

THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 49 No. 17 October 5, 2016

THE SEC'S RENEWED FOCUS ON GATEKEEPERS

In recent years, the SEC has emphasized the pursuit of “responsible individuals” in its enforcement program, focusing in particular on “gatekeepers to our financial system.” In this article, the author notes this renewed emphasis and then turns to relatively recent SEC actions against directors, accountants and audit committees, and other gatekeepers. He concludes by noting that the renewed emphasis may hinder internal oversight efforts.

By Todd S. Fishman *

In the fall of 2001, Enron Corporation collapsed amidst a scandal over its suspect corporate governance practices and accounting strategies. Arthur Andersen, the company's primary gatekeeper, became part of the narrative over its role in the auditing of Enron and, more significantly, the charges of document destruction and obstruction of justice. Andersen was criminally prosecuted and went out of business, only to have the conviction overturned by the Supreme Court years later.¹

Fade in, fade out. In 2013, with financial crisis matters running their course, the Securities and Exchange Commission pivoted back to its historical mission of audit, accounting, and financial reporting issues. To advance this move, the SEC set up a task force – the Financial Reporting and Audit, or FRAud, Task Force – which now has evolved into a more permanent “Group” within the Enforcement Division. The Group is devoted to “fraud detection and increased

prosecution of violations involving false or misleading financial statements and disclosures.”²

A number of core principles emerged from the SEC's enforcement program. In a widely reported speech on September 26, 2013, SEC Chair Mary Jo White articulated a “subtle shift” in pursuing “responsible individuals,” noting that the SEC wants to be sure “we are looking first at the individual conduct and working out to the entity, rather than starting with the entity as a whole and working in.”³ Chair White remarked that this approach is “one that could bring more individuals into enforcement cases.”

In an equally important statement of policy, the SEC has renewed its focus on gatekeepers. The modern

¹ *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005).

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² SEC Press Rel. No. 2013-121, *SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis* (July 2, 2013).

³ Speech, Chair Mary Jo White, *Deploying the Full Enforcement Arsenal*, Council of Institutional Investors (Sept. 26, 2013).

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system of securities law enforcement “contemplates that much of the front-line work for prevention and discovery of financial misconduct will be done by private-sector gatekeepers.”⁴ The term gatekeeper, though commonly used, acquires a special definition in the context of financial markets regulation. One expert has described gatekeepers as “reputational intermediaries who provide verification and certification services to investors.”⁵ In 2015 congressional oversight testimony, the current director of enforcement emphasized “the importance of gatekeepers to our financial system” and identified a variety of private actors that can serve as gatekeepers, namely “attorneys, accountants, fund directors, board members, transfer agents, broker-dealers, and other industry professionals who play a critical role in the functioning of the securities industry.”⁶

Actions against Directors

This emphasis on gatekeepers has taken on expansive attitudinal approach, marked by a proactive, prosecutorial program to ensure effective corporate governance. In a June 2014 speech at the Stanford Directors’ Conference, Chair White confirmed that this approach pointedly extends to non-management directors who are associated with an issuer and have responsibilities for overseeing financial reporting. She declared that “while there are certainly other gatekeepers who may be closer to some of the action or more familiar with the details of a transaction or a disclosure document,” “a company’s directors serve as its most important gatekeepers.”⁷ Chair White added that directors are “essential gatekeepers” and “play a critically important role in overseeing what your company is doing, and by preventing, detecting, and stopping violations of the federal securities laws at your companies, and responding to any problems that do occur.” To punctuate her remarks, Chair White advised:

“As directors, you must understand your company’s business model and the associated risks, its financial condition, its industry, and its competitors. You must pay attention to what senior managers are saying, but also listen for things they are not saying.”

SEC charges against gatekeepers, even non-traditional ones like directors, while not frequent, are not new. For instance, during the immediate fallout of the 2007-2008 financial crisis the SEC filed civil fraud charges, in 2010, against a former director of InfoGroup premised in part on the failure to respond appropriately to red flags concerning the CEO’s improper expenses and related-party transaction.⁸ In 2011, the SEC filed charges against three outside directors of DBH Industries who were “willfully blind” to red flags signalling accounting fraud, reporting violations, and misappropriation of assets by senior management.⁹ Going further back in time, the SEC’s post-Enron enforcement included a series of actions against the outside directors of Tyco (2002),¹⁰ Chancellor Corporation (2003),¹¹ and Van Wagoner Funds (2004).¹² In reporting on those cases, the SEC’s then director of enforcement commented that the agency would “exercise particular scrutiny in considering the role of directors in approving or acquiescing in transactions by company management.”¹³

What may be new, however, in this era of individual responsibility for corporate wrongs, or at least resumed, is the degree to which gatekeepers – who structurally and informationally are positioned beyond the moat of the kingdom of company management – may be called to task for misdeeds that occur well inside the castle’s walls. The SEC appears to have embraced the access theory, a targeted approach which says “[e]nsure good

⁴ *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, Report of the Staff to the Senate Committee on Governmental Affairs, at 16 (Oct. 8, 2002).

