Debevoise & Plimpton

June 2017
Issue 2

Accounting & Financial Reporting Enforcement Round-Up

In this issue:

Welcome to the second issue of the Accounting & Financial Reporting Enforcement Round-Up. As we noted in our first issue, the U.S. Securities and Exchange Commission ("SEC") remains focused on financial reporting matters and is likely to continue this focus in the coming years. This periodic newsletter aims to provide short, bite-sized updates and analysis about some of these bread-and-butter financial reporting matters that often represent a substantial portion of the enforcement cases brought by the SEC.

As the new SEC Chairman, Jay Clayton, and the new co-Directors of Enforcement, Stephanie Avakian and Steven Peikin, settle into their positions, we will begin to better understand the SEC's future direction with respect to enforcement more generally. However, it is likely that there will be minimal changes to the overall direction of enforcement. Chairman Clayton stated during his confirmation hearing that he is "100 percent committed to rooting out any fraud and shady practices in our financial system." While nuanced issues like the relative size of penalties and the concept of corporate negligence (when no single person can be said to have engaged in negligence) will likely continue to be debated at the SEC, financial reporting matters will likely remain among the agency's enforcement priorities. Of course, any budget cuts at the SEC under the new Administration will likely upset the SEC's ability to pursue cases more generally. In fact, the cuts do seem to have

Continued on page 2

already impacted enforcement as the press release announcing the appointment of co-Directors used the number 1,200 as the number of staff in Enforcement, which is already lower than the 1,400 number used in the past couple of years. Fewer hands to do the work will, over time, certainly result in fewer enforcement matters.

Discussed below are four recent cases. The first highlights the financial reporting violations that can follow from an aggressive sales culture paired with significant pressure to achieve market guidance. The second, third, and fourth suggest the SEC is continuing to pursue individual executives—in one case even in the absence of anti-fraud violations under Section 10(b) and Section 17(a). Financial reporting cases remain fruitful cases for individual focus, as executives and mid-level executives are often involved in these sorts of financial reporting decisions.

Semiconductor Manufacturer and Former CFO Settle Charges in Alleged Scheme to Achieve Market Guidance

The SEC continues to pursue companies allegedly manipulating revenue and other financial metrics in order to meet earnings targets. During the Enron era, these sorts of cases were more common, as companies would undertake a variety of measures, some problematic, to attempt to achieve guidance they provided to the Street. Although these types of cases have become less common in recent years, revenue recognition and other similar issues remain a focus for enforcement investigations, internal investigations, and whistleblowers. On May 1, 2017, the SEC settled charges with South Korea-based MagnaChip Semiconductor Corp. ("MagnaChip") and its former CFO over an accounting scheme undertaken as a result of "immense pressure" to achieve revenue and gross margin guidance communicated to the market. The SEC found that MagnaChip engaged in a variety of fraudulent practices designed to inappropriately recognize revenue, including (1) a practice in which sales distributors were offered various concessions in undisclosed side agreements to order products earlier than wanted or needed so that MagnaChip would hit revenue targets; (2) a practice of recognizing revenue on non-existent or unfinished products by circumventing internal controls and falsifying books and records; and (3) a practice of applying payments on recent sales to receivables on older sales to make those receivables appear less aged. The SEC also identified other manipulative practices that were employed to recognize revenue inappropriately, avoid recording expenses, disguise rising accounts receivable balances, and manipulate gross margin.

Charges settled by MagnaChip and its former CFO included fraud under Section 10(b) and Section 17(a), as well as books and records and internal controls violations. MagnaChip agreed to a $3 million penalty. Additionally, the SEC agreed to defer payment of another $3 million in civil monetary penalties in exchange for continued cooperation with no such further payment required if the company cooperates fully. The former CFO agreed to a $135,000 penalty, as well as officer/director and Rule 102(e) bars.

