



SEC Flexes Its Muscle on Accounting Fraud and Targets More Individuals

The Securities and Exchange Commission recently announced the settlement or filing of a number of significant accounting fraud cases. Coupled with recent statements by the SEC and the Department of Justice, it is clear that accounting fraud is a priority and that individuals are in the cross hairs.

This focus on accounting reflects a return to bread-and-butter issues that have been the agency's traditional focus, now that the financial crisis cases are largely behind it. The agency has signaled this trend for some time, through speeches by staff and commissioners.¹ The data support this shift: The number of accounting matters has increased by more than 40 percent from 2013 to 2014, and 2015 appears to be at least on par with the prior year. Indeed, the early part of September saw the SEC bring several financial reporting and accounting fraud actions over the span of a few days, demonstrating its commitment to this area. Below is a sampling of the most recent cases brought by the SEC.

- The SEC sued a former U.S. Attorney for allegedly making materially misleading statements and omissions to investors and auditors during his term as chairman of a publicly traded staffing services company.² The SEC also announced a settlement

with the company's auditors relating to their allegedly deficient audits.³ The entire matter centered on \$2.3 million (half of the company's assets and most of its cash) that went missing and then reappeared under "suspect circumstances." The SEC alleged the former U.S. Attorney not only knew where the \$2.3 million initially went and how it eventually came back to the company, but that he also was acting as the agent for a convicted felon, the alleged orchestrator of the entire scheme.

- The SEC announced that it had settled, for \$15 million, accounting fraud charges against a company that operates an internet-based consumer banking and personal finance network.⁴ The SEC alleged the company's former CFO, director of accounting, and vice president of finance had directed certain of the company's divisions to record unsupported revenue and had reduced or failed to book certain expenses, all in an attempt artificially to inflate its financial results to meet analyst earnings targets. The executives also allegedly provided misleading and generic explanations to auditors to justify the fabricated numbers. The former president of finance settled with the SEC, agreeing to pay a civil penalty, disgorge all ill-gotten gains, and accept five-year officer, director, and public-accounting bars.⁵

- The SEC reached an agreement with a sports nutrition company and four individuals, including the company's former audit committee chair, to settle a series of accounting and disclosure violations.⁶ The SEC alleged the company's disclosures understated the perquisites paid to executives by almost \$500,000. These included the use of a private jet, vehicles, meals, apparel, private golf club memberships, and medical costs for the birth of a child. The company also allegedly committed a number of other violations, including failing to disclose related party transactions, overstating revenue, and failing to implement internal accounting controls. The company agreed to pay a \$700,000 penalty, and the executives who received the unreported perks agreed to pay \$180,000 in penalties.
- The SEC filed civil charges against the former CEO and CFO of a bankrupt online video management company.⁷ The SEC alleged the executives engaged in a number of schemes to falsify the company's financial statements so that it appeared more profitable. The executives allegedly caused the company falsely to recognize revenue from sales that were never consummated and diverted money from the company to create a slush fund that was then used to create phony reductions in receivables. The SEC also alleged the executives hid a \$2 million loss of cash and, as a result of their various frauds, caused the company to file false and misleading forms with the SEC.

What This Means

These cases, as well as the recent guidance from the DOJ and the SEC staff and commissioners, provide several important lessons or reminders to public companies and their officers and directors:

The SEC is intensely focused on accounting fraud and looking to bring cases. This is clear from the guidance from senior SEC leadership, the creation of the Financial Reporting and Audit Group,⁸ the increasing number of filed matters, and the increasing number of financial reporting-related whistleblower complaints that the SEC is pursuing. And while many of the recent matters look like simple fraud cases, management

and audit committees should avoid complacency when it comes to financial reporting. The SEC is looking more closely at internal controls failures, multiple revisions that do not individually amount to a material error, accounting errors that might result from misjudgments about estimates or reserves, disclosures relating to executive compensation and related party transactions, and other areas that are beyond simple fraud.

The SEC and DOJ are focused on naming individuals, not just companies, in these cases. In all the recent accounting cases, the SEC has named individuals, including a former audit committee chair, partners, CEOs, CFOs, and accounting directors. In the most egregious cases, the government has also brought criminal charges against individuals. The recent DOJ guidance emphasizing the prosecution of individuals highlights the new risks that face both individuals and companies.⁹

Companies and boards must continue to focus on internal controls. This directive has been repeated over and over in SEC speeches, but it also comes through in the cases the agency has filed. Good controls can prevent fraud and accounting errors, or at least allow companies to detect such errors earlier. Companies and management must be diligent in not only putting appropriate and realistic internal controls in place, but also in adhering to them.

