SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 78490 / August 5, 2016

Admin. Proc. File No. 3-15168

In the Matter of

JOHN J. AESOPH, CPA and
DARREN M. BENNETT, CPA

CORRECTED OPINION OF THE COMMISSION

Rule 102(e) PROCEEDING

Grounds for Remedial Action

Improper Professional Conduct

Certified public accountant serving as engagement partner engaged in improper professional conduct in the audit of the financial statements of a public company. *Held*, it is in the public interest to deny the accountant the privilege of appearing or practicing before the Commission with a right to apply for reinstatement after three years.

Certified public accountant serving as senior manager engaged in improper professional conduct in the audit of the financial statements of a public company. *Held*, it is in the public interest to deny the accountant the privilege of appearing or practicing before the Commission with a right to apply for reinstatement after two years.

APPEARANCES

George B. Curtis and *Monica K. Loseman* of Gibson, Dunn & Crutcher LLP, for John J. Aesoph, CPA.

Gary F. Bendinger, *Kevin A. Burke*, and *Paul J. Zidlicky* of Sidley Austin LLP for Darren M. Bennett, CPA.

Nicholas Heinke and *Gregory A. Kasper* for the Division of Enforcement.

Appeal filed: August 11, 2014
Last brief received: November 2, 2015
Oral argument: July 12, 2016

I. Introduction

John J. Aesoph, CPA ("Aesoph") and Darren M. Bennett, CPA ("Bennett") (collectively, "Respondents") appeal from an administrative law judge's ("ALJ") Initial Decision finding that they engaged in "improper professional conduct" during their service as the engagement partner and senior manager of KPMG, LLP's audit of the 2008 financial statements of TierOne Corporation, a holding company for TierOne Bank (collectively, "TierOne" or the "Bank"), that resulted in KPMG's issuing an unqualified audit opinion dated March 12, 2009. The ALJ found their conduct was negligent "improper professional conduct" under Commission Rule of Practice 102(e) and Section 4C of the Securities Exchange Act of 1934: (1) a single instance of highly unreasonable conduct that resulted in a violation of Public Company Accounting Oversight Board ("PCAOB") auditing standards in circumstances in which they knew, or should have known, that heightened scrutiny is warranted; and (2) repeated instances of unreasonable conduct, each resulting in a violation of PCAOB auditing standards, that indicate a lack of competence to practice before us.[1]

This case concerns TierOne's loss estimates for impaired commercial real estate loans recorded in its allowance for loan and lease losses ("ALLL") balance sheet reserve account.[2] Those impairment losses drastically increased for TierOne in 2008 because of the sharp deterioration of the real estate market. The ALJ found that Respondents knew or should have known that their audit of the ALLL warranted heightened scrutiny because, among other things, the Office of Thrift Supervision ("OTS") had increased TierOne's capital requirements after finding, during a mid-2008 examination, that TierOne was in "deteriorating financial condition" because of its impaired loan losses. The ALJ found that Respondents knew that TierOne's management had an incentive to intentionally misstate the ALLL to meet the increased capital requirements and prevent potential OTS enforcement action.

The ALJ found that Respondents violated PCAOB auditing standards in three aspects of their audit of the ALLL: (1) the effectiveness of internal control over financial reporting; (2) substantive audit test work; and (3) post-audit procedures. On appeal, Respondents ask that we dismiss the charges against them and set aside the sanctions imposed—a one-year suspension on Aesoph and a six-month suspension on Bennett from appearing or practicing before us as accountants. The Division of Enforcement ("Division") cross-appeals the sanctions imposed, contending that Aesoph should have received a three-year suspension and Bennett a two-year suspension.

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1 *John J. Aesoph, CPA*, Initial Decision Release No. 624, 2014 WL 2915931, at *32 & n.38 (June 27, 2014). The Commission adopted Rule 102(e), 17 C.F.R. § 201.102(e), in its current form in 1998. *Amendment to Rule 102(e) of the Commission's Rules of Practice ("Amendment to Rule 102(e)")*, Securities Act Release No. 7593, 1998 WL 729201 (Oct. 19, 1998). The Rule's language was later codified in Exchange Act Section 4C, 15 U.S.C. § 78d-3, with the passage of the Sarbanes Oxley Act in 2002. Because the Rule and the statute include the same provisions, for ease of reference we will refer to only Rule 102(e).

2 The ALLL also included TierOne's losses on other types of impaired loans (*e.g.*, automobile loans) and probable losses on unimpaired loans.

Based on our independent review of the record, we find that Respondents engaged in "improper professional conduct" as defined by Rule 102(e)'s negligence-based standards, and that it is in the public interest to deny Respondents the privilege of appearing or practicing before us with a right for Aesoph to apply for reinstatement after three years and for Bennett to apply for reinstatement after two years.

II. Background

A. Many of TierOne's risky loans became impaired by 2008 and required ALLL reserves.

TierOne was a regional bank that, from 2002 to 2005, greatly increased its origination of high-risk construction and land-development loans by opening or acquiring nine loan production offices ("LPOs") in Nevada, Arizona, Florida, North Carolina, and Colorado.[3] When the real estate market deteriorated in 2008, the Bank closed these nine LPOs and refocused its future lending activity on its historical market area of Iowa, Kansas, and Nebraska.

But the high-risk loans remained on TierOne's books. For those that were impaired (*i.e.*, for which it was probable TierOne would be unable to collect all amounts due), TierOne was required by Generally Accepted Accounting Principles ("GAAP") to measure any impairment and recognize the resulting losses in its ALLL.[4] The ALLL had two components: losses on impaired loans for which TierOne was required to follow Financial Accounting Standards ("FAS") No. 114, and probable losses on unimpaired loans for which TierOne was required to follow FAS No. 5. Only the FAS 114 portion of the ALLL is at issue in this case.[5]

B. TierOne's process for recording losses on its impaired loans.

TierOne management was responsible for estimating losses on impaired loans in conformance with FAS 114 at least quarterly. Its process for doing so proceeded by: (1) the Special Assets Executive preparing "FAS 114 templates" estimating FAS 114 losses on a loan-by-loan basis; (2) the Controller reviewing and approving the templates; and (3) the Asset Classification Committee ("ACC") performing a high-level review of the ALLL.[6] The Special Assets Executive, Controller, and all eleven members of the ACC were part of TierOne's management team.

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[3] TierOne considered these loans to be high-risk, a characteristization which Respondents do not dispute and which we accept.

[4] FAS 114. TierOne determined that all loans past-due ninety days or more were impaired.

[5] Hereinafter, we refer to the commercial real estate loans that TierOne identified as impaired and therefore subject to loss measurement as "impaired loans" or "FAS 114 loans."

[6] Each FAS 114 template contained loans associated with an individual lending relationship or borrower, meaning that one template might include several loans for one borrower.

In general, TierOne determined whether a FAS 114 loss existed by subtracting the fair value of the collateral securing a loan (collateral value) from the loan's book value.[7] Most impaired loans were collateral-dependent, and therefore any recovery of such a loan's balance was by foreclosing on and selling the collateral. ALLL reserves were required if the collateral value was less than the loan's book value.

Appraisals were a key part of the process; management used them in estimating the current fair value of collateral on loans. But appraisals become stale over time following real estate market fluctuations. TierOne's lending policy acknowledged that an appraisal might be valid for only a few months in a rapidly escalating or deteriorating market. If an appraisal became stale, TierOne's policy required its management to estimate fair value by either obtaining a new appraisal or by adjusting the stale appraisal based on estimates from available market information concerning the collateral.

KPMG organized impaired loans into "buckets": (1) bucket-one for impaired loans in which the collateral value was lower than the book value, resulting in required reserves; and (2) bucket-two for impaired loans in which the collateral value exceeded the book value, resulting in no required reserves.[8] If the collateral value for a bucket-one loan continued to decline below book value from prior quarters, then additional ALLL reserves were required. If the collateral value for a bucket-two loan declined below book value, then the loan would become a bucket-one loan and require ALLL reserves.

C. Before KPMG's audit, OTS issued an examination report finding that TierOne was in "deteriorating financial condition" and that TierOne was not properly accounting for its ALLL.

On October 8, 2008, OTS issued a report on its examination of TierOne that generally covered the eighteen month period ending on June 30, 2008.[9] OTS found that TierOne was in a "deteriorating financial condition" principally because of "poorly administered concentrations" of high-risk loans in "rapidly flagging" LPO markets. OTS criticized TierOne's board and management for "exceptionally poor" performance and breaching their fiduciary duty to exercise the highest standard of care in the conduct, management, and oversight of bank affairs.

OTS downgraded TierOne to a composite CAMELS rating of 4, designated for financial institutions that "pose a risk to the deposit insurance fund" because they present a distinct

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[7] The book value was the loan's original value minus any charge-offs that occurred in prior periods. The collateral value was the estimated fair value of the collateral minus the selling costs (or estimated cost to foreclose) and discounted for the number of months projected to sell the collateral.

[8] A third bucket, not relevant to our analysis, consisted of loans evaluated for impairment but eventually deemed unimpaired by TierOne.

[9] OTS, TierOne's primary federal regulator, conducted its examination of TierOne from June 2 to August 30, 2008. OTS has since been integrated with the Office of the Comptroller of the Currency.

possibility of failure if their "problems and weaknesses are not satisfactorily addressed and resolved."[10] OTS also increased TierOne's minimum core capital ratio from the standard 4% to 8.5% and its minimum risk-based capital ratio from 8% to 11%.[11] OTS found that TierOne's "ability to maintain appropriate capital and allowance levels depends greatly on management's ability to successfully workout of the existing asset problems in Las Vegas and Florida, and preclude the development of significant problems in other markets that have shown signs of weakness, particularly Arizona, Minnesota, and the Carolinas."

As to the ALLL, OTS found that TierOne had failed to "satisfactorily monitor, assess, and respond timely" to the impact of the weakening LPO markets on the adequacy of the ALLL. OTS identified "unreserved losses ranging between $17.0 million and $22.0 million" as of March 31, 2008, but concluded that TierOne addressed the issue by recording an additional $28.4 million of loss provisions and $42.3 million of charge-offs during the quarter ended June 30, 2008.[12] These provisions and charge-offs were not prospective; they applied to losses that existed prior to June 30, 2008.

D. Market deterioration accelerated in the second-half of 2008.

The real estate market deterioration that began during the period covered by the OTS report generally accelerated through the second-half of 2008. This was particularly true for three of the states that OTS considered to challenge TierOne's ability to maintain appropriate capital and allowance levels: Nevada, Arizona, and Florida.

