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Looking under the hood at SEC enforcement trends in 2017

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In a seminar at the 2017 Ray Garrett Jr. Corporate & Securities Law Institute at Northwestern University Pritzker School of Law, two former SEC enforcement officials and the in-house counsel for a major public company discussed potential dramatic shifts in SEC enforcement under the Trump Administration, including possibly higher hurdles for bringing enforcement cases against public companies, changes in whistleblower rules, and increased reliance on self-policing by companies. Despite many unknowns in the new environment, panelists had some practical advice for counsel to consider in representing clients.

The panel, "Perspectives on SEC Enforcement in 2017," was moderated by Peter K.M. Chan, a partner at Morgan Lewis and former head of the Municipal Securities and Public Pensions Unit in the SEC's Chicago office. Other panelists included Susan Goetz Markel, a managing director at AlixPartners and former chief accountant for the Enforcement Division, and Tom Szromba, principal senior counsel at The Boeing Company.

Commission currently at half strength. Peter Chan noted that currently the SEC has only two commissioners: Acting Chairman Michael Piwowar and Commissioner Kara Stein. Chan expects that Jay Clayton will soon be confirmed as SEC chairman, leaving two open commissioner spots, one Republican and one Democrat. The new chairman is expected to choose a new Director of Enforcement.

New directions under the Trump Administration. There are many possible changes in direction of the Division of Enforcement under the Trump Administration, said Chan. First, the SEC may return to a higher bar for pursuing civil penalties against public companies. Enforcement used to weigh certain factors more heavily than in recent years. One factor in particular that used to weigh significantly is whether the fraud benefited the shareholders, because the SEC does not want to punish innocent shareholders. Chan suspects there may be a return to the older framework on this point.

Another factor that might be revisited in weighing possible penalties is whether there is enough evidence to support individual liability. Previously, if Enforcement could not prove an individual liable, then they would hesitate to pursue the company. There may be a return to this approach, said Chan. The flip side of that, however, is that a return to limiting cases in this way could lead to an increase in cases involving penalties for individuals, he noted.

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Other possible changes include backing off the "broken windows" approach to enforcement implemented under former Chair Mary Jo White, in which Enforcement vigorously pursued even minor or technical violations. This policy brought tremendous cost to entities, said Chan. The Division also might turn away from "rulemaking by enforcement" or setting new standards by enforcement actions. Another potential change includes Acting Chairman Piwowar's recent signal that he may act to narrow the subpoena power of front-line staff, and would require subpoenas to be issued only with the Director of Enforcement's consent.

In addition, the Division might soften its aggressive "early resolution program." Chan explained that under this approach, the Division would make an early settlement demand and "invite" the parties to settle at specific penalties and terms. If they did not, then the Division would pursue burdensome investigation and litigation in which individuals would be potentially be subject to higher penalties. Chan said the Division might return to a fairer approach in this area.

Increase in financial reporting cases. According to Susan Markel, financial reporting cases have seen an upward trend in recent years. When she was in the Enforcement Division between 1994 and 2008, financial reporting cases used to average about 20 to 25 percent, then declined between 2008 and 2013, then ratcheted up again under Mary Schapiro and Mary Jo White. Rob Khuzami played a role in creating specialized task units, including in municipal securities, trading and markets, and the FCPA unit. Markel said there is not a specialized financial reporting unit, but the financial fraud task force does help bring cases faster.

Revenue recognition cases continue to be an enforcement mainstay, said Markel. One recent multi-billion dollar fraud case, Desarrolladora Homex S.A.B. de C.V., involved a Mexican homebuilder that claimed it had hundreds of homes already built, and SEC staff used satellite imagery to discover that those homes had in fact not been built. In another recent case, a marijuana seller touted increased revenues but concealed that the revenues came from an affiliate with which it had close contacts. A third case involved "multi-element arrangements" in which a technology company prematurely recognized revenue by improperly splitting purchase orders between professional services and software.

Markel said the SEC has also been putting more weight on deficient controls in recent years. Controls have always been an important piece of cases, but in the past the Division typically would bring a case because the numbers were wrong, and control violations would follow from that. Now, she said, cases are sometimes leading with control violations, or it might even be the only type of violation. Markel believes this trend will continue—even with the change in administration—because deficient controls are looked at as an accident waiting to happen.

Overall, the SEC continues to be very interested in earnings management cases, Markel warned. For companies that get a request, the SEC will want to see post-closing journal entries, which is where a lot of manipulation can happen. They have also requested general ledgers from companies. In addition, the SEC has been looking for a long time for a particular type of case in which the company doesn't disclose anything in terms of a contingency, and then suddenly a major settlement hits. Possibly referring to the RPM International case, Markel said the SEC brought an action in this area last year.

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Upgraded surveillance tools. According to Chan, the dip in financial reporting cases between 2008 and 2013 prompted a look at surveillance practices and a new focus on "incubating" and identifying financial fraud cases. Initially the task force consisted of six attorneys and six accountants who would triage incoming tips and either farm them out or incubate them, said Markel. In the latter approach, they would send out an initial letter with basic questions and from the response decide whether it was a live case or not. This group was also involved with data analytics.

Markel believes "big data" will be an increasing focus for the SEC. The task force has worked with the economics group to develop models, including the accounting quality model or "RoboCop," which looks at a lot of comparable data and spits out companies that may be involved in fraud. This has had some value, said Markel, but it also generates a lot of false positives.

