UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15168

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In the Matter of

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

Respondents.

BRIEF OF DARREN M. BENNETT IN OPPOSITION TO DIVISION OF ENFORCEMENT'S BRIEF IN SUPPORT OF ITS PETITION FOR REVIEW

December 23, 2014

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INTRODUCTION

As set forth in his Opening Brief in support of his separate petition for review, no sanction against Respondent Darren Bennett is warranted, let alone the two-year suspension advocated by the Division of Enforcement ("Division"). That is because Mr. Bennett, as senior manager for the KPMG engagement team, did not engage in improper professional conduct in violation of Commission Rule 102(e) during the 2008 integrated audit of TierOne. Never before has the Commission suspended a non-partner auditor for the type of conduct reflected in this record.

In petitioning for review, the Division argues that all factual and legal determinations of the Administrative Law Judge ("ALJ") in the Initial Decision were entirely correct *except* for the sanction, a six-month suspension. Throughout its brief, the Division invokes overheated rhetoric, claiming that Respondents committed "significant audit failures," disregarded "glaring red flags," and committed "serious violations" that are nowhere found in the Initial Decision. It argues that Respondents' supposed "misconduct tainted nearly all areas of the audit" when no such finding exists in the Initial Decision. Div. Br.-1-4. And it argues that "Respondents did not test or question in any serious way TierOne's collateral valuations," when the Initial Decision says no such thing. Div. Br.-10. In fact, the only time the Initial Decision uses the term "serious" in connection with the conduct of Respondents is in commending their work with respect to the Office of Thrift Supervision ("OTS") report. ID-12 ("Both took the report seriously and were fully aware of its findings.").

Based on this embellishment, the Division asks the Commission to quadruple the sanction proposed by the ALJ and suspend Mr. Bennett for a period of two years, arguing, in effect, that Respondents must be punished for exercising their right to defend their conduct in the

face of the Division's allegations that the audit was perfunctory. To support that punitive result, the Division insists that Respondents "fail to grasp the basic rules that govern auditor conduct," because they supposedly rely on undocumented audit procedures in defending their conduct. Div. Br.-1, 4, 16. These arguments cannot justify the two-year suspension sought by the Division. As a minimum requirement of due process, and as contemplated by the Commission's rules, Mr. Bennett is entitled to mount a vigorous defense. Further, audit documentation standards do not provide a basis for ignoring uncontradicted evidence of work that Mr. Bennett and the engagement team planned and performed during the course of the audit. That is particularly true here given that the Division ignores the substantial audit documentation reflected in the record and has abandoned any claim that Respondents' documentation violated professional standards in this case.

Viewed in its entirety, the record reflects that no suspension of Mr. Bennett is necessary to protect the Commission's processes or the investing public, and no legitimate remedial goal would be served by increasing the length of the suspension proposed in the Initial Decision. As explained fully in his Opening Brief, during the 2008 integrated audit of TierOne, Mr. Bennett and the KPMG engagement team properly identified risks associated with TierOne's internal control over financial reporting ("Internal Controls") and its allowance for lease and loan losses ("ALLL"). They carefully considered the findings of the OTS and monitored TierOne's remediation and compliance with regulatory requirements. They planned and implemented enhanced audit procedures. Aware that professional standards neither defined nor required "current" appraisals, they observed audit evidence that supported the reasonable conclusion that management's efforts to estimate FAS 114 impaired loan reserves at year-end 2008 were themselves reasonable. And they completed the audit during a period of unprecedented market

uncertainty without knowledge that members of TierOne's management were engaged in concerted efforts to mislead them.

Further, in his role as senior manager, Mr. Bennett worked tirelessly to carry out his responsibilities while under the supervision and with the concurrence of other more senior members of the KPMG engagement team. There is no allegation that he failed to communicate or that he withheld information from supervising partners (as is reflected elsewhere in the administrative case law involving non-partner auditors). A sanction against a non-partner auditor on such a record would be unprecedented.

Mr. Bennett has endured a multiple-year investigation that has derailed his professional life. All the while, he has cooperated in the Division's investigation of TierOne, as well as in related investigations of the fraud that TierOne management perpetrated against multiple parties, including the auditors. There should be no real dispute that Mr. Bennett is a competent and conscientious auditor. Imposition of a suspension under these circumstances, let alone an increased suspension, is not necessary to protect the Commission's processes or the investing public and instead would have a profound and devastating impact on his career. That punitive result is inappropriate under the Commission's rules, is unnecessary to serve the remedial goals of Rule 102(e), and would send a precarious message to young auditors in the profession.

ISSUES PRESENTED

1. Whether the Division's request for a two-year suspension of Mr. Bennett should be rejected because the record shows that he complied with applicable professional standards and did not engage in improper professional conduct under Commission Rule 102(e).

2. Whether audit work performed by Mr. Bennett and the engagement team should be disregarded based on the Division's claim that such work was not adequately documented in the audit workpapers.

3. Whether a two-year suspension of Mr. Bennett, based on his conduct as senior manager on the KPMG engagement team, is excessive and unnecessary to serve the remedial goals underlying Rule 102(e).

4. Whether a two-year suspension of Mr. Bennett, because he presented a defense to the Division's claims, would be arbitrary, capricious and contrary to law because it would punish him in violation of the remedial goals of Rule 102(e).

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." Here, the Commission has stated that, pursuant to Rule of Practice 411(d), it would "determine what sanctions, if any, are appropriate in this matter." Order Granting Pets. for Review and Scheduling Brs. at 1 (Sept. 4, 2014).

STATEMENT OF THE CASE

In his Opening Brief filed on October 24, 2014, Mr. Bennett described the relevant legal standards governing the imposition of liability under Rule 102(e), *e.g.*, Opening Br.-4-5, as well as the applicable professional standards governing the 2008 integrated audit of TierOne, *id.* at 5-8. Likewise, Mr. Bennett set forth, in detail, the efforts that he and the KPMG engagement team undertook in connection with the 2008 integrated audit of TierOne. *Id.* at 9-14. Below, Mr. Bennett highlights and supplements that prior discussion as necessary to address fully the issue whether Mr. Bennett should be subject to the two-year suspension sought by the Division.

I. APPLICABLE LEGAL AND PROFESSIONAL STANDARDS

A. Commission Rule 102(e)

As the Division notes, Div. Br.-19, the Commission brought proceedings against Mr. Bennett and his supervisor John Aesoph in connection with KPMG's 2008 integrated audit of TierOne, under 15 U.S.C. § 78d-3, and Commission Rule 102(e). Section 78d-3 and Rule 102(e) grant 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 unethical or improper professional conduct." 15 U.S.C. § 78d-3(a)(2) (emphasis added).

In describing the intended scope of Rule 102(e), the Commission explained that "a finding of 'improper professional conduct' under Rule 102(e) is warranted only when an accountant lacks competence to practice before the Commission." Amendment to Rule 102(e), Exchange Act Release No, 33-7593, 63 Fed. Reg. 57,164, 57,166 (Oct. 26, 1998) ("Rule 102(e) Release"). Rule 102(e) does not and is not intended "to encompass every professional misstep." *Id.* Thus, "[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 Commission has recognized that "[a] professional often must make difficult decisions, navigating through complex statutory and regulatory requirements, and in the case of accountants, complying with [GAAS] and applying [GAAP]," and that "[t]hese determinations require the application of independent professional judgment and sometimes involve matters of first impression." *Id.* at 57,166 n.27 (internal quotation marks omitted). The Commission has

disavowed using Rule 102(e)(1)(iv) to "establish new standards for the accounting profession," *id.* at 57,166, and "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. And, "[b]ecause the purpose of Rule 102(e)(1)(ii) is to address conduct that demonstrates a future threat to the Commission's processes, the rule is remedial and not punitive in nature." *Id.* at 57,166 n.26; *see McCurdy v. SEC*, 396 F.3d 1258, 1264-65 (D.C. Cir. 2005) ("The Commission may impose sanctions for a remedial purpose, but not for punishment" (citing *Johnson v. SEC*, 87 F.3d 484, 490 (D.C. Cir. 1996))).

