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WHITE PAPER

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SEC Enforcement in Financial Reporting and Disclosure: Summer 2023 Update

We are pleased to present our latest 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 July 2023.

INTRODUCTION

As anticipated in our 2022 Year-End Update on SEC Enforcement in Financial Reporting and Disclosure, the SEC, under Chair Gary Gensler and Director of Enforcement Gurbir Grewal, has continued aggressive enforcement in the financial reporting and issuer disclosure space. The SEC has also remained committed to an ambitious regulatory agenda. These trends, combined with continued focus on non-GAAP financial measures, suggest issuers will see sustained SEC enforcement activity surrounding these subjects for the balance of this SEC administration, despite judicial setbacks that could complicate or curtail the SEC's enforcement powers.

FOCUS ON NON-GAAP FINANCIAL MEASURES

The SEC continues to focus on financial reporting with non-GAAP financial measures. In December 2022, the SEC's Division of Corporation Finance ("Corp Fin") released new and revised Compliance and Disclosure Interpretations ("CDIs") that provide guidance on proper reporting of non-GAAP financial measures. Read Jones Day's *Commentary*, "SEC Updates Guidance on Non-GAAP Financial Measures," on these CDIs. Then, on March 14, 2023, the SEC charged an information technology company with making misleading disclosures about non-GAAP financial measures in multiple reporting periods from 2018 to early 2020. According to the SEC, the company had materially increased its reported non-GAAP net income by negligently misclassifying expenses as one-time or nonrecurring transaction, separation, and integration-related ("TSI") costs and improperly excluding them from its non-GAAP earnings. The SEC's order found that the company's non-GAAP disclosure controls and procedures were inadequate to ensure the company's TSI expense classifications were consistent with its own public description of these items. Accordingly, the SEC alleged the company violated the negligence-based antifraud provisions of the Securities Act, the reporting provisions of the Exchange Act, and Rule 100(b) of Regulation G of the Exchange Act. That regulation prohibits registrants from making public a non-GAAP financial measure that contains an untrue statement of material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. Without admitting or denying the findings, the company consented to a cease-and-desist order, to pay an $8 million penalty, and to develop and implement appropriate non-GAAP policies and disclosure controls and procedures. The case demonstrates the SEC's ongoing intention to evaluate and hold accountable misstatements in non-GAAP financial measures.

EXPANDED REPORTING AND DISCLOSURE REGULATIONS

The SEC's enforcement efforts go hand-in-hand with the agency's commitment to new rules and guidance related to issuer disclosure. In our 2022 Year-End Update on SEC Enforcement in Financial Reporting and Disclosure, we discussed final rules, proposed amendments, and guidance related to disclosures promulgated by the SEC in 2022. Here, we provide an update on a few key items:

- **Pay Versus Performance Disclosure.** On February 10, 2023, Corp Fin published CDIs addressing open questions related to Item 402(v) of Regulation S-K, adopted as part of the SEC's August 2022 final rules. The CDIs provide answers to 13 curated questions prompted by the final rules and include, among other things, confirmation that pay versus performance disclosure is not required to be included in a Form 10-K.

- **Clawback of Incentive Compensation.** On January 27, 2023, Corp Fin published four CDIs on the rules for clawback of erroneously awarded incentive compensation under Dodd-Frank that provide guidance about the timing of the new required disclosure, which officers of foreign private issuers are subject to the disclosure rule, and the plans subject to the clawback. On February 22, 2023, NYSE and Nasdaq filed rule proposals to adopt new listing standards to implement the new clawback rule, Rule 10D-1. Both rule proposals (NYSE and Nasdaq) were published for comment in the Federal Register on March 13, 2023. On June 9, 2023, the SEC published notices and orders granting accelerated approval of the listing standards proposed by the exchanges (NYSE and Nasdaq). Issuers have until December 1, 2023, to adopt a compliant clawback policy.