The accounting quality model has now advanced in the "Corporate Issuer Risk Assessment" tool, or CIRA. The tool looks at data from EDGAR, comparing companies across geographies, industries, and years. Markel pointed to WorldCom as example of a fraud that might have been caught by CIRA if the tool had been in existence. About 35 accountants and attorneys across the country have access to CIRA, and this is really a focus area for the SEC, said Markel. Now, a company may receive a subpoena on the sole basis that it got picked out by CIRA review.

Chan observed that surveillance tools like RoboCop and CIRA look for outliers. He suspects that at some point, the SEC will begin asking companies whether they realize that their performance is aberrational, and whether that realization threw up any red flags that the company then acted on. Chan thinks that the SEC might start thinking along those lines not too far in the future, and companies may want to start being proactive about it.

Tom Szromba concurred that that could be a future possibility, adding that he would hope that the SEC would be frank about it. Szromba said that typically in inquiries from SEC staff, they are very "cagey" about what they're looking for. There is much less of that with the DOJ, he said.

Explaining compliance to the SEC. One factor the Division looks at in investigations is the adequacy of the company's compliance program, said Chan. Szromba emphasized that it's important to not only have an effective compliance program, but also to explain to the SEC and DOJ how it works. In Szromba's experience, Enforcement has an ideal compliance program in mind and compares a company's compliance to that ideal. For example, they want company counsel and compliance departments to design controls on a top-down basis.

Szromba said the trouble is that this ideal is based on securities companies, which have a very top-down control structure, and doesn't necessarily work for how other kinds of companies operate. In manufacturing companies like Boeing, the design of many internal controls is pushed to the business operating units, because people in those units understand the risks the best. The government thinks that this is taking the easy way out and business units will create loopholes for themselves, said Szromba. Therefore, companies with this type of structure need to explain how the compliance division monitors compliance by the business units, including how employee training is developed and rolled out; how the effectiveness of the compliance program is measured; and how compliance is monitored

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and adjusted as appropriate. Szromba said this may become even more important if the SEC and DOJ begin to rely more on self-policing by companies, as he thinks may start to happen.

Chan observed that the DOJ now has a specialized position to evaluate corporate compliance programs, currently held by Hui Chen, and asked whether it would be a good idea for the SEC to create a similar position. Szromba said that would not be a bad idea and could bring real-world compliance experience to the SEC.

Whistleblowers. According to Chan, the SEC has been very aggressive in the area of whistleblowing, providing substantial awards and pursuing any possibility of retaliation or practices that have a chilling effect on whistleblowing. Cases where companies include improper confidentiality clauses in employment agreements are sometimes called "pretaliation."

Szromba believes that whistleblowers should be required to report any violations internally before reporting to the SEC. He explained that Boeing has an effective, extensive, and independent ethics organization, including anonymous hotlines and live ethics officers, among other features, and performs a "triaging" process that narrows complaints to actual possible violations and directs them to the proper department. Sometimes the government has a view of the "ideal" whistleblower as an earnest employee who tries to raise real issues and gets knocked down. In reality, said Szromba, a whistleblower may raise ten issues of which five boil down to "My boss is mean to me and the people I work with don't like me." Most of the remaining issues may not be meritorious, because the individual doesn't see the big picture, but there may be one or two issues that merit investigation.

Without that internal triaging process, explained Szromba, the government lacks context to know what is actually significant. Therefore, it would be best to require whistleblowers to first report internally before reporting to the SEC. He thinks the administration may be open to a rule change on this. Chan agreed that the administration may be amenable, and also Congress may include something in this area in the Financial CHOICE Act, which was recently re-introduced. Chan added that he wonders whether the requirement sometimes gets left out for the whistleblower having a "reasonable basis" to believe a violation has occurred.

FCPA enforcement. Chan noted that Attorney General Jeff Sessions has indicated that the administration will continue to enforce cases under the Foreign Corrupt Practices Act (FCPA) but has said he is aware that FCPA requirements may have a negative competitive effect for U.S. businesses. Markel said she believes the FCPA will likely continue to be a hot issue. Greater cooperation with foreign counterparties is yielding significant results, and the monetary penalties get split between the prosecuting countries. In particular, any case that can be linked to terrorism is likely to be pursued. However, she thinks one area that could be ripe for change is statutes of limitation. In FCPA cases, often the misconduct occurred years before the case is brought.

According to Chan, one wrinkle for FCPA enforcement is how well international cooperation will fare in the new administration. How do you conduct international investigations when at a very high level, certain countries don't like each other?

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Advice for counsel. Although there are many open questions about the SEC's direction under the new administration and Congress, companies can nevertheless take specific actions to stay compliant and avoid the SEC's radar. Counsel may want to consider the following steps:

- Become thoroughly familiar with the company's compliance program and be prepared to explain it to the SEC and DOJ;
- Examine internal controls for any possible areas of deficiency;
- Scrutinize employment agreements for improper confidentiality clauses or other restrictions that may chill whistleblowing;
- In the area of revenue recognition and earnings management, be cautious not to cross the line into manipulative territory, including failing to disclose known contingencies;
- Consider pursuing data analytics to learn whether the company is an outlier among its peers in significant financial metrics.

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