Wall Street LAWYER
Securities in the Electronic Age
September 2013 ■ Volume 17 ■ Issue 9

Public Companies: Back in the SEC Hot Seat?

BY MARC FAGEL & LESLIE WULFF

Marc Fagel is a partner in Gibson, Dunn & Crutcher LLP's San Francisco office and a member of the firm's Securities Enforcement and White Collar Defense practice groups. Mr. Fagel previously spent more than 15 years with the Securities and Exchange Commission, including serving from 2008-2013 as Regional Director of the SEC's San Francisco office. Leslie Wulff is a litigation associate in Gibson, Dunn & Crutcher LLP's San Francisco office. Contact: mfagel@gibsondunn.com or lwulff@gibsondunn.com.

After several years of relative quiet, public companies are about to find themselves once again in the Securities and Exchange Commission's (SEC's) enforcement crosshairs. On July 2, the SEC announced several new initiatives designed to detect financial reporting fraud. Among other things, the SEC's Division of Enforcement has established a task force to focus on public company reporting, supported by new analytic tools intended to proactively identify signs of potential accounting irregularities. This announcement followed revelations by SEC officials just weeks earlier of new software being used by the agency to perform quantitative and qualitative analyses of corporate filings for indications of fraud.

Recent years have seen a significant decline in the number of enforcement actions alleging financial improprieties by publicly-traded companies, with the Enforcement Division directing far more resources at other program areas. Aside from a targeted run at foreign companies (primarily China-based) trading in U.S. markets, the SEC's public-company focus has been predominantly limited to a small number of high-profile Foreign Corrupt Practices Act (FCPA) matters and a steady stream of insider trading actions. The agency's recent pronouncements thus mark a profound change in the Enforcement Division's priorities.

Whether these initiatives will bear fruit is an open question. There are no obvious signs that there is some hidden reserve of undiscovered accounting fraud that the agency has failed to identify, and investigations based merely on potential red flags in financial statements rather than actual evidence of fraud are less likely to result in enforcement actions. In the meantime, these proactive efforts on the part of the SEC are almost certainly going to mean a significant resource drain for public companies on the receiving end of an enforcement inquiry. It seems likely that, with little more to go on than some statistical anomalies, the Enforcement Division will be sending document requests and other demands for information to a potentially large number of public companies in the weeks and months ahead. As detailed below, public companies would be well-served by a careful strategy of preparing in advance for the coming sweep in order to minimize both the costs of these investigations and the repercussions should improprieties surface.

Financial Reporting Fraud on the Decline

The SEC's recent announcement comes in the wake of a steady decline in financial fraud actions over the past five years. Historically, financial fraud cases represented at least a quarter of the enforcement actions brought by the SEC in any given year, rising to a high of 33% of all enforcement actions in 2007.[1] Since 2008, such cases have represented a steadily declining percentage of the SEC's

WEST®

CONTINUED FROM PAGE 1

enforcement docket, settling in at just under 11% in 2012.[2]

There are no obvious signs that there is some hidden reserve of undiscovered accounting fraud that the agency has failed to identify, and investigations based merely on potential red flags in financial statements rather than actual evidence of fraud are less likely to result in enforcement actions.

This trend can be explained by several factors, both structural and cyclical. There can be little doubt that the Sarbanes-Oxley Act, enacted in 2002 in the wake of the accounting-related scandals at Enron, WorldCom and other companies, has been an effective tool in improving corporate governance and curbing accounting improprieties. Similarly, the public scrutiny surrounding those matters, and the intense focus of both the SEC and the Justice Department, no doubt emboldened auditors and boards to take a harder line on reporting oversight.

While Sarbanes-Oxley likely created some structural improvements to financial reporting, much of the decline in enforcement activity also stems from other more cyclical developments. Given the economic downturn of recent years, much of the incentive to report fraudulent revenue growth that has driven past accounting scandals has been minimized. And the slowdown in IPO's means fewer unseasoned companies reporting financial results before adequate internal controls have been put in place.

Meanwhile, the financial crisis that roiled the U.S. economy in 2007-2008 led the SEC to redirect significant resources towards investigations of financial institutions. The agency reports that it has sued more than 150 individuals and entities for matters arising out of the financial crisis; factor in a number of large, resource-intensive investigations that did not ultimately result in enforcement actions, and it is clear that much of the staff's attention has been focused elsewhere. At the same time, due to structural changes within the Division of Enforcement (such as the creation of specialized units) and shifting priorities, the SEC has targeted significant enforcement attention to other areas of interest, most notably cases involving investment advisers (including managers of private equity and hedge funds). Indeed, the more than 50% decline in financial fraud cases in the past few years has been mirrored by a doubling of cases against investment advisers and investment companies, which reached a historical high of 20% of all enforcement actions in 2012.[3]

