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SEC ENFORCEMENT

The Securities and Exchange Commission recently announced the creation of a new Financial Reporting and Audit Task Force in the Division of Enforcement along with a Center for Risk and Quantitative Analysis. The new groups are being formed as the agency refocuses its enforcement program in the post-market crisis era. The new task forces are likely to draw on the Commission's history of bringing significant financial fraud actions and couple that approach with one tied to risk and data analysis.

The SEC's New Financial Fraud Task Force

BY THOMAS O. GORMAN

On July 2, 2013, the Securities and Exchange Commission announced the formation of a Financial Reporting and Audit Task Force (''Financial Task Force''). Its purpose is to detect ''fraudulent or improper financial reporting'' and ''enhance the [Enforcement] Division's ongoing enforcement efforts related to accounting and disclosure fraud.'' A similar group is being formed to focus on microcap fraud, according to the announcement.

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The Center for Risk and Quantitative Analysis (''Analytics Group'') is also being created as part of the new focus on financial reporting. The new Analytics Group will work in close coordination with the Division of Economic and Risk Analysis and ''serve as both an analytical hub and a source of information about characteristics and patterns indicative of possible fraud or other illegality.''

The formation of a new Financial Task Force, coupled with the creation of the Analytics Group, suggests a new focus for an enforcement program that has centered on insider trading, offering fraud, Ponzi scheme and market crisis cases since the 2009 reorganization of the Division. *See also SEC Enforcement: Is the Swagger Back?*, www.secactions.com (Oct. 13, 2013) (discussing new SEC chair's enforcement goals). It also suggests that the new task force will adopt at least some of the risk analysis and metric oriented ap-

proach utilized by the Division of Enforcement since its reorganization.

If the new Financial Task Force has an impact similar to that of the 2009 reorganization which spawned record numbers of cases, it is reasonable to expect that the Commission will be opening a significant number of new investigations and bringing more actions centered on financial statement fraud and related reporting issues. Indeed, there are indications that those efforts may well have been underway prior to the announcement. *See, e.g., SEC v. Senior*, Civil Action no. 3:12cv60 (N.D. Ind. filed Jan, 30, 2012) (accounting fraud action against former senior officers and outside auditors of British subsidiary of issuer).

This is not the first time that the SEC has focused on financial statement fraud and reporting issues. Following a 1998 address by then Chairman Arthur Levitt titled ''The Numbers Game'' which decried the manipulation of financial statements to meet Wall Street earnings expectations, the agency brought a series of high profile financial statement fraud actions. The new task force can be expected to draw from and build on that history.

The critical question for issuers, directors, executives, their auditors and business partners is the approach the new task force will take. Knowing that focus should permit an examination of current practices now to avoid liability tomorrow. Stated differently, understanding how the SEC Enforcement plans to proceed is good business today and tomorrow.

To analyze the likely approach of the new task force four key points will be considered:

1. The ''Numbers Game'' speech – the genesis of an earlier financial statement fraud effort;
2. Financial statement fraud cases brought in the wake of the ''Numbers Game'' speech;
3. Market crisis financial actions; and
4. The Enforcement Division's use of risk analysis and big data.

Analyzing these points should provide a guide to the future approach of the new task force which can be used now by issuers, their executives and auditors to conduct an analysis of current practices to avoid liability tomorrow.

I. The 'Numbers Game Speech'

In 1998 then SEC Chairman Arthur Levitt delivered a speech titled the ''Numbers Game.'' It launched a campaign against financial statement fraud which will serve as the roots of the current efforts. Following Chairman Levitt's speech the Commission brought increasing numbers of financial statement fraud actions. Those efforts resulted, in part, in the passage of the Sarbanes-Oxley Act of 2002 (''SOX'') which instituted certain reforms. Those included the creation of the Public Company Accounting Oversight Board (''PCAOB'') to oversee the auditing process for public companies and the requirement that the chief executive officer and chief financial officer of issuers execute certain certifications. *See, e.g.,* Thomas O. Gorman & Heather J. Stewart, *Is There A New Sheriff In Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley of 2002*, 56 Adm. L. Rev. 135 (2004) (discussing key provisions of Sarbanes-Oxley Act). Following the passage of SOX, the Commission continued to bring a significant number of financial statement fraud actions, at least through the early years of the market crisis. *See, e.g.,* Cornerstone Research, Securities Class Action Filings, 2012 year in Review, available at http://tinyurl.com/lppz3tf (''Cornerstone Report'').

In his remarks the Chairman detailed his concern that the numbers in financial statements being furnished to the investing public and the markets by issuers did not reflect the substance of the enterprises' business. The Chairman went on to state that he had:

> become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; Integrity may be losing out to illusion.

Chairman Levitt identified key practices being used to alter financial results through what he called ''accounting hocus-pocus.'' Those included:

- ***Big bath charges***: The use of restructuring charges to clean up the balance sheet;
- ***Cookie jar reserves***: The use of unrealistic assumptions to create pools of cash to smooth earnings; and
- ***Revenue recognition***: Boosting earnings through inappropriate manipulation of the recognition of revenue.

The driver of financial statement fraud, according to Chairman Levitt, was the ''pressure to make the numbers'' or meet street expectations.

In the wake of Chairman Levitt's speech the Commission brought a series of financial statement fraud actions. Two years later Richard Walker, then the director of the Enforcement Division, summarized those efforts to that point, noting that for fiscal 1999 the Commission brought about 90 financial statements and reporting actions, a 15 percent increase over 1998. Those cases ''cover a broad spectrum of conduct – from multi-faceted pervasive frauds to more subtle instances of earnings management to situations involving violations of auditor independence rules,'' he noted. Richard H. Walker, Director, Division of Enforcement, addressing 27th Annual National AICPA Conference on Current SEC Developments (Dec. 7, 1999).

Following the passage of SOX the Commission continued to bring a significant number of financial statement fraud cases. Beginning in 2007, as the worst market crisis since the great depression of the 1930s was unfolding, the Commission focused a large part of its investigative resources on ascertaining its causes. *See, e.g.*, Testimony, SEC Commissioner Elisse B. Walter before the U.S. House of Representatives Committee on Financial Services (March 20, 2009). Those efforts resulted in a significant number of market crisis actions being brought. *SEC Enforcement Actions, Addressing Misconduct that Lead to or Arose From the Financial Crisis*, available at http://www.sec.gov/spotlight/enf-actions-fc.shtml.

By the end of the market crisis the number of financial statement fraud actions being brought by the Commission had dropped significantly. *See* Cornerstone Report. At the same time the Division of Enforcement un-

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dertook its most significant reorganization in history. That reorganization included the creation of specialty groups. SEC Press Release, SEC News, *New Specialized Unit Chiefs and Head of New Office of Market Intelligence* (January 13, 2010), available at http://www.sec.gov/news/press/2010/2010-5.htm. None of those groups focused on financial statement fraud. Yet the pressure that Chairman Levitt identified as the driving force causing financial statement fraud remained unabated.

II. Cases Following the Speech

A. Revenue Enhancement.

Following the Numbers Game speech, and continuing through the market crisis to the time of the reorganization of the Enforcement Division, the Commission brought a series of financial statement fraud cases. Driven by pressure to meet street expectations, executives used a variety of techniques that ranged from the simple falsification of revenue, to sham transactions to managing income using a variety of improper accounting devices. One group of actions used various devices to improperly enhance revenue.

