SEC Enforcement in Financial Reporting and Disclosure: Summer 2022 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 mid-August 2022.
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In the most recent editions of this publication, we predicted the SEC Enforcement Division would more aggressively enforce the federal securities law than the previous administration’s Enforcement Division.¹ While the quantity of enforcement activity in the areas of financial reporting and disclosure fraud cases has not yet exceeded that of recent years, telltale signs remain that issuers can reasonably expect enforcement activity to increase across the board as the Gary Gensler-led Commission and the Gurbir Grewal-led Enforcement Division gain their footing.

Among these signs is the Commission’s aggressive commitment to regulation and enforcement in emerging areas of securities law. For example, in May, the Enforcement Division announced the allocation of 20 additional positions to the unit responsible for protecting investors in crypto markets and from cyber-related threats, nearly doubling the size of that unit.² This announcement followed the SEC’s groundbreaking proposed rule on climate risk disclosure, which, if adopted, we anticipate will lead to enforcement activity in the coming years.³

We anticipate that going forward, an aggressive approach will be applied more broadly, including to more traditional areas of SEC enforcement activity. For example, in public comments near the end of 2021, Grewal announced that the SEC will, “in appropriate circumstances, be requiring admissions in certain cases where heightened accountability and acceptance of responsibility are in the public trust.”⁴

This update discusses enforcement actions from January through July 2022 with an emphasis on financial reporting and disclosure fraud cases. It also touches on a recent decision by the United States Court of Appeals for the Seventh Circuit regarding the scope of injunctive relief as a remedy in enforcement actions.

**FINANCIAL REPORTING CASES**

- On January 28, 2022, the SEC announced a settled fraud case with a technology start-up that allegedly engaged in a scheme to boost the company’s valuation to more than $1 billion by inflating key financial metrics and doctoring internal sales records. According to the complaint, the company and its former CEO used its inflated valuation and financials to deceive investors to invest more than $80 million between 2018 and 2020. The alleged scheme unraveled following an internal investigation that resulted in the swift ouster of the CEO, a revised valuation of the company down to $300 million, and repayment of investors. Among other remedial measures, the company hired new senior management, expanded its board of directors, and instituted new procedures to ensure the transparency and accuracy of deal reporting and associated revenues. Without admitting or denying the allegations, the company agreed to be permanently enjoined from violating the anti-fraud provisions of Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. The SEC imposed no financial penalties on the company as part of the settlement. The SEC has filed a separate enforcement action against the former CEO.⁵

- On February 22, 2022, the SEC instituted settled proceedings against a health care products company and two former employees for improperly leveraging its foreign exchange rate convention (“FX Convention”), resulting in material misstatements in its public filings. According to the SEC, from at least 1995 through July 2019, the company improperly leveraged its FX Convention by engaging in intra-company transactions for the purpose of generating foreign exchange accounting gains or avoiding foreign exchange accounting losses (“FX Transactions”). This FX Convention allegedly was not in accordance with GAAP, and had the effect of materially misstating the company’s reported net income. The company subsequently conducted an internal investigation concerning these transactions, and restated its financial statements, reducing its previously reported net income for 2017 through June 30, 2019, and retained earnings as of January 1, 2017, by $582 million, collectively. Of this amount, $517 million was tied to the foreign exchange gains and losses dating back to 2010, which was partially attributable to FX transactions. The SEC alleged that the company violated Sections 17(a) (2) and 17(a)(3) of the Securities Act and Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and various rules thereunder. The SEC alleged the former employees violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.
Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and various rules thereunder. Without admitting or denying the SEC’s allegations, the company agreed to cease and desist from further violations and to pay a civil penalty of $18 million. The first former employee agreed to cease and desist from further violations, to pay disgorgement and prejudgment interest of roughly $89,000, and to pay a civil penalty of $100,000. The second former employee agreed to cease and desist from further violations and to pay a civil money penalty of $125,000.6

