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WHITE PAPER

August 2022

# SEC Enforcement in Financial Reporting and Disclosure: Summer 2022 Update

We are pleased to present our latest update on financial reporting and issuer disclosure enforcement activity. This *White Paper* primarily focuses on the U.S. Securities and Exchange Commission's ("SEC") enforcement activity through mid-August 2022.

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In the most recent editions of this publication, we predicted the SEC Enforcement Division would more aggressively enforce the federal securities law than the previous administration's Enforcement Division.[1] While the quantity of enforcement activity in the areas of financial reporting and disclosure fraud cases has not yet exceeded that of recent years, telltale signs remain that issuers can reasonably expect enforcement activity to increase across the board as the Gary Gensler-led Commission and the Gurbir Grewal-led Enforcement Division gain their footing.

Among these signs is the Commission's aggressive commitment to regulation and enforcement in emerging areas of securities law. For example, in May, the Enforcement Division announced the allocation of 20 additional positions to the unit responsible for protecting investors in crypto markets and from cyber-related threats, nearly doubling the size of that unit.[2] This announcement followed the SEC's groundbreaking proposed rule on climate risk disclosure, which, if adopted, we anticipate will lead to enforcement activity in the coming years.[3]

We anticipate that going forward, an aggressive approach will be applied more broadly, including to more traditional areas of SEC enforcement activity. For example, in public comments near the end of 2021, Grewal announced that the SEC will, "in appropriate circumstances, be requiring admissions in certain cases where heightened accountability and acceptance of responsibility are in the public trust."[4]

This update discusses enforcement actions from January through July 2022 with an emphasis on financial reporting and disclosure fraud cases. It also touches on a recent decision by the United States Court of Appeals for the Seventh Circuit regarding the scope of injunctive relief as a remedy in enforcement actions.

## FINANCIAL REPORTING CASES

- On January 28, 2022, the SEC announced a settled fraud case with a technology start-up that allegedly engaged in a scheme to boost the company's valuation to more than $1 billion by inflating key financial metrics and doctoring internal sales records. According to the complaint, the company and its former CEO used its inflated valuation and financials to deceive investors to invest more than $80 million between 2018 and 2020. The alleged scheme unraveled following an internal investigation that resulted in the swift ouster of the CEO, a revised valuation of the company down to $300 million, and repayment of investors. Among other remedial measures, the company hired new senior management, expanded its board of directors, and instituted new procedures to ensure the transparency and accuracy of deal reporting and associated revenues. Without admitting or denying the allegations, the company agreed to be permanently enjoined from violating the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. The SEC imposed no financial penalties on the company as part of the settlement. The SEC has filed a separate enforcement action against the former CEO.[5]

- On February 22, 2022, the SEC instituted settled proceedings against a health care products company and two former employees for improperly leveraging its foreign exchange rate convention ("FX Convention"), resulting in material misstatements in its public filings. According to the SEC, from at least 1995 through July 2019, the company improperly leveraged its FX Convention by engaging in intra-company transactions for the purpose of generating foreign exchange accounting gains or avoiding foreign exchange accounting losses ("FX Transactions"). This FX Convention allegedly was not in accordance with GAAP, and had the effect of materially misstating the company's reported net income. The company subsequently conducted an internal investigation concerning these transactions, and restated its financial statements, reducing its previously reported net income for 2017 through June 30, 2019, and retained earnings as of January 1, 2017, by $582 million, collectively. Of this amount, $517 million was tied to the foreign exchange gains and losses dating back to 2010, which was partially attributable to FX transactions. The SEC alleged that the company violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and various rules thereunder. The SEC alleged the former employees violated Sections 17(a)(2) and 17(a)(3) of the Securities

Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and various rules thereunder. Without admitting or denying the SEC's allegations, the company agreed to cease and desist from further violations and to pay a civil penalty of $18 million. The first former employee agreed to cease and desist from further violations, to pay disgorgement and prejudgment interest of roughly $89,000, and to pay a civil penalty of $100,000. The second former employee agreed to cease and desist from further violations and to pay a civil money penalty of $125,000.[6]

- On April 18, 2022, the SEC instituted settled proceedings against a pest control services company and its former CFO. The SEC alleged that the company made unsupported reductions to its accounting reserves in an amount sufficient to allow the company to round up its reported EPS to the next penny without conducting an analysis of the appropriate accounting criteria under GAAP, and without adequately memorializing the basis for the CFO's decision to reduce accounting reserves. Additionally, the SEC alleged that the company made other accounting entries without adequate supporting documentation in multiple quarters from 2016 through 2018. Thus, the SEC alleged that the company violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 13(a), 13(b)(2)(A), 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, 13a-13, and 13a-15(a) thereunder. The SEC further alleged that the former CFO violated Sections 17(a)(2) and 17(a)(3) of the Securities Act; and Section 13(b)(5) of the Exchange Act, and Rule 13b2-1 thereunder. The company and the former CFO agreed to cease and desist from future violations and to penalties of $8,000,000 and $100,000, respectively. This resolution marked the fourth resolution under the SEC's EPS initiative, which we have discussed at length in previous editions of this publication.[7]

