Looking Back & Looking Ahead

SEC 2020: Expect SEC Enforcement to Cast Wide Net on Corporate Disclosure

Introduction

Based on our ongoing analysis of SEC enforcement actions in 2019, we expect the SEC's Division of Enforcement to continue its expansive view of company disclosure issues that warrant enforcement scrutiny. In 2019, the SEC was aggressive against alleged accounting fraud by public companies and their executives, including actions alleging accounting schemes to meet earnings expectations and actions alleging sham transactions with third parties. Consistent with this focus on accounting misstatements, the SEC also brought stand-alone actions for internal control deficiencies. In addition, the Commission brought actions against outside auditors for recurrent audit failures and violation of auditor independence rules.

Expanding beyond this traditional focus, the SEC investigated companies for alleged misstatements or omissions involving non-accounting issues, such as data privacy breaches and cyber-related violations, as well as other non-technology negative developments affecting a company's core operations. The SEC also brought actions against companies that were already sanctioned by other non-securities regulators. Finally, the SEC expanded its enforcement reach to foreign companies with securities that are primarily listed overseas, as long as the Enforcement Staff could find a U.S. jurisdictional hook to sue such companies and their executives—a trend we have seen continue into recent weeks.

Ongoing Focus on Corporate Accounting Misstatements, Internal Control Deficiencies and Audit Failure

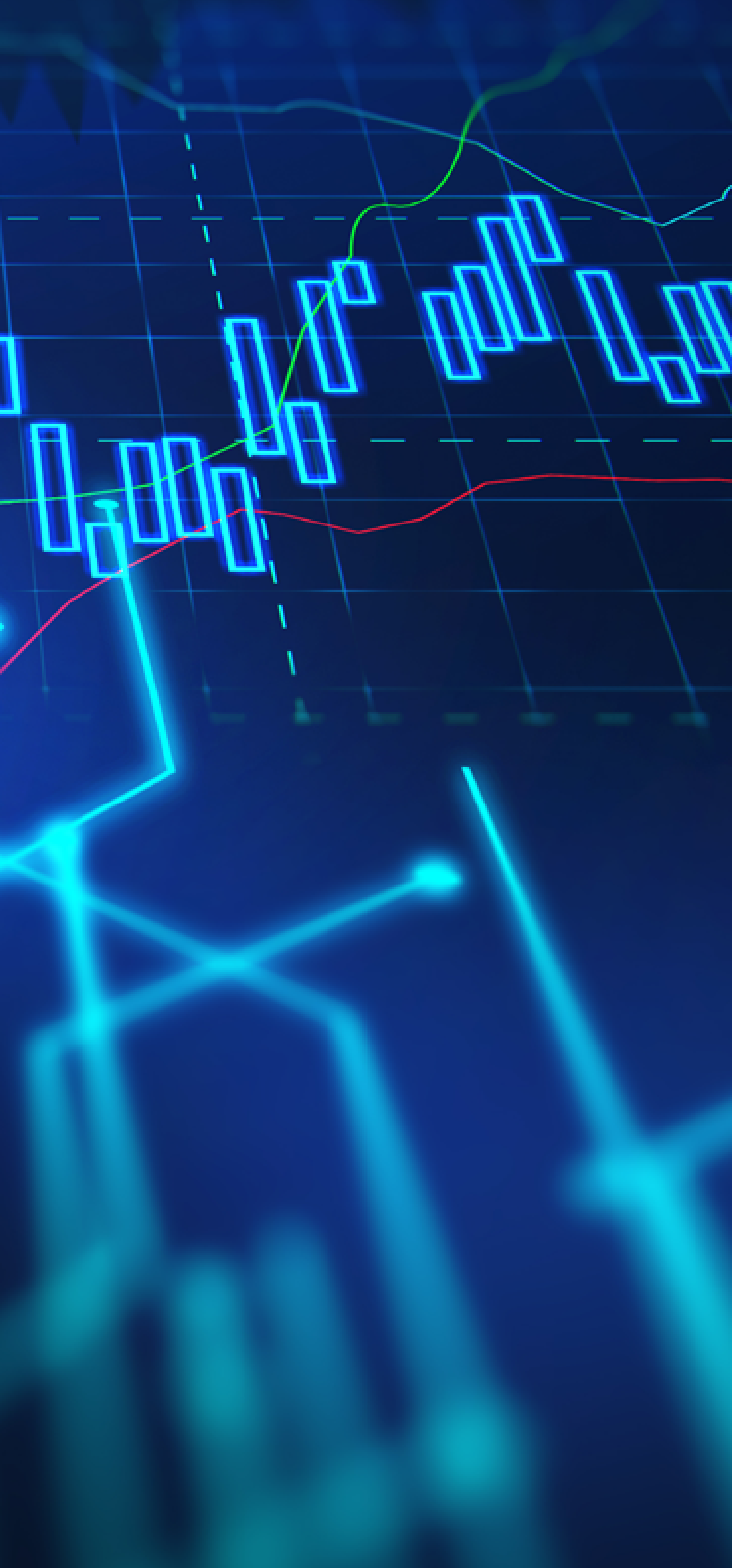
Pressure to Meet Earnings Expectation: In the SEC's 2019 fiscal year, the Enforcement Staff continued its traditional focus on accounting fraud by public companies, finding that pressure to meet earnings expectations continues to be a prime motive for accounting fraud. For instance, the SEC alleged that a publicly traded transportation company and its executives improperly deferred expenses and spread them across multiple quarters to minimize impact on net earnings. The SEC also alleged that reductions to liabilities were manipulated to create an income "cushion" for future quarters. These manipulative schemes were designed to help executives meet earnings targets and projections. In light of what we have seen in the 2019 cases, we can expect that the Staff will continue in 2020 to look for and investigate potential accounting fraud driven by earnings management. To do so, it will likely look for suspicious accounting patterns involving companies' abilities to meet or exceed earnings expectations.