In this context, Rule 102(e) provides a special definition of "improper professional conduct" applicable to "persons licensed to practice as accountants." Rule 102(e)(1)(iv). Under Rule 102(e), "improper professional conduct" refers first to "[i]ntentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards." *See* Rule 102(e)(1)(iv)(A). In addition, "improper professional conduct" also can include "negligent conduct" but only if the Commission alleges and satisfies additional elements. *See* Rule 102(e)(1)(iv)(B). Negligent "improper professional conduct" can take the form of "[1] a single instance of highly unreasonable conduct [2] that results in a violation of applicable professional standards [3] in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted." *Id.*[1] Likewise, negligent "improper professional conduct" also can mean "[1] [r]epeated instances of unreasonable conduct, [2] each resulting in a violation of applicable

[1] In assessing whether conduct is "highly unreasonable," "[t]he conduct at issue is measured *by the degree of the departure from professional standards*," *id.* at 57,167 (emphasis added), rather than "the impact of a violation on financial statements filed with the Commission" or "the risk of harm posed by the conduct," *id.* at 57,168.

professional standards, [3] that indicate a lack of competence to practice before the Commission." *See* 17 C.F.R. § 201.102(e)(1)(iv)(B)(2).

B. Audit Documentation Standard

Audit Standard No. 3 ("AS No. 3") sets forth the professional standards for audit documentation. JPF ¶105. AS No. 3 requires auditors to document "procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions." AS No. 3 ¶ 6 (RX–49). "Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement [to] understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusion reached." *Id.* ¶ 6(a) (RX–49). When audit documentation is "[i]nadequate," "it casts doubt as to whether the necessary work was done." AS No. 3, App. A ¶ A10.

AS No. 3 does not mandate the specific *content* of audit documentation. It states that "[a]uditors exercise professional judgment in nearly every aspect of planning, performing and reporting an audit," including their "professional judgment in the documentation of an audit and other engagements." AS No. 3, App. A ¶ A18. In exercising that judgment, auditors must consider "the need to document procedures performed, evidence obtained and conclusions reached *in light of time and cost*." *Id.* (emphasis added). As explained by Respondents' accounting and audit expert, Sandra Johnigan,[2] if an auditor were "to record everything [he/she] did, it would be totally impractical" because "[t]here [are] so many things that are done," Tr.–2061. As a result, auditors must "make a judgment as to what ... to put in work papers to

[2] Ms. Johnigan is a current member of the Auditing Standards Board of the American Institute of Certified Public Accountants, JPF ¶456, and both the Commission and the Department of Justice have engaged Ms. Johnigan as an expert in prior unrelated matters, JPF ¶461.

demonstrate that you have enough evidence to come to your conclusion and the procedures that [the auditor] performed around that process." *Id.* As acknowledged by the Division's expert, John Barron, AS No. 3 does not require every document auditors receive and consider "to be included in the work papers." Tr.–1224 (Barron).

II. FACTUAL BACKGROUND

In his Opening Brief, Mr. Bennett set forth a detailed discussion of the facts underlying KPMG's 2008 integrated audit of TierOne and his role, as senior manager, within the KPMG engagement team. *See*, *e.g.*, Opening Br.-9-14. Mr. Bennett also addressed, in detail, the factual evidence demonstrating that he complied with applicable professional standards in connection with (1) KPMG's audit of TierOne's Internal Controls, *id.* at 20-26, (2) KPMG's audit work regarding TierOne's ALLL, *id.* at 26-37, and (3) certain appraisals received by KPMG after completion of the 2008 audit, *id.* at 38-39. In doing so, Mr. Bennett explained that the ALJ erred by misapplying the applicable professional standards and failing to address relevant evidence in the record.

In its brief, the Division "presumes the law judge's findings of fact and conclusions of law on all issues other than sanctions are correct," and, for that reason, the Division's "citations are generally to the findings and conclusions of the Initial Decision, rather than the underlying evidentiary record." Div. Br.-5 n.4. As a result, the Division's discussion of the factual background suffers from the same errors that Mr. Bennett identified in his Opening Brief challenging the Initial Decision.

III. THE ALJ'S INITIAL DECISION REGARDING SANCTIONS

As relevant here, the ALJ concluded that "Respondents' course of conduct related to the audit, taken as a whole, constituted 'a single instance of highly unreasonable conduct' within the

meaning of Rule 102(e)(1)(iv)(B)(1)." ID-36. The ALJ stated that Respondents' "procedures in testing TierOne's internal control over financial reporting and evaluating the FAS 114 estimates" were inadequate. *Id.* In the alternative, the ALJ concluded that "each Respondent's participation in the engagement included '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' within the meaning of Rule 102(e)(1)(iv)(B)(2)." *Id.* at 36 n.38. The ALJ identified two instances of unreasonable conduct: (1) "[t]he failure to identify material weakness in TierOne's internal control over financial reporting," and (2) "the failure to evaluate the FAS 114 portion of the ALLL in accordance with professional standards." *Id.* The ALJ concluded that "[b]oth instances demonstrate a lack of due care and failure to obtain sufficient evidence in a high risk and material area of the audit." *Id.*

As to the appropriate sanction, the ALJ acknowledged the Division requested that Mr. Bennett be suspended from practicing or appearing before the Commission for two years and that Mr. Aesoph be suspended for three years. ID-36. The ALJ explained, however, that the purpose of Rule 102 sanctions "is not to punish, but to protect the public from future reckless or negligent conduct by professionals who practice before the Commission and to encourage more rigorous compliance with auditing standards in future audits." *Id.* The ALJ considered both the issue of "deterrence" and the so-called *Steadman* factors, which look to "'[1] the egregiousness of the defendant's actions, [2] the isolated or recurrent nature of the infraction, [3] the degree of scienter involved, [4] the sincerity of the defendant's assurances against future violations, [5] the defendants' recognition of the wrongful nature of his conduct, and [6] the likelihood that defendant's occupation will present opportunities for future violations.'" *Id.* at 36-37 & n.39 (quoting *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979)).

Applying these factors, the ALJ noted that "Respondents' auditing lapses, which were negligent, occurred in a single audit." ID-37. The ALJ concluded that continued employment with KPMG would "present opportunities for future violations," and that "[c]onsistent with a vigorous defense of the charges, [Mr. Bennett] has [not] recognized the unreasonable nature of his conduct." *Id.* Addressing "egregiousness," the ALJ stated only that "Respondents' conduct fell short of professional standards in their failure to evaluate management's FAS 114 estimates in accordance with professional standards in the face of a need for heightened scrutiny and the corresponding failure to identify a material weakness in TierOne's internal control over financial reporting." *Id.* According to the ALJ, Respondents' "conduct involved a lack of due care and failure to obtain sufficient evidence to support their audit judgments." *Id.*

The ALJ acknowledged that Respondents are "highly regarded at their firm," have "significant experience, recognized risks associated with the ALLL, worked longer hours on the 2008 audit than on the previous audit, and adequately covered other areas of the audit." ID-37. Further the ALJ explained that "[n]one of the previous auditing engagements on which either Respondent has worked has been the subject of any regulatory complaint." *Id.* Ultimately, the ALJ concluded that "[a] one-year suspension for Aesoph and six-month suspension for Bennett are appropriate sanctions and consistent with Commission precedent and take account of Aesoph's more responsible role in the engagement." *Id.* at 37 & n.40 (citing Commission cases).

ARGUMENT

The Division's core arguments are both that Respondents' conduct violated "basic audit standards," Div. Br.-1, and that the nature of those violations supports "a longer suspension" to "protect the investing public and encourage more rigorous compliance with professional standards," *id.* at 4. As set forth *infra* (at 11-28), the record evidence refutes the Division's threshold argument that Mr. Bennett violated professional standards. And, as addressed *infra* (at

29-39), an increased sanction is unnecessary to serve the goals underlying Rule 102(e) and would be arbitrary, capricious and contrary to law because it would be excessive and would punish Mr. Bennett for presenting a defense to the Division's allegations.

I. THE DIVISION'S REQUEST FOR A TWO-YEAR SUSPENSION SHOULD BE REJECTED BECAUSE MR. BENNETT DID NOT VIOLATE RULE 102(e).

As set forth in Mr. Bennett's Opening Brief, no sanction should be imposed because Mr. Bennett did not violate Rule 102(e) and therefore no suspension is necessary to serve Rule 102(e)'s remedial goals. For the same reasons, no *increased* sanction should be imposed. The specific arguments that the Division advances in its appeal do nothing to alter that conclusion.

