

SEC 2014 Financial Reporting Initiatives						
The Task Force, Big Data and Admissions: What's on the Horizon?						

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March 18, 2014

SEC 2014 Financial Reporting Initiatives – Introduction

- July 2, 2013 marked the announcement of the first major enforcement initiative in the area of financial reporting since the Enron Task Force was created more than 10 years ago.
- What prompted this announcement?
 - Mary Jo White – former prosecutor faced with allegations that SEC hasn't been “tough enough” on executives.
 - Financial crisis cases winding down.
 - Noticeable decline in accounting fraud investigations and enforcement proceedings for the last several years.
 - Significant uptick in whistleblower complaints in the area.
 - Improving economy may create conditions that are ripe for financial reporting misconduct.
 - Fear that accounting fraud has become more sophisticated and simply is not being detected.
 - Fee declines among Big Four leading to concern over audit quality.
 - Audit independence issues as auditors scramble for audit and non-audit revenue.

SEC 2014 Financial Reporting Initiatives – Introduction

“You’re always going to see a lot of insider-trading cases being done, a lot of FCPA. That will continue. We bring cases against investment advisers. Recently you’ve seen cases brought against the SROs, and those are important to do. *I think financial statement fraud, accounting fraud has always been important to the SEC, and you’re going to see more targeted resources in that area going forward.*”

– Mary Jo White, Chairman of SEC (June 23, 2013)
(emphasis added)

SEC 2014 Financial Reporting Initiatives – Introduction

“And no discussion of the SEC in 2014 would be complete without my touching on some of these changes and giving you some idea of what to expect this year. The coming year promises to be an incredibly active year in enforcement, as we continue to vigorously pursue wrongdoers and bring enforcement actions across the entire industry spectrum.”

– Mary Jo White, January 27, 2014

SEC 2014 Financial Reporting Initiatives – Introduction

“Last fall, the Enforcement Division formed a Financial Reporting and Audit Task Force. This dedicated group has very talented accountants and attorneys who will broaden and thereby improve the way we look at financial reporting misconduct....*[W]e are closely focusing on senior executives for possible misconduct warranting charges.*” (emphasis added)

– Mary Jo White, January 27, 2014

SEC 2014 Financial Reporting Initiatives – Introduction

“The importance of pursuing financial fraud cannot be overstated. Comprehensive, accurate and reliable financial reporting is the bedrock upon which our markets are based because false financial information saps investor confidence and erodes the integrity of the markets.”

– Andrew Ceresney, September 19, 2013

SEC 2014 Financial Reporting Initiatives – Introduction

Focus on Conduct of Individuals

- Mary Jo White recently said that the SEC would pursue charges against individuals “wherever possible,” rather than charging companies. The instructions to staff (as a “subtle shift”) are to look first at misconduct at the individual level, “working out to the entity, rather than starting with the entity as a whole and working in.”
 - Bloomberg.com – *SEC to Shift Enforcement Focus to Individuals, White Says* – 9/26/13
- “When people fear for their own reputations, careers or pocketbooks, they tend to stay in line.”
 - Sec.gov – *Deploying the Full Enforcement Arsenal* – Speech by Chair Mary Jo White at Council of Institutional Investors fall conference in Chicago, IL on 9/26/13
- According to Andrew Ceresney – The SEC “must ensure” that individuals “feel the pain of our remedies.”
 - WSJ.com – *SEC Ramps Up Fine Amounts to Deter Misconduct* – 10/1/13

SEC 2014 Financial Reporting Initiatives – Requests for Admissions of Liability

- This “get-tough” tone in financial reporting has been coupled with other developments.
- First: The “unprecedented” demand for admissions from companies caught in the cross-hairs of a serious SEC enforcement matter.
 - Where a “neither admit nor deny” settlement was once “the rule,” we have seen the SEC deviate from that rule several times in the last few months – e.g., the London Whale case; the Harbinger case.