1. Falsification of revenue In some instances the pressure to make the numbers resulted in the fabrication of income. Examples of these cases include:

■ *SEC v. HealthSouth Corporation*, Civil Action CV-03-J-0615 (N.D. Ala. filed March 19, 2003). The Commission's complaint alleged that the company systematically overstated its earnings by at least $1.4 billion to meet street expectations beginning as early as 1999. Each quarter the company accounting staff created entries to ensure that the firm met expectations for the period. In many instances these entries took the form of reducing a contra revenue account and/or decreasing expenses and correspondingly increasing assets or decreasing liabilities. The Commission's complaint alleged violations of 1933 Securities Act Section 17(a) and 1934 Securities Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and13(b)(20(B); *See* Lit. Rel. No. 1804 (March 20, 2003).

■ *SEC v. Koninkijke Ahold N.V.*, Civil Action No. 04-1742 (D.D.C. filed Oct. 13, 2004) is an action against the company and three of its former senior executives centered on an accounting fraud that took place between 2000 and 2002. While the complaint alleged a variety of fraudulent practices, one of the key elements of the scheme was the inflation of revenue. An important source of operating income was vendor payments known as promotional allowances. The company materially inflated those allowances, according to the Commission's complaint. *See also* Lit. Rel. No. 18929 (Oct. 13, 2004).

■ Other significant cases include: *SEC v. The Penn Traffic Company*, Civil Action No. 08-CIV-01035 (N.D.N.Y. filed Sept. 30, 2008) (alleging a financial fraud which in part involved creating fraudulent entries and/or adjustments to the books of a wholly owned subsidiary to inflate income in 2003); *SEC v. VeriFone Holdings, Inc.*, CV 09-4046 (N.D. Cal. Filed Sept. 1, 2009) (complaint alleging that the company improperly boosted its gross margins and income by 129 percent in the first three quarters of 2007 by doing manual adjustments at quarter end to ensure that earnings expectations were met); *SEC v. Farkas*, Civil Action No. 1:10 CV 667 (E.D. Va. filed June 16, 2010); *U.S. v. Farkas*, 10-cr-00206 (E.D. Fla. filed June 16, 2010) (civil and criminal actions against the former chairman of collapsed mortgage lender Taylor, Bean and Whitaker who engaged in a massive kiting scheme based on fictitious mortgaged backed loans in an effort to sustain the mortgage loans being originated); *SEC v. NurtraCea*, Civil Action No. 11-0092 (D. Az. filed Jan. 13, 2011)(Lit. Rel. No. 21819 Jan. 20, 2011) (in a settled action the SEC complaint alleged that the Arizona company and three former executives engaged in an accounting fraud scheme in which the company recorded false sales, thereby over-stating product sales and revenue by as much as 35 percent in the second quarter of 2007).

2. Sham transactions In some instances issuers structured deals to create the false appearance of a legitimate business transaction that generated revenue. Those transactions frequently recycled company cash or goods through a third party and back to create the appearance of an arm-length transaction. These ''round trip'' transactions lacked economic substance.

■ *SEC v. Dynergy, Inc.*, Case No. H-0203623 (S.D. Tex. filed Sept. 25, 2002); *In the Matter of Dynergy, Inc.*, Adm. Proc. File No. 3-10897 (Sept. 25, 2002) is an action against the company which alleged in part that its statement of cash flows was falsified by recording cash flow from a structured financing transaction that was nothing more than a loan. In addition, the company recorded the impact of two huge round trip energy trades that were nothing more than pre-arranged sham transactions. The company settled the action which alleged violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B).

■ *SEC v. Time Warner Inc.*, Civil Action No. 1:05 cv 00578 (D.D.C. filed March 21, 2005) is an action alleging in part that over a two year period beginning in 2000 the company fraudulently inflated its revenue from online advertising by utilizing fraudulent round-trip transactions. Central to the scheme was the fact that the company essentially funded the advertising by giving counterparties the means to pay for what they otherwise would not have purchased. To conceal the true nature of the transactions, the company documented the round trip arrangements as if they were two separate, arms-length transactions. The complaint alleged violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). The company settled the case at filing.

■ *SEC v. Delphi Corporation*, Civil Action No. 2:06-cv-14891 (E.D. Mich. filed Oct. 30, 2006) is an action against the company and 13 former officers based on a scheme which took place from 2000 to 2004. The complaint alleged that the company entered into two improper inventory schemes to sell and then repurchase $270 million of metals, automotive batteries and similar items at year end, concealed a $237 million warranty claim, booked what it claimed as a $20 million rebate that was really part of a round trip transaction and concealed about $325 million in factoring, or sales of accounts receivable to boost non-generally accepted accounting principles pro forma measures of company performance. *See* Lit. Rel. No. 19891 Oct. 30, 2006.

■ *SEC v. Goldberg,* Civil Action No. 09 Civ. 6939 (S.D.N.Y. filed Aug. 6, 2009) is an action against the former chairman and CEO and the former vice chairman of the company for managing the financial results of American International Group Inc. from 2002 through 2005. During that period the complaint alleges that the defendants: (a) used sham reinsurance transactions to make it appear AIG had legitimately increased its general loss reserves; (b) entered into purported deals with an offshore entity to conceal multi-million dollar underwriting losses; (c) engaged in round trip transactions to improperly report income; and (d) improperly realized capital gains on the sale of tax exemption bonds owned by a subsidiary to a trust AIG controlled. The complaint alleged violations of Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). *See* Lit Rel. No. 21270 (Aug. 6, 2009); *see also SEC v. General Re Corporation,* Civil Action No. 10 Civ. 458 (S.D.N.Y. filed Jan 20, 2010) (charged for its involvement in two sham transactions with AIG). *See* Lit. Rel. No. 3108 (Jan. 20, 2010).

■ Other significant cases: *SEC v. Foster,* Civil Action No. H-03-2044 (filed June 12, 2003) (action against three former employees of Dynegy Inc. charging them with fraud). *See also SEC v. Prudential Financial,* Inc., Civil Action No. 08 Civ. 3916 (D. N.J. Aug. 6, 2008) (firm entered into round trip sham reinsurance agreements with General Re to build up and draw down off-balance sheet sums; firm settled books and records charges); *In the Matter of CMS Energy Corp.,* Adm. Proc. File No. 3-11436 (March 19, 2009) (round trip trades used to artificially increase revenue).

3. Channel stuffing Another technique used by a number of issuers in an effort to increase reported revenue is channel stuffing. In the typical scheme the company ships product that may not have been ordered or is not needed by customers prematurely in an effort to record additional revenue. Examples of this type of activity include:

■ *SEC v. Bristol-Myers Squibb Company,* Civil Action No. 04-3680 (D.N.J. filed Aug. 4, 2004) is an action in which the Commission alleged that beginning in 2000, and continuing through the end of 2001, the company systematically overstated revenue by engaging in channel stuffing and improperly recognizing about $1.5 billion in revenue from consignment-like sales associated with the channel-stuffing. The company also used cookie jar reserves to further inflate income when it fell short of street expectations. The complaint alleged violations of the antifraud, books and records and internal control provisions of the federal securities laws. The company settled with the Commission at the time of filing. *See* Lit. Rel. No. 18820 (Aug. 4, 2004).

■ *SEC v. Take-Two Interactive Software, Inc.,* Civil Action No. 1:05-CIV 5443 (S.D.N.Y. filed June 9, 2005). The Commission's complaint alleged that the software maker and its senior executives engaged in a fraudulent accounting scheme which inflated revenue for the fiscal years 2000 to 2001. At or near the end of a quarter the company shipped hundreds of thousands of video games to distributors who had no obligation to pay for the product. The shipments, which were what the complaint calls ''parking transactions,'' were then recorded as sales. This practice, along with others, permitted the company to improperly recognize about $60 million in revenue during 2000 and 2001. When the company announced a restatement of earnings its stock price declined by 31 percent. The complaint alleges violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). The company, and the officers named in the complaint, settled with the Commission on filing. *See* Lit. Rel. No. 2259 (June 9, 2005).

