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FINANCIAL FRAUD

A Harbinger of the SEC's Tough New Approach to Public Company Reporting Fraud

BY MARC J. FAGEL AND LAUREN ESCHER

The Securities and Exchange Commission typically seeks to transmit its strongest ''message'' cases with bold headlines and marquee-name defendants. But occasionally the best indicators of where the agency is headed can be found in the smaller cases that might otherwise fly beneath the radar. One such harbinger of things to come may be detected in an enforcement action filed in late July, an internal controls case involving a small (and bankrupt) public company and facts old enough to be outside the statute of limitations. The case nonetheless provides valuable lessons about the SEC's renewed focus on tenaciously pursuing financial reporting cases, however small, as well as the aggressive positions being taken by the current SEC administration in both settled and litigated actions.

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The Return of Accounting Fraud Investigations. After many years as one of the largest components of the SEC's enforcement program, the number of cases involving accounting improprieties and misleading disclosures by public companies dwindled significantly in recent years. Though due in part to the reforms of 2002's Sarbanes-Oxley Act, and heightened compliance in the wake of the Enron-Worldcom era, the downturn no doubt was partially attributable to the deployment of limited SEC resources to other priorities. The financial crisis of the late 2000's resulted in numerous resource-intensive investigations of Wall Street and financial institutions generally, while the Division of Enforcement made deliberate shifts to other focus areas, most notably investment advisers and brokers.

But shortly after the appointment of a new Chair and a new Enforcement Division Director in mid-2013, the agency announced a return to financial reporting as a program priority. The Enforcement Division announced a new Financial Reporting and Audit Task Force, accompanied by the roll-out of technological tools to help proactively ferret out signs of suspect accounting.[1] And at least anecdotally, members of the bar have observed an uptick in the number of new investigations involving public companies.

Yet what concerns some in the industry is that, in the absence of a major financial scandal, the SEC may overreach in an effort to show results from its stepped up efforts. The Enforcement Division may pour significant investigative resources into smaller cases, or seek significant sanctions for lesser violations.

Which brings us to the QSGI case.

[1] *See* Marc Fagel and Leslie Wulff, *Public Companies: Back in the SEC Hot Seat?*, Wall Street Lawyer (Sept. 2013), *available at* www.gibsondunn.com/publications/Pages/PublicCompaniesBackintheSECHotSeat.aspx.

The July 2014 QSGI Matter. On July 30, 2014, the SEC announced charges against two officers of QSGI Inc., a small computer equipment reseller and services provider based in West Palm Beach, Florida.[2] The company reported about $34 million in annual revenue and around 164 employees during the relevant period[3] and filed for bankruptcy in July 2009.

According to the SEC, CEO Marc Sherman and former CFO Edward Cummings falsely represented in documents accompanying the fiscal year 2008 annual report that Sherman participated in the company's assessment of its internal controls, when in fact he did not actually participate. In addition, the Commission alleged that each officer certified that he had disclosed all significant internal controls deficiencies to the outside auditors, but had in fact misled the auditors regarding inadequate inventory controls, and withheld information about steps the company had taken to accelerate the recognition of certain inventory and accounts receivable.

Notably, the SEC alleged that the company had misstated its inventory in its internal books in order to maximize the amount of money the company could borrow from its chief creditor, but did not allege the company reported fraudulent financial information to investors. Nonetheless, the SEC charged both the CEO and CFO with fraud, as well as with violating the internal controls, books, and records, and Sarbanes-Oxley certification provisions of the securities laws. The former CFO agreed to settle the charges without admitting or denying the allegations, while the SEC instituted non-settled administrative proceedings against the CEO. The company itself was not sued.

To be sure, the case involves some serious allegations, with misconduct at the highest levels of the company. But on its face, the case is more an internal controls and books and records matter than an egregious financial fraud action. The headline of the SEC press release says as much—*SEC Charges Company CEO and Former CFO with Hiding Internal Controls Deficiencies and Violating Sarbanes-Oxley Requirements*. Given the focus of the enforcement action, it is unusual to see the SEC charge the executives not just with the usual litany of non-fraud violations, but with violating Section 10(b) of the Exchange Act, the scienter-based antifraud statute at the heart of the SEC's most serious cases.[4]

While there is no way of knowing what motivated the SEC to include the Section 10(b) charge in this particular action, its inclusion can be fairly read as symptomatic of the Enforcement Division's tougher stance generally, and in financial reporting cases particularly. Making the seriousness of the charges even more anomalous is the fact that they are being leveled against executives of a small company that filed for bankruptcy in 2009, based on conduct dating back to 2008. These circumstances could signal an agency willing to take a forceful stand against fraud regardless of the size or age of the case; or they could just be reflective of an Enforcement Division eager to establish its presence in the financial reporting space, even if it means reaching far down in its investigative pipeline to do so. Either way, the case should give pause to any public company concerned about whether its own internal control weaknesses or reporting errors could give rise to enforcement interest. In the current climate, even a lesser financial reporting case is going to draw heightened attention, and potentially serious charges, from the SEC.

