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What Financial Regulators Are Focused on This Season

On March 11, Skadden presented a seminar titled "What Financial Regulators Are Focused on This Season." Areas of focus for 2015 included: offshore cash reserves, tax rate reconciliation in MD&A, accounting cases, contingent liability disclosures, Dodd-Frank's swap rules, Dodd-Frank's whistleblower provisions and insider trading.

Panelists included Wayne Carnall, partner at PwC and former chief accountant of the Division of Corporation Finance at the U.S. Securities and Exchange Commission (SEC); Patrick Fitzgerald, partner in Skadden's Government Enforcement and White Collar Crime practice and former U.S. attorney; David Meister, partner in Skadden's Government Enforcement and White Collar Crime practice and former enforcement director of the U.S. Commodity Futures Trading Commission (CFTC); Erich Schwartz, partner in Skadden's Securities Enforcement and Compliance practice and former assistant director in the Division of Enforcement at the SEC; and Meg Wright, director, associate general counsel and assistant corporate secretary at CME Group Inc. Brian V. Breheny, partner in Skadden's Mergers and Acquisitions and Securities Regulation practices and former deputy director of Legal and Regulatory Policy at the SEC, moderated the discussion.

Offshore Cash Reserves

Wayne identified offshore cash as an area of heightened scrutiny from SEC accountants. U.S. companies continue to carry record amounts of cash on their balance sheets that are held offshore by foreign subsidiaries. If the cash is held offshore and is likely to be repatriated to the U.S., companies must record a provision for taxes. If a company asserts that foreign earnings are permanently reinvested and the cash is not likely to be repatriated, no tax provision needs to be recorded. If a company asserts that it will not repatriate the cash, companies should evaluate the impact on their discussion of liquidity in the management discussion and analysis (MD&A). This would frequently include disclosing the amount of cash held offshore. The staff may also question the company's assertion about not repatriating cash if it appears the company needs the cash for liquidity purposes. This could result in the company recording a tax provision. The SEC accountants may question a company that asserted that its foreign earnings are permanently reinvested when it subsequently repatriates cash.

Tax Rate Reconciliation in MD&A

Wayne continued by stating that SEC accountants will frequently request the company to provide a discussion in the MD&A about the effective tax rate reconciliation. Regulation S-X requires a company to provide reconciliation from the federal statutory tax rate to the effective tax rate. It is important for a company to discuss the nature of the reconciling items that are not otherwise obvious from the financial statement disclosure. For example, some of the reconciling items may be unique to a particular year while others will have a continuing impact on the company. It is important for a reader to understand the nature of these items, as they will have an impact on the sustainability of profits.

SEC's Focus on Accounting Cases

Erich provided an overview of recent trends in SEC enforcement. Before the financial crisis, accounting cases made up approximately one-third of the SEC enforcement division's docket. That fell to about 10 percent during the crisis. Recently, the SEC's enforcement division has expressed renewed interest in such matters. Among its initiatives is a new Accounting and Audit Task Force, whose purview is to incubate accounting cases by analyzing broad trends in accounting disclosures. Second is a data mining group that analyzes all data submitted to the SEC. The enforcement division has direct access to the results of the data mining and intends to work closely with the data analytics teams to identify matters for investigation. Though the types of cases that will result from these new efforts is not clear, the SEC's renewed focus on accounting cases is notable.

Contingent Liability Disclosures

Next, the panel discussed the disclosure of contingent liabilities. As recently as 2010, this was a hot topic for the SEC staff. Wayne noted that the staff's focus here has recently subsided, but it remains an area of interest. Specifically, the staff is interested in the disclosure of a specific dollar amount and the likely timing of the liability. For example, for a liability relating to the Foreign Corrupt Practices Act, a company should record as an expense the minimum amount that it knows it will pay to settle the investigation. The company can then disclose the maximum penalty it might pay, without booking that maximum amount.

Erich noted a recent willingness by the SEC staff to investigate the reasonableness of judgmental accounting determinations and second-guess such judgments.

Dodd-Frank's Swap User Rules and the CFTC

David started the discussion of the Dodd-Frank Act. Under Dodd-Frank, which gave the CFTC jurisdiction over the entire derivatives markets, the CFTC has adopted more than 70 rules relating to derivatives markets. Among the most important of these is one that mirrors longstanding SEC Rule 10b-5. This new CFTC rule has both anti-fraud and anti-manipulation applications, and could be used to bring insider trading-like charges in the future. Any company that uses swaps should be cognizant of the CFTC's anti-fraud rules. David expects the CFTC staff to bring anti-fraud cases in the near future.