- On June 7, 2022, the SEC instituted settled proceedings against a technology company that allegedly engaged in certain instances of improper accounting, resulting in material misstatements in its public filings. The company allegedly improperly recognized revenue by (i) recognizing revenue upfront when it was instead contingent on future events; and (ii) immediately recognizing revenue for software licenses with multiyear related supporting services instead of recognizing this revenue ratably over the term of the arrangements. The company subsequently revised its financial statements to restate approximately $190 million in cumulative revenues. The SEC alleged that the company violated Section 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder; Section 13(a) of the Exchange Act and various rules thereunder; and Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. To settle the charges, the company agreed to cease and desist from future violations and to a civil money penalty of $12,500,000. The SEC also brought settled proceedings relating to the alleged misconduct against the company's former general counsel, several former senior employees of the company, and one current employee of the company.[8]

- On June 8, 2022, the SEC announced settled proceedings against a medical supply company, its former CEO and chairman, and its former COO. The SEC alleged that the company and these individuals defrauded investors by materially inflating the company's financial results in its 2017 and 2018 filings by engineering two fraudulent sales transactions that the company reported in publicly filed financial statements. In the first sales transaction, the former CEO and former COO allegedly produced a backdated sham purchase order for product that was quickly canceled and that the company never shipped. In the second transaction, the former CEO and former COO allegedly orchestrated a purported sale of a large amount of product to a customer who had never ordered it. The former CEO and former COO allegedly directed the company to report these fraudulent sales as revenue and receivables in the company's 2017 and 2018 Forms 10-Q and 10-K.

  The SEC thus alleged that the company, the former CEO, and the former COO directly violated or aided and abetted violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the reporting, books and records, and internal controls provisions of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 thereunder. It also alleged that the former CEO and former CFO violated Section 13(b)(5) of the Exchange Act and Rule 13b2-1 thereunder and lied

to accountants in violation of Exchange Act Rule 13b2-2, and that the former CEO violated the certification provision of Rule 13a-14 and the insider security ownership filing requirements of Section 16(a) of the Exchange Act and Rule 16a-3 thereunder. Without admitting or denying the allegations, the company, former CEO, and former COO consented to the entry of final judgments, subject to court approval, which would result in permanent injunctions, civil penalties of $450,000 against the company, $240,000 against the former CEO, and $225,000 against the former COO, director-and-officer bars against the former CEO and former COO, and reimbursement of $1,010,976.15 by the former CEO of profits from his sales of company stock pursuant to the clawback provisions of Section 304(a) of the Sarbanes-Oxley Act of 2002.[9]

- On July 1, 2022, the SEC instituted settled proceedings against a foreign private issuer and its CFO relating to the issuer's reporting regarding its compliance with a finance contract it entered into with the European Investment Bank ("EIB"), and for the state of its internal accounting controls. One provision of the company's contract with the EIB allegedly was a requirement that the company comply with debt covenants, one of which was a ratio of Total Net Financial Debt to EBITDA. Ultimately, the company allegedly breached the EBITDA Covenant, but it allegedly did not disclose this on its financial statements. Instead, the company's financial statements allegedly each represented that they were prepared in accordance with disclosure requirements for interim financial reporting purposes specified by International Accounting Standards (IAS) 34. However, because the company allegedly failed to disclose the EBITDA Covenant breach, the financial statements were allegedly not prepared in accordance with the requirements of IAS 34. Further, the company allegedly recorded the debt as a noncurrent liability, when it should allegedly have been classified as a current liability. The SEC alleged that the company violated Section 13(a) of the Exchange Act and Rules 13a-16 and 12b-20 thereunder, which contain requirements for filing reports and mandate that periodic reports contain any further material information necessary to make the required statements not misleading. The SEC also alleged violations of books and records requirements, as well as violations of Section 13(b)(2)(B)'s requirements for internal accounting controls. The SEC further alleged that the CFO caused each of these violations. The issuer and its CFO agreed to cease and desist from further violations, comply with certain undertakings, and pay civil money penalties in the respective amounts of $175,000 and $50,000. The SEC noted the issuer's cooperation and remedial actions as mitigating factors.[10]