A critical component of the Division's argument is its contention that alleged violations of audit documentation standards authorize the wholesale disregard of the procedures that Mr. Bennett and the engagement team performed during the audit. Div. Br.-22.[3] To be sure, where audit documentation is "inadequate," that finding may "cast[] doubt as to whether the necessary work was done." AS No. 3, App. A ¶ A10. As discussed below, the Division ignores record evidence showing that Respondents adequately documented their work here. Moreover, the Division waived any claim that the audit documentation was inadequate.[4] As a result, the

[3] Div. Br.-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"); *see also id.* at 25 ("Respondents repeatedly return to multiple undocumented procedures to justify their conduct."); *id.* ("Respondents' continued reliance on undocumented audit procedures further demonstrates the egregiousness of their misconduct and their failure to recognize or respect the basic principles of professional conduct.").

[4] Although the Order Initiating Public Administrative Proceedings ("OIP") alleged that Respondents had violated audit documentation standards, OIP ¶¶ 69-70, the Division did not ask the ALJ to make any finding that Respondents violated the audit documentation standards in AS No. 3. In turn, the Initial Decision explained that "[t]o the extent the Division does not propose findings of fact or conclusions of law in support of other allegations in the OIP, those charges are deemed abandoned." ID-35 n.37. The Division does not challenge this determination.

Division's refrain that Respondents failed to comply with audit documentation standards provides no basis for the Division's disregard of critical aspects of the audit.[5]

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

The Division mischaracterizes the engagement team's audit testing with respect to Internal Controls bearing on the ALLL. *See* Div. Br.-11-12. It argues, in effect, that there was *one* critical risk, designated as a risk of "collateral overvaluation," and "the control Respondents selected for testing simply did not address that risk." *Id.* at 11. The Division's argument is wrong because it ignores much of the engagement team's work in testing Internal Controls.

Mr. Bennett and the engagement team appropriately determined that TierOne's ALLL was a "significant account" and proceeded to identify and test key Internal Controls over it. JPF ¶¶237-304. As an initial matter, the team obtained an understanding of TierOne's ALLL estimation process, including the likely sources of potential misstatements. JPF ¶¶238-240; RX-7 at KPMGTO0005004-28. The team observed that management used several processes to determine the risk rating of loans and identify impaired loans, *i.e.*, loans with respect to which it was probable that the full amounts owed under the terms of the loan agreements would not be collected. JPF ¶¶223, 243. With respect to loans deemed impaired, the team observed that management estimated the amount of loss or impairment using a collateral-dependent fair value model on a loan-by-loan basis considering the facts and circumstances of each loan pursuant to FAS 114. JPF ¶224. As documented in quarterly FAS 114 "templates," management charged off the difference between the impaired loan's book value and estimated fair value of collateral

[5] Even if this argument has not been waived, audit documentation standards, as discussed in Mr. Bennett's Opening Brief, do not provide a basis for ignoring credible evidence of audit procedures planned and performed by Mr. Bennett and the engagement team. Opening Br.-17-18. Indeed, for this reason, Mr. Bennett respectfully disagrees with a number of the ALJ's conclusions regarding the procedures that were performed during the course of the 2008 audit. *Id.* at 18-20.

and applied 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. Thereafter, multiple levels of management reviewed and approved these reserve estimates, along with the ALLL in its entirety. JPF ¶¶244-45.

After obtaining this understanding of the process, Mr. Bennett and the engagement team performed a variety of tests to determine if the related controls were designed properly and operating effectively. *First*, the team, with the assistance of a KPMG credit review specialist, tested TierOne's risk rating and impaired loan identification process by reviewing loan files, including third-party appraisals, loan analyses and credit reviews prepared by loan officers, and borrower and guarantor information. JPF ¶¶253-59. Based on this work, the engagement team concluded that management appropriately was risk rating loans and identifying impaired loans. JPF ¶¶183-84. Throughout the administrative proceeding, the Division never challenged this aspect of the Internal Controls testing, *id.* ¶269, and ignores it here.

Second, the engagement team identified and tested Internal Controls designed to ensure impaired loans were secured by collateral that was supported by appraisals which had been reviewed by TierOne for reasonableness. JPF ¶¶271-74. The team 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 also tested 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. Both of these controls addressed whether the impaired loan component of TierOne's ALLL was secured by adequate collateral at the "front end." Tr.-492 (Bennett). Control 7-2 in particular was significant because the OTS

had reported that TierOne previously had collateral-dependent loans "with no appraisal" or "unsupported appraisals." ID-28.

Although Control 7-2, "Appraisal Review," is the sole control the Division identifies in its appeal brief, the Division fails to acknowledge the context within which the control operates. Div. Br.-11-12. The Division ignores that the control was designed to address one aspect of the ALLL estimation process, at the front end, and was not the *only* control in place with respect to the risk of understatement of the ALLL and likewise was not the only control over the ALLL that the engagement team observed and tested.

Third, the Division simply ignores that the engagement team also tested TierOne's continuing review of the ALLL by multiple levels of management on the "back end." JPF ¶277. After TierOne's Special Assets Executive, David Frances, prepared the FAS 114 templates based on collaboration with other key members of management, including Donald Langford, the Chief Credit Officer ("CCO"), JPF ¶¶226, 244, TierOne's Controller, David Kellogg, then independently reviewed and approved each of the FAS 114 templates. JPF ¶279. This 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 overvalued. JPF ¶¶245, 280-81, 299-301. And the engagement team documented in the workpapers that Mr. Kellogg reviewed the FAS 114 templates as a control over the estimation process for impaired loans. JPF ¶278; RX-7D at KPMGTO0005056; Tr.-1598 (Bennett).

As documented in the workpapers, TierOne's Asset Classification Committee ("ACC")—comprised of eleven members from management and senior management, including Mr. Kellogg and Mr. Langford—reviewed, evaluated, and approved the sufficiency of TierOne's ALLL on a continuing and regular basis. JPF ¶¶282, 287, 299; RX-7D at KPMGTO0005054-56. The ACC

reviewed reports containing detailed information about individual impaired loans and related reserves and collateral. JPF ¶¶285-86, 288-296. In testing the ACC review, the engagement team 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 (emphasis added); JPF ¶284. The engagement team corroborated this representation by obtaining and reviewing both the ACC Meeting Minutes, which identified detailed reports reviewed by the ACC, and the reports themselves. JPF ¶¶285-86, 298. The meeting minutes stated that the ACC reviewed information contained in the various reports to analyze whether there should be "any changes to Specific and General Reserves." RX-7D at KPMGTO0005058; JPF ¶288. And, upon inspection by the engagement team, the reports 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.[6] The Division altogether ignores the engagement team's testing of this control.

After reviewing all of the audit workpapers regarding the Internal Controls work, Respondents' expert Ms. Johnigan concluded that Mr. Bennett and the engagement team appropriately identified and tested key controls over TierOne's ALLL estimation process, including the FAS 114 component. JPF ¶303; Tr.-2031; RX-42 at 15, 24. Ms. Johnigan concluded, in particular, that the Controller's review of the FAS 114 templates coupled with subsequent review by the ACC, Tr.-2022-26, provided the engagement team with "sufficient,

[6] For example, the Classification of Assets reports detailed the loan balance, risk rating, appraised value, appraisal date, and analysis from TierOne personnel for individual impaired loans. *E.g.*, DX-108 at TOB0092309-27; JPF ¶292.

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 own expert, Mr. Barron, 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 acknowledges that the engagement team tested this control, but its dismissal of the control as "high-level," ID-8, 28, ignores all of this evidence.

With hindsight it is now known that members of management on the ACC committed fraud, but the auditing standards are clear that "[c]ollusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false." JPF ¶77; AU § 316.10. Further, because "the auditor's opinion on the financial statements or internal control over financial reporting is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States)." JPF ¶73; AU § 230.12, .13 (effective 2008) (RX-55). There is no allegation that Respondents should have discovered the fraud.

