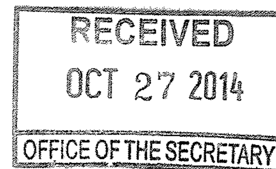
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-15168

In the Matter of

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

Respondents.

BRIEF OF RESPONDENT DARREN M. BENNETT

October 24, 2014

Gary F. Bendinger
Kevin A. Burke
Sidley Austin LLP
787 Seventh Avenue
New York, NY 10019
Telephone: (212) 839-5300
Facsimile: (212) 839-5599
gbendinger@sidley.com
kaburke@sidley.com

Paul J. Zidlicky
Sidley Austin LLP
1501 K Street, N.W.
Washington, DC 20005
Telephone: (202) 736-8000
Facsimile: (202) 736-8711
pzidlicky@sidley.com

Attorneys for Respondent Darren M. Bennett

TABLE OF CONTENTS

Page

INTRODUCTION AND SUMMARY 1

ISSUES PRESENTED 4

BACKGROUND 4

A. Commission Rule 102(e) 4

B. Applicable Professional Standards 5

1. Accounting Principles 6

2. Auditing Standards 7

C. Factual Background 9

1. TierOne Corporation 9

2. Mr. Bennett And The KPMG Engagement Team 10

3. The 2008 Integrated Audit 10

4. The Discovery Of Management Fraud After The 2008 Audit 13

D. The Hearing And Initial Decision 14

STANDARD OF REVIEW 15

ARGUMENT 16

I. THE INITIAL DECISION MISAPPLIES APPLICABLE PROFESSIONAL STANDARDS AND FAILS TO ADDRESS RELEVANT EVIDENCE 16

A. The Initial Decision Misapplies Applicable Professional Standards 16

B. The Initial Decision Fails To Address Relevant Evidence 18

II. MR. BENNETT DID NOT VIOLATE RULE 102(e) 20

A. Mr. Bennett's Conduct With Respect To Auditing TierOne's Internal Controls Complied With Professional Standards 20

1. The Engagement Team Obtained Sufficient Competent Evidence Of The Design And Operating Effectiveness Of TierOne's Internal Controls 20

2. The Initial Decision Misconstrues The Significance Of The Internal Controls Tested And Ignores Relevant Evidence 23

B. Mr. Bennett's Audit Conduct With Respect To TierOne's ALLL Complied With Professional Standards 26

1. Mr. Bennett And The Engagement Team Obtained Sufficient Competent Evidence Relating To The Reasonableness Of TierOne's ALLL Estimate 26

2. The Initial Decision Misconstrues The Applicable Professional Standards And Ignores Contrary Evidence 32

C. Mr. Bennett's Response To Appraisals Acquired After The 2008 Integrated Audit Complied With Professional Standards 38

D. Mr. Bennett Did Not Engage In Any Instance Of "Highly Unreasonable Conduct" Or In Repeated Instances Of "Unreasonable Conduct" 40

III. THE INITIAL DECISION'S PROPOSED SANCTION SHOULD BE REJECTED AS ARBITRARY AND CAPRICIOUS 42

CONCLUSION 45

TABLE OF AUTHORITIES

CASES **Page(s)**

Checkosky v. *SEC*, 139 F.3d 221 (D.C. Cir. 1998)....................18, 40

Checkosky v. SEC, 23 F.3d 452 (D.C. Cir. 1994)....................40

Gen. Elec. Co. v. EPA, 53 F.3d 1324 (D.C. Cir. 1995)....................16, 34

In re Bloomfield, Exchange Act Release No. 71632, 2014 SEC LEXIS 698 (Feb. 27, 2014)......15

In re Carter & Johnson, Exchange Act Release No. 17597, 1981 WL 384414 (Feb. 28, 1981)....................42

In re Dohan & Co., Release No. ID-420, 2011 SEC LEXIS 2205 (June 27, 2011)....................41

In re Fundamental Portfolio Advisors, Inc., Exchange Act Release No. 48177, 56 S.E.C. 651 (July 15, 2003)....................15

In re Oprins & McNeeley, Release No. ID-411, 2010 SEC LEXIS 4450 (Dec. 28, 2010).....41, 42

KPMG v. SEC, 289 F.3d 109 (D.C. Cir. 2002)....................16, 34

Lakeland Bus Lines, Inc. v. NLRB, 347 F.3d 955 (D.C. Cir. 2003)....................18

Landry v. FDIC, 204 F.3d 1125 (D.C. Cir. 2000)....................18

Morall v. DEA, 412 F.3d 165 (D.C. Cir. 2005)....................18, 19

SEC v. Chenery Corp., 332 U.S. 194 (1947)....................20

SEC v. First City Fin. Corp., 890 F.2d 1215 (D.C. Cir. 1989)....................44

State Corp. Comm'n v. Fed. Power Comm'n, 206 F.2d 690 (8th Cir. 1953)....................20

Trailways, Inc. v. ICC, 673 F.2d 514 (D.C. Cir. 1982)....................20

STATUTES AND REGULATIONS

5 U.S.C. § 556(d)....................18

15 U.S.C. § 78d-3....................4, 5

15 U.S.C. § 78y(a)(4)....................18

17 C.F.R. § 201.102(e)(1)....................5

RULES

SEC Rule of Practice 102(e) .... *passim*

SEC Rule of Practice 411(a) 15

OTHER AUTHORITIES

Amendment to Rule 102(e), Exchange Act Release No. 33-7593, 63 Fed. Reg. 57,164 (Oct. 26, 1998) .... *passim*

AS No. 3 .... 4, 8, 17, 19

AS No. 5 .... 8, 20

AU § 230 .... 8, 17

AU § 312 35

AU § 326 8

AU § 342 .... 8, 11, 35

AU § 328 .... 8, 26, 33

AU § 561 38

FAS 5 6

FAS 114 6

FAS 157 .... 7, 12

SEC Release No. 2008-234, Clarifications on Fair Value Accounting 7

RECORD CITATION ABBREVIATIONS

"ID-__"	Initial Decision, dated June 27, 2014-Page Number
"JPF ¶__"	Respondents' Joint Proposed Findings of Fact, dated December 10, 2013
"Tr.-__"	Corrected Transcript of Hearing-Page Number
"RX-__"	Respondents' Exhibit
"DX-__"	Division's Exhibit

INTRODUCTION AND SUMMARY

The Division of Enforcement has pursued Respondent Darren Bennett, as a first-year senior manager at KPMG, for allegedly engaging in "improper professional conduct" in violation of Commission Rule 102(e) while auditing a regional bank during 2008's Great Recession. He alone has been targeted among thousands of non-partner accountants involved in audits of public financial institutions during that turbulent time.

At the administrative proceeding, the record showed that Mr. Bennett worked tirelessly on the 2008 integrated audit of TierOne Corporation ("TierOne") under the regular supervision of multiple KPMG partners. He did not withhold information from his superiors or fail to do what was asked of him. KPMG partners reviewed and concurred with Mr. Bennett's professional judgments, including with respect to the single component of the financial statement assertion now at issue, the FAS 114 reserves for impaired loans within TierOne's allowance for loan and lease losses ("ALLL"). It would be unprecedented for a non-partner auditor to be deemed to have engaged in "improper professional conduct" under Rule 102(e) under these circumstances.

Mr. Bennett and the KPMG engagement team diligently planned and executed the audit during a time of extreme economic uncertainty. They considered and assessed financial statement risks, including identification of the ALLL as a significant risk area. They carefully reviewed and analyzed the findings of TierOne's regulator at the Office of Thrift Supervision ("OTS") and monitored management's compliance with regulatory requirements. In response to identified risks and market conditions, they modified their audit approach, developed and carried out *enhanced* audit procedures and observed audit evidence showing management's unbiased and good-faith efforts to estimate the fair value of TierOne's FAS 114 impaired loans at year-end 2008. Ultimately, Mr. Bennett and the engagement team concluded in their professional

judgment that the audit evidence provided a reasonable basis for KPMG's 2008 integrated audit opinions.

Hindsight should not be permitted to obscure the reasonableness of their judgments, but that risk here is grave. In August 2009, TierOne recorded substantial, additional loan losses on construction and land development loans in regions hard-hit by the Great Recession. In June 2010, the OTS closed TierOne because it incurred further loan losses. And, as the Commission alleged in civil actions brought in 2012, management had perpetrated a collusive fraud to deceive TierOne's shareholders, regulators, *and auditors* about management's belief in the reasonableness of the ALLL dating back to the 2008 financial statements.

In the stark light of this hindsight, the Administrative Law Judge substituted her judgment for that of the engagement team and concluded that Mr. Bennett violated Rule 102(e). Predicating her ruling largely on market indices from the *second half* of 2008, and misconstruing the significance of "current" appraisals in illiquid markets, the Initial Decision concludes that the engagement team failed (1) to "identify or test a control that sufficiently addressed the prevention or detection of a material misstatement caused by collateral overvaluation on FAS 114 loans," ID-28, (2) "to perform sufficient audit procedures with respect to, and obtain persuasive evidence supporting, management's [FAS 114] estimates," ID-32, and (3) to "conduct[] further inquiry and investigation to appropriately determine whether the new appraisals" received in 2009 "would have affected their [audit] report," ID-35. These conclusions are arbitrary, capricious and contrary to law because they misapply applicable professional standards, ignore relevant evidence, and misunderstand the requirements of Rule 102(e).

First, sanctions under Rule 102(e) cannot be based on "novel" professional standards adopted, retrospectively, through adjudication. The accounting principles applicable to the fair value estimates in this matter include both FAS 157 and related guidance issued in 2008 by the Commission's Office of the Chief Accountant ("OCA") and the Financial Accounting Standards Board ("FASB") Staff. Under those principles, a fair value measurement assumes the exchange of collateral in an "orderly transaction" and "[d]istressed or forced liquidation sales are not orderly transactions." Those principles do not require "current" appraisals and make clear that market indices, such as those available to the engagement team, are not determinative of fair value. Yet, under the Initial Decision, in a period of economic uncertainty where liquidation sales are pervasive, an auditor could not issue an unqualified audit opinion unless there are "current" appraisals of collateral. That is *not* what the OCA and FASB advised auditors and market participants in 2008, and it would be fundamentally unfair to change these standards retroactively.

Second, the bedrock requirements of due process and reasoned decision-making applicable here through the Administrative Procedure Act require more than a blanket declaration that "[a]ll arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision were considered and rejected." ID-2. The record reflects that there was sufficient competent audit evidence to support Mr. Bennett's professional judgment regarding the reasonableness of TierOne's ALLL at year-end 2008. That evidence included workpapers outside of the FAS 114 memorandum singled out by the Division, fact testimony elaborating on procedures reflected in the workpapers, manager review comments, documentation from TierOne's loan files, and expert testimony regarding the reasonableness of Mr. Bennett's conduct. Much of that evidence, however, is unaddressed in the Initial Decision. The Initial

Decision adopts a misguided interpretation of the applicable audit documentation standard for workpapers (AS No. 3) that improperly treats it as a rule of evidence to disregard critical testimony substantiating the reasonableness of Mr. Bennett's conduct.

