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SEC Enforcement Update

The SEC Speaks in 2014: Beware the Data Crunchers

Even more notable to securities practitioners than the attendance of Mark Cuban at this year's SEC Speaks event (held in Washington, D.C. on February 21-22, 2014) was the start-to-finish focus of the Enforcement Division on data, data, data. Beginning with Chair Mary Jo White's kick-off address, and extending throughout the two-day event, the Commission and its staff lauded the SEC's increasing efforts to identify "trends," "aberrations," "areas of risk," and investigative leads from the vast troves of public company disclosures and trading data the SEC routinely collects. Particularly when it comes to financial reporting, public companies—along with their executives, attorneys, and auditors—are likely to find themselves at increased risk of Enforcement scrutiny if their financial statements stand out from the pack.

Touting a record $3.4 billion in disgorgement and civil penalties ordered during the SEC's 2013 fiscal year, Chair White highlighted Enforcement's relatively new Financial Reporting and Audit Task Force ("FRA Task Force"). This task force was formed "to look at trends or patterns of conduct that are risk indicators for financial fraud, including in areas like revenue recognition, asset valuations, and management estimates."[1] It is reminiscent of an earlier effort developed by Enforcement's Asset Management Unit that focused specifically on identifying what the SEC viewed as "aberrational" hedge fund performance. One former SEC Commissioner described this so-called Aberrational Performance Inquiry as "an analytical model that uses performance data to identify hedge fund advisers worthy of further review." She warned, for example, that "if an equity fund consistently outperforms similar funds over a period of years or as suspiciously consistent, positive results, it would be identified and examined."[2]

Critics of this approach charged the SEC with using its considerable Enforcement heft to penalize success—that is, having the ostensibly desirable goal of a hedge fund out-performing its peers lead to potential SEC investigation. But the SEC appears not to have been swayed. In press releases and other public statements, Enforcement officials have praised the Aberrational Performance Inquiry as being responsible for several successful enforcement actions, the most recent being a December 2013 settlement in which London-based hedge fund adviser GLG Partners L.P. agreed to pay $9

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million for alleged internal controls failures that caused an overvaluation of the fund's investments.[3]

The concept of using data-mining to focus Enforcement efforts appears now to have spread far beyond hedge funds. In describing the priorities of the Enforcement Division's Complex Financial Instruments Unit, Chief Michael Osnato described how that unit would synthesize data from a variety of sources to identify areas of potential focus as it shifts past the concerns of the recent credit crisis. Osnato explained that his unit might, for example, use data to find situations in which complex products represent a disproportionate share of certain investors' assets.

David Woodcock, Chair of the FRA Task Force, echoed the skepticism expressed by other SEC staff members that recent decreases in financial reporting and accounting cases were wholly due to the success of laws like Sarbanes-Oxley. Woodcock said he was confident that as long as there are "human beings running companies, there will be fraud." The FRA Task Force is dedicated to using data-based analytical inquiries and other resources to more quickly identify potentially "risky" companies that are "worth investigating."

One resource described by Woodcock is the Accounting Quality Model ("AQM") being developed by the SEC's Division of Economic and Risk Analysis ("DERA"). In a much-discussed speech given in December 2012, DERA Director Craig Lewis (who has since announced that he will be returning to academia) described the AQM as "being designed to provide a set of quantitative analytics that could be used across the SEC to assess the degree to which registrants' financial statements appear anomalous," in other words whether they "stick out from the pack."[4] Details about the AQM remain murky, but the model appears to focus on the same kinds of data used by other earnings quality tools to attempt to identify companies where there is an unusually large difference between so-called accounting or "book" income, and actual cash flows, and where that difference could be due largely to management's discretionary accounting judgments. According to Division of Corporation Finance Chief Accountant Mark Kronforst, the AQM is still in development and not currently being used. However, with the perceived success of the prior Aberrational Performance Inquiry, one would guess that Enforcement is anxious to take the new AQM out for a spin.

Woodcock made clear that the AQM is not the sole focus of the FRA Task Force, whose work is current and ongoing. The Task Force aims to draw from a larger set of data—including information gleaned from academia, whistleblowers, and past and ongoing SEC investigations—to look at different accounting issues as they affect particular industries, and to identify risky companies that otherwise would have gone unidentified "until something catastrophic happens."

It is difficult to predict what impact Enforcement's data-mining strategies will have on future financial fraud and accounting cases. The SEC appears to recognize that one distinct advantage it enjoys over other regulators and law enforcement agencies is the mandatory financial data that public companies are required to report to the SEC in an XBRL format that lends itself to instantaneous slicing and dicing through computer-driven analysis. What is certain is that the SEC will seek to leverage every advantage it has—whether it is troves of public company information, a whistleblower program offering monetary bounties to incentivize company employees and others to report alleged fraud, or a staff that is growing increasingly sophisticated in isolating key risk indicators from large pools of financial and other data—to prove that it remains a relevant and effective agency in pursuing its core mission of protecting investors. Companies would be well-advised to consider how their own financial reporting might attract Enforcement scrutiny, and to take proactive steps to address any issues and ensure that any SEC staff inquiry can be met with a swift and convincing response.

If you would like to discuss any of these issues, or if you have other questions about the SEC or its Enforcement program, please do not hesitate to contact us.

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[1] Mary Jo White, Chairman, SEC, Chairman's Address at SEC Speaks 2014 (Feb. 21, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370540822127.

[2] Elisse Walter, Chairman, SEC, Harnessing Tomorrow's Technology for Today's Investors and Markets at American University School of Law (Feb. 19. 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1365171492300.

[3] See SEC Release No. 2013-259, available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540491613.

[4] Craig Lewis, Chief Economist & Director, Division of Risk, Strategy, & Financial Innovation, SEC, Risk Modeling at the SEC: The Accounting Quality Model at Financial Executives International Committee on Finance and Information Technology (Dec. 13, 2012), available at: http://www.sec.gov/News/Speech/Detail/Speech/1365171491988.