Lastly, contrary to the Division's argument, Div. Br.-11-12, there was no professional requirement that TierOne maintain a control focused specifically on whether appraisals were current at year-end to address the risk of collateral overvaluation. Such a control would have

been too narrow given, as discussed further below, 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 at all. JPF ¶93; AU § 328.02, .06 (RX-60). During the tumultuous economic climate of the Great Recession, that is just what the audit evidence obtained by the engagement team showed management had done.

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.

The Division also ignores significant audit work performed, and reflected in the audit work papers, to test the reasonableness of the ALLL and instead improperly focuses on a narrow subset of the work done to test the FAS 114 reserves. Div. Br.-12-15.

After appropriately identifying TierOne's ALLL as having a "high" inherent risk, JPF ¶177, Mr. Bennett and the engagement team increased the scope of their interim and year-end audit procedures for testing the reasonableness of the estimate, JPF ¶¶161, 163, 180. This is in large part why the engagement team devoted 50% more time to the 2008 audit compared to the 2007 audit, and why Mr. Bennett personally devoted 90% more time. JPF ¶¶180, 182. Although the quantity of work is not determinative, the record shows that the team obtained sufficient competent audit evidence indicating the ALLL estimate was reasonable, JPF ¶¶305-98, and that throughout his work, including with respect to the FAS 114 reserves discussed below, Mr. Bennett met all professional standards.

First, the engagement team conducted extensive "substantive" audit procedures regarding the reasonableness of the FAS 114 reserves. JPF ¶¶317-86. In addition to reviewing

management's memorandum regarding its ALLL process, along with Internal Audit's tie-out of that memorandum to supporting documentation, JPF ¶¶310-12, the team performed a variety of procedures with respect to each of the 54 loan relationships that management had identified as impaired and potentially impaired. JPF ¶¶308, 317-318, 322-23, 350-58, 361. This included review of third-party appraisals for approximately two-thirds of the year-end FAS 114 loan relationships, which the team documented with the notation "agreed to appraisal" on the impairment templates in the workpapers. JPF ¶341; RX-8M. This also included review of additional materials from TierOne's voluminous loan files regarding the background of each loan, the financial condition of the borrowers and guarantors, and the nature and condition of loan collateral. JPF ¶¶340, 344-46.

Based on these procedures, among others, Mr. Bennett and the engagement team observed that management continued throughout 2008 to obtain appraisals and to discount appraisals based on market conditions and other loan-specific factors. *E.g.*, JPF ¶366. Management obtained 26 new appraisals in different geographic areas in the second half of 2008 in particular. 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 13 impaired loan relationships in Nevada. JPF ¶¶342, 366. The engagement team observed, at year-end, that every one of the 13 Nevada impaired loan relationships had either a 2008 appraisal or a discount applied to an earlier appraisal, or both. JPF ¶366.

Mr. Bennett and the engagement team also regularly met with key members of management to discuss the FAS 114 loans and 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. These individuals included, among others, Mr. Kellogg, the Controller, Mr. Langford, the CCO, and Mr. Frances, the Special Assets Executive. JPF ¶¶316, 322.g, 334. The engagement team understood that management, having obtained updated appraisals on a substantial portion of Nevada collateral, was disinclined to spend more resources on Nevada appraisals in the midst of the economic crisis because of an expressed concern that updated appraisals would be unduly influenced by liquidation sales/prices. JPF ¶¶369-71; *see also* JPF ¶59; RX-8 at KPMGTO0005450, 58.

As discussed in more detail in Mr. Bennett's Opening Brief, because under FAS 157 and related guidance foreclosures and liquidation sales are not "orderly transactions" and therefore are not "determinative" of fair value, management's expressed concern appeared reasonable. JPF ¶¶55, 58-59; Tr.-1994 (Johnigan). Likewise, Mr. Bennett understood management's position to be that certain appraisals obtained in the first half of 2008 continued to provide 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 foreclosures and liquidation sales. JPF ¶371.

At the same time, Mr. Bennett and the engagement team observed that management continued actively to monitor its impaired loans through year-end. They observed in the second half of the year that management determined that 17 additional loans were 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 management applied new or additional discounts to appraised values in the second half of the year, including for Nevada impaired loans. JPF ¶386. And they observed that management continued at year-end to record significant discounts to reflect the estimated number of months to sell collateral securing impaired loans. JPF ¶321.

Second, the engagement team reviewed and determined that market data were not inconsistent with the losses TierOne had recorded on its impaired loans. JPF ¶¶315-16; JPF ¶¶310-12, 372-74, 402. Specifically, during the year-end audit procedures, Mr. Bennett and Mr. Aesoph questioned Mr. Kellogg, the Controller, about TierOne's discounting decisions for Nevada appraisals. JPF ¶¶371-73. Mr. Kellogg responded by referring to TierOne's recorded losses and their correlation with the declines reflected in available market data. JPF ¶¶310-12, 315-16, 372-74; Tr.-535-37 (Bennett); 1786-87 (Aesoph). Mr. Bennett and the engagement team obtained corroborating information with respect to Mr. Kellogg's explanation. They observed that TierOne had recognized $34.7 million in losses on Nevada loans—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. This 30% loss recognition in 2008 for Nevada impaired loans, which did not include additional losses TierOne previously recorded in 2007, approximated the decline of approximately 33% in Nevada reflected in third-party market data. JPF ¶¶376-77. And the engagement team understood the market data *included* foreclosures and liquidation sales and therefore indicated declines exceeding the actual declines in fair value under FAS 157. *Id.*

The engagement 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. The L-37C workpaper in particular reflected the roughly 30% loss recognition on Nevada impaired loans. JPF ¶¶375, 377; RX-8U at 5590-91. As Ms. Johnigan testified, the 30% loss recognition was "apparent" on the face of the workpaper as well as in TierOne's 2008 financial statements. JPF ¶437; Tr.-1929-31 (workpapers "clearly show" the 30% loss via a "really simple calculation"). The Division's expert, Mr. Barron, also

agreed it was a simple calculation, and that the data supporting the 30% loss recognition on Nevada loans were included in the workpapers. JPF ¶378; Tr.-1145, 1364-65.

Third, Mr. Bennett and the engagement team considered the risk of management bias. JPF ¶¶399-411. In carefully considering the OTS's findings set forth in the 2008 report of examination, Mr. Bennett and Mr. Aesoph consulted with senior KPMG partners, including the SEC concurring review partner on the engagement and the regional Professional Practice Partner. JPF ¶199. They also engaged KPMG regulatory specialists. JPF ¶198. As acknowledged by the Initial Decision, Respondents "[b]oth took the [OTS] report seriously and were fully aware of its findings." ID-12. Notwithstanding significant criticisms in the report, the engagement team observed that even the OTS acknowledged a variety of positive actions initiated by management to enhance credit administration. JPF ¶212. For example, management: (i) "filled the chief credit officer position and the newly created senior credit officer position with experienced candidates"; (ii) "contracted with a special assets consultant to assist in managing the Las Vegas portfolio"; (iii) "further enhanced the credit administration department by expanding the special assets and loan recovery department, and hired an experienced loan workout specialist in August 2008"; and (iv) "developed an appropriate template in 2008 to measure quarterly impairment loss on impaired loans pursuant to SFAS No. 114." *Id.*

Following issuance of the OTS report, Mr. Bennett personally monitored management's remediation of deficiencies identified by the OTS, which included the implementation of new controls. JPF ¶¶201-02. During year-end audit procedures, Mr. Aesoph and Mr. Bennett also directly contacted Douglas Pittman, the OTS Field Manager who oversaw regulatory examinations of TierOne, to discuss management's response to the OTS's findings. JPF ¶¶135,

204, 206-07. Mr. Pittman confirmed that management was "complying with the requirements to submit additional information" and "appropriately addressing concerns raised." Tr.-1456-58; JPF ¶400. This audit evidence indicated not only an affirmative effort by management to improve TierOne's operations and the quality of its financial reporting but also a lack of management bias. JPF ¶¶201-16.

The engagement team also observed evidence of a lack of management bias relating specifically to the ALLL. For example, management had determined that a number of the 54 borrower relationships evaluated under FAS 114 were not impaired and consequently recorded approximately $6.3 million in FAS 5 reserves that would have been avoided if the loans had been deemed impaired. JPF ¶403. Management applied FAS 5 loss factors exceeding actual, historic losses experienced by TierOne, which again resulted in higher FAS 5 reserves. *Id.* And 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. *Id.* All of this audit evidence following the OTS report—which is ignored by the Division and the ALJ—indicated a lack of management bias. JPF ¶411.