Finally, the proposed sanction is arbitrary, capricious and contrary to law. Through years of investigation and the disruption caused by a public administrative proceeding, Mr. Bennett's career and life have been turned upside down. Now, the Initial Decision recommends a six-month ban from practicing before the Commission, in practical effect derailing his chosen career within public accounting. No just aim is accomplished by this sanction. Any ban at this stage would be punitive and unnecessary to serve the goals underlying Rule 102(e).

ISSUES PRESENTED

1. Whether the Initial Decision misconstrued and misapplied applicable professional standards?

2. Whether the Initial Decision's failure to consider and address relevant record evidence was arbitrary, capricious, and contrary to law?

3. Whether Mr. Bennett, as a senior manager, engaged in improper professional conduct under Commission Rule 102(e)?

4. Whether imposition of a potentially career-ending sanction against Mr. Bennett is necessary to protect the Commission's processes under Rule 102(e)?

BACKGROUND

A. Commission Rule 102(e)

15 U.S.C. § 78d-3 grants the Commission the "[a]uthority to censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission, after notice and opportunity

for hearing in the matter ... to have engaged in ... improper professional conduct." 15 U.S.C. § 78d-3(a)(2). Under Section 78d-3(a), "improper professional conduct" includes:

> (2) negligent conduct in the form of—
>
> > (A) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which the registered public accounting firm or associated person knows, or should know, that heightened scrutiny is warranted; or
> >
> > (B) 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.

Id. § 78d-3(b)(2); *accord* 17 C.F.R. § 201.102(e)(1).

The Commission has explained that Rule 102(e) was "not intended to cover all forms of professional misconduct" but instead only "that category of professional conduct that threatens harm to the Commission's processes." Amendment to Rule 102(e), Exchange Act Release No. 33-7593, 63 Fed. Reg. 57,164, 57,165 (Oct. 26, 1998) ("Rule 102(e) Release"). The Commission "does not seek to use Rule 102(e)(1)(ii) to establish new standards for the accounting profession." *Id.* at 57,166. Indeed, Rule 102(e) "does not permit judgment by hindsight but rather compares the actions taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken if faced with the same situation." *Id.* at 57,168. In assessing whether conduct is "highly unreasonable," "[t]he conduct at issue is measured by the degree of the departure from professional standards" rather than "the impact of a violation on financial statements" or "the risk of harm posed by the conduct." *Id.* at 57,167-68.

B. <u>Applicable Professional Standards</u>

TierOne was responsible for (i) establishing effective internal controls over financial reporting ("Internal Controls") and (ii) reporting its financial results in accordance with generally accepted accounting principles ("GAAP"). JPF ¶¶39-41. The auditor's responsibility, in turn,

was to express an opinion on (i) the effectiveness of the company's Internal Controls, and (ii) on management's financial statements. JPF ¶70. The issues presented here involve the application of these professional standards to the audit procedures applied to TierOne's ALLL, "a balance-sheet reserve account intended to cover known and inherent losses in TierOne's loan portfolio," ID-7, which was a single account on TierOne's year-end 2008 financial statements. Although the ALLL consisted of both "losses for unimpaired loans evaluated under FAS 5," and "losses for impaired loans evaluated under FAS 114," ID-7, the Division's allegations addressed only the fair value estimates for *impaired loans under FAS 114*.

1. Accounting Principles

ALLL is an accounting estimate of incurred loan losses inherent in an institution's loan portfolio as of the balance sheet date. JPF ¶42. ALLL is not a prediction of future losses; rather, it is an estimate of loan losses that management has concluded are "probable and reasonably estimable." FAS 5 ¶ 8 (RX-46); JPF ¶44. Estimates of loan losses are inherently subjective, require the exercise of judgment, and are considered for reasonableness within a range. JPF ¶45. Under FAS 114, TierOne was obligated to determine "when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." FAS 114 ¶ 8 (RX-44); JPF ¶48. Measuring impairment "requires judgment and estimates, and the eventual outcomes may differ from those estimates." FAS 114 ¶ 8 (RX-44); JPF ¶51. The magnitude of impairment can be "based on ... the fair value of the collateral if the loan is collateral dependent." FAS 114 ¶ 13 (RX-44); JPF ¶52. Neither GAAP nor any other professional standard requires a "current" appraisal in estimating the "fair value" of collateral securing an impaired loan. JPF ¶96.

Fair value estimates are governed by FAS 157, which defines fair value as "the price that would be received to sell an asset ... in an orderly transaction between market participants at the measurement date." FAS 157 ¶ 5 (RX-45); JPF ¶55. Under FAS 157, an "orderly transaction" is "not a forced transaction (for example, a forced liquidation or distress sale)." *Id.* In September 2008, in response to a "period of market uncertainty" that "made questions surrounding the determination of fair value particularly challenging for preparers, auditors, and users of financial information," JPF ¶58, the Commission's OCA and the FASB Staff issued a release clarifying that "[d]istressed or forced liquidation sales are not orderly transactions," and therefore "[t]he results of disorderly transactions are not determinative when measuring fair value." SEC Release No. 2008-234, Clarifications on Fair Value Accounting (RX-66); JPF ¶59.

FAS 157 establishes "a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels." FAS 157 ¶ A21 (RX-45); JPF ¶61. At one end, Level 1 inputs are "quoted prices ... in active markets for identical assets or liabilities." FAS 157 ¶ 24 (RX-45); JPF ¶62. At the other end, "Level 3 inputs are unobservable inputs for [an] asset or liability, that is, inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability (including assumptions about risk) developed based on the best information available in the circumstances." FAS 157 ¶ 21 (RX-45); JPF ¶¶63, 65-66. The fair value estimates here are based on Level 3 inputs. JPF ¶118.

2. Auditing Standards

In an integrated audit, the auditor expresses an opinion as to management's (i) Internal Controls, and (ii) financial statements. JPF ¶70. Auditing Standard No. 5 requires the auditor to obtain "sufficient evidence to support the auditor's opinion on internal control over financial

reporting as of year-end." AS No. 7 ¶ 7 (RX-50); JPF ¶71. Likewise, the auditor's objective is to obtain "sufficient evidence to support the auditor's control risk assessments for purposes of ... financial statements." AS No. 7 ¶ 7 (RX-50); JPF ¶71. As to both, AU Section 230 requires the auditor to obtain "reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment." AU § 230.10 (RX-55); JPF ¶72.

To meet these obligations, the auditor seeks "sufficient competent evidential matter to provide ... a reasonable basis for forming an opinion." AU § 230.11 (2008) (RX-55); JPF ¶73. The auditor exercises professional judgment in determining the quality of audit evidence and properly may rely "on evidence that is persuasive rather than convincing." AU § 326.22 (RX-59); JPF ¶75. The auditor expresses no opinion on individual loan values or on the ALLL itself, JPF ¶¶78, 85, and is not expected to "function as an appraiser" or "substitute [his] judgment for that of the entity's management," AU § 328.38 (RX-60); JPF ¶86. Rather, the auditor assesses whether management's ALLL estimate falls within a *reasonable* range, JPF ¶87, and evaluates the "reasonableness" of accounting estimates "in the context of the financial statements taken as a whole," AU § 342.04 (RX-61); JPF ¶¶78-79.

Finally, Auditing Standard No. 3 ("AS No. 3") provides that auditors should document their work so that an experienced auditor, not involved in the audit, can understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached. AS No. 3 (RX-49); JPF ¶106. AS No. 3 requires the exercise of professional judgment, as an auditor need not document every fact or conversation considered. JPF ¶108; RX-49.

C. **Factual Background**

1. TierOne Corporation

TierOne Corporation was the holding company of TierOne Bank, a regional bank headquartered in Lincoln, Nebraska. ID-4. Outside its primary market area of Nebraska, Iowa, and Kansas, the bank originated loans to customers in states including Nevada, Arizona and Florida until the third quarter of 2008 when it closed its loan production offices in those other states. ID-4. At year-end 2008, TierOne's total loan portfolio amounted to $2.8 billion, comprised mostly of unimpaired loans. JPF ¶117.[1] TierOne's net impaired loan balance totaled $170 million, *i.e.* 6% of total loans. JPF ¶121. TierOne recorded losses of approximately $57 million on its impaired loans through 2008 (*i.e.*, reserves of $16.4 million at year-end and charge-offs of $40.4 million throughout 2008). JPF ¶314 n.520.

The OTS conducted periodic examinations of TierOne, including one that resulted in a Report of Examination ("ROE") issued in October 2008. The ROE contained a variety of criticisms of TierOne. Although the OTS concluded TierOne's March 31, 2008 ALLL was deficient by $17 to $22 million, it did *not* require TierOne to restate its March 31, 2008 financial statements for these additional losses recorded in the quarter ending June 30, 2008. JPF ¶¶189, 196, 211(a). The OTS determined that "the adequacy of ALLL has been adequately addressed by management—and greatly enhanced with quarterly SFAS No. 114 impairment templates" and that "[c]redit must be given to management," which "has taken appropriate and requested steps to strengthen the bank and address the problems." RX-151; JPF ¶213(a), 215.

---

[1] TierOne's ALLL estimate for the total loan portfolio was $63.2 million. The approximately $2.6 billion of the total loan portfolio not deemed impaired was accounted for under FAS 5. Estimated reserves for these non-impaired loans were $46.8 million, or 74% of the total ALLL. JPF ¶117.

2. Mr. Bennett And The KPMG Engagement Team

Mr. Bennett served as the senior manager for the 2008 TierOne integrated audit. ID-6. At the time, he had been with KPMG for eight years, had been a senior manager for one year, and had completed extensive continuing professional education courses, in excess of the requirements, in areas pertaining to the banking industry and the prevailing economic crisis. JPF ¶19. The Division's expert, John Barron, testified that Mr. Bennett was "technically competent" and knowledgeable about FAS 114 and FAS 157. Tr.-1215-16; JPF ¶¶20, 471.

The engagement team also included Mr. Aesoph, Beth Burke, the audit senior, Sandra Washek, a credit specialist, and Terence Kenney, the SEC reviewing partner. JPF ¶¶28, 37. Mr. Bennett had four years of prior experience auditing TierOne, which provided him with cumulative knowledge of TierOne's business, operations, processes, accounting and management. JPF ¶22. Mr. Aesoph likewise had detailed knowledge of TierOne from working on TierOne audits since 2002, first as the manager and then as the engagement partner. JPF ¶7. Mr. Kenney was a senior partner and financial services practice leader at KPMG. JPF ¶33.

Mr. Bennett reported directly to Mr. Aesoph and Mr. Kenney. Before providing them with the workpapers for their review and approval, Mr. Bennett reviewed each one; his sign-off appears on every "L-series" workpaper relating to TierOne's loans and ALLL. JPF ¶¶31, 436. Mr. Bennett closely supervised junior professionals on the team and provided hundreds of detailed review comments with respect to all aspects of the quarterly and year-end audit workpapers. JPF ¶¶30, 35, 324-25, 327-29. The Division's expert, Mr. Barron, acknowledged that Mr. Bennett performed the functions expected of a senior manager. Tr.-1211-15; JPF ¶30.