⁵ John C. Coffee, Jr., *Understanding Enron: It’s About the Gatekeepers, Stupid*, Columbia Law School, The Center for Law and Economic Studies, Working Paper No. 207, at 5 (July 30, 2002).

⁶ Andrew Ceresney, Director, Division of Enforcement, *Testimony of Oversight of the SEC’s Division of Enforcement* (March 19, 2015).

⁷ Speech, Chair Mary Jo White, *A Few Things Directors Should Know About the SEC*, Stanford University Rock Center for Corporate Governance, Twentieth Annual Stanford Directors’ College (June 23, 2014).

⁸ SEC Press Rel. No. 2010-39, *SEC Charges Former Executives in Illegal Scheme to Enrich CEO with Perks* (Mar. 15, 2010).

⁹ SEC Litigation Rel. No. 21867, *SEC v. DHB Industries, Inc.* (Feb. 28, 2011).

¹⁰ SEC Press Rel. No. 2002-135, *SEC Sues Former Tyco CEO Kozlowski, Two Others for Fraud* (Sept. 12, 2002).

¹¹ SEC News Digest No. 2003-79, *SEC Sues Former Top Officers, Directors and Auditors of Chancellor Corporation For Financial Fraud* (April 25, 2003).

¹² SEC News Digest No. 2004-166, *SEC Brings Settled Fraud Action Against Mutual Fund Adviser Van Wagoner Capital Management, Inc., and Garrett Van Wagoner* (Aug. 27, 2004).

¹³ Speech, Stephen M. Cutler, *The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program*, UCLA School of Law (Sept. 20, 2004).

behavior by those who control ‘access’ to our capital markets and you could achieve more than you would by going after every bad actor.”¹⁴

Actions against Accountants and Audit Committees

The SEC has touted its “intensified” focus on financial reporting fraud in the last three years.¹⁵ At the forefront of those efforts has been its scrutiny of the role of a company’s primary gatekeeper, its outside auditors, in accounting fraud cases.

In one notable example, in September 2015, the SEC instituted settled proceedings against audit firm BDO USA and five of its partners for allegedly dismissing red flags and signing off on an audit in the presence of unresolved material issues.¹⁶ In this matter an audit client, a staffing services company, advised the firm that it invested \$2.3 million in a certificate of deposit, representing approximately half of its assets, which was not repaid by the bank upon its maturity date. The money ultimately was returned to the client, but from sources other than the bank where the funds were supposedly held. The SEC’s order found that the audit firm issued an unqualified opinion in the face of multiple, allegedly conflicting accounts by company management about the missing money. According to the SEC, the audit firm demanded an independent investigation overseen by the audit committee, but then days later “despite no reasonable explanation from the company” subsequently withdrew its demand.

Significantly, the SEC pursued enforcement actions not only against the partners on the engagement team, but also against certain regional and national leadership personnel within the firm who were consulted on the engagement. The audit firm agreed to retain an independent compliance consultant and paid approximately \$2.1 million to settle the proceeding, and the individuals, without admitting or denying the findings, also paid a combined \$75,000 in fines.

Another example is the SEC’s recent proceedings against an accountant for failure to perform sufficient

procedures to detect allegedly fraudulent sales and improper revenue recognition in an internet service company’s financial statements.¹⁷ The accountant agreed to pay a \$25,000 penalty in addition to being permanently suspended from appearing and practicing before the SEC.

Audit committee members have faced similar scrutiny. In a 2016 keynote address, the current director of enforcement stated that “audit committee members who fail to reasonably carry out their responsibilities . . . can expect to be in our focus.”¹⁸ The director stressed that “when an audit committee member learns of information suggesting that company filings are materially inaccurate, it is critical that he or she take concrete steps to learn all relevant facts and cease annual and quarterly filings until he or she is satisfied with the accuracy of future filings.”

