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.

REPLY BRIEF OF RESPONDENT DARREN M. BENNETT IN SUPPORT OF HIS PETITION FOR REVIEW

January 23, 2015

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INTRODUCTION

During KPMG's 2008 integrated audit of TierOne, Darren Bennett worked diligently with the engagement team, in the face of economic uncertainty unprecedented in recent decades, designing and implementing heightened procedures concerning the effectiveness of TierOne's Internal Controls and the reasonableness of its ALLL estimate. *See* Bennett Opening-10-13, 20-39. He exercised "due professional care" and "professional skepticism" and concluded that the engagement team had obtained "sufficient competent audit evidence" to support KPMG's integrated audit opinions. *See id.* at 13. Multiple KPMG partners supervised his work and concurred in the reasonableness of his judgments. The Initial Decision's contrary conclusion should be rejected because, in violation of the Administrative Procedure Act ("APA") and due process, it (i) retroactively imposes "novel" professional standards that are inconsistent with Financial Accounting Standards Board ("FASB") Statement No. 157, *Fair Value Measurements*, and related guidance, (ii) fails to address evidence that contradicted the Initial Decision's conclusions, and (iii) conflates the legal requirements for a violation of Rule 102(e). *See id.* at 16-20, 40-42; Bennett Opposition-12-28.

Ignoring much of the evidence from the hearing, the Division argues that Mr. Bennett violated Rule 102(e) by conducting a "cursory" audit, Div. Opposition-2, 17, 20, and asserts, without citation, that Mr. Bennett's efforts constitute an "extraordinary departure" from professional standards, *id.* at 12. The Division urges the Commission to disregard documented procedures that Mr. Bennett and the engagement team performed by applying a myopic and crabbed evaluation of the workpapers. The Division rejects the engagement team's conclusion that TierOne's fair value estimates underlying its FAS 114 reserves within the ALLL were reasonable "since TierOne was not using updated appraisals," *id.* at 28, even though there was no requirement to obtain "current" appraisals under any professional standard. At bottom, in a glaring mischaracterization of the record, the Division insists that it is "incredible" that "collateral values on numerous properties in hard-hit states had all held their value during the course of the Great Recession." *Id.* at 29.

The record reveals a different picture. Mr. Bennett and the engagement team were aware that market indices showed significant declines in 2008. They observed, however, that TierOne recorded approximately $57 million of loan losses on its $226 million impaired loan portfolio throughout 2008, including an approximately 30% write down on the value of its Nevada impaired loans. Management's recorded losses were "not inconsistent with" the approximately 33% decrease reflected in Nevada market indices, which included distressed sales that FAS 157 and related guidance explain are not determinative of fair value. Mr. Bennett observed and considered management's write downs in light of these market indices—and other substantive audit procedures performed on each impaired loan—and concluded, based on his professional judgment, that TierOne's FAS 114 reserves at year-end 2008 were reasonable.

In applying Rule 102(e), the Commission must, without using hindsight, "compare[] 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." Amendment to Rule 102(e), Exchange Act Release No. 33-7593, 63 Fed. Reg. 57,164, 57,168 (Oct. 26, 1998) ("Rule 102(e) Release"). There is no allegation that Mr. Bennett withheld information or failed to communicate with the KPMG partners who supervised, reviewed and approved his work and concurred with his professional judgments. The Division nowhere identifies what a reasonable senior manager should have done differently in evaluating TierOne's Internal Controls and the reasonableness of its fair value estimates in the midst of the Great Recession.

Suspension of Mr. Bennett on this record would be unprecedented under the Commission's decisions addressing conduct by senior managers. *See* Bennett Opposition-32-35. Suspension is not necessary to protect the Commission's processes or the investing public, but would have a devastating impact on Mr. Bennett's career. That punitive result would be contrary to the purposes of Rule 102(e) and would chill the exercise of professional judgment by senior managers within the profession.