After performing these and other procedures, JPF ¶¶387-98, Mr. Bennett concluded in his professional judgment that the engagement team had collected sufficient competent audit evidence substantiating the reasonableness of the ALLL, including with respect to the FAS 114 reserves, JPF ¶¶360, 396. His supervising engagement partner, Mr. Aesoph, and the SEC concurring review partner concurred. *Id.* And, following her own review of the workpapers, Ms. Johnigan agreed as well. Tr.-2033-38; JPF ¶¶397, 462; *see* JPF ¶308.

2. The Division Misconstrues The Applicable Legal And Professional Standards.

The Division's argument that Mr. Bennett's conduct fell "well short"[7] of professional standards with respect to testing the reasonableness of the ALLL, Div. Br.-14, is based on hindsight and a misunderstanding of the applicable professional standards.

First, notwithstanding that a Rule 102(e) determination must not be predicated on hindsight, the Division highlights at the outset that TierOne "disclosed a staggering $120 million in additional loan losses" in 2009. Div. Br.-9 (citing ID-5). Not content just to rely on hindsight, the Division embellishes that these subsequent losses were disclosed "*just a few months* after the[2008] audit opinion." Div. Br.-9 (emphasis added). That is not true, nor is it what the Initial Decision finds. ID-5 (containing no reference to nor characterization of the number of months after the 2008 audit opinion). In any event, the fact that the Division cannot refrain from punctuating TierOne's subsequent loan losses confirms the corrupting effect after-the-fact developments have on the Division's analysis of Mr. Bennett's conduct.

Second, the Division, like the Initial Decision, attacks Mr. Bennett's conduct because TierOne purportedly did not obtain "current" appraisals in estimating FAS 114 reserves at year-end 2008. Div. Br.-13-14; ID-28, 30, 35, 36. In attempting to create this novel "current" appraisal requirement, the Division insists that TierOne had a policy requiring that an appraisal be discounted if it was older than six months. Div. Br.-14. Yet TierOne's Lending Policy did not require management to obtain an updated appraisal on any specific periodic basis. JPF ¶227.[8] It provided that loans be supported *either* by appraisals *or* evaluations, that a new

[7] This is yet another instance in which the Division exaggerates what is actually stated in the Initial Decision. *Compare* Div. Br.-14 (citing ID-31) *with* ID-31 (stating that Respondents' procedures "fell short of professional standards") and ID-37 ("conduct fell short of professional standards").

[8] Management's statement, with respect to Nevada loans in particular, that it "tries to estimate collateral value declines in real estate by discounting appraised values[] which are older than six months," JPF

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). More broadly, no applicable professional standard requires that a creditor obtain "current" appraisals for impaired loans or to update appraisals on any periodic basis. JPF ¶68. The Division's expert, Mr. Barron, readily acknowledged this fact.[9] Indeed, he acknowledged that the terms "current" and "stale" appraisals are "not defined, as far as I know, in the professional literature." Tr.-1239-40; *see also id.* (Barron) ("I don't believe that 'stale' is a term you'll find in the professional literature."). That is important because the "Commission does not seek to use Rule 102(e)(1)(iii) to establish new standards for the accounting profession." Rule 102(e) Release, 63 Fed. Reg. at 57,166. Here, accounting principles require measurement of impairment to be based on all reasonably available information, which might not include an appraisal at all. JPF ¶¶64, 93; Tr.-1974-75 (Johnigan); AU § 328.02, .06 (RX-60).

Neither the Division nor the Initial Decision disputes the reasonableness of a view that "current" appraisals and market data in the second half of 2008 were not determinative of fair value given the prevalence of forced liquidation and distressed sales. Rather, the Division refuses to accept that Mr. Bennett considered the applicable accounting principles and related guidance that would justify such a view. Reciting the Initial Decision, the Division contends it is doubtful that "either [Respondents'] or management's proffered interpretation of FAS 157... played any meaningful role in their assessment of TierOne's fair value estimates." Div. Br.-17;

¶368, did not reflect a "policy" requiring that all such appraisals be discounted, Div. Br.-14. It was an indication of management's efforts to deal with the economic crisis, and the engagement team observed such discounts being taken by management in 2008. JPF ¶¶366-68.

[9] Tr.-1239-41 (Barron) ("Q ... Is it your view, Mr. Barron, that TierOne should have obtained an appraisal at least once every six months and potentially more frequently than that for every FAS 114 loan with collateral located in markets that you refer to as having rapidly declining values? A That sounds -- No. I couldn't agree that on every single loan you have to have an appraisal every six months.").

ID-18. That determination, though, inevitably derives from the hindsight knowledge of management's fraud—of course, now it is known that management's proffered interpretation was not the basis for their fraudulent fair value estimates. At the time, however, management's proffered interpretation appeared reasonable, based on the audit evidence, to the engagement team. JPF ¶¶369-71; *see also* JPF ¶59; RX-8 at KPMGTO0005450, 58.

In addition, regardless of whether the engagement team "recommended that TierOne update appraisals" or whether it ever "recommended adjusting[] an appraisal" once obtained, Div. Br.-17-18, ID-19, there can be no dispute that FAS 157 and its related guidance applied to the fair value estimates here, JPF ¶¶55-59.[10] TierOne explicitly addressed FAS 157 in its 2008 Form 10-K; the engagement team tied the FAS 157 disclosure in TierOne's 10-K to the audit work on impaired loans; and Mr. Bennett personally reviewed and was thoroughly familiar with FAS 157 and TierOne's disclosure during the 2008 audit. JPF ¶¶61, 118-19, 230. In the context of these undisputed facts, the engagement team concluded that management's expressed concern that current appraisals in Nevada were not determinative of fair value was reasonable. JPF ¶369; *see also* JPF ¶59; RX-8 at KPMGTO0005450, 58. Again, the Initial Decision does not find otherwise.

Third, the Division exposes its own misapprehension of professional standards, and the realities of audit practice, when it insists that the engagement team did not "document" the work about which Respondents testified.[11] Div. Br.-16-19. Conspicuously, for purposes of criticizing

[10] Regardless of whether Mr. Bennett testified during investigative examination that "a current appraisal was the best indicator of fair value," Div. Br.-18, ID-19, he understood FAS 157 governs fair value determinations and referenced "fair value" throughout the examination, contrary to the Division's insinuation at the hearing. JPF ¶61 n.106; Tr.-716-17, 1700 (Bennett); Tr.-2062-63 (Johnigan).

[11] While standing by his professional judgment that the engagement team's documentation was sufficient, Mr. Bennett did acknowledge at the hearing that, under the circumstances, "it would have been nice" to have another memorandum documenting more specifically "everything we considered." Tr.-577-578 (Bennett). However, AS No. 3 does not require, nor could it, that auditors anticipate at the time of an

Mr. Bennett, the Division focuses on a two-page workpaper containing an (admitted) inaccuracy, stating "market conditions have not materially deteriorated" since interim reviews in 2008. Div. Br.-14. Beyond that, however, the Division is reluctant to credit *any* of the other ALLL workpapers, among almost a thousand pages of quarterly and year-end audit workpapers regarding the ALLL. *See* JPF ¶¶435-36. Those workpapers demonstrate beyond doubt that the engagement team understood market conditions had deteriorated and that it responded by increasing audit procedures relating to the ALLL. *E.g.*, JPF ¶¶163-64, 175-77, 355.

The Division is wrong in arguing that the audit procedures substantiating the engagement team's professional judgments are not documented. Most notably, the engagement team's procedures addressing the lack of inconsistency between TierOne's 30% loss recognition on Nevada impaired loans in 2008 and available market data are documented. Div. Br.-18-19. While there is not a specific workpaper devoted to recounting Respondents' conversation with Mr. Kellogg in which he referenced the Nevada market declines, the workpapers do describe that the auditors discussed with management loan portfolio trends affecting the ALLL. JPF ¶373. In addition, the Division's own expert conceded at the hearing that (i) the calculations underlying the engagement team's analyses were simple, mathematically accurate and yielded a 30% loss recognition figure for Nevada, JPF ¶378; (ii) 30% was not inconsistent with the reported market declines in 2008 in Nevada, JPF ¶379 n. 671; and (iii) the data supporting TierOne's loss recognition on the Nevada loans was included in the workpapers, JPF ¶378.[12] The L-37 workpaper series, in particular, is where the Nevada loss recognition is documented. JPF ¶¶356,

audit, and address in the workpapers, every possible theory of violation that the Division may raise in a subsequent disciplinary proceeding.