■ *SEC v. Vitesse Semiconductor Corporation,* Case No. 10 Civ. 9239 (S.D.N.Y. filed Dec. 10, 2010) is an action against the company and four of its executives centered on an accounting fraud and options backdating claims. The complaint, in part, alleges that from September 2001 through April 2006 the defendants engaged in a channel stuffing scheme to inflate revenue. Specifically, the defendants caused the company to immediately recognize revenue for product shipped to a large distributor that had the unconditional right to return it. As a result, the revenue for the company was materially inflated over fourteen quarters from September 2001 through early 2006. The Commission's complaint alleges violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 14(a). The defendants settled the action simultaneously with filing. *See* Lit. Rel. No. 21769 (Dec. 10, 2010).

■ Other significant cases: *SEC v. Lucent Technologies Inc.,* Civil Action No. 04-2315 (D. N.J. filed May 17, 2004) ($1.1 billion accounting fraud action against the company and ten officers based in part on the recognition of revenue from conditional sales; the company and three officers settled on filing); *see* Lit. Rel. No. 18715 (May 17, 2004). *SEC v. Silva,* Case No. 09-5395 (N.D. Cal. filed Nov. 17, 2009) (action against the former Vice President at Tvia, Inc., named in complaint which alleged in part that the company prematurely recognized revenue because the sales were subject to side agreements in which the customers were promised extended payment terms); *SEC v. Bjorkstrom,* Case No. 09-5394 (N.D. Cal. filed Nov. 17, 2009) (action against the former CFO of Tvia, Inc.).

4. Premature recognition In a number of cases the issuer prematurely recognized revenue in violation of GAAP in a misguided effort to increase earnings and make street expectations.

■ *SEC v. System Software Associates, Inc.,* Civ. No. 00C 4240 (N.D. Ill. filed July 13, 2000) is an action against the software maker and its former CEO and Chairman and former CFO. The complaint alleged that for the fiscal years 1994 through 1996 the company prematurely recognized revenue on its developmental stage UNIX-language software product in violation of GAAP. The Commission's complaint alleged violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). *See* Lit. Rel. No. 1667 (July 14, 2000).

■ *In the Matter of i2 Technologies, Inc.,* Adm. Proc. File No. 3-11518 (June 9, 2004) is a proceeding in which the Order alleged that the company misstated about $1 billion of software license revenue, including about $125 million which should never have been recognized. The events took place over five years which ended in 2002. During that period the company, in part, immediately recognized revenue for its software licenses de-

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spite the fact that some required lengthy implementation and customization efforts to meet customer needs. This practice was not in accord with GAAP. The action, settled at the time of filings, alleged violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B).

■ *SEC v. Computer Associates International, Inc.,* Case No. 04 Civ. 4088 (E.D.N.Y. filed Sept. 22, 2004) is an action in which the company recognized over $3.3 billion in revenue from 363 software contracts that had yet to be executed. The scheme took place from January 1, 1998 through September 30, 2000 and was implemented in part by ''holding open'' the end of the quarter so that revenue from later executed agreements could be counted in the held open quarter. This practice improperly inflated quarterly revenue in fiscal year 2000 for each quarter by 25 percent, 53 percent, 46 percent and 22 percent beginning with the first. When the practice was halted in the first quarter of fiscal 2001 the company missed its earnings estimate. The share price fell 43 percent. The Commission's complaint alleges violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B). The company settled simultaneously with the SEC and the U.S. Attorney's Office. *See* Lit. Rel. No. 18891 (Sept. 22, 2004). Later the former CEO of the company, Sanjay Kumar, was sentenced to serve 12 years in prison. *See,* Lit. Rel. No. 19898 (Nov. 3, 2006); *see also SEC v. Kumar,* 04-Civ. 4104 (E.D.N.Y. filed Sept. 22, 2004); *SEC v. Woghin,* Case No. 04-cv-4087 (E.D.N.Y. filed Sept. 22, 2004) (actions against Computer Associates executives).

■ *In the Matter of Raytheon Company,* Adm. Proc. File No. 3-12345 (June 28, 2006) is a proceeding against the company and certain officers which centered on improper accounting practices. Specifically, the Order alleged that from 1997 through 2001 Raytheon improperly recognized revenue on the sale of unfinished aircraft through a ''bill and hold'' arrangement that failed to comply with GAAP. This resulted in a material overstatement of sales. The company also engaged in improper disclosures during the same period. The Order alleges violations of Securities Act Sections 17(a)(2) and (2) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B). The case was settled at the time of filing.

■ Other significant cases include: *SEC v. Saylor,* Civil Action No. 1:00 CV 02995 (D.D.C. filed Dec. 14, 2000) (settled action against the three senior officers of MicroStrategy, Inc., alleging violations of Securities Act Section 17(a) and Exchange Act Section 10(b) in connection with the premature recognition of revenue from the sale of software, contrary to GAAP, from the time of the IPO for the company in June 1998 through early 2000); *SEC v. Peregrine Systems, Inc.,* Civil Action No 03 CV 1276 (S.D. Cal. filed July 23, 2003) (alleging an accounting fraud from mid-1999 through the end of 2001 centered on premature revenue recognition which improperly inflated revenue resulting in a restatement that reduced previously reported revenue of $1.34 billion by $509 million, at least $259 million of which was reversed because the underlying transactions lacked substance). *SEC v. Redeopp,* Case No. 3:10-cv-05557 (W.D. Wash. filed Aug. 9, 2010) (actions against, respectively, the company and an officer, based on a scheme in 2007 involving the recognition of revenue prematurely from what were called ''drop shipments'' where the product was not actually purchased); *see also, In the Matter of Dolan + Company, CPAs,* Adm. Proc. File No. 3-13997 (Aug. 9, 2010) (proceeding against outside auditors of Redeopp); *SEC v. TheStreet, Inc.,* Civil Action No. 12-CV-9187 (S.D.N.Y. filed Dec. 18, 2012) (action against media company centered on premature recognition of revenue where work not completed); *SEC v. Ashman,* Civil Action No. 12-CV-9189 (S.D.N.Y. filed Dec. 18, 2012); *SEC v. Alwine,* Civil Action No. 12-CV-9191 (S.D.N.Y. filed Dec. 19, 2012) (actions against the officers of TheStreet).

B. Distorting Trends and Balance Sheet Items

In some instances issuers have distorted revenue trends by improperly combining income from one source with that from another, manipulating reserves or other techniques.

1. Masking revenue Trends were frequently distorted to mask the fact that the primary business of the company was not meeting expectations in terms of revenue.

■ *SEC v. Quest Communications International Inc.,* Civil Action No. 04-Z-2179 (D. Co. filed Oct. 21, 2004) is an action against the telecommunication company. The complaint alleged that Quest fraudulently recognized over $3.8 billion in revenue while excluding about $231 million in expenses to meet street expectations. When the revenue for the company from telecommunications services began to decline, it started selling indefeasible rights of use which are an irrevocable right to use a specific fiber strand or specific amount of fiber capacity for a period. Later the company sold capital equipment. While the investment community discounts such one-time transactions Quest continually used these types of non-recurring transactions to bolster revenue. The company also engaged in a number of other fraudulent practices. The complaint alleged violations of Securities Act Sections 5(a), 5(c) and 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 14(a). The company settled the case at the time of filing. *See* Lit. Rel. No. 2127 (Oct. 21, 2004); *see also SEC v. Nacchio,* Civil Action No. 05-MSK-480 (D. Co. filed March 15, 2005) (action against former Chairman and others of company).

■ *SEC v. Tenent Healthcare Corporation,* Civil Action No. CV 07-2144 (C.D. Cal. filed April 2, 2007) is a financial statement fraud action in which the company concealed the fact that a key source of income came not from the primary business of the company but by exploiting a loophole in a statute. Specifically, from 1999 through 2002 the revenue of the company was largely the result of exploiting a loophole in the Medicare reimbursement system, a fact not disclosed to the shareholders. *See* Lit. Rel. No. 2591 (April 2, 2007).

