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.

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RESPONDENT JOHN J. AESOPH'S BRIEF IN OPPOSITION TO THE DIVISION OF ENFORCEMENT'S OPENING BRIEF REGARDING SANCTIONS

December 23, 2014

George B. Curtis
Monica K. Loseman
[redacted]

[redacted]

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I. INTRODUCTION

In its appeal, the Division of Enforcement asks the Commission to impose more severe sanctions on Messrs. Aesoph and Bennett than those imposed by the Initial Decision ("Decision" or "ID"). Not only was the Decision fatally flawed as a matter of law and fact, the Division's effort to adopt the entire Decision save its holding as to sanctions is simply untenable and should be rejected. In the end, the Commission must ultimately focus on the specific circumstances presented by this matter and determine, first, whether a Rule 102(e) violation occurred and if so, what sanction, if any, is appropriate. Any sanction, let alone an increased sanction, is wholly inappropriate on this record.

Rather than expose egregious behavior that poses a future threat to the Commission's processes, the record here exposes nothing more than a challenge to professional judgments: judgments made by committed audit professionals, judgments as to the application of new guidance on fair value accounting applied in the midst of unprecedented market volatility, judgments made on the basis of substantial audit procedures, and judgments made to increase those procedures precisely because of the noted effect of the market volatility on TierOne's financial statements and impaired loans. These professional judgments were supported and wholly agreed with by the expert testimony of an experienced bank auditor and member of the Auditing Standards Board of the American Institute of Certified Public Accountants ("AICPA"). The Decision makes no finding that Respondents missed a critical audit area or failed to recognize the importance of the Allowance for Loan and Lease Losses ("ALLL") or FAS 114, nor does the Division make any such allegation. Rule 102(e)'s purpose is not to penalize good faith exercise of judgment, even close calls in hindsight.

Nor is Rule 102(e)'s purpose to punish those who bring to light intentional financial reporting fraud by others. And yet, that is precisely what the Division asks here. Neither the

Decision nor the Division mentions that it was Mr. Aesoph and his team who brought to light the wrongdoing of TierOne executives. As of this date, that wrongdoing has resulted in two criminal pleas and an indictment for fraud, including fraud on Mr. Aesoph and his team. It was Mr. Aesoph who, in light of the developing facts, refused to conclude as to the third quarter 2009 financial statements and declined to issue the audit opinion for 2009. It was Mr. Aesoph who first learned of potential inconsistencies in management's representations, and it was Mr. Aesoph who directly and repeatedly confronted management when he became aware of those inconsistencies. It was Mr. Aesoph who discovered reserve documentation that had not been timely disclosed to the auditors, and it was that documentation, among other factors, that caused him to conclude that he could no longer rely on management representations. Ultimately, it was Mr. Aesoph who caused KPMG to withdraw its prior opinions and to terminate its auditor relationship with the company in April 2010. Rather than recognize these established facts, both the Division and Decision cite the $120 million loan loss provision to imply that Respondents failed in their responsibilities during the 2008 audit. But if the temptation to second-guess by hindsight is to be resisted, as it must in a Rule 102(e) proceeding, the events of 2009 and 2010 are relevant only to underscore the extent of the fraud and the decisive actions Mr. Aesoph took ultimately to help expose it.

Equally—perhaps even most—disturbing is the Division's attempt to induce the Commission into punishing Mr. Aesoph for asserting his right to defend against the Division's charges. The Division would have the Commission further sanction Mr. Aesoph for having defended the Division's charges, yet basic notions of fairness and due process guarantee Mr. Aesoph the right to mount a vigorous defense. The Division's—and indeed the

Decision's—interpretation of *Steadman*[1] raises particularly significant due process concerns. Mr. Aesoph has denied allegations he believes to be untrue and legal theories he believes to be unfounded. His defense was wholly supported by, among other things, an exceptionally qualified audit expert who has even testified for the SEC in other matters. Mr. Aesoph cannot be punished for the mere fact of his defense, particularly one so well supported.

The Commission should not be distracted by the Division's series of arguments that reflect neither the actual audit procedures applied to the ALLL and impaired loans nor the accounting guidance properly recognized and applied by Mr. Aesoph and his team. And while not repeated here, the many errors in the Decision, which are noted in detail in Mr. Aesoph's Opening Brief, are equally important in considering the Division's request for more severe sanctions. Any finding of professional misconduct is simply not supported by the record. And there is no basis for the Commission to grant either the sanction specified by the Decision or the enhanced sanction now sought by the Division.

II. THE DIVISION IMPROPERLY SEEKS TO COMPOUND THE DECISION'S ERROR IN IMPOSING ANY SANCTIONS AT ALL

The Decision relies on the *Steadman* factors to impose a one-year suspension against Mr. Aesoph, and the Division points to those same factors as a basis for even greater sanctions. Neither position has merit. A proper analysis of the *Steadman* factors supports the conclusion that no sanction at all should be imposed against Mr. Aesoph. The purpose of the factors is to determine the likelihood of future violations or threats to the Commission's processes as a guide to imposing sanctions. *See Steadman*, 603 F.2d at 1140 (citing *SEC v. Blatt*, 583 F.2d 1325,

[1] *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir.1979).

1334 n.29 (5th Cir. 1978)); *McNeeley*, Exchange Act Rel. No. 68431, 105 SEC Docket 655, 2012 SEC LEXIS 3880, at *48-55 (Dec. 13, 2012). The evidence presented in this case does not demonstrate any likelihood of future violations or threats to the Commission's processes by Mr. Aesoph.

While the *Steadman* factors may serve as a helpful touchstone, the "appropriate sanction in any case . . . depends on the particular facts and circumstances presented," and the "Commission itself must make the determination as to whether the respondent's conduct fits within certain standards carefully defined under Rule 102(e)(1)." *Pattison*, Exchange Act Rel. No. 67900, 104 SEC Docket 58890, 2012 SEC LEXIS 2973, at *27-28, *49 (Sept. 20, 2012). In applying the *Steadman* factors in a Rule 102(e) proceeding, careful and critical attention must be paid to the specific circumstances to prevent a result that violates due process and basic fairness. Unfortunately, the Decision's and Division's interpretation of *Steadman* runs headlong into those very violations.