ARGUMENT

I. THE INITIAL DECISION MISAPPLIES PROFESSIONAL STANDARDS AND FAILS TO ADDRESS RELEVANT EVIDENCE IN VIOLATION OF THE APA AND DUE PROCESS.

A. The Initial Decision Misapplies Applicable Professional Standards.

Mr. Bennett previously showed that the Initial Decision misapplied professional standards and violated Rule 102(e) by imposing an obligation on the engagement team to require TierOne to obtain "current" appraisals when (i) there was no such obligation, (ii) such an obligation would be inconsistent with the skepticism of such appraisals under FAS 157, and (iii) Rule 102(e) may not be used "to establish new standards for the accounting profession." *See* Bennett Opening-16 (quoting Rule 102(e) Release, 63 Fed. Reg. at 57,166).

The Division does not dispute that Rule 102(e) proceedings may not establish or impose "new standards for the accounting profession" or question the impact that FAS 157 has on "updated appraisals in a down market." Div. Opposition-28. Instead, it insists that "the ALJ did not find (and the Division did not argue) that current appraisals were required." *Id.* That is wrong. The Division's core position is that "the ALJ correctly ruled that, *since* TierOne was not using *updated* appraisals, Respondents needed to obtain sufficient, competent evidence that TierOne's loss estimates based on *stale, undiscounted appraisals were reasonable*." *Id.* (emphases added). The linchpin of the Division's case is the alleged absence of "current" appraisals, even though the Division's expert acknowledged that there was no definition of "current" or "stale" appraisals in applicable professional standards, Tr.-1239-40 (Barron).

Respondents showed that they satisfied their obligations by submitting substantial evidence of the procedures they undertook to assess the reasonableness of TierOne's ALLL estimate. *See* Bennett Opening-26-37. In addition to observing that TierOne obtained multiple new appraisals throughout 2008, JPF ¶342, the engagement team, among other procedures discussed below, reviewed individual loan files that contained information about the purpose and background of the loans as well as analyses of the borrowers and guarantors for the loans. JPF ¶¶344-46. The Initial Decision rejected that review because of "TierOne's use of numerous undiscounted appraisals from the first half of 2008 or earlier," ID-32, and because the review of individual loan files "involved procedures unrelated to whether appraisals were current or valid at year-end," ID-18. The Initial Decision's basis for rejecting the engagement team's judgments was a perceived absence of "current" appraisals at year-end 2008, even though retroactive imposition of a new "current" appraisal obligation would be fundamentally unfair and unlawful under Rule 102(e).

Imposition of a "new" appraisal requirement also would contradict the "fair value" principles of FAS 157 applicable to TierOne's 2008 financial statements. Specifically, the Commission's Office of the Chief Account ("OCA") and the FASB Staff issued guidance under FAS 157 to address "market uncertainty" that "made questions surrounding the determination of fair value particularly challenging." JPF ¶58. The Division does not dispute the guidance explains that "[d]istressed or forced liquidation sales are not orderly transactions" and therefore such sales "are not determinative when measuring fair value." *Id.* ¶59 (quoting RX-66).

Imposing liability based on an absence of "current" appraisals therefore would violate the very guidance issued in 2008 to assist auditors in evaluating "fair value" determinations.

B. The Initial Decision Fails to Address Relevant Evidence.

Mr. Bennett previously demonstrated that the Initial Decision ignored critical evidence submitted by Respondents, including the testimony of Ms. Sandra Johnigan (and Professor James), and failed to reconcile that evidence with its determinations. *See* Bennett Opening-18-20. In response, the Division asserts that Mr. Bennett's "contention that the ALJ ignored [his] evidence rings hollow," Div. Opposition-12, and argues that an "ALJ 'need not evaluate in writing every piece of testimony and evidence submitted,'" *id.* at 13 (quoting *Carlson v. Shalala*, 999 F.2d 180, 181 (7th Cir. 1993)). These arguments should be rejected.