Nevada properties comprised 56.7% of TierOne's FAS 114 loans. All of the loans relevant to our discussion below were in Clark County (encompassing Las Vegas). Based on an index maintained by the National Association of Realtors ("NAR"), the median sales price of existing single-family homes in Clark County declined in 2008 by 8.4% and 6.7% in the first and second quarters, but by 10.4% and 13.5% in the third and fourth quarters.[13]

Arizona properties comprised 4.9% of TierOne's FAS 114 loans. All of the loans relevant to our discussion below were in Maricopa and Pinal Counties (which are part of the greater Phoenix metropolitan area). Based on the NAR index, the median sales price of existing single-family homes in Maricopa County declined in 2008 by 6.5% and 9.7% in the first and

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10 CAMELS is an acronym for the components of the OTS examination: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

11 Bennett testified that he understood that OTS could take enforcement action against TierOne if the Bank failed to meet its capital requirements.

12 Increases to the ALLL were recognized as losses (provisions) through the income statement. If TierOne later confirmed the loss, it would charge off the loss amount from the loan balance (*i.e.*, reduce the loan balance) and reduce the ALLL. An example of a loss-confirming event would be foreclosure on collateral property.

13 Two additional Nevada impaired loans not discussed below were in Nye County, which experienced market declines in 2008 similar to Clark County.

second quarters, but by 11.1% and 14.8% in the third and fourth quarters; and in Pinal County by 6.2% and 9.4% in the first and second quarters, but by 10.7% and 14.5% in the third and fourth quarters.[14]

Florida properties comprised 4% of TierOne's FAS 114 loans. All of the loans relevant to our discussion below were in St. Lucie County. Based on the NAR index, the median sales price of existing single-family homes in St. Lucie County declined in 2008 by 12.6% and 9.9% in the first and second quarters, but by 7.6% and 12% in the third and fourth quarters.

Loans in the other three states that challenged TierOne's ability to maintain appropriate capital and allowance levels—Minnesota, North Carolina, and South Carolina— accounted for about 11% of TierOne's FAS 114 loans. Minnesota's real estate market experienced modest declines in the second half of 2008, dropping by 2.7% in the third quarter and 8% in the fourth quarter. While the Carolina real estate markets also generally declined in 2008, the Division's expert on economic analysis concluded that, in North Carolina, the declines "did not have major effects on the value of the collateral" and, in South Carolina, "market values did not materially change . . . in the areas where the collateral securing the . . . loans was located."

E. In planning the 2008 audit, Aesoph and Bennett identified the FAS 114 portion of the ALLL as presenting a high risk of material misstatement.

Aesoph and Bennett began planning TierOne's 2008 audit in October 2008. As the engagement partner, Aesoph had final authority over the planning, execution, and supervision of the audit, and he had full responsibility for KPMG's audit opinion. As the senior manager, Bennett reported directly to Aesoph and was responsible for supervising the engagement team's day-to-day work. He and Aesoph interacted on a near-daily basis about the audit. Bennett assisted Aesoph in all aspects of planning and performing the audit, including the design and test of controls and the design and implementation of substantive procedures. Aesoph reviewed and approved all significant audit work papers, including those regarding the FAS 114 loans, and Bennett reviewed and approved all of the audit work papers.

In planning the audit, Aesoph and Bennett considered both the OTS report and the turmoil in the real estate market and determined that the FAS 114 portion of the ALLL presented a high risk of material misstatement because of the high risk that TierOne's management would overvalue the collateral securing the FAS 114 loans.[15] The risk of potential collateral overvaluation was attributed to both the risk of fraud and the risk of unintentional error.

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14 Two additional Arizona impaired loans not discussed below were in Mohave County, which experienced market declines in 2008 slightly less severe (27.1%) than Maricopa and Pinal Counties (more than 30%).

15 While KPMG determined that the ALLL as a whole (*i.e.*, both the FAS 5 and 114 portions) had a high audit risk, Respondents also recognized that the FAS 114 portion individually presented a high risk of material misstatement or material weakness in internal control.

Respondents understood that additional market-driven losses on TierOne's FAS 114 loans could make TierOne unable to meet OTS' increased capital requirements. As a result, TierOne's management had an incentive to intentionally understate those losses by overvaluing collateral. Respondents also understood that the FAS 114 portion of the ALLL had a high inherent risk of misstatement because it depended on managements' subjective estimates of collateral value. This is because, as noted above, if TierOne did not obtain an updated appraisal on a FAS 114 loan but market conditions changed, its policy was to estimate fair value by adjusting the stale appraisal based on estimates from other market information.

Aesoph and Bennett also understood that the size of the FAS 114 portion of the ALLL—about $16.4 million on $186 million in FAS 114 loans at year-end 2008—was quantitatively and qualitatively material to TierOne's financial statements. Respondents had established a $1.9 million materiality threshold in planning the 2008 audit,[16] a threshold that could be surpassed by a change in estimated losses on a single FAS 114 loan. It was qualitatively material for two reasons.[17] Additional FAS 114 loan losses could threaten TierOne's ability to meet its increased capital requirements; TierOne reported a year-end core capital ratio of 8.9%, which exceeded the required 8.5% ratio by $12.4 million, and a year-end risk-based capital ratio of 11.6%, which exceeded the required 11% ratio by $15.8 million. TierOne reported "net interest income after provision for loan losses" of $2.9 million at year-end 2008, and an increase in FAS 114 losses could readily result in the Bank reporting a loss.

F. KPMG issued an unqualified opinion on TierOne's 2008 consolidated financial statements, which it subsequently withdrew in 2010.

On March 12, 2009, KPMG issued an audit report containing an unqualified opinion on TierOne's consolidated financial statements and on the effectiveness of its internal control over financial reporting as of year-end 2008. KPMG's audit report on the financial statements reflected in TierOne's year-end 2008 annual reported (filed on Form 10-K), stated that TierOne's consolidated financial statements "presented fairly, in all material respects, the financial position of TierOne . . . and the results of [its] operations and [its] cash flows . . . in conformity with" U.S. GAAP. KPMG also reported that TierOne "maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008."

In April 2009, Respondents discovered two new appraisals for two bucket-one loans in Nevada that TierOne had received before KPMG issued its audit reports dated March 12, 2009. The new appraisals, received by TierOne in January and February 2009, resulted in an additional $3.6 million in FAS 114 loss provisions for the Bank's first-quarter 2009 financial statements.

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[16] Respondents established the $1.9 million materiality threshold based on 4% of profit or loss before income taxes.

[17] SEC Staff Accounting Bulletin No. 99 explains that "[q]ualitative factors may cause misstatements of quantitatively small amounts to be material," including "whether the misstatement affects the registrant's compliance with regulatory requirements." Release No. SAB-99, 1999 WL 1123073, at *3-4 (Aug. 12, 1999).

Respondents did not perform any procedures to determine whether the new appraisals affected TierOne's year-end 2008 financial statements.

In early 2010, KPMG learned that TierOne had not disclosed to it an internal analysis by management from the first quarter of 2009 estimating additional potential loan loss reserves. As a result, in April 2010, KPMG resigned as TierOne's independent auditor and withdrew its 2008 audit opinion. TierOne's Form 8-K, filed with the Commission on April 23, 2010, stated that KPMG had advised the company that it could no longer rely on management's representations; TierOne's 2008 "financial statements contain material misstatements related to certain out of period adjustments for loan loss reserves"; and KPMG was withdrawing its internal control assessments relating to the company's 2008 financial statements due to "a material weakness in internal control over financial reporting related to the material misstatements." OTS closed TierOne two months later.

III. Respondents violated professional standards.

The Division contends, and we agree, that Respondents violated PCAOB auditing standards in three specific areas related to the audit of the FAS 114 portion of the ALLL: (1) their audit of the effectiveness of internal control over financial reporting; (2) their substantive audit test work over the account; and (3) their post-audit procedures following the discovery of new appraisals in 2009.

A. Applicable professional standards in general: auditors must exercise due professional care and obtain sufficient competent evidential matter.

In performing an audit, auditors must adhere to "applicable professional standards," which primarily refers to PCAOB auditing standards, the American Institute of CPAs ("AICPA") Code of Professional Conduct, and Commission regulations.[18] PCAOB auditing standards require auditors, among other things, to exercise due professional care when conducting an audit and preparing an audit report,[19] and to obtain "[s]ufficient competent evidential matter . . . through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."[20]

The exercise of due professional care requires auditors to maintain an attitude of professional skepticism, including "a questioning mind and a critical assessment of audit

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[18] *Amendment to Rule 102(e)*, 1998 WL 729201, at *5. PCAOB auditing standards include (i) generally accepted auditing standards ("GAAS"), hereinafter cited as "AU § __"; and (ii) auditing standards issued by the PCAOB, hereinafter cited as "AS No. __." *See PCAOB Order Granting Approval of Proposed Rules to Implement the Reorganization of PCAOB Auditing Standards*, Exchange Act Release No. 75935, 2015 WL 5450917, at *1 (Sept. 17, 2015).

[19] AU §§ 150.02, 230.01; *Wendy McNeeley, CPA*, Exchange Act Release No. 68431, 2012 WL 6457291, at *9 (Dec. 13, 2012).

[20] AU § 150.02; *Gregory M. Dearlove, CPA*, Exchange Act Release No. 57244, 2008 WL 281105, at *6 (Jan. 31, 2008), *petition denied*, 573 F.3d 801 (D.C. Cir. 2009).

evidence."[21] It also requires auditors to "not be satisfied with less than persuasive evidence because of a belief that management is honest."[22]

The process for obtaining sufficient competent evidential matter requires asking appropriate questions of management, but management representations "are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."[23] If the auditor "remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until he or she has obtained sufficient competent evidential matter to remove such substantial doubt, or the auditor must express a qualified opinion or a disclaimer of opinion."[24]

When auditors conclude that there is high risk of material misstatement or fraud, the auditors must "increase their professional care and skepticism" by applying additional procedures or obtaining more reliable evidence.[25] For example, an auditor should consider "designing additional or different auditing procedures to obtain more reliable evidence" and "obtaining additional corroboration of management's explanations or representations concerning material matters."[26]

B. Respondents violated auditing standards in their evaluation of the effectiveness of TierOne's internal control over financial reporting.

The 2008 TierOne audit was an integrated audit, in which the auditor expresses "an opinion on the effectiveness of the company's internal control over financial reporting."[27] The Division alleges that Respondents "had no reasonable basis to conclude that TierOne maintained, in all material respects, effective internal control over financial reporting."[28] The Division alleges that Respondents violated a PCAOB auditing standard concerning internal control, AS

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21 AU §§ 230.07, 230.08; *Dearlove*, 2008 WL 281105, at *6.

22 AU § 230.09; *McNeeley*, 2012 WL 6457291, at *13.

23 AU § 333.02; *McNeeley*, 2012 WL 6457291, at *13.

24 AU § 326.25; *Barry C. Scutillo*, Exchange Act Release No. 48238, 2003 WL 21738818, at *6 (July 28, 2003), *aff'd*, 345 F.3d 722 (9th Cir. 2003).

25 *Dearlove*, 2008 WL 281105, at *6 ("Certain audit conditions require auditors to increase their professional care and skepticism, as when the audit presents a risk of material misstatement or fraud."); *see* AU §§ 312.17, 316.46, 316.52.