[12] Ultimately, the Division's expert suggested that the engagement team merely should have noted in the margin that they had in fact confirmed the math amounted to a 30% decline. Tr.-1114:16-24 (Barron).

363, 373-75. Notwithstanding its arguments about the absence of audit documentation, the Division makes *no* mention of those workpapers in its brief.

The Division also is wrong in arguing that Respondents did not "point to loan-specific evidence" to support their professional judgments that management's fair value estimates at year-end 2008 were reasonable. Div. Br.-12-13, 18. Respondents absolutely *did* point to such evidence. JPF ¶¶335-48. These materials included, for example, Loan Analyses and Annual Credit Reviews containing discussions of not only the purposes and backgrounds of loans but also collateral analyses and borrower and guarantor analyses. *E.g.*, JPF ¶344 (discussing HDB loan files reviewed by auditors), *id.* ¶345 (discussing Double M Construction loan files reviewed by auditors). And while the Division's expert chose not to review any loan files, JPF ¶483, Ms. Johnigan, approaching the matter as an experienced bank auditor, did review the available loan files, RX-42 at 16. She then addressed in her expert report each of the impaired loan relationships with detailed loan-specific audit evidence tied directly to the workpapers, RX-42 at 88-139 Exs. B-C. Ms. Johnigan concluded not only that Respondents obtained sufficient competent audit evidence supporting the reasonableness of management's 2008 ALLL estimate, including the FAS 114 reserves, JPF ¶462.c, but also that Respondents complied with the standards of AS No. 3 in documenting their 2008 audit work, JPF ¶462.e.

C. Mr. Bennett's Response to Appraisals Obtained After The 2008 Audit Complied With Professional Standards.

With respect to Mr. Bennett's consideration, after issuance of the 2008 integrated audit opinions, of appraisals obtained in the first quarter 2009, the Division disregards the threshold issue in applying the audit standard. Div. Br.-15-16. 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 Division does not even mention this critical provision of AU § 561. Div. Br.-15.

As set forth in his Opening Brief, Mr. Bennett did not violate applicable professional standards with respect to appraisals obtained in the first quarter 2009. In April 2009, when the engagement team became aware of new appraisals dated January and February 2009—reflecting both decreases and at least one increase to collateral values estimated at year-end 2008, JPF ¶¶419-20—Mr. Bennett considered the information and concluded, in the exercise of his professional judgment, that the additional net losses recorded in 2009 did not give rise to an error in TierOne's 2008 financial statements. JPF ¶421; Tr.-1664-67. It followed that the appraisals did *not* affect KPMG's 2008 integrated audit opinions. *Id.* Mr. Aesoph conducted his own review of the information in 2009 and concurred. JPF ¶421. Likewise, in this proceeding, Ms. Johnigan reviewed the information and concluded that the new appraisals would not "have triggered a restatement or recall of the 2008 audit opinion." Tr.-2049.[13]

The Division failed to present any evidence to support a contrary conclusion, with its own expert disavowing such an opinion. Tr.-1158-59 (Barron) ("I'm not really opining on whether they should have restated the financial statements."). And the Division entirely ignores this threshold issue in its brief here.[14] As such, AU § 561 does not support a determination of liability, let alone an increased sanction.

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[13] 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 net loss of $4.2 million recorded by TierOne in the first quarter 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.

[14] The Division, Div. Br.-15-16, adopts the Initial Decision's novel domino theory, whereby the existence of "new appraisals put into question the reliability of the financial statement assertions relating to the FAS

II. A TWO-YEAR SUSPENSION OF MR. BENNETT IS NOT NECESSARY TO SERVE THE GOALS UNDERLYING RULE 102(E) AND WOULD BE PUNITIVE UNDER THE CIRCUMSTANCES.

Mr. Bennett is a diligent and competent auditor who should be permitted to continue to appear and practice before the Commission. Imposition of the two-year suspension proposed by the Division would not serve the remedial goals of Rule 102(e) and instead would punish Mr. Bennett for defending himself and the engagement team's performance during a period of historic market uncertainty and in the face of a concerted fraud designed to mislead them.

A. Suspension of Mr. Bennett Is Not Necessary To Serve the Remedial Goals Underlying Rule 102(e).

As noted previously, the Commission may not impose sanctions to punish, but only for remedial purposes. *Johnson v. SEC*, 87 F.3d 484, 490-91 (D.C. Cir. 1996). That is, a sanction must be necessary to ensure that the Commission's "processes continue to be protected, and that the investing public continues to have confidence in the integrity of the financial reporting process." Rule 102(e) Release, 63 Fed. Reg. at 57,164. The Commission, in turn, has explained that a sanction under Rule 102(e) is authorized only if the record shows that an accountant is not competent to practice before the Commission. *Id.* at 57,166. Moreover, "as the circumstances in a case suggesting that a sanction is excessive and inappropriately punitive become more evident, the Commission must provide a more detailed explanation linking the sanction imposed to those circumstances." *McCarthy v. SEC*, 406 F.3d 179, 190 (2d Cir. 2005). These structural limitations on the imposition of sanctions are critical because "Rule [102(e)] threatens 'to

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114 portion of the ALLL." ID-35. Neither the Initial Decision nor the Division identifies any evidence to support the conclusion that Mr. Bennett was obligated pursuant to AU § 561 to extrapolate from specific collateral appraisals from January and February 2009 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." JPF ¶515. Indeed, one of the new appraisals from the first quarter 2009 reflected a $1.5 million *increase* in collateral value as compared to that recorded at year-end 2008. JPF ¶419.

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) (Randolph, J.) (quoting Henry J. Friendly, *Some Kind of Hearing*, 123 U. PA. L. REV. 1267, 1297 (1975)).[15]

The Initial Decision proposed a six-month suspension because "Respondents' conduct fell short of professional standards in their failure to evaluate management's FAS 114 estimates in accordance with professional standards in the face of the need for heightened scrutiny and the corresponding failure to identify a material weakness in TierOne's internal control over financial reporting." ID-37. In his Opening Brief, Mr. Bennett challenged that ruling because (i) there has been no violation of Rule 102(e), Opening Br.-20-42, and (ii) even if the Commission were to conclude that Mr. Bennett negligently fell short of the applicable requirements, no suspension would be necessary to protect the Commission's processes or the investing public from Mr. Bennett, *id.* at 42-45. For those same reasons, the six-month suspension proposed by the ALJ should not be increased to two years.

B. A Two-Year Suspension Of Mr. Bennett Would Be Excessive And Punitive.

The Division's request to increase the proposed suspension of Mr. Bennett from six months to two years independently should be rejected. A two-year suspension is unnecessary to serve the remedial functions of Rule 102(e) but would impose a devastating penalty on Mr. Bennett (and his family) by not only depriving him of the ability to perform his livelihood

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[15] In *In re Dohan & Co., CPA, et al.*, the Commission recognized that "while Administrative Law Judges have cited the *Steadman* factors in Rule 102(e) proceedings against CPAs, the Commission has not." Release No. ID-420, 2011 SEC LEXIS 2205, *52 n.41 (June 27, 2011). The *Steadman* factors require an evaluation of "[1] the egregiousness of the defendant's actions, [2] the isolated or recurrent nature of the infraction, [3] the degree of scienter involved, [4] the sincerity of the defendant's assurances against future violations, [5] the defendant's recognition of the wrongful nature of his conduct, and [6] the likelihood that the defendant's occupation will present opportunities for future violations." *Steadman*, 603 F.2d at 1140.

for a period of two years but also likely jeopardizing any future in public financial reporting. *See McCarthy*, 406 F.3d at 190 (noting, without deciding, that two-year suspension could destroy the "brokerage practice" that respondent "had built during several years of rule-abiding trading").