- **Insider Trading Arrangements.** On February 27, 2023, the SEC's final rules imposing new conditions on and disclosures relating to trading conducted under Rule 10b5-1

became effective. For additional information about these rules, please see Jones Day's *Commentary*, "SEC Adopts Final Rules Regarding Rule 10b5-1 Trading Plans and Related Disclosures." The same week, the U.S. Department of Justice filed the first-ever criminal insider trading prosecution arising from trading conducted under a 10b5-1 plan. The SEC filed a parallel, litigated civil action against the same defendant, the CEO of a health care treatment company, alleging that the CEO, shortly after learning that the company's relationship with its largest customer was at risk, executed a new 10b5-1 plan and sold more than $19.2 million of company shares. According to the SEC, three months later the CEO learned the relationship was on the brink of termination and then executed another 10b5-1 plan and sold an additional $1.9 million of company shares. The SEC's complaint alleges the CEO avoided more than $12.7 million in losses by executing the two trading plans. While these cases were brought under the previous regulations governing 10b5-1 plans, they demonstrate regulators' continued, data-driven scrutiny of insiders' trading activities.

- **Share Repurchase Disclosure.** On May 3, 2023, the SEC adopted final rules regarding disclosure of issuer share repurchases. Originally proposed in 2021, the final rules require issuers to make quarterly disclosures of share repurchase activity, officer and director share transactions around announcement regarding share repurchases, and, for domestic issuers, the adoption or termination of corporate trading plans and their material terms. For more information, please see Jones Day's *White Paper*, "SEC Adopts Final Rules Regarding Share Repurchases and Related Disclosures." On May 12, 2023, the Chamber of Commerce of the United States of America and two other organizations filed a petition with the U.S. Court of Appeals for the Fifth Circuit seeking to vacate the regulation on First Amendment and Administrative Procedure Act grounds.

- **Cybersecurity Disclosure.** On July 26, 2023, the SEC adopted final rules that significantly alter cybersecurity disclosure obligations for issuers. The final rules require domestic issuers to disclose on Form 8-K material aspects of the nature, scope, and timing of material cybersecurity incidents within four business days of determining that a cybersecurity incident is material, with similar requirements for foreign private issuers. Companies must also make annual disclosures regarding cybersecurity risk management, strategy, and governance. For more information, please see Jones Day's *Commentary* "SEC Adopts Rules on Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure."

- **Climate-Related Disclosure.** This summer, the SEC for the second time delayed the release of its final climate-related disclosure rules, which it had originally proposed in March 2022. The final rules are now scheduled for release in October 2023, a year later than the SEC originally planned. Following intense public and political debate about aspects of the proposal, such as Scope 3 disclosures and the definition of "double materiality," as well as potential applicability of the "major questions" doctrine from the Supreme Court's June 2022 decision in *West Virginia v. EPA*, it is unclear how closely the final rules will track the original proposal.

The SEC's aggressive rulemaking shows no sign of slowing down. According to the SEC's regulatory agenda released by the U.S. Office of Information and Regulatory Affairs, the SEC has 55 rules it plans to finalize or propose between now and April 2024. Climate-related disclosure rules and rules regarding special purpose acquisition companies, or SPACs, are among those expected to be adopted and finalized.

CHALLENGES TO SEC AUTHORITY

While the SEC has been busy with rulemaking and enforcement, litigants have been chipping away at its authority. On April 14, 2023, the Supreme Court issued a consolidated opinion in *Axon Enterprise, Inc. v. FTC* and *SEC v. Cochran* holding unanimously that federal courts have jurisdiction to hear constitutional challenges to the SEC's and FTC's structure, procedure, and existence, notwithstanding the agencies' statutory review schemes.[1] In other words, litigants may raise constitutional challenges to the agencies' structure, procedure, and existence without being required to first exhaust the administrative process within the agency. For more information, see Jones Day's *Alert*, "U.S. Supreme Court Paves the Way for Challenging Agencies' Structure in Federal District Court."