26 AU §§ 316.46, 316.52; *see also Dearlove*, 2008 WL 281105, at *9 (when an audit presents a "much greater than normal risk," the auditor should "expand the extent of procedures applied . . . or modify the nature of procedures to obtain more persuasive evidence" (quoting AU § 312.17)).

27 AS No. 5 ¶ 3. An integrated audit is an audit of internal control that is integrated with an audit of the financial statements. AS No. 5 ¶¶ 1, 6.

28 *John J. Aesoph, CPA*, Exchange Act Release No. 68605, 2013 WL 98717, at *1 (Jan. 9, 2013) (the "OIP").

No. 5, and breached their duties to exercise due professional care and obtain sufficient competent evidential matter, by failing "to adequately identify and evaluate defects in the design and operating effectiveness of controls over collateral valuation that would have been important to the auditors' conclusion about whether TierOne's controls sufficiently addressed the assessed risk of misstatement."[29] We agree.

Under AS No. 5, if the auditor finds "there is a reasonable possibility that a material misstatement" in the company's financial statements "will not be prevented or detected" (*i.e.*, that there is a material weakness in internal control), the auditor "must express an adverse opinion on the company's internal control over financial reporting."[30] To issue an unqualified opinion, the auditor must "obtain competent evidence that is sufficient to obtain reasonable assurance" that there are no material weaknesses.[31]

Not all controls are treated equally; those that address the highest risks of material misstatement are the most important to evaluate.[32] Risk assessment determines "the selection of controls to test, and the determination of the evidence necessary for a given control."[33] The higher the risk, the more evidence needed.[34]

Respondents identified the risk of collateral overvaluation as a high risk of material misstatement and fraud. Effective controls concerning collateral overvaluation were especially important for TierOne in 2008. The Bank was in a "deteriorating financial condition" in the first half of the year as a result of its FAS 114 loan losses. And the accelerated market decline in the second half of the year made it very likely that losses would grow. In this environment, management had an incentive to understate its FAS 114 loan loss estimates, which effective controls would have helped prevent or detect.

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29 OIP, 2013 WL 98717, at *1.

30 AS No. 5 ¶¶ 2, 3, 90, Appx. A ¶ A7. "A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met." AS No. 5 Appx. A ¶ A3 (emphasis added). "A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively." *Id.* (emphasis added).

31 AS No. 5 ¶¶ 3, 87.

32 *See* AS No. 5 ¶¶ 10-11, 14, 39-41, 46.

33 AS No. 5 ¶ 10.

34 AS No. 5 ¶ 46. AS No. 5 states that some tests "produce greater evidence of the effectiveness of controls than other tests," and it ranks the following tests in order from least to most evidence produced: "inquiry, observation, inspection of relevant documentation, and re-performance of a control." *Id.* ¶ 50. As No. 5 notes that "[i]nquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control." *Id.*

Respondents identified one control for the risk of collateral overvaluation: "Control Lot 7-2" concerning appraisal review. Respondents also identified two controls for the related risk that the "ALLL is improperly valued": (1) "Control Lot 12-2" concerning review and approval of the ALLL by the Controller and ACC; and (2) an unnumbered control concerning the review of impaired loans by the ACC. None of the identified controls, however, addressed TierOne's use of current appraisals or adjustment of stale appraisals in measuring the impairment loss for the FAS 114 portion of the ALLL.

Control Lot 7-2 required TierOne to obtain appraisals at loan *origination*. Respondents admitted at the hearing that the purpose of the control was not to determine whether appraisals for impaired loans were current when calculating the FAS 114 portion of the ALLL. The control also did not address the adjustment of stale appraisals for FAS 114 loans.

The latter two controls required the Controller and the ACC to review the ALLL quarterly, and the ACC to review various reports about impaired loans twice quarterly. The Controller reviewed the ALLL calculation and the FAS 114 templates, and the ACC reviewed information for individual FAS 114 loans including appraisal dates, appraisal values, and total reserves. However, the design of both controls did not require that the Controller or ACC address whether appraisals were current or that the methodology applied for adjusting stale appraisals to estimate collateral values for individual FAS 114 loans was appropriate.

To test the operating effectiveness of these two controls, the audit team (i) reviewed the ALLL calculation for two quarters and verified "that it is calculated in accordance with the approved methodology"; (ii) verified that the Controller and ACC reviewed the ALLL; (iii) reviewed the ACC meeting minutes "noting evidence of review [of the ALLL] by the signatures of those in attendance"; and (iv) "assessed the knowledge" of three TierOne employees. These tests produced no evidence that the controls addressed the risk of collateral overvaluation for individual FAS 114 loans from the use of stale appraisals. In addition, these two controls could not adequately address the high risk of material misstatement because that risk stemmed from management's incentive to intentionally overvalue the collateral securing the FAS 114 loans.[35]

In conclusion, Respondents violated AS No. 5 and breached their duties to exercise due professional care and obtain sufficient competent evidential matter, when they issued an

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[35] Respondents contend that the law judge ignored the latter two controls. Respondents contend that their identification and testing of these "back end" controls, along with Control Lot 7-2 on the "front end," provided them with a sufficient basis to conclude that TierOne's internal controls over the ALLL were designed properly and operated effectively at year-end. The ALJ in fact did consider these controls, and, in any event, we find that they did not adequately address the high risk of collateral overvaluation for the reasons discussed above.

Bennett also contends that their audit conclusions were supported by their identification and testing of an additional "front end" control: Lot 7-1, designed to ensure that collateral securing the loans was properly recorded in the public record. As Aesoph admitted in testimony, Lot 7-1 did not address the risk of collateral overvaluation.

unqualified opinion that TierOne maintained effective internal control over financial reporting for year-end 2008 because they (i) identified management's incentive to overvalue the collateral securing the FAS 114 loans as presenting a high risk of material misstatement, but (ii) identified no controls addressing that risk.[36]

C. Respondents violated auditing standards in their substantive audit of the FAS 114 portion of TierOne's ALLL for year-end 2008.

The Division alleges, and we agree, that Respondents violated AU §§ 328 and 342 (*i.e.*, the standards for auditing fair value measurements and accounting estimates), and failed to exercise due professional care or obtain sufficient competent evidential matter, in their evaluation of management's collateral value estimates for the FAS 114 portion of the ALLL.[37] Auditors are required by AU § 342 to evaluate, with an attitude of professional skepticism, the reasonableness of management estimates in the context of the financial statements taken as a whole.[38] The auditors' objective is to obtain sufficient competent evidential matter to provide reasonable assurance that, among other things, the "estimates are reasonable in the circumstances."[39]

AU § 328 sets forth audit procedures where management's estimate involves fair value measurements.[40] Among other things, AU § 328 provides that: (1) when the fair value measurement such as an appraisal is dated prior to the financial reporting date, the auditor must "obtain evidence that management has taken into account the effect of events, transactions, and

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36 Respondents contend that the Division's accounting and audit expert, John E. Barron, agreed that the review of the FAS 114 templates by TierOne's Controller was an effective internal control over the risk of collateral overvaluation. But Barron said no such thing; in response to a hypothetical question, he testified that if the Controller was "an independent party outside the process" of estimating impaired loan losses, his evaluation of the FAS 114 templates and supporting information for reasonableness "could be an effective control." The Controller was a part of management and not outside the process of estimating impaired loan losses.

37 OIP, 2013 WL 98717, at *2.

38 AU § 342.04; *Michael J. Marrie, CPA*, Exchange Act Release No. 48246, 2003 WL 21741785, at *10 (July 29, 2003), *rev'd on other grounds*, 374 F.3d 1196 (D.C. Cir. 2004).

39 AU § 342.07. In evaluating reasonableness, auditors "should obtain an understanding of how management developed the estimate" and then use one or more of the following three approaches: (i) "[r]eview and test the process used by management"; (ii) "[d]evelop an independent expectation of the estimate"; or (iii) "[r]eview subsequent events or transactions occurring prior to the date of the auditor's report." AU § 342.10. Respondents followed the first approach in evaluating the reasonableness of the ALLL, which the parties' accounting and audit experts agreed was appropriate.

40 AU § 328.06 (noting that AU § 342 "provides guidance on auditing accounting estimates in general" and that AU § 328.06 "addresses considerations similar to those in section 342 as well as others in the specific context of fair value measurements"); AU §§ 328.23-.39 (setting forth audit procedures for testing an entity's fair value measurements).

changes in circumstances occurring between the date of the [appraisal] and the reporting date";[41] and (2) when testing the fair value measurements, the auditor must "evaluate whether . . . [m]anagement's assumptions are reasonable and reflect, or are not inconsistent with, market information."[42]

We find that Respondents violated these auditing standards:

1. Respondents failed to exercise due professional care when they reviewed and approved the memorandum that documented KPMG's audit procedures for the FAS 114 loans. KPMG concluded in the memorandum that "market conditions have not materially deteriorated" since KPMG performed audit procedures earlier in the year, "and thus the year-end valuations appear reasonable."[43] The market had in fact plummeted, as Respondents knew. Aesoph testified that the memorandum's conclusion about market conditions "wasn't consistent with what we were seeing during 2008," and Bennett testified that the conclusion did not "make sense" to him.

The memorandum also stated that KPMG considered appraisals to be current if they were issued "within the past twelve months," and that if they were not current "KPMG inquired whether a discount was applied to the appraised value, and if not, KPMG inquired as to why TierOne didn't think it was necessary or appropriate." TierOne policies were, in fact, inconsistent with KPMG's documented approach. TierOne stated in a memorandum on its fourth-quarter 2008 ALLL, that the Bank "trie[d] to . . . discount[]" Nevada appraisals that were "older than six months." Also, Bennett testified that he knew that (i) TierOne's lending policy provided that an appraisal may be valid for only a few months in a rapidly escalating or deteriorating market, and (ii) the Nevada and Arizona markets were "rapidly deteriorating" in 2008. Nonetheless, there is no evidence on any inquiry being undertaken to determine why no discount was taken on numerous FAS 114 loans, as we detail below.

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41 AU § 328.25.

42 AU § 328.26; *see also* AU § 328.29 ("Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information."); AU § 328.31 ("The auditor evaluates the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information."); AU § 328.34 ("The auditor considers the sensitivity of the valuation to changes in significant assumptions, including market conditions that may affect the value."); AU § 328.36 ("To be reasonable, the assumptions on which the fair value measurements are based . . . need to be realistic and consistent with . . . [t]he general economic environment, the economic environment of the specific industry, . . . [and] [e]xisting market information . . . .").

43 The memorandum was prepared by Beth Burke, who reported to Bennett. Both Aesoph and Bennett signed off on the memorandum.