The SEC's Proactive Search for Accounting Fraud

In light of recent enforcement trends, the SEC's renewed attention on accounting fraud represents a marked shift in focus. Notably, these new initiatives come at a time of significant change for the agency. In April, former U.S. Attorney Mary Jo White was sworn in as the agency's 31st Chair. Shortly thereafter, she named two former criminal prosecutors, George Canellos and Andrew Ceresney, as Co-Directors for the Division of Enforcement. Almost immediately the new leadership showed signs of a more aggressive enforcement stance, including, among other things, a willingness to revisit the SEC's long-standing policy of allowing parties to settle enforcement actions without admitting wrongdoing.[4] With both an impetus to make their own mark on the direction of the enforcement program, and the freeing up of staff resources as the financial crisis investigations wind down, it comes as little surprise that the new leadership has seized on public company disclosures as a top priority.

With its July 2nd announcement, the SEC created the new Financial Reporting and Audit Task Force, whose "principal goal… will be fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures."[5] According to the announcement, the Task Force's work will include "on-going review of financial statement restatements and revisions, analysis of performance trends by industry, and use of technology-based tools." These efforts will be aided by a new "Center for Risk and Quantitative Analytics" which, working alongside the SEC's pre-existing Division of Economic and Risk Analysis, will assist staff nationwide in conducting risk-based investigations and developing methods of monitoring for signs of possible wrongdoing."

The announcement came just weeks after SEC officials shared details of some of these new analytic tools, including software that analyzes suspicious word choices in the Management Discussion and Analysis (MD&A) section of annual reports, as well as an "Accounting Quality Model" that searches for statistical anomalies among financial statements.[6]

© 2013 THOMSON REUTERS

Of course, having the tools and the motivation to search for corporate fraud does not necessarily mean the SEC will ultimately be successful in finding it. Historically, most SEC enforcement actions begin with at least some indicia of wrongdoing—a whistleblower coming forward; a dramatic and unexpected earnings shortfall; the discovery of incriminating documents by an auditor or new management team. Instances of significant cases coming out of industry sweeps based on quantitative analytics are few and far between.

The announcement came just weeks after SEC officials shared details of some of these new analytic tools, including software that analyzes suspicious word choices in the Management Discussion and Analysis (MD&A) section of annual reports…

Nonetheless, there are some noteworthy exceptions. For example, in the investment adviser space, the Enforcement Division (working with other Divisions) initiated an "Aberrational Performance Inquiry" using hedge fund performance data to identify funds with suspicious or improbable returns. According to the SEC, the initiative resulted in several enforcement actions against fund managers.[7]

For public companies, the obvious precedent lies in the series of stock option backdating cases filed by the SEC in the mid-2000s. Prompted by the findings of a few early investigations, as well as academic studies and media reports suggesting a much more widespread phenomenon, the SEC launched a broad look into whether public companies had systematically backdated their stock option grants to executives, directors, and employees in order to provide undisclosed compensation in violation of accounting rules. According to then-Director of Enforcement Linda Thomsen, the SEC opened well over 100 investigations of public companies, based at least in part on quantitative analytics and academic literature.[8] The agency ultimately filed actions against executives of around 30 public companies.[9]

Unfortunately, the breadth of the backdating initiative also highlights the hazards of such a risk-based approach to investigations. According to a *Wall Street Journal* analysis in 2009, more than 140 public companies were ultimately investigated by the SEC for alleged backdating, with only a portion ultimately charged.[10] Even assuming that improprieties existed at companies not charged by the SEC, which obviously had resource limitations (as well as statute of limitations issues) and likely concluded a sufficient deterrent effect could be achieved without bringing every possible case, a tremendous amount of corporate resources went into investigations that did not result in fraud charges.

And the new initiative seems even more troubling for public companies. In contrast to the backdating scandal, where the SEC's sweep originated from an undeniable phenomenon backed by compelling academic studies, there is no evidence that there is a raft of accounting fraud currently going undetected by the agency. A quantitative or qualitative analysis of public company filings may well identify outliers or potential red flags, but there is presently no basis to conclude this analysis will lead to the uncovering of corporate fraud. To the contrary, the steady decline in financial fraud investigations in recent years (along with the parallel decline in private class actions)[11] strongly suggests that the quality of internal controls and reporting integrity has improved dramatically since the scandals of the early 2000s and the passage of Sarbanes-Oxley.

Nonetheless, as a legal matter, the burden for the agency's enforcement staff to launch an investigation is low—courts have described the threshold to be nothing more than "official curiosity."[12] Even more troubling for companies, the past decade has seen an increasing shift to an investigative model whereby the staff essentially places the burden on the company to conduct its own internal investigation and report its findings to the agency. While this is not necessarily a wholly negative situation for the company—a self-directed internal investigation gives the company a better opportunity to streamline and control the scope of the case than a flurry of SEC subpoenas directed at a wide swatch of executives and employees—it also makes it easier for the Enforcement Division to cast a wide net without impacting its limited resources.