SEC 2014 Financial Reporting Initiatives – Does Cooperation Matter?

- Once the hallmark of attempting to get a company out of the cross-hairs and a “lesser penalty,” does cooperation matter any more?
- What does cooperation mean? What does “prompt” cooperation mean?
- Privilege waivers – are they required or not?

SEC 2014 Financial Reporting Initiatives – All Eyes on the Gatekeepers

- Second: The SEC is acutely focused not just on issuers, but the “gatekeepers” of reliable financial reporting – audit committees and auditors.
 - Audit committee focus developed after Sarbanes-Oxley, but now Audit Committees are the subject of major SEC enforcement speeches.
 - Auditor independence has always been an issue, but the recent KPMG decision has brought it back to forefront. Auditor competence is also subject to scrutiny by the SEC and PCAOB.

SEC 2014 Financial Reporting Initiatives – Whistleblowers Are Blowing the Whistle

- SEC Whistleblower program cranking on all cylinders, especially in the area of financial disclosures.
- Importance of whistleblowers - can lead directly to an informal inquiry or formal investigation and can corroborate indicators (like AQM) that a company's financial statements are potentially wrong or misleading.

SEC 2014 Financial Reporting Initiatives – Crunching Big Data – Midas and AQM

- SEC using modern day tools to review both company financial statements and trading information of investment managers
 - Accounting Quality Model (AQM)
 - Market Information Data Analytics System (MIDAS)
 - National Exam Analytics Tool (NEAT)

SEC 2014 Financial Reporting Initiatives – Today's Program

- The SEC's Financial Reporting and Audit Task Force – its objectives, role, and hot accounting topics.
- Crunching Big Data – AQM, MIDAS and NEAT
- The roles of audit committees and auditors
- Requests for admissions/cooperation
- Whistleblower Program; and
- Handling big accounting claims in light of the “new normal”.

SEC 2014 Financial Reporting Initiatives – The Financial Reporting and Audit Task Force

- Announced by SEC on July 2, 2013. Not the first time SEC has created specialized units (e.g., FCPA, Structured Products, Market Abuse, Asset Management).

- Mission and purpose:

“Often, when you get a group of smart people in a room focused on a problem, you can find the answer. Kind of reminds me of that scene in Apollo 13 where they bring all of the disparate tools available on the space capsule into a room, dump it on to a table in front of a bunch of smart people, and say find a way to fix the problem. And so we created the Financial Reporting and Audit Task Force – what we like to call the Fraud Task Force. This is our Apollo 13 moment.”

– Andrew Ceresney, September 19, 2013

SEC 2014 Financial Reporting Initiatives – The Financial Reporting and Audit Task Force

■ Methods and Tactics of the Task Force

- Monitoring high risk companies.
- Analyzing securities law filings/restatements.
- Analyzing performance trends by industry.
- Accounting Quality Model and data analytics.
- Outreach to Academic Community.
- Conduct street sweeps on industries and particular accounting areas.
- Task Force staffed by Enforcement, Corporate Finance and Office of the Chief Accountant.
- “Task Force”-like results in other areas: insider trading, FCPA.

SEC 2014 Financial Reporting Initiatives – The Financial Reporting and Audit Task Force

■ Hot Accounting Topics

- Material weaknesses and ineffective internal controls: Failed Audit Syndrome.
- Discretionary reserves.
- Valuation questions concerning assets and securities.
- Off-balance sheet transactions.
- Revenue recognition – Diamond Foods, IBM, cloud-based revenue.
- Multiple revisions of financial statements over short periods.
- Disclosures including related parties – footnotes and MD&A.