2. Respondents simply accepted, without question, management's estimates for loan collateral values.[44] They did so despite determining that there was a high risk of material misstatement due to management fraud with these estimates: a determination that required Respondents to "increase their professional care and skepticism." In addition, not only did Respondents fail to obtain corroborating evidence for management's estimates, they ignored evidence that those estimates were inconsistent with current market information.

KPMG reviewed all fifty-four FAS 114 templates that TierOne prepared, and did not note any exceptions to TierOne's fair value estimates on them.[45] Aesoph and Bennett both signed off on KPMG's review. TierOne based the fair value estimates in the FAS 114 templates in many instances on undiscounted stale appraisals inconsistent with current market information and its own general policy to discount appraisals. For example, TierOne used undiscounted appraisals from (i) the first-half of 2008 to estimate fair value for 17 bucket-one and seven bucket-two loans in Nevada and Arizona; and (ii) the second-half of 2007 to estimate fair values for three bucket-one loans in Florida and seven bucket-two loans in Nevada and Arizona.[46] Respondents knew that the markets in these three states had dropped by over 30% in 2008 with double-digit declines in the second-half of the year as reflected in the NAR and Case-Shiller indices.[47] Neither the templates nor KPMG's other audit work papers document TierOne's rationale or contain any supporting evidence for not discounting the appraisals for these loans.[48] And at the hearing, Bennett could not identify any loan-specific evidence or documented procedures that supported KPMG's conclusion that TierOne's fair value estimates for bucket-one loans in Nevada, Arizona, and Florida were reasonable as of year-end 2008.

With respect to the Nevada estimates, Respondents contend that they relied on a conversation with TierOne's Controller, David Kellogg, in which Kellogg explained that TierOne had recorded a 30% FAS 114 loss for Nevada loans in 2008, and that these losses were

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[44] *Cf. McNeeley*, 2012 WL 6457291, at *14 (finding that respondent failed to obtain sufficient competent evidential matter in her audit because she relied on "unsubstantiated management representations"); *Dearlove*, 2008 WL 281105, at *17 (Respondent's "unquestioning acceptance of [management's] proposed disclosure language was a clear . . . departure from the requirements of GAAS to apply greater than normal skepticism and additional audit procedures in order to corroborate management representations in a high risk environment.").

[45] Respondents contend that they were not responsible for evaluating the reasonableness of TierOne's loan-by-loan collateral valuation decisions; only the reasonableness of the ALLL estimate as a whole. These evaluations were inseparable. Respondents could not properly evaluate the reasonableness of the ALLL estimate overall without evaluating a sufficient selection of the individual FAS 114 loan collateral estimates.

[46] These thirty-four loans had a total net balance of $54.2 million.

[47] The Case-Shiller Home Price Index is based on similar analysis as the NAR index.

[48] The only exception being for an Arizona loan in bucket-two with an appraisal dated December 2007, for which KPMG noted on the FAS 114 template that the property sold in January 2009 "for close to appraised value."

not inconsistent with the 33% market decline reported in the S&P/Case-Shiller Home Price Index for Nevada in 2008. Respondents claim that after this conversation, they corroborated Kellogg's representations by confirming that TierOne recorded a 30% FAS 114 loss for Nevada and comparing that to the Case-Shiller index.

Respondents did not document this conversation with Kellogg in the audit work papers, yet Bennett testified that it was an "important" procedure for their conclusion that TierOne's FAS 114 estimates were reasonable. Auditors "must document the procedures performed, evidence obtained, and conclusions reached" as to "relevant financial statement assertions"; "if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done."[49]

Even if the conversation did take place, Kellogg's purported statements do not justify the conclusion that the FAS 114 loss for the Nevada loans was a reasonable estimate.[50] A substantial portion of the FAS 114 loan losses that TierOne reported for Nevada at year-end 2008 actually related to prior years. Moreover, whatever the merit of Kellogg's explanations, they do not make the Respondents' conclusions about TierOne's fair value estimates for loans in Arizona and Florida reasonable. For example, TierOne recorded a 15% FAS 114 loss for Arizona loans in 2008 but Arizona's market dropped by over 34% in 2008 based on the S&P/Case Shiller Home Price Index for Phoenix.

Respondents introduced analysis from their economic expert, Christopher M. James, who opined that the Case-Shiller and NAR indices did not reflect fair value in the second-half of 2008 because they included distressed sales. But even accepting James's analysis, if distressed sales were removed from the market indices, the indices still would have shown the real estate markets in Las Vegas and Phoenix suffered double-digit declines in 2008. Indeed, James calculated that without including distressed sales, Data Quick—a home price index similar to Case-Shiller and NAR—showed median home sale prices declining by 18% in Las Vegas and 19% in Phoenix in 2008, and median condominium sale prices declining by 26% in Las Vegas and 18% in Phoenix in 2008.

Respondents argue that TierOne's FAS 114 loan loss estimates for 2008 were not inconsistent with market information because the Bank was required to follow FAS 157 in determining fair value, and in turbulent markets, FAS 157 prohibits the Bank from considering market information that includes forced transactions such as foreclosures. Respondents contend

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[49] AS No. 3 ¶ 6, App. A ¶ A10; *cf.* Rule 2-06 of Regulation S-X, 17 C.F.R. § 210.2-06 (requiring that "the accountant shall retain records relevant to the audit or review, including workpapers and other documents that form the basis of the audit or review," and defining workpapers as "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the Commission or by the [PCAOB]").

[50] *McNeeley*, 2012 WL 6457291, at *12 ("'If a representation made by management is contradicted by other audit evidence,' an auditor . . . 'should investigate the circumstances, and consider the reliability of the representation made.'" (quoting AU § 333.04)).

that market indices (like the NAR and Case Shiller indices) and appraisals from the second-half of 2008 were not determinative of fair value under FAS 157 given the prevalence of foreclosures, and that it was reasonable for TierOne "to use appraisals obtained at a time when the market was relatively more stable. . . ."

Tellingly, during the audit, Respondents and TierOne did not believe that FAS 157 prohibited them from considering year-end market information such as appraisals and market indices. KPMG's audit work papers do not mention that Respondents or TierOne did not consider market indices or appraisals from the second-half of 2008 to be determinative of fair value under FAS 157. Indeed, KPMG's work paper on FAS 157 does not reference FAS 114 or the ALLL in its inventory of significant accounts and disclosures accounted for under that standard. This lack of documentation casts doubt on Respondents' FAS 157 assertions.[51] In addition, Respondents concede that they relied on Kellogg's consideration of the Case-Shiller index for Nevada at year-end; during the audit KPMG recommended that TierOne update appraisals to value the loans at year-end; TierOne used appraisals from the second-half of 2008 to estimate fair value for three bucket-one loans in Florida, which Respondents found to be reasonable; TierOne used new appraisals from January and February 2009 to estimate fair value for two bucket-one loans in Nevada for its first-quarter 2009 financial statements, which Respondents found to be reasonable; and TierOne stated in a memorandum on its fourth-quarter 2008 ALLL that it "trie[d] to estimate collateral value declines in [Nevada] real estate by discounting appraised values, which are older than six months."

FAS 157 did not give TierOne license to ignore market conditions in the second-half of 2008. It is true that FAS 157 requires that the fair value determination assume an orderly and not a forced transaction.[52] But the Basis for Conclusions to FAS 157 states that "it would be reasonable to presume that a market participant . . . would undertake efforts necessary to become sufficiently knowledgeable about the asset . . . *based on available information*, including information obtained through usual and customary due diligence efforts, and would factor any related risk into the fair value measurement."[53] Current appraisals and market indices are sources of available information that a market participant would consider.

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[51] AS No. 3, App. A ¶ A10.

[52] FAS 157 ¶ 5 ("Fair value is the price that would be received to sell an asset . . . in an orderly transaction between market participants at the measurement date."); *id.* ¶ 7 ("An orderly transaction . . . is not a forced transaction (for example, a forced liquidation or distress sale).").

[53] FAS 157 Appx. C ¶ C34 (emphasis added). On September, 30, 2008, Commission staff and the FASB staff issued a joint release reiterating that available market information should not be ignored. SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, Press Release No. 2008-234, 2008 WL 4411374 (Sept. 30, 2008) ("An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered *when weighing the available evidence*." (emphasis added)).

In light of the above, we find that Respondents failed to exercise due professional care or obtain sufficient competent evidential matter, and violated AU §§ 328 and 342, in their evaluation of TierOne's fair value estimates for the FAS 114 portion of the ALLL.

D. Respondents violated AU § 561 by applying no audit procedures when, after KPMG issued its 2008 audit opinion for TierOne, they discovered new appraisals that might have affected that opinion.

The Division alleges, and we agree, that Respondents violated AU § 561, which requires that auditors perform additional audit procedures after issuing a report if "new information which may affect the report comes to [their] attention."[54] The Division alleges that Respondents discovered, shortly after KPMG issued its March 2009 audit report, two appraisals that pre-dated the opinion and that reflected approximately $3.6 million in additional probable losses under FAS 114.

AU § 561 sets forth procedures that auditors should perform if, after issuing an audit report, they become "aware that facts may have existed at" the date of the report "which might have affected the report had [they] then been aware of such facts."[55] First, if the information is "of such a nature and from such a source that [they] would have investigated it had it come to [their] attention during the course of [the] audit," the auditors "should . . . undertake to determine whether the information is reliable and whether the facts existed at the date of [the] report."[56] "In this connection, the auditor[s] should discuss the matter with [their] client at whatever management levels [they] deem[] appropriate . . . ."[57] Second, if the information is both reliable and existed at the date of the auditors' report, they "should take action" to "prevent future reliance on [the] report" if (i) the "report would have been affected if the information had been known to" the auditors; and (ii) they believe "there are persons currently relying or likely to rely on the financial statements who would attach importance to the information."[58] Those actions include advising the client "to make appropriate disclosure of the newly discovered facts and

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54 AU § 561.03.

55 AU § 561.01.

56 AU § 561.04. The terms set forth in the PCAOB auditing standards describe the degree of responsibility that the standards impose on auditors: (1) the "words 'must,' 'shall,' and 'is required' indicate unconditional responsibilities"; (2) the "word 'should' indicates responsibilities that are presumptively mandatory; the "auditor must comply with requirements of this type . . . unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard"; and (3) the "words 'may,' 'might,' 'could,' and other terms and phrases describe actions and procedures that auditors have a responsibility to consider." PCAOB Rule 3101.