- On April 18, 2022, the SEC instituted settled proceedings against a pest control services company and its former CFO. The SEC alleged that the company made unsupported reductions to its accounting reserves in an amount sufficient to allow the company to round up its reported EPS to the next penny without conducting an analysis of the appropriate accounting criteria under GAAP, and without adequately memorializing the basis for the CFO’s decision to reduce accounting reserves. Additionally, the SEC alleged that the company made other accounting entries without adequate supporting documentation in multiple quarters from 2016 through 2018. Thus, the SEC alleged that the company violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 13(a), 13(b)(2)(A), 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, 13a-13, and 13a-15(a) thereunder. The SEC further alleged that the former CFO violated Sections 17(a)(2) and 17(a)(3) of the Securities Act; and Section 13(b)(5) of the Exchange Act, and Rule 13b2-1 thereunder. The company and the former CFO agreed to cease and desist from future violations and to penalties of $8,000,000 and $100,000, respectively. This resolution marked the fourth resolution under the SEC’s EPS initiative, which we have discussed at length in previous editions of this publication.7

- On June 7, 2022, the SEC instituted settled proceedings against a technology company that allegedly engaged in certain instances of improper accounting, resulting in material misstatements in its public filings. The company allegedly improperly recognized revenue by (i) recognizing revenue upfront when it was instead contingent on future events; and (ii) immediately recognizing revenue for software licenses with multiyear related supporting services instead of recognizing this revenue ratably over the term of the arrangements. The company subsequently revised its financial statements to restate approximately $190 million in cumulative revenues. The SEC alleged that the company violated Section 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder; Section 13(a) of the Exchange Act and various rules thereunder; and Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. To settle the charges, the company agreed to cease and desist from future violations and to a civil money penalty of $12,500,000. The SEC also brought settled proceedings relating to the alleged misconduct against the company’s former general counsel, several former senior employees of the company, and one current employee of the company.8

- On June 8, 2022, the SEC announced settled proceedings against a medical supply company, its former CEO and chairman, and its former COO. The SEC alleged that the company and these individuals defrauded investors by materially inflating the company’s financial results in its 2017 and 2018 filings by engineering two fraudulent sales transactions that the company reported in publicly filed financial statements. In the first sales transaction, the former CEO and former COO allegedly produced a backdated sham purchase order for product that was quickly canceled and that the company never shipped. In the second transaction, the former CEO and former COO allegedly orchestrated a purported sale of a large amount of product to a customer who had never ordered it. The former CEO and former COO allegedly directed the company to report these fraudulent sales as revenue and receivables in the company’s 2017 and 2018 Forms 10-Q and 10-K.

The SEC thus alleged that the company, the former CEO, and the former COO directly violated or aided and abetted violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the reporting, books and records, and internal controls provisions of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 thereunder. It also alleged that the former CEO and former CFO violated Section 13(b)(5) of the Exchange Act and Rule 13b2-1 thereunder and lied
to accountants in violation of Exchange Act Rule 13b2-2, and that the former CEO violated the certification provision of Rule 13a-14 and the insider security ownership filing requirements of Section 16(a) of the Exchange Act and Rule 16a-3 thereunder. Without admitting or denying the allegations, the company, former CEO, and former COO consented to the entry of final judgments, subject to court approval, which would result in permanent injunctions, civil penalties of $450,000 against the company, $240,000 against the former CEO, and $225,000 against the former COO, director-and-officer bars against the former CEO and former COO, and reimbursement of $1,010,976.15 by the former CEO of profits from his sales of company stock pursuant to the clawback provisions of Section 304(a) of the Sarbanes-Oxley Act of 2002. 

**DISCLOSURE FRAUD CASES**

- On February 17, 2022, the SEC announced litigation against a company that produces and distributes specialty pharmaceutical products, its CEO, its consultant, and three penny stock promoters. The defendants allegedly conducted a “pump-and-dump” scheme to artificially inflate the company’s stock price. The first part of the alleged scheme consisted of the company, through its CEO, preparing false and misleading press releases and SEC filings pertaining to the company’s emergency use authorization submissions to the FDA for three COVID-19 tests. The second part of the alleged scheme involved a comprehensive promotional campaign where the company utilized a stock promotion firm to promote the sale of shares to potential investors, but the stock promotion firm failed to disclose that it was being compensated by the company for this promotion, and failed to disclose that the CEO and its consultant planned to sell their company shares. As a consequence of the two-part scheme, they collectively sold at least $1.95 million worth of company shares. The SEC’s complaint charged all defendants with violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The SEC is seeking permanent injunctions and monetary penalties against all defendants, disgorgement with prejudgment interest against the CEO and the promoters, and a director-and-officer bar against the CEO. The U.S. Attorney’s Office for the Southern District of California has announced parallel criminal charges.

