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EXECUTIVE COMPENSATION

SEC Adopts Final Pay Ratio Disclosure Rule

By Michele Luburich, Ning Chiu, and Kyoko Takahashi Lin

On August 5, 2015, in a 3–2 vote, the SEC adopted a final rule implementing the provision of the Dodd-Frank Act that requires US public companies to disclose the ratio of their CEO's compensation to that of their median employee. The final rule is generally consistent with the SEC's original proposal that was issued in 2013, but contains a few accommodations, which are intended to help mitigate compliance costs.

Background and the Final Rule

Section 953(b) of the Dodd-Frank Act directs the SEC to amend Item 402 of Regulation S-K to require each registrant to disclose:

- the median of the annual total compensation of all employees of the registrant, except the chief executive officer (or any equivalent position) of the registrant, determined in accordance with Item 402(c);

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SEC (Re)Focused on Financial Reporting and Auditing Matters

By Brian Neil Hoffman

The Securities and Exchange Commission (SEC) has kept public companies, audit firms, and their personnel in its enforcement cross-hairs through its pursuit of potential financial reporting and auditing fraud.[1] Based on the takeaways and trends explored in the report and this article, entities and individuals should carefully scrutinize their own practices, and promptly and appropriately address potential concerns that may arise.

SEC's Renewed Focus

Financial reporting and auditing enforcement is a traditional area of focus for the SEC. Yet news about these cases in recent years was overshadowed by headlines on cases concerning the Financial Crisis of 2008, insider trading, and Ponzi schemes of all types.

Signaling a renewed focus, the SEC announced the formation of the Financial Reporting and Audit Task Force in mid-2013. By now, the SEC has had more opportunity to flex its enforcement muscles in this area: 2014 was the first full calendar year after forming the Task Force, and the initiative has had two years of enforcement activity by mid-2015.

According to SEC Chair Mary Jo White, the efforts are "starting to bear fruit." The SEC announced 68 new financial reporting and auditing matters involving 114 defendants during calendar year 2014. The first half of 2015 trended towards similar totals—56 cases and 112 defendants. These results over the past 18 months represent upticks from 2013's totals of 51 cases and 106 defendants. The SEC pursues claims against all types of entities and individuals. In 2014, for example, 44 percent of defendants were officers or directors of public companies; 24 percent public companies; 14 percent audit firms; 10 percent individual auditors; and 8 percent others.

Potential Pitfalls Abound

The SEC will not hesitate to put virtually every aspect of a company's public disclosures, and the processes by which they are compiled and audited, under the microscope. It is not surprising, therefore, that the SEC's cases over the past 18 months covered a broad range of subjects—for example, concerns about revenue recognition, overstated assets, understated expenses, misuses of corporate assets, effectiveness of internal controls, and other disclosures. Entities and individuals should keep a careful eye on all quantitative and qualitative public disclosures, as well as on internal controls and uses of corporate assets.

Quantitative Disclosures

More than half of the SEC's financial reporting and auditing cases in 2014 and early 2015 involved alleged accounting manipulations designed to make reported results appear better than they actually were.

Cases concerning alleged manipulations of revenue recognition remain prevalent. The SEC clearly pursues what it believes to be entirely fabricated revenues. In one case, for example, the SEC claimed that the defendants recorded revenues for sales of livestock and feed that did not exist. In a second case, the SEC alleged revenues based on occupancy by individuals who did not live at the company's assisted living

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facilities. The SEC may also challenge the timing for revenue recognition. The SEC claimed that one company improperly recognized revenues for sales prematurely, before customers had fully secured financing to pay for the purchases.

The SEC frowns on misstated financial performance, no matter where the allegedly manipulated line item appears in the financials. For instance, the SEC filed a case against a snack-food company, and its former CEO and CFO, for allegedly improving the company's publicly reported performance by underreporting expenses paid to walnut growers. And, in another case, the SEC charged a jewelry company and its CFO for allegedly inflating the value of inventory by 99 percent to 227 percent by making it appear that the company owned inventory that actually belonged to customers in consignment arrangements.

Moreover, the SEC has long targeted defendants that engage in abuses such as "cookie jar" reserves or otherwise misstated accruals and provisions. In one settlement, the SEC alleged that executives in a technology company's Australia office maintained excess unsupportable accruals associated with gift cards given to employees that were later released to boost earnings.

Qualitative Disclosures

A significant number of the SEC's cases in 2014 and early 2015 involved allegedly inaccurate disclosures other than accounting manipulations. Entities and individuals should carefully review all of their public disclosures to ensure accuracy.