57 *Id.*

58 AU §§ 561.05, 561.06.

their impact on the financial statements" such as by issuing revised financial statements accompanied by a new auditor's report.[59]

AU § 561 sets forth its procedures "in general terms," giving auditors some leeway over "the specific actions to be taken in a particular case."[60] At a minimum, however, AU § 561 requires auditors to perform some inquiry or other auditing procedures if, after the date of the audit report, "new information which may affect the report comes to [their] attention."[61]

Respondents violated AU § 561 by performing no procedures when they discovered two new appraisals for two bucket-one loans in Nevada after KPMG issued its audit report on March 12, 2009. TierOne received the appraisals in January and February 2009, but Respondents did not discover them until KPMG reviewed the Bank's first-quarter 2009 financial statements in April 2009. The new appraisals resulted in about $3.6 million in additional FAS 114 loss provisions in the first-quarter 2009, split equally among the two loans.[62] One declined in fair value by 27%; the other by 36%. In comparison, the Nevada market declined at a monthly rate of between approximately 3% to 4% in January and February 2009 based on the S&P/Case-Shiller Home Price Index for Las Vegas.[63]

Aesoph admitted that Respondents performed no procedures under AU § 561 upon discovering that TierOne had received the two new appraisals.[64] The two appraisals "existed at the date of" KPMG's audit opinion on TierOne's 2008 financial statements and, since TierOne regularly used such appraisals for measuring the fair value of collateral securing its FAS 114 loans, Respondents should have undertaken to determine whether the information in the appraisals was reliable. At a minimum, Respondents should have inquired into whether the new appraisals might have affected TierOne's year-end 2008 financial statements.

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[59] AU § 561.06.

[60] AU § 561.02.

[61] AU § 561.03 ("After the date of the report, the auditor has *no obligation* to make any further or continuing inquiry or perform any other auditing procedures . . . *unless* new information which may affect the report comes to his or her attention." (emphasis added)).

[62] After issuing the 2008 audit opinion, Respondents also discovered new appraisals that pre-dated the opinion for three lending relationships in North Carolina (showing a decrease in collateral value) and one lending relationship in Nebraska (showing an increase in collateral value). The net impact of these new appraisals and the two new appraisals discussed above for Nevada loans was about $4.2 million in FAS 114 loss provisions in TierOne's interim financial statements for the first and second quarters of 2009. The Nebraska real estate market was relatively stable in 2008.

[63] Bennett conceded in testimony that TierOne needed to consider any appraisal received after December 31, 2008, but prepared before the date of the financial statements, to assess whether the appraisal affected the Bank's year-end fair value measurements.

[64] Bennett testified that he does not recall discussions with anyone at TierOne as to whether the losses reflected in the new appraisals should have been recorded at year-end 2008.

The size of the FAS 114 losses suggest that the new appraisals may have affected KPMG's audit opinion. $3.6 million is almost twice KPMG's $1.9 million materiality threshold for the 2008 audit. It is also more than the $2.9 million in "net interest income after provision for loan losses" that TierOne reported at year-end 2008, and therefore might have changed that figure into a loss depending upon how much of the $3.6 million loss was attributed to 2008.[65] Accordingly, we find that Respondents violated AU § 561.

IV. Respondents engaged in "improper professional conduct."

Rule 102(e) permits us to censure or deny (either permanently or temporarily) the privilege of appearing or practicing before the Commission to persons found to have engaged in "improper professional conduct."[66] Rule 102(e) has two alternative standards for determining whether an accountant has engaged in negligent "improper professional conduct": (1) "a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted"; or (2) "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."[67] We find that Respondents' conduct satisfies both.

A. Highly unreasonable conduct

Highly unreasonable conduct "is an intermediate standard, higher than ordinary negligence but lower than the traditional definition of recklessness."[68] This is an objective standard "measured by the degree of the departure from professional standards and not the intent of the accountant."[69] There were numerous instances of highly unreasonable conduct:[70]

1. Respondents decision to issue an unqualified opinion that TierOne maintained effective internal control over financial reporting when they knew that management's incentive

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65 In light of the foregoing, we reject Respondents' contention that a $3.6 million loss was insignificant in comparison to the $84 million loan loss provision and $93 million pretax loss reported in TierOne's 2008 financial statements.

66 Rule 102(e), 17 C.F.R. § 201.102(e); 15 U.S.C. § 78d-3(a). As noted above, Exchange Act Section 4C codified the standards set forth in Rule 102(e). For ease of reference, we will refer to only Rule 102(e) in discussing whether Respondents engaged in "improper professional conduct."

67 17 C.F.R. § 201.102(e)(1)(iv)(B).

68 *Amendment to Rule 102(e)*, 1998 WL 729201, at *6.

69 *Id.* at *7.

70 The Division alleges that Respondents' conduct consisted of a single instance of highly unreasonable conduct, and the law judge found that Respondents' conduct "taken as a whole" constituted a single instance of highly unreasonable conduct. We find that Respondents' conduct in any one of the three audit areas at issue satisfies the first negligence-based standard of Rule 102(e).

to overvalue the collateral securing the FAS 114 loans presented a high risk of material misstatement, and nonetheless identified no controls addressing that risk.

2. Respondents' decision not to question management's fair value estimates based on undiscounted stale appraisals for many FAS 114 loans, in light of management's incentive to misstate those estimates and the obvious inconsistencies between the stale appraisals and market conditions. Respondents relied largely on representations from the very people responsible for the estimates that they had determined presented a high risk of material misstatement due to fraud, and did so when those representations were at odds with market information that Respondents admittedly reviewed.

3. Respondents' conclusion that management's fair value estimates were reasonable based on a finding that "market conditions have not materially deteriorated," a conclusion Respondents admitted did not make sense. The market had in fact dropped drastically, as Respondents knew at the time.

4. Respondents' decision to ignore two new appraisals that they discovered after KPMG issued its 2008 audit opinion.[71] Those appraisals were strong evidence that TierOne had additional, material FAS 114 losses in 2008 that were not included in its year-end financial statements. The two appraisals reflected $3.6 million in FAS 114 losses for two loans, an amount almost double KPMG's materiality threshold and high enough to potentially turn into a loss TierOne's year-end "net interest income after provision for loan losses." These new appraisals also cast doubt on whether TierOne reasonably estimated the losses for dozens of other FAS 114 loans based on stale appraisals. AU § 561 required the application of at least some auditing procedures in response to this new information; Respondents did nothing.

These audit failures were egregious violations of multiple auditing standards, including AS No. 5, AU §§ 328, 342, and 561, and the standards requiring that Respondents exercise due professional care and obtain sufficient competent evidential matter. We also find that Respondents' highly unreasonable conduct that resulted in these violations was in circumstances in which Respondents knew or should have known that heightened scrutiny was warranted.[72]

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[71] Bennett contends that the ALJ "did not rely upon the claimed violation of AU § 561 as support for [her] determination of 'a single instance of highly unreasonable conduct' or 'repeated instances of unreasonable conduct,'" and that the Division did not appeal that decision. This contention lacks merit because the ALJ found that Respondents violated AU § 561, and in concluding that "Respondents' course of conduct met the highly unreasonable conduct threshold, specifically referenced Respondents' procedures in "evaluating the FAS 114 estimates," procedures that necessarily include their treatment of post-audit evidence affecting the reliability of those estimates. *Aesoph*, 2014 WL 2915931, at *31-32 & n.38.

[72] Heightened scrutiny is warranted "when matters are important or material, or when warning signals or other factors should alert an accountant" to a heightened risk. *Amendment to Rule 102(e)*, 1998 WL 729201, at *8; *James Thomas McCurdy, CPA*, Exchange Act Release No. 49182, 2004 WL 210606, at *8 (Feb. 4, 2004), *aff'd*, 396 F.3d 1258 (D.C. Cir. 2005).

Respondents admitted that they knew that the FAS 114 portion of the ALLL was material to TierOne's financial statements and presented a high risk of material misstatement.

Accordingly, we conclude that Respondents engaged in "improper professional conduct" within the meaning of the first negligence-based standard of Rule 102(e).

B. Unreasonable conduct

Alternatively, we find that Respondents engaged in repeated instances of unreasonable conduct, each resulting in a violation of PCAOB auditing standards, that indicate a lack of competence to practice before us. Because Respondents engaged in repeated instances of *highly unreasonable conduct* for the reasons discussed above, they more than satisfy the element of having engaged in repeated instances of *unreasonable conduct*.[73] Unreasonable conduct is a lower standard than highly unreasonable conduct, and signifies an ordinary or simple negligence standard.[74]

Respondents' unreasonable conduct indicates a lack of competence to practice before us. When we adopted amendments to Rule 102(e) in 1998, we explained that if "an accountant fails to exercise reasonable care on more than one occasion, the Commission's processes may be threatened," and that "[m]ore than one violation of applicable professional standards ordinarily will indicate a lack of competence."[75] We must "make a specific finding that the conduct indicates a lack of competence" because "two isolated violations of applicable professional standards . . . may not pose a threat to the Commission's processes."[76]

Respondents' instances of unreasonable conduct were not isolated; they were sustained throughout the audit of the ALLL. We find that the recurrence of unreasonable conduct in so many audit areas concerning the ALLL demonstrates a lack of competence to practice before us. Compounding this finding is that Respondents' repeated misconduct occurred in a high risk audit area, where auditors must increase their professional care and heighten their professional skepticism. Respondents' conclusively demonstrated that they pose a threat to our processes by (1) relying on management's representations when they knew management had a strong

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[73] Respondents contend that they cannot have engaged in "repeated instances of unreasonable conduct" because their alleged misconduct involved a single account: the ALLL. As we have stated previously, however, "Rule 102(e) looks to the number of instances of unreasonable conduct, not the number of accounts." *Kevin Hall, CPA*, Exchange Act Release No. 61162, 2009 WL 4809215, at *7 (Dec. 14, 2009); *cf. Amendment to Rule 102(e)*, 1998 WL 729201, at *9 ("'Repeated instances' means more than once. The term 'repeated' may encompass as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits.").

[74] *Amendment to Rule 102(e)*, 1998 WL 729201, at *6, 9.

[75] *Amendment to Rule 102(e)*, at *9. In contrast, we stated that highly unreasonable conduct when heightened scrutiny is warranted "conclusively demonstrates a lack of competence to practice before the Commission." *Id.* at *2, 5.

[76] *Id.* at *10.

incentive to lie, and in the face of evidence that market conditions contradicted those representations; (2) ignoring their responsibilities under AU § 561 when they discovered additional evidence contradicting management's representations; and (3) issuing an unqualified opinion on the effectiveness of internal control when they identified collateral overvaluation as presenting a high risk of material misstatement but identified no adequate controls designed to address that risk. The number of PCAOB auditing standard violations in an area of high audit risk demonstrates a lack of competence to practice before us.

Accordingly, Respondents engaged in "improper professional conduct" within the meaning of the second negligence-based standard of Rule 102(e).

V. Sanctions

When determining an appropriate sanction, "we are mindful of the remedial nature of Rule 102(e) and our purpose in promulgating the rule to ensure that the Commission's 'processes continue to be protected, and that the investing public continues to have confidence in the integrity of the financial reporting process."[77] As we recognized in our release adopting the 1998 amendments to Rule 102(e), "the Commission has limited resources" and therefore "must rely on the competence and independence of the auditors who certify, and the accountants who prepare, financial statements."[78] Because of this, the Commission and the investing public must "rely heavily on accountants to assure corporate compliance with federal securities law and disclosure of accurate and reliable financial information."[79]

Respondents' conduct was egregious, highly unreasonable, and conclusively demonstrates that they lack competence to practice before us.[80] Respondents have failed to acknowledge the wrongful nature of their conduct or provide assurances against future violations.[81] Taken together, these facts lead us to conclude that there is a risk that Respondents

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[77] *Dearlove*, 2008 WL 281105, at *29 (quoting *Amendment to Rule 102(e)*, 1998 WL 729201, at *4).