- **Market Guidance and Sales Culture** – The SEC's order highlighted that MagnaChip executives in Korea set aggressive revenue and gross margin targets, then often berated sales and manufacturing employees when they fell short of those targets. Before restating its financials as a result of the

Continued on page 4

Semiconductor Manufacturer and Former CFO Settle Charges in Alleged Scheme to Achieve Market Guidance

Continued from page 3

practices uncovered, MagnaChip had claimed it met its market guidance for ten consecutive quarters. Such continuous performance is often a red flag to potential accounting improprieties and often attracts SEC attention. After the restatement, it was revealed that MagnaChip had missed revenue and/or gross margin guidance in seven of those ten quarters. The connection between the sales culture and the importance placed on meeting market guidance likely bolstered the SEC's scienter arguments with respect to Section 10(b) and Section 17(a)(1) fraud charges.

- **Potential Benefits of Cooperation** – MagnaChip's audit committee undertook an independent internal investigation after concerns were raised about aged accounts receivable by MagnaChip's auditors and board members. MagnaChip also self-reported the revenue issues initially uncovered. The SEC's order specifically noted that the relatively small $3 million penalty was based on MagnaChip's cooperation and undertaking to continue to cooperate with additional proceedings. There are often complaints that the benefits for self-reporting and cooperation are not apparent from actions but the SEC here attempted to demonstrate the tangible benefits of such efforts.
- **Efforts to Obstruct the Internal Investigation** – The SEC's order noted that management in Korea, as part of an effort to conceal misconduct, provided employees with a list of words not to say during interviews being conducted during the audit committee's independent internal investigation. Such efforts to control employee conduct during an internal investigation are fraught with peril, as investigators will view such "advice" as efforts to obstruct the investigators.
- **Focus on Individuals** – We know the SEC has continued to focus on charges against individuals in connection with financial reporting cases. Here, MagnaChip's then CFO allegedly directed or indirectly approved several of the fraudulent accounting practices, or learned of others doing so, and failed to remediate. While the former CFO settled charges against her concurrently with MagnaChip, it is possible that charges against other individuals may follow, particularly given the reference to immense pressure placed upon employees to meet earnings targets by executives in Korea. Notably, MagnaChip agreed to continue to produce documents and use best efforts to make its employees and directors available in connection with this matter even after its own settlement.

Continued on page 5

Semiconductor Manufacturer and Former CFO Settle Charges in Alleged Scheme to Achieve Market Guidance

Continued from page 4

- **Corporate Penalties** – This case was approved by the two-person Commission before Chairman Clayton was sworn in. Given the $3 million penalty, the Staff was likely able to show that MagnaChip had obtained a corporate benefit as a result of the misconduct, thereby justifying Commissioner Piwowar's support of a corporate penalty. It still remains to be seen what Chairman Clayton's approach will be to such corporate penalties.

The settlement order with MagnaChip and its former CFO can be found here: http://www.sec.gov/litigation/admin/2017/33-10352.pdf.

Former Defense Contractor Executives Charged in Connection with Alleged Improper Revenue Recognition

The SEC has continued its focus on individual culpability for alleged financial reporting improprieties. On April 28, 2017, the SEC charged two former executives of L3 Technologies, Inc. ("L3") in connection with alleged improper recognition of $17.9 million in revenue in 2013 and early 2014. L3 had previously agreed to settle books and records and internal controls charges against it in this matter for a $1.6 million penalty. While one of the individuals (a former L3 division president) settled books and records and internal controls violations with the SEC and agreed to pay a $25,000 penalty, the SEC instituted litigated administrative proceedings against the other individual (a former L3 vice president of finance).

The underlying alleged accounting violation resulted from a fixed-price maintenance contract with the U.S. Army. The SEC alleged that the former vice president of finance instructed a subordinate to create invoices in L3's internal accounting system for performed but unbilled work related to the contract, but to then withhold delivery of the invoices to the U.S. Army. By generating the invoices in the system and never sending many of them, L3 recognized revenue that was not actually billed to the U.S. Army under the contract. The former division president claimed to have little accounting knowledge and relied on the vice president of finance, but is alleged to have disregarded "red flags" that should have indicated revenue was improperly recognized. The former division president might also have helped to procure a misleading email provided to L3's auditors suggesting that the U.S. Army would accept the invoices, which the SEC alleged to be "contrary to the truth."

