Section 10A and the Internal Investigations at Financial Institutions

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Introduction

In 1995 Congress added Section 10A to the Securities Exchange Act of 1934 ("Exchange Act") as part of the Private Securities Litigation Reform Act ("PSLRA").[1] Prior to the passage of the PSLRA, Congress had left the accounting profession to its own devices when it came to promulgating auditing standards.

Congress enacted Section 10A with the intent "to require auditors to blow the whistle on the fraudulent activities of their clients."[2] According to the bill's chief sponsor, Rep. Ron Wyden of Oregon: "Because the regulators and the [accounting] profession have abdicated their responsibility, we feel it is time for Congress to step in."[3] Although auditors are trained to investigate accounting irregularities, and reveal some types of accounting misconduct, they are not generally trained to detect fraud, especially in the complex world of financial institutions. But in the Post Sarbanes-Oxley corporate environment, the impact of Section 10A is being felt in a number of different ways, and creating greater pressure for internal investigations at financial institutions.

Summary of Section 10A

Section 10A provides:

(a) Each audit . . . shall include, . . .
  (1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

Although Section 10A requires that auditors conduct audits in accordance with the requirements of generally accepted accounting principles ("GAAP"), auditing standards "may be modified or supplemented from time to time by the [SEC]."[4] Section 10A also provides that where an auditor discovers, either through its own work, through the client itself, or through an advisor to the client, that a reporting audit client may have committed an illegal act, the auditor must:

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[1] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

[2] *See* Thomas L. Riesenberg, *Trying to Hear the Whistle Blowing: The Widely Misunderstood "Illegal Act" Reporting Requirements of Exchange Act Section 10A*, 56 BUS. LAW. 1417 (Aug. 2001), *citing* 132 CONG. REC. E1837 (daily ed. May 22, 1986) (statement of Rep. Wyden).

[3] 132 CONG. REC. E1837 (daily ed. May 22, 1986) (statement of Rep. Wyden).

[4] Exchange Act § 10A(a).

- Determine whether it is likely that an illegal act has occurred; and
- If so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
- As soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.

The triggering of an auditor's investigation and reporting duties under Section 10A is the detection of an "illegal act," which is discussed below in further detail. Once the auditor discovers an "illegal act" the auditor must disclose the matter to the institution's management, audit committee, and the board of directors, regardless of the degree of effect on the financial institution, provided that the violation is not "clearly inconsequential." Because Section 10A does not define a "clearly inconsequential" violation, and "no obvious consensus exists as to what acts fall within this category, audit committees should establish a clear understanding with the auditors as to the types of acts that will not be brought to the audit committee's attention, in order to avoid later recriminations."[5]

Response to Failure to Take Remedial Action

If the auditor, after reporting to senior management, audit committee, or other designated contact person, determines that

- The illegal act has a material effect on the financial statements of the issuer;
- The senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and
- The failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement.

the auditor must report the illegal conduct to the institution's board of directors.

Remediation Duties

Remediation in the current environment appears to be viewed in a less flexible way than perhaps it was in the past. For example, independent counsel engaged to evaluate the acts in question may generally conclude that: (i) no illegal act occurred; (ii) an illegal act did occur; or (iii) because of its lack of subpoena authority, for example, it cannot conclude that an illegal act

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[5] Harvey L. Pitt, David B. Hardison & Lawrence R. Bard, *More than 'Classical GAAS': Audits and Corporate Illegality under the Litigation Reform Act*, THE CORPORATE ANALYST, Aug. 1996 (hereafter "Classical GAAS") at p. 8-9.

did ***not*** occur. The tough question is what the auditors will require as remediation in the latter case. Recent examples suggest that unless counsel can categorically state that no illegal act occurred, remediation is required, and that remediation may likely be the termination of the officer/employees involved in the activity.

If, however, the auditor reports to the board of directors that remedial action has not been taken to correct the detected illegal act, the institution must inform the SEC within one business day, providing the auditor with a copy of the notice provided to the SEC. If, however, the institution fails to report such conduct to the SEC, or the auditor fails to receive a copy of the board's notice to the SEC, then the reporting obligation falls to the auditor, who must then resign from the engagement or furnish the SEC with a copy of the audit report the following day. If the auditor resigns from the engagement, the reporting responsibility continues, for the auditor must still provide the SEC with a copy of the auditor's report within one day following the client's failure to do so.[6]