Under *Steadman*, the following factors may be considered in determining whether a suspension is warranted in a Rule 102(e) proceeding:

> [T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman, 603 F.2d at 1140 (quoting *Blatt*, 583 F.2d at 1334 n.29). In this case, there is no allegation of intentional misconduct on Mr. Aesoph's part. Rather, Mr. Aesoph played an important role in exposing fraud and deceit on the part of TierOne executives who have now pled guilty to criminally deceiving Mr. Aesoph and his audit team.[2] Therefore, the only arguably relevant *Steadman* factors are: (1) whether Mr. Aesoph, in mounting his defense, failed to recognize his wrongful conduct (the factor insisted upon most heavily by the Division and improperly relied upon by the Decision); (2) the purported "egregiousness" of the challenged conduct; (3) whether Respondents' reliance on alleged "undocumented" audit procedures shows they do not recognize their misconduct; (4) the purported "recurrent" nature of the infraction; and (5) the likelihood that Mr. Aesoph's occupation presents opportunities for future violations. *See id.* An examination of each of these factors offers no support for the imposition of any sanctions against Mr. Aesoph.

A. The Fact of a Respondent's Defense Cannot Be Used Against Him

The most alarming of the Division's arguments is that Mr. Aesoph, in presenting his defense, has not "recognized the wrongful nature of his conduct" and that, as such, he presents an ongoing threat to the Commission's mission of protecting the investing public. Div. Br. at 27. The Decision likewise plainly and wrongfully faults Mr. Aesoph for a "vigorous defense." ID at 37. The Division's and the Decision's cursory treatment of this factor demonstrates a significant lack of understanding of the *Steadman* factors and a corresponding lack of respect for and violation of the due process to which Mr. Aesoph is entitled. The imposition of sanctions based upon the fact of Mr. Aesoph's defense would not only violate any notion of fairness in an

[2] Donald Langford, TierOne's Chief Lending Officer and a key audit contact during the 2008 audit, pled guilty to criminal charges in September 2014 that included misleading Mr. Aesoph and his team. *United States v. Langford*, No. 4:14-cr-03103-JMG-CRZ, Plea Agreement at 4 (D. Neb. Sept. 9, 2014). More recently, James Laphen, TierOne's Chief Operating Officer at the time of the 2008 audit, also pled guilty to criminal charges based in part on "conspir[ing] with senior executives and other employees at TierOne to conceal TierOne's true financial condition" from Messrs. Aesoph and Bennett. *United States v. Laphen*, No. 4:14-cr-03133-JMG-CRZ, Plea Agreement at 4 (D. Neb. Dec. 8, 2014).

administrative hearing, but it would also confirm widely-held concerns about the SEC's administrative process, *viz.*, that SEC administrative proceedings deprive respondents of due process.[3] Mr. Aesoph simply cannot be sanctioned for presenting the vigorous defense to which he is entitled.

1. The Circumstances Under Which a Defense Can Be Used as a Basis for Sanctions Are Extraordinarily Narrow

In using Mr. Aesoph's defense as a basis for sanctions, neither the Decision nor the Division assesses nor even mentions the relevant case law on this issue. An analysis of the legal precedent does not support the Decision's sanction imposed against Mr. Aesoph, much less the more severe sanction sought by the Division. The Decision and the Division ignore the case law guidance that:

> Absent a showing of bad faith, the defendant should not be prejudiced for presenting a vigorous defense and requiring the SEC to meet its proper evidentiary burden . . . .

SEC v. Ingoldsby, No. 88-1001-MA, 1990 U.S. Dist. LEXIS 11383, at *6 (D. Mass. May 15, 1990). The *Ingoldsby* court's holding is consistent with any formulation of due process—respondents to an administrative proceeding, who are denied the benefit of ordinary discovery and the rules of evidence, are entitled to deny allegations that are untrue and to contest faulty legal theories. "They are not to be punished because they vigorously contest the government's accusations." *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1229 (D.C. Cir. 1989) ("The securities laws do not require defendants to behave like Uriah Heep in order to avoid

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[3] *See, e.g.*, Russell G. Ryan, *The SEC as Prosecutor and Judge,* WALL STREET JOURNAL, Aug. 4, 2014, available at http://www.wsj.com/articles/russell-g-ryan-the-sec-as-prosecutor-and-judge-1407195362.

injunctions."). In analyzing whether a defendant acted in bad faith in presenting a defense such as to justify sanctions, the *Ingoldsby* court considered the defendant's "level of truthfulness, candor and cooperation in his initial SEC investigatory interview, during his trial testimony, and at the evidentiary relief hearing." *Ingoldsby*, 1990 U.S. Dist. LEXIS 11383, at *6-7. The Decision and the Division fail to mention these factors, let alone analyze them.

While the Division may disagree with Mr. Aesoph's position, the Division does not suggest that Mr. Aesoph was ever dishonest or obstructive. Indeed, Mr. Aesoph fully cooperated with the Staff and continues to cooperate with the U.S. Department of Justice ("DOJ") in its investigation of TierOne principals. Instead, the Decision and the Division appear to rely on the fact that, "[c]onsistent with a vigorous defense of the charges, [Mr. Aesoph has not] recognized the unreasonable nature of his conduct." ID at 37. The Division parrots this argument and adds, without explanation, that Mr. Aesoph's arguments "demonstrate a fundamental misunderstanding of basic auditing standards and raise serious concerns about whether [Mr. Aesoph] will repeat [his] misconduct in the future." Div. Br. at 27. As demonstrated below, these arguments are belied by the record and, in any event, are insufficient to warrant sanctions under *Ingoldsby*.