■ *SEC v. Dell, Inc.,* Civil Action No. 10-cv-01245 (D.D.C. filed July 22, 2010) in an action against the company, it found and other officers alleging that they concealed a key source of the company's revenues. Specifically, the complaint alleged that from 2003 through 2007 the company repeatedly touted its superior products and management as the source of its consistently increasing revenues. In fact, a significant and increasing portion of those revenues were from payments made by chip maker Intel Corp. so that Dell would not buy chips from a rival manufacturer. When the pay-

ments began to decrease in 2007, so did Dell's revenues. The complaint alleges violations of Securities Act Sections 17(a)(2) and 17(a)(3). The action settled at the time of filing. *See also SEC v. Davis,* Case No. 1:10-cv-01464 (D.D.C. filed Aug. 2, 2010); *SEC v. Inhofe,* Case No. 1:10-cv-01465 (D.D.C. filed Aug. 27, 2010) (actions against Dell officers).

■ *See also SEC v. Biovail Corporation,* Civil Action No. 08 CV 02979 (S.D.N.Y. filed March 24, 2009) (issuer falsely blamed failure to meet revenue goals on a truck accident while improperly moving certain expenses off-balance sheet, creating a fictitious bill and hold transaction to increase revenue and misstating foreign exchange losses).

2. Reserves In a number of cases, issuers distorted trends by managing their earnings through the improper use of reserves. In some instances the company failed to release cash from the reserve as required by GAAP, holding it until needed to smooth an earnings trend. In other instances the company failed to add to the reserves as required by GAAP.

■ *Cendant Corporation*. This company was at the center of what was at the time one of the largest financial frauds. The company was the product of a merger between CUC International Inc. and HFS Incorporated in 1997. The financial fraud began prior to the merger and traces to the 1980s. It continued until Cendant discovered and disclosed it in April, 1998. At the core of the allegations was the manipulation of reserves. For example, in the complaint against Walter Forbes and E. Kirk Shelton, two former senior officers of CUC, the Commission alleged that the two men implemented a program of mergers and acquisition in an effort to generate inflated merger and purchase reserves. The transaction with HFS which created Cendant was sought out for this reason. *SEC v. Forbes,* Civil Action No. 01-987 (D.N.J. filed Feb. 28, 2001); *see also* Lit. Rel. Nos. 16910 (Feb. 28, 2001) and 21356 (Dec. 30, 2009). Similarly, the complaint against Cosmo Corigliano, Anne Pember, Casper Sabatino and Kevin Kearney, also officers of CUC, alleged in part that the reserves of the company were manipulated to fraudulently inflate revenue. *SEC v. Corigliano,* Civil Action No. 00-2873 (D.N.J. filed June 14, 2000); *see also* Lit. Rel. No. 16587 (June 14, 2000).

■ *SEC v. Integrated Electrical Services, Inc.,* Case No. 4:07-CV-2779 (S.D. Tex. filed Aug. 29, 2007) is an action against the company and its senior officers alleging that in 2003 and 2004 the company failed to disclose that about $3 million in unsigned change orders from two construction contacts were in dispute at one of its subsidiaries. To the contrary, the subsidiary president represented that the change orders were fully collectible. The parent failed to reserve for the change orders. Subsequently, about 70 percent of the change orders were written off. In addition, the company lowered its allowance for doubtful accounts by about $1.8 million without informing investors. The Commission's complaint alleged violations of Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B). *See* Lit. Rel. No. 2673 (Aug. 30, 2007); *see also In the Matter of David A. Miller, CPA,* Adm. Proc. File No. 3-12714 (Aug. 29, 2013) (proceeding against the former Chief Accounting Officer of the company).

■ *SEC v. Dunn,* Civil Action No. 07-CV 2058 (S.D.N.Y. filed March 12, 2007) is an action initially brought against three senior officers of Nortel Networks Corporation. The amended complaint, filed on September 12, 2007, added four additional officers as defendants. That complaint alleged that in the second half of 2002 and early 2003 various business units of the company had millions of dollars in excess reserves. Those reserves were held and not immediately released as required by GAAP. Subsequently, in early January 2003, and during the year end closing, $44 million in additional excess reserves were established to lower Nortel's consolidated earnings and bring it in line with internal management expectations. Then, in the first and second quarters of 2003, about $500 million of excess reserves were released to inflate earnings, changing a loss into a profit for the first quarter and largely eliminating a loss in the second. The release also permitted the payment of bonuses. The complaint alleges violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). *See* Lit. Rel. Nos. 20036 (March 12, 2007) and 2676 (Sept. 12, 2007).

■ *See also, SEC v. Rand,* Civil Action No. 1:09-CV-1780 (N.D. Ga. filed July 1, 2009) (action against the former chief operating officer of Beazer Homes, USA, Inc. alleging that during some periods net income was decreased by improperly recording reserves between 2000 and 2005 to meet expectations and later reversing those entries to pay bonuses and mask declining financial performance. *See* Lit. Rel. No. 2114 (July 1, 2009).

3. Expenses In some of the largest financial statement fraud cases the issuer's earnings were distorted by minimizing the expenses which offset revenue.

■ *SEC v. WorldCom, Inc.,* Civil Action 02 CV 4963 (S.D.N.Y. filed June 27, 2002) is one of a series of actions arising out of the $3.8 billion financial fraud at the global communications provider. In 2001 and the first quarter of 2002, the company falsely portrayed itself as being profitable by capitalizing and thus deferring about $3.8 billion in costs. Those costs were transferred to capital accounts in violation of GAAP. The complaint alleged violations of Exchange Act Sections 10(b) and 13(a). *See* Lit. Rel. No. 1585 (June 27, 2002).

■ *SEC v. Adelphia Communications Corporation,* Case No. 02 Civ. 5776 (S.D.N.Y. filed July 24, 2002) is an action against the cable company and six of its senior executives which the Commission called ''one of the most extensive financial frauds ever to take place at a public company.'' One key aspect of the fraud was the exclusion from mid-1999 through the end of 2001 of over $2.3 billion in bank debt by shifting the liability onto the books of Adelphia's off-balance sheet, unconsolidated affiliates. This resulted in a series of misrepresentations about those liabilities including the creation of sham transactions backed by fictitious documents and misleading notes in the financial statements claiming that all the bank debt was included in the financial statements. The principals of the company also used a series of loans and other devices to essentially loot the company. *See* Lit. Rel. No. 1599 (July 24, 2002).

■ *See also In the Matter of America Online Inc.,* Adm. Proc. File No. 3-10203 (May 15, 2000) (alleging violations of the books and records provisions by capi-

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talizing most of the costs of acquiring new subscribers in violation of GAAP).

C. Balance Sheet Items

While most financial fraud actions focus on improperly boosting earnings, in some instances issuers have sought to enhance select balance sheet entries through improper techniques. Examples of these cases include:

■ *Overstate assets: SEC v. Parmalat Finanziaria S.p.A.*, Case No. 03 CV 10266 (S.D.N.Y. filed Dec. 30, 2003) is an action against an Italian seller of dairy products. The complaint alleged that from August through November of 2003 the company sold debt securities in the United States while engaging in what the complaint called ''one of the largest and most brazen corporate financial frauds in history.'' The assets of the company in its audited financial statements were overstated by at least €3.95 billion. In addition, during 2003 the company also told U.S. investors that it had used its ''excess cash balances'' which actually did not exist to repurchase corporate debt securities worth about €2.9 billion. In fact there had been no repurchase and the securities remained outstanding. Earlier the company had sold about $1.5 billion in bonds and notes to U.S. investors. The complaint alleged violations of Securities Act Section 17(a). *See* Lit. Rel. No. 18527 (Dec. 30, 2003).

