

Where Have All The Public Company Frauds Gone?

By **Marc Fagel** (May 30, 2018, 12:48 PM EDT)

Financial consulting firm Cornerstone Research recently released its analysis of enforcement actions filed by the U.S. Securities and Exchange Commission in the first half of fiscal 2018. The report found that the SEC filed only 15 new cases against public companies between October 2017 and March 2018 — the lowest semiannual total since fiscal 2013, and a 70 percent decline from the first half of fiscal 2017.[1]

Just a few years after the SEC and its Division of Enforcement touted its renewed focus on pursuing accounting fraud and financial disclosure cases against public companies and their executives, the initiative appears to be something of a bust. The trend raises some obvious questions. Is the SEC no longer conducting public company investigations with the same zeal as in the past? Or are public companies simply behaving better? Predictably, the answer likely lies somewhere in between.



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SEC Enforcement Trends

Historically, financial reporting fraud by public companies has been one of the largest categories of SEC enforcement actions. In FY 2007, issuer reporting and disclosure matters represented a third of the cases filed by the agency, comprising the largest component of the SEC's enforcement caseload.[2] Many of these actions implicated large, marquee-name companies. But following the accounting fraud scandals of the early 2000s — Enron, Worldcom, Tyco, etc. — and the stock option backdating cases that ensnared numerous companies a few years later, there has been a precipitous drop-off in the number (and prominence) of such cases.

By 2012, just five years after the 2007 peak, financial reporting cases had dropped below 11 percent of SEC enforcement filings.[3] Some of the decline was the natural result of limited enforcement resources being redirected to more pressing needs, most notably the mortgage meltdown investigations that consumed much of the SEC's enforcement staff beginning in 2008. But once these financial crisis investigations had largely run their course, the SEC vowed to return its attention to traditional reporting cases.

In mid-2013, amidst much fanfare, the SEC rolled out various initiatives aimed at beefing up its investigations into public company financial reporting, including the formation of a new "Financial Reporting and Audit Task Force" and the implementation of new data analysis tools to proactively identify potential misconduct.[4] And while the number of financial reporting cases did rebound somewhat, representing about 17 percent of the docket in FY 2015, many of the cases were on the smaller side.[5]

The new Cornerstone report suggests that even this slight uptick has been short-lived. And even Cornerstone's report of 15 new public company actions in the first half of the year is a bit overstated, as Cornerstone includes in its tally several cases against publicly traded financial institutions, such as cases involving the deceptive sale of mutual funds, which would more aptly be considered investment adviser/broker-dealer actions, not public company reporting matters.

Only a few cases this fiscal year fall into traditional accounting and disclosure fraud. For example, the SEC charged a biotech company and, later, an energy company for allegedly inflating their revenue through premature revenue recognition,[6] and charged a pharmaceutical company for allegedly failing to report millions of dollars in compensation and perks paid to its former CEO.[7] The SEC also continued to periodically bring cases alleging violations of the Foreign Corrupt Practices Act.[8]

A small number of public company cases have also been initiated since the period covered by Cornerstone. Most notably, in April the SEC filed its first case against a public company for its alleged failure to timely disclose a cybersecurity breach.[9] And two weeks later, the SEC filed another FCPA case, which also included allegations that the company had overstated its financial performance.[10]

Beyond that, however, the SEC — which continues to pursue enforcement actions at a normal (if seemingly slower than average) clip — appears to be focusing its efforts elsewhere. The Division of Enforcement has rolled out the usual array of cases: insider trading, Ponzi schemes, penny stock pump and dumps, and misconduct by investment advisers and brokers (not to mention a ballooning number of cases involving cryptocurrency scams and initial coin offerings). But where are the public company financial reporting cases?

Explaining the Decline

With the numbers dropping precipitously in the first year of the new SEC administration, the obvious question is whether Chairman Jay Clayton and the enforcement leadership are deliberately pulling back on public company investigations. This seems unlikely. First, simply as a practical matter, SEC investigations (particularly complex matters like accounting frauds) typically take two to three years to complete. Absent an unlikely dictate from the new SEC leadership to close pending investigations, it appears that there was already a shallow pipeline of new financial fraud investigations before Clayton assumed his duties in early 2017.