- On April 18, 2022, the SEC announced litigation against a former executive of a Brazilian reinsurance company for allegedly planting a false story with the media and disseminating false documents claiming that a major financial
institution had recently made a substantial investment in the company. The SEC's complaint alleges that following a significant decline in the company's stock price, the executive created and shared with investors false information indicating that a major financial institution had made substantial purchases of the company's stock. The executive allegedly communicated the false information to analysts and investors in both the United Kingdom and the United States. According to the SEC, the company's stock price rose by more than 6% during the 24-hour period following U.S. and Brazilian media reports that the financial institution had invested, and subsequently dropped by more than 40% after the financial institution denied a week later that it had invested. The SEC alleges violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and seeks civil money penalties as well as a director-and-officer bar. The U.S. Department of Justice announced parallel criminal charges.

On May 31, 2022, the SEC filed a complaint against a publicly traded grocer that operates wholesale businesses and retail supermarkets across New York, Massachusetts, and Florida, and its CEO, alleging that the company and its CEO failed to properly disclose numerous related party transactions between the company and entities related to the CEO and the CEO's brother. The complaint alleges that the company's financial statements were materially misstated in 2016, 2017, 2018, 2019, and 2020. For example, between 2017 and 2020, a significant percentage of accounts receivable (between 18% to 54%) were attributable to undisclosed related party transactions. Moreover, between 2016 and 2020, the company allegedly failed to disclose more than $12 million in payments to a company owned by the CEO's brother. The SEC alleged that these omissions by the company and the CEO, who closely controlled the company's operations and financial information, deprived investors of an accurate picture of the relationship between the company and the CEO's business interests. The SEC thus alleged that the company violated Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20 and 13a-1 thereunder. The SEC also alleged that the CEO violated and aided and abetted violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and that the CEO aided and abetted the company's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder. The SEC seeks injunctive relief, disgorgement with prejudgment interest, and civil monetary penalties against all defendants, and a director-and-officer bar against the CEO.¹³

On June 13, 2022, the SEC instituted settled proceedings against a publicly traded company that develops tar sands, mining, and process technology, and its former executive chairman. The SEC alleged that the company and former chairman made materially false and misleading disclosures in the company's SEC filings about related party transactions, the company's assets, and the former chairman's receipt and use of company funds. Specifically, the SEC alleged that the company's filings failed to disclose the related party nature of multiple transactions, including the company's payment of $23.8 million in cash and stock for rights to mine tar sands in Utah. The companies from which the company purchased these rights were "related" because they and their affiliates controlled large blocks of the company's stock. Much of the funds that the company paid for the rights made their way back to the company and former chairman in round-trip transactions, but these facts were not disclosed in the company's filings. Additionally, the rights were subject to various undisclosed risks, contingencies, and costs that may prevent the company from ever exercising the rights, but the company's 10-K filings for 2019, 2020, and 2021 valued the rights at the full purchase price of $23.8 million. The SEC also found that the former chairman directed undisclosed transfers of more than $3 million of company funds to himself, his relatives, and his former domestic partner. The SEC alleged that the company violated Sections 5(a), 5(c), and 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, and 13a-15(a) thereunder. To settle these allegations, the company agreed to a cease-and-desist order and remedial undertakings, as well as a $1 million civil penalty. The SEC also alleged that the former chairman violated Sections 5(a), 5(c), and
17(a) of the Securities Act and Sections 10(b) and 13(b)(5)
of the Exchange Act and Rules 10b-5, 13a-14, 13b2-1, and
13b2-2 thereunder, and caused the company's violations of
Securities Act Sections 5(a), 5(c), and 17(a), and Exchange
Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and various
rules thereunder. The former chairman agreed to a cease-
and-desist order, a director-and-officer bar, a $450,000
civil penalty, and disgorgement and prejudgment interest
in an amount subject to further proceedings.14

