To Our Clients and Friends

Memorandum

SEC Imposes Civil Penalties for Ongoing Violations Relating to Internal Control Over Financial Reporting

On January 29, 2019, the Securities and Exchange Commission (Commission) announced cease-and-desist orders and monetary penalties ranging from $35,000 to $200,000 in connection with four civil enforcement actions against issuers relating to ongoing failures to comply with the rules relating to internal control over financial reporting (ICFR).

Internal control over financial reporting is defined by the Exchange Act as a "process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles."[1] Generally, effective ICFR indicates that an issuer's financial reporting and preparation of financial statements are reliable. If one or more material weaknesses exist, the issuer's ICFR cannot be considered effective.[2]

The four issuers against whom the Commission brought enforcement actions had each reported material weaknesses for several years, with the same material weaknesses frequently reappearing in subsequent disclosures, even after the Commission contacted the issuers about these deficiencies. In bringing the enforcement actions, the Commission noted that the extent and persistence of the material weaknesses over a period of years highlighted the issuers' failure to address appropriately, and in some periods to assess adequately, their ongoing ICFR failures.

While three of the four issuers had remediated their material weaknesses before the Commission brought actions against them, the Commission nonetheless filed the complaints because of the persistent failure of these issuers to address the deficiencies in an appropriate and timely manner.

Set forth below is a brief summary of each of the enforcement actions, as alleged by the Commission:

- An OTC-traded issuer disclosed material weaknesses in each of its Form 10-Ks from 2008 through 2016 and included the same boilerplate description of material weaknesses for those

1 See Exchange Act Rules 13a-15(f) and 15d-15(f).

2 See Paragraph 2 of PCAOB Auditing Standard No. 5.

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periods. The issuer did not begin remediation efforts until 2012 and did not fully remediate its material weaknesses until May 31, 2017.

- A NASDAQ-traded issuer disclosed material weaknesses in each of its Form 10-Ks from 2007 through 2016, and had three financial statement restatements in the same period. The issuer did not begin remediation efforts until 2013 and did not fully remediate its material weaknesses until the fiscal year ended December 31, 2017.
- A NASDAQ-traded issuer disclosed material weaknesses in each of its Form 10-Ks for its fiscal years 2011 through 2017. The issuer did not begin remediation efforts until 2012 and did not fully remediate its material weaknesses until the end of its 2018 fiscal year.
- A NYSE-traded issuer disclosed material weaknesses in each of its Form 10-Ks from 2008 through 2017 and, in two of those years, failed to complete the required ICFR management evaluations. The issuer did not begin remediation efforts until 2016 and is still in the process of remediating its material weaknesses.

These cases highlight the Commission's continuing focus on internal control deficiencies and put reporting issuers on notice that boilerplate disclosures and failures to take effective action to address known deficiencies will potentially subject the issuer to significant Commission scrutiny. In light of the sustained regulatory focus in this area, issuers and their financial reporting teams should discuss plans with their auditors and legal counsel to ensure that procedures are in place to evaluate on an ongoing basis the sufficiency and effectiveness of ICFR. Additionally, these recent enforcement actions highlight the need for issuers to remediate any ICFR shortcomings promptly.

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Authors

Lee T. Barnum

Una A. Dean

Brian B. Margolis

Evan Ewing

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

New York

Andrew B. Barkan	+1.212.859.8468	andrew.barkan@friedfrank.com
Lee T. Barnum	+1.212.859.8883	lee.barnum@friedfrank.com
Daniel J. Bursky	+1.212.859.8428	daniel.bursky@friedfrank.com
Joshua T. Coleman	+1.212.859.8633	joshua.coleman@friedfrank.com
Mark S. Hayek	+1.212.859.8890	mark.hayek@friedfrank.com
Meredith L. Mackey	+1.212.859.8974	meredith.mackey@friedfrank.com
Joshua Wechsler	+1.212.859.8689	joshua.wechsler@friedfrank.com

London

Ashar Qureshi	+44.20.7972.9173	ashar.qureshi@friedfrank.com