Moreover, it is not unusual for the SEC to experience a slowdown in new case filings following a presidential election. The enforcement staff may spend some time briefing the new leadership on its investigation inventory; as part of that exercise, the staff and leadership team may take a more critical eye to some older or more marginal matters and shut them down, further contributing to the decline in new case filings.

That said, at least some of the trend could derive from changing SEC priorities. Clayton has repeatedly expressed his focus on “retail fraud,” emphasizing matters impacting “Mr. and Ms. 401(k),” such as “pump-and-dump scammers, those who prey on retirees, and increasingly those who use new technologies to lie, cheat and steal.”[11] While this does not mean the Enforcement Division won't investigate public companies, the preferences of the chairman could influence how the division prioritizes the tips it receives and how it allocates staffing.

Even if public company accounting cases are less of a priority under the new administration, the more likely cause of the drop-off appears to be the absence of strong candidates for investigation. Research firm Audit

Analytics has reported that public company restatements reached a six-year low in 2016, and that significant restatements declined for nine consecutive years.[12] The sharp decline in financial restatements in the years since Sarbanes-Oxley strongly suggests that the post-Enron regulatory changes — from enhanced internal controls requirements to increased scrutiny of auditors following the creation of the Public Company Accounting Oversight Board — are successfully curbing accounting errors and improprieties. (Industry participants and investors can debate whether the high costs of maintaining an internal controls system satisfactory to the SEC are truly warranted, but the result seems undeniable.)

Another factor in the drop in public company fraud cases is the decline in the number of public companies themselves. According to one study, the number of public companies fell by nearly 50 percent between 1996 and 2016, from over 7,300 to under 3,700; the same study reported that the number of initial public offerings had fallen from over 700 in 1996 to about 100 in 2016.[13] Arguably, the same Sarbanes-Oxley reforms that have curtailed restatements have deterred some companies from going public in the first place, though some attribute the drop-off to other factors (i.e. the growth in mergers and acquisitions, reduced demand for smaller offerings, or more financing options for private companies).[14]

Additionally, some of the trend in financial reporting cases is driven by economic cycles. Historically, the pressure on executives and personnel to creatively inflate financial performance ratchets up when the company faces economic headwinds. With the markets generally on an upswing in the years since the financial crisis, there may simply be less need for companies to resort to accounting shenanigans in order to meet analyst expectations.

One interesting question that arises is how whistleblowers factor into the equation. As the SEC has repeatedly trumpeted in the years since Dodd-Frank created a financial award regime for whistleblowers, both the number of whistleblowers and the financial incentives for whistleblowers continue to rise. And “corporate disclosures and financials” continues to be the largest single subject area for whistleblower complaints (generating nearly 1,000 tips in 2017).[15] With so many complaints coming into the SEC, why so few cases?

On the one hand, it may just be that, notwithstanding the aspirations of the whistleblower program, the promise of monetary rewards and the formality around the whistleblower tip submission process are not necessarily improving the quality of the tips, and most investigations are not leading to successful enforcement actions. More favorably, the empowerment of corporate whistleblowers (and high risk of internal whistleblowers going to the SEC) could be incentivizing companies to take internal complaints more seriously, remedying potential issues before the SEC comes calling and reducing the risk of an investigation or enforcement action.

What’s Around the Corner?

Does the sharp drop in these enforcement actions mean that public companies, their executives and employees, and their auditors are off the hook? Hardly. Public company reporting and disclosure cases are a perennial favorite of the SEC and the enforcement staff, and it would be unwise for corporate America, and its gatekeepers, to let their guard down. For all the talk about prioritizing “retail fraud” at the Clayton SEC, mom and pop investors do own stocks, and the SEC will not turn a blind eye to reports of corporate improprieties. Restatement announcements, market-moving disclosures that call into question earlier representations by the company, or promising leads from whistleblowers or the SEC’s own Division of Corporation Finance remain likely to draw an inquiry from a curious Enforcement Division.