Sham Transactions with Third Parties: A number of the accounting fraud cases included alleged phony transactions with third parties. In one case, a company bought and sold trucks at inflated prices from third parties. Indeed, in the press release for that case, the SEC specifically emphasized that it is the latest in a line of actions brought against companies and their executives for committing accounting fraud via sham agreements with third parties, suppliers or customers. As a result of the SEC's concern with sham transactions, we expect the Enforcement Staff to investigate and even recommend actions against outside vendors and customers who may have engaged in such transactions with public companies.

Stand-Alone ICFR Cases: To deter and prevent accounting fraud, the SEC in 2019 continued to bring stand-alone cases asserting deficient internal control by public companies. As part of an apparent sweep, the Commission simultaneously announced settled actions against four public companies for failing to maintain internal controls over financial reporting (ICFR) for seven to ten consecutive annual reporting periods. These ICFR deficiencies had been disclosed in the company's corporate filings. The investigations for these matters were conducted by the SEC Enforcement Division's Financial Reporting and Audit Group, also known as the FRAud Group. This specialized team is tasked with detecting trends affecting corporate financial reporting. It is thus likely that this group will continue to monitor corporate filings and identify companies with recurrent internal control deficiencies that have not been remedied over extended period.

Pattern of Deficient Audit and Focus on Independence: Consistent with its ongoing focus on accounting fraud, the Enforcement Staff in 2019 brought actions against outside auditors for audit failures and for violation of auditor independence rules. In particular, the SEC identified an alleged pattern of audit failures and brought actions against audit firms that failed to perform adequate audits for multiple companies. For instance, the SEC brought an action against an audit firm and its partners for failure to comply with professional audit standards for 10 audits and 11 interim reviews for five public companies. The SEC is concerned with audit firms that are not able consistently to perform adequate audits. In 2020, the Enforcement Staff will likely continue to look for audit firms that are unwilling or unable to provide adequate resources or staff audits with sufficient number of competent professionals to conduct appropriate audits. The Staff will likely do so by identifying and looking deeper at firms and audit personnel who repeatedly show up in SEC investigations involving public company financial misstatements.

The SEC continues to be concerned with the independence of outside auditors. For instance, in 2019, it charged RSM US LLP with violating auditor independence rules. The SEC alleged that RSM or its associated entities provided non-audit services to, and had an employment relationship with, affiliates of RSM US audit clients; we expect the Enforcement staff to continue to focus on auditor independence in 2020.



Expanding Enforcement Reach on Corporate Disclosure

In 2019, the Enforcement Division investigated companies and the SEC brought actions for alleged misstatements or omissions involving non-accounting issues, such as negative developments affecting a company's operations. The Commission also instituted proceedings against companies that already had been sanctioned by other non-securities regulators. Finally, the SEC expanded its enforcement reach to foreign companies with securities that are primarily listed overseas, as long as the Enforcement Staff could find a U.S. jurisdictional hook to sue such companies and their executives. While the underlying case theory for these cases is not novel, these actions are noteworthy as they reflect a greater willingness by the Division of Enforcement to apply its relatively scarce resources to expand its reach on corporate disclosure. As noted above, we already are seeing more of the same in 2020.