First, the Initial Decision's citation to "workpapers and testimonial admissions," Div. Opposition-12, does not relieve the ALJ of her obligations under the APA and due process. Here, the Initial Decision never attempts to reconcile its analysis with the substantial evidence submitted by Mr. Bennett. *See* Bennett Opening-18-19. For example, Ms. Johnigan and Professor James, respectively, testified that Mr. Bennett satisfied applicable professional standards and that the Division's position with respect to disorderly sales on appraisals and pricing in 2008 was contrary to SEC and FASB guidance. *Id.* The ALJ acknowledged that these witnesses testified, ID-21, but never attempted to reconcile their evidence with the Initial Decision's liability determinations. As a result, the Initial Decision should be rejected as it does not reflect "consideration of the evidence on *both* sides." *Landry v. FDIC*, 204 F.3d 1125, 1140

(D.C. Cir. 2000); *cf. In re McNeeley*, Exchange Act Release No. 68431, 2012 SEC LEXIS 3880, at *58-*59 (Dec. 13, 2012) (addressing persuasiveness of expert's testimony).[1]

Second, the Division's only answer is that ALJs have "discretion to summarize their analysis" because "initial decisions would quickly become unwieldy." Div. Opposition-13. The Division misses the point entirely. Mr. Bennett does not complain about the length of the Initial Decision or suggest that ALJs lack discretion to summarize evidence. That discretion, however, is not a license to disregard evidence that Mr. Bennett complied with professional standards and that refutes the ALJ's liability determination.[2] As explained by the D.C. Circuit, the agency is obligated "to consider relevant contradictory evidence." *Morall v. DEA*, 412 F.3d 165, 180 (D.C. Cir. 2005). The APA and due process required the ALJ not only to acknowledge, in passing, that Mr. Bennett's witnesses testified, ID-21, but to consider and reconcile their evidence with the ultimate liability determinations.

C. <u>The Initial Decision Misapplies AS No. 3 To Disregard Relevant Evidence.</u>

The Division argues that the ALJ properly interpreted AS No. 3 because it "did not exclude" "evidence of the undocumented procedures." Div. Opposition-13. Mr. Bennett's argument is not that the ALJ refused to admit proffered evidence at the hearing. Rather, Mr. Bennett demonstrated that the Initial Decision misapplied AS No. 3 by improperly "disregard[ing] or minimiz[ing] probative evidence," which itself was reflected in the workpapers. Bennett Opening-17; *id.* at 37 (citing ID-17-20, 31-33).

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[1] The ALJ's failure to address this evidence is critically flawed because the Division's expert, Mr. Barron, had *no experience* auditing banks and evaluated only a limited selection of the 2008 TierOne audit workpapers. *See* Bennett Opening-19 n.4.

[2] For example, the Initial Decision ignores that Ms. Johnigan testified that the new appraisals in 2009 would not have "triggered a restatement or recall of the 2008 audit opinion," Tr.-2049, and the Division's expert Mr. Barron declined to offer any opinion whether new appraisals received in 2009 "would have resulted in a restatement of [TierOne's] financial statements." Tr.-1158-59.

The Division has encouraged that result, arguing that "given the lack of any audit documentation or contemporaneous written evidence of Respondents' purported procedures, it would be appropriate to disregard Respondents' claims that the undocumented procedures occurred." Div. Opposition-15. As discussed below, the Division misinterprets the workpapers, including its suggestion that FAS 157 is a "procedure" to be documented rather than an accounting principle to be applied. *Id.* at 23-26. In all events, the Division's criticisms are not a legitimate basis for disregarding credible evidence demonstrating the reasonableness of Mr. Bennett's conduct.

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

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

Contrary to the Division's argument, Div. Opposition-36-39, the Commission should neither disregard several key Internal Controls that the engagement team identified and tested nor evaluate the engagement team's workpapers in isolation from one another. *See* Div. Opposition-36-39.