1. A Two-Year Suspension Is Not Necessary to Protect the Commission's Processes or the Investing Public.

At the outset, the Division highlights that "auditor competence is of paramount importance." Div. Br.-21. But that factor does not support suspension of Mr. Bennett because the record reflects that he is a competent senior manager. At the time of the audit, Mr. Bennett had been a senior manager for only one year. JPF ¶18.[16] Nevertheless, as the Initial Decision acknowledges, Mr. Bennett is "highly regarded" at KPMG, he and the engagement team "recognized risks associated with the ALLL, worked longer hours on the 2008 audit than the previous audit, and adequately conducted other areas of the audit." ID-37. The Initial Decision recognizes these unchallenged facts as "praiseworthy." *Id.* Likewise, the Division's own expert acknowledged that aspects of Mr. Bennett's conduct in the 2008 audit reflected technical competence and appropriate knowledge of accounting principles with respect to risks relating to TierOne's ALLL. Tr. 1211-16.

The Division's brief does not dispute any of these underlying factual determinations, and acknowledges that Mr. Bennett's alleged audit failures were "negligent and not intentional." Div. Br.-22. It argues, however, that "negligent conduct ... can be as egregious as ... intentional or reckless conduct." Div. Br.-22 (citing *In re Dearlove*, Exchange Act Release No. 57244, 2008 WL 281105, *30 (Jan. 31, 2008)). That argument should be rejected in this case because Respondents' alleged negligent failures were not "egregious." Div. Br.-23. Mr. Bennett and the

[16] *Cf. McCurdy*, 396 F.3d at 1265 (affirming sanction because respondent's "'significant experience in audit work'" rendered his audit failures "'particularly troublesome'" (quoting *Johnson*, 87 F.3d at 490)).

engagement team appropriately identified the ALLL as a high-risk account, ID-37, and took substantial steps to enhance their audit procedures with regard to the ALLL, 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.

Contrary to the Division's arguments, the ALJ did not conclude that "Respondents failed to adhere to even the most basic standards of auditing," Div. Br.-23, or that the asserted audit failures "represent a serious threat to the Commission's processes," *id.* at 22. Instead, in assessing the nature of Mr. Bennett's conduct, the ALJ stated only that "Respondents' conduct fell short of professional standards." ID-37.

Nor did the ALJ conclude that Mr. Bennett's conduct was "recurrent." Div. Br.-25-26. Rather, the ALJ explained that "Respondents' auditing lapses, which were negligent, occurred in a single audit." ID-37. As the Commission has made clear, "Rule 102(e)(1)(ii) is not meant ... to encompass every professional misstep." Rule 102(e) Release, 63 Fed. Reg. at 57,166. Here, the "auditing lapses" with respect to which Mr. Bennett purportedly fell short are a far cry from the type of conduct that has resulted in the suspension of managers by the Commission.

For example, in *In re Danna and Dentinger*, the Commission suspended a manager for six months because numerous red flags "required implementation of greater planning, a higher than low risk assessment in the cash and fixed accounts, and the use of more intensive, critical auditing procedures ... than had occurred in previous audits." Release No. ID-62, 1995 SEC LEXIS 1041, *23-28 (Apr. 11, 1995), *overruled on other grounds*, Exchange Act Release No. 907, 1997 SEC LEXIS 807 (April 14, 1997). Those conditions included that the company had suffered its first operating loss in more than 16 years, the President and CEO and several top

financial and accounting personnel had resigned, and the Audit Committee had directed the auditors to "scrub the audit totally." *Id.* at *25-26. The Commission imposed a six-month suspension because the engagement team, including the manager, made *no* change to the cash account's low risk assessment or the audit procedures. *Id.* at *36.[17]

Likewise, in *In re Rubin and Lewis*, the Commission suspended the manager for three years because he "acted at least recklessly" when he learned during audit planning that $2 million had been embezzled from customer accounts by one of the company's representatives but he failed "to conduct basic inquiries of the ... embezzlement and its effect on the financial statements." Release No. ID-295, 2005 SEC LEXIS 2312, *65 (Sept. 8, 2005). The ALJ had imposed the same three-year suspension because there was a "substantial risk" that the manager would "commit future violations of GAAS."[18]

Here, in contrast, the Initial Decision does not characterize the supposed lapses as egregious or pervasive. The ALJ described two "auditing lapses": (1) Respondents' "failure to evaluate management's FAS 114 estimates in accordance with professional standards" and (2) Respondents' "failure to identify a material weakness in TierOne's internal control over financial reporting." ID-37. Even with regard to those areas, the ALJ noted that Mr. Bennett

[17] Even so, the ALJ rejected the Division's proposed two-year suspension because it was "too harsh in this situation." *Danna & Dentinger*, 1995 SEC LEXIS 1041, *58. Specifically, the ALJ explained that with regard to the accountant manager, his lack of audit experience supported a lesser sanction. *Id.*

[18] *See also In re Dohan & Co., et al.*, Release No. ID-420, 2011 SEC LEXIS 2205, *4 (June 27, 2011) (manager barred from practicing before the Commission for two years where he contended that he was not acting as an auditor and not subject to PCAOB standards); *In re McNeeley*, Exchange Act Release No. 68431, 2012 SEC LEXIS 3880, *30 (Dec. 13, 2012) (manager barred for six months when she "did essentially nothing" despite concluding that the company's internal controls were ineffective and having knowledge of "numerous red flags and other irregularities" and where record did not demonstrate the manager brought the red flags to the engagement partner's attention); *cf. In re Mullen*, Exchange Act Release No. 51084, 2005 SEC LEXIS 178, *1-2 (Jan. 27, 2005) (suspending accountant who worked as a manager on annual audits from appearing or practicing before the Commission under Rule 102(e)(2) after he pleaded guilty to lying to an FBI agent when he told the agent that "he had not made any changes to the ... working papers for audits and reviews of NextCard's financial statements").

and the engagement team "recognized risks associated with the ALLL," ID-37, and sought to address those risks with enhanced procedures. Further, Mr. Bennett's "work in other areas of the audit" was conducted "to the highest professional standards." ID-31.

For these reasons, the Division's reliance on *Dearlove* is misplaced. In *Dearlove*, the Commission concluded that the engagement partner repeatedly had violated audit standards in "four auditing areas." 2008 WL 281105, *30. The Commission highlighted that the "frequency of Dearlove's failures far exceed the minimum threshold established by Rule 102(e)(1)(iv)(B)(2)" and that "[u]nreasonable failures to comply with auditing standards that so pervasively compromise an audit, such as those of Dearlove, 'jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors.'" *Id.* Given his "lengthy audit experience," the Commission concluded that "Dearlove's repeated, substantial departures from his professional duties establish that the Commission cannot, at present, rely upon him to perform diligently and with reasonable competence his audit responsibilities." *Id.*

Unlike *Dearlove*, which involved an "engagement partner" with "lengthy audit experience," Mr. Bennett had been a senior manager for only one year during the time of the 2008 TierOne audit, JPF ¶18, and the asserted "auditing lapses" were limited to one component – the FAS 114 loans – of TierOne's ALLL. In his role as senior manager, Mr. Bennett appropriately communicated audit evidence to his superiors and 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. Moreover, as discussed *supra* (at 11-28), Mr. Bennett worked diligently throughout the 2008 audit, reviewed all of the 2008 audit workpapers, and increased the time he devoted to the audit by approximately 90% compared to

the prior year.[19] JPF ¶¶31, 182, 436. There is no need to impose any suspension on Mr. Bennett – let alone a two-year suspension – to serve the remedial goals of protecting the investing public or the Commission's processes.[20]

2. Mr. Bennett's "Attempts to Justify His Conduct" Do Not Provide A Basis For An Increased Sanction.

The Division argues that Mr. Bennett should receive a more severe sanction because he has defended himself in response to the Division's claims. Incredibly, the Division contends that Mr. Bennett should be sanctioned for his allegedly "improper conduct ... both during the audit *and throughout this litigation*," Div. Br.-1 (emphasis added), and that "Respondents' defenses do not excuse – and indeed exacerbate – their audit failures," *id.* at 16. Put simply, the Division contends that Respondents should be sanctioned because they defended themselves against the Division's allegations. *Id.* at 27.

