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SEC'S Expansive View of "Accounting Controls" Draws Unusual Dissent from Two Commissioners

On October 15, 2020, the Securities and Exchange Commission issued a settled administrative order charging Andeavor LLC with failing to devise and maintain adequate internal controls surrounding its buyback of company stock pursuant to a Rule 10b5-1 plan.[1] The settlement was unusual in several respects, including its characterization of the allegedly deficient controls as "accounting controls" and the subsequent publication of a dissenting statement by two of the agency's commissioners. We briefly discuss the case and its import below.

THE SETTLEMENT ORDER AND DISSENT

According to the SEC's settlement order, Andeavor's executive management team adopted a corporate Rule 10b5-1 plan to repurchase $250 million of Andeavor stock in early 2018 pursuant to a buyback authorization approved by the company's board of directors several years earlier. The order found that the company's CEO and others were aware at the time that Andeavor was about to renew its stalled discussions with another company about a potential acquisition of Andeavor. In fact, those discussions resumed the same day the plan was adopted. The order further found that the company's legal department had a "deficient understanding of all the relevant fact and circumstances" surrounding the acquisition discussions when it approved the Rule 10b5-1 plan because of the "abbreviated and informal process [used] to evaluate the materiality of the acquisition discussions," including the failure to consult with the CEO or others who had personal knowledge about the status of the acquisition talks.

The order made no mention of the company's accounting books and records, its financial statements, or its accounting treatment for the stock buyback. Nevertheless, the SEC concluded that the company failed to design and maintain "internal accounting controls" sufficient to provide reasonable assurance that its 2018 buyback would be executed in

accordance with its Board's authorization, thereby violating the internal accounting controls requirements of Section 13(b)(2)(B) of the Securities Exchange Act of 1934. Without admitting or denying the SEC's findings, Andeavor agreed to cease and desist from violating Section 13(b)(2)(B) and to pay a $20 million civil penalty.

On November 13, a month after the SEC announced its settlement with Andeavor, Commissioners Hester Peirce and Elad Roisman issued a public statement explaining why they dissented from and voted against the settlement.[2] In this rare public airing of disagreement over a settled enforcement case, Commissioners Peirce and Roisman opined that the settlement rested on an "unduly broad view" of the accounting controls provisions of Section 13(b)(2)(B). The dissenting commissioners specifically rejected the notion that the concept of "internal accounting controls" encompasses a "generic 'internal controls' requirement." They noted the lack of judicial or even SEC precedent supporting such a broad view, and they cited both accounting literature and legislative history to support their own view that Section 13(b)(2)(B) was not intended to regulate public company internal controls having no direct effect on the company's accounting records or financial statements, or to empower the SEC to "second-guess" management's decision processes outside the accounting area.

The *Andeavor* settlement is noteworthy for several reasons, which we briefly discuss below.

ONGOING SEC FOCUS ON "GOOD CORPORATE HYGIENE"

The *Andeavor* settlement did not occur in a vacuum. Commission officials have recently stepped up calls for "good corporate hygiene" including stricter compliance policies around the protection of material nonpublic information and the use of Rule 10b5-1 trading programs. Starting in September 2017, SEC Chairman Jay Clayton described policies to restrict executives from trading while in possession of inside information as an "important part of good corporate hygiene."[3] In March 2020, as the growing specter of COVID-19 caused market disruptions and delayed standard corporate disclosures, the SEC's Co-Directors of Enforcement warned corporate insiders to take special care to avoid trading based on material nonpublic information.[4] Shortly thereafter, in April 2020, Chairman Clayton and the SEC's Director of Corporation Finance issued a statement urging companies to "practice good corporate hygiene, particularly with regard to the protection and distribution of material nonpublic information."[5]

In recent months, commentary from the Commission on policies surrounding material nonpublic information has accelerated, including calls by Chairman Clayton for new rules to require "cooling off periods" up to 90 days after implementation or substantial alteration of Rule 10b5-1 trading programs.[6] And in a recent speech before the Economics Club, Chairman Clayton reiterated his view that "companies should strongly consider requiring all Rule 10b5-1 plans for senior executives and board members to include mandatory seasoning, or waiting periods after adoption, amendment or termination before trading under the plan may begin or recommence."[7] This is a clear shot across the bow to some issuers whose policies and practices may not align with the Chairman's strong recommendations. According to the *Andeavor* order, the company's 10b5-1 plan had no waiting period between its adoption and the commencement of the buyback. The order does not allow a more informed assessment regarding the circumstances surrounding the plan. While the company was not charged with a Section 10(b) and Rule 10b-5 violation, this may be an area for future enforcement in appropriate circumstances.