The record demonstrates that Mr. Bennett and the engagement team appropriately determined that TierOne's ALLL was a "significant account" and identified and tested key Internal Controls over it. *See* JPF ¶¶237-304. They identified and tested Internal Controls on the "front end" of the ALLL estimation process at loan origination to determine whether loans were secured by collateral supported by appraisals reviewed by TierOne for reasonableness. *See* JPF ¶¶271-74; Bennett Opening-21; Bennett Opposition-13-14. Testing of these front-end controls did not "exacerbate[]" any problem, Div. Opposition-37, but demonstrated sound professional judgment in addressing an important stage in the estimation process. The engagement team, with the assistance of a KPMG credit review specialist, further tested (on three separate occasions throughout 2008) TierOne's risk rating process through which loans were identified for, among other things, FAS 114 impairment analysis. *See* JPF ¶¶252-59; Bennett Opening-21; Bennett Opposition-13. The engagement team then identified and tested, on the "back end," TierOne's continuing review by multiple levels of management of the sufficiency of the ALLL—including the FAS 5 and FAS 114 components for non-impaired and impaired loans. *See* JPF ¶277; Bennett Opening-21-23; Bennett Opposition-14-16.

Ignoring the integrated nature of the audit, the Division disregards most of the engagement team's testing of the ALLL estimation process, and focuses exclusively on the front-end appraisal control. *See* Div. Opposition-36-39. The Division argues, "*regardless of Respondents' other audit work* testing other ALLL controls, the fact remains that Respondents identified only one control aimed at the critical risk that collateral may be overvalued." *Id.* at 38-39 (emphasis added). That is wrong. The engagement team identified and tested multiple key controls regarding TierOne's *entire* process for estimating the ALLL. The aggregate of audit evidence obtained regarding all of these key controls provided the basis upon which Mr. Bennett formed professional judgments about TierOne's Internal Controls.

The Division's argument that the engagement team did not "identif[y] or test[]" the TierOne Controller's independent review of FAS 114 reserves ignores the audit evidence documented in the workpapers. Div. Opposition-37-38. Because the audit evidence establishes that the Finance Department, led by the Controller, reviewed and approved "[a]ll new and existing SFAS 114 templates," RX-2 at KPMGTO0003027, the Division argues that the engagement team did not actually identify or test this internal control because it "appears only in a listing of TierOne's FDICIA/Section 404 internal control assessment," Div. Opposition-38 n.12. But the Section 404 binder in KPMG's wokpapers provided important support for its professional judgments, as Mr. Bennett specifically documented in that binder:

> The Company provided KPMG these materials … as a record copy for the annual integrated audit. We reviewed the key controls related to the consolidated financial statements and key processes as part of our testwork procedures.… We are retaining these materials as they were reviewed throughout 2008 and at final to document our understanding of key controls at the Company.

RX-2 at KPMGTO0002703. The Division ignores this evidence. Moreover, the engagement team documented its testing with respect to this control in the "Test of Design and Operating Effectiveness" of Control 12-2 workpaper: "The *controller* and the Asset Classification Committee review all the ALLL quarterly." RX-7D at KPMGTO0005055 (emphasis added). That workpaper reflects that the engagement team (i) inspected documents, including ACC minutes and detailed reports review by the ACC, and (ii) met directly with the Controller, who conveyed specific information regarding the review of the sufficiency of the ALLL, including that "due to the current economic conditions and trends, the analysis of ALLL includes a detailed analysis of the loans 60-90 days past due." *Id.* at KPMGTO0005056. In a related "Test of Design and Operating Effectiveness" regarding "Management Review of Impaired Loans," the engagement team again met directly with the Controller, who conveyed that he and other members of the ACC addressed "recent trends, status changes within the portfolios, reserves modifications, and FAS 114 impairments." RX-7 at KPMGTO0005076.[3] The engagement team

[3] The Division argues that the workpapers do not support Mr. Bennett's showing that the Controller "reviewed the FAS 114 templates as an internal control over the estimation process for impaired loans." *See* Div. Opposition-38 n.12 (arguing that one of six enumerated paragraphs in one workpaper "says no such thing"). The Division ignores that the Opening Brief identifies multiple relevant workpapers immediately following the citation highlighted by the Division, *see* Bennett Opening-22 (citing JPF ¶279, which itself cites RX-7D at KPMGTO0005054-66 and RX-7 at KPMGTO0005074-77), and the same paragraph cites to additional workpapers on point, *id.* (citing JPF ¶278, which itself cites RX-2 at KPMGTO0003027). The Division never addresses these workpapers, discussed above, all of which

corroborated the Controller's statements by inspecting the documentation reviewed by the ACC. *See* Bennett Opening-22-23; Bennett Opposition-14-15.