3. The 2008 Integrated Audit

The engagement team appropriately identified the ALLL as a significant audit area, Tr.-1163; JPF ¶176, and appropriately identified a high inherent risk of material misstatement,

Tr.-1023-24; JPF ¶177. The Division's expert also acknowledged that the engagement team (i) correctly identified the risk of fraud in the ALLL, Tr.-1164-65; JPF ¶¶177, 473, (ii) appropriately identified the risk posed by deteriorating economic conditions, JPF ¶177, (iii) appropriately developed an understanding of that estimation process, which was well-documented in the audit workpapers, Tr.-1215-16; JPF ¶¶218-31, 471, and (iv) selected an appropriate approach to test the reasonableness of the ALLL, *i.e.*, reviewing and testing management's process to develop the estimate, Tr.-1118-19; JPF ¶¶80-83, 306-07, 475; AU § 342.10(a)-(c) (RX-61).

TierOne's ALLL estimation process was a central focus of the audit. JPF ¶462; *see also* JPF ¶¶218-31, 251, 303. Mr. Bennett and the engagement team observed that TierOne's process included review and assessment of reserves for $2.1 billion of non-homogeneous loans, comprised of $1.9 billion of non-impaired loans under FAS 5 and $225 million of loans potentially impaired under FAS 114. JPF ¶¶120, 220-21. The vast majority of the non-impaired loans consisted of non-homogeneous construction and land development loans. JPF ¶120. Under FAS 5, TierOne estimated reserves for these loans by grouping similar loans and then applying loss factors based on historical experience. JPF ¶¶220-21. The Division did not criticize any of the engagement team's work and judgments relating to TierOne's FAS 5 loan portfolio. JPF ¶¶222, 470.

Mr. Bennett and the engagement team observed that TierOne evaluated for impairment, on an individual basis, loans rated substandard or worse. JPF ¶223. For each loan deemed impaired, management generally employed "a collateral-dependent fair value model" to estimate a reserve. RX-8 at KPMGTO0005435-35; JPF ¶224. Given the nature of the collateral, management relied on "Level 3" unobservable inputs, which required TierOne to develop its

"own assumptions about the assumptions that market participants would use." FAS 157 ¶ 30 (RX-45); JPF ¶¶61-65, 118. Management documented reserve estimates for impaired loans quarterly in FAS 114 "templates," charged off the difference between the impaired loan's book value and estimated fair value and discounted further for the estimated selling costs and the present value of the collateral based on an estimated time to sell. JPF ¶¶224-25, 279. TierOne's Special Assets Executive, David Frances, prepared the FAS 114 templates in conjunction with Don Langford, the Chief Credit Officer ("CCO"), and the Controller, David Kellogg, reviewed and approved each FAS 114 template. JPF ¶¶226, 244, 279. TierOne's Asset Classification Committee ("ACC")—comprised of eleven members including Mr. Langford, Mr. Kellogg and other senior executives—then reviewed and approved the ALLL. JPF ¶¶282, 287, 299.

Mr. Bennett and the engagement team evaluated the OTS's regulatory findings in consultation with regulatory specialists, and David Butler, KPMG's regional Professional Practice Partner. They monitored management's responses to OTS's findings through the audit period and, before completing the audit, communicated directly with the OTS regulator in charge. JPF ¶¶ 190, 198-200, 203, 491. Mr. Bennett observed that management undertook a variety of initiatives in response to the OTS's findings, which included:

- Creating an independent Internal Asset Review ("IAR") Department, and hiring an officer to lead the department and report directly to the Audit Committee and CEO;
- Implementing a new IAR Policy that required independent review, classification, and valuation of assets;
- Engaging a third-party, Reynolds Williams Group, to assist IAR in reviewing all non-homogeneous loan relationships over $1 million; and
- Holding bi-weekly Problem Loan/Watch Loan Committee meetings to review all delinquent loans for impairment and/or non-performance.

JPF ¶216.

Based on its understanding of the ALLL estimation process, as well as the heightened risks and management's efforts to respond to those risks, Mr. Bennett and the engagement team modified the audit approach and increased both interim and year-end audit procedures for testing the reasonableness of the ALLL. JPF ¶180; *see also* JPF ¶¶161, 163. These enhanced procedures included (1) engaging a credit risk specialist to conduct loan reviews *three times* during the year, (2) performing substantive procedures on *all* of TierOne's FAS 114 impaired loans, and (3) evaluating TierOne's impaired loans by state. JPF ¶¶191, 200, 317-318, 322, 355-56.

Mr. Bennett and the engagement team documented their extensive work in nineteen quarterly review and year-end audit binders, including more than one thousand pages of workpapers addressing the ALLL, each of which bears Mr. Bennett's sign-off. JPF ¶¶435-36. Likewise, the engagement team increased the time devoted to the 2008 TierOne audit by over 50% compared to the 2007 audit (from about 1,760 hours in 2007 to 2,650 hours in 2008). JPF ¶¶180-81. Mr. Bennett increased the time he devoted to the 2008 TierOne audit by approximately 90% over time spent on the 2007 audit. JPF ¶182.

Ultimately, Mr. Bennett and the engagement team made a professional judgment that the evidence obtained supported KPMG's 2008 integrated audit opinions. Throughout the 2008 audit, Mr. Aesoph and Mr. Kenney—two KPMG partners with decades of bank auditing experience—reviewed and concurred with each significant judgment made by Mr. Bennett, including this ultimate judgment. JPF ¶¶7, 32-33, 360, 396.

4. <u>The Discovery Of Management Fraud After The 2008 Audit</u>

Both the Commission and the Department of Justice pursued former TierOne executives for fraud and deceit of auditors in connection with TierOne's ALLL. In 2012, the Commission filed complaints in federal court alleging that management perpetrated a fraud designed to

"deceive" the KPMG engagement team. JPF ¶¶122-24, 442-43; RX-234-35. This collusive fraud included management's failure to disclose that it *questioned* the sufficiency of certain FAS 114 reserves, and that the FAS 114 fair value estimates were not the result of a good-faith consensus process. JPF ¶¶443-47. In 2014, TierOne's former CCO, Mr. Langford, entered a guilty plea and admitted to conspiring with senior executives and other employees to conceal TierOne's true financial condition from shareholders, regulators, and the KPMG engagement team. *See* Plea Agreement, *United States v. Langford*, No. 4:14-cr-03103-JMG-CRZ (D. Neb. Sept. 9, 2014). Mr. Bennett and the engagement team had no knowledge of management's fraud, which affected the persuasiveness of the audit evidence, JPF ¶¶447-48, and the Division does not contend that they should have discovered it.

D. <u>The Hearing And Initial Decision</u>

The hearing before the ALJ lasted nine days. ID-2. At the hearing, the Division presented five witnesses, including Mr. Bennett and Mr. Aesoph and two experts, Anjan V. Thakor and John Barron. Mr. Bennett and Mr. Aesoph testified about their respective roles in the 2008 audit. Tr.-344-723 (Bennett); Tr.-724-1000 (Aesoph). Dr. Thakor, who is not an accountant, testified regarding his view of the relevant real estate markets in 2008, Tr.-107-343, including his erroneous conclusion that under FAS 157 distressed sales properly reflected fair market value. Tr.-252-53. Mr. Barron opined that Mr. Bennett and Mr. Aesoph violated relevant accounting and auditing standards. Tr.-1001-392. The Division's final witness, Douglas Pittman, was the field manager for the OTS in its 2008 examination of TierOne Bank. Tr.-1405-67.

Mr. Bennett and Mr. Aesoph also testified in their own cases about their conduct in planning and performing the integrated 2008 audit. Tr.-1518-1727 (Bennett); Tr.-1728-1802

(Aesoph). Christopher James, Ph.D., testified about the impact of distressed sales on fair value of real estate, and criticized Dr. Thakor's misapplication of FAS 157. Tr.-1804-1910. Finally, Sandra Johnigan, who was accepted as an expert in accounting and auditing, testified that Mr. Bennett and Mr. Aesoph complied with PCAOB auditing standards and gathered sufficient competent evidence to support a reasonable basis for the audit opinions. Tr.-1910-2188.

In the Initial Decision issued on June 27, 2014, the ALJ "denies [Mr.] Bennett the privilege of appearing or practicing before the Commission as an accountant for six months." ID-1. Conspicuously, the Initial Decision points to post-hoc evidence that in August 2009 TierOne "recorded $120 million in losses relating to its loan portfolio after obtaining updated appraisals," ID-5, in June 2010, "OTS closed TierOne," and in 2012, the Commission filed Complaints against TierOne management alleging "fraud and deceit of auditors in connection with TierOne's loan-related losses." ID-5. The Initial Decision recognizes that substantial aspects of the audit were properly planned and performed "to the highest professional standards," ID-31, but concludes that Mr. Bennett violated Rule 102(e) with regard to the integrated audit of TierOne's Internal Controls, ID-26-28, and the process used by management to develop the FAS 114 component of the ALLL estimate. ID-29-35.

STANDARD OF REVIEW

Under Rule of Practice 411(a), the Commission has authority to "affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part, an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper and on the basis of the record." The Commission conducts an independent, *de novo* review of the record, except for those findings that are not challenged on appeal. *In re Fundamental Portfolio Advisors, Inc.*, Exchange Act Release No. 48177, 56 S.E.C. 651, 653 (July 15, 2003); *In re Bloomfield*, Exchange Act Release No. 71632, 2014 SEC LEXIS 698, at *38 (Feb. 27, 2014).

ARGUMENT

I. THE INITIAL DECISION MISAPPLIES APPLICABLE PROFESSIONAL STANDARDS AND FAILS TO ADDRESS RELEVANT EVIDENCE.

The Commission's independent review of the record is critical because the Initial Decision is predicated on (1) a misapplication of professional standards (and impermissible imposition of "new" professional standards) and (2) a disregard for critical evidence in violation of the APA. A brief discussion of these foundational legal errors is necessary because they permeate the ALJ's analysis and, as detailed in Part II, mandate reversal of the Initial Decision.

A. The Initial Decision Misapplies Applicable Professional Standards.

The Initial Decision's liability conclusions were based on the absence of "current" appraisals, concluding that the engagement team considered appraisals from earlier in 2008 "despite contrary market information." ID-35-36; *see also* ID-28, 30. But, there is no requirement of "current" appraisals under the professional standards, and, any such requirement would be inconsistent with the skepticism of such appraisals under FAS 157 during periods where liquidation and distressed sales skew sale prices and undermine the determinative value of "current" appraisals. JPF ¶¶58, 96. Moreover, the retroactive application of a "current" appraisal requirement to Mr. Bennett's conduct would be improper because Rule 102(e) may not be used "to establish new standards for the accounting profession." Rule 102(e) Release, 63 Fed. Reg. at 57,166; *see, e.g., KPMG v. SEC*, 289 F.3d 109 (D.C. Cir. 2002) (commission erred in finding auditor violated professional standards where novel interpretation of auditing standard resulted in the denial of fair notice); *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1329-34 (D.C. Cir. 1995) (reversing finding of liability where agency interpretation was "so far from a reasonable person's understanding of the regulations that they could not have fairly informed [company] of the agency's perspective" and therefore violated company's due process rights).