The Commission has also brought other enforcement actions this year focused on failures to maintain and implement policies designed to protect material nonpublic information. In February 2020, the Commission issued a settled order against a Wyoming-based investment adviser for failing to maintain adequate policies to prevent its employees from misusing material nonpublic information in violation of Section 204A of the Investment Advisers Act, including a $150,000 penalty.[8] In May 2020, the Commission issued a similar settled order against a California-based investment adviser with a $1 million penalty.[9] These actions followed similar ones against other investment advisers in 2015 and 2017.[10]

But these enforcement actions against investment advisers were less controversial than the *Andeavor* settlement for several reasons. First, Section 204A of the Investment Advisers Act of 1940 explicitly requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information.[11] Section 15(g) of the Securities Exchange Act of 1934 imposes similarly explicit requirements on broker-dealers.[12] By contrast, the securities laws do not explicitly impose similar requirements on public companies like Andeavor that are not SEC-regulated securities firms. Yet the $20 million penalty imposed against Andeavor was magnitudes higher than the penalties the Commission has generally assessed against investment advisers charged with inadequate insider trading policies.

PUBLIC DISSENTS ON THE RISE?

While it remains rare, with some notable exceptions,[13] for SEC commissioners to issue public dissenting statements in connection with settled enforcement cases, the practice appears to have become more commonplace in recent months. This is the third time in recent months that Commissioner Peirce has issued a public statement dissenting from an enforcement settlement. In mid-September she dissented from the Commission's initial coin offering settlement with Unikrn, Inc.,[14] and in early October she dissented from the Commission's trust fund registration settlement with Great Plains Trust Company, Inc.[15] Later in October she also issued a public statement in which she concurred with the Commission's security-based swaps settlement against Tradenet Capital Markets Ltd. but expressed reservations about it.[16]

We expect Commissioner Peirce – and likely her colleagues, none of whom appear reticent to express their views on important regulatory and enforcement issues – to continue this trend going forward by publicly explaining dissenting views not only on rulemaking and policy issues (which is common), but on enforcement matters too. For practicing attorneys eager to learn as much as possible about the views of individual SEC Commissioners, this increased transparency should be welcome.

LOOKING AHEAD

Andeavor should prompt companies to review and shore up their internal controls surrounding stock buybacks during periods when company management is aware of material nonpublic information – whether they consider those to be "accounting" controls or not. For companies that use Rule 10b5-1 plans for buybacks, controls surrounding the adoption and amendment of such plans should also be part of the analysis, as should careful consideration of a waiting period between adoption of the plan and trading.

On the enforcement front, the *Andeavor* settlement took an expansive view of the types of public company internal controls that constitute "accounting" controls within the SEC's regulatory ambit under Exchange Act Section 13(b)(2)(B). As the dissent pointed out, it is by no means self-evident that controls surrounding stock buybacks, the use of material nonpublic information, or the adoption of corporate Rule 10b5-1 plans fall within an ordinary understanding of the term "accounting" controls, nor that Congress ever intended that result. But because very few companies subject to the requirements of Section 13(b)(2)(B) ever litigate against the SEC, there is little authoritative judicial precedent regarding the scope of these requirements and little likelihood of pushback from anyone other than occasional commentators.

Concerns about SEC overreach in defining internal "accounting" controls also arise in FCPA cases involving foreign corruption, where the SEC has sometimes relied on Section 13(b)(2)(B) to address perceived deficiencies in other controls not directly related to a company's accounting processes or financial statements – for example, controls for vetting third-party agents, for performing due diligence on acquisition targets, and for hiring relatives of foreign officials. For this reason, the public dissenting statement by two commissioners in *Andeavor* is very significant, as it may embolden investigative subjects and litigants to fight back when arguing that certain internal controls – despite their

importance – are not "accounting" controls. And if the issue were ever litigated in court, a dissent by two commissioners would lend support and credence to any such challenge.

[1] *In re Andeavor LLC*, Exchange Act Rel. No. 90208 (Oct. 15, 2020), https://www.sec.gov/litigation/admin/2020/34-90208.pdf.

[2] Hester Peirce and Elad Roisman, Comm'rs, SEC, Statement of Commissioners Hester M. Peirce and Elad L. Roisman - Andeavor LLC (Nov. 13, 2020), https://www.sec.gov/news/public-statement/peirce-roisman-andeavor-2020-11-13.

[3] Robert J. Jackson Jr., Comm'r, SEC, Corporate Governance: On the Front Lines of America's Cyber War, (Mar. 15, 2018) (quoting Testimony of SEC Chairman Jay Clayton before Senate Committee on Banking, Housing, and Urban Affairs), https://www.sec.gov/news/speech/speech-jackson-cybersecurity-2018-03-15.

[4] Stephanie Avakian and Steven Peikin, Co-Dirs. Div. Enf't, SEC, Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity (Mar. 23, 2020), https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity.

[5] Jay Clayton, Chairman, and William Hinman, Dir. Div. Corp. Fin, SEC, The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19 (Apr. 8, 2020), https://www.sec.gov/news/public-statement/statement-clayton-hinman.