■ *Overstated mineral reserves:In the Matter of Royal Dutch Petroleum Company*, Adm. Proc. File No. 3-11595 (Aug. 24, 2004) is a settled proceeding against the company and its affiliates alleging that the issuer's proved oil reserves were overstated. Specifically, in 2004 the company recategorized 4.47 billion barrels of oil equivalent, or about 23 percent of the proved reserves reported at the end of 2002, because they did not conform to the applicable rule. This action reduced the standardized measure of future cash flows reported by the company by about $6.6 billion. It also significantly reduced the reserves replacement ratio of the company from a previously reported 100 percent to 80 percent. That ratio is a standardized measure of future cash flows. The company had delayed the recategorization to avoid this impact, according to the Order. Previously, Shell had disregarded warnings about these errors. In early 2004 the boards of directors requested and received the resignations of the chairman of two companies in the group. The CFO of the group also stepped aside. Following the recategorization, Shell under took substantial remedial efforts and addressed its internal control deficiencies. The Order alleged violations of Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). The action was resolved at the time of filing. The company also resolved market abuse charges in the U.K.

■ *Reduce liabilities: In the Matter of PNC Financial Services Group, Inc.*, Adm. Proc. File No. 3-10838 (July 18, 2002) is a settled action against the financial services company. The Order alleged that the company improperly removed about $762 million in loan and venture capital assets from its books through the use of a special purpose entity in a transaction with American International Group. The purpose was to eliminate the risk of the loans while having the opportunity to benefit from their possible appreciation. The Order alleged violations of Securities Act Section 17(a)(2). *See also SEC v. American International Group, Inc.*, No. 1:04CV02070 (D.D.C. Dec. 7, 2004) (companion action against AIG).

D. Related Party Transactions/looting

Perhaps the ultimate financial statement fraud case is one centered on what is essentially the looting of the corporation by certain executives for their personal benefit. While these cases can be viewed as financial fraud actions because the financial statements of the company are distorted, they differ significantly from those where the focus is to meet street expectations. Examples of these cases include:

■ *SEC v. Black*, Civil Action No. 04C7377 (N.D. Ill. filed March 16, 2007) is an action against Conrad Black, the former chairman of Hollinger International, David Radler, the former deputy chairman of the company and Hollinger Inc., a Canadian holding company. The complaint alleged that over a period of four years beginning in 1999 the defendants engaged in a scheme to fraudulently divert cash and assets from Hollinger International and conceal their self-dealing schemes from the public. Specifically, the complaint alleged that through a series of related party transactions the individual defendants diverted to themselves and others about $85 million from the sale by the company newspaper publications. In addition, the two men are alleged to have orchestrated the sale of newspaper properties at below market prices to an entity controlled by them. The Commission's complaint alleged violations of Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 13(b)(5) and 14(a). A parallel criminal case was also filed. *See* Lit. Rel. No. 2136 (Nov. 15, 2007).

■ Other significant cases include: *SEC v. Kozlowski*, Civil Action No. 02 CV 7312 (S.D.N.Y. filed Sept. 12, 2002) (action against three senior executives of Tyco International Ltd. alleging that from 1997 through 2002 they looted the company through a variety of techniques for their personal benefit. *See* Lit. Rel. No. 17722 Sept. 12, 2002); *SEC v. Brooks*, Civil Action No. 07-61526 (S.D. Fla. filed Oct. 25, 2007); *SEC v. Schlegel*, Civil Action No. 06-61251 (S.D. Fla. filed Aug. 17, 2006); *SEC v. DBH industries, Inc.*, Civil Action No. 0:11-cv-60431 (S.D. Fla. filed Feb. 28, 2011) (series of actions against senior officers of body armor manufacturer for looting the company; parallel criminal charges were also brought); *SEC v. Rica Foods, Inc.*, Case No. 08-23546 (S.D. Fla. filed Dec. 29, 2008) (action against the company and its former CEO based on related party transactions in which the former CEO utilized company assets to secure personal loans).

E. Using Multiple Improper Techniques

While some issuers utilized primarily one improper approach to ensure that the firm met its numbers, others utilized a variety of techniques. In those instances issuers frequently enhanced revenue, manipulated expenses and managed trends. Select examples of these cases include:

■ *SEC v. Buntrock*, Civil Action No. 02C 2180 (N.D. Ill. filed March 26, 2002) is an action against the founder and other former senior officers of Waste Management, Inc. The complaint alleges a massive accounting fraud beginning in 1992 and continuing through 1997 which involved, in part, improperly eliminating and deferring current period expenses to inflate earnings. A variety of other techniques were used including: avoiding depreciation expense on certain assets; assigning arbitrary salvage values to others; failing to record expenses for decreases in the value of landfills as

they were filled in with waste; and improperly capitalizing a variety of expenses. When the financial statements were restated for the periods 1992 through 1997 the company acknowledged misstating its pre-tax earnings by about $1.7 billion. At the time the restatement was the largest in corporate history. The complaint alleged violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). *See* Lit. Rel. No. 17435 (March 26, 2002).

■ *SEC v. Xerox Corporation* Civil Action No. 02-CV-2780 (S.D.N.Y. filed April 11, 2002) is an action against the office equipment manufacturer alleging an accounting fraud to manage earnings from 1997 through 2000. During that period Xerox employed seven different accounting actions to help it meet street expectations as to earnings. Those included in its leasing operations shifting revenue from servicing and financing which is recognized over the term of the lease to the equipment so that it could be immediately recognized; shifting revenue to equipment that the company had historically allocated to financing; and shifting revenue to equipment that historically had been allocated to servicing. These techniques, which departed from GAAP and the historical practices of the company, were combined with a series of other artful accounting conventions, the adoption of which added about $1 billion of revenue. All of these actions, in conjunction with the use of ''cookie jar reserves,'' helped the company meet street expectation. The Commission's complaint alleges violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and13(b)(2)(B). *See* Lit. Rel. No. 17465 (April 11, 2002).

■ *SEC v. Safety-Kleen Corp.,* Civil Action No. 02 Civ. 9791 (S.D.N.Y. filed Dec. 12, 2002) is an action in which the Commission alleged a massive accounting fraud beginning in late 1998 and continued through the end of the first quarter of 2000. During that period two officers of the company implemented a scheme to inflate revenue primarily by improperly recognizing revenue, inappropriately capitalizing expenses, incorrectly recording derivative transactions, improperly deferring expenses and other fraudulent techniques. The company's revenue was further distorted by fraudulently recording about $38 million of cash generated by speculative derivative transactions. The SEC's complaint alleged violations of Securities Act Section 17(a) and Exchange Act Sections 10(b) and 13(b)(5). The two individual defendants were also criminally charged. *See* Lit. Rel. Nos. 17891 (Dec. 12, 2002) and 185555 (Jan. 28, 2004).

■ *SEC v. Symbol Technologies, Inc.,* Case No. CV 04 2276 (E.D.N.Y. filed June 3, 2004) is an action against the company and eleven former officers alleging a massive accounting fraud scheme that took place from 1998 through early 2003. During that period the defendants utilized numerous fraudulent accounting practices which had a cumulative net impact of over $230 million on reported revenue and over $530 million on pretax earnings. To ensure that the company met its financial projections the defendants: (a) made baseless accounting entries to conform quarterly results to management projections; (b) fabricated and misused restructuring and other non-recurring charges to artificially reduce operating expenses, and create ''cookie jar'' reserves; (c) engaged in channel stuffing and other revenue recognition schemes; and (d) manipulated inventory levels and accounts receivable data to conceal the adverse side effects of the revenue recognition scheme. The company settled at the time of filing. *See* Lit. Rel. No. 18734 (June 3, 2004).