Hence, if the SEC is serious about its accounting fraud initiative, it is not hard to foresee the staff using its analytic modeling tools to identify a large number of public companies with suspect filings, sending document requests to each company seeking information on its accounting practices and internal controls, and requesting that the company conduct an internal investigation and report its findings to the staff in short order.

© 2013 THOMSON REUTERS

[A]s a legal matter, the burden for the agency's enforcement staff to launch an investigation is low—courts have described the threshold to be nothing more than "official curiosity."

Needless to say, this proposition presents a tremendous burden for public companies. Even responding to a narrowly-focused inquiry may require substantial resources. Significant document reviews will be likely, an increasingly difficult proposition in an era of massive stores of electronic data. Interviews of key employees, executives, and directors may be required. Companies with extensive overseas operations could face particularly heavy burdens. Moreover, the risks of an SEC inquiry–even one that is part of a broad sweep triggered by no more than computer analytics–are imposing. As noted above, the new SEC leadership, at the same time it is rolling out its accounting fraud initiative, is also showing signs of a much more aggressive enforcement stance. And the private bar, having also experienced a significant decline in its caseload in recent years, will undoubtedly latch onto these SEC investigations as the basis to initiate their own lawsuits.

Strategies to Prepare for the SEC

In this environment, it is crucial for public company executives, their boards, and their counsel to be planning in advance for the possibility of an enforcement inquiry. Described below are several basic steps that should be considered to minimize the risks of being caught up in the SEC's sweep:

1. ***Identify Potential Issues before the SEC Comes Calling—***Obviously, the best way to minimize the risk of the SEC uncovering accounting irregularities is to do what you can to not have any in the first place. While the corporate governance and internal controls mechanisms put in place by public companies after Sarbanes-Oxley appear to be generally effective (based on the reduction in corporate restatements and accounting fraud enforcement actions in recent years), this is not the time to take these measures for granted. Steps should be taken to make sure internal controls are effective, and policies are being followed. Particular attention should be paid to any offshore operations, which may present larger challenges given both their physical distance from headquarters and limited familiarity with U.S. regulations and business practices; management should also pay close attention to the integration of newly acquired businesses, which may require that financial controls be raised to the level of the acquiring company. Along similar lines, while the SEC has not disclosed precisely what sort of quantitative metrics or MD&A language choices will subject a company to scrutiny, companies should consider comparing their disclosures to those of their peers for anomalies. A company's regular auditor or a third-party consultant may also add value in undertaking such an exercise. Taking advance measures to identify potential irregularities may serve not only to facilitate preemptive corrective action, but, in the event of an SEC investigation resulting in potential enforcement action, may help demonstrate the sort of voluntary remediation efforts that the agency will take into account in making its decisions in regard to legal charges and remedies.

2. ***Set the Right Tone at the Top—***Just as with prereviewing the company's disclosures and internal controls, creating a culture of compliance can go a long way towards minimizing the potential for improper accounting practices. "Tone at the top" is a phrase that may be thrown around too cavalierly, but with the SEC's new focus, it is an opportune time for senior management to ensure that their messaging on the importance of compliance is clear and serious. No less meaningful is the "tone at the middle": Managers responsible for the day-to-day oversight of the entity's sales and accounting practices must also convey the importance of ethical behavior across the organization. As the economy improves and the pressure to grow revenue and solidify earnings increases, it will be essential for all layers of management to establish a corporate culture where cutting corners is not incentivized.

3. ***Get a Handle on Your Documents (Particularly E-mail)—***One does not have to look very far to find examples of SEC complaints and trials built largely around incriminating (or simply inartful) language in e-mail messages. It is important for companies to train their personnel on the appropriate use of e-mail and other electronic communications. Companies also need to ensure they follow an established docu

© 2013 THOMSON REUTERS

ments and routinely deleting the rest. This will serve not just to reduce the risk of imprudent language being taken out of context and used against the company years down the road, but will greatly reduce the burden of locating and producing documents in the event of an investigation. Searching through terabytes of data for responsive electronic records (particularly when the technology has changed over time) can be a massively expensive exercise. At the same time, it is important to be prepared to locate and preserve relevant documents immediately upon being notified of SEC interest. For centrally preserved electronic data, it will be necessary to halt routine data deletion protocols. And all officers, directors and employees will need to be promptly instructed to retain potentially relevant data. Destroying documents (including deleting email messages) after learning of an SEC inquiry can subject the company to repercussions more serious than it may face for the underlying conduct under investigation.