[78] *Amendment to Rule 102(e)*, 1998 WL 729201, at *4.

[79] *Id.*

[80] As we have stated, "a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive." *Amendment to Rule 102(e)*, 1998 WL 729201, at *6. "A disciplinary matter involving highly unreasonable conduct is therefore not necessarily less egregious than one involving intentional or reckless conduct." *McNeeley*, 2012 WL 6457291, at *20.

[81] Respondents contend that their due process rights are violated should we evaluate whether they recognize their wrongful conduct. "[D]ue process is not violated by giving a respondent a choice between recognizing the wrongfulness of his conduct, or refusing to do so and thereby risking more severe remedial action." *Seghers v. SEC*, 548 F.3d 129, 136-37 (D.C. Cir. 2008).

will commit future violations.[82] We find that it is in the public interest to deny Respondents the privilege of appearing or practicing before us, with a right for Aesoph to apply for reinstatement after three years and for Bennett to apply for reinstatement after two years.[83] These remedies will also serve as a deterrent to Respondents and other auditors.[84]

Respondents' various arguments do not undermine the need for these sanctions. Respondents blame TierOne for their audit failures, contending that it committed fraud directed precisely at the audit of FAS 114 loss estimates.[85] TierOne's fraud, however, did not cause Respondents' auditing standards violations; those violations resulted from Respondents' failures to, among other things, obtain sufficient competent evidential matter or evaluate TierOne's FAS 114 loss estimates with professional skepticism, perform the inquiry required by AU § 561 after discovering new appraisals that might have affected KPMG's audit opinion, and identify controls designed to address the risk of collateral overvaluation.[86]

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82 *McNeeley*, 2012 WL 6457291, at *18 ("As the D.C. Circuit has recognized, 'the existence of a violation raises an inference that it will be repeated.'" (quoting *Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004))).

83 Bennett contends that he had been a senior manager for only one year at the time of the TierOne audit, and that at every step he "consulted with the engagement partner and the SEC concurring review partner, who assured him that they concurred with his judgments and believed his conduct complied with professional standards." Although the record shows that Bennett had significant responsibility for TierOne's year-end 2008 audit, including supervising the audit team's day-to-day work, we acknowledge that he did not have final authority over the audit or experience comparable to that of Aesoph. We took this into consideration in giving Bennett a shorter period of time than Aesoph to apply for reinstatement.

84 Typically, if we decide that it is in the public interest to deny a person the privilege of appearing or practicing before us, we either impose a temporary suspension for up to twelve months or a bar with the right to apply for reinstatement after a period of years. *Compare McNeeley*, 2012 WL 6457291, at *20 (six-month suspension), *and McCurdy*, 2004 WL 210606, at *9 (one-year suspension), *with Dearlove*, 2008 WL 281105, at *31 (bar with right to apply for reinstatement after four years), *and Scutillo*, 2003 WL 21738818, at *17 (bar with right to apply for reinstatement after three years). We follow our usual practice here.

85 On November 6, 2015, a jury in federal district court found TierOne's Chairman and CEO, Gilbert Lundstrom, guilty of conspiring with management to conceal TierOne's true financial condition from shareholders, regulators, and KPMG. *See* Verdict, *United States v. Lundstrom*, No. 4:14-cr-03136 (D. Neb. Nov. 6, 2015). In 2014, TierOne's President and COO, James Laphen, and CCO, Don Langford, pleaded guilty to the same charge in federal district court. *See* Plea Agreement, *United States v. Laphen*, No. 4:14-cr-03133-JMG-CRZ (D. Neb. Dec. 8, 2014); Plea Agreement, *United States v. Langford*, No. 4:14-cr-03103-JMG-CRZ (D. Neb. Sept. 9, 2014).

86 *Cf. S.W. Hatfield, CPA*, Exchange Act Release No. 69930, 2013 WL 3339647, at *24 (July 3, 2013) ("Whether the companies withheld documents or made misrepresentations, however, did not relieve Applicants of their auditing responsibilities described in this opinion.").

Respondents contend that the ALJ found their work in other audit areas to be at "the highest professional standards"; they significantly increased the hours they and the audit team spent on the 2008 audit over the prior year audit for TierOne; they are well-respected at KPMG as auditors, leaders, and mentors; they have unblemished disciplinary histories and continue to practice as auditors without any questions being raised as to their competence; and they have cooperated with the investigations by the Department of Justice and the Commission into TierOne's management. Aesoph also contends that he played a substantial role in bringing TierOne's fraud to light by "repeatedly confronting Bank management" when he became aware that it may have "deprived him of material information"; and then, after concluding that "KPMG could no longer rely on management's representations," informing TierOne in 2010 that KPMG was resigning as independent auditor and withdrawing its 2008 year-end audit opinion. We have considered these facts, but find that they do not outweigh our concerns that Respondents lack competence to practice before us and that significant sanctions are warranted.

Aesoph further contends that there is no likelihood of future violations given the uniqueness of the situation in which Respondents conducted the 2008 audit, including the difficulty in applying FAS 157 in the midst of a recession. But our finding that there is a risk of future violations is based on, among other things, Respondents' highly unreasonable conduct in violating auditing standards that are always applicable. Moreover, as discussed, FAS 157 has discernable parameters that did not permit TierOne to ignore market conditions, and Respondents' misconduct was egregious, in part, because it was obvious that TierOne's fair value estimates were inconsistent with market information.

Respondents contend that sanctions would effectively end their careers. Bennett also contends that he "has not been able to audit public companies since" the institution of these proceedings, "so he effectively has been penalized already for an extended period." We recognize that our imposition of sanctions could have collateral consequences, but such consequences are outweighed by our concern that "[a]n incompetent or unethical practitioner has the ability to inflict substantial damage to the Commission's processes, and thus the investing public, and to the level of trust and confidence in our capital markets."[87] "[W]here such individuals engage in professional misconduct which impairs the integrity of the Commission's processes, the Commission has an obligation to respond through the application of" Rule 102(e).[88]

Finally, Bennett contends that his purported conduct was "a far cry from the type of conduct that has resulted in the suspension of managers by the Commission" in five prior proceedings because, he claims, it was not egregious or recurrent. We disagree with Bennett's assessment of his own conduct; as discussed above, it was egregious and highly unreasonable as to the three audit areas at issue. In any event, the appropriate sanction "depends on the facts and

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87 *McNeeley*, 2012 WL 6457291, at *19 (quoting *Steven Altman, Esq.*, Exchange Act Release No. 63306, 2010 WL 5092725, at *20 (Nov. 10, 2010), *petition denied*, 666 F.3d 1322 (D.C. Cir. 2011)).

88 *Id.*

circumstances of each particular case and cannot be precisely determined by comparison with action take in other proceedings."[89]

VI. Respondents' Constitutional and Fairness Arguments

A. Respondents were not denied the protections of the Administrative Procedure Act or due process.

Respondents contend that the ALJ violated Section 556(d) of the Administrative Procedure Act ("APA") and due process under the U.S. Constitution by not considering the whole record, including the opinions of their economic and accounting and auditing experts.[90] Respondents also contend that the ALJ erred in admitting the report and testimony of the Division's economic expert, Anjan V. Thakor, because he analyzed fair value using indices that included distressed sales, and because he is not a CPA or an accounting expert.

These contentions are meritless. Respondents do not point to any specific piece of relevant evidence that the ALJ ignored, and our review of the record reveals none. In any event, the ALJ's Initial Decision "ceased to have any force or effect once [Respondents] filed [their] petition for review."[91] Our review is *de novo* and plenary as to evidentiary rulings, as well as to factual findings and legal conclusions; accordingly, we are not bound by the ALJ's mode of analysis or the manner in which she weighed the evidence. For example, we have chosen to rely on the analysis from Respondents' economic expert that market indices showed that the Las Vegas and Phoenix real estate markets dropping by double-digits in 2008 even after removing distressed sales. We have considered the whole record, including the expert opinions, and find that the preponderance of the evidence supports our conclusion that Respondents violated Rule 102(e) for the reasons discussed above.[92]

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[89] *Robert L. Burns*, Advisers Act Release No. 3260, 2011 WL 3407859, at *11 n.52 (Aug. 5, 2011 (quoting *PAZ Sec., Inc.*, Exchange Act Release No. 57656, 2008 WL 1697153, at *9 (Apr. 11, 2008)), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009))); *see also Butz v. Glover Livestock Comm'n Co., Inc.*, 411 U.S. 182, 187 (1973) ("The employment of a sanction within the authority of an administrative agency is . . . not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases.").

[90] 5 U.S.C. § 556(d) ("A sanction may not be imposed or rule or order issued except on consideration of the whole record or those parts thereof cited by a party and supported by and in accordance with the reliable, probative, and substantial evidence.").

[91] *Dearlove*, 2008 WL 281105, at *10 & n.42.

[92] As to the parties' economic experts, we find that both were qualified and that their opinions were relevant to this proceeding because they concerned, among other things, the economic conditions of the market during the time at issue. We therefore find that the ALJ did not err in admitting into evidence Thakor's report and testimony.

As to the parties' experts on accounting and auditing, they reached opposite conclusions, with Respondents' expert opining that Respondents complied with auditing standards and the

Respondents also make a series of due process arguments. Respondents contend that the loan files supported TierOne's fair value estimates, that the Division did not prove its allegations because it obtained only about one-third of the loan files in its investigation, and that Respondents could not obtain the remaining loan files because TierOne no longer existed by the time Respondents could obtain discovery. We reject these arguments.

Respondents were required under AS No. 3 to "document the procedures performed, evidence obtained, and conclusions reached" as to "relevant financial statement assertions."[93] The record contains all of KPMG's audit work papers, which do not document TierOne's rationale, or supporting evidence from any purported review of loan files, for not discounting stale appraisals in estimating fair value. This absence casts doubt on Respondents' assertion that they contemporaneously obtained and reviewed loan files that would have supported TierOne's fair value estimates.[94] Moreover, at the hearing, Bennett could not identify any loan-specific evidence which he believed existed but he did not have that could support the conclusion that TierOne's fair value estimates were reasonable.[95]

We also reject Respondents related argument that the procedural limitations on discovery deprived Respondents of due process. The fact that different discovery mechanisms are available in federal district court does not establish a violation of due process.[96] In short, we find that Respondents have established neither a violation of due process nor any cognizable prejudice to their defense.[97]

Division's expert opining that they did not so comply. But we need not defer to either expert. We set forth our judgment and the reasons supporting it above.