Actions against Volkswagen and other Non-U.S. Companies: An example of the SEC's expansive reach is its March 2019 action against Volkswagen and its CEO for allegedly defrauding U.S. investors, raising billions through the issuance of U.S. corporate bonds while making deceptive claims about the environmental impact of the company's "clean diesel" fleet. Multiple aspects of this case would have historically persuaded the SEC to exercise its discretion and not bring an enforcement action. Volkswagen is primarily a German-based company and its stock is traded outside the U.S. In addition, the underlying issues involve the alleged circumvention of clean air standards for its diesel engines and did not involve traditional SEC concerns relating to accounting fraud. Further, the alleged scheme to circumvent clean air standards were comprehensively investigated by other law enforcement agencies resulting in significant settlements. Indeed, the district court judge presiding in this enforcement procedure severely criticized the SEC for what he identified as regulatory overreach and redundancy. Nonetheless, the SEC focused on Volkswagen's issuance of corporate bonds to U.S. investors and continues to vigorously litigate this matter.

Despite criticism the SEC received for the *Volkswagen* case, the SEC, in September 2019, brought a settled action against Nissan, its former CEO Carlos Ghosn and a former director related to alleged false financial disclosures that purportedly omitted more than $140 million to be paid to Ghosn in retirement. Like Volkswagen, Nissan is an overseas company with its stock listed and traded in Japan. The SEC indeed noted that the company made false disclosures regarding pension increases in annual securities reports that violated *Japanese* disclosure requirements. However, the SEC noted that Nissan's annual reports were translated into English for the benefit of U.S. investors in Nissan American Depository Receipts (ADRs). The SEC filed this settled action despite the pre-existing action by the Japanese criminal authorities, and before Mr. Ghosn's notorious flight from the Japanese jurisdiction.

U.S. Non-Accounting Corporate Disclosure Cases: The SEC in 2019 brought enforcement actions against public companies for corporate disclosures that involved core operational as opposed to accounting issues, including data privacy and cyber breach issues. For example, the Commission charged Facebook for making allegedly misleading disclosures regarding the risk of misuse of Facebook user data. The SEC alleged that Facebook presented the risk of misuse of user data as merely hypothetical when it knew that a third-party developer, Cambridge Analytica, had actually misused Facebook user data.

During fiscal year 2019, the Commission also ominously issued what is commonly known as a 21(a) Report of Investigation to warn public companies to consider cyber threats when implementing internal accounting controls, even though the SEC decided not to sue nine public companies that had wired nearly $100 million from company accounts to fraudulent actors as a result of cyber fraud. In so doing, the SEC issued a warning that it views certain cybersecurity deficiencies of public companies as internal accounting control deficiencies, even though cybersecurity has not previously been viewed as an accounting/controls issue by the SEC Enforcement Staff.

The SEC also brought enforcement cases for alleged inadequate disclosure regarding potential issues or liabilities involving other government regulators. For example, the SEC brought charges against Mylan N.V. for what the SEC labeled as accounting and disclosure failures relating to a Department of Justice (DOJ) probe into whether Mylan overcharged Medicaid by hundreds of millions of dollars for EpiPen, its largest revenue and profit generating product. According to the SEC complaint, the Centers for Medicare and Medicaid Services (CMS) informed Mylan that EpiPen was misclassified as a generic drug. The SEC alleged that Mylan disclosed as a risk that government authorities may take a contrary position on Mylan's Medicaid submissions but failed to disclose that CMS already had notified Mylan that EpiPen was misclassified. The SEC also faulted Mylan for failing to disclose DOJ's likelihood of charging and seeking significant monetary damages from Mylan, based on Mylan's knowledge of the status of the DOJ's civil investigation.

This focus on non-accounting disclosure is further reinforced by the SEC's recent guidance on MD&A discussion of key financial indicators and metrics, including non-financial metrics.

Conclusion

We will continue to follow and keep you informed of developments and trends in these areas, which are so important to our clients worldwide. If you have questions, please do not hesitate to contact any one of our team.

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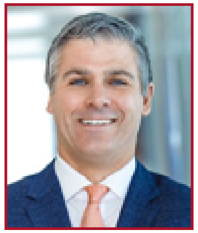

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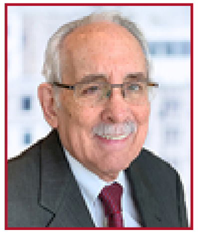

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