The Initial Decision also misconstrues applicable standards by asserting that Mr. Bennett conceded that "to evaluate the reasonableness of the [FAS 114] estimates in the context of the financial statements taken as a whole" the engagement team was "required to evaluate *those* estimates on a loan-by-loan basis." ID-3-4 (emphasis added). There is no requirement that auditors evaluate each FAS 114 loan estimate. Mr. Bennett acknowledged that when evaluating FAS 114 estimates it was necessary to do so on an individual basis. *See, e.g.*, JPF ¶322. That is critically distinct from conceding that auditors are *required* to evaluate *each* individual FAS 114 estimate.[2] To the contrary, an auditor's objective is to obtain reasonable assurance to allow the auditor to express opinions on whether the financial statements are free of material misstatements and whether a material weakness exists. AU § 230.10 (RX-55). The auditor does not express an opinion on the reasonableness of a single accounting estimate such as the ALLL, let alone a component thereof. Although the engagement team performed a variety of procedures with respect to each FAS 114 loan, that approach was an exercise of heightened skepticism and due care, not the manifestation of an obligation to "audit" each impaired loan reserve.

Finally, the Initial Decision's reliance on commentary to AS No. 3, ID-25, to disregard or minimize probative evidence is arbitrary and capricious and violates fundamental notions of due process. ID-18, 33. AS No. 3 requires auditors to document their work so that an experienced auditor not involved in the audit can understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached. AS No. 3 ¶ 6(a) (RX-49);

[2] The engagement team was not required to document audit conclusions for each individual impaired loan. *See* ID-18 n.22. Rather, AS No. 3 requires conclusions for *financial statement assertions*—here, TierOne's ALLL. JPF ¶106 (citing AS No. 3 ¶ 6 (RX-49)).

JPF ¶107. Nothing in AS No. 3 nullifies testimonial or other documentary evidence that proves audit work was performed, or dictates the weight to be accorded such evidence.

B. The Initial Decision Fails To Address Relevant Evidence.

The Initial Decision ignores critical evidence submitted by Respondents and fails to reconcile that evidence with its determinations. Under the APA, "[a] sanction may not be imposed ... 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." 5 U.S.C. § 556(d); *see also* 15 U.S.C. § 78y(a)(4). Further, "an agency violates the APA when it fails to include in its adjudicatory decision a meaningful 'statement of findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record.'" *Checkosky v. SEC*, 139 F.3d 221, 226 (D.C. Cir. 1998) ("*Checkosky II*") (quoting and applying 5 U.S.C. § 557(c)(3)(A)).

Thus, in *Morall v. DEA*, the Court set aside the agency decision because petitioner "presented extensive testimony pertaining to each of these disputed facts" but "one would not know it from the [agency's] analysis." 412 F.3d 165, 178-80 (D.C. Cir. 2005). Likewise, in *Lakeland Bus Lines, Inc. v. NLRB*, the Court held that that NLRB's "clipped view of the record" did not support the conclusion that the employer committed an unfair labor practice. 347 F.3d 955, 963 (D.C. Cir. 2003). And, in *Landry v. FDIC*, the court explained that the APA requires "consideration of the evidence on *both* sides." 204 F.3d 1125, 1140 (D.C. Cir. 2000). In failing to consider and weigh the relevant record evidence, including the testimony of both fact and expert witnesses, the Initial Decision lacks an adequate evidentiary foundation.

For example, Mr. Bennett submitted substantial evidence through the expert testimony of Sandra Johnigan (an expert in accounting and auditing) and Professor James (an expert in

economic analysis). *E.g.*, JPF ¶¶455-63; 493-507; RX-42; RX-43A. Ms. Johnigan—whom the Division and Department of Justice have previously engaged as an expert in other matters— is an experienced bank auditor and member of the AICPA's Auditing Standards Board. JPF ¶¶455-57, 461. Ms. Johnigan testified that Mr. Bennett and the engagement team (i) obtained sufficient, competent evidence to support the conclusion that TierOne's Internal Controls over the ALLL estimation process were effective, (ii) appropriately audited the ALLL by reviewing and testing management's estimation process, and (iii) complied with AS No. 3 in documenting the 2008 integrated audit. JPF ¶462; *e.g.*, Tr.-2002, 2031, 2039-40, 2059.[3] In turn, Professor James, who has held positions with the FDIC and the U.S. Department of Treasury, testified about the market conditions in 2008, the impact of disorderly sales on appraisals and pricing indices, and that the methodology employed by the Division's economic analysis witness would lead to a biased and flawed measure of fair value. JPF ¶¶497, 504; *e.g.*, Tr.-1817, 1828-30.

The Initial Decision acknowledges that these expert witnesses testified at the hearing, ID-21, but thereafter ignores their evidence. The Initial Decision makes no credibility determinations about these witnesses, makes no effort to explain why their testimony was ignored, and, critically, makes no effort to reconcile the Initial Decision's conclusions with this contrary evidence.[4] *See Morall,* 412 F.3d at 178-80 (granting petition for review and remanding to the agency where decision ignored relevant evidence that was favorable to the petitioner). The

[3] Ms. Johnigan reached this conclusion from the perspective of "an experienced auditor" who "has studied the company's industry as well as the accounting and auditing issues relevant to the industry." AS No. 3 ¶ 6 (RX-49); JPF ¶107.

[4] The Division's audit expert Mr. Barron had no experience auditing banks and evaluated only a limited selection of workpapers. He ignored the significant charge-offs recorded by TierOne in 2008, including with respect to Nevada impaired loans, and formulated his opinions without reviewing a complete set of the audit workpapers or *any* of TierOne's loan files, even though he admitted that the loan files contained relevant material that might have changed his opinions. JPF ¶¶466, 469-70, 476, 483; *e.g.*, Tr.-1184-85, 1201-04, 1320-21.

Initial Decision cannot side-step the requirements of due process and the APA through a blanket assertion that "[a]ll arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision were considered and rejected." ID-2. Such boilerplate is inadequate because "[i]f the administrative action is to be tested by the basis upon which it purports to rest, that basis must be set forth with such clarity as to be understandable." *See SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947); *State Corp. Comm'n v. Fed. Power Comm'n*, 206 F.2d 690, 723 (8th Cir. 1953) ("A mere assertion that the Commission has examined all of the available evidence of record on this subject" does not satisfy the APA (internal quotation marks omitted)); *Trailways, Inc. v. ICC*, 673 F.2d 514, 518 (D.C. Cir. 1982) (APA not satisfied by "cursory findings and conclusions").

II. MR. BENNETT DID NOT VIOLATE RULE 102(e).

A. Mr. Bennett's Conduct With Respect To Auditing TierOne's Internal Controls Complied With Professional Standards.

Effective Internal Controls provide "reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes." AS No. 5, ¶ 2 (RX-50). Mr. Bennett complied with AS No. 5 because, in the exercise of professional judgment, he reasonably concluded that there was substantial evidence to provide an unqualified opinion with respect to TierOne's Internal Controls.

1. The Engagement Team Obtained Sufficient Competent Evidence Of The Design And Effectiveness Of TierOne's Internal Controls.

Pursuant to AS No. 5, Mr. Bennett and the engagement team identified TierOne's ALLL as a "significant account" over which they identified and tested key Internal Controls over financial reporting. JPF ¶237. They obtained an understanding of TierOne's ALLL estimation process, including the likely sources of potential misstatements, by performing a walkthrough of TierOne's loan process "of initiating, authorizing, processing, recording and reporting individual

transactions (or estimates) and controls, including anti-fraud controls." RX-7 at KPMGTO0000504-28; JPF ¶¶238-240.[5]

First, the engagement team tested TierOne's risk rating process by reviewing TierOne's loan files, including third-party appraisals, loan analyses and credit reviews prepared by loan officers, and borrower and guarantor information. JPF ¶254. Mr. Bennett reviewed a selection of these loan files to understand first-hand the nature of management's loan documentation. JPF ¶¶260-61. Based on these procedures and the evidence obtained, Mr. Bennett and the engagement team concluded that TierOne had effective controls regarding the classification of its loans as impaired or unimpaired. JPF ¶268. The Division did not challenge that determination.

Second, the engagement team identified and tested Internal Controls designed to ensure that impaired loans were secured by collateral supported by appraisals that had been reviewed by TierOne for reasonableness. JPF ¶¶271-74. They tested the effectiveness of Control 7-1, which was designed to ensure that collateral underlying the loans was properly recorded in the public record, JPF ¶¶271-72, and Control 7-2, which was designed to ensure that the underwriter or loan approval officer reviewed the appraised value for reasonableness and documented that review, JPF ¶¶273-74. These Internal Controls addressed whether the impaired loan component of TierOne's ALLL was secured by adequate collateral at the "front end." Tr.-492 (Bennett).

Third, with respect to the "back end," Mr. Bennett and the engagement team tested TierOne's continuing review of the ALLL by multiple levels of management. JPF ¶277. The engagement team determined that TierOne documented reserve estimates for impaired loans quarterly in FAS 114 "templates," charged off the difference between the impaired loan's book

[5] The engagement team met with multiple members of TierOne management, including the Controller, CCO, Special Assets Executive, Internal Financial Reporting Specialist, External Reporting Manager, Chief Appraiser, and Risk Assessment Officer. JPF ¶241.

value and estimated fair value and recorded an additional discount after considering the estimated selling costs and present value of the collateral based on an estimated time to sell. JPF ¶¶224-25, 279. TierOne's Special Assets Executive, Mr. Frances, prepared the FAS 114 templates, which documented individual impaired loan loss estimates. JPF ¶¶226, 244. TierOne's Controller, Mr. Kellogg, then independently reviewed and approved each of the FAS 114 templates. JPF ¶279. This internal control was designed to address the risk that TierOne's ALLL may be understated, including the risk that the collateral for impaired loans could be over-valued. JPF ¶¶245, 280-81, 299-301. The engagement team documented that Mr. Kellogg, as Controller, reviewed the FAS 114 templates as an internal control over the estimation process for impaired loans. JPF ¶278; RX-7D at KPMGTO0005056; Tr.-1598 (Bennett).

Further, TierOne's ACC (Asset Classification Committee)—comprised of eleven members from management and senior management, including Mr. Kellogg and Mr. Langford, TierOne's CCO—reviewed, evaluated, and approved the sufficiency of TierOne's ALLL on a continuing and regular basis. JPF ¶¶282, 287, 299. The ACC reviewed reports containing detailed information about individual impaired loans and related reserves and collateral. JPF ¶¶285-86, 288-296. In testing that control, the engagement team reviewed both the ACC Meeting Minutes, which identified the reports reviewed by the ACC, and the reports themselves. JPF ¶¶285-86, 298.

The engagement team further assessed the knowledge of Mr. Kellogg, who informed the auditors that the ACC "discusses the recent trends, status changes within the portfolios, reserve modifications, and FAS 114 impairments." RX-7 at KPMGTO0005075-77; JPF ¶284. The engagement team confirmed that analysis by obtaining and reviewing the materials obtained and

reviewed by the ACC to address the status of delinquent loans. JPF ¶285.[6] The materials provided to the ACC, and reviewed by the engagement team, set forth extensive information about impaired loans, including property locations, appraisal dates, collateral values, reserve amounts, and narrative and statistical discussions of recommendations for non-accrual and specific reserves. JPF ¶290.