2. Mr. Aesoph's Presentation of a Reasonable Defense Contrary to the Division's Position Does Not Justify a Sanction for the Fact of the Defense

This case focuses on the audit procedures applied to one segment of the ALLL in TierOne's year-end financial statements, with particular attention to the last six months of 2008. The Decision finds the auditors performed insufficient procedures to support their judgments with respect to the estimated fair value of the collateral for the FAS 114 loans. The evidence clearly demonstrates otherwise; at a minimum, it shows the reasonable exercise of professional judgment by Mr. Aesoph and his team. Beyond that, the evidence also demonstrates that the Decision and the Division mistakenly conflate market value with fair value.

Thus, as noted by the Decision, Mr. Aesoph does not concede that his conduct with regard to the 2008 audit was unreasonable, and he presented a vigorous defense in support of his position. *See* ID at 37. For this reason, both the Decision and Division insist that sanctions are justified because Mr. Aesoph has apparently refused to acknowledge the wrongfulness of his actions, and therefore, he poses a risk of repeated violations in the future. *See id*; Div. Br. at 27. Yet these arguments are squarely contrary to the holdings of *Ingoldsby*, which concluded that a defendant's failure to acknowledge the wrongfulness of his conduct by virtue of his vigorous defense "is not evidence of a propensity [of the defendant] to commit future violations." *Ingoldsby*, 1990 U.S. Dist. LEXIS 11383, at *6.

In addition, neither the Decision nor the Division suggests that Mr. Aesoph's defense of his conduct in the 2008 audit was so unreasonable or implausible that the mere fact of that defense reflects bad faith and justifies a sanction. Nor could they when a highly qualified expert reviewed all of the work papers and procedures performed and concluded Mr. Aesoph's work and conclusions complied with all professional standards and provided a reasonable basis for issuing an unqualified audit opinion. Respondents' audit expert, Ms. Johnigan—a member of the Auditing Standards Board of the AICPA who has decades of experience auditing regional banks and has been previously engaged as an expert by the DOJ and SEC—opined that Mr. Aesoph complied with all professional auditing standards. (J.P.F.[4] ¶¶ 456-58, 461-62.) It would defy

[4] Citations to "J.P.F." refer to the Joint Proposed Findings of Fact and Conclusions of Law that Mr. Aesoph and Respondent Darren Bennett filed on December 10, 2013. Citations to "Resp'ts Ex." refer to Respondents' Joint Exhibits admitted at trial. Citations to "Div. Ex."

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reason for this Commission to declare a defense so implausible as to reflect bad faith and justify a sanction when a member of the Auditing Standards Board supported that defense. Particularly given the Decision's wholesale failure to address—much less *critique*— Ms. Johnigan's opinions and testimony, the argument that Mr. Aesoph's defense lacked support such as to justify sanctions based on the defense itself strains credulity.

B. Mr. Aesoph's Conduct Was Entirely Professional and Not Remotely Egregious

The Division contends that Mr. Aesoph's conduct during the 2008 audit was egregious. To support its contention, the Division repeatedly resorts to mischaracterizations of the record and statements of hyperbole while ignoring relevant evidence of Respondents' extensive audit procedures and expert testimony supporting the auditors' conclusions. A proper consideration of the entire record demonstrates that Mr. Aesoph's conduct and conclusions were reasonable and not egregious.

1. The Division's Exaggerated Allegations Regarding Use of Stale, Undiscounted Appraisals Are Not Supported by the Record

The Division's primary attempt to support its allegation of egregious conduct is through the frequent refrain that TierOne used undiscounted "stale appraisals" to estimate losses. *See, e.g.*, Div. Br. at 23-24. In repeated mischaracterizations of the record, the Division attempts to convince the Commission that TierOne used stale, undiscounted appraisals more often than not and that the auditors did absolutely nothing to assess the reasonableness of these practices. *See* Div. Br. at 2 ("TierOne *typically estimated* collateral values using stale appraisals that were not

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Refer to Division's Exhibits admitted at trial. Citations to "Tr." refer to pages of the Trial Transcript, with witnesses indicated in parentheses where necessary.

discounted to reflect these precipitous market declines.") (emphasis added); *id.* at 23 ("Respondents' audit work papers deemed an appraisal 'current,' and *did no further assessment of whether the appraisal's value was still reasonable*, so long as the appraisal was dated some time during 2008.") (emphasis added). The evidence shows that these allegations are highly exaggerated. Rather, the auditors engaged in multiple steps to assess the reasonableness of TierOne's collateral valuations, and their conclusions as to the reasonableness of discounts applied to the most recent appraised values were well supported.

First, the auditors observed that every single impaired loan, at each quarter and at year-end, carried a time-value discount, including those loans for which the Division claims that TierOne applied no discount. (Resp'ts Ex. 42, Johnigan Report at 53-54.) Each loan's documented fair value analysis shown in the FAS 114 templates included a significant discount to the most recent appraised value given management's assessment that it would take a year or more to sell the collateral due to expected illiquid market conditions in the subsequent period. (Resp'ts Ex. 42, Johnigan Report at 53-54.) Thus, the Division's repeated contention that TierOne applied wholly undiscounted appraisals to assess collateral value is fundamentally incorrect.

Second, the engagement team observed management applying significant discounts to the most recent appraised value and saw them doing so continually throughout 2008. The auditors requested the management-prepared FAS 114 templates for every impaired loan and included them in the work papers. (J.P.F. ¶ 322.) These templates contained extensive, loan-specific information and included additional notations reflecting audit work done on individual loans. (J.P.F. ¶¶ 317, 321.) The Office of Thrift Supervision ("OTS") referred to them as "an appropriate template . . . to measure quarterly impairment loss on impaired loans pursuant to

SFAS No. 114." (J.P.F. ¶ 212.) The collateral discounts applied and losses recorded were readily visible from the face of each template. (J.P.F. ¶ 321.) The templates, reviewed by the auditors quarterly, also reflected the change in TierOne's practice with regard to individual loan loss calculations that occurred in the first half of 2008. At the behest of the OTS, TierOne began charging off any outstanding loan balance above the estimated fair value of the collateral rather than carrying that amount as a reserve. (J.P.F. ¶ 197.)