Aggressive Settlement and Litigation Posture. The increasingly aggressive ground being staked out by the SEC's Enforcement Division is further demonstrated by the respective outcomes of the enforcement actions against the CEO and former CFO of QSGI.

The CFO Settlement. The SEC filed a settled administrative action against former CFO Edward Cummings. The settlement terms included a $23,000 penalty, a five-year bar from serving as an officer or director of a public company, and a five-year suspension from practicing as an accountant before the SEC. The absence of any disgorgement, and the relatively low penalty (the SEC rarely assesses penalties against individual defendants below $25,000, and 6-figure penalties are increasingly common) suggest that Cummings did not personally profit from the misconduct and may have limited means at his disposal. In light of the limited financial sanctions, coupled with, as noted above, allegations that sound more like internal controls violations than serious accounting fraud, the five-year bars stand out as seemingly harsh.

Certainly, compared to the permanent bars that the SEC sometimes imposes, the time-limited bars agreed to here are less onerous. But for a CPA, even a five-year bar from practicing before the Commission—essentially eliminating any accounting role at a public company—is essentially a career-ender.

By way of comparison, consider other recent SEC settlements with accountants which included five-year officer and director and SEC practice bars, and which appear at least arguably more egregious. In one case, the SEC alleged that a public company finance employee passed a series of tips about his employer's financial performance to a friend, who in turn relayed the information to hedge fund employees who parlayed it into millions of dollars of illicit trading profits and avoided losses; in another, the SEC alleged that the CFO of a China-based company, among other things, failed to disclose the transfer of $41 million in securities offering proceeds to numerous unknown entities.[5]

Had the SEC foregone the Section 10(b) claim and charged this as a simple internal controls and books and records case, the matter almost certainly would

[2] SEC Press Release, *SEC Charges Company CEO and Former CFO with Hiding Internal Controls Deficiencies and Violating Sarbanes-Oxley Requirements* (July 30, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370542561150.

[3] *See* QSGI, Inc. Form 10-K for fiscal year ended December 31, 2008, filed March 31, 2009.

[4] In contrast, in 2011 the SEC sued the CFO of NIC Inc., alleging that he was aware that the CEO was receiving undisclosed perks yet still signed and certified SEC filings which failed to accurately report the CEO's compensation. The CFO settled to various non-fraud charges. *In re Eric J. Bur, CPA*, Exchange Act Rel. No. 63743 (Jan. 20, 2011).

[5] SEC Press Release, *SEC Charges Technology Company Insider in California with Tipping Confidential Information Exploited by Hedge Funds* (Apr. 23, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370541624596, and *In re Chris Choi, CPA*, Exchange Act Rel. No. 72494 (June 27, 2014); *In re Jing Xie*, Exchange Act Rel. No. 70602 (Oct. 2, 2013).

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have settled without the bars.[6] The SEC instead took a hardline position. The agency has faced significant pressure in recent years, both politically and from the judiciary, to focus its attention on the culpability of individual corporate executives and ratchet up the sanctions demanded in settlements; the relief ordered here seems aimed at furthering those objectives. (One thing the SEC did *not* seek in the settlement is an admission of liability, another new and potentially devastating weapon the Enforcement Division has rolled out over the past year but which has, to date, been limited to a relatively small number of cases.)

The Litigated Case Against The CEO. In contrast, CEO Marc Sherman did not agree to settle with the SEC, and the SEC instead filed a litigated enforcement action against him. Here, too, one finds indicia of the SEC's more aggressive stance in financial reporting matters. Rather than file a civil injunctive action in federal district court, as is typical in litigated financial reporting cases, the SEC instituted administrative proceedings against Sherman.

Though not without exception, the administrative forum was historically used by the SEC primarily for registered persons and entities, such as investment advisers and brokers, and for more routine and streamlined matters. Originally, the SEC could obtain sanctions specific to investment professionals in these proceedings, including bars from associating with advisers or brokers, but only limited remedies for unregistered persons such as corporate executives. This changed dramatically in recent years, with Sarbanes-Oxley and Dodd-Frank authorizing the SEC to obtain officer and director bars and monetary penalties from non-registrants, such that the Enforcement Division can now recover essentially the same remedies in either administrative proceedings or federal court actions.