Decisions by the board regarding these matters should be memorialized in writing. Where possible illegal acts have been identified by the auditors, management should be able to demonstrate that it was informed of the matter, that management proposed a remedial approach to addressing the problem, and that the auditors posed no objection to management's proposed course of action. Where management rejects the suggestions of the auditors, the basis for such rejection should be recorded, supported, and discussed with the auditors. "A close working relationship between management and a company's auditors is critical to allay any concerns on the part of the auditors that management is prepared to, and will, respond appropriately and promptly to any concerns that may be brought to management's attention."[7]

Safe Harbor

The PSLRA provides the auditor with protection against private actions based on any finding, conclusion, or statement by the auditor in the report to the board of directors or the SEC.[8] The statute also authorizes the SEC to bring a civil action against an auditor who violates the reporting obligations.[9]

Triggering Section 10A Obligations

The statute describes the "illegal act" requirement in very general terms: "an act or omission that violates *any* law, or *any* rule or regulation having the force of law."[10] The accounting industry has also provided a definition for "illegal acts" in Statement of Auditing Standards No. 54, which describes "illegal acts" as "violations of laws or governmental regulations."[11] Unlike the triggering acts for other reporting obligations, for example suspicious activity reports ("SAR Reports") where the relevant statute requires a violation specifically of

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6 Exchange Act § 10A(b)(3)(A)-(B).
7 *Classical GAAS* at p 5.
8 Exchange Act § 10A(c).
9 *Classical GAAS* at p. 3.
10 Exchange Act § 10A(f) (emphasis added).
11 AICPA Auditing Standards Board Statement of Auditing Standards No. 54 at 317.02.

federal criminal law to trigger the reporting requirement, any violation of law may trigger Section 10A reporting obligations.

Federally insured financial institutions, such as banks, thrifts, and their respective holding companies, are subject to a broad range of complex laws, the violation of which could trigger Section 10A. These laws are derived from statutes and regulations, found in such fields as securities, banking and thrift law. Experienced practitioners understand that bank examination reports often contain allegations or conclusions that laws or regulations have been violated. While it is not every such violation that triggers Section 10A, regulated financial institutions are certainly in a much different position under Section 10A because they are so closely regulated. For example, it may often be the case that the purported violation of law is first brought to the auditor's attention by an exam report or counsel.

In *SEC v. Solucorp Indus., Ltd.*,[12] a U.S. District Court in New York, on a motion for summary judgment, addressed the level of knowledge that an auditor must have of illegal acts on the part of a registrant so as to trigger the reporting requirements of Section 10A. The auditor in *Solucorp* argued that he was entitled to summary judgment "because the SEC fail[ed] to allege facts showing that he had actual knowledge of, or was reckless as to the existence of, any illegal acts."[13] The court rejected this interpretation of Section 10A and concluded "that under the plain and unambiguous terms of the statute an auditor becomes subject to the § 10A requirements upon acquiring knowledge of information indicating that an illegal act has *or may have* occurred."[14] Further, the court stated that as Section 10A "requires only knowledge of facts indicating that an illegal act may have occurred, any failure on the part of the SEC to allege reckless or fraudulent behavior [by the auditor] is immaterial."[15]

Role of Auditor in Examination Findings

Although examination findings may serve as the basis of a Section 10A investigation, increasingly auditors are assuming the role of quasi-examiners. The banking regulators "encourage[] auditors to attend examination exit conferences upon completion of field work or other meetings between supervisory examiners and an institution's management or Board of Directors (or a committee thereof) at which examination findings are discussed that are relevant to the scope of the audit."[16] When attending these types of meetings, auditors are bound by agency-imposed confidentiality requirements. Moreover, "[u]nauthorized disclosure of confidential supervisory information may subject the auditor to civil and criminal actions and fines and other penalties."[17]

Bank regulators view the audit function as "an essential component of risk management for the banking industry, and it is becoming more critical as banks expand into new products,

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12 *SEC v. Solucorp Indus., Ltd.*, 197 F. Supp. 2d (S.D.N.Y. 2002).

13 *Id*. at 10.

14 *Id*. at 10 (emphasis added).

15 *Id*. at 11.

16 Federal Reserve Board, Division of Banking Supervision and Regulation SR 92-28: *Interagency Guidance on Coordination and Communication Between External Auditors and Examiners* (July 24, 1992); FDIC Financial Institutions Letter (FIL-57-92) (July 24, 1992).

17 *Id*.

services, and technologies."[18] As part of the regulators' review of an institution, examiners review a bank's internal controls and audit processes during examinations. Conclusions by auditors have an "important influence" on the work performed by agency examiners and "examiners will often rely upon work performed by the auditors, rather than engage in direct validation and testing of bank operations."[19] Therefore, where examiners find deficient internal controls, and the auditors have not otherwise cited such in their audit report, the examiners may conclude that the failure to discover imprudent practices or even violations of law may reflect a failure in the audit process generally.