In the second half of 2008, the auditors observed that TierOne continued to impair loans and apply additional discounts to the most recent appraised values for loans in the Nevada portfolio. (J.P.F. ¶ 386.) For any appraisals pre-dating 2008, the auditors noted that TierOne continued to substantially discount the most recent appraised value of the collateral on the related loans. For example, in their review of the Nevada loan, Celebrate 50, the auditors observed management increasing the discount to a 2006 appraisal from 45% in the second quarter to 50% in the third quarter and 55% at year end. (J.P.F. ¶ 368.) The loans with appraisal dates prior to 2008 were discounted in the range of 34% to 55%. (J.P.F. ¶ 386.)

Third, as to the specific subset of loans upon which the Division and Decision focus—Nevada loans with early-to-mid-2008 appraisals and no change to estimated fair value at year-end—the auditors observed that management estimated the fair value of the collateral for these loans in accordance with FAS 157 and the bank's own written description of its estimation process. (J.P.F. ¶¶ 368-71.) The Division's contention that the auditors' conclusions regarding estimates based on "undiscounted" appraisals were unreasonable is both factually flawed and relies upon the erroneous assumption that further losses were required as a result of changes in prices from market data. Critically, GAAP and guidance by the SEC's own Office of Chief Accountant ("OCA") prove this assumption to be wrong: the September 2008 guidance issued jointly by the Financial Accounting Standards Board ("FASB") and OCA expressly acknowledged difficulties faced by auditors in the unique economic environment and directed that, where forced transactions permeate the market, market prices are not determinative of fair value under GAAP. (J.P.F. ¶¶ 57-59.) To claim, as the Division does, that fair value estimates were "routinely based on stale, undiscounted appraisals," Div. Br. at 10, simply ignores the record: (1) TierOne did record substantial losses on each of these loans in 2008; (2) its fair value estimates incorporated substantial discounts from the appraised value for each of these loans; and (3) the SEC's own real-time guidance directed the auditors' conclusions as to the reasonableness of TierOne's fair value estimates.

The joint September 2008 OCA/FASB guidance was released at a point in time the guidance itself described as "particularly challenging." (J.P.F. ¶ 58.) In the view of both FASB and the OCA, the determination of fair value was made particularly difficult in light of the then-current dislocation in the market and an increasing number of foreclosures. In light of those observations, this guidance expressly clarified that forced sale transaction prices are not determinative of fair value. (*Id.*) FAS 157 and the OCA/FASB guidance both applied to and informed the year-end audit of TierOne. (J.P.F. ¶¶ 59-61, 376.) The record is clear that Mr. Aesoph and his team recognized that the Nevada market, particularly in the last half of 2008—and therefore applicable market price indices—were dominated by forced transactions and therefore yielded pricing not determinative of fair value under FAS 157. (J.P.F. ¶¶ 371, 374.) In such an environment, the "precipitous market declines" that are the basis for the Division's allegations did not directly translate into declines in fair value because they included forced sale transactions.

The Division claims the auditors' invocation of FAS 157 is a "red-herring", Div. Br. at 17, an argument that reflects the Division's inexplicable refusal to accept the applicability of an accounting principle that—as expressly noted in the disclosures to the very financial statements audited—applies to the collateral fair value estimates used to measure impaired loan losses. The Division insists Respondents ignored FAS 157 in evaluating TierOne's fair value estimates for impaired loans, Div. Br. at 17-18, but the undisputed evidence is to the contrary. The relevant audit work papers—including the "Loans" work paper series—consistently rely on and document the auditors' consideration of FAS 157 using the term "fair value" or "FV." (J.P.F. ¶ 119.) This term, as all the auditors testified, is synonymous with "FAS 157"—meaning, according to Mr. Barron (the Division's own audit expert), that references to "fair value" in the work papers are equivalent to references to FAS 157. (J.P.F. ¶¶ 61, 376; Tr. 1771:5-23 (Aesoph); Tr. 2242:16-43:11 (Barron).) Indeed, FAS 157 is titled "Fair Value Measurements." The work papers also document Respondents' review and comment on the extensive FAS 157 disclosure in TierOne's 10-K, including an annotation from the audit team tying the disclosure to the impaired loan test work. (J.P.F. ¶¶ 118-19, 230.) And Mr. Aesoph himself gave a PowerPoint presentation—retained in the work papers—to TierOne's Audit Committee regarding the implementation of FAS 157 in 2008, the year FAS 157 first became effective. (J.P.F. ¶ 119.)

The Division's argument that it is "telling" that "KPMG had a separate work paper on FAS 157 (in a separate section of the work papers)," that "does not reference FAS 114 or the ALLL", Div. Br. at 17, carries no weight. The logic—that because a work paper admittedly having nothing to do with FAS 114 or the ALLL discusses FAS 157, the auditors must not have considered FAS 157 in the ALLL portion of the audit—collapses under its own weight. As the

Division recognizes, the referenced work paper is in a "separate," i.e., non-FAS 114, non-ALLL, section of the work papers, which relates to a completely different aspect of the audit. Hence, a reference to FAS 114 or the ALLL in that work paper would be unexpected and incongruous. In any event, the fact remains that the auditors documented their understanding and application of FAS 157 in the work papers, which must be viewed in their entirety in assessing professional conduct under the professional standards.

The Division also holds out a one-sentence misstatement in a single work paper as "proof" that Respondents failed to consider fair value in light of deteriorating market conditions. *See* Div. Br. at 14. The sentence in question states that "market conditions have not materially deteriorated in 2008," *id.,* but as Mr. Aesoph testified, that sentence was an error, did not belong in the memorandum, did not reflect what he was seeing in the market in 2008, and was not indicative of the audit team's procedures or findings as documented throughout the rest of the audit work papers. (Tr. 838:22-841:1.) Yet the Division would have this one sentence—an acknowledged mistake—trump the remainder of the evidentiary record, in which multiple witnesses and work papers addressed the relevance of fair value under FAS 157 to the real estate markets of 2008 and TierOne's impaired loan losses. (ID at 12; J.P.F. ¶¶ 163-64, 180, 356.) For example, a Client Risk Assessment work paper described KPMG's increased 2008 audit procedures "[i]n response to the economic downturn in the banking industry driven by delinquencies in the housing and real estate markets," (J.P.F. ¶ 163), and the lead ALLL memorandum noted that "[s]ince our 2007 year-end audit and during our 2008 quarterly reviews, some of the loans (real estate values) we reviewed continued to deteriorate." (Resp'ts Ex. 8 at KPMGTO 5426.) Again, the Division and Decision's myopic view of a single sentence within the context of a relevant body of work paper documentation (and uncontroverted testimony) is wholly inconsistent with a proper examination of whether Mr. Aesoph complied with professional standards.