And the Supreme Court is currently reviewing the Fifth Circuit's decision in *Jarkesy v. SEC*, which found unconstitutional the SEC's administrative proceedings adjudicated by

administrative law judges. A Supreme Court decision affirming *Jarkesy* could force the SEC to move away from administrative remedies entirely and to conduct all enforcement activity in federal court. If the SEC is unable to initiate contested administrative proceedings, certain administrative remedies, such as Rule 102(e) proceedings against auditors, accountants, and attorneys who engaged in unethical or improper professional conduct, could also be lost absent a statutory fix from Congress.

ENFORCEMENT REVIEW

The balance of this *White Paper* summarizes several notable enforcement actions in the area of financial reporting and issuer disclosure during the first half of 2023.

Financial Reporting

- On February 7, 2023, the SEC filed settled proceedings against an American automotive electronics and technology company and its CFO. According to the SEC, the CFO directed the reduction of an accrual for a performance-based bonus program, resulting in the company reporting earnings per share that met consensus estimates of analysts. The CFO allegedly directed this accrual reduction without documenting the basis for his decision or performing a GAAP analysis. The SEC further alleged that throughout a three-year period, company employees made similar adjustments to bonus compensation accrual without the required analysis or documentation. The SEC alleged the company violated the internal accounting controls, books-and-records, and reporting provisions of the Securities Exchange Act of 1934 ("Exchange Act"). The SEC also alleged that the CFO violated Section 13(b)(5) of the Exchange Act and Rule 13b2-1 thereunder and caused the company's violations. Notably, the SEC did not charge either party with making misrepresentations, even though the SEC's allegations suggested that some of the accrual decisions were influenced by consensus analyst earnings-per-share forecasts. Without admitting or denying the SEC's findings, the company and CFO agreed to the entry of cease-and-desist orders and to pay civil penalties of $4 million and $75,000, respectively.[2]

- On February 14, 2023, the SEC filed settled proceedings against a shipping and logistics company for allegedly engaging in an accounting fraud scheme over a four-year period. According to the SEC, the company manipulated its financial reports to hit earnings guidance and analyst projections. Specifically, the company allegedly hid incurred expenses by improperly deferring and spreading them over multiple quarters to minimize their impact on the company's net earnings. The SEC also alleged that the company manipulated earnout liabilities related to the company's acquisitions, which created an income "cushion" that could be used in future quarters to offset expenses. As a result of this alleged conduct, the company allegedly materially misstated its financial results in its earnings releases, earnings calls, and quarterly and annual reports over a three-year period in violation of the antifraud, reporting, books-and-records, and internal accounting controls provisions of the Exchange Act. Without admitting or denying the findings, the company agreed to entry of a cease-and-desist order and to pay disgorgement of $7,096,092 and prejudgment interest of $2,539,820.[3]

- On February 22, 2023, the SEC filed settled proceedings against a former officer of a Georgia microcap company. According to the SEC, the former officer made materially false and misleading statements in various reports posted by the company, including falsely and misleadingly certifying that the financial statements fairly presented the financial condition of the company and representing that the financial statements were prepared in accordance with GAAP. The SEC alleged that the former officer violated the antifraud provisions of the Exchange Act. Without admitting or denying the findings, the former officer agreed to entry of a cease-and-desist order, to a five-year officer-and-director bar, and to pay a civil penalty of $75,000.[4]

- On March 13, 2023, the SEC filed a settled civil action against a global water technology provider and its former finance director for alleged improper accounting practices that allegedly resulted in the material misstatement of the company's revenue in SEC filings over the span of two years. According to the SEC, the company prematurely recognized revenue from the sale of products, which allegedly resulted in the improper reporting of materially false revenue amounts in various financial statements. As a result, the SEC alleged that the company improperly reported almost