SEC 2014 Financial Reporting Initiatives – The Financial Reporting and Audit Task Force

Books and Records Cases of Interest

- Applies to all US and non US companies with registered securities, including ADRs, or that file reports with the SEC.
- Requirements
 - Maintain accurate books, records, and accounts that:
 - Have reasonable detail
 - Accurately and fairly reflect nature of transactions (e.g., nature of payments to government officials)
 - Show disposition of assets
 - Are retained for 5 years

SEC 2014 Financial Reporting Initiatives – Crunching Big Data – NEAT-MIDAS-AQM

- Crunching Big Data – The buzz phrase of 2014 for the SEC. It means the use by the SEC of data it receives daily, to monitor the financial markets, investment advisors, and publicly traded companies.
- NEAT – designed to identify potential insider trading around specific events in time. Analytics could indicate insider trading, front running, window dressing or other misconduct.

SEC 2014 Financial Reporting Initiatives – Crunching Big Data – NEAT-Midas-AQM

- MIDAS – collects one billion trading records every day to help the SEC understand how the markets are working (or are not working).
- Worldwide Capital Reg (Short-Selling) Case - SEC reportedly used high-speed data crunching tool to analyze stock sales.

SEC 2014 Financial Reporting Initiatives – Crunching Big Data – NEAT-Midas-AQM

- AQM – Today nearly all financial statements filed with the SEC use a language called XBRL. XBRL is like a Twitter-like hashtag which codes or tags information in a financial statement so that it can be analyzed and categorized quickly by a computer program, e.g., #accrual, #cash, etc.

SEC 2014 Financial Reporting Initiatives – Crunching Big Data – NEAT-Midas-AQM

- By examining the results of the automated review, the SEC can quantify or score the degree to which a company's financial statements are potentially problematic.
- In essence, AQM adds up potential warning signs (accruals, off balance sheet transactions, change in auditor) and compares them to other companies in the industry peer group.

SEC 2014 Financial Reporting Initiatives – Crunching Big Data – NEAT-Midas-AQM

- A high score alone may warrant “more review.”
- In some cases it might warrant a letter from Corporation Finance requesting the issuer to explain certain elements of its financial statements.
- A high score, coupled with other factors such as a whistleblower, may result in an informal inquiry, or possibly a formal investigation by the Enforcement Division.

SEC 2014 Financial Reporting Initiatives – Audit Committees and Auditors

“I think it also is important to focus on audit committees, which serve as a gatekeeper for quality financial reporting. These committees play a critical role by overseeing and monitoring the financial reporting process. We have brought actions against audit committees in the past for failing to recognize red flags and we intend to continue holding committees and their members accountable when they shirk their responsibilities.”

– Andrew Ceresney, September 19, 2013

SEC 2014 Financial Reporting Initiatives – Audit Committees and Auditors

- Audit committee's roles include providing review and oversight of a company's:
 - Financial reporting processes
 - Internal controls
 - Independent auditors

SEC 2014 Financial Reporting Initiatives – Audit Committees and Auditors

- Big focus on Audit Committee “conduct” and “performance”:
 - Has there been a critical evaluation of the qualifications and the performance of the auditor, or has the committee functioned as a rubber stamp for management’s recommendation?
 - Has the committee had regular and direct contact with the auditor, or has management served as an intermediary?
 - Has the committee monitored the independence of the auditor, which should include a “continuing dialogue between the auditor and the audit committee,” so that issues like non-audit services and scope creep can be evaluated?

SEC 2014 Financial Reporting Initiatives – Audit Committees and Auditors

Real issue: Has Audit Committee exercised real judgment and oversight of the audit process, or did it sit back and simply follow management recommendations?

SEC 2014 Financial Reporting Initiatives – Audit Committees and Auditors

- Big Focus on Auditors
 - Auditor independence is the big issue.
 - Declining audit fees have caused concern that auditors will not staff properly or work as hard given the decline.
 - Declining audit fees have given rise to a lot of non-audit engagements, thus creating potential for conflicts of interest.
 - The KPMG case.

SEC 2014 Financial Reporting Initiatives – Requests For Admissions

- Biggest new development at SEC enforcement – requests for admissions.
- Biggest change in “policy” in a long while.
- Consequences for companies, directors, officers, and carriers.
- With recent Credit Suisse settlement, this issue does not seem to be going away.