The SEC also filed a complaint against the former CFO
of the company alleging that the former CFO's reckless
or, at minimum, negligent execution of his duties led to
the company's alleged violations. The complaint alleges
that the CFO failed to consider whether the mining rights
were appropriately priced and analyzed for impairment,
and was at least negligent in not inquiring into or disclos-
ing the multiple transactions benefiting the former chair-
man, his relatives, and former domestic partner. The SEC
thus alleges that the former CFO violated Section 17(a)(3)
of the Securities Act and Section 13(b)(5) of the Exchange
Act and Rules 13a-14 and 13b2-1 thereunder, and that he
aided and abetted the company's violations of Exchange
Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B), and Rules
12b-20, 13a-1, 13a-13, and 13a-15(a) thereunder. The SEC
seeks permanent injunctive relief against the CFO and a
civil monetary penalty.15

• On July 28, 2022, the SEC announced litigation against
a health care management company, its CEO, and a for-
mer director of the company for issuing press releases
and tweets falsely claiming that the company was actively
negotiating a merger and planning to issue dividends.
According to the SEC, the CEO and former director also
promoted the nonexistent merger by issuing a public let-
ter falsely claiming that the former director and another
director had purchased millions of shares of the com-
pany. The SEC's complaint also alleges further acts by the
former director, such as impersonating a chiropractor to
promote the company on a radio talk show, misleadingly
posing as an unaffiliated investor, and using a pseudonym
to post false and misleading statements promoting the
merger and insider purchases on an Internet chat board.
The SEC thus alleged violations of Section 17(a) of the
Securities Act and Section 10(b) of the Exchange Act and
Rule 10b-5 thereunder against each of the defendants. The
former director consented to the entry of a judgment that
imposes a permanent injunction, $5,256 in disgorgement
plus prejudgment interest thereon, a $120,000 penalty, a
director-and-officer bar, and a penny stock bar. Litigation
remains ongoing against the company and its CEO.16

SCOPE OF SEC INJUNCTIVE RELIEF –
SEC V. GOULDING

As evident from the cases discussed above, the SEC often
seeks an injunction from future violations of the securities laws
against defendants. On July 8, 2022, the United States Court
of Appeals for the Seventh Circuit issued an opinion in SEC v.
Goulding, 40 F.4th 558 (7th Cir. 2022), addressing the ap-
propriate scope of such injunctions. In Goulding, an investment
advisor was held liable for defrauding investors, and the dis-
trict court imposed injunctive relief enjoining the defendant
from further violations of the securities laws. The defendant
appealed, arguing in relevant part that the district court had
abused its discretion by issuing an "obey-the-law injunction"
that "simply repeat[ed] a statute."

The Seventh Circuit agreed with the defendant, holding that
"the judge could and should have forbidden with greater
specificity what [the defendant] must not do." Id. To that
end, the court noted that the defendant was likely to face
a stricter injunction when the case was remanded. Id. While
this issue has been litigated on several occasions in the last
few decades, it remains to be seen whether the SEC will use
Goulding to commonly seek more specific and stricter injunc-
tive relief than its longstanding practice of seeking "obey-the-
law" injunctions.
ENDNOTES

7 “Atlanta-Based Pest Control Company, Former CFO Charged with Improper Earnings Management” (April 18, 2022); See also SEC Enforcement In Financial Reporting And Disclosure: Year-End 2020 Update.
8 “SEC Charges New Jersey Software Company and Senior Employees with Accounting-Related Misconduct” (June 7, 2022).
9 Litigation Release No. 25413 (June 8, 2022).
10 “SEC Files Settled Charges Against voxeljet AG and Its CFO Rudolf Franz, Notes Self-Reporting, Cooperation, and Remediation” (July 1, 2022).
11 Litigation Release No. 25232 (February 17, 2022).
13 Litigation Release No. 25404 (June 1, 2022).
14 Litigation Release No. 25419 (June 14, 2022).
15 Id.