The Division quibbles about how the testwork was packaged but ignores that the aggregate of workpapers shows the engagement team obtained sufficient competent audit evidence regarding the effectiveness of the Controller's review of FAS 114 reserves. Indeed, the Division does not argue that Controller review of FAS 114 reserves was improperly designed or not operating effectively. Even its own expert, Mr. Barron, acknowledged that such review "could be an effective control." Tr.-1248-49; JPF ¶¶277-84 & n.469.

The Division's dismissal of the ACC's review of the ALLL as a "high-level" control, Div. Opposition-38 (citing ID-28), similarly ignores the record and instead improperly relies upon hindsight. The Division's assertion that the ACC did not "review FAS 114 templates" misses the point. The workpapers reflect that (i) the Finance Department, led by the Controller, who was a member of the ACC, reviewed "[a]ll new and existing SFAS 114 templates," RX-2 at KPMGTO0003027, (ii) the ACC discussed "FAS 114 impairments," RX-7 at KPMGTO0005076, and (iii) both the Controller and the ACC, in reviewing the ALLL, conducted "a detailed analysis of the loans 60-90 days past due," RX-7D at KPMGTO0005056. These "back end" controls on the ALLL estimation process—each of which was tested by the engagement team and determined to be operating effectively—address the risk that the ALLL was not sufficient, due to collateral overvaluation or otherwise.[4]

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contained audit evidence considered by Mr. Bennett in forming his professional judgments about TierOne's Internal Controls.

[4] Through hindsight, we now know that members of the ACC circumvented those controls by committing fraud with respect to the sufficiency of the ALLL. That hindsight has no bearing on whether Mr. Bennett satisfied professional standards given that there is no allegation that the engagement team should have discovered TierOne's fraud and the auditing standards provide 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." AU § 316.10; JPF ¶77.

The Division is thus wrong in asserting that TierOne was "[w]ithout a control addressing the risk that the ALLL was understated because collateral was overvalued at year end." Div. Opposition-37. 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). The Division does not identify any Internal Controls procedure that a reasonable senior manager should have performed that Mr. Bennett did not. As multiple experienced KPMG partners concluded at the time, and as Ms. Johnigan opined following a review of the workpapers in this proceeding, Mr. Bennett and the engagement team appropriately identified, tested and documented TierOne's key Internal Controls addressing the risk that the ALLL was understated because of collateral overvaluation or otherwise.

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

The Division's core argument that Mr. Bennett and the engagement team performed a "cursory" audit with respect to the FAS 114 reserves within the ALLL, Div. Opposition-2, 17, 20, is refuted by the record and finds no support even in the Initial Decision.[5] Mr. Bennett agrees that, as the senior manager, he was obligated to exercise "due professional care" and "professional skepticism," *id.* at 17, and that such care and skepticism are important particularly where, as here, the audit addresses "a high-risk account involving management's estimates," *id.*

Mr. Bennett met these professional obligations during the 2008 TierOne integrated audit by "obtain[ing] sufficient competent audit evidence to provide reasonable assurance that fair

[5] The Division again improperly relies upon hindsight, asserting, *incorrectly*, that "[j]ust a few months after the audit, TierOne obtained updated appraisals and disclosed a staggering $120 million in losses related to its loan portfolio." Div. Opposition-11 (citing ID-5). The Initial Decision did not state loan losses were disclosed "just a few months after the audit," *see* ID-5, and the continued reference to subsequent events underscores the improper use of hindsight by the Division.

value measurements and disclosures [were] in conformity with GAAP." *Id.* at 18 (citing AU § 328.03 (RX-60)); *see* JPF ¶¶305-98. The following facts are not disputed:

- Mr. Bennett and the engagement team appropriately identified TierOne's ALLL as having a "High" inherent risk. JPF ¶177.