Indeed, in the face of fewer financial fraud cases panning out, the staff may be more inclined to pursue a

whistleblower tip or inquire about a questionable public announcement or financial filing that comes to its attention, just to maintain a presence in the area. Even if its priorities currently lay elsewhere, the SEC is historically inclined to “cover the waterfront” of the various issues within its jurisdiction, and may feel pressured to file even arguably marginal financial fraud or internal controls cases just to maintain a deterrent effect and prevent gatekeepers from growing complacent.

Finally, a reversal in SEC enforcement trends is often just a scandal (or an economic downturn) away. Regardless of its leadership’s priorities, the SEC’s Enforcement Division is at heart a reactive law enforcement body, and its agenda is ultimately driven by the securities law violations that cross its path. Financial reporting gatekeepers should be cautioned to recall that in October 2001, President George W. Bush’s first SEC chairman famously referenced the SEC as a “kinder and gentler place for accountants.”^[16] The very same day, Enron publicly announced it was under SEC investigation; WorldCom, Tyco and other accounting fraud investigations broke open not long thereafter, and soon the Big Five accounting firms were winnowed down to the Big Four.

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[1] Cornerstone Research, SEC Enforcement Activity: Public Companies and Subsidiaries (Midyear FY 2018 Update), available at www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-Public-Companies-and-Subsidiaries-Midyear-FY-2018-Update.

[2] Select SEC and Market Data, Fiscal 2007, available at www.sec.gov/about/secstats2007.pdf.

[3] Select SEC and Market Data, Fiscal 2012, available at www.sec.gov/about/secstats2012.pdf.

[4] SEC Press Release, SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis (July 2, 2013), available at www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975.

[5] Select SEC and Market Data, Fiscal 2015, available at www.sec.gov/about/secstats2015.pdf.

[6] SEC Press Release, SEC Charges Biotech Company, Executives with Accounting Fraud (Nov. 2, 2017), available at www.sec.gov/news/press-release/2017-207; SEC Press Release, SEC Charges Energy Storage Company, Former Executive in Fraudulent Scheme to Inflate Financial Results (Mar. 27, 2018), available at www.sec.gov/news/press-release/2018-48.

[7] SEC Press Release, SEC Charges Biopharmaceutical Company with Failing to Properly Disclose Perks for Executives (Dec. 12, 2017), available at www.sec.gov/news/press-release/2017-229.

[8] SEC Press Release, Kinross Gold Charged with FCPA Violations (Mar. 26, 2018), available at www.sec.gov/news/press-release/2018-47.

[9] SEC Press Release (Apr. 24, 2018), available at www.sec.gov/news/press-release/2018-71.

[10] SEC Press Release (Apr. 30, 2018), available at www.sec.gov/news/press-release/2018-73.

[11] Chairman Jay Clayton, Remarks at the Economic Club of New York (July 12, 2017), available at www.sec.gov/news/speech/remarks-economic-club-new-york.

[12] See T. Sheridan, Financial Restatements Fell 11% in 2016, AccountingWeb (June 15, 2017), available at www.accountingweb.com/aa/auditing/financial-restatements-fell-11-in-2016.

[13] See Steven Solomon, A Dearth of I.P.O.s, but It's Not the Fault of Red Tape, NYTimes (Mar. 28, 2017), citing Credit Suisse research note entitled "The Incredible Shrinking Universe of Stocks."

[14] See *id.*

[15] 2017 Whistleblower Program Annual Report to Congress at 24, available at www.sec.gov/files/sec-2017-annual-report-whistleblower-program.pdf.

[16] Chairman Harvey Pitt, Remarks Before the AICPA Governing Council (Oct. 22, 2001), available at www.sec.gov/news/speech/spch516.htm.