Based on these efforts, Mr. Bennett and the engagement team reasonably concluded that the ACC had adequate information to review and approve the individual impaired loan loss estimates included in the ALLL and that these estimates reflected a good faith consensus by TierOne management. JPF ¶291. As explained by Ms. Johnigan, Mr. Bennett and the engagement team appropriately identified and tested key Internal Controls over TierOne's ALLL estimation process, including the FAS 114 component, and these procedures provided them with sufficient competent evidence to conclude that Internal Controls over TierOne's ALLL estimate were designed properly and operating effectively at year-end 2008. JPF ¶303; Tr.-2031; RX-42 at 15, 24.

2. The Initial Decision Misconstrues The Significance Of The Internal Controls Tested And Ignores Relevant Evidence.

The Initial Decision's one-page analysis does not support its conclusion that Mr. Bennett violated professional standards in the audit of TierOne's Internal Controls. ID-28. It criticizes the engagement team's identification and testing of "Control Lot 7-2, Appraisal Review, as related to the risk of collateral overvaluation." *Id.* That criticism is in error.

Control Lot 7-2 was designed to verify, at origination, "that the underwriter or loan approval officer reviewed the appraised value for reasonableness and that documentation of that

[6] The meeting minutes state that the ACC reviewed detailed information contained in these various reports to analyze whether there should be "any changes to Specific and General Reserves," and concluded that there would be no such changes. RX-7D at KPMGTO0005058; JPF ¶288.

review was maintained in the loan file." RX-7G at KPMGTO0005089; JPF ¶273. That review was important because OTS had reported that TierOne previously had collateral-dependent loans "with no appraisal" or "unsupported appraisals." ID-28. Control Lot 7-2 was appropriate to test, at the "front end," whether collateral securing TierOne's loans was adequate. JPF ¶¶273-74. The engagement team's identification and testing of Control Lot 7-2 addressed an important aspect of the risk of overvaluation of ALLL, *i.e.*, if TierOne had no appraisal or unsupported appraisals for the collateral securing impaired loans. ID-28.

The balance of the Initial Decision asserts, mistakenly, that (1) "there is no evidence" that "other ALLL-related controls" "sufficiently addressed the risk of collateral overvaluation at year-end," and (2) the "high-level reviews performed by management and the ACC, and tested by the auditors, do not reveal that an internal control meaningfully or specifically addressed this risk." ID-28. As Mr. Bennett testified, the engagement team identified and tested TierOne's review and levels of authority regarding its estimates of impaired loans in TierOne's ALLL. Tr.-1585-88.

> [W]e thought it was important to have a control identified and tested that had the allowance for loan losses being reviewed and approved.
>
> And as part of that review and approval, we had a controller of the company, [David] Kellogg, who was also a member of the asset classification committee, and then also having senior management of the company, loan officers, people in credit administration, people like that that understood the allowance for loan losses and the process that management used as part of the control.

Tr.-1586. Mr. Bennett testified that, in his professional judgment, this multi-level review by TierOne management "was designed and operating effectively at year-end." Tr.-1588. In turn, Respondents' expert, Ms. Johnigan, testified that the Controller's review of the FAS 114 templates coupled with subsequent review by the ACC, Tr.-2022-26, provided the audit team

with "sufficient, competent evidence to support their conclusion that the controls over the FAS 114 part of the allowance estimation process were effective in testing the TierOne statements." Tr.-2031. Indeed, as acknowledged by the Division's expert, review by the Controller from "outside the process" of developing the FAS 114 estimates "sounds like it could be an effective control." Tr.-1248-49; JPF ¶¶277-84 & n.469. The Initial Decision ignores all of this evidence.

The record further shows that the engagement team's testing included review of both ACC meeting minutes and the materials reviewed by the ACC, all of which confirmed that Mr. Kellogg and the ACC reviewed detailed reports and backup materials regarding individual impaired loans. JPF ¶¶277-304. These processes should not be dismissed as "high level" because corroborating audit evidence reflected extensive information about individual impaired loans, including property locations, appraisal dates, collateral value estimates, loss/reserve amounts, and narrative and statistical discussion of recommendations for non-accrual and specific reserves. *See, e.g.*, DX-108; RX-141; RX-142; JPF ¶¶290-96. For example, the Classification of Assets reports provided to the ACC detailed the loan balance, risk rating, appraised value, appraisal date, and analysis from TierOne personnel for individual impaired loans. *E.g.*, DX-108 at TOB0092309-97; JPF ¶292. The ACC also reviewed individual credit reviews for specific impaired loans. *E.g.*, DX-108 at TOB0092328-64; JPF ¶293. Indeed, many of the loans evaluated for impairment in 2008 were included in the credit reviews in the materials provided to the ACC. *E.g.*, DX-108 at TOB0092336, 45, 47, 50, 57. The engagement team further documented Mr. Kellogg's confirmation that the ACC discussed FAS 114 loan impairments. JPF ¶284; *see also* RX-7 at KPMGTO0005076. Here, too, the Initial Decision simply ignores this evidence.

Contrary to the Initial Decision's suggestion, ID-28, there was no requirement that TierOne maintain a control focused "specifically" on whether appraisals were current at year-end to address the risk relating to collateral overvaluation. Indeed, such a control would have been myopic given that TierOne was neither required by GAAP to obtain current appraisals for impaired loans nor to obtain updated appraisals on any periodic basis. JPF ¶68. The accounting principles required TierOne to consider all reasonably available information in estimating fair value, which might or might not include an appraisal. AU § 328.02, .06 (RX-60); JPF ¶93.

B. Mr. Bennett's Audit Conduct With Respect To TierOne's ALLL Complied with Professional Standards.

1. Mr. Bennett And The Engagement Team Obtained Sufficient Competent Evidence About The Reasonableness Of TierOne's ALLL Estimate.

After identifying TierOne's ALLL as a high risk account given the market conditions and OTS's regulatory findings, JPF ¶¶177, 192-193, Mr. Bennett and the engagement team increased the scope of their interim and year-end audit procedures for testing the reasonableness of the ALLL, JPF ¶¶161, 163, 180. Mr. Bennett and the engagement team gained an understanding of how TierOne developed the ALLL estimate and planned and performed substantive audit procedures to review and test TierOne's ALLL estimation process. Through that testing, they obtained sufficient competent evidence that TierOne's ALLL was within a reasonable range.

First, the engagement team conducted extensive substantive audit procedures regarding the reasonableness of the ALLL. JPF ¶¶305-98. The team engaged a credit-risk specialist, who performed loan reviews three times during the year and at year-end and confirmed that TierOne appropriately rated the risk of its loans and identified impaired loans. JPF ¶¶183-84. As to the impaired loans, they performed substantive procedures to evaluate all of the fifty-four loan

relationships management had identified as impaired and potentially impaired. JPF ¶¶308, 317-318, 322-23, 350-58, 361.[7]

These procedures provided Mr. Bennett and the engagement team with audit evidence that corroborated the rationales and assumptions management used in estimating the fair value of its FAS 114 impaired loans. They reviewed independent appraisals for approximately two-thirds of the year-end FAS 114 loan relationships, which they documented in the impairment templates with the notation "agreed to appraisal." JPF ¶341; RX-8M. They reviewed TierOne's voluminous loan files, which included information about the background of each loan, the financial condition of the borrowers and guarantors, and loan collateral. JPF ¶¶340, 344-46.

In the course of their work, Mr. Bennett and the engagement team observed that TierOne management continued to monitor impaired loans and to discount appraisals based on market conditions and other loan-specific factors in estimating fair value. *E.g.*, JPF ¶366. For example, as to the Rising Sun loan, TierOne adjusted the loan's fair value and recorded additional losses of approximately $717,000 (beyond the $1.36 million reserve) in the first quarter of 2008 because management believed these losses were inherent in light of market conditions and declines in other Nevada loans with more recent appraisals. RX-28 at KPMGTO0000430. In the second quarter, TierOne received an updated appraisal for this loan indicating additional losses of $696,000, approximating the amount TierOne had anticipated and already recorded. *Compare* RX-28 at KPMGTO0000430 ($1,362,912 required first-quarter reserves); *with* RX-28 at KPMGTO0000875 ($2,059,525 required second-quarter reserves); RX-42 at 98-100; JPF ¶485. As Mr. Bennett explained, management's treatment of this loan provided evidence that TierOne considered market conditions and made appropriate fair value estimates. Tr.-587; JPF

[7] Ms. Johnigan's expert report addressed each of these individual loan relationships with detailed loan-specific audit evidence tied directly to the workpapers. RX-42 at 88-139 Exs. B-C.

¶¶407-08. The Division's expert Mr. Barron concurred with this assessment. Tr.-1367-76; JPF ¶485.

Mr. Bennett and the engagement team further observed that TierOne obtained new appraisals in different geographic areas throughout the year, including 26 new appraisals in the second half of 2008. JPF ¶¶323, 342. While there was only one new Nevada appraisal obtained in the second half of 2008, the engagement team confirmed that TierOne had obtained many new Nevada appraisals in mid-2008, including several in April and May for seven of the thirteen impaired loan relationships in Nevada. JPF ¶¶342, 366. Indeed, every one of the thirteen Nevada impaired loan relationships had either a 2008 appraisal or a discount applied to an earlier appraisal, or both; the discounts applied to all pre-2008 Nevada appraisals ranged from 34% to 55%. JPF ¶366.[8] These discounts were evidence that TierOne was monitoring and addressing its impaired loan portfolio "throughout 2008 on a continual basis." Tr.-1738 (Aesoph); *see* JPF ¶369.

Mr. Bennett and the engagement team met frequently with management—including Mr. Kellogg, the Controller, Mr. Frances, the Special Assets Executive, and Mr. Langford, the CCO—to discuss the FAS 114 loans and to understand management's rationales and assumptions in estimating fair value, including discounts of appraisals. JPF ¶¶316, 322, 330-34, 372-73; *see also* JPF ¶¶241, 349. The engagement team understood that management, having obtained updated appraisals on a substantial portion of Nevada collateral, was disinclined to

---

[8] Carlos Escapa – March/April 2008 appraisals; Clearwater – April 2008 appraisal; Grand Teton – April 2008 appraisal; HDB – May 2008 appraisal with 10% discount; MME – April 2008 appraisal for comparable Storybook property; Pueblos Partners – August 2008 appraisal; Rising Sun – May 2008 appraisal; Stratton – January 2008 appraisal; Structured Homes – April 2008 appraisal; Celebrate 50 – 55% discount to May 2006 appraisal; Double M – 50% discount to November 2006 appraisal; Mohave Sun – 50% discount to December 2006 appraisal; Valley Heights – 34%-55% discounts to May and August 2006 appraisals. JPF ¶¶342, 366, 368, 386; *see also* RX-28 at KPMGTO0000879, 899, 900, 1805.

spend more resources on Nevada appraisals in the midst of the economic crisis because of a concern that updated appraisals likely would be unduly influenced by liquidation sales/prices. JPF ¶¶369-71.[9] Because liquidation or distressed sales are not "orderly transactions" and therefore are not "determinative" of fair value under FAS 157, management's concern appeared reasonable. JPF ¶¶55, 58-59.[10] At the same time, Mr. Bennett and the engagement team observed that management continued at year-end to record significant discounts to reflect the present value of the proceeds based on the estimated number of months to sell given the illiquid market conditions. JPF ¶321.