Some cases involved alleged misstatements about companies' business operations. For example, the SEC recently alleged that an international information technology company made misstatements about its performance of a significant contract by claiming that it was meeting performance obligations on time and without incident, when in fact there were extensions and issues. Similarly, the SEC alleged that an oil and gas exploration and production company publicized exaggerated estimates of oil reserves that lacked a reasonable basis and that were falsely attributed to a third-party.

The SEC has also charged alleged misstatements about the role played by certain personnel. In one case, the SEC alleged that defendants misstated that certain individuals served as CEO and CFO when, in fact, the chairman of the board ran the company.

In other cases, the SEC focused on alleged misstatements occurring during corporate acquisitions. The SEC settled with one company for engaging in a series of transactions that put stock in the hands of a management-friendly director, allegedly to defeat a hostile tender offer, without proper disclosure. In another matter, the SEC alleged that misstatements about the acquisition of another company were made to mask the acquired company's prior Foreign Corrupt Practices Act (FCPA) violations.

Internal Controls

From the SEC's perspective, a weak internal control environment increases the likelihood that a violation may occur. Predictably, SEC staff have oft proclaimed that the effectiveness of internal controls is an important issue and an ongoing area of focus.

In a settlement with a jewelry company, the SEC claimed that the CFO (who also was charged) "took advantage of [the company's] weak internal control environment to intentionally manipulate" inventory valuations. The alleged deficient controls included:

- a lack of sufficient written policies,
- insufficient staffing in the accounting department,
- a failure to follow accounting best practices,
- unsupported and improperly described entries,

- insufficient processes and systems,
- a lack of proper audit trail, and
- insufficient data security.

The company settled to reporting, recordkeeping, and internal controls failures only, not fraud. In apparent recognition of the company's remedial efforts—which included personnel changes, new policies and procedures, and hiring an independent consultant—the SEC did not impose a civil penalty on the company.

The SEC's clear message to all entities and individuals through this case can be summarized as "best, better, bad." That is, robust internal controls *best* help companies avoid issues in the first instance, and the SEC will pursue companies with deficient controls. Yet this case also tells a "*better* late than never" story—although the company allegedly lacked sufficient proactive controls safeguards, its prompt self-identification, investigation, and remediation yielded benefits. And, taking these steps apparently helped the company avoid a "*bad*" result.

Potential Misuses of Corporate Funds

The SEC expects entities and individuals to use corporate assets to benefit shareholders, not to misuse those assets to line the pockets of foreign officials, executives, or related parties. Although each of these cases entails its own facts and circumstances, they generally lead to the same overall takeaways.

The FCPA cases teach that:

- Companies of all sizes doing business abroad cannot ignore the FCPA;
- Certain business practices, such as relying on third-party consultants or agents, increase the risks of an FCPA violation;
- Benefits that violate the FCPA can take many forms, and companies must be vigilant in their efforts to avoid infractions;
- Policies, training, and controls focused on FCPA risks provide critical safeguards against potential FCPA violations;
- Many FCPA actions involve parallel Department of Justice and SEC proceedings;
- Self-discovery, investigation, and remediation may yield benefits, such as a reduced civil penalty;
- Even in a favorable settlement, the monetary costs of an FCPA violation, including disgorgement and civil penalties, can be staggering;
- Given the proliferation of potential FCPA risks, companies are well advised to explore efficient and cost-effective investigation of potential issues by counsel, in lieu of employing a scorched-earth approach every time potential FCPA issues arise.

The SEC's recent undisclosed related-party transaction and compensation cases teach that:

- Entities should fully identify and appropriately disclose related-party transactions, and the SEC will sanction companies—as well as individuals—who do not vigilantly undertake this task; and
- Companies should ensure that their controls include careful scrutiny of executive submissions for reimbursement of supposed business expenses, lest the amounts actually constitute undisclosed personal perquisites.

One recent case provides an important cautionary tale: the SEC expects much from companies in terms of internal compliance over uses of corporate assets. A global resources company allegedly sponsored a hospitality program at the Beijing Summer Olympics that included foreign government officials, some of whom were in a position to influence business and regulatory matters involving the company. The company had some controls over the program, including a questionnaire form intended to identify potential FCPA risks. Yet the SEC levied multiple criticisms against the form's

sufficiency and the company's allegedly deficient compliance follow-up to the answers provided. The company settled to non-fraud charges. This case shows that the SEC will not shy from aggressively and expansively using non-fraud charges to sanction ineffectual efforts to prevent misuses of corporate assets.