Imposition of increased sanctions based on a respondent's decision to present a defense to the Division's allegations would be inconsistent with the Commission's Rules of Practice that expressly allow respondents to present a defense. By its terms, Rule 102(e) expressly provides an "opportunity for hearing," Rule 102(e)(1), and nothing in the text of the Rule suggests that an accountant may be subject to sanction (or an increased sanction) based upon the exercise of his or her right to insist on a hearing. Moreover, before the hearing, a respondent has the right to require the Division to make available "documents obtained by the Division prior to institution

[19] Mr. Bennett also diligently provided junior professionals on the engagement team 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.

[20] The Division also argues that an increased sanction is appropriate because Mr. Bennett's continued employment with KPMG "presents an opportunity for future violations." Div Br.-26. That Catch-22 argument should not be permitted to justify the increased sanction sought by the Division. Indeed, under the Division's argument, the only way that Mr. Bennett could avoid a suspension that prevents him from practicing his livelihood is by voluntarily abandoning that livelihood.

of proceedings," Rule 230(a)(1) or "any statement of any person called or to be called as a witness by the Division," Rule 231(a). A respondent also may request "the issuance of subpoenas requiring the attendance and testimony of witnesses" for the hearing. Rule 232(a). At the hearing, the ALJ officer is empowered to "receiv[e] relevant evidence," Rule 111(c), and "regulat[e] the course of a proceeding and the conduct of the parties and their counsel." Rule 111(d). After the hearing, a party may submit proposed findings of fact and conclusions of law, which will aid the ALJ in preparing "an initial decision" in the matter. Rule 111(i). Finally, a respondent is authorized to appeal an adverse initial decision to the Commission.[21]

As the D.C. Circuit has ruled in a related context, Defendants may "vigorously contest the government's accusations" and are not required "to behave like Uriah Heep in order to avoid" a sanction. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1229 (D.C. Cir. 1989) (rejecting request for an injunction). To the same effect is *SEC v. Brethen*, where the Court explained that defendant's decision to "to exercise his right to contest this litigation ... was his right under our system of justice" and did not support the sanction sought by the SEC. No. C-3-90-071, 1992 WL 420867, *24 (S.D. Ohio Oct. 15, 1992). Finally, in *SEC v. Ingoldsby*, the district court denied the SEC's request for a permanent injunction and civil penalty, explaining that "[a]bsent 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 both at trial and at the injunctive relief stage of the judicial proceedings." No. 88-cv-1001, 1990 WL 120731, *3 (D. Mass. May 15, 1990).[22]

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[21] The Commission's Rules likewise authorize the hearing officer to impose sanctions for "[c]ontemptuous conduct" at the hearing. *See* Rule 180. Notwithstanding that the Division now seeks to punish Mr. Bennett for his conduct during the litigation, Div. Br.-1, the Division never before has suggested that Mr. Bennett's defense at the hearing before the ALJ supported sanctions under Rule 180.

[22] *See also SEC v. Johnson*, 595 F. Supp. 2d 40, 45 (D.D.C. 2009) (rejecting SEC's argument that a party's testimony that "he did nothing wrong" could support a sanction because the party "has a right to

The record does not support, and the ALJ made no determination, that Mr. Bennett's defense was made in bad faith. Nor does Mr. Bennett's defense support the conclusion that he does not understand the professional standards at issue here. The record reflects that he understands FAS 157 and the considerations involved in evaluating "fair value." He understands the need to obtain sufficient competent evidential matter regarding the effectiveness of management's Internal Controls and the reasonableness of management estimates. In defense, Mr. Bennett disputed the Division's allegations regarding the extent of audit work and its hindsight contention that his judgments that the engagement team had obtained sufficient competent evidential matter regarding these matters, and documented its work appropriately, were unreasonable.

Allowing respondents to defend their conduct against accusations leveled by the government is thus a minimum requirement of due process designed to protect liberty and property rights and to aid the Commission's own fact-finding process. The proceedings below provide a vivid example. By interposing a defense, Respondents refuted the Division's core claim, made repeatedly in its opening argument, that they violated Rule 102(e) by conducting a "perfunctory audit" of TierOne. Tr.-12. The Division argued that (i) Respondents engaged in "perfunctory work at year-end, *id.* at 38, (ii) the fraud committed by TierOne's management against respondents was irrelevant because "[t]he fact that management did not tell the auditors everything cannot, and does not, excuse *this perfunctory audit*," *id.* at 41, and (iii) the broad scope of work completed by Respondents should be ignored because their "*perfunctory*

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vigorously contest the SEC's allegations"); *cf. KPMG v. SEC*, 289 F.3d 109, 127 (D.C. Cir. 2002) (Randolph, J., dissenting) ("The reconsideration order criticizes KPMG for its 'consistent failure to recognize the seriousness' of its violations. True, KPMG mounted a vigorous defense to the SEC's case, but those charged with misconduct have a right to defend themselves.").

procedures over this critical audit area [FAS 114 portion of the ALLL] are improper regardless *of other audit work done*," *id.* at 42 (emphases added).[23]

During the course of his defense, Mr. Bennett squarely challenged the Division's core claim that the audit was "perfunctory." He introduced evidence regarding his conduct during the 2008 TierOne audit. That evidence showed that the engagement team increased the time devoted to the 2008 audit by over 50 percent over the 2007 audit, increased interim and year-end audit procedures for testing the reasonableness of the ALLL, engaged a credit risk specialist to conduct loan reviews, performed substantive procedures on all of TierOne's FAS 114 impaired loans, and evaluated TierOne's loans by state. These efforts were documented in 7,000 pages of workpapers contained in nineteen quarterly review and year-end binders, including more than one thousand pages addressing TierOne's ALLL, each of which was reviewed and signed off by Mr. Bennett. JPF ¶¶435-36. That evidence was supported, in turn, by Respondents' expert Ms. Johnigan, who, relying upon her review of the audit evidence, expressly rejected the Division's characterization of the audit as "perfunctory." Tr.-2009. Even the Division's own expert stated that he did not "like the word perfunctory" and admitted that "perfunctory" was not a "good description" of Respondents' conduct. *Id.* at 1034 (addressing Respondents' review of TierOne's loan files).

It would be fundamentally unfair, arbitrary and capricious, and a violation of the Due Process Clause for the Commission to adopt rules that authorize and facilitate a party's ability to present a vigorous defense to the Division's allegations, but then allow the Division to seek

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[23] *See also* Tr.-36 ("A look at what the auditors actually said about their interim procedures shows just how perfunctory this audit was."); *id.* at 38 ("these new appraisals are perhaps the clearest illustration of the unreasonableness of the auditors' perfunctory work at year-end").

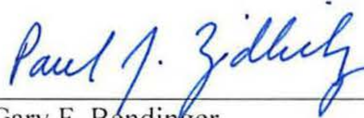
increased sanctions for exercising those rights to defend one's conduct and livelihood before the Commission.

CONCLUSION

The Division's appeal seeking to increase the proposed six-month suspension of Mr. Bennett to two years should be rejected, and the public administrative proceeding against him should be dismissed, as no sanction is warranted to protect the Commission's processes or the investing public.

Dated: December 23, 2014

Respectfully submitted,



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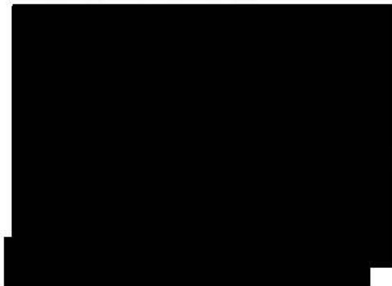

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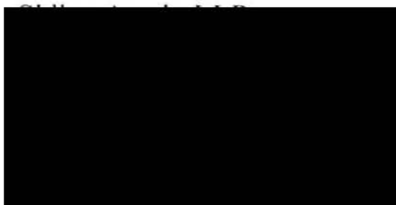

RULE 450(d) CERTIFICATE OF COMPLIANCE

Pursuant to Commission Rule 450(d), I hereby certify that the foregoing Brief Of Darren M. Bennett In Opposition To Division of Enforcement's Brief In Support of Its Petition For Review complies with the length limitation set forth in Commission Rule 450(c). The Brief is 12,418 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