Finally, as a check on the reasonableness of management's estimation process, Mr. Aesoph observed that, consistent with the Nevada market trends observed by the auditors, TierOne had recorded losses of 30% on impaired loans in the Nevada market at year-end 2008. (J.P.F.¶¶ 372-73.) The Division's claim that the audit procedures Respondents undertook to test TierOne's 30% loss recognition on Nevada loans, including a conversation with TierOne's Controller, Mr. Kellogg, are not documented in the work papers and thus did not occur, Div. Br. at 19, is belied by the record, including testimony by Mr. Barron, who admitted that the calculation showing the 30% Nevada loan loss recorded was easily observed from the work papers. (J.P.F. ¶¶ 377-78.) He and Respondents' audit expert, Ms. Johnigan, did just that—relying solely on information in the work papers—and precisely derived the 30% loss amount. (J.P.F. ¶ 379; *see also* Tr. 1364:11-1365:2, 1366:10-13 (Barron) (stating he had "take[n] those numbers and calculate[d] 30 percent," and had no reason to doubt Respondents could have done so in "less than five minutes").) Further, the L-30 work paper documents the engagement team's discussions with management—which included their conversations with Mr. Kellogg—regarding market trends and TierOne's recording of significant losses. (J.P.F. ¶¶ 371-73.) The L-30 work paper thus corroborates Messrs. Aesoph's and Bennett's uncontradicted testimony. (J.P.F. ¶¶ 363, 372-80.)

The Division tacitly admits that TierOne's total annual loss recognition and charge-offs (as documented in the work papers), including those for the Nevada market, were actually consistent with market declines and disruption (also documented in the work papers), as measured by market indices that, in several respects, included losses other than losses in fair value as defined by FAS 157. Div. Br. at 19; (J.P.F. ¶¶ 372, 376, 402.) The Division dismisses these *facts* as pure coincidence, asserting that "any happened consistency between total annual charge-offs and market declines does not amount to sufficient audit evidence." Div. Br. at 19. However, audit evidence that contradicts the Division's charges does not, by that fact, become disqualified. In truth, the demonstrated facts defy the Division's contentions.

There was nothing egregious about Mr. Aesoph's careful consideration of relevant GAAP and use of professional judgment in auditing TierOne's Nevada portfolio of FAS 114 loans. Mr. Aesoph was confronted with a series of difficult judgments at a time of both economic displacement and, as described by the SEC, confusion as to the application of appropriate accounting standards. His good faith approach to these challenges was not egregious and does not provide an appropriate context for the imposition of sanctions.

2. The Division Identifies the Wrong Internal Control in Support of Its Allegation That Mr. Aesoph Acted Egregiously

In arguing that Mr. Aesoph's conclusions were unreasonable and his conduct egregious, the Division fails to mention or address the actual test work the engagement team performed and documented in support of its internal control work related to impaired loans. Both the Division and the Decision properly credit Mr. Aesoph with overseeing an integrated audit that appropriately identified the risk posed by TierOne's ALLL account, including the specific risk of collateral overvaluation associated with TierOne's FAS 114 loans. Div. Br. at 9-11; ID at 13. However, the Division then characterizes "Appraisal Review" as "*the* control" identified by Respondents to address the risk of collateral overvaluation when several other controls were identified and tested. Div. Br. at 11 (emphasis added). This contention unduly elevates and takes out of context the purpose of this one control within the larger control environment and the auditors' control test work.

As indicated on the face of the work paper and testified to at the hearing, the "Appraisal Review" served to verify that the underwriter or loan approval officer reviewed the appraised value for reasonableness and that documentation of that review was maintained in the loan file. (J.P.F. ¶¶ 273-75.) Respondent Bennett described this as a "front end" control, and in the words of Respondents' audit expert, Ms. Johnigan, the Appraisal Review was one of two controls intended "to make sure that the appraisals that [came] into the process [were] relevant, reliable data." (J.P.F. ¶¶ 270-71, 273-75.)

Neither the Division nor the Decision meaningfully addresses the other controls identified and tested by Respondents to ensure TierOne had a process in place to effectively address the risk that loan losses on FAS 114 loans were improperly valued. *See* Div. Br. at 11; ID at 13. These controls included (1) finance department review of the FAS 114 templates—that is, confirmation of the process and review of the fair value estimates by someone independent of the credit administration personnel who prepared the estimates in the first instance—and (2) review of the ALLL by a key executive group, the Asset Classification Committee ("ACC"). (J.P.F. ¶¶ 277-82.)