[6] Jay Clayton, Chairman, SEC, Testimony before Senate Committee on Banking, Housing and Urban Affairs (Nov. 17, 2020), https://www.banking.senate.gov/hearings/10/23/2020/oversight-of-the-securities-and-exchange-commission. In response to a question from Senator Sherrod Brown from Ohio regarding the Commission's *Andeavor* order, Chairman Clayton responded:

> "Let me say this about stock buybacks and 10b5-1 plans, as I mentioned in my response to Chairman Crapo. I think additional hygiene in this area is appropriate Senator. Look, buybacks provide a very efficient way from the company's standpoint to manage their capital allocation and balance sheet. But they should be applied with good corporate hygiene including policies and procedures to ensure that when they are put in place or restarted the company does not have material nonpublic information. And for executives, I am a proponent of a cooling off period and that is that when you put your 10b5-1 plan

> in place, say you do it in June, there are no purchases or sales—in most cases its sales with an executive 10b5-1 program—for a period of time. Now whether that period of time is three months or six months or whatever it is, that gives everybody comfort that timing was not planned ahead, that fortuity wasn't intent, and I think that's something we should all explore."

See also Letter from Jay Clayton, Chairman, SEC, to Representative Brad Sherman (Sept. 14, 2020) ("I want to reiterate my view on the importance of good corporate hygiene in the area of Rule 10b5-1 plans."), https://www.sec.gov/files/clayton-letter-to-chairman-sherman-20200914.pdf;

Jay Clayton, Chairman, SEC, Investor-Focused, Nimble and Vigorous Enforcement at the SEC (Sept. 17, 2020), https://www.sec.gov/news/speech/clayton-vigorous-enforcement-sec-091720;

Bill Hinman, Dir. Div. Corp. Fin., SEC, The Regulation of Corporation Finance – A Principles-Based Approach (Nov. 18, 2020), https://www.sec.gov/news/speech/hinman-regulation-corporation-finance-2020-11-18.

[7] Jay Clayton, Chairman, SEC, Putting Principles into Practice, the SEC from 2017-2020 - Remarks to the Economic Club of New York (Nov. 19, 2020), https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19. Chairman Clayton further commented:

> "In my view, these required seasoning periods are appropriate between the establishment of a plan and the date of the initial trade, as well as between any modification, suspension or termination of a plan and the resumption of trading or entry into a new plan. Such seasoning periods not only help demonstrate that a plan was executed in good faith, but they also can bolster investor confidence in management teams and in markets generally."

[8] *In re Cannell Capital LLC*, Advisers Act Rel. No. 5441 (Feb. 4, 2020), https://www.sec.gov/litigation/admin/2020/ia-5441.pdf.

[9] *In re Ares Management LLC*, Advisers Act Rel. No. 5510 (May 26, 2020), https://www.sec.gov/litigation/admin/2020/ia-5510.pdf.

[10] *In re Marwood Research Group LLC*, Advisers Act Rel. No. 4279 (Nov. 24, 2015) ($375,00 penalty), https://www.sec.gov/litigation/admin/2015/34-76512.pdf;

In re Deerfield Management Company, L.P., Advisers Act Rel. No. 4749 (Aug. 21, 2017) ($4,757,962 penalty, disgorgement, and prejudgment interest), https://www.sec.gov/litigation/admin/2017/ia-4749.pdf.

[11] 15 U.S.C. §80b-4a.

[12] 15 U.S.C. § 78o(g).

[13] Commissioners have published notable dissents from Commission votes on waiver requests. *See, e.g.*, Luis A. Aguilar and Kara M. Stein, Comm'rs, SEC, Dissenting Statement In the Matter of Oppenheimer & Co., Inc. (Feb. 4, 2015), https://www.sec.gov/news/statement/dissenting-statement-oppenheimer-inc.html; Kara M. Stein, Comm'r, SEC, Dissenting Statement in the Matter of The Royal Bank of Scotland Group, plc, Regarding Order Under Rule 405 of the Securities Act of 1933, Granting a Waiver From Being an Ineligible Issuer (Apr. 28, 2014), https://www.sec.gov/news/public-statement/2014-spch042814kms.

Examples of other Commission dissents in settled enforcement actions are: Luis A. Aguilar, Comm'r, SEC, Dissenting Statement In the Matter of Lynn R. Blodgett and Kevin R. Kyser, CPA, Respondents (Aug. 28, 2014), https://www.sec.gov/news/public-statement/2014-08-28-statement-laa;

Daniel M. Gallagher, Comm'r, SEC, Statement on Recent SEC Settlements Charging Chief Compliance Officers With Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html.

[14] Hester Peirce, Comm'r, SEC, Statement on SEC Settlement Charging Token Issuer with Violation of Registration Provisions of the Securities Act of 1933 (Sept. 15, 2020), https://www.sec.gov/news/public-statement/peirce-statement-settlement-charging-token-issuer.

[15] Hester Peirce, Comm'r, SEC, Statement of Commissioner Hester M. Peirce - Great Plains Trust Company (Oct. 2, 2020), https://www.sec.gov/news/public-statement/peirce-dissent-great-plains-2020-10-01.

[16] Hester Peirce, Comm'r, SEC, Statement Regarding Tradenet Capital Markets Ltd. (Oct. 23, 2020), https://www.sec.gov/news/public-statement/peirce-tradenet-statement-10232020.