- **No Fraud Claims** – Despite the headline allegations that revenue was recognized in the internal accounting system by generating potentially false invoices and providing L3's auditors with a potentially misleading email, the SEC did not pursue claims for violations of the anti-fraud provisions of Section 10(b) or Section 17(a) against L3 or either of the former executives in these matters. The fact pattern needed to allege fraud was likely complicated because the amounts in question appear to have been part of a potential contract dispute with the U.S. Army, thereby allowing the individuals to claim that the Army did in fact owe these amounts.

Continued on page 7

Former Defense Contractor Executives Charged in Connection with Alleged Improper Revenue Recognition

Continued from page 6

- **Bonus Targets** – The SEC alleged that the additional revenue helped employees in the relevant division "barely" achieve bonus targets. This circumstance—and the SEC's continued focus on individual conduct—might have led the SEC to pursue books and records and internal controls violations, even in the absence of Section 10(b) and Section 17(a) fraud allegations.
- **No Settlement by Former Vice President of Finance** – The vice president of finance has not settled with the SEC. Among other things, the SEC's order asks an administrative law judge to determine whether the vice president of finance should be barred from practicing before the SEC as an accountant. In recent months, the SEC has brought few litigated cases as administrative proceedings because of the recent case in the 10th Circuit holding that the failure of the SEC to appoint the administrative law judges violates the Appointments Clause of the Constitution. Given the uncertainty of what will happen with pending administrative proceedings, the SEC has hesitated in bringing new ones. However, there are certain remedies, such as Rule 102(e) bars, which are only available in administrative proceedings and that likely explains the SEC's decision to bring this action in an administrative proceeding. U.S. Supreme Court review of the 10th Circuit opinion is likely because a three-judge D.C. Circuit panel had upheld the SEC's administrative law judge appointments process and a recent D.C. Circuit en banc review resulted in a deadlock.
- **Alleged Culpability of Former Division President** – The SEC emphasized that the former division president's lack of accounting knowledge could not be viewed to immunize him from culpability. Senior executives often use this defense, and the SEC will often seek to overcome it by relying on allegations that the presence of red flags should have alerted the executive to the issue.

The order instituting administrative proceedings against the former vice president of finance can be found here:
https://www.sec.gov/litigation/admin/2017/34-80548.pdf.

The settlement order with the former division president can be found here:
https://www.sec.gov/litigation/admin/2017/34-80547.pdf.

The earlier settlement order with L3 can be found here:
http://www.sec.gov/litigation/admin/2017/34-79772.pdf.

Former CEO of Marketing Company Settles Executive Perks Disclosure Case

Disclosure of executive perks remains an SEC enforcement priority, with several recent cases focusing on this issue, including cases involving Musclepharm and Polycom. On May 11, 2017, the SEC settled an executive perks disclosure case with the former CEO of MDC Partners, Inc. ("MDCA"), a publicly-traded marketing company, for $1.85 million in disgorgement, $150,000 of prejudgment interest, and a civil monetary penalty of $3.5 million. We reported on MDCA's earlier settlement with the SEC regarding the same matter as part of the April 2017 issue.

As alleged in the SEC's settlement order, the former CEO, who also served as the chairman of MDCA's board of directors, received and failed to disclose $11.285 million in perks over a six-year period beginning in 2009. MDCA's proxy statements over the same period disclosed approximately $3.87 million in perks provided to the former CEO by MDCA. Undisclosed perks and personal benefits included private aircraft use, cosmetic surgery, jewelry, and pet care, among several others. MDCA is alleged to have incorrectly recorded many of these amounts as business expenses instead of compensation. The former CEO was charged with violation of Section 10(b), as well as books and records and internal controls violations. The CEO's settlement payments ordered herein are in addition to the $21.7 million—the $10.5 million in cash bonus awards plus the $11.2 million in perks and personal benefits—he already repaid to MDCA.