$12 million of additional expected revenue for fiscal year 2017 in its registration statement and IPO Prospectus. The SEC further alleged that negligent conduct in managing the financial reporting and accounting controls processes facilitated the finance director's improper accounting practices. The SEC alleged that the company violated the antifraud provisions of the Securities Act and the reporting, books-and-records, and internal accounting controls provisions of the Exchange Act. The SEC alleged the former finance director violated the antifraud provisions of the Securities Act and the Exchange Act and Section 13(b)(5) of the Exchange Act and various rules thereunder and aided and abetted the company in its alleged violations the Exchange Act. Without admitting or denying the findings, the company consented to the entry of an injunction and to pay a civil penalty of $8.5 million. Also without admitting or denying the findings, the former finance director agreed to the entry of an injunction and to pay disgorgement, prejudgment interest, and a civil penalty, the amounts of which will be determined by the court. The court will also determine whether an officer-and-director bar is appropriate.[5]

- On March 14, 2023, the SEC charged an information technology company with making misleading disclosures about non-GAAP financial measures in multiple reporting periods from 2018 to early 2020. According to the SEC, the company had materially increased its reported non-GAAP net income by negligently misclassifying expenses as one-time or nonrecurring TSI costs and improperly excluding them from its non-GAAP earnings. The SEC's order found that the company's non-GAAP disclosure controls and procedures were inadequate to ensure the company's TSI expense classifications were consistent with its own public description of these items. Accordingly, the SEC alleged the company violated the negligence-based antifraud provisions of the Securities Act, the reporting provisions of the Exchange Act, and Rule 100(b) of Regulation G of the Exchange Act. That regulation prohibits registrants from making public a non-GAAP financial measure that contains an untrue statement of material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. Without admitting or denying the findings, the company consented to a cease-and-desist order, to pay an $8 million penalty, and to develop and implement appropriate non-GAAP policies and disclosure controls and procedures.[6]

- On March 17, 2023, the United States District Court for the District of Maryland entered a final consent judgment against a former CFO of a biotech company. According to the SEC, the company routinely overstated company performance and issued fraudulent financial statements for almost two years. The former CFO allegedly provided false information to the company's auditors and caused the company to book fictitious revenue. Accordingly, the SEC alleged that the former CFO violated the antifraud provisions of both the Securities Act and Exchange Act and provisions prohibiting false certifications of SEC filings and lying to auditors, and also aided and abetted the company's violations of the securities laws. The former CFO consented to an injunction, an officer-and-director bar, and a SOX 304 clawback of nearly $225,000. The court waived payment of all but $45,000 of this reimbursement, based on the former CFO's financial condition.[7]

- On April 10, 2023, the SEC announced the resolution of a civil accounting fraud action against former executives of a transportation and logistics company. According to the SEC, the former executives allegedly participated in a scheme to buy and sell assets at inflated prices in order to conceal the company's failure to record the assets' net book values and take impairment charges. As a result, the company allegedly overstated its earnings per share, pre-tax income, and net income in a 2016 annual report. Without admitting or denying the allegations, the former executives consented to the entry of an injunction prohibiting further violations of the antifraud, reporting, books-and-records, and lying to auditors provisions of the Exchange Act. The final judgment also imposes a $50,000 civil penalty and three-year officer-and-director bar for both former executives.[8]

- On June 5, 2023, the SEC announced settled proceedings against a Pennsylvania software company for allegedly engaging in improper revenue recognition practices from the fourth quarter of fiscal year 2017 through the third quarter of fiscal year 2018. According to the SEC, the company attempted to maximize end-of-quarter revenue by entering into allegedly improper "bill and hold" transactions and by

shipping items to customers that customers did not order. The SEC alleged that the company violated Sections 17(a)(2) and (a)(3) of the Securities Act and the reporting, internal accounting controls, and books-and-records provisions of the Exchange Act. Without admitting or denying the findings, the company agreed to the entry of a cease-and-desist order and to pay a $1.5 million civil penalty.[9]