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- The “Neither Admit Nor Deny” settlement was the general rule of SEC Enforcement unless there were criminal convictions in the case, or other written admissions of wrongdoing like in a deferred prosecution agreement.
 - Testimony of Robert Khuzami, May 17, 2012

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- June 2013 internal memo authored by Andrew Ceresney and George Canellos to staff:
 - There may be other cases that “justify requiring the defendant’s admission of allegations in our complaint or other acknowledgement of the alleged misconduct as part of any settlement.”
 - This represented a potential sea change of years of prior assumptions that “neither admit nor deny settlements were the rule.”

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- Genesis of the Admissions Policy
 - Hard to tell, but at least partly the result of judicial criticism of the Citigroup settlement in late 2011.
 - Citigroup – settled enforcement action of Section 17 claims for \$285 million involving claims that Citigroup Capital Markets negligently misrepresented key deal terms for a collateralized debt obligation it was marketing.
 - SDNY Judge Jed Rakoff refused to approve the settlement, noting that:

SEC 2014 Financial Reporting Initiatives – Request For Admissions

“Citigroup’s failure to admit liability deprived the court of the most minimal assurance that the substantial injunctive relief it is be asked to impose has any basis in fact” and that “a consent judgment that does not involve any admissions and that results in only very modest penalties is just as frequently viewed, particularly by the business community, as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than any indication of where the truth lies.”

- Both sides appealed Citigroup decision to Second Circuit Court of Appeals. SEC also filed a motion to stay the District Court proceedings pending appeal.

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- Second Circuit Decision Granting Stay on Appeal
 - The Court noted that SEC and Citigroup had “made a strong showing of likelihood of success,” that the District Court’s ruling would be overturned and such circumstances had shown “serious, perhaps irreparable” harm sufficient to justify grant of stay.
 - The Court also found that the SEC’s “assessment of the importance of its settlement to the public interest” was entitled due deference.
 - The Second Circuit also stated it is not “the proper function of federal courts to dictate policy to executive administrative agencies. . . . While we are not certain we would go so far as to hold that under no circumstances may courts review an agency decision to settle, the scope of a court’s authority to second-guess an agency’s discretionary and policy-based decision to settle is, at best, minimal.”

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- Genesis of the Admissions Policy
 - A lot of criticism from the public concerning the perceived failure to bring financial crisis cases.
 - Mary Jo White becomes Chair of SEC in April 2013 – former S.D.N.Y. U.S. Attorney.
 - Ms. White commented, “In the interest of public accountability, you need admissions” in some cases. **“Defendants are going to have to own up to their conduct on the public record...”** This will help with deterrence, and it’s a matter of strengthening our hand in terms of enforcement.”

SEC 2014 Financial Reporting Initiatives – Request For Admissions

Genesis of the Admissions Policy

- In a September 26, 2013 speech by Mary Jo White to Council of Institutional Investors, the SEC identifies cases where admissions would be sought:
 - Cases where large numbers of investors have been harmed or the conduct was otherwise egregious.
 - Cases where the conduct posed a significant risk to the market or investors.
 - Cases where admissions would aid investors deciding whether to deal with a particular party in the future.
 - Cases where reciting unambiguous facts would send an important message to the market about a particular case.

SEC 2014 Financial Reporting Initiatives – Request For Admissions

Genesis of the Admissions Policy

- The London Whale
 - On September 19, 2013, JPM settled an enforcement action filed by the SEC concerning a \$6.2 billion trading loss in its London derivatives business.
- Harbinger Capital
 - In August 2013, Harbinger Capital, an advisory firm, and its CEO, Philip Falcone, settled an enforcement action for \$18 million.