As documented in the work papers, the engagement team performed a walkthrough of the entire loan process and also obtained and reviewed Internal Audit's walkthrough of the loan process. (J.P.F. ¶ 240.) As part of these walkthrough procedures, the engagement team obtained documentation that TierOne's process included the Controller's review of the FAS 114 templates as a control over the impaired loan loss estimation process. (J.P.F. ¶¶ 242-45, 278-80.) Ms. Johnigan testified that "when you have a process this important that is being performed, it is a strong control when you note there's another separate party looking at it and seeing all the information that was used, and concurring on the method that was used and the amounts that were arrived at." (J.P.F. ¶ 280.) Mr. Barron, the Division's audit expert, agreed that independent review of the FAS 114 loan loss estimates by a knowledgeable person "outside the process" could be an effective control, and that the Controller would be an appropriate person to conduct a second review. (*Id.*)

The fact that *both* experts agree on this point should suffice to establish the reasonableness of Mr. Aesoph's conduct. But the evidence goes even further to establish the reasonableness of Respondents' conduct. In addition to the Controller's FAS 114 template review, the engagement team also tested and documented the Controller's and ACC's periodic review and approval of the ALLL as another key control relating to the FAS 114 part of the ALLL estimation process. (J.P.F. ¶ 281.) The eleven-member ACC included senior management—the Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, Chief Lending Officer, Chief Credit Officer, as well as the Controller, Mr. Kellogg—who reviewed detailed loan-by-loan reports to aid their assessment of the ALLL. (J.P.F. ¶¶ 282, 285.) As part of this test work, the auditors conducted (and documented in the work papers) a knowledge assessment with Mr. Kellogg, who confirmed to the auditors that the ACC "discusses the recent trends, status changes within the portfolios, reserve modifications, and FAS 114 impairments." (J.P.F. ¶ 284.) This audit evidence is wholly ignored in the Decision and by the Division.

The engagement team also obtained and reviewed copies of meeting minutes and materials received and reviewed by the ACC to corroborate the design and effectiveness of the control. (J.P.F. ¶¶ 285-86.) This too is documented in the work papers. (J.P.F. ¶¶ 285, 298-99.) These ACC materials included Delinquency Reports, Risk Rating Grading Reports, Operating Performance and Grading Summary Reports, Classification of Assets Reports, and interim credit reviews. (J.P.F.¶¶ 285, 292-96.) These reports contained extensive and detailed loan information, including specific impaired loan information such as property location, appraisal date, collateral value, and recommendations for non-accrual and specific reserves. (J.P.F. ¶¶ 290-95.) The signed ACC meeting minutes specifically state that the ACC reviewed these materials in order to "conduct[] an Asset Review for any changes to Specific and General Reserves"—"Specific Reserves" meaning impaired loan loss reserves. (J.P.F. ¶ 288.) These materials were reviewed in detail by Respondents' audit expert, Ms. Johnigan, who testified that the auditors had obtained sufficient, competent evidence, including evidence from the ACC, of sufficient internal controls over collateral valuations of FAS 114 loans. (Tr. 2024:6-31:9 (Johnigan).) Neither the Decision nor the Division references this evidence.

The record demonstrates that Mr. Aesoph's audit opinion with respect to internal controls and the FAS 114 portion of the ALLL relied on far more than a solitary work paper pertaining to an "Appraisal Review" control. The evidence presented during the hearing demonstrated that Mr. Aesoph and his team developed a detailed understanding of TierOne's loan processes and identified, tested, and documented the key controls showing review of the ALLL and impaired loan loss estimates by an appropriate level of management authority. (J.P.F. ¶ 277.)

3. Careful Consideration of the 2008 OTS Report of Examination Does Not Amount to Egregious Conduct

The Division's Opening Brief, like the Decision, also discusses the 2008 OTS Report of Examination ("ROE"), which was released in October 2008 and included several findings critical of bank management and the troubled state of TierOne's loan portfolio. Div. Br. at 7-8; ID at 9-10. The Division implicitly calls into question the sufficiency of the audit work in light of this "damning examination report." Div. Br. at 7. However, completely absent from the Division's account of the ROE is the careful consideration Mr. Aesoph and his team actually gave to the report. (J.P.F. ¶ 194.)

As noted in the Decision, Mr. Aesoph took the report seriously and was aware of its findings. ID at 12. He had Mr. Bennett analyze the ROE in a detailed work paper memorandum and also engaged KPMG's regulatory specialists to assist in evaluating the implications of the ROE. (J.P.F. ¶¶ 194, 198.) Messrs. Aesoph and Bennett then diligently monitored management's responses to the OTS and even reached out directly during year-end field work to Mr. Pittman, the OTS Field Manager with oversight responsibility for TierOne, to confirm their understanding of TierOne's responses to the OTS. (J.P.F. ¶¶ 201-04.) Mr. Barron, the Division's audit expert, admitted that both the auditor's monitoring function and their reaching out directly to Mr. Pittman reflected due professional care. (J.P.F. ¶ 203-04.) There was nothing egregious about Mr. Aesoph's considered and extensive response to the ROE.

4. An Alleged Lack of Documentation Does Not Equate to Egregious Conduct

As another example of alleged "egregious" behavior, the Division claims that Respondents' reliance on alleged "undocumented" procedures should serve as the basis for more severe sanctions. Div. Br. at 24-25 ("The egregiousness of Respondents' conduct is only exacerbated by their continued insistence that they performed important, undocumented procedures that—they claim—save their deficient audit."); *id.* at 25 ("Respondents [sic] continued reliance on undocumented audit procedures further demonstrates the egregiousness of their misconduct.") Yet again, the Division mischaracterizes the record. As described above and in Mr. Aesoph's Opening Brief, the auditors did point to extensive documentation to support their conclusions, including documentation of the auditors' extensive review of the loan files.[5]

But even more importantly, the Division's contention makes clear that its charges rapidly reduce to a challenge regarding audit documentation, or an alleged lack thereof. It would be unprecedented for the Commission to sanction an auditor under Rule 102(e) over what is essentially a dispute as to the required level of work paper documentation under Auditing Standard No. 3 ("AS No. 3"). While the adequacy of audit documentation is frequently addressed in the PCAOB inspection process, it has never served as the basis for a finding of "egregious" conduct in a Rule 102(e) proceeding.