- On June 27, 2023, the SEC filed a settled civil action against former sales executives and a former contract CFO of a nutritional supplement company for their participation in improper revenue recognition practices allegedly designed to achieve revenue growth demanded by the former CEO. According to the SEC, the former employees prematurely recognized certain revenue and overstated other revenue by misclassifying customer credits as advertising expenses rather than as reductions to revenue. The officers' actions allegedly inflated the company's publicly reported quarterly revenues by as much as 25% and gross profits by as much as 49%. The SEC alleged that the two sales executives violated the antifraud provisions of the Securities Act and the Exchange Act and that the former contract CFO violated Sections 17(a)(2) and (a)(3) of the Securities Act. All three were also charged with violating the books-and-records, internal accounting controls, reporting, and proxy solicitation provisions of the Exchange Act. Without admitting or denying the allegations, the former officers agreed to the entry of injunctions, disgorgement plus prejudgment interest totaling approximately $95,000, and civil penalties totaling approximately $250,000, with an additional civil penalty to be determined by the court against one of the former sales executives. The senior sales executive also received a five-year officer-and-director bar.

The SEC separately filed a litigated civil action against the former CEO, alleging violations and/or aiding and abetting violations of the antifraud provisions of the Securities Act and the Exchange Act and the reporting, internal accounting controls, and proxy solicitation provisions of the Exchange Act. The SEC also alleges that the former CEO aided and abetted the company's violations of the reporting and internal accounting control provisions of the Exchange Act. In addition to alleging that the CEO was involved in the purported accounting-related improprieties described above, the SEC also alleged that the CEO had obtained undisclosed executive perquisites. The complaint against the former CEO seeks injunctive relief, civil penalties, SOX 304 clawback, and an officer-and-director bar.[10]

ISSUER DISCLOSURE

- On January 6, 2023, the SEC filed a litigated civil action against five individuals relating to an alleged fraud in connection with a technology holding company. According to the SEC, a director of the company, along with the CEO, chief marketing officer ("CMO"), and an employee of the director, made false statements and omitted material information in the company's filings with the SEC, including about a critical business relationship, in order to conceal the company's poor financial condition. These defendants also allegedly published a series of fraudulent promotional articles, secretly funded by the director, about the company. The SEC further alleged that the director, with the assistance of his ex-wife, concealed his ownership of company shares by filing false beneficial ownership reports with the SEC. As a result, the SEC alleges that the director violated the antifraud provisions of the Securities Act and the Exchange Act, the registration provisions of Sections 5(a) and (c) of the Securities Act, and the beneficial ownership disclosure provisions of Sections 13(d) and 16(a) of the Exchange Act and various rules thereunder. The SEC also alleges that the CEO and CMO violated certain of the antifraud provisions and, in the alternative, aided and abetted certain of the director's violations. It also alleges that the director's employee and ex-wife aided and abetted certain of the director's violations. The complaint seeks injunctive relief and civil penalties against all defendants; disgorgement and prejudgment interest from the director, the officers, and the employee; and officer-and-director bars against the director and the officers.[11]

- On February 24, 2023, the SEC announced a settled civil action against a Georgia microcap company, its former CEO, his son, and a company allegedly controlled by the CEO and his son. According to the SEC, from at least 2014 to 2022, at the CEO's direction, the Georgia company publicly posted false and misleading annual and quarterly disclosure reports, including false financial statements, and false and misleading attorney opinion letters relating to the company's disclosure reports. The SEC also alleges that the defendants made false and misleading statements to third

parties and engaged in other deceptive conduct, including the use of forged documents to facilitate the controlled company's allegedly fraudulent and unregistered transactions in company stock. The SEC alleges violations of Sections 5 of the Securities Act and the antifraud provisions of both the Securities Act and the Exchange Act. Without admitting or denying the allegations, the defendants consented to the entry of injunctions and to payments of disgorgement, prejudgment interest, and civil penalties in amounts to be determined by the court. The individual defendants have also consented to the entry of officer-and-director bars and penny stock bars, and the controlled company has consented to the entry of a penny stock bar.[12]