■ *SEC v. Gemstar-TV Guide International, Inc.,* Case No. CV 04-04-4506 (C.D. Cal. filed June 23, 2004) is an action in which the Commission alleged that the company fraudulently inflated its revenues from 1999 through 2002 using five improper practices: (a) It recorded revenue under expired, disputed or non-existent agreements; (b) revenue was reported under long-term agreements on an accelerated basis in contravention of GAAP and company policy; (c) revenue was improperly recorded from multi-element transactions, some of which utilized round trip transactions; (d) revenue was improperly recorded from non-monetary and barter transactions; and (e) revenue was improperly classified. During the period the company overstated revenue by almost $250 million. The complaint alleged violations of Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B). The company settled on filing. The settlement was based in part on the cooperation and remedial efforts of the company. *See also* Lit. Rel. No. 2045 (June 23, 2004).

■ The collapse of Enron Corporation was the result of perhaps the largest financial fraud to date. It spawned a number of cases. At the center of the improper practices was the manipulation of the financial statements of the company utilizing a variety of techniques. A key case regarding Enron is *SEC v. Causey,* Civil Action No. H-04-0284 (S.D. TX. filed July 8, 2004; amended Feb. 19, 2004), an action against former Enron Corporation President and CEO Jeffrey Skilling and Richard Causey, the former chief accounting officer of the company. The amended complaint details a massive accounting fraud scheme which centered on claims that the defendants: (a) manufactured and manipulated reported earnings through the improper use of reserves; (b) concealed huge losses in the retail energy business by manipulating Enron's business segment reporting; (c) fraudulently promoted another Enron Broadband Service using false statements and fraudulently inflated its value and manufactured earnings by recognizing millions of dollars as earnings from the increase in the stock price; and (d) used special purpose entities to manipulate financial results. *See* Lit. Rel. No. 18582 (Feb. 19, 2004) (amended complaint) and No. 18776 (July 8, 2004) (adding former Chairman and CEO Kenneth Lay).

■ *SEC v. Collins & Akiman, Corp.,* Case No. 1:07-CV-2419 (S.D.N.Y. filed March 26, 2007) is an action against the company, former Office of Management and Budget Director David Stockman, and other officers at the company. The complaint, echoed in part by a parallel criminal case which was later dropped, alleged a multi-year earnings fraud beginning in 2001 and continuing through 2005. During that period the defendants engaged in a multifaceted financial fraud which included: (a) Fictitious round trip transactions which supposedly gave the company increased revenue through the payments of rebates; (b) improper accounting for certain rebates by, in some instances, recognizing the income prematurely while, in other instances, taking the sums into income when in fact they should not have been booked; and c) concealing a liquidity crisis at the firm. The complaint alleged violations of Se-

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curities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). *See* Lit. Rel. No. 20005 (March 26, 2007).

■ *SEC v. Cardinal Health, Inc.,* Civil Action No. 07 CV 6709 (S.D.N.Y. filed July 26, 2007) is a settled action against the pharmaceutical distribution company. The complaint alleged that from September 2000 through March 2004 the company managed its earnings to match guidance and analysts' expectations using a variety of techniques. Those included: (a) misclassifying over $5 billion of "bulk sales" – those that related to certain full case sales of product under firm policies – as operating revenue; (b) selectively accelerating without disclosing the payment of vendor invoices to prematurely record about $133 million in cash discounts; (c) improperly adjusting reserve accounts which misstated earnings by more than $65 million; and (d) improperly classifying $22 million of expected litigation settlement proceeds to increase operating earnings. The SEC's complaint alleged violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B). *See* Lit. Rel. No. 20212 (July 26, 2007).

■ *SEC v. Fisher,* Civil Action No. 07C 4483 (N.D. Ill. filed Aug. 9, 2007) is an action against three former senior executives of Nicor, Inc., a major Chicago-area natural gas distributor. From 1999 through 2002 the defendants devised a method by which the company could profit from accessing its low cost last-in, first-out layers of gas inventory through a series of misrepresentations and improper transactions. They also failed to disclose the impact of LIFO inventory liquidations on the reported income of the company, manipulated earnings and improperly caused losses on a supply agreement with an insurance provider to be charged to its utility customers. The complaint alleged violations of Securities Act Section 17(a) and Exchange Act Section 10(b). *See* Lit. Rel. No. 20233 (Aug. 9, 2007).

■ *SEC v. General Electric Co.,* Civil Action No. 3:09 CV 1235 (D. Conn. filed Aug. 4, 2009) is a financial fraud action which alleged that the company used four key fraudulent practices to artificially impact its financial results: (a) beginning in 2003 it applied an improper application of the accounting standards to GE's commercial paper funding program to avoid unfavorable disclosures and about a $200 million pre-tax charge to earnings; (b) in the same year the company failed to correct a misapplication of financial accounting standards to certain interest rate swaps; (c) in 2002 it improperly accelerated $370 million in revenue by reporting as a year-end transaction the sale of locomotives that had not occurred; and (d) in 2002 the company made an improper change in accounting for sales and commercial aircraft engines' spare parts that increased earnings by $585 million. The complaint alleged violations of Securities Act Sections 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B). The company settled the action on filing. *See* Lit. Rel. No. 21166 (Aug. 4, 2009).

■ Other significant cases include: *SEC v. Dunlap,* Civil Action No. 01-8437 (S.D. Fla. filed May 15, 2001) (action against former CEO and Chairman of Sunbeam Corporation and others based on an accounting fraud that began in 1996 and continued through 1998 which used channel stuffing and cookie jar reserves); *In the Matter of Sunbeam Corporation*, Adm. Proc. File No. 3-10481 (filed May 15, 2001)(proceeding against the company); *In the Matter of David C. Fanning,* Adm. Proc. File No. 3-10482 (filed May 15, 2001) (action against former executive vice president and general counsel of Sunbeam for participating in drafting of false press releases); *SEC v. Conaway,* Case No. 05 Civ. 40263 (E.D. Mich. filed Aug. 23, 2005) (action against two former officers of Kmart alleging that they failed to disclose in the management discussion and analysis the reasons for a massive inventory build-up which had a material impact on the liquidity of the company); *SEC v. Federal National Mortgage Association,* Case No. 06-00959 (D.D.C. filed May 23, 2006) (action alleging that from 1998 through 2004 the company used a variety of devices to smooth earnings to establish a trend and obtain bonuses by, among other things, not properly applying FAS 91 which requires that loan fees, premiums and discounts be taken as adjustments over the life of the applicable loan; failing to comply with FAS 133 regarding accounting for derivative instruments and hedging activities; and improperly estimating and maintaining the loan loss reserve); *SEC v. Fraser,* Case No. 2:09-cv-00442 (D. Ariz. filed March 6, 2006) (action against four executives of CSK Auto Corporation who manipulated earnings from 2002 to 2004 through the use of allowances with vendors); *SEC v. BISYS Group, Inc.,* Case No. 07-Civ-4010 (S.D.N.Y. filed May 23, 2007) (alleging earnings management through a series of accounting practice which included improperly recording as revenue commissions earned by entities acquired by BISYS before they were acquired and failing to properly adjust reserves. *See* Lit. Rel. No. 20125 May 23, 2007); *SEC v. Italian Pasta Co.,* Civil Action No. 4:08-CV-00675 (W.D. Mo. filed Sept. 15, 2008) (action against the company and its senior executives who engaged in a variety of fraudulent actions in from 2002 to 2004 including inflating earnings, fraudulently capitalizing period costs, failing to write off obsolete or missing spare parts, engaging in round trip cash transactions and recording false receivables).