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- Credit Suisse Settlement – February 21, 2014
 - Settled administrative proceeding against Credit Suisse arising out of allegations that it provided cross-border securities services to thousands of U.S. clients and collected fees totaling approximately \$82 million without adhering to the registration provisions of the federal securities laws.

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- The SEC's Cease and Desist order states that Credit Suisse willfully violated Section 15(a) of the Securities Exchange Act of 1934 and Section 203(a) of the Investment Advisers Act of 1940.
- Credit Suisse admitted the facts in the SEC's order, acknowledged that its conduct violated the federal securities laws, accepted a censure and a cease-and-desist order, and agreed to retain an independent consultant. Credit Suisse agreed to pay \$82,170,990 in disgorgement, \$64,340,024 in prejudgment interest, and a \$50 million penalty.

SEC 2014 Financial Reporting Initiatives – Request For Admissions

- What do these admissions cases have in common?
 - Big companies/firms
 - Bad facts
 - Messaging to the registrants/audit committees/auditors
- How can requests for admissions be avoided/mitigated?

SEC 2014 Financial Reporting Initiatives – What Does “Cooperation” Mean?

■ 2010 SEC Cooperation Initiative – Three Areas of Focus

1. **Cooperation Agreements:** Formal written agreements in which the Division of Enforcement agrees to recommend to the Commission that a cooperator receive credit for cooperating in its investigations or related enforcement actions. Such credit will only be extended if the cooperator provides “substantial assistance.”
2. **Deferred Prosecution Agreements:** Formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator if the individual or company agrees to cooperate fully and truthfully and to comply with certain reforms, controls and other undertakings.
3. **Non-prosecution Agreements:** Formal written agreements, entered into under very limited and appropriate circumstances, in which the Commission agrees not to pursue an enforcement action against a cooperator.

SEC 2014 Financial Reporting Initiatives – What Does “Cooperation” Mean?

- Does cooperation really matter? In a study of the cases listed on the SEC’s website of “cooperation” cases:
- With respect to companies involved:
 - 2 Deferred Prosecution agreements
 - 3 Non-Prosecution agreements
 - 2 Settled Cases
 - 2 Cases in which no charges were filed
- With respect to individuals:
 - 8 Cases of disgorgement
 - 5 Cases Involving civil penalties
 - 4 Industry bars

SEC 2014 Financial Reporting Initiatives – What Does “Cooperation” Mean?

- Does cooperation really matter?
 - Difficult to tell how cooperation affected these results.
 - What does it mean to cooperate? Must you waive privilege?
 - What does “prompt cooperation” mean?
 - What value is there in self-reporting?
 - Lots of unanswered questions on value of cooperation.

SEC 2014 Financial Reporting Initiatives – The Whistleblower Program

- Whistleblower program has been in existence for three years.
- 2013 Annual Report of the Whistleblower Office of the SEC just issued:
 - Over \$14 million paid out.
 - 3,238 formal tips received in 2013 (up 8%).
 - 17.2% of all tips relate to Corporate Disclosures and Financial Statements.
 - Reports of all levels of tips, from unsubstantiated to very high-level tips.
 - Came from all states and more than 50 countries.
 - \$60+ million DOJ/FDIC award just announced.

SEC 2014 Financial Reporting Initiatives – The Whistleblower Program

- Issues with Whistleblowers
 - Do they self-report to the company?
 - (1) Does the company have a whistleblower-friendly policy in effect that is conducive to self-reporting?
 - (2) Does the Company have the “smarts” and “resources” to handle a self-reported claim in a timely manner so that the whistleblower feels like the claim is being “taken seriously?”
 - (3) Recent Navex Global Ethics and Compliance Report – the number of days a company is taking to “close a report” have increased to 36 days over the past 5 years.
 - Or do they go right to the SEC because the company does not have a friendly whistleblower policy?
 - Anti-Retaliation Provisions of Dodd Frank – What do they mean for companies? Take note of *Asadi* and *Liu* cases.

SEC 2014 Financial Reporting Initiatives

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