We are seeing the fruits of the SEC's whistleblower program: After being in place for more than three years, it is resulting in more whistleblower complaints, many of which relate to financial reporting and accounting and contain information the agency could not have obtained otherwise. This heightens the need for (i) strong procedures for promptly escalating and addressing whistleblower complaints internally and (ii) good controls for preventing retaliation against whistleblowers.

The risk of clawbacks against executives is also only increasing. Under Sarbanes-Oxley section 304 (and in the future under Dodd-Frank section 954),¹⁰ executives face a fatal trap any time there is accounting or financial reporting misconduct. The best way to avoid the possibility of a clawback is to limit the opportunity and incentives for wrongdoing within the company.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com/contactus/.

David Woodcock

Dallas

+1.214.969.3681

dwoodcock@jonesday.com

Harold K. Gordon

New York

+1.212.326.3740

hgordon@jonesday.com

Henry Klehm III

New York

+1.212.326.3706

hklehm@jonesday.com

Joan E. McKown

Washington

+1.202.879.3647

jemckown@jonesday.com

Peter J. Romatowski

Washington

+1.202.879.7625

pjromatowski@jonesday.com

Joseph Van Asten and Tyson Lies, associates in the Dallas Office, assisted in the preparation of this Commentary.

Endnotes

- 1 See Andrew Ceresney, Director, SEC Division of Enforcement, [Address at the American Law Institute Continuing Legal Education](#) (Sept. 19, 2013); [Oversight of the SEC's Division of Enforcement](#) before the S. Comm. on Financial Services, 114th Cong. 1 (2015) (statement of Andrew Ceresney, Director, SEC Division of Enforcement); [Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request](#) before the H. Comm. on Financial Services, 114th Cong. 1 (2015) (statement of Mary Jo White, Chair, SEC); Daniel M. Gallagher, Commissioner, SEC, [Remarks at the 21st Annual Stanford Directors' College](#) (June 23, 2015); Kara M. Stein, Commissioner, SEC, [Address at the Institute of Chartered Accountants in England and Wales](#) (Sept. 9, 2015).
- 2 Complaint, No. 1:15-CV-7077 (S.D.N.Y. Sept. 9, 2015).
- 3 See *id.*; Exchange Act Release No. 75,862, Accounting and Auditing Enforcement Release No. 3692 (Sept. 9, 2015); Exchange Act Release No. 75,859, Accounting and Auditing Enforcement Release No. 3689 (Sept. 9, 2015).
- 4 See Securities Act Release No. 9901, Exchange Act Release No. 75,849, Accounting and Auditing Enforcement Release No. 3683 (Sept. 8, 2015).
- 5 Litigation against the former CFO and director of accounting is ongoing.
- 6 See Securities Act Release No. 9903, Exchange Act Release No. 75,851 (Sept. 8, 2015); Securities Act Release No. 9904, Exchange Act Release No. 75,852 (Sept. 8, 2015); Securities Act Release No. 9905, Exchange Act Release No. 75,853, Accounting and Auditing Enforcement Release No. 3685 (Sept. 8, 2015); Securities Act Release No. 9906, Exchange Act Release No. 75,854, Accounting and Auditing Enforcement Release No. 3686 (Sept. 8, 2015); Exchange Act Release No. 75,855, Accounting and Auditing Enforcement Release No. 3687 (Sept. 8, 2015).
- 7 See Press Release, SEC, “SEC Charges Video Management Company Executives With Accounting Fraud” (Sept. 8, 2015). In a parallel action, the U.S. Attorney's Office has announced criminal charges against the executives.
- 8 See Stephanie Russell-Kraft, “SEC's ‘RoboCop’ Drags Agency Into 21st Century,” *Law360* (Aug. 21, 2015).
- 9 Jones Day Commentary, “[U.S. Department of Justice Announces Updated Guidelines on Individual Accountability for Corporate Wrongdoing](#)” (Sept. 2015).
- 10 Jones Day Commentary, “[SEC Proposes Dodd-Frank Act Clawback Rules](#)” (July 2015).

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