Second, Mr. Bennett and the engagement team reviewed voluminous market data that enabled them to determine that the losses TierOne recorded on its impaired loans were not inconsistent with those market data. JPF ¶¶315-16; JPF ¶¶310-12, 372-74, 402. As to the Nevada impaired loans, Mr. Bennett and the engagement team determined that TierOne had recognized $34.7 million in losses—between charge-offs and year-end reserves—through year-end 2008, amounting to approximately 30% of the gross Nevada impaired loan balance of $118 million. JPF ¶¶363, 374-75. Further, TierOne's 30% loss recognition in 2008 for Nevada

[9] As explained by Professor James, the number of distressed sales in Nevada had increased dramatically over the course of 2008, Tr.-1819-23; JPF ¶¶148-49, 499-501, and by the fourth quarter 2008, 58% of total sales of single-family homes were distressed sales, making it difficult to estimate fair value based on appraisals influenced by such distressed sales. JPF ¶¶147-49.

[10] The expert report and hearing testimony regarding market data presented by the Division's expert, Dr. Thakor, should be accorded no weight because he misapplied FAS 157 and the OCA and FASB's clarification of FAS 157, opining that a transaction is "orderly" as long as it has been exposed to market forces. JPF ¶¶509-10, 515, 518-19, 520-22. Dr. Thakor is not a CPA and was not qualified to opine on accounting matters or to modify the requirements of FAS 157. In violation of GAAP, he "simply calculate[d] how TierOne's calculated 'Required ALLL' would have changed had the publicly-available market data been used to discount appraisals." DX-191 ¶ 346. Moreover, he relied solely on market indices that include distressed sales and foreclosures, which is directly contrary to FAS 157. JPF ¶¶503, 512, 514, 517, 522. Even if one were to credit the faulty analysis of the Dr. Thakor, the result would be that management would have recorded an additional loss of less than 3/4 of one percent of its $2.8 billion loan portfolio. DX-191.

impaired loans did not include additional losses TierOne previously recorded in 2007. JPF ¶477. The losses recognized by TierOne were not inconsistent with market data in Nevada for 2008.

At year-end 2008, Mr. Bennett and Mr. Aesoph discussed the trends with Mr. Kellogg, the Controller, and raised questions about TierOne's discounting decisions for Nevada appraisals, as documented in the L-30 workpaper. JPF ¶¶371-73. Mr. Kellogg responded by referring to TierOne's loss recognition and its correlation with the decline as reflected in market data. JPF ¶¶310-12, 315-16, 372-74; Tr.-535-37 (Bennett); 1786-87 (Aesoph). Mr. Bennett and the engagement team then tested and corroborated Mr. Kellogg's statements. In performing their substantive audit procedures, which included the review of management's L-30A memorandum and Internal Audit's related tie-out, Mr. Bennett and the engagement team reviewed third-party market data sources such as the Case-Shiller index and MGIC reports. *Id.* They observed that TierOne's loss recognition approximated the decline of approximately 33% in Nevada reflected in third-party market data—which they understood *included* distressed or forced sales, and therefore indicated declines exceeding the actual declines in fair value under FAS 157. *Id.* The team also performed a state-by-state evaluation of TierOne's impaired loans to consider trends in different geographic regions, which they documented in the L-37 series workpapers. JPF ¶¶355-56; RX-8U. This workpaper reflected the roughly 30% loss recognition on Nevada impaired loans. JPF ¶¶375, 377; RX-8U at 5590-91.[11]

Third, Mr. Bennett and the engagement team considered the risk of management bias relating to TierOne's ALLL, and observed significant evidence of a lack of such bias. JPF

[11] As Ms. Johnigan testified, from the perspective of an experienced bank auditor, the 30% loss recognition was "apparent" on the face of the workpaper as well as in TierOne's 2008 financial statements. Tr.-1929-31 (workpapers "clearly show" the 30% loss via a "really simple calculation"); JPF ¶437. The Division's expert, Mr. Barron, also agreed it was a simple calculation, and that the data supporting TierOne's 30% loss recognition on Nevada loans were included in the workpapers. Tr.-1145, 1364-65; JPF ¶378.

¶¶399-411. They determined that TierOne had obtained many new appraisals throughout 2008, JPF ¶¶323, 342, 366, and obtained significant evidence contradicting management bias with respect to the ALLL estimate:

- In early 2008, management wrote down $42 million of goodwill (JPF ¶116);
- In the second quarter 2008, upon receipt of a new appraisal indicating a higher valuation for the collateral securing the HDB loan—which could have supported a reduction in the reserve—management maintained the existing reserve (JPF ¶403);
- In the second quarter 2008, management recorded $28 million in loan losses, which were at the *high* end of the range of reasonableness when the OTS had recommended loan losses between $17 and $22 million (JPF ¶¶195, 197);
- At year-end 2008, management determined that a number of the 55 borrower relationships evaluated under FAS 114 were not impaired and recorded approximately $6.3 million in FAS 5 reserves that they would have avoided if the loans were deemed *impaired* (JPF ¶403);
- At year-end 2008, management applied FAS 5 loss factors exceeding actual, historic losses experienced by TierOne, which again resulted in higher FAS 5 reserves (JPF ¶403); and
- At year-end 2008, management recorded a FAS 114 reserve on the Valley Heights loan that was *higher* than the reserve recommended by Internal Audit based on its separate evaluation of the loan (JPF ¶403).

This evidence supported Mr. Bennett's reasonable conclusion that management had not been biased in developing the ALLL. JPF ¶411.

Fourth, Mr. Bennett and the engagement team also considered the OTS's 2008 ROE. Mr. Bennett and Mr. Aesoph consulted with senior KPMG partners, including Mr. Kenney, the SEC concurring review partner, and David Butler, the regional Professional Practice Partner and a prior SEC concurring review partner on the TierOne engagement, and engaged regulatory specialists to help them understand the significance of the ROE findings. JPF ¶¶198-99. They monitored management's response to the remediation of deficiencies identified by OTS, JPF ¶¶201-02, and, prior to issuing the audit opinions, contacted Douglas Pittman—the OTS Field

Manager who oversaw regulatory examinations of TierOne—to discuss TierOne's response to the concerns raised. JPF ¶¶135, 204, 206-07. Mr. Pittman informed them that TierOne management was "complying with the requirements to submit additional information" and "appropriately addressing concerns raised in the ROE." Tr.-1456-58; JPF ¶400. At the request of partners Aesoph, Kenney, and Butler, Mr. Bennett prepared a workpaper summarizing the conversation and noting, *inter alia*, the OTS's receipt of timely and satisfactory responses from TierOne. JPF ¶209. The Division's expert Mr. Barron agreed that *each* of Mr. Bennett's actions in this regard reflected due professional care. Tr.-1382-85; JPF ¶¶203, 490-91.[12]

After performing all of these procedures, Mr. Bennett and Mr. Aesoph, along with Mr. Kenney, concurred in the professional judgment that the engagement team had collected sufficient competent audit evidence regarding the reasonableness of the ALLL estimate, including the FAS 114 reserves, in the context of the financial statements taken as a whole. JPF ¶¶360, 396. Prior to concurring in that judgment, Mr. Aesoph sat side-by-side with Mr. Bennett to discuss TierOne's FAS 114 loans and to review the impairment templates. JPF ¶347. Ms. Johnigan agreed with their professional judgment, concluding that their procedures provided them with competent and reliable audit evidence. Tr.-2033-38; JPF ¶¶397, 462; *see* JPF ¶308.

2. The Initial Decision Misconstrues The Applicable Professional Standards And Ignores Contrary Evidence.

The Initial Decision's conclusion that Mr. Bennett failed to comply with professional standards in the 2008 financial statement audit should be rejected. The ALJ, with the benefit of knowing that the OTS ultimately closed TierOne—and that management had perpetrated a fraud

[12] In evaluating the OTS's criticisms of TierOne, Mr. Bennett and the team also considered the OTS's acknowledgment of positive actions taken by management to enhance its credit administration processes, JPF ¶¶212-16, including OTS's acknowledgement that management had developed an appropriate template to use in evaluating FAS 114 loans for impairment and loan charge-offs. JPF ¶¶212-13.

with respect to their belief in the reasonableness of the ALLL—improperly substituted her judgment for the professional judgments made by Mr. Bennett and the engagement team in a time of economic uncertainty.

First, the Initial Decision is premised on a requirement—unsupported by the applicable professional standards that guided Mr. Bennett's audit work—that TierOne obtain "current" appraisals in estimating the fair value of collateral securing its FAS 114 loans. ID-35, 36; *see also* ID-28, 30. The ALJ applied this novel "requirement" in reaching liability conclusions based on a perceived lack of current appraisals, concluding that Mr. Bennett and the engagement team relied on appraisals from earlier in 2008 "despite contrary market information." *Id.* As discussed, there is no requirement that TierOne obtain "current" appraisals for impaired loans or to update appraisals on any periodic basis. JPF ¶68; Tr.-1239-41 (Barron). Rather, accounting principles required TierOne to measure impairment based on all reasonably available information, and that information might not include an appraisal at all. JPF ¶¶64, 93; Tr.-1974-75 (Johnigan); AU § 328.02, .06 (RX-60). Moreover, the Initial Decision's imposition of a new requirement of "current" appraisals is inconsistent with the skepticism of such appraisals reflected in FAS 157. Under FAS 157 and related guidance from the OCA and FASB Staff, appraisals in the second half of 2008 were not determinative of fair value given the prevalence of forced liquidation and distress sales. *See* JPF ¶58; Tr.-1994 (Johnigan). The professional standards do not require an auditor to ensure that management has obtained a "current" appraisal at any specific interval in estimating its FAS 114 reserves, and retroactive application of new professional standards is impermissible under Rule 102(e). *See* Rule 102(e) Release, 63 Fed. Reg. at 57,166. The retroactive imposition of such a requirement likewise would be arbitrary,

capricious and contrary to law (including Mr. Bennett's rights under Due Process of law). *See KPMG*, 289 F.3d at 126-27; *Gen. Elec.*, 53 F.3d at 1329-30.