- In response to declining economic conditions and OTS's regulatory findings, the engagement team increased the scope of their interim and year-end audit procedures for testing the reasonableness of the ALLL. JPF ¶¶161, 163, 180.

- The engagement team engaged a credit review specialist on three occasions to review loan files, including third-party appraisals, loan analyses and credit reviews prepared by loan officers, and borrower and guarantor information, to determine, among other things, if TierOne properly was identifying loans for impairment analysis. If a loan was impaired, the specialist also evaluated whether the FAS 114 methodology for estimating reserves was appropriate. JPF ¶¶252-59.

- The engagement team conducted procedures with respect to each of the 54 loan relationships that management had identified as impaired and potentially impaired at year-end, JPF ¶¶308, 317-318, 322-23, 344-58, 361, including review of third-party appraisals for approximately two thirds of the 54 loan relationships, which the team documented on the FAS 114 templates in the workpapers, *id.* ¶341; RX-8M.[6]

- At year-end, the engagement team observed that every one of the 13 Nevada impaired loan relationships—on which the Division focused almost exclusively in this administrative proceeding—had either an appraisal from 2008 or a discount applied to an earlier appraisal, or both. JPF ¶366.

- Management, after having obtained updated appraisals on a substantial portion of Nevada collateral, expressed a disinclination to spend more resources on Nevada appraisals in the midst of the economic crisis because updated appraisals would be unduly influenced by liquidation sales/prices in the second half of the year. JPF ¶¶369-71; *see also* JPF ¶59; RX-8 at KPMGTO0005450, 58.

- Nevertheless, market indices reflected Nevada real estate prices had declined by approximately 33% during 2008, and management recorded losses of approximately 30% on the Nevada impaired loans during 2008. JPF ¶¶310-16, 363, 371-77, 402.

[6] Most, if not all of these appraisals, were obtained from TierOne's loan files. JPF ¶¶338-46. Nevertheless, the Division argues that the loan files were irrelevant to the audit because the workpapers supposedly make no reference to them. *See* Div. Opposition-28-30 & nn.8-9. Here, too, the Division cannot negate indisputable evidence of the engagement team's efforts based on a misguided analysis of the workpapers.

This audit evidence was documented in the workpapers, including the 30% loss recognition on Nevada impaired loans, as the citations above demonstrate. Bennett Opposition-17-27.

Rather than address this audit evidence, the Division mischaracterizes the record and Respondents' position:

> The claim that there was reliable evidence to support management's assertion that collateral values on numerous properties in hard-hit states had all held their value during the course of the Great Recession *is on its face incredible*.

Div. Opposition-29 (emphasis added). That argument is a straw man. Nothing in the record suggests TierOne's management concluded that collateral in Nevada and other hard-hit states "all held their value" during 2008, let alone during the entirety of the Great Recession. During 2008, management wrote down the value of *most* Nevada impaired loans, in large part due to decreased estimates of the value of collateral. JPF ¶¶362-86. Further, in the second half of 2008, management (i) determined that five Nevada loans (Double M, HD Tbella, MME, Pueblos Partners, Valley Heights) had become newly impaired, and (ii) applied substantial discounts to appraisals relating to three of the 13 Nevada impaired loans (Celebrate 50, HDB, Mohave Sun), one of which was dated *May 2008* (HDB). *See* JPF ¶386. Management also continued at year-end to apply significant discounts on all impaired loans, including in Nevada, to reflect the estimated number of months to sell collateral. JPF ¶321. The Division's mischaracterization of the record ignores that the engagement team was aware TierOne had taken these significant steps to address the impact of market declines on its impaired loan estimates throughout 2008.[7]

[7] The Division cannot dismiss this evidence by pointing to one admittedly erroneous sentence in the FAS 114 memo ("market conditions have not materially deteriorated"). *See* Div. Opposition-42. The workpapers are replete with references to market deterioration, and the Initial Decision acknowledges Respondents "were fully aware of these market conditions." ID-30.