III. The Market Crisis and a Change of Direction

From 2007 through 2009 the U.S. suffered through the worst economic crisis since the great depression of the 1930s. The SEC launched a series of investigations and subsequently filed a number of actions. Many of those actions were financial fraud cases. In contrast to traditional financial fraud actions which typically centered on increasing revenue to meet street expectation, these cases frequently involved concealing the impact of the evolving economic crisis on the company. Examples of these actions include:

■ *SEC v. Mozilo,* Civil Action No. CV 09-03994 (C.D. Cal. filed June 4, 2009) is an action against the former CEO of Countrywide Financial and two of its other officers. The firm was the largest writer of subprime mortgages. The SEC's complaint alleged that as the subprime real estate market collapsed Countrywide continued to tell investors that it was writing quality loans while failing to state that the lending standards had been altered and that in fact the quality and value of the loan portfolio was deteriorating. The complaint alleged violations of Securities Act Section 17(a) and

Exchange Act Sections 10(b) and 13(a). *See* Lit. Rel. No. 21068A (June 4, 2009).

■ *SEC v. Strauss,* Civil Action No. 09 CIV 4150 (S.D.N.Y. filed April 29, 2009) is an action against the former CEO and president of American Home Mortgage Investment Corp and two other officers. For years this company had successfully written mortgages. By late 2006 however, and in early 2007, additions were required to the reserves as the market crisis developed. As the losses mounted the defendants concealed them by making misleading disclosures, not revealing that much of its book of loans had been sold and misleading investors about the cash position of the company. The complaint alleged violations of the antifraud, reporting and internal controls provisions of the securities laws.

■ Other significant cases include: *SEC v. Morrice*, Civil Action No. CV 09-01426 (C.D. Cal. filed Dec. 7, 2009) (fraud action against senior officers of subprime lending giant New Century centered on concealing true financial condition of firm); *SEC v. Perry*, Civil Action No. CV 11-01309 (C.D. Cal. filed Feb. 11, 2011) (similar action against the officers of IndyMac Bancorp); *SEC v. Wu,* Case No. CV -11-4988 (N.D. Cal. filed Oct. 11, 2011) (action against officers of United Commercial Bank and UCBH Holdings, Inc. alleging that defendants failed to write down several large non-performing loans as market crisis moved forward); *SEC v. Nocella,* Case No. 4:12-cv-1051 (S.D. TX. filed April 6, 2012) (action against two officers of Franklin Bank Corp. centered on allegations that as the market crisis unfolded and the loan portfolio deteriorated the defendants concealed the true value of the assets); *SEC v. Woodard,* Civil Action No. 2:13cv16 (E.D. Va. filed Jan. 9, 2013) (action against officers of Common Wealth Bank Shares based on similar theory); *see also SEC v. General Motors Corporation,* Civil Action no. 1:09-cv-0019 (D.D.C. filed Jan. 22, 2009) (action centered on improper disclosures regarding estimated payments for pension plan and errors in accounting for derivatives).

IV. Risk Analysis and Big Data

In 2009 the Division of Enforcement undertook its largest reorganization. As part of that effort specialty groups were created to marshal the resources of the Division in select areas. No specialty group was created to focus on financial statement fraud.

The retooled Division adopted new techniques centered on risk and data analysis to help identify performance outliers as an earlier indicator of possible misconduct. The asset management unit, for example, developed what its former chief called ''risk-based investigative approaches through which the Unit can detect and prevent fraudulent conduct. Each initiative utilizes data analysis and appropriate risk criteria to identify individuals or entities that may be engaged in specific types of misconduct.'' Remarks of Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit, delivered to the Regulatory Compliance Association, New York, New York (Dec. 18, 2012).

The Aberrational Performance Inquiry is another recent initiative that is risk and data driven. It focuses on suspicious or improbable performance returns by hedge fund advisers. The point is to find abnormal performance returns. *See* SEC Press Release, 2011-252 (Dec. 1, 2011); *see also* SEC Press Release 2012-209 (Oct. 17, 2012). Utilizing a big data type approach and working with the Office of Inspections, performance metrics were developed to utilize in evaluating fund results in an effort to identify possible wrongful conduct at an earlier date.

The creation of the Analytics Group will undoubtedly build on these efforts. This new group can be expected to create metrics to help the Task Force identify and root out financial statement fraud. Those efforts will be aided by the huge repository of interactive financial data available to the Commission. *See, e.g., What is Interactive Data And Who's Using It?* Available at http://www.sec.gov/spotlight/xbrl/what-is-idata.shtml This will permit the SEC to use big data analytics approach to create metrics by which to measure performance. The approach will undoubtedly build on similar efforts undertaken in conjunction with the 2009 reorganization of the Enforcement Division. *See generally*, Viktor Myer-Schonberger & Kenneth Cukier, *Big Data: A Revolution That Will Transform How We Live, Work and Think* (2013) (describing the manner in which the big data approach is creating new analytics).

The risk-based approach and, in particular, the Aberrational Performance Inquiry, has to date spawned several enforcement actions which give some indication of the direction this approach may take. Typically, these cases are based on abnormal results which are ''too good to be true.'' SEC Press Release 2011-252 (Dec. 1, 2011). The cases brought to date tend to focus on misrepresentations regarding the manner in which the fund operated or on the valuation of assets. Examples include:

■ *Misrepresentations: SEC v. Balboa,* Case No. 11 Civ. 8731 (S.D.N.Y. filed Dec. 12, 2011) is an action against Michael Balboa, the portfolio manager of now defunct Millennium Global Emerging Credit Fund who resides in England, and Gilles De Charsonville, a representative at a U.K.-based broker dealer who resides in Spain. The scheme centered on the overvaluation of key assets in 2008. Specifically, during the first ten months of 2008, Mr. Balboa is alleged to have enlisted two independent brokers, defendant De Charsonville and another U.K. broker, to furnish false mark-to-market quotes for two of the Fund's securities. Those quotes were furnished to the fund's independent valuation agent and auditors. As a result of this scheme, the net asset value was overstated by about $163 million for a fund with reported assets of $844 million. The incorrect valuation yielded millions of dollars in illegitimate management and performance fees and attracted over $400 million in new investments while deterring redemptions. The complaint alleges violations of Securities Act Section 17(a), Exchange Act Sections 10(b) and 20(e) and Advisers Act Sections 206(1), (2), (4) and 209(f).

■ *Misrepresentations: SEC v. Kapur,* Civil Action No. 11-CIV-8094 (S.D.N.Y. filed Nov. 10, 2011) is an action against investment adviser ThinkStrategy Capital Management and its principal, Chetan Kapur. ThinkStrategy managed two hedge funds. The complaint alleges that over a period of about seven years the defendants engaged in a deceptive pattern of conduct in which they made a series of misrepresentations about the funds concerning their performance, returns, assets and performance history. The complaint alleges violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Advisers Act Section 206(4).

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■ *Misrepresentations: SEC v. Rooney*, Case No. 11-cv-8264 (N.D. Ill. filed Nov. 18, 2011). Patrick Rooney and Solaris Management, LLC are named as defendants in the case. Mr. Rooney is the founder and managing partner of Solaris Management. The firm serves as the general partner and investment adviser of hedge funds Solaris Opportunity Fund, LP (''the Fund'') and Solaris Offshore Fund. The two entities were managed together. The Fund claims to follow a non-directional strategy to trade equity, options and futures. According to the Fund, under this strategy it used long, short and neutral positions to hedge risk, generate income and maintain equity growth over the long term. Between August 2003 and September 2008 investors put nearly $30 million into the Fund. The Fund had 30 investors and reported assets of $16,277,780 as of December 2008. Initially Mr. Rooney caused the Fund to trade in accord with its defined strategy. Beginning in 2005, however, the defendants caused the Fund to begin investing in Positron Corporation, a molecular imaging company whose shares were traded on the Nasdaq OTC Bulletin Board. At the time the company had reported significant losses. Its auditors expressed substantial doubt as to its ability to continue as a going concern. Mr. Rooney joined the board of directors, became Chairman and started drawing a salary in 2004 in connection with financing furnished to Positron from another entity whose board included his father. By 2007 the Fund invested millions of dollars in Positron and held about 60 percent of the outstanding shares. Fund investors were not told about the investment in Positron until March 2009. At that point a newsletter told investors that Mr. Rooney became Chairman of the company to safeguard the investment of the Fund. This statement was false, according to the complaint. In fact, the investment in Positron benefited that company and Mr. Rooney. In the end, Fund investors were left with a concentrated, undiversified and illiquid position in a cash poor company with a history of losses. The Commission's complaint alleges violations of Securities Act Section 17(a), Exchange Act Sections 10(b) and 13(d)(1) and Advisers Act Sections 206(1), (2) and (4).