## DISCLOSURE FRAUD CASES

- On February 17, 2022, the SEC announced litigation against a company that produces and distributes specialty pharmaceutical products, its CEO, its consultant, and three penny stock promoters. The defendants allegedly conducted a "pump-and-dump" scheme to artificially inflate the company's stock price. The first part of the alleged scheme consisted of the company, through its CEO, preparing false and misleading press releases and SEC filings pertaining to the company's emergency use authorization submissions to the FDA for three COVID-19 tests. The second part of the alleged scheme involved a comprehensive promotional campaign where the company utilized a stock promotion firm to promote the sale of shares to potential investors, but the stock promotion firm failed to disclose that it was being compensated by the company for this promotion, and failed to disclose that the CEO and its consultant planned to sell their company shares. As a consequence of the two-part scheme, they collectively sold at least $1.95 million worth of company shares. The SEC's complaint charged all defendants with violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The SEC is seeking permanent injunctions and monetary penalties against all defendants, disgorgement with prejudgment interest against the CEO and the promoters, and a director-and-officer bar against the CEO. The U.S. Attorney's Office for the Southern District of California has announced parallel criminal charges.[11]

- On April 18, 2022, the SEC announced litigation against a former executive of a Brazilian reinsurance company for allegedly planting a false story with the media and disseminating false documents claiming that a major financial

institution had recently made a substantial investment in the company. The SEC's complaint alleges that following a significant decline in the company's stock price, the executive created and shared with investors false information indicating that a major financial institution had made substantial purchases of the company's stock. The executive allegedly communicated the false information to analysts and investors in both the United Kingdom and the United States. According to the SEC, the company's stock price rose by more than 6% during the 24-hour period following U.S. and Brazilian media reports that the financial institution had invested, and subsequently dropped by more than 40% after the financial institution denied a week later that it had invested. The SEC alleges violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and seeks civil money penalties as well as a director-and-officer bar. The U.S. Department of Justice announced parallel criminal charges.[12]

- On May 31, 2022, the SEC filed a complaint against a publicly traded grocer that operates wholesale businesses and retail supermarkets across New York, Massachusetts, and Florida, and its CEO, alleging that the company and its CEO failed to properly disclose numerous related party transactions between the company and entities related to the CEO and the CEO's brother. The complaint alleges that the company's financial statements were materially misstated in 2016, 2017, 2018, 2019, and 2020. For example, between 2017 and 2020, a significant percentage of accounts receivable (between 18% to 54%) were attributable to undisclosed related party transactions. Moreover, between 2016 and 2020, the company allegedly failed to disclose more than $12 million in payments to a company owned by the CEO's brother. The SEC alleged that these omissions by the company and the CEO, who closely controlled the company's operations and financial information, deprived investors of an accurate picture of the relationship between the company and the CEO's business interests. The SEC thus alleged that the company violated Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20 and 13a-1 thereunder. The SEC also alleged that the CEO violated and aided and abetted violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and that the CEO aided and abetted the company's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder. The SEC seeks injunctive relief, disgorgement with prejudgment interest, and civil monetary penalties against all defendants, and a director-and-officer bar against the CEO.[13]

- On June 13, 2022, the SEC instituted settled proceedings against a publicly traded company that develops tar sands, mining, and process technology, and its former executive chairman. The SEC alleged that the company and former chairman made materially false and misleading disclosures in the company's SEC filings about related party transactions, the company's assets, and the former chairman's receipt and use of company funds. Specifically, the SEC alleged that the company's filings failed to disclose the related party nature of multiple transactions, including the company's payment of $23.8 million in cash and stock for rights to mine tar sands in Utah. The companies from which the company purchased these rights were "related" because they and their affiliates controlled large blocks of the company's stock. Much of the funds that the company paid for the rights made their way back to the company and former chairman in round-trip transactions, but these facts were not disclosed in the company's filings. Additionally, the rights were subject to various undisclosed risks, contingencies, and costs that may prevent the company from ever exercising the rights, but the company's 10-K filings for 2019, 2020, and 2021 valued the rights at the full purchase price of $23.8 million. The SEC also found that the former chairman directed undisclosed transfers of more than $3 million of company funds to himself, his relatives, and his former domestic partner. The SEC alleged that the company violated Sections 5(a), 5(c), and 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, and 13a-15(a) thereunder. To settle these allegations, the company agreed to a cease-and-desist order and remedial undertakings, as well as a $1 million civil penalty. The SEC also alleged that the former chairman violated Sections 5(a), 5(c), and

17(a) of the Securities Act and Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13a-14, 13b2-1, and 13b2-2 thereunder, and caused the company's 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 various rules thereunder. The former chairman agreed to a cease-and-desist order, a director-and-officer bar, a $450,000 civil penalty, and disgorgement and prejudgment interest in an amount subject to further proceedings.[14]