The Division's argument that the engagement team's "reliance on FAS 157" was a "plainly undocumented[] procedure[]" itself is a misapprehension. Div. Opposition-22. An accounting principle is not a "procedure" to be performed. Still, the Division argues that Mr. Bennett cannot invoke FAS 157 because, while referencing "fair value" throughout the workpapers, his investigative examination, and his Wells submission, he did not also expressly invoke "FAS 157" and he provided investigative testimony that appraisals were the best indicator of fair value. *See* Div. Opposition-25-26.[8] The Division ignores, however, that Mr. Bennett and the engagement team reviewed and commented on TierOne's draft disclosure in its 2008 financial statements, which expressly addressed the application of FAS 157 to FAS 114 loans. The procedure, as evidenced by an audit notation in the draft financial statements in the workpapers, included tying TierOne's FAS 157 disclosures to TierOne's impaired loans. *See* JPF ¶230.[9] These documented procedures confirm that Mr. Bennett was aware of and understood the "fair value" principles set forth in FAS 157 and that they applied to TierOne's FAS 114 estimates.

Nor does Mr. Bennett advocate "*ignoring*" "market conditions." Div. Opposition-27 ("ignoring dramatically declining market conditions"; "ignore market realities"; "ignore market conditions"). It is undisputed that neither "current" appraisals nor market data were

[8] Throughout his investigative testimony, Mr. Bennett was responsive to the Division's questions about the audit *and* management's fraud, which included deceit with respect to how TierOne obtained appraisals. *See* RX-234; RX-235. In his Wells submission, Mr. Bennett addressed *ten* separate issues (many of which were not raised in the administrative proceeding), including, for example, the contention that KPMG was required to develop its own fair value estimates regarding TierOne's FAS 114 loans. And, in doing so, Mr. Bennett discussed "accounting literature expressly authorizing use of other valuation methods as alternatives to appraisals." DX-230 at 2.

[9] The Division seeks to divert attention from this evidence by arguing that the engagement team prepared a FAS 157 memorandum addressing certain financial instruments held by TierOne, but did not prepare a separate FAS 157 memorandum addressing the FAS 114 reserves. *See* Div. Opposition Br.-23-24. There was no requirement to prepare a separate FAS 157 workpaper for FAS 114 loans, and the engagement team already had prepared more than one thousand pages of workpapers regarding the reasonableness of TierOne's ALLL estimate, including the "fair value" of FAS 114 loan collateral. JPF ¶435.

determinative of fair value given the prevalence of forced liquidation and distressed sales in the second half of 2008. *See* Bennett Opposition-24-25. Applicable fair value accounting principles make clear that a forced liquidation or distressed transaction, like a foreclosure sale, is not an orderly transaction and therefore is not "determinative" of fair value. JPF ¶¶55-56. Notwithstanding the Division's insinuation of a misinterpretation, Div. Opposition-27-28, Mr. Bennett and the engagement team were aware of this guidance and correctly understood that market indices in late 2008, which included disorderly transactions, were not determinative of fair value—and decreases in market indices in late 2008 were thus not determinative of decreases in fair value. *See* Bennett Opening-28-29, 33-34; Bennett Opposition-24-25.

The Division's further argument that market indices were "entirely inconsistent" with management's FAS 114 reserves is contrary to the record. *See* Div. Opposition-26. TierOne recorded $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, 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; *see also* JPF ¶379 n. 671(Division's expert acknowledged that 30% was not *inconsistent* with certain reported market declines Nevada). In corroborating management's expressed view that Nevada loan losses recorded were not inconsistent with market conditions, the engagement team reviewed the market data, JPF ¶¶310-12, 315-16 (discussing Respondents' review of TierOne Internal Audit's tie-out of ALLL memorandum to market indices), and understood that it included foreclosures and liquidation sales and therefore reflected declines that may have exceeded the actual declines in fair value under FAS 157, *id.* ¶¶376-79.[10] Rather than being "plainly at odds" with market data, Div. Opposition-25, the engagement team exercised its professional judgment to conclude that management's Nevada FAS 114 estimates were reasonable based on a consideration and interpretation of the relevant market information at the time of the audit.