This is a case in which an auditor interpreted and applied accounting and auditing standards during a time of extreme economic crisis and came to reasonable conclusions despite the presence of fraud by management. (J.P.F. ¶¶ 442-50.) Mr. Aesoph did so under the then-recent guidance of the SEC's OCA. (J.P.F. ¶¶ 58-60.) An auditor's conduct in following GAAP and SEC pronouncements in the midst of market distress and uncertainty over the application of accounting standards is simply not the type of "egregious" conduct targeted by *Steadman*. The Division can only sustain an argument that Mr. Aesoph's conduct was "egregious" if it willfully

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[5] The work papers document over 200 instances in which the auditors reviewed TierOne's loan files. (J.P.F. ¶ 451.) Ms. Johnigan's report discusses this evidence with respect to every impaired loan the auditors evaluated, citing information from the loan files and work papers documenting the evaluation of each loan, and demonstrates that the audit record supports Mr. Aesoph's conclusion about TierOne's ALLL and FAS 114 loans. (Ex. 42, Johnigan Report at Exhibit B.) At the hearing, the Division's own audit expert, Mr. Barron, walked through multiple FAS 114s and loan files, and testified that tick-marks on the FAS 114s documented that the auditors had agreed the FAS 114s to appraisals and other information they had reviewed in the loan files. (Tr. 1332:10-15, 1334:14-1343:25, 1347:2-1362:10 (Barron).)

ignores the evidentiary record with respect to the audit procedures actually performed and the stark reality of fair value accounting in 2008.

C. The Audit Documentation Standard Cannot Be Used to Foreclose Consideration of Evidence Relevant to Mr. Aesoph's Professionalism

According to the Division, Mr. Aesoph's reliance on alleged "undocumented"[6] audit procedures not only shows that Mr. Aesoph acted egregiously, but it also demonstrates that Mr. Aesoph does not recognize his misconduct. *See, e.g.*, Div. Br. at 4 ("Respondents do not recognize their misconduct, resting their defense on claims of undocumented audit procedures despite conceding that auditors are required to document their work."); *id.* at 27 ("Respondents continue to rely heavily on claims that they performed significant audit procedures that are simply not documented in the audit work papers . . . despite the clear guidance in the PCAOB standards that auditors must document their work . . . demonstrat[ing] a fundamental misunderstanding of basic auditing standards and rais[ing] serious concerns about whether Respondents will repeat their misconduct in the future.").

But Mr. Aesoph's testimony indicating that the auditors endeavored to document all important procedures, (Tr. 841:12-20), is not an indication that Mr. Aesoph disregards audit documentation standards; rather, his testimony demonstrates his appreciation of the importance of those standards and his efforts to meet them. In the few instances where Mr. Aesoph

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[6] Many of the Division's claims of "undocumented procedures" are exaggerated, and the procedures focused upon by the Division were in fact documented by the Respondents in the work papers. *See, e.g.*, Div. Br. at 17-18 (suggesting that Respondents must not have considered loan files in connection with the FAS 114 portion of the audit because they "could have documented" their review in the FAS 114 work papers, but instead only documented their review of loan files in "other work papers"); *id.* at 19 (claiming that certain audit procedures Respondents undertook to test TierOne's 30% loss recognition on Nevada loans were not documented in the work papers even though the 30% loss recognized by TierOne on Nevada impaired loans was plainly evident in the L-37 work paper, as admitted by the Division's own audit expert. (J.P.F. ¶¶ 373, 377-78.)

conceded that certain of the auditors' observations were not noted in particular work papers, he agreed that additional documentation in such instances might have been helpful or smart. (*See, e.g.,* Tr. 847:3-22.) Mr. Aesoph's honesty and open recognition of areas where audit documentation could have been improved do not, as the Division claims, demonstrate a fundamental misunderstanding of basic auditing standards or raise serious concerns about whether Mr. Aesoph will repeat his alleged mistakes in the future. Rather, his conduct demonstrates his appreciation of best practices and willingness to improve upon his performance in the future.

Regardless of the impact of Mr. Aesoph's recognition of the importance of audit documentation standards under a *Steadman* analysis, these issues do not preclude Mr. Aesoph from offering testimony providing further explanation of the audit work papers as part of his defense, nor should the fact that he has offered such testimony be used as a basis for sanctions against him. While Mr. Aesoph has recognized certain areas where audit documentation might have been improved, Mr. Aesoph has never agreed with the Division's interpretation of AS No. 3, which would require auditors to document every conversation and every piece of evidence reviewed, because this interpretation is both impractical and contrary to explicit PCAOB guidance, which requires auditors to employ professional judgment in developing audit documentation. *See* AS No. 3 App. ¶¶ A18-19, A22, A31 (explaining that auditors must "exercise professional judgment in the documentation of an audit and other engagements", that "[n]othing in the standard precludes auditors from exercising their professional judgment", and that "[t]he auditor need not document each conversation that occurred", as doing so would be impractical).

Additionally, Mr. Aesoph has never agreed with the Division's and Decision's attempt to turn the audit documentation standard into a rule of evidentiary exclusion in judicial and administrative proceedings—an approach the PCAOB has already been explicitly rejected. AS No. 3 App. ¶¶ A21-25. Contrary to PCAOB guidance and to every case in which the Commission and its ALJs have relied on the testimony of respondent witnesses, the Division suggests (without actually challenging his credibility) that Mr. Aesoph's testimony is inherently unreliable and should be rejected because it cannot be found verbatim in the work papers. But if testimony could be rejected for this reason, there would be little point in permitting respondents to testify at evidentiary hearings. The uncontroverted testimony by Respondents and their expert witnesses constitute a meaningful part of the evidentiary record that cannot be ignored.

D. Mr. Aesoph Poses No Threat to the Commission's Processes

In evaluating whether Mr. Aesoph should be sanctioned, the Commission must also consider whether Mr. Aesoph poses some future threat to the Commission's processes. Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57,164, at 57,166 (Oct. 26, 1998). Rule 102(e) does not and is not intended "to encompass every professional misstep." *Id.* "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 pose a future threat to the Commission's processes sufficient to require Commission action under Rule 102(e)(1)(ii)." *Id.*

The Division argues that Mr. Aesoph's conduct was recurrent because it "flowed through the audit" and that Mr. Aesoph "violated professional standards nearly every time [he] performed audit work over [the FAS 114 portion of the ALLL] account." Div. Br. at 25-26. Not only does the Division's argument avoid the requisite analysis, but it also applies an incorrect legal standard and assumes incorrect factual findings that even the Decision did not adopt.