4. ***Be Attentive to Whistleblowers***—One of the most significant legal developments of recent years has been the establishment of the SEC's whistleblower program pursuant to the Dodd-Frank Act. This program provides cash awards to individuals who report original information to the SEC that results in the successful prosecution of an enforcement action. The agency has trumpeted its desire to demonstrate that this program will prove effective in incentivizing corporate employees to report potential securities law violations to the SEC. Hence, a company identified as potentially high risk by the Task Force which has also been the subject of a whistleblower complaint is certain to be a top priority for the staff. Indeed, it is likely that, in the event of an SEC inquiry, the SEC staff will ask if the company has received any complaints concerning the subject matter of the inquiry, and, if so, how the company responded. It is thus particularly important for companies to encourage employees to report concerns internally and to maintain a transparent, fulsome system for evaluating internal whistleblower complaints. Taking appropriate action to resolve employee concerns and to be responsive to complainants not only minimizes the risk of an aggrieved employee taking the matter to the government, but, as with effective compliance systems described above, will weigh in the company's favor in the eyes of the SEC in the event of an investigation. Conversely, failing to appropriately address whistleblower complaints can be an aggravating factor in any enforcement action the SEC ultimately determines to file.

5. ***Plan a Response Strategy***—Finally, it is essential for companies to give some advance thought to how they will respond in the event they are contacted by the SEC enforcement staff. Once an inquiry begins, the company will need to make some difficult decisions very quickly, and the tone set by those responding on behalf of the company can have significant implications for the remaining course of the investigation. As noted above, in recent years the Division has increasingly "outsourced" some of its early investigative steps to the company itself, relying on company counsel to conduct an internal investigation and report back to the staff. This can be a double-edged sword. A company undertaking an internal investigation, particularly under the aegis of independent counsel with some credibility among the staff, may have broader latitude to control the scope of the investigation. On the flip-side, these efforts will provide a blueprint not only for the government to follow, but for the plaintiffs in a private suit who are likely to obtain access to the information shared with the SEC. While the SEC has repeatedly stated that the extent of a company's cooperation with the government will be a significant consideration in any eventual charging decisions, for every example of a company which received leniency for its cooperation there is a case where a company that did all it could to assist the government nonetheless found itself subject to serious sanctions due to the gravity of the underlying allegations. Determining the extent and nature of cooperation to provide requires a careful balancing of considerations, made all the more challenging when undertaken while in the midst of a potential corporate crisis.

NOTES

1. Select SEC and Market Data, Fiscal 2007, *available at* www.sec.gov/about/secstats2007.pdf.
2. Select SEC and Market Data, Fiscal 2012, *available at* www.sec.gov/about/secstats2012.pdf.
3. Select SEC and Market Data, Fiscal 2012, *available at* www.sec.gov/about/secstats2012.pdf.

© 2013 THOMSON REUTERS

4. *See* Marc Fagel, "The U.S. Securities and Exchange Commission's Troubling New Policy Requiring Admissions," Bloomberg BNA (July 30, 2013), available at www.bna.com/us-securities-exchange-n17179875550.
5. 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.
6. Jean Eaglesham, "Accounting Fraud Targeted," Wall St. J. (May 27, 2013).
7. Speech by Bruce Karpati, Chief, Asset Management Unit, "Enforcement Priorities in the Alternative Space" (Dec. 18, 2012), *available at* www.sec.gov/News/Speech/Detail/Speech/1365171492012.
8. Speech by Linda Thomsen, Director, Division of Enforcement, "Options Backdating: The Enforcement Perspective" (Oct. 30, 2006), *available at* www.sec.gov/news/speech/2006/spch103006lct.htm.
9. *See* cases reported at www.sec.gov/spotlight/optionsbackdating.htm.
10. Mark Maremont, "Backdating Likely More Widespread," Wall St. J. (Aug. 18, 2009).
11. *See* Cornerstone Research/Stanford Law School Press Release, "Securities Class Action Filings Remain Depressed in First Half of 2013" (July 24, 2013), *available at* securities.stanford.edu/scac_press/CsR_2013_Filings_MYA_Press%20Release_072413.pdf.
12. *See Securities and Exchange Commission v. Arthur Young & Co., 584 F.2d 1018, Fed. Sec. L. Rep. (CCH) P 96502 (D.C. Cir. 1978)*

Article REPRINT

(#78620) Reprinted with permission from the September 2013 issue of Wall Street Lawyer. ©2013 West Services Inc., a Thomson Reuters company. All rights reserved. For more information about this publication please visit www.store.westlaw.com.
For more information about reprints from Wall Street Lawyer, visit PARS International Corp. at www.reutersreprints.com.
This PDF is authorized for electronic distribution and limited print distribution through September 30, 2014.