PUBLICATION

Recent SEC Enforcement Actions Impact Compliance Landscape [Ober|Kaler]

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A periodic bulletin keeping small businesses informed about current developments in securities law and related matters.

There was not a lot of Securities and Exchange Commission (SEC) activity this past Spring and Summer that was directly relevant to most small and medium-sized SEC reporting companies, with the SEC focusing on credit ratings and credit rating agencies, security-based swaps, money market fund reform and asset-backed securities disclosure and registration. We are still waiting for final rules on CEO pay ratio disclosure and proposed rules on pay-for-performance and hedging disclosure as well as on issuer clawback of erroneously paid executive incentive-based compensation emanating from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Nevertheless, there were two important SEC enforcement actions of which SEC reporting companies and their executive officers and directors should be aware. We discuss these, as well as other relevant developments, below.

Late Section 16(a) Reports No Longer a Matter of Just “Name and Shame

Last month, the SEC announced that it had charged 28 officers, directors and major stockholders of SEC reporting companies for the failure to timely file reports of beneficial ownership required under Sections 16(a) (Forms 3, 4 and 5) and 13(d) (Schedules 13D and 13G) of the Securities Exchange Act of 1934 (Exchange Act). In addition, the SEC charged six SEC reporting companies “for contributing to the filing failures by insiders or failing to report their insiders' filing delinquencies.” In the former case, the companies had agreed to assist their insiders with these filings and to make such filings on their behalf, as is common, but that agreement to assist triggered an enforcement action against the companies despite the fact that the filing obligation is the individuals' responsibility. Thirty-three out of 34 of the defendants settled and agreed to financial penalties totaling $2.6 million. The 13 individuals who were named in the SEC's orders paid penalties ranging from $25,000 to $100,000, while the companies paid penalties of either $75,000 or $150,000.

The SEC's press release announcing the enforcement actions notes that “[t]he failure to timely file a required beneficial ownership report, even if inadvertent, constitutes a violation of” the relevant provisions of the Exchange Act. While this has always been the case, historically the SEC had not brought enforcement actions solely for missed filings, instead bringing these actions in conjunction with a fraudulent action or other substantive violation, such as insider trading, in which the failure to file the required forms had been a part. As a result, the only practical impact of these missed filings was that SEC reporting companies, as required under Item 405 of Regulation S-K, were required to note in their annual report on Form 10-K or annual proxy statement whether any of their officers, directors and major stockholders had filed any late Section 16(a) reports. Companies often agreed to assist their insiders in making such reports in order, among other things, to avoid the embarrassment of listing late filings in their reports. With this enforcement action, however, this long-standing rubric has changed. It is true that the subjects of this action appear to be extreme cases – repeated late filings that were, as noted in the press release, “weeks, months, or even years” late. The SEC's action in bringing these charges, however, emphasizes that the enforcement staff is acting in accordance with Chair White's 2013 broken windows speech in which the Chair noted her belief that it was important for the SEC to pursue even the smallest infractions of federal securities laws. Therefore, future actions in this regard, while we believe are unlikely to focus on one or two missed filings, may not focus on only the most egregious cases as seems to have been the case here. SEC reporting companies and their officers, directors and significant stockholders need to keep in mind that the standard narrative surrounding the late filing of beneficial ownership reports has changed, and that late reports can now reasonably potentially result in SEC enforcement action and fines instead of just having to publicly disclose such late filings. As a result, SEC reporting companies and their management need to ensure that they have adequate procedures in place to ensure the timely filing of beneficial ownership reports as well as the disclosure of late-filed reports.

Internal Control Violations Result in Enforcement Action Against CEO and CFO

In July, the SEC announced charges against the CEO and CFO of QSGI Inc., an SEC reporting company, for "misrepresenting to external auditors and the investing public the state of its internal controls over financial reporting." According to the SEC, QSGI's CEO and CFO represented in the management's report on internal control over financial reporting (ICFR) included in QSGI's 2008 Form 10-K that they had participated in management's evaluation of ICFR when in fact the CEO had not so participated. Each officer also falsely certified that they had "evaluated the report and disclosed all significant deficiencies in internal controls to the outside auditors." According to the SEC, the latter was untrue because the CEO and CFO had in fact misled the auditors by withholding information regarding inadequate inventory controls; they also withheld from the auditors and investors that the CEO was directing and the CFO participating in a series of maneuvers to accelerate the recognition of certain inventory and accounts receivables in QSGI's books and records by up to a week at a time. According to the SEC, "the[se] improper accounting maneuvers, which rendered QSGI's books and records inaccurate, were performed in order to maximize the amount of money that QSGI could borrow from its chief creditor."

This matter involved direct fraudulent conduct and is therefore more typical of SEC enforcement actions than the Sections 13(d) and 16(a) actions discussed above. It is notable, however, that while the SEC stated in its order [PDF] against QSGI's CEO that the acceleration of the receivables "would have had the effect of improperly increasing revenue," it did not actually charge that it did so or allege any financial statement fraud, which would be typical in an enforcement action in this area. Rather, the focus was primarily on ICFR and the related management's report and Sarbanes-Oxley certifications. Thus, this action serves as a reminder to SEC reporting companies and their management of the need to take seriously their ICFR and representations regarding ICFR, and that the violation of ICFR requirements is a violation of the Exchange that can trigger an SEC enforcement action regardless of the impact on the financial statements a company files with the SEC in its Exchange Act reports.

NASDAQ's New All-Inclusive Fee; Auditing of Related Party Transactions

The Nasdaq Stock Market LLC (Nasdaq) is revising its fee structure to implement an all-inclusive annual listing fee beginning in 2015. Under this fee structure listed companies will pay no additional fees to list additional shares, change their name or trading symbol, request a written rule interpretation of make any other corporate changes. The new structure is optional for listed companies until 2018, at which point it will become mandatory. Listed companies can opt in to the annual fee structure early by completing the All-Inclusive Annual Listing Fee Opt-in Form electronically through the NASDAQ OMX Listing Center by December 31, 2014. In order to encourage listed companies to do so, Nasdaq is guaranteeing that even if such a company issues additional shares that would normally move it to a higher billing tier, its all-inclusive fee will not increase until at least 2018. In addition, listed companies will not be charged any fees for listing additional shares in 2014 after they submit the opt-in form. Companies that list on Nasdaq after January 1, 2015 will be required to pay the all inclusive fee.

Finally, in June, the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 18, *Related Parties*, and amendments to three other auditing standards. According to the PCAOB news release on the new standard, the purpose of the new standard and amendments is "to strengthen auditor performance requirements in three critical areas of the audit: related party transactions, significant unusual transactions, and a company's financial relationships and transactions with its executive officers." The new standard requires enhanced audit procedures with respect to transactions between a company and its related parties, while the amendments include specific audit procedures to assist auditors in identifying and evaluating unusual transactions. If approved by the SEC, which we expect, the new standard and amendments will be effective for audits of financial statements and reviews of interim financial information for fiscal years beginning on or after December 15, 2014 or, for calendar year-end companies, beginning with the first quarter of 2015. As a result, SEC reporting companies can expect heightened scrutiny of their related-party transactions and relationships and any significant unusual transactions during their audit or auditor review of financial information.