Dodd-Frank's Whistleblower Provisions as Impetus for SEC Action

Erich pointed out the significant financial incentives Dodd-Frank created for whistleblowers. The SEC and CFTC will pay 10 percent to 30 percent of sanctions to whistleblowers who bring forth qualifying tips, where the resulting case leads to more than $1 million in government sanctions. There is a statutory entitlement to a minimum of 10 percent of the sanctions awarded if the relevant requirements are met, even if the whistleblower spends only a brief amount of time making the complaint.

The SEC enforcement division, according to Erich, believes that the number of tips and quality of tips regarding financial fraud has improved as a result of the whistleblower rules. In 2014, the SEC made 14 payments to whistleblowers, including one for $30 million.

Companies should be mindful that employees face powerful incentives to report irregularities to governmental authorities and work with employees so they feel welcome to report to the company before contacting the SEC.

Patrick framed the discussion in terms of making meaningful contact with whistleblowers. Many whistleblowers are disenfranchised with the organization and are cast as outsiders. Companies can be tempted to discount what whistleblowers say. This is a mistake. From the outset, a company should express a willingness to listen and in some circumstances should consider putting the employee in touch with an investigator from outside the company or another division within the company. It is better for an organization to have the chance to correct any problem on its own.

Meg noted the importance of fostering a culture of compliance within a corporation. CME has an internal helpline to which employees can anonymously report irregularities. The company closely tracks the number of calls to the helpline to determine the efficacy of its policies. The company even reports the number of calls to the Risk and Audit committees of its board of directors. Further, the board elected to participate in the same training provided to employees. This allows managers to stress to employees that compliance is an important tenet of the company, from the board of directors on down. CME also conducts exit interviews before each employee leaves the company. This provides employees an opportunity to report fraud or irregularities if the employee did not previously feel comfortable doing so. Moreover, six months after an employee leaves the company, CME sends a letter to remind employees of the mechanisms available to report fraud.

The SEC can bring an enforcement action for improper retaliation against a whistleblower. The SEC brought its first such case in 2014.

Insider Trading

Patrick noted insider trading cases will continue to be a priority for U.S. attorneys, both in New York City and elsewhere. In 2014, 52 of 66 insider trading cases were brought outside Manhattan. The New York-based cases tend to make headlines, but prosecutions will occur across the country this year. Further, despite the U.S. Court of Appeals for the Second Circuit overturning the government's convictions against Todd Newman and Anthony Chiasson, insider trading cases will generate significant prosecutorial activity in 2015. A string of 85 consecutive convictions for insider trading by Preet Bharara, the U.S. attorney for the Southern District of New York, demonstrates the appeal of these cases to prosecutors.

Although the Newman and Chiasson case has been the subject of much attention in the press about the weakening of the government's ability to prosecute insider trading, employees should be reminded that insider trading laws still apply to them.

Final Thoughts

Each panelist identified a challenge that general counsels will face in the near future.

Patrick began with cybersecurity risks. In 2008, only 8 percent of company boards had committees that focused on cybersecurity risks. Today, nearly 50 percent of them do. He said most companies have been the subject of cyberattacks. Brian noted that a company must determine whether these attacks rise to such a level that it must be disclosed in SEC filings.

David stated that companies need to focus on the steps that managers take after an employee reports fraudulent or irregular activity. Managers should ask questions such as, "Has this happened before?" and "Are other people doing this?" when an employee makes a report. Escalation is important.

Meg focused on employee awareness of corporate policies. Every company has policies. The question is whether employees take notice of them and understand them.

Erich discussed SEC enforcement to address unintentional violations. SEC Chair Mary Jo White's emphasis on "broken window" enforcement will lead to more enforcement actions for inadvertent mistakes, such as failure to file Form 4 in a timely manner. Companies should take stock of those filings they could inadvertently miss and then implement systems to prevent such oversights.

Wayne addressed the SEC's requirement for disclosure regarding internal control over financial reporting. The SEC staff is increasingly questioning a company's conclusion that it did not have a material weakness in its internal controls for financial reporting when there is an error that does not result in a restatement. A restatement generally indicates that there is a material weakness. However, the fact that a company does not restate for an error, but rather revises the financial statements or records an out-of-period adjustment, could still result in a material weakness. Companies need to evaluate these matters to determine if there is a material weakness based on what is referred to as the "could factor" — could the deficiency in controls lead to material error even if the actual error was not material.