planned cost and sources of electricity for its hydrogen production, and the risks and benefits of a contemplated partnership with a leading auto manufacturer. Thus, according to the SEC's order, the company violated antifraud and disclosure control provisions of the federal securities laws.

Without admitting or denying the allegations, the company agreed to cease and desist from future violations of the charged provisions, to certain voluntary undertakings, and to continue cooperating with ongoing proceedings, in addition to the monetary penalty. The SEC order also establishes a Fair Fund to return the penalty proceeds to defrauded investors.[21]

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ENDNOTES

1 U.S. Sec & Exch. Comm'n, Addendum to Division of Enforcement Press Release Fiscal Year 2021 at 2.

2 *Id.*

3 And, while the number of enforcement actions may have decreased from FY 2020, the Enforcement Division obtained judgments for monetary penalties totaling more than $1.4 billion, which represented a 33% increase from FY 2020 (though it also saw a 33% decrease in the amount disgorged from FY 2020). *Id.*

4 U.S. Sec & Exch. Comm'n, Division of Enforcement 2020 Annual Report at 16.

5 "SEC Announces Enforcement Results for FY 2021" (Nov. 18, 2021).

6 *Id.*

7 Exchange Act Release No. 92735 (Aug. 24, 2021); "SEC Charges Healthcare Services Company and CFO for Failing to Accurately Report Loss Contingencies as part of Continuing EPS Initiative" (Aug. 24, 2021).

8 "SEC Charges Former CEO of Technology Company with $80 Million Fraud" (Aug. 25, 2021).

9 "SEC Charges Telecommunications Company Pareteum Corporation with Accounting and Disclosure Fraud" (Sept. 2, 2021); Exchange Act Release No. 92866 (Sept. 2, 2021).

10 SEC Press Release No. 2021-174 (Sept. 3, 2021).

11 "SEC Institutes Three Administrative Proceedings Against Former Top Executives Charged in Mexico-Based Homebuilder's $3.3 Billion Accounting Fraud."

12 "SEC Charges Amyris with Improper Revenue Recognition Resulting from Internal Accounting Control Failures" (Oct. 15, 2021).

13 "Executive Charged by SEC for Financial Fraud Scheme Sentenced to 13 Years in Prison in Parallel Criminal Case" (Nov. 4, 2021).

14 "SEC Obtains Final Judgment Against Sequential Brands Group, Inc. for Failing to Timely Impair Goodwill" (Dec. 15, 2021).

15 "SEC Charges Pearson Plc for Misleading Investors About Cyber Breach" (Aug. 16, 2021); Exchange Act Release No. 92676 (Aug. 16, 2021).

16 "SEC Charges Company and Its CEO with Fraudulent Statements Concerning Covid-19 Products" (Aug. 17, 2021).

17 "SEC Obtains Final Judgments Against Four Former Renewable Energy Industry Executives." (Sept. 7, 2021).

18 "SEC Obtains Final Judgments Against Former CEO and COO of Indiana-Based Plastics Manufacturer" (Nov. 24, 2019).

19 "SEC Obtains Final Judgment Against Former Company Executive Charged with Fraud for False Disclosures About Management."

20 "Court Enters Default Judgment Against Microcap Company and Orders Penalty for Fraudulent Press Release" (Dec. 3, 2021).

21 "Nikola Corporation to Pay $125 Million to Resolve Fraud Charges" (Dec. 21, 2021).