- On April 10, 2023, the United States District Court for the District of Delaware entered a final consent judgment against the former chief credit officer of a financial services company in a case first filed in 2015. The underlying complaint alleged that the former officer played a role in the company making false or misleading public statements and omissions regarding its loan portfolio. In particular, the company allegedly underreported its real estate loans that were 90 days or more past due by hundreds of millions of dollars. The SEC further alleged that the former officer made false and misleading statements concerning the credit quality of certain of the company's loans. Without admitting or denying the allegations, the former officer consented to the entry of an injunction against future violations of the antifraud provisions of the Securities Act and Exchange Act and Section 13(b)(5) of the Exchange Act and certain rules thereunder, as well as from aiding and abetting future violations of the reporting, internal accounting controls, and books-and-records provisions of the Exchange Act. The former officer also agreed to pay a civil penalty of $10,000.[13]

- On May 10, 2023, the SEC filed a settled civil action against a publicly traded Brazilian reinsurance company for allegedly disseminating false documents and planting false stories with the media in order to influence the company's stock price. According to the SEC's complaint, the company and a former executive spread a fabricated story that a conglomerate holding company had invested in the company. The false information was allegedly shared with analysts and investors. The complaint alleges that the company's stock price rose by more than 6% following media reports that the conglomerate holding company had invested in the company. After the conglomerate holding company denied that it was an investor, the company conducted an internal investigation and took extensive remedial measures, including replacing its board of directors and senior management and implementing processes designed to prevent this sort of misconduct. The company consented to a final judgment enjoining it from violating the antifraud provisions of the Exchange Act. The SEC did not impose civil penalties against the company due in part to the company's cooperation in the matter. Separately, the SEC filed a litigated civil action against a former officer of the company, alleging violations of the antifraud provisions of the Exchange Act and seeking civil penalties and an officer-and-director bar.[14]

- On May 15, 2023, the SEC announced the resolution of an action brought against a biopharmaceutical company, its CEO, and its executive vice president in charge of operations. According to the SEC's complaint, the company and CEO, in a press release, misrepresented that the FDA staff had validated a clinical study conducted in the Dominican Republic and recognized the potential therapeutic benefits of a drug introduced by the company as a COVID-19 treatment. These statements allegedly gave investors the false impression that the FDA's staff was positive about the proposed clinical trials, when in fact the FDA staff stated that the clinical trial "cannot be directly leveraged to support your proposed clinical trial." The SEC's complaint further alleged that the company included almost $200,000 of improperly recognized revenue in its Form 10-Q for the first quarter of 2021, causing the company to overstate total revenue by 61% that quarter. Without admitting or denying the allegations, the company consented to the entry of a final judgment that permanently enjoins it from violating the antifraud, books-and-records, and internal controls provisions of the Exchange Act. The CEO and executive VP in charge of operations also consented, without admitting or denying the allegations, to the entry of final judgments permanently enjoining them from violating the antifraud provisions of the Securities Act and the Exchange Act and section 13(b)(5) of the Exchange Act and various rules thereunder. The final judgments also imposed five-year officer-and-director bars, five-year penny stock bars, and civil penalties of $150,000 and $75,000 against the CEO and executive VP in charge of operations, respectively.[15]

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ENDNOTES

1 Nos. 21-86 and 21-1239, 598 U.S. ---- (2023).
2 SEC Press Release No. 3-21296; Exchange Act Release No. 96819.
3 SEC Press Release No. 3-21301; Securities Act Release No. 11156.
4 Securities Exchange Act Release No. 96961.
5 Litigation Release No. 25662.
6 SEC Press Release No. 2023-49; Securities Act Release No. 11166.
7 Litigation Release No. 25671.
8 Litigation Release No. 25690.
9 SEC Press Release No. 3-21483; Securities Act Release No. 11202.
10 Litigation Release No. 25757.
11 Litigation Release No. 25610.
12 Litigation Release No. 25648.
13 Litigation Release No. 25691.
14 Litigation Release No. 25718.
15 Litigation Release No. 25726.