93 AS No. 3 ¶ 6 & App. A ¶ A10.

94 It is undisputed that the loan files actually obtained by the Division were turned over to Respondents when the Division made available its investigative file in compliance with Rule of Practice 230.

95 *See Bernard E. Young*, Exchange Act Release No. 774421, 2016 WL 1168564, at *20 (March 24, 2016) (finding no prejudice to Respondent from being unable to access certain documents held by a receiver because he did not show how the documents "might have been relevant, or identified any categories of documents that were relevant to his defense which he did not have access to by virtue of the Division's document production"), *appeal docketed*, No. 16-1149 (D.C. Cir. May 24, 2016).

96 *Dearlove*, 2008 WL 281105, at *37 (finding that the deadlines for the completion of administrative proceedings in Commission Rule of Practice 360(a), 17 C.F.R. § 201.360(a), did not violate due process); *Young*, 2016 WL 1168564, at *19 n.84 (noting it is well established that no due process violation results from failure to apply federal Rules of Evidence).

97 *Kirlin Sec., Inc.*, Exchange Act Release No. 61135, 2009 WL 4731652, at *17 (Dec. 10, 2009) ("Because Applicants have failed to establish what information they were denied and how that denial prejudiced their case, we reject Applicants' argument that the proceedings against them were procedurally flawed.").

B. Respondents' Appointments Clause argument lacks merit.

Respondents argue that ALJ Carol Fox Foelak—who presided over this matter and issued the Initial Decision—was not appointed in a manner consistent with the Appointments Clause of Article II of the Constitution.[98] We have rejected this claim before and, for the same reasons, again do so here.[99] Because the Commission's ALJs are employees, not constitutional officers, their manner of appointment is not subject to the requirements of the Appointments Clause.

We are unpersuaded by Respondents' criticisms of our prior decisions. They point out that several federal district courts have concluded, in decisions that the Commission has appealed, that the Commission's ALJs are inferior officers.[100] Those decisions decline to apply *Landry v. FDIC*,[101] in which the D.C. Circuit held that the FDIC's ALJs were employees, and rely instead on *Freytag v. Commissioner*,[102] in which the Supreme Court held that a "special trial judge" of the Tax Court was an inferior officer. But as we have previously explained, we agree with *Landry*'s analysis and the distinctions that the D.C. Circuit identified between ALJs and the special trial judges at issue in *Freytag*.[103] Under *Landry*, the touchstone for determining whether adjudicators are inferior officers is the extent to which they have the power to issue "final decisions."[104] Like the FDIC's ALJs, the Commission's ALJs conduct hearings, take testimony,

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[98] The Clause provides that the President "by and with the advice and consent of the Senate, shall appoint . . . Officers of the United States . . . but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments." U.S. Const. art. II, § 2, cl. 2.

[99] *See, e.g.*, *David F. Bandimere*, Exchange Act Release No. 76308, 2015 WL 6575665, at *19 (Oct. 29, 2015), *petition for review filed*, No. 15-9586 (10th Cir. Dec. 22, 2015); *Timbervest, LLC*, Advisers Act Release No. 4197, 2015 WL 5472520, at *23-26 (Sept. 17, 2015), *petition for review filed*, No. 15-1416 (D.C. Cir. Nov. 13, 2015); *Raymond J. Lucia Companies*, Exchange Act Release No. 75837, 2015 WL 5172953, at *21-23 (Sept. 3, 2015), *petition for review filed*, No. 15-435 (D.C. Cir. Oct. 7, 2015).

[100] *See Gray Financial Group Inc. v. SEC*, No. 15-cv-00492, ECF No. 56 (N.D. Ga. Aug. 4, 2015) (appeal pending); *Duka v. SEC*, No. 15 Civ. 357(RMB)(SN), 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015) (appeal pending); *Hill v. SEC*, No. 1:15–CV–1801–LMM, 2015 WL 4307088 (N.D. Ga. June 8, 2015) (appeal pending).

[101] 204 F.3d 1125 (D.C. Cir. 2000).

[102] 501 U.S. 868 (1991).

[103] *See, e.g.*, *Bandimere*, 2015 WL 6575665, at *19, 21; *Timbervest, LLC*, 2015 WL 5472520, at *24-26; *Raymond J. Lucia Cos.*, 2015 WL 5172953, at *21-23.

[104] 204 F.3d at 1133-34. Respondents assert that the Commission has changed its views on this point, having previously taken the position in *Free Enterprise Fund* that members of the PCAOB were inferior officers even though they lacked authority to issue final decisions. *See* Br. for the United States, *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010) (No. 08-861), 2009 WL 3290435 (Oct. 13, 2009). Respondents misapprehend what was at issue in *Free Enterprise Fund*. There, it was "undisputed" that PCAOB Board members

rule on admissibility of evidence, and issue subpoenas. And just as the FDIC's ALJs issue only "recommended decisions" that are not final decisions of the agency, our ALJs issue "initial decisions" that are likewise not final and subject to our *de novo* review.[105]

Respondents contend that we wrongly concluded in our prior decisions that our ALJs cannot issue final decisions in our administrative proceedings. Specifically, they claim that review of an ALJ's initial decision "by the Commission is not mandatory or automatic." We are not persuaded by this argument, which rests on a misunderstanding of our review process. Any respondent may petition for review of an ALJ's initial decision, and it is "our 'longstanding practice [to] grant[] virtually all petitions for review'"; indeed, we are unaware of any case in which a respondent's timely filed petition for review has been denied.[106] Further, even if no respondent seeks review, we have the authority to review a decision on our own initiative.[107]

Respondents also assert that "where the parties choose not to file a petition for review, and the Commission does not [direct] review on its own initiative, the ALJ's Initial Decision is 'deemed the action of the Commission.'" They rely on Section 4A(c) of the Exchange Act, which provides that if the Commission declines to review "delegated action," then the action "shall, for all purposes, including appeal or review thereof, be deemed the action of the

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were inferior officers, so there was no occasion to address the distinction between mere employees and inferior officers. *See id.* at 29 n.8. Further, that case did not turn on the absence or presence of adjudicative finality, because PCAOB Board members performed "enforcement or policymaking functions." *Free Enterprise Fund*, 561 U.S. at 507 n.10.

[105] *See, e.g.*, *Bandimere*, 2015 WL 6575665, at *20; *Timbervest, LLC*, 2015 WL 5472520, at *24; *Raymond J. Lucia Cos.*, 2015 WL 5172953, at *22; *accord George R. Jarkesy, Jr. v. SEC*, 803 F.3d 9, 12-13 (D.C. Cir. 2015) ("The Commission reviews ALJ decisions de novo, and it alone possesses the authority to issue a final order.").

[106] *See, e.g.*, *Bandimere*, 2015 WL 6575665, at *20 (quoting Exchange Act Release No. 35833, 1995 WL 368865, at *80-81 (June 9, 1995)). Respondents assert that Rule of Practice 411 "set[s] forth criteria to be considered by the Commission" in entertaining petitions for review. That Rule merely recites general considerations that inform the exercise of our discretion. 17 C.F.R. § 201.411(b)(2). We have made clear that, "[u]nder these standards, the Commission grants a petition for review in virtually all cases." 1995 WL 368865, at *80.

[107] Rule of Practice 411(c), 17 C.F.R. § 201.411(c); *see, e.g.*, *Bandimere*, 2015 WL 6575665, at *20; *Timbervest, LLC*, 2015 WL 5472520, at *24; *Raymond J. Lucia Cos.*, 2015 WL 5172953, at *22. We have *sua sponte* ordered review on a number of occasions. *See, e.g.*, *MGSI Sec., Inc.*, Exchange Act Release No. 42717, 2000 WL 462952, at *1 (Apr. 25, 2000) ("The Commission has determined to review the decision on its own initiative . . . ."); *Robert I. Moses*, Exchange Act Release No. 37795, 1996 WL 580130, at *1 (Oct. 8, 1996) ("On our own motion, we ordered a limited review of the [initial] decision . . . ."); *accord Dian Min Ma*, Exchange Act Release No. 74887, 2015 WL 2088438, at *1 (May 6, 2015); *Michael Lee Mendenhall*, Exchange Act Release No. 74532, 2015 WL 1247374, at *1 (Mar. 19, 2015); *George C. Kern, Jr.*, Exchange Act Release No. 29356, 1991 WL 284804, at *1 (June 21, 1991).

Commission."[108] But this argument overlooks Rule of Practice 360(d), which was promulgated "pursuant to our general rulemaking authority under the securities laws."[109] Regardless of whether review is sought or ordered, "[u]nder our rules, no initial decision becomes final simply 'on the lapse of time.'"[110] It is *our* issuance of a finality order that makes an ALJ's decision final and effective.[111] As we have explained, the effect of Rule 360(d) is "that our ALJs' initial decisions (like the FDIC's ALJs' recommended decisions) do not become the final and effective decision of the [Commission] without affirmative action on our part—specifically, our issuance of a finality order."[112] Section 4A reserves to us the "right to exercise . . . review" over any initial decision as we deem fit, and Rule of Practice 360(d) is one element of how we have chosen to structure that process.[113] In sum, even when no party challenges an ALJ's initial decision, we must determine whether to exercise our authority to *sua sponte* take up the matter or to issue a finality order.

Turning to respondents' next contention, we do not view the fact that we accord our ALJs deference in the context of demeanor-based credibility determinations to vest them with the type of authority that would qualify them as inferior officers. First, as we have repeatedly made clear, we do not accept such determinations "blindly," and we will "disregard explicit determinations of credibility" when our *de novo* review of the record as a whole convinces us that a witness's testimony is credible (or not) or that the weight of the evidence warrants a different finding as to the ultimate facts at issue.[114] Second, our practice in this regard is no different from the FDIC's and so is not a basis for distinguishing or declining to follow *Landry*.[115] In *Freytag*, by contrast,

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108 15 U.S.C. § 78d-1(c).

109 *Raymond J. Lucia Cos.*, 2015 WL 5172953, at *21 n.109.

110 *Id.* at *21 (quoting Exchange Act Release No. 49412, 2004 WL 503739, at *12 (Mar. 12, 2004)); *see also Timbervest, LLC*, 2015 WL 5472520, at *24.

111 *See* Rule of Practice 360(d)(2), 17 C.F.R. § 201.360(d)(2) (providing that "the *Commission* will issue an order that the decision has become final" and that an initial decision becomes final only "upon issuance of the order" by the Commission) (emphasis added).

112 *Raymond J. Lucia Cos.*, 2015 WL 5172953, at *21 n.109. Respondents err in suggesting that the finality order merely "formaliz[es] the finality of the ALJ's initial decision." To the contrary, the finality order is what makes the decision final and effective.

113 15 U.S.C. § 78d-1(c).