The SEC also filed a complaint against the former CFO of the company alleging that the former CFO's reckless or, at minimum, negligent execution of his duties led to the company's alleged violations. The complaint alleges that the CFO failed to consider whether the mining rights were appropriately priced and analyzed for impairment, and was at least negligent in not inquiring into or disclosing the multiple transactions benefiting the former chairman, his relatives, and former domestic partner. The SEC thus alleges that the former CFO violated Section 17(a)(3) of the Securities Act and Section 13(b)(5) of the Exchange Act and Rules 13a-14 and 13b2-1 thereunder, and that he aided and abetted the company's violations of Exchange Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B), and Rules 12b-20, 13a-1, 13a-13, and 13a-15(a) thereunder. The SEC seeks permanent injunctive relief against the CFO and a civil monetary penalty.[15]

- On July 28, 2022, the SEC announced litigation against a health care management company, its CEO, and a former director of the company for issuing press releases and tweets falsely claiming that the company was actively negotiating a merger and planning to issue dividends. According to the SEC, the CEO and former director also promoted the nonexistent merger by issuing a public letter falsely claiming that the former director and another director had purchased millions of shares of the company. The SEC's complaint also alleges further acts by the former director, such as impersonating a chiropractor to promote the company on a radio talk show, misleadingly posing as an unaffiliated investor, and using a pseudonym to post false and misleading statements promoting the merger and insider purchases on an Internet chat board. The SEC thus alleged violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder against each of the defendants. The former director consented to the entry of a judgment that imposes a permanent injunction, $5,256 in disgorgement plus prejudgment interest thereon, a $120,000 penalty, a director-and-officer bar, and a penny stock bar. Litigation remains ongoing against the company and its CEO.[16]

## SCOPE OF SEC INJUNCTIVE RELIEF – *SEC V. GOULDING*

As evident from the cases discussed above, the SEC often seeks an injunction from future violations of the securities laws against defendants. On July 8, 2022, the United States Court of Appeals for the Seventh Circuit issued an opinion in *SEC v. Goulding*, 40 F.4th 558 (7th Cir. 2022), addressing the appropriate scope of such injunctions. In *Goulding*, an investment advisor was held liable for defrauding investors, and the district court imposed injunctive relief enjoining the defendant from further violations of the securities laws. The defendant appealed, arguing in relevant part that the district court had abused its discretion by issuing an "obey-the-law injunction" that "simply repeat[ed] a statute."

The Seventh Circuit agreed with the defendant, holding that "the judge could and should have forbidden with greater specificity what [the defendant] must not do." *Id*. To that end, the court noted that the defendant was likely to face a stricter injunction when the case was remanded. *Id*. While this issue has been litigated on several occasions in the last few decades, it remains to be seen whether the SEC will use *Goulding* to commonly seek more specific and stricter injunctive relief than its longstanding practice of seeking "obey-the-law" injunctions.

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## ENDNOTES

1 *SEC Enforcement In Financial Reporting And Disclosure: Year-End 2021 Update; SEC Enforcement In Financial Reporting And Disclosure: Summer 2021 Update*.

2 "SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit" (May 3, 2022).

3 Jones Day issued a comment letter on the SEC's proposed climate-related disclosure rules on June 16, 2022. *See https://www.jonesday.com/en/insights/2022/06/jones-day-submits-comment-letter-on-secs-proposed-climaterelated-disclosure-rules*.

4 https://www.sec.gov/news/speech/grewal-sec-speaks-101321

5 Litigation Release No. 25320 (Jan. 28, 2022).

6 "SEC Charges Health Care Co. and Two Former Employees for Accounting Improprieties" (Feb. 22, 2022); Exchange Act Release No. 94294 (Feb. 22, 2022).

7 "Atlanta-Based Pest Control Company, Former CFO Charged with Improper Earnings Management" (April 18, 2022); *See also SEC Enforcement In Financial Reporting And Disclosure: Year-End 2020 Update*.

8 "SEC Charges New Jersey Software Company and Senior Employees with Accounting-Related Misconduct" (June 7, 2022).

9 Litigation Release No. 25413 (June 8, 2022).

10 "SEC Files Settled Charges Against voxeljet AG and Its CFO Rudolf Franz; Notes Self-Reporting, Cooperation, and Remediation" (July 1, 2022).

11 Litigation Release No. 25332 (February 17, 2022).

12 Litigation Release No. 25370 (April 18, 2020).

13 Litigation Release No. 25404 (June 1, 2022).

14 Litigation Release No. 25419 (June 14, 2022).

15 *Id*.

16 Litigation Release No. 25456 (July 28, 2022).