The Initial Decision suggests that this issue is not implicated here because it doubts that "Respondents' contention that either their or management's proffered interpretation of FAS 157—*i.e.*, that appraisals and market information were less indicative of fair value due to increased distressed sales and/or foreclosure in 2008—played any meaningful role in their assessment of TierOne's fair value estimates." ID-18. That conclusion is mistaken. FAS 157 unquestionably applied to TierOne's fair value estimates for impaired loans; TierOne referenced FAS 157 in its 2008 Form 10-K; the engagement team tied TierOne's FAS 157 disclosure in the 2008 Form 10-K to the audit work on TierOne's impaired loans; and Mr. Bennett reviewed and was thoroughly familiar with FAS 157 and TierOne's disclosure during the 2008 integrated audit. JPF ¶¶61, 118-19, 230.[13] Moreover, TierOne management thought current appraisals in Nevada were not determinative of fair value under FAS 157 because those appraisals were based on foreclosures and distressed sales in the market. JPF ¶369; *see also* JPF ¶59; RX-8 at KPMGTO0005450, 58. Mr. Bennett understood management's position to be that appraisals obtained in the first-half of 2008 provided a reasonable basis to estimate fair value at December 31, 2008, in part because the Nevada market in the latter part of the year was dominated by disorderly sales.[14]

---

[13] Likewise, in investigative testimony, Mr. Bennett understood FAS 157 and referenced "fair value" throughout the examination, contrary to the Division's insinuation at the hearing. JPF ¶61 n.106; Tr.-716-17, 1700, 2062-63 (Johnigan).

[14] The Initial Decision likewise mistakenly concludes that the engagement team's FAS 114 procedures "memo's definition of a current 'appraisal'—'within the past twelve months'—was inconsistent with TierOne's stated policies and the 2008 economic climate." ID-15. TierOne's Lending Policy provided that loans be supported *either* by current appraisals *or* evaluations, that a new appraisal *may* be required depending on several factors, and that "[c]hanges in market or property conditions ... could justify an updated *evaluation*." RX-143 at KPMGTO-E-00106163 (emphasis added); JPF ¶227. It did not require TierOne to obtain an updated appraisal on any specific periodic basis. *Id.*

Second, the Initial Decision misconstrues the auditing standards applicable to accounting estimates such as ALLL. The ALJ erroneously concluded Mr. Bennett conceded that "to evaluate the reasonableness of the estimates in the context of the financial statements taken as a whole, they were required to evaluate those estimates on a loan-by-loan basis." ID-3-4. Mr. Bennett acknowledged that auditors are required when evaluating impaired loans to do so on a loan-by-loan basis, but not that auditors are required to evaluate *each* FAS 114 loan in evaluating the reasonableness of the estimates in the context of the financial statements taken as a whole. *See, e.g.*, JPF ¶322; *see* JPF ¶¶412-13 (discussing analysis of ALLL "as a whole"). After performing these procedures, Mr. Bennett and the engagement team evaluated the audit evidence obtained and concluded that the ALLL was reasonable in the context of the financial statements taken as a whole. JPF ¶412. Performing procedures with respect to individual impaired loans is distinct from the ALJ's conclusion that auditors are *required* to evaluate each FAS 114 estimate on a loan-by-loan basis.

Under the applicable professional standards, an auditor evaluates the reasonableness of the ALLL in the context of the financial statements *taken as a whole*, and does so by evaluating whether the ALLL is within a reasonable range. AU § 342.01, .03, .04, .07 (2008) (RX-61); AU § 312.36 (RX-57). The professional standards do not require the auditor to *audit* each FAS 114 loan in reaching a conclusion that the ALLL was reasonable, or to perform testwork on each FAS 114 loan. Mr. Bennett should not be penalized because he and the engagement team expanded the scope of their audit procedures by conducting procedures on each impaired loan.

Third, the Initial Decision fails to consider or credit evidence of the engagement team's ALLL procedures and audit evidence. In particular, the Initial Decision concludes "Respondents could not point to loan-specific evidence or documented procedures to support TierOne's

decision to not discount such appraisals in the wake of deteriorating market conditions." ID-31. That conclusion is in error.

Mr. Bennett and the engagement team properly assessed whether TierOne's reliance on and discounting of appraisals, including from the first half of 2008 and earlier, was reasonable at year-end 2008. Mr. Bennett and the engagement team communicated with management regarding the rationales and assumptions it used in estimating fair value at year end, and obtained corroborating evidence that included third-party appraisals, other loan file materials, and market data that enabled them to conclude that the actual losses TierOne recorded on its impaired loans were not inconsistent with the market trends during the year. JPF ¶¶310-12, 315-16, 322-23, 330-48, 372-74, 379; *see also* JPF ¶¶241, 349.

Moreover, Mr. Bennett and the engagement team observed that, in the second half of 2008, management identified 17 additional loans as impaired (which included a $17 million Nevada lending relationship determined to be impaired in the fourth quarter), recorded charge-offs of $19.4 million, and established reserves of $17 million. JPF ¶¶323, 386. They observed that TierOne obtained many new appraisals and applied new or additional discounts to appraised values in the second half of 2008, including for Nevada impaired loans. JPF ¶386. They observed that TierOne continued at year-end to record significant discounts to reflect the estimated number of months to sell collateral securing impaired loans. JPF ¶321. And they observed that management appeared in earnest to respond to regulatory requirements following the October 2008 ROE—and confirmed that observation by contacting the OTS directly. JPF

¶¶204, 206-07, 216. All of this evidence supported Mr. Bennett's judgment, yet the Initial Decision does not address it.[15]

The Initial Decision's disregard of this evidence reflects, in part, a misapplication of the audit documentation standards of AS No. 3. ID-17-20, 31-33. Nothing in AS No. 3 justifies exclusion from consideration of Mr. Bennett's testimony regarding audit procedures performed and evidence obtained that corroborated the reasonableness of his professional judgments.

Finally, the Initial Decision ignored the effect of TierOne's management fraud. Management affirmatively sought to mislead Mr. Bennett and the engagement team with respect to the reasonableness of TierOne's FAS 114 estimates. The Initial Decision states that "TierOne established provisions to maintain the ALLL at a level management *believed* would cover all known and inherent losses in TierOne's portfolio that were both probable and reasonable to estimate at each reporting date." ID-7 (emphasis added). Yet, TierOne's management engaged in a collusive fraud designed to deceive the auditors with respect to the ALLL, as alleged in separate actions by the Commission itself. JPF ¶¶442-43. That fraud included, *inter alia*, lying about the absence of other appraisals in response to the auditors' requests that all appraisals be provided, falsifying FAS 114 impaired loan templates provided to the auditors, and failing to disclose to the auditors that members of management questioned the reasonableness of TierOne's FAS 114 estimates. JPF ¶¶442-43; RX-234-35. The Initial Decision entirely disregards the effect this fraud had on a reasonable auditor's view of the persuasiveness of audit evidence.

[15] The ALJ could not have reviewed or addressed all of the evidence because the Division failed to collect, during its multiple-year investigation, approximately two-thirds of the loan files at issue that the engagement team, indisputably, consulted during the 2008 audit. JPF ¶453.

C. Mr. Bennett's Response To Appraisals Acquired After The 2008 Integrated Audit Complied With Professional Standards.

Mr. Bennett's conduct complied with the standards in AU § 561 concerning procedures that auditors should follow if they discover reliable information that "existed at the date of the auditor's report." AU § 561 (RX-63).

AU § 561 is triggered only "if the nature and effect of the matter are such that (a) [the auditor's] report would have been affected if the information had been known to him at the date of the report and had not been reflected in the financial statements." AU § 561.05 (emphasis added) (RX-63). The decision whether the necessary trigger has been satisfied is a matter of professional judgment. Tr.-1664 (Bennett); *see also* Tr.-2048-50 (Johnigan).

After KPMG issued its 2008 integrated audit opinions in March 2009, the engagement team became aware of new appraisals dated January and February 2009. ID-34. Appraisals from three borrower relationships showed a decrease in fair value from TierOne's 2008 year-end estimate; one appraisal reflected a $1.5 million *increase* in collateral value; and, in the aggregate, the new appraisals caused TierOne to provision and charge-off $4.2 million in the first quarter of 2009. JPF ¶¶419-20; Tr.-1666-67 (Bennett). Mr. Bennett reviewed the FAS 114 templates relating to these loans and concluded, in the exercise of professional judgment, that the additional losses recorded in 2009 as a result of the new appraisals did not give rise to an error in TierOne's year-end 2008 financial statements. Tr.-1664-67. After conducting his own review of the workpapers, Mr. Aesoph concurred. JPF ¶421.

The requirements of AU § 561 apply only if "the nature and effect" of the new information "are such that [the auditor's] report would have been affected if the information had been known to him at the date of [the] report and had not been reflected in the financial statements." AU § 561.05 (RX-63). On that point, the Division failed to present any evidence to

support a conclusion that the new appraisals *would have* affected TierOne's 2008 financial statements, *i.e.*, required a restatement. Indeed, the Division's expert Mr. Barron disavowed any opinion that the new appraisals "would have resulted in a restatement of the financial statements." Tr.-1158-59 ("I'm not really opining on whether they should have restated the financial statements."). Ms. Johnigan likewise testified that the new appraisals would not "have triggered a restatement or recall of the 2008 audit opinion." Tr.-2049.[16]

The Initial Decision does not address any of this testimony. ID-35. Instead, it asserts a novel domino theory, whereby the existence of "new appraisals put into question the reliability of the financial statement assertions relating to the FAS 114 portion of the ALLL." *Id.* According to the Initial Decision, "[u]nder the circumstances of this case and given the risk of collateral overvaluation, the new appraisals cast doubt on the collateral values that TierOne used at year-end 2008, given that numerous loans, particularly in Nevada, were also valued using older or undiscounted appraisals from the first half of 2008 or earlier, despite contrary market information." *Id.* The Initial Decision, however, identifies no evidence to support its conclusion that Mr. Bennett was obligated to extrapolate from loan appraisals from January and February 2009 addressing specific collateral in Nevada to other TierOne collateral in other locations and thereby "cast doubt on the collateral values that TierOne used at year-end 2008." ID-35. To the contrary, the record reflects that such extrapolation is misguided because collateral, especially real estate, is "unique." Tr.-256-58 (Thakor) ("every property has its unique characteristics").

[16] The Initial Decision asserts that "at least a portion of the losses recognized in early 2009 would have been the result of collateral deterioration experienced in 2008 and thereby related to TierOne's year-end 2008 financial statements." ID 35. But there is no evidence that some or all of the losses realized in 2009 should have been attributed to 2008. Further, even if the full $4.2 million loss recorded by TierOne in Q1 2009 should have been recorded in the year-end 2008 financial statements, such amount would not have been material to TierOne's 2008 financial statements taken as a whole—which already included an $84 million loan loss provision and $93 million pretax loss—and would not have affected KPMG's 2008 integrated audit opinions. Tr.-1666-67; Tr.-2049-51 (Johnigan); JPF ¶423.

D. Mr. Bennett Did Not Engage In Any Instance of "Highly Unreasonable Conduct" Or In Repeated Instances of "Unreasonable Conduct."

Mr. Bennett did not engage in "improper professional conduct" under Rule 102(e). *First*, the Initial Decision makes no effort to explain how Mr. Bennett's conduct was "highly unreasonable" within the meaning of Rule 102(e). To be sure, the Initial Decision notes that "heightened scrutiny was warranted" given the circumstances, but it makes no effort to address the separate requirement of "highly unreasonable conduct," especially as that necessary showing pertains to a senior manager. That omission is particularly stark because the Commission has explained that a determination of "highly unreasonable" conduct must be made based on an analysis of "the degree of the departure from professional standards" and, unlike ordinary negligence, "describes conduct that poses a threat of future harm to the Commission's processes and conclusively demonstrates that the accountant lacks competence to practice before it." Rule 102(e) Release, 63 Fed. Reg. at 56,167.