Focusing on Gatekeepers and Individuals

When looking back at SEC financial reporting and auditing enforcement trends, 2014 may well be remembered as the "Year of the Auditor." The number and percentage of auditor and audit firm defendants increased in 2014, as compared to 2013. SEC Director Andrew Ceresney has proclaimed that an investigation of outside auditors occurs "in virtually every case."

The SEC's auditing enforcement cases centered around two primary themes: protecting the integrity of auditors' role as independent gatekeepers and sanctioning allegedly deficient auditor performance.

First, the auditor independence cases involved an array of alleged transgressions, including firms allegedly providing legislative advisory, bookkeeping, and shared staffing services to audit clients, or an auditor accepting casino credits from a gaming client.

Second, in its audit quality cases, the SEC alleged that auditors accepted management's representations without appropriate testing and backup, failed to appropriately supervise the audit procedures and audit documentation, and/or failed to appropriately audit potential areas of risk—such as related-party transactions, accounts receivables, or internal controls.

In short, auditors and audit firms should safeguard their independence and should ensure that audits are diligently performed and documented.

Moreover, the SEC has historically targeted individuals in financial reporting and auditing matters; 2014 and early 2015 were no exception. Indeed, 2015 so far has trended toward a significant uptick in enforcement against individuals, particularly against corporate personnel. In other words, if 2014 was the "Year of the Auditor," then 2015 is trending towards being the "Year of the Officers and Directors."

Over the past 18 months, the SEC sued almost 100 individuals for financial reporting and auditing matters, 82 of whom were public company officers or directors. Not surprisingly, CEOs, CFOs, controllers, and other finance professionals constitute most of these defendants. Yet the SEC also will not hesitate to pursue other employees who it believes were involved in the challenged issues.

Nor will the SEC shy from employing its full arsenal of sanctions against individuals, including disgorgement, civil penalties, and O & D bars. The *Wall Street Journal* has reported that the civil penalties levied by the SEC against individuals more than doubled over the past decade.[2]

Additionally, in appropriate cases, the SEC will pursue clawbacks under Sarbanes-Oxley Act Section 304, which requires the CEO and CFO to repay their bonuses or incentive-based compensation to the issuer if it restates its financials due to misconduct. The SEC used Section 304 several times during 2014 and early 2015, successfully clawing back millions of dollars.

We may be witnessing the leading cusp of an increasingly frequent pursuit of clawbacks. On July 1, 2015, the SEC announced proposed rules that would require issuers to implement policies stating that the issuer, in the event of an accounting restatement and with only limited exceptions, will seek to claw back incentive-based compensation from current and former Section 16 officers that they would not have received based on the restatement.

Simply put, the SEC will—in the words of Director Ceresney—"aggressively pursue individual responsibility while rewarding

extraordinary cooperation and remediation by companies." Individuals embroiled in SEC investigations thus are well advised to consult with their own SEC defense counsel, independent from company counsel, to best protect their individual interests.

Whistleblowers Rewarded

The SEC's whistleblower program continued to make headlines in 2014 and early 2015. Under this program, established with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), whistleblowers who provide information that leads to a successful enforcement action involving sanctions of more than $1 million may receive an award of 10 percent to 30 percent of the amount collected by the SEC.

The number of whistleblower tips received by the SEC's Office of the Whistleblower continued to rise in SEC fiscal year 2014. These tips most commonly raised concerns about "Corporate Disclosures and Financials" (aside from tips classified as "other"), thus stoking SEC suspicion about a profusion of financial reporting and auditing issues for potential enforcement. The SEC also publicly touts the high quality of the tips that it has received.

The whistleblower program achieved several milestones in 2014 and early 2015. It issued more awards to individuals than in all prior years combined. On September 22, 2014, the SEC announced its largest single award to an individual to date: $30 million. This award more than doubled the preexisting largest award of $14 million.

Additionally, the SEC took steps to protect the opportunity for whistleblowers to submit tips. For instance, the SEC sanctioned a company for allegedly using confidentiality agreements to stifle whistleblower reports. In addition, the SEC announced its first award to a whistleblower in a retaliation case. The SEC also issued an award to an individual who reported to the SEC after the company failed to address the issue internally and awards to several individuals serving in compliance and audit functions.