■ *Misrepresentations: In the Matter of LeadDog Capital Markets, LLC*, Adm. Proc. File No. 3-14623 (filed Nov. 15, 2011) is a proceeding which names as Respondents the firm, its owner Chris Messalas, and Joseph Laroco, a managing member and counsel to LeadDog. From late 2007 through August 2009 Respondents raised about $2.2 million from 12 investors for investments in LeadDog Capital LP, a hedge fund. Investors were told that the fund would be invested in part in liquid assets. Investors were also told about the securities expertise of the Respondents. These representations were false. In fact, the fund invested in illiquid penny stocks. Many of the firms had received going-concern qualifications from their auditors. Investors were also not told that Mr. Messalas controlled a broker dealer that had been repeatedly fined, censured and ultimately expelled by the Financial Industry Regulatory Authority. In addition, Respondents concealed significant conflicts and related party transactions from investors and the auditors, according to the Order. The Order alleged violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Advisers Act Section 206(4).

■ *Valuation: SEC v. Yorkville Advisors, LLC,* Civil Action No. 12 CIV 7728 (S.D.N.Y. filed Oct. 17, 2012). This case names as defendants a registered investment adviser and its CFO and COO. The action focused on the valuation of the assets in the fund during the period of the market crisis. While the private placement memorandum assured investors that the securities in the fund would be fair valued in accord with GAAP, in fact they were not, according to the Commission's complaint. As the market crisis unfolded, the adviser had increasing difficulty valuing the assets. It switched methods, and untested methodology was adopted. That resulted in an over-valuation by about $50 million. The over-valuation aided in attracting new investors to the fund and improperly inflated management fees. The complaint alleges violation of each subsection of Securities Act Section 17(a), Exchange Act Section 10(b) and Advisors Act Sections 206(1) and (2) and 204(4).

■ *Valuation: In the Matter of KCAP Financial, Inc.*, Adm. Proc. File No. 3-15109 (Nov. 28 2012) is the first proceeding centered on FAS 157 regarding Fair Value Measurement. The proceeding against the closed ended fund alleged that during late 2008, and continuing until the middle of 2009, the firm did not account for certain market based activity in determining the fair value of its debt securities. It also did not account for certain market based activity for its two largest CLO investments by properly fair valuing them. At the time KCAP's filings stated that those CLOs were valued using a discounted cash flow method that incorporated market data. In fact the CLOs were valued at KCAP's cost. In May 2010 the firm disclosed that it had to restate the fair values for certain securities and the CLOs. It had materially overstated NAV. The internal controls also were not designed to properly value illiquid securities. As a result, the Order alleges that the firm violated Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B). Also named in the proceeding were the CEO and CFO of the firm who are alleged to have caused the violations.

■ *See also In the Matter of J. Kenneth Alderman, CPA*, Adm. Proc. File No. 3-15137 (Dec. 10, 2012) (proceeding against eight mutual fund directors alleging that the directors failed to cause the funds to adopt and implement reasonable procedures as to valuation). *SEC v. Mannion*, Civil Action No. 10-cv-3374 (N.D. Ga. filed Oct. 19, 2010(assets of fund materially overvalued to conceal losses).

V. Analysis and Conclusion

The new financial task fraud task force is currently being formulated. Its path has yet to be charted. Yet, if history is any guide, issuers and their directors, executives and auditors would do well to be prepared.

Following Chairman Levitt's ''Numbers Game'' speech the Commission launched a very successful campaign against financial statement fraud. Significant cases were brought against dozens of issuers and their executives. In some instances the outside auditors of the firm and even business partners became embroiled in enforcement litigation. In several instances criminal prosecutions were brought.

Now under a new Chair and with a freshly minted ''get tough'' policy the Commission is launching a similar campaign. The new campaign has more weapons than in the past. There is a rich history of cases illuminating wrongful practices to serve as an initial guide. The SOX certification process provides a potential

guide for investigators to what should be key company financial issues while serving as an enhancement to potential liability for the CEO and CFO. The electronic tags added to financial data filed with the SEC facilitate data evaluation. And, a reorganized enforcement program is keyed to risk and data analysis as well as the use of industry metrics to measure and evaluate performance as an indication of possible wrongful conduct.

In view of this, issuers and their executives should consider four key points. First, the lessons from the financial statement fraud actions brought in the wake of the ''Numbers Game'' speech that will serve as the roots of the new Task Force should be carefully assessed. An analysis of cases such as *HealthSouth*, *Time Warner, Bristol-Myers, Xerox* and *GE* and others yields a guide to improper practices which can be used as a red flag check list to identify improper practices. *See generally* Richard H. Walker, Director, Division of Enforcement, *27th Annual National AICPA Conference on Current SEC Developments* (Dec. 7, 1999) (Identifying 10 lessons from financial statement fraud cases).

Second, the market crisis financial cases point to another key metric which the Task Force will clearly consider. Actions such as *Mozilo* where deteriorating assets were masked giving investors a distorted view of the company will surely be a central issue. This counsels a careful analysis of valuation and reserve issues as well as disclosure controls.

Third, the analytic and big data approach illustrated by the Aberrational Performance Inquiry offers a good guide for issuers evaluating performance. The focus is a risk based set of industry metrics that identify outliers. Issuers can conduct this same kind of analysis by evaluating trends in their performance in view of specific metrics. If, in view of those metrics, the company is an outlier or its performance is too good to be true, further inquiry may be warranted. Conducting that inquiry now before any SEC investigation is not just prudent, it is good business.

Finally, the stakes in these cases could not be higher. Senior executives of the company are frequently charged as in *Cendant*, *Enron*, *WorldCom*, *Adelphia* and other cases. In some instances business partners are charged as in *Koninkijke Ahold*. In others the outside auditors are named in Commission enforcement actions as in *Xerox* and *Bally*. And, since the line between civil and criminal securities fraud is at best murky, there may be criminal liability as in many instances. *See, e.g.*, Thomas O. Gorman, *SEC Enforcement Trends 2011*, *Financial Fraud, Secactions* (April 18, 2011), available at http://www.secactions.com/sec-enforcement-trends-2011-financial-fraud.

Those who believe that the new Financial Task Force will find a vastly changed financial reporting landscape and fewer cases would do well to remember the predicate for Chairman Levitt's ''Numbers Game'' speech. It was the constant pressure on companies and executives to meet street expectations, according to the Chairman. The string of cases brought in the wake of that speech bore out Chairman Levitt's point. Today's 24/7 news cycle, active class action bar, and waiting whistleblowers have done nothing but intensify those pressures. With a new SEC task force looming, the prudent company and executive will understand that acting today is good business for tomorrow. Acting today can ensure that those pressures do not turn their financial reporting into a ''Numbers Game.'' *See, e.g., Ex-Olympus Chairman Gets Suspended Sentence for Fraud*, Bloomberg (July 3, 2013) (Chairman of Olympus sentenced on criminal charges related to financial statement fraud).

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