As noted by the *Ingoldsby* court, "the mere fact of a single past violation by the defendant does not demonstrate a realistic likelihood of recurrence." *Ingoldsby,* 1990 U.S. Dist. LEXIS 11383, at *6. Instead, the court considered whether the conduct was isolated or recurrent (i.e., whether the Commission presented evidence of past or subsequent violations) and whether the defendant's assurances that he would commit no future violations were genuine and sincere. *Id.* at *6-7.

The Division has failed to establish evidence of recurrent violations or lack of sincerity by Mr. Aesoph. First, the Division only alleges wrongdoing with respect to a single account within a single audit during a singularly challenging time frame[7]; it has alleged no wrongdoing with respect to other audits or to interim reviews. Second, Mr. Aesoph has never before been sanctioned. In other words, the Division attempts to stretch allegations regarding a single audited account into a finding that Mr. Aesoph is a repeat offender because every time he reviewed a loan loss estimate in the 2008 TierOne audit, he did it the same way. This is not the type of "recurrent" conduct contemplated by the case law. The Division relies solely upon the fact of a single alleged past violation in contravention of *Ingoldsby* to justify sanctions against Mr. Aesoph.

Relatedly, the Division contends that "there is a likelihood that [Mr. Aesoph's continued employment at KPMG] could lead to further violations." Div. Br. at 26. The Division's concern is ill-founded given the uniqueness of the situation in which Mr. Aesoph conducted the 2008 audit. As acknowledged by the Commission Staff, "[t]he current environment [in 2008] made

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[7] The Decision's findings of improper conduct relate to both substantive procedures and internal controls, but the Decision's findings and Division's allegations all concern the same FAS 114 portion of the ALLL account. ID at 36; Div. Br. at 2-3. They do not properly support an allegation of recurrent behavior.

questions surrounding the determination of fair value particularly challenging for preparers, auditors, and users of financial information." (J.P.F. ¶ 58 (quoting the OCA/FASB September 2008 guidance).) The complexity of the 2008 audit in the midst of the recession, the lack of available precedent for implementing new accounting standards on fair value, and the pervasiveness of fraudulent misrepresentations by management created a special set of circumstances that is highly unlikely to be encountered again by Mr. Aesoph or indeed by the accounting profession. The Division's position on this issue is not supported by the facts, the law, or the relevant accounting guidance.

E. Mr. Aesoph's Role in Uncovering the Fraud Perpetrated by TierOne Executives Cannot Be Overlooked

In seeking more severe sanctions against Mr. Aesoph, the Division focuses solely upon Mr. Aesoph's conduct with regard to his one-time audit of a single account, conducted in the midst of market upheaval and under the uncertain application of an important new accounting principle. The Division wholly fails to address or explain why the Commission should not credit Mr. Aesoph's conduct in performing the remainder of the 2008 audit according to the "highest professional standards," *see* ID at 31, in exposing the fraud perpetrated by management, and in cooperating fully in the subsequent government investigations.

Neither the Decision nor the Division takes issue with the work Mr. Aesoph performed on other areas of the audit. Mr. Aesoph devoted a significant number of hours to the 2008 audit and to TierOne's ALLL in particular, far in excess of hours spent in prior years, and demanded the same from his staff. (J.P.F. ¶¶ 180-82.) The quarterly and year-end 2008 work papers—comprising 19 binders and over 7,000 pages, all of which are now part of the record (J.P.F. ¶ 435)—reflect this carefully planned audit and set forth the significant amount of audit evidence Mr. Aesoph and his team gathered in assessing TierOne's ALLL and internal controls. Indeed, the auditors obtained and performed procedures on FAS 114 analyses for fifty-five borrower relationships, accounting for a total of 186 loans, 156 of which were impaired. Mr. Aesoph's work on the 2008 audit was far from perfunctory, and his conduct in performing that audit was far from egregious.

The Division further specifically fails to address Aesoph's substantial role in bringing management's fraud to light and ignores entirely that Mr. Aesoph was willfully deceived by TierOne management. It was Mr. Aesoph—not the OTS or any other person outside KPMG—who first learned of the potential inconsistencies in management's representations, and it was Mr. Aesoph who directly and repeatedly confronted management when he became aware of those inconsistencies. (J.P.F. ¶ 449.) After concluding from his investigation that KPMG could no longer rely on management's representations, Mr. Aesoph informed TierOne that KPMG was immediately resigning as independent auditor and withdrawing its audit opinion on TierOne's year-end 2008 financial statements and internal control assessment. (J.P.F. ¶¶ 449-50.) Mr. Aesoph's role did not stop there. Mr. Aesoph fully and willingly cooperated with government investigators once TierOne's fraud had been exposed. Both the Department of Justice and the Commission have charged central figures in TierOne management with misleading the auditors, which thus far has resulted in settled proceedings and guilty pleas by TierOne's Chief Executive Officer and Chief Credit Officer. The Division fails to recognize the critical role Mr. Aesoph played in the initiation and pursuit of those proceedings—a role that illustrates Mr. Aesoph's commitment to the integrity of the profession and negates any inference that Mr. Aesoph is a threat to the Commission's processes.

III. CONCLUSION

The fact that Mr. Aesoph has been sanctioned at all is contrary to fundamental concepts of fairness and due process. The evidence presented during the hearing shows a painstakingly detailed and comprehensive audit, conducted during a tumultuous period of financial upheaval under a new and complicated accounting standard, and in the midst of material fraudulent representations made by management, ultimately brought to light by Mr. Aesoph himself. Mr. Aesoph's conduct simply does not justify sanctions under Rule 102(e). Mr. Aesoph respectfully requests that the Commission deny the Division's request for more significant sanctions.

Rule 450(d) Certification: Undersigned counsel certifies that this brief contains 9,158 words and therefore complies with the limitations set forth in Rule of Practice 450(c).

Dated: December 23, 2014

Respectfully submitted,

George B. Curtis
[redacted]

Counsel for John J. Aesoph