Administrative proceedings move at an expedited pace (typically going to trial within months, rather than the years characteristic of court cases), saving resources for both parties, of particular importance to the SEC as an increasing number of enforcement actions litigate rather than settle. But the administrative process is also prejudicial to the targets of enforcement actions. The SEC's Rules of Practice allow for only minimal discovery, meaning that while the SEC staff has been able to take witness testimony and subpoena documents over the course of its investigation, respondents do not have any right to take depositions, leaving them at the mercy of the evidentiary record the Enforcement staff developed (or did not develop). In addition, there is limited motion practice, flexible application of the rules of evidence, and no right to a jury trial. And parties losing at the hearing level face an uphill battle on appeal.[7]

Perhaps more fundamentally, there is a perception that the Enforcement Division has a home-court advantage in administrative proceedings. After all, the administrative law judge is an SEC employee, and one who hears exclusively SEC enforcement actions. With the SEC losing a number of high-profile civil trials in the past year, the move to more administrative proceedings at least suggests an effort by the agency to gain an advantage in a friendlier forum.[8]

The broadened use of administrative proceedings has started to draw some critical attention. Several individuals charged administratively by the SEC have filed civil lawsuits contending the proceedings deprive them of due process rights.[9] And New York District Court Judge Jed Rakoff, whose attack on the SEC's use of neither-admit-nor deny settlements (ultimately reversed by the Second Circuit) made him a thorn in the agency's side, has recently weighed in with a skeptical view of administrative proceedings.[10] Notwithstanding well-founded concerns about the fairness of the process, the SEC has been unabashed in publicly confirming it will be increasingly relying on administrative proceedings. As Enforcement Division Director Andrew Ceresney recently proclaimed, ''I think there will be more [administrative proceedings] going forward.''[11] The QSGI action stands as confirmation that defendants in financial reporting cases can expect to increasingly find themselves in fast-tracked proceedings before an SEC administrative law judge with few of the protections of the federal civil procedure rules.

Conclusion. Public companies on the receiving end of an SEC financial reporting investigation are unfortunately arriving there at a particularly inopportune time. With the financial crisis largely behind it, the SEC has the luxury of selecting its own priority areas (at least until the next crisis), and it has made a very public showing of focusing resources on public company accounting and disclosure. Given this heightened scrutiny, coupled with the Enforcement Division's increasingly aggressive charging decisions and law enforce-

[6] *See, e.g., In re George B. Doherty*, Exchange Act Rel. No. 64496 (May 13, 2011) (controller in revenue recognition case charged with non-fraud financial reporting violations; no bars ordered).

[7] For example, the initial appeal of an administrative law judge decision is heard by the SEC itself—specifically, the same five Commissioners who authorized the staff to file the suit in the first place.

[8] For the author's assessment of the SEC's trial record earlier this year, *see* Marc Fagel and Mary Kay Dunning, *Implications of the SEC's Recent Trial Losses*, Law360 (Feb. 5, 2014), *available at* www.gibsondunn.com/publications/Pages/ImplicationsOfTheSECsRecentTrialLosses.aspx.

[9] One federal court recently dismissed the civil case, concluding that it lacked jurisdiction and that the complainant would need to raise his due process arguments in the SEC's administrative proceeding or on appeal of that matter. *Jarkesy v. SEC*, Case No. 14-CV-00114 (D.D.C. June 10, 2014). A similar action in another court remains pending. *Chau v. SEC*, Case No. 14-CV-1903 (S.D.N.Y., filed March 18, 2014).

[10] In 2011, Judge Rakoff declined to approve the SEC's settlement with Citigroup, in part because the lack of an admission of wrongdoing. On August 5, 2014, following reversal by the Second Circuit (*SEC v. Citigroup Global Mkts., Inc.*, 752 F.3d 285 (2d Cir. 2014)), Judge Rakoff entered an order (begrudgingly) approving the settlement. Commenting on the Second Circuit's observation that the SEC was free to avoid judicial scrutiny of its settlements by filing administrative proceedings, Judge Rakoff wrote: ''One might wonder: from where does the constitutional warrant for such unchecked and unbalanced administrative power derive?'' *SEC v. Citigroup Global Markets, Inc.*, 11-cv-7387 (S.D.N.Y. Aug. 5, 2014) at 3 n.8. The same judge had once before questioned whether an administrative proceeding comported with due process, though in that matter the SEC ultimately dropped the administrative proceeding. *SEC v. Gupta*, 796 F. Supp.2d 503 (S.D.N.Y. 2011).

[11] Bruce Carton, *SEC's Ceresney Expects Agency to Bring More Insider Trading Cases as APs*, Compliance Week (June 13, 2014).

ment approaches, corporate executives and boards would be well served by taking compliance and governance seriously before something goes wrong, and moving quickly to prevent minor issues from festering into larger ones.

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