In *SEC v. KPMG, LLP, et al.*, the SEC brought a civil action alleging that Joseph T. Boyle, CPA, a KPMG partner permitted Xerox Corp. to manipulate its accounting practices to close a gap between actual operating results and results reported to the public, among other accounting improprieties. Among the several alleged violations of law cited by the SEC, was a violation of Section 10A by Mr. Boyle for failing to raise the issue of possible fraudulent financial reporting to the Xerox audit committee.[20]

Role of Outside Counsel

Where an auditor has reason to believe that an illegal act may have been committed so as to invoke the procedures required by Section 10A, the auditor may require the bank's audit committee to conduct an internal investigation to determine whether a violation of law which will have a material affect on the financial statements has in fact been committed, what remediation is required to correct such violation, and whether the board and management have taken adequate steps to achieve such remediation.

Reports of examination of troubled institutions often will contain the examiners' findings and impressions as to the operations, effectiveness, and sometimes integrity of bank management. The report of examination may also detail how conduct on the part of management has resulted in violations of law or exposed the bank to other regulatory, reputation, and litigation risks. These situations often pit management against their own boards as auditors, examiners, shareholders, and the media, attempt to determine where culpability lies. Experienced outside counsel is essential in these situations to assist the board, especially the independent directors, in maintaining its focus on guiding the bank through the examination and 10A processes.

Where the issues or problems raised by the auditor or ROE are especially pervasive and involve senior officers of the institution, the institution's normal outside counsel may be viewed

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[18] John D. Hawke, Comptroller of the Currency, Statement before the U.S. Securities and Exchange Commission (July 26, 2000).

[19] *Id.*

[20] *SEC v. KPMG, LLP, et al.*, No. 03 Civ. 671, Fed Sec. L. Rep. P92,492 (S.D.N.Y. Aug. 22, 2003); *In the Matter of Joseph T. Boyle, CPA*, Exchange Act Release No, 52878 (S.E.C. Dec. 2, 2005). *See also*, *In the Matter of David Decker, CPA and Theodore Fricke, CPA*, Exchange Act Release No. 47731, 80 SEC Docket 80 (S.E.C. Apr. 24, 2003) (alleging that auditors failed to design appropriate audit procedures to detect illegality as required by Section 10A); *In Re Yonkers*, 2001 SEC Lexis 1493 (S.E.C. July 27, 2001) (imposing sanctions and cease and desist order under, *inter alia*, Section 10A against auditor whose client's quarterly financial statements were materially misstated).

by the auditor as not being "independent." In such situations, it is necessary for the board of directors to retain independent counsel, which has little or no prior history with the institution and its management.

Independent counsel likely will provide an oral (and sometimes written) report of their factual findings and legal conclusions as to whether the conduct identified by the auditors actually constituted violations of law. This report usually will be presented to the audit committee, the board of directors, and then to the auditor. Bank regulators and the SEC may also request either an oral or written description of counsel's findings. The issue of whether attorney/client privilege is waived by such a process is the subject of other articles that we have authored.[21] Suffice it to say that it is an issue that must be evaluated before the process begins.

Practical Tips

A financial institution should observe the following in avoiding triggering a Section 10A report and in dealing with Section 10A if it is triggered:

- Senior management shall be proactive in working with auditors to learn of, investigate, and respond to, any auditor concerns about, or suspicions of, illegal conduct.
- Audit committees should insist upon an ongoing, periodic dialogue with senior management to ascertain whether there have been indications of potential illegal acts, and to satisfy themselves as to the ability of management to timely respond to such indications.
- Any and all indications of possible illegal conduct should be dealt with carefully and effectively, whether brought to management's attention by the outside auditors or otherwise.
- Discuss with the auditing firm any special or unique circumstances that may have an impact on the financial statements, prior to commencing the audit.
- Key bank employees must clearly understand the lines of communication and how the bank will address internal control or other problems noted by the external auditor.
- Assign responsibility to a member of management who reports directly to the bank's board of directors, to serve as a liaison between the bank and the audit firm.
- Have a contingency plan in place should an audit engagement be suddenly terminated, whether for Section 10A, regulatory pressures, or other reasons, in order to mitigate any significant discontinuity in audit coverage.
- Maintain effective internal systems and controls so as to uncover illegal acts before they are discovered by third parties.

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[21] *See e.g.*, Thomas P. Vartanian, Lawrence R. Bard & Travis P. Nelson, *Internal Investigations in the Post-Sarbanes-Oxley Era*, Newsletter of the ABA Section of Business Law Committee on Banking Law (Nov. 2005).