- **Focus on Perk Disclosures** – As we previously reported, perk disclosures remain a common area of focus for the SEC. The perk amounts at issue in this case were substantially higher than those observed in other recent perks disclosure cases. MDCA's proxy statements during the relevant period understated the perks portion of the former CEO's compensation by an average of 300% each year. These factors likely led to a higher civil monetary penalty for MDCA and, more recently, the significant settlement with the former CEO.
- **Monetary Penalty Amount** – Often, the SEC is able to order higher disgorgement amounts than the civil monetary penalty assessed. In this case, the civil penalty of $3.5 million was substantially higher than the $1.85 million disgorgement amount, likely because the CEO had already reimbursed the company for a significant amount of the perks. Furthermore, the civil penalty assessed against the former CEO was also substantially higher than the $1.5 million civil penalty assessed against MDCA, which appears to have

Continued on page 9

Former CEO of Marketing Company Settles Executive Perks Disclosure Case

Continued from page 8

received credit for its cooperation. In light of the U.S. Supreme Court's recent decision in *Kokesh*, which held that the SEC's authority to obtain disgorgement is restricted to a five-year period of limitation, it remains to be seen whether the SEC will begin to pursue higher penalty amounts relative to the amount of disgorgement ordered.

- **Presence of Section 10(b) Claim** – It is notable that the SEC alleged violations of the anti-fraud provisions of Section 10(b), which require intent or recklessness. MDCA, by contrast, settled a Section 17(a)(2) negligence-based claim. This is not uncommon as the SEC often provides credit to a company that cooperates both in terms of level of penalties and through reduced charges.
- **Officer and Director Bar** – The CEO agreed to a five-year officer and director bar. That is the typical length for an officer and director bar when the individual settles Section 10(b) claims. It is rare for the SEC to agree to a bar of a shorter length under those circumstances.

The settlement order with the former CEO can be found here: https://www.sec.gov/litigation/admin/2017/34-80652.pdf.

The earlier settlement order with MDCA can be found here: https://www.sec.gov/litigation/admin/2017/33-10283.pdf.

SEC Charges Company, Executive and Executive's Friend with Using a Sham Transaction to Boost Financial Results

Related party transactions have also been the subject of many enforcement actions over the years. On June 8, 2017, the SEC announced litigated claims against Integrated Freight Corporation ("Integrated Freight"), the company's former CEO, and the former CEO's long-time friend in connection with a related party transaction that was allegedly designed to boost the financial results of two publicly traded companies by hiding over $5 million in liabilities. Alleged violations included fraud under Section10(b) and Section 17(a), as well as other violations.

According to the complaint the SEC filed in the U.S. District Court for the Southern District of New York, the former CEO had served in that role, and as the chairman of the board, for two companies concurrently: Integrated Freight and New Leaf Brands ("New Leaf"). The two companies, which were experiencing financial difficulties at the time, also hired the former CEO's company as their turnaround consultant. He quickly implemented plans to sell four of the companies' non-operational subsidiaries to Deep South, a shell company that his long-time friend and business partner allegedly formed at his request. Deep South paid $1 for each of the subsidiaries and agreed to indemnify Integrated Freight and New Leaf for all liabilities related to the subsidiaries, which totaled over $5 million. In exchange, Deep South received ten million shares of Integrated Freight's common stock and six million shares of New Leaf's common stock. In reporting these transactions, Integrated Freight and New Leaf reclassified the subsidiaries to the discontinued operations section of their financial statements, ultimately reporting gains from discontinued operations of $4.3 million and $750,000, respectively.

- **No Related Party Disclosures** – The SEC alleged that Integrated Freight and New Leaf violated GAAP by failing to disclose in their SEC filings the nature of the CEO's control over Deep South. According to the SEC, "[s]uch disclosures would alert the investing public that the transactions between the Companies and the buyer were not arms' length." In alleging the CEO's control over Deep South, the SEC cited the fact that the former CEO caused the entity's formation only weeks before the first sale, that he was the signatory on the entity's bank account, and that he caused the entity to obtain financing prior to the sales.