The Division is wrong when it argues that the engagement team did not "document" the work about which Respondents testified. *See* Bennett Opposition-26-27. Most notably, the engagement team documented the lack of inconsistency between available market data and TierOne's 30% loss recognition on Nevada impaired loans in 2008. There is no obligation to document each specific conversation with TierOne management, and the workpapers plainly show that the auditors discussed with management loan portfolio trends affecting the ALLL. JPF ¶373. In addition, the Division's own expert conceded that the data supporting TierOne's loss recognition on the Nevada loans were included in the workpapers. JPF ¶378; *see also* JPF ¶¶356, 363, 373-75 (addressing L-37 series workpaper, which documented Nevada 30% loss recognition).

In the end, armed with hindsight knowledge that TierOne's management was engaged in fraud and that TierOne ultimately failed, the Division second-guesses the professional judgments of Mr. Bennett and the engagement team because TierOne did not obtain "current" appraisals. Div. Opposition-19-22 ("Respondents could not identify any specific evidence to support the conclusion that TierOne's use of stale, undiscounted appraisals was reasonable at year-end 2008."). But neither TierOne's loan policy nor applicable professional standards required that

[10] Contrary to the Division's suggestion, Respondents did not contend that during the 2008 audit they commissioned an extensive economic study assessing various market indices for different property types on a quarter-by-quarter basis. *See* Div. Opposition-26 (arguing that Division's witness Thakor was retained "to do what Respondents claimed they had done"); Tr.-307-09 (explaining that Thakor's methodology was implemented by a "team" of economists and accountants from Navigant Consulting). Nor were they required to do so in concluding that market indices containing liquidation sales were not determinative of fair value and indicated declines exceeding actual declines in fair value.

TierOne obtain "current" appraisals for impaired loans or update existing appraisals on any periodic basis. *See* JPF ¶68; Bennett Opposition-23-24. Again, the Division does not identify any other substantive procedure that a reasonable senior manager should have performed. As multiple experienced KPMG partners concluded,[11] and as Ms. Johnigan opined following a review of the workpapers, Mr. Bennett and the engagement team appropriately tested and documented the reasonableness of TierOne's 2008 ALLL estimate.

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

With respect to the appraisals received in 2009, which the ALJ does not include as a predicate for liability under Rule 102(e), *see* ID-36 & n.38, the Division ignores key provisions of AU § 561. *See* Div. Opposition-39-41. Focusing on Paragraph 4, the Division argues the standard "is triggered whenever an auditor learns of information 'which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit.'" *Id.* at 40-41 (quoting AU § 561.04 (RX-63)). The Division thus contends that Mr. Bennett was required to "perform some analysis to determine whether the information is reliable, including discussing the matter with management." *Id.* The argument is empty formalism.

Paragraph 4 of AU § 561 addresses whether information obtained after the audit is reliable and existed at the time of the audit report. At the hearing, there was no dispute that the appraisals were reliable and existed at the time of the report. Rather, Respondents showed that, pursuant to Paragraph 5 of AU § 561, the new appraisals—which suggested both decreased

[11] The Division cannot trivialize the role of KPMG's SEC concurring review partner, *see* Div. Opposition-35-36, who was a well-respected financial services partner with decades of experience relevant to the 2008 TierOne audit, JPF ¶33. Indeed, the review partner, like Mr. Aesoph, supervised Mr. Bennett's work and reviewed and signed off on, among other ALLL workpapers, the "overall ALLL memo and the FAS 114 memo." Div. Opposition-