In early 2014, the SEC filed a federal court action charging an animal feed company, AgFeed Industries, and senior executives with allegedly conducting an accounting fraud scheme in which they repeatedly reported false revenues from their China operations in order to meet financial targets and buoy the stock price.¹⁹ The SEC principally alleged that, while the company was engaged in efforts to raise capital for expansion and acquisitions, the audit committee chair learned facts from a high level employee who had visited China suggesting that Chinese sales were inflated. The audit committee chair then allegedly sought advice from a former director and company advisor, who noted that there was “not just smoke but fire” and recommended that AgFeed conduct a full internal investigation. But the audit committee chair allegedly ignored the recommendation and strong indications of fraud, and his failure to disclose the alleged fraud to outside auditors and others led to the public filing of inaccurate financial statements.

AgFeed, having filed for chapter 11 bankruptcy protection in July 2013, settled with the SEC shortly after the agency initiated suit. Still, the SEC’s securities fraud and related claims against the individual

¹⁴ *Id.*

¹⁵ Chair Mary Jo White, Testimony of Oversight of the U.S. Securities and Exchange Commission, Before the Commission on Banking, Housing, and Urban Affairs, United States Senate (June 14, 2016).

¹⁶ SEC Press Rel. No. 2015-184, *SEC Charges BDO and Five Partners in Connection with False and Misleading Audit Opinions* (Sept. 9, 2015); Exchange Act Rel. No. 75862, *In re BDO USA, LLP* (Sept. 9, 2015).

¹⁷ SEC Press Rel. No. 2016-147, *Accountant Suspended for Failing to Spot Fraud in Company Audit* (July 22, 2016).

¹⁸ Speech, Andrew Ceresney, Director, Division of Enforcement, *Directors Forum 2016 Keynote Address* (Jan. 25, 2016).

¹⁹ SEC Press Rel. No. 2014-47, *SEC Charges Animal Feed Company and Top Executives in China and U.S. With Accounting Fraud* (Mar. 11, 2014); Complaint, *SEC v. AgFeed Indus., Inc.* (M.D. Tenn. Mar. 11, 2014).

defendants, including those against the chairman of the board's audit and compensation committees, remained contested. In its July 2016 decision, the district court largely upheld those claims, and expressly sustained the SEC's claims under Rule 10b-5(a) for a "scheme to avoid or delay disclosure of the fraud."²⁰

In another 2014 case, the SEC charged an issuer's former audit committee chair for signing an annual report that she knew or should have known contained a false Sarbanes-Oxley certification with the digital signature of a purported acting CFO when, in fact, the person selected for that role had rejected the offer to serve in the position.²¹

In a 2015 action, the SEC found that MusclePharm's former audit committee chair signed several filings that did not disclose the full extent of executive perks. According to the SEC, he then learned through an internal review that certain perks had not been disclosed. Still, despite being directly involved in the process, the audit committee chair allegedly substituted his interpretation of SEC perk disclosure rules for the views of the independent consultant MusclePharm had hired, resulting in additional filings with incorrect perk disclosures. Without admitting or denying the findings, the audit committee chair paid \$30,000 to settle the matter.²²

In a very recent development, on September 8, 2016, federal prosecutors and the SEC announced securities fraud charges against the former chief financial officer and the former chief accounting officer of American Realty Capital Partners, a publicly traded real estate investment trust, for allegedly inflating an important metric typically employed to measure ongoing performance and the ability to pay dividends.²³ As part

of the announcement, federal prosecutors stated that the chief accounting officer pled guilty in June 2016 to securities fraud and is cooperating with authorities. Pertinent to the discussion here, the SEC specifically alleged in its federal court complaint that although company accounting personnel raised concerns about the method of calculating the earnings metric to the chief financial officer and chief accounting officer, neither senior executive "took steps to inform the Board of Directors, the Audit Committee, or the external auditors of the error or the concerns raised to them by [the company's] accounting personnel."²⁴

Actions against Other Gatekeepers

The SEC's focus has extended to other market actors with gatekeeping roles. In February 2016, the SEC filed fraud charges against a Manhattan-based lending company and its owner for misleading investors in private placement offerings about its financial condition and its audit status.²⁵ Of special importance, the SEC also charged the company's placement agent, its owner, and its president for allegedly knowing that the offering materials were not accurate. As alleged, the placement agent's owner informed the president that the offering materials misrepresented that the company's financial statements had been audited, but the president took no action and the documents continued to be used to solicit sales to prospective investors. At the time the charges were filed, the director of the SEC's New York regional office commented that the placement agent's principals "looked the other way" and "allowed [the placement agent] to facilitate the fraud." This case remains in active litigation.