There has been no showing that the conduct of Mr. Bennett was "highly unreasonable" with reference to how a reasonable senior manager would have acted or that the "degree of departure" of his conduct from the applicable "professional standards" qualifies as "highly unreasonable." *See Checkosky II*, 139 F.3d at 225 (rejecting SEC's imposition of sanctions under Rule 102(e) because the Court was "at a loss to know what kind of standard [the agency] is applying or how it is applying that standard to this record" (internal quotation marks omitted). Such a showing is essential because, as the D.C. Circuit has explained, "[a] proceeding under Rule [102(e)] threatens 'to deprive a person of a way of life to which he has devoted years of preparation and on which he and his family have come to rely.'" *Checkosky v. SEC*, 23 F.3d 452, 479 (D.C. Cir. 1994) (per curiam). Here, Mr. Bennett did everything that was asked of him, he did not withhold any information from his superiors, and those superiors then reviewed and

concurred with each of his professional judgments. *Cf. In re Oprins & McNeeley*, Release No. ID-411, 2010 SEC LEXIS 4450, at *103-06 (Dec. 28, 2010) (failure to inform partner of relevant information); *In re Dohan & Co.*, Release No. ID-420, 2011 SEC LEXIS 2205, at *22-23, 44-45 (June 27, 2011) (failure to conduct walk-throughs of key audit areas). The Initial Decision offers no indication of what more Mr. Bennett should have done in his role as a senior manager.

Second, the Initial Decision also misapplies the distinct standards of liability for "highly unreasonable" and "unreasonable" conduct under Rule 102(e) as applied to Mr. Bennett's role as a senior manager. The Initial Decision states that Mr. Bennett's "course of conduct related to the audit, taken as a whole," constitutes a "single instance of highly unreasonable conduct." ID-36. Specifically, the ALJ asserts:

> They knew that heightened scrutiny was warranted over the ALLL in general *and the FAS 114 portion in particular*, collateral overvaluation was a specific risk point, and management continued to rely on older or undiscounted appraisals from the first half of 2008 or earlier at year-end 2008, despite contrary market information. Numerous red flags indicated that management was inept and had an incentive to understate losses. Yet, *their procedures in testing TierOne's internal control over financial reporting and evaluating the FAS 114 estimates failed to sufficiently address these issues*, and KPMG issued a clean audit opinion.

ID-36 (emphases added). Then with respect to "repeated instances" of "unreasonable conduct," the Initial Decision relies on the very same conduct.

> The *failure to identify a material weakness in TierOne's internal control over financial reporting* constitutes one course of such conduct, *and the failure to evaluate the FAS 114 portion of the ALLL in accordance with professional standards* is another course of such conduct. Both instances demonstrate a lack of due care and failure to obtain sufficient evidence in a high risk and material area of the audit.

ID-36 n.38 (emphases added). The Initial Decision thus aggregates Mr. Bennett's conduct with respect to impaired loans to conclude that he engaged in a *single* instance of highly unreasonable

conduct, but then disaggregates the very same conduct to conclude that he engaged in *repeated* instances of unreasonable conduct. This analysis improperly conflates the separate negligence standards in Rule 102(e).

Finally, the narrow scope of this case—addressed to the aspect of the audit directed at the FAS 114 loans within TierOne's ALLL—does not support a sanction for repeated instances of "unreasonable" conduct under Rule 102(e). The Commission has explained that "a single judgment error, ... even if unreasonable when made, may not indicate a lack of competence to practice before the Commission" and therefore may not "require Commission action under Rule 102(e)." Rule 102(e) Release, 63 Fed. Reg. at 57166. The Initial Decision focuses exclusively on a component of a financial statement assertion (the FAS 114 portion of TierOne's ALLL) within a single audit of TierOne. That determination, even if accepted, should not support liability based on repeated instances of unreasonable conduct under Rule 102(e). *See id.* at 57,169 ("[a] single error that results in an issuer's financial statements being misstated in more than one place would not, by itself, constitute a violation of this subparagraph").

III. THE INITIAL DECISION'S PROPOSED SANCTION SHOULD BE REJECTED AS ARBITRARY AND CAPRICIOUS.

As the Commission has explained, "[n]ot every violation of law ... may be sufficient to justify invocation of the sanctions available under" Rule 102(e). *In re Carter & Johnson*, Exchange Act Release No. 17597, 1981 WL 384414, at *6 (Feb. 28, 1981). Indeed, "[t]he purpose of Rule 102 sanctions is not to punish." *In re Oprins & McNeeley*, 2010 SEC LEXIS 4450, at *110 (internal citations omitted). Rather, sanctions must be "*necessary* to protect the investing public and the Commission from the future impact on its processes of professional conduct." *In re Carter & Johnson*, 1981 WL 384414, at *5 (emphasis added). And, in assessing whether a sanction would be appropriate, the "accountant's good faith" may be a relevant

consideration. Rule 102(e) Release, 63 Fed. Reg. at 57,170. Here, it is simply not necessary to impose any suspension on Mr. Bennett to protect the investing public or the Commission's processes.

At the time of the audit, Mr. Bennett had been a senior manager for one year. JPF ¶18. He is considered by KPMG partners to be a tireless worker, an effective communicator, and a strong mentor and supervisor. JPF ¶24. He was diligent and hard working throughout the 2008 audit, and he reviewed all of the 2008 audit workpapers. JPF ¶¶31, 436. He trained and closely supervised junior professionals on the team by, among other things, providing them with hundreds of detailed review comments with respect to all aspects of the quarterly and year-end audit workpapers. JPF ¶¶30, 35, 324-25, 327-29. He increased his hours on the 2008 TierOne engagement by approximately 90% compared to the prior year. JPF ¶182. Likewise, there is no dispute that Mr. Bennett appropriately communicated audit evidence to his superiors and that each of his professional judgments was reviewed and approved by multiple KPMG partners who had decades of bank auditing experience between them. JPF ¶¶360, 396.

The Initial Decision suggested a six-month suspension because it concluded, in the stark light of hindsight, that Mr. Bennett's "conduct involved a lack of due care and failure to obtain sufficient evidence to support [his] audit judgments" as to one component of one account in the context of a single audit. ID-37. But even in that audit, there was no dispute that Mr. Bennett and the engagement team appropriately identified the ALLL as a high-risk account and, as a result, enhanced their procedures, including by performing substantive procedures with respect to *every* one of TierOne's FAS 114 loans and engaging both credit risk and regulatory specialists to assist in important aspects of the ALLL-related work. JPF ¶¶180, 191, 200, 317-318, 322, 355-56. Mr. Bennett, at every step, 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.

Indeed, the Division's own expert acknowledged several aspects of Mr. Bennett's background and conduct in the 2008 audit that belie the necessity of sanctions to protect the Commission's processes.[17] And. Ms. Johnigan testified that, as an experienced bank auditor, she would have wanted Mr. Bennett to serve as the senior manager on her audit engagements. JPF ¶462(f). This is not the picture of an incompetent professional who poses a threat to the Commission's processes. More broadly, auditors should not be required to exercise their professional judgment against the threat of devastating sanctions imposed against them despite their good-faith and diligent efforts in the context of unprecedented economic uncertainty. Imposition of a sanction under these circumstances would not serve the purposes of Rule 102(e) but instead would send an inappropriate and harmful signal to the auditing profession. Rule 102(e) Release, 63 Fed. Reg. at 57,165. Nor should Mr. Bennett's "vigorous defense of the charges," ID-37, be permitted to support imposition of a sanction against him. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1229 (D.C. Cir. 1989).

Finally, there is no basis to impose any sanction against Mr. Bennett to protect the investing public and the Commission's processes. Apart from this matter, Mr. Bennett has an unblemished record throughout his career, and has continued practicing as an auditor without any question being raised as to his competence, diligence, or compliance with professional standards. At the same time, given the commencement of this public administrative proceeding, Mr.

[17] Mr. Barron acknowledged Mr. Bennett's technical competence and knowledge regarding the relevant accounting principles, Tr.-1215-16; JPF ¶¶20, 471, and concluded that he (1) performed the functions expected of a senior manager, Tr.-1211-15; JPF ¶30, (2) appropriately assessed risks relating to the ALLL, Tr.-1010-11, 1023-24, 1164-65; JPF ¶¶176-77, 473, (3) appropriately selected a methodology to test the ALLL process, Tr.-2249; JPF ¶¶80-83, 218-221, 223-231, 306-07, 471, 475, and (4) exhibited due care throughout the 2008 audit by engaging the assistance of a credit risk specialist and addressing the OTS's regulatory findings, Tr.-1382-85; JPF ¶¶191, 200-03, 490-91.

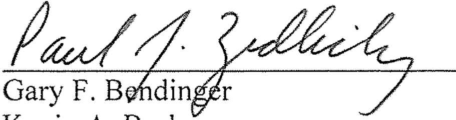
Bennett, as a practical matter, has not been able to audit public companies since February 2013, so he effectively has been penalized already for an extended period. Mr. Bennett should be permitted to put behind him this ordeal, which began more than four years ago when the Commission commenced its TierOne investigation during the collapse of the entire banking sector. Mr. Bennett fully cooperated with the Division's investigation and voluntarily assisted the Division in understanding TierOne, its accounting, and the audit. He continues to assist the government in investigating the fraud. His conduct, during the 2008 audit and thereafter, in no way resembles the type of conduct that the Commission previously has concluded would warrant sanction under Rule 102(e).

CONCLUSION

For these reasons, the allegations leveled against Mr. Bennett should be dismissed, and, in the alternative, Mr. Bennett should not be suspended from practicing before the Commission under Rule 102(e).

Dated: October 24, 2014

Respectfully submitted,



Gary F. Bendinger
Kevin A. Burke
Sidley Austin LLP
787 Seventh Avenue
New York, NY 10019
Telephone: (212) 839-5300
Facsimile: (212) 839-5599
gbendinger@sidley.com
kaburke@sidley.com

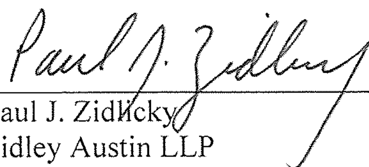
Paul J. Zidlicky
Sidley Austin LLP
1501 K Street, N.W.
Washington, DC 20005
Telephone: (202) 736-8013
Facsimile: (202) 736-8711
pzidlicky@sidley.com

Attorneys for Respondent Darren M. Bennett

RULE 450(d) CERTIFICATE OF COMPLIANCE

Pursuant to Commission Rule 450(d), I hereby certify that the foregoing Brief of Respondent Darren M. Bennett complies with the length limitation set forth in Commission Rule 450(c). The Brief is 13,995 words exclusive of the cover page, Table of Contents, Table of Authorities, this Certificate, and the Certificate of service. This total was calculated using Microsoft Word 2007's word count function.

Respectfully submitted,



Paul J. Zidlicky
Sidley Austin LLP
1501 K Street, N.W.
Washington, DC 20005
Telephone: (202) 736-8013
Facsimile: (202) 736-8711
pzidlicky@sidley.com