114 *Kenneth R. Ward*, Exchange Act Release No. 47535, 2003 WL 1447865, at *10 (Mar. 19, 2003), *aff'd*, 75 F. App'x 320 (5th Cir. 2003); *accord Francis V. Lorenzo*, Exchange Act Release No. 74836, 2015 WL 1927763, at *10 n.32 (Apr. 29, 2015), *petition for review filed*, No. 15-1202 (D.C. Cir. July 1, 2015); *Irfan Mohammed Amanat*, Exchange Act Release No. 54708, 2006 WL 3199181, at *8 n.46 (Nov. 3, 2006), *petition denied*, 269 F. App'x 217 (3d Cir. 2008); *see also Kay v. FCC*, 396 F.3d 1184, 1189 (D.C. Cir. 2005) ("The law is settled that an agency is not required to adopt the credibility determinations of an administrative law judge.").

115 *Compare [Redacted] (Insured State Nonmember Bank)*, FDIC-82-73a, 1984 WL 273918, at *5 (June 18, 1984) (stating, "as a general rule," that "the assessment of the credibility of witnesses" by the FDIC's ALJs is given "deference" by the FDIC) *with Ramon M. Candelaria*,

the Tax Court was "required to defer" to the special trial judges' factual and credibility findings "unless they were clearly erroneous."[116]

Respondents assert that our "Rules also provide ALJs with authority to punish contemptuous conduct." That authority is far more limited than that at the disposal of district court judges or judges on an Article I court; indeed, the Supreme Court has made clear that the absence of contempt powers generally distinguishes agency from court proceedings.[117] Our rules provide ALJs with authority to punish contemptuous conduct in only the following, limited ways: If a person engages in contemptuous conduct before the ALJ during any proceeding, the ALJ may "exclude that person from such hearing or conference, or any portion thereof" or "summarily suspend that person from representing others in the proceeding in which such conduct occurred for the duration, or any portion, of the proceeding."[118] If there are deficiencies in a filing, a Commission ALJ "may reject, in whole or in part," the filing, such filing "shall not be part of the record," and the ALJ "may direct a party to cure any deficiencies."[119] Finally, if a party fails to make a required filing or to cure a deficiency with a filing, then a Commission ALJ "may enter a default . . . , dismiss the case, decide the particular matter at issue against that person, or prohibit the introduction of evidence or exclude testimony concerning that matter."[120] Any such ruling would, of course, be subject to *de novo* Commission review.[121] In these respects, too, our ALJs are akin to the FDIC's ALJs that *Landry* found to be "mere employees."[122] By contrast, the Tax Court (and by extension the court's special tax judges)

FDIC-95-62e, 1997 WL 211341, at *3-4 (Mar. 11, 1997) (noting that the FDIC ALJ found respondent to be "entirely credible" but rejecting respondent's testimony "in light of the entire record").

116 *Landry*, 204 F.3d at 1133.

117 *See ICC v. Brimson*, 154 U.S. 447, 488-89 (1894), *overruled on other grounds*, *Bloom v. Illinois*, 391 U.S. 194 (1968)); *Shasta Minerals & Chemical Co. v. SEC* , 328 F.2d 285, 286 (10th Cir.1964). The Commission *itself*, as distinguished from its ALJs, possesses a variety of other powers that in the aggregate endow Commissioners with significant authority under the laws of the United States, including the power to promulgate final rules (15 U.S.C. § 77s), to institute administrative proceedings (*id.* § 77h-1(a)), to bring suit in federal district court (*id.* § 77t(b)), and to grant exemptions from otherwise applicable securities laws (*id.* § 77z-3).

118 Rule of Practice 180(a), 17 C.F.R. § 201.180(a).

119 Rule of Practice 180(b), 17 C.F.R. § 201.180(b).

120 Rule of Practice 180(c), 17 C.F.R. § 201.180(c).

121 An order excluding or summarily suspending a person is subject to Commission review on an expedited and interlocutory basis. Rule of Practice 180(a)(2), 17 C.F.R. § 201.180(a)(2).

122 *See, e.g.*, *First Bank of Jacksonville*, FDIC-96-155b, 1998 WL 363852, at *11-12 (May 26, 1998) (approving the FDIC ALJ's imposition of a sanction precluding the respondent from offering certain evidence); 12 C.F.R. § 308.108.

exercised “a portion of the judicial power of the United States,” including the “authority to punish contempts by fine or imprisonment.”[123]

We do not agree with respondents’ contention that *Landry* is distinguishable. Instead, we adhere to our determination that the duties and powers of the Commission’s ALJs are comparable to those of the FDIC’s ALJs, and so continue to be guided by *Landry* in rejecting Respondents’ Appointments Clause claim.

An appropriate order will issue.[124]

By the Commission (Chair WHITE and Commissioner STEIN); Commissioner PIWOWAR, concurring in part and dissenting in part.

Brent J. Fields
Secretary

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123 *Freytag*, 501 U.S. at 891.

124 We have considered all of the parties’ contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

Commissioner PIWOWAR, concurring in part and dissenting in part:

I concur with the opinion's findings that the Respondents Aesoph and Bennett engaged in "improper professional conduct" as defined by Rule 102(e)'s negligence-based standards.[1] However, I dissent from the imposition of a permanent denial of the privilege of appearing or practicing before the Commission as an accountant.

As recognized by the U.S. Court of Appeals for the D.C. Circuit, "[t]he Commission may impose sanctions for a remedial purpose, but not for punishment" under Rule 102(e).[2] In her initial decision, the administrative law judge determined that Aesoph should be denied the privilege of appearing or practicing before the Commission for one year and Bennett should be denied for six months.[3] In reaching her decision, she considered the *Steadman* factors and the need for deterrence.[4] She noted as "praiseworthy factors" that the Respondents were highly regarded at their firm, recognized risks associated with the allowance for loan and lease losses, worked longer on the 2008 audit than on the previous audit,[5] and adequately conducted other areas of the audit.[6] Nonetheless, she concluded that these factors did not obviate the need for sanctions and she considered numerous other Commission precedents in reaching her decision.[7]

The Division of Enforcement ("Division") requested that Aesoph be denied the privilege for three years and that Bennett be denied for two years.[8] At oral argument, I specifically asked counsel for the Division to clarify whether the Division was seeking a three-year and two-year suspension for Aesoph and Bennett, respectively, or whether he was seeking a bar with the right

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[1] With respect to the constitutional arguments raised by the Respondents regarding the Appointments Clause of the Constitution, I have previously expressed my views. *See* Dissenting Opinion of Commissioner Gallagher and Commissioner Piwowar, *Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.* (Sept. 3, 2015), available at https://www.sec.gov/news/statement/dissenting-opinion-gallagher-piwowar.html.

[2] *McCurdy v. SEC*, 396 F.3d 1258, 1264 (D.C. Cir. 2005) (citations omitted).

[3] *Joseph J. Aesoph, CPA, and Darren M. Bennett, CPA*, Initial Decision Release No. 624 (June 27, 2014), at 36, *available at* https://www.sec.gov/alj/aljdec/2014/id624cff.pdf (the "Initial Decision").

[4] *Id*.

[5] Separately, I have concerns that the inspection process of the Public Company Accounting Oversight Board has resulted, and continues to result, in audits where significant efforts are undertaken by auditors to ensure that every "box" is checked off regardless of material effect, thereby making it more difficult for auditors, management, and audit committees to focus on the most critical areas of an issuer's financial statements. In other words, there is more effort and less effectiveness.

[6] Initial Decision at 37.

[7] *Id*. at 37 n.40.

[8] *Id*. at 36.

to apply for reinstatement after three years and two years. Counsel for the Division responded the former.

By imposing a permanent bar with the right to apply for reinstatement after three years and two years, the majority of the Commission has imposed a punitive sanction that goes far beyond what the Division requested. There is a significant difference between a three-year and two-year suspension as compared to a bar with the right to apply for reinstatement after three years and two years. Under a suspension, the Respondents would be free to resume practicing or appearing before the Commission when the suspension ends. Under a bar with the right to apply for reinstatement, once the requisite time period has passed, Respondents will only be no longer prohibited from seeking reinstatement from the Commission. They must still file a petition with the Commission even to be considered for reinstatement.[9]

Petitions for accountant reinstatements are first evaluated by our Office of the Chief Accountant and, if satisfactory, are then recommended to the Commission for approval.[10] There are no deadlines for the Commission or its staff to complete this process. Pursuant to Rule 102(e)(5) of our Rules of Practice,[11] the Commission may, but is not obligated, to reinstate a person "for good cause shown." Based on my experience as Commissioner, the reinstatement process, even if successful, can take years to complete after the requisite time period has expired. Moreover, since there is no assurance that a petition for reinstatement will be granted by the Commission, the right to apply for reinstatement can be illusory.[12]

Given the record in this matter, I find no compelling reason for going beyond the Division's request and imposing a permanent bar with a right to apply for reinstatement on the Respondents. The majority's sole justification for this punitive sanction and resulting

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9 A permanent bar with a right to apply for reinstatement after a period of time is harsher than an outright permanent bar. With an outright bar, an individual may petition the Commission at any time for reinstatement. With a right to apply for reinstatement, the individual must wait until the stated time period has elapsed before filing. Thus, to the extent that providing a right to apply for reinstatement after a certain period of time creates the appearance of moderation to an otherwise permanent bar, that perception is false.

10 The amount of time and resources (e.g., retention of counsel) needed to navigate the process may deter some individuals from even attempting to petition for reinstatement.

11 17 C.F.R. 201.102(e).

12 On its face, Rule 102(e)(5) does not address whether the presence, or absence, of a period before which a respondent has a right to apply for reinstatement in connection with a permanent bar should affect the "good cause" analysis. In light of such uncertainty, any respondent in a Commission enforcement action (including a settlement with the Commission) should be on notice of the possibility that, in consideration of a reinstatement petition, the inclusion of a right to apply for reinstatement period may have no effect on a future Commission's decision as whether to grant reinstatement.

destruction of the Respondents' professional careers is that it "follow[s] our usual practice." This is not a sufficient justification under our rules and legal precedents.[13]

[13] *See, e.g., Steadman v. SEC*, 603 F.2d 1126, 1140 ("In our view, however, permanent exclusion from the industry is 'without justification in fact' unless the Commission specifically articulates compelling reasons for such a sanction.").

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 78490 / August 5, 2016

Admin. Proc. File No. 3-15168

In the Matter of JOHN J. AESOPH, CPA and DARREN M. BENNETT, CPA

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that John J. Aesoph, CPA, be denied the privilege of appearing or practicing before the Commission as an accountant with the proviso that, after three years, he may apply to the Commission for reinstatement, upon an appropriate showing; and it is further

ORDERED that Darren M. Bennett, CPA, be denied the privilege of appearing or practicing before the Commission as an accountant with the proviso that, after two years, he may apply to the Commission for reinstatement, upon an appropriate showing.

By the Commission.

Brent J. Fields
Secretary