Along similar lines, in June 2016, the SEC announced two settled proceedings against a provider of administrative services to private investment funds arising out of charges that it failed to detect alleged indications of fraud and to correct improper accounting by two clients.²⁶ In the accompanying press release, the current director of enforcement stated that the fund administrator "failed to live up to its gatekeeper responsibility and essentially enabled the schemes to

²⁰ *SEC v. AgFeed Indus., Inc.*, No. 3:14-cv-663, slip op. at 27 (M.D. Tenn. July 21, 2006).

²¹ SEC Press Rel. No. 2014-59, *SEC Announces Fraud Charges Against Coal Company and CEO for False Disclosures About Management* (Mar. 27, 2014).

²² SEC Press Rel. No. 2015-179, *SEC Charges Sports Nutrition Company With Failing to Properly Disclose Perks for Executives* (Sept. 8, 2015); Exchange Act Rel. No. 75855, *In re Donald W. Prosser, CPA* (Sept. 8, 2015).

²³ Press Release, U.S. Attorney's Office, Southern District of New York, *Former Chief Financial Officer of American Realty Capital Partners Charged With Accounting Fraud* (Sept. 8, 2016); SEC Press Rel. No. 2016-180, *Executives Charged with Inflating Performance of Real Estate Investment Trust* (Sept. 8, 2016).

²⁴ Complaint, *SEC v. Block et al.*, ¶ 36 (S.D.N.Y. Sept. 8, 2016).

²⁵ SEC Press Rel. No. 2016-12, *SEC Charges Lending Company and Brokerage Firm with Fraud* (Feb. 3, 2016); Complaint, *SEC v. American Growth Funding II, LLC, et al.* (S.D.N.Y. Feb. 3, 2016).

²⁶ Investment Advisers Act Rel. Nos. 4428, 4429, *In re Apex Fund Services (US), Inc.* (June 16, 2016).

persist at these advisory firms until the SEC stepped in.²⁷

Broader Implications

The SEC's current enforcement agenda in the accounting and financial reporting area could be summed up simply as a function of its "broken windows" policy.²⁸ That is, enforcement efforts designed to address minor violations in egregious and willful circumstances involving clearly delineated wrongs.

Such a view, however, might be incomplete. In a "Street Scene" piece, columnist William Cohan publicized statements by former U.S. Attorney General Eric Holder as to why there were so few individual prosecutions arising out of the 2008 financial crisis. Holder was quoted as saying that "if you look at the different ways in which decision-making was made in these financial institutions, we simply did not have the ability to point to specific individuals to say that person was responsible for this specific action."²⁹ From a regulatory enforcement perspective, the logic of pursuing gatekeepers is the ability to hold individuals, often prestigious, to account for specific conduct, often in the form of identifiable failures in duty. But the

practical impact of the SEC's reliance on acts of omission, as opposed to acts of commission, cannot be overlooked as means to implement policy. Breaches of duty of care, such as a failure to fully investigate and disclose, will be equated with willful or reckless violations of the federal securities laws. As the SEC Chair intimated in her June 2014 remarks, the violation (at least through the prism of hindsight) is the failure to spot what senior managers "are not saying."

Indeed, there are strong cross-currents to this approach insofar as gatekeepers are concerned.³⁰ the attractiveness of what in the past has been perceived as a prominent position. The hydraulic pressure on companies to identify, investigate, and self-report apparent bad actors to government regulators, as embodied in the eponymous Yates memorandum, may create strong incentives for those with certification or oversight responsibilities not to probe for wrongdoing when put on notice or to cooperate with internal investigations. And the stated goal of "de-confliction" between an internal review and a government investigation only serves to confirm the government's deep intrusion into internal corporate affairs.³¹ As a result, by addressing the perceived problem of individual accountability, the SEC's enforcement program may work to undermine the very self-correcting function regulators have sought to strengthen. ■

²⁷ SEC Press Release No. 2016-12, *Private Fund Administrator Charged With Gatekeeper Failures* (June 16, 2016).

²⁸ See, e.g., Speech, Chair Mary Jo White, *Remarks at the Securities Enforcement Forum*, Washington, D.C. (Oct. 9, 2013).

²⁹ William D. Cohan, *A Clue to the Scarcity of Financial Crisis Prosecutions*, New York Times (July 21, 2016).

³⁰ See, e.g., David Woodcock & Allison Fuller, *A Prosecutor's Approach to SEC Enforcement (And What It Means For Smaller Companies)*, 49 Rev. of Sec. & Comm. Reg. 1, 6 (Jan. 6, 2016).

³¹ Andrew Weissman, U.S. Department of Justice, *Fraud Section's Foreign Corrupt Practices Act Enforcement Plan and Guidance*, at 5 (April 5, 2016).