Continued on page 11

SEC Charges Company, Executive and Executive's Friend with Using a Sham Transaction to Boost Financial Results

Continued from page 10

- **Improper Derecognition of Debt** – The sale to Deep South failed to rid New Leaf of its liabilities under GAAP, which provides that a liability can only be derecognized if the debtor pays the creditor in full or is legally released from liability, either judicially or by the creditor. New Leaf continued to be the primary obligor on an $800,000 note payable even after the sale to Deep South, so it should have continued to report this debt on its balance sheet in accordance with GAAP. Accordingly, the SEC found that New Leaf understated its debt and overstated its income in derecognizing the note payable. The SEC also found that the former CEO aided and abetted this violation.
- **Misleading Indemnification Disclosures** – The SEC also alleged that New Leaf made false and misleading disclosures concerning Deep South's agreement to indemnify New Leaf. According to the SEC's complaint, the former CEO should have known these disclosures were misleading because Deep South had no assets, operations, or revenue streams and thus no ability to cover the liabilities it assumed or to indemnify the companies for their liabilities. As a result, the SEC alleges that the purported indemnifications given by Deep South were worthless.
- **Auditor Misrepresentations** – As we have indicated previously, auditor misrepresentations appear to be a common focus in financial reporting enforcement actions, and this case is no exception. The SEC alleged that the former CEO failed to disclose his involvement with his longtime friend and the creation of Deep South when Integrated Freight's auditors asked him about the subsidiary sales during their annual audits and quarterly reviews. The SEC noted that the auditors specifically asked the former CEO whether the transactions would qualify as related party transactions under GAAP.
- **Temporary Suspension of Trading** – The SEC issued an order temporarily suspending trading in Integrated Freight's common stock and instituted administrative proceedings to determine whether it is necessary to suspend or revoke Integrated Freight's securities in order to protect investors. Trading suspensions are common in these sorts of actions when the company has not met its public filing obligations and where publicly filed disclosures about the company are not up-to-date and reliable.

The SEC's complaint can be found here: https://www.sec.gov/litigation/complaints/2017/comp23855.pdf.

The order suspending trading in Integrated Freight's common stock can be found here: https://www.sec.gov/litigation/suspensions/2017/34-80862-o.pdf.

The order instituting administrative proceedings with respect to Integrated Freight's stock can be found here: https://www.sec.gov/litigation/admin/2017/34-80863.pdf.

Accounting & Financial Reporting Enforcement Round-Up

AFR Enforcement Round-Up
is a publication of
Debevoise & Plimpton LLP

919 Third Avenue
New York, New York 10022
+1 212 909 6000
www.debevoise.com

Washington, D.C.
+1 202 383 8000

London
+44 20 7786 9000

Paris
+33 1 40 73 12 12

Frankfurt
+49 69 2097 5000

Moscow
+7 495 956 3858

Hong Kong
+852 2160 9800

Shanghai
+86 21 5047 1800

Tokyo
+81 3 4570 6680

Andrew J. Ceresney
Co-Editor-In-Chief
+1 212 909 6947
aceresney@debevoise.com

Jonathan R. Tuttle
Co-Editor-In-Chief
+1 202 383 8124
jrtuttle@debevoise.com

Matthew E. Kaplan
Co-Editor-In-Chief
+1 212 909 7334
mekaplan@debevoise.com

Arian M. June
Co-Editor-In-Chief
+1 202 383 8053
ajune@debevoise.com

John T. Chisholm
Member
+1 202 383 8176
jtchisholm@debevoise.com

Mark D. Flinn
Member
+1 202 383 8005
mflinn@debevoise.com

Anne M. Croslow
Member
+1 202 383 8077
amcroslow@debevoise.com

Please address inquiries regarding topics covered in this publication to the editors.