In Chair White's words, the SEC's whistleblower awards have "created a powerful incentive for companies to self-report wrongdoing to the SEC—companies now know that if they do not, we may hear about the conduct from someone else." As a practical matter, the announcements provide important reminders that companies should appropriately and promptly address reports of potential wrongdoing, typically by engaging independent counsel to investigate the issues.[3]

Shifting Litigation Forums

The SEC's increasingly frequent choice to file its enforcement cases as administrative proceedings (APs), versus filing in federal court—and the ramifications of this choice for defendants—is easily one of the most significant enforcement developments over the past 18 months, and has overshadowed much of the agency's overall enforcement program. The public pushback on this trend will not be belabored here.[4] Yet, the negative ramifications for respondents forced to defend complex charges in APs cannot be understated.

An uptick in APs certainly occurred with the SEC's financial reporting and auditing cases. Of the new cases filed in 2014, the SEC initiated 59 APs involving 89 respondents, versus filing 8 cases in the federal courts against 24 defendants. The SEC's forum selections during the first half of 2015 appear to continue this trend. Moreover, the SEC has more frequently filed APs against entities and individuals than it historically has sued in federal courts.

As in years past, the majority of defendants settled the SEC's charges at the time of filing. In 2014, more than two-thirds of defendants (69 percent) settled their charges at filing. The first half of 2015 trended toward an annualized total of defendants settling upon filing that is similar to 2013 (approximately 60 percent). Although

more defendants are litigating their APs than in years past, as detailed in Holland & Hart's report, the AP remains a daunting venue for the potential litigant.

At bottom, deciding to litigate or settle claims is a highly case-and-defendant-specific decision to be carefully considered.

Severe Sanctions

The SEC's financial reporting and auditing settlements in 2014 and early 2015 involved not only pricey monetary penalties, but also costly nonmonetary sanctions such as undertakings and professional bars.

The matters that resolved during this time frame resulted in an average civil penalty of more than $550,000 in 2014, and more than $5 million in early 2015. These averages are overshadowed by five eye-popping civil penalties announced in 2014 and early 2015, in which the SEC obtained civil penalties of $190 million, $55 million, $25 million, and two of $20 million each. For those keeping count, these five outlier settlements—some recognizing the company's cooperation and remedial efforts!—yielded a grand total of $310 million in civil penalties for the SEC.

Several settlements in financial reporting and auditing cases also included undertakings. These sanctions impose significant costs on the companies and individuals involved. In one settlement, a company agreed to engage a national consulting firm to identify errors in "electronic accounting system functioning, reconcile prior inventory discrepancies, and balance the general ledger to the physical inventory counts," as well as to implement other prospective remedial measures. Such far-reaching ongoing obligations do not come cheap.

The SEC additionally continues to seek bars against individual defendants—sanctions that have significant ramifications for individuals and their families. The SEC has sought bars prohibiting individual defendants from serving as an officer or director of a public company or from practicing before the Commission. True to historical trends, O&D bars during 2014 and the first-half of 2015 ranged from five years to permanent. The SEC also sought 102(e) bars against individual accountants that ranged from a suspension to permanent.

Conclusion

Financial reporting and auditing enforcement will continue to remain an SEC focus for the foreseeable future. In light of the takeaways and trends explored in this article, entities and individuals should carefully scrutinize their own practices promptly and appropriately address potential concerns that may arise.

Notes

1. Holland & Hart closely monitors the SEC's enforcement activity in this area and recently issued its *SEC Financial Reporting and Auditing Enforcement Review* covering 2014 and the first half of 2015. It is available at *https://www.hollandhart.com/pdf/HH_BriansReport_R7.pdf*, last accessed Oct. 5, 2015.

2. *See,* "Wall Street's Top Cop Takes Harder Line," Wall Street Journal, July 13, 2015 at *http://www.wsj.com/articles/sec-escalates-financial-penalties-1436804327*.

3. *See, e.g.,* "Two Million More Reasons to Appropriately and Promptly Address Reports of Potential Wrongdoing," Brian Neil Hoffman, Holland & Hart News Update, June 11, 2015, at *https://www.hollandhart.com/address-reports-of-potential-wrongdoing*, last accessed Oct. 5, 2015.

4. *See, e.g.*, "The SEC is All Dressed Up… Now Where to Go?," Brian Neil Hoffman, Holland & Hart Client Alert, June 11, 2015, at *http://www.hollandhart.com/the-sec-is-all-dressed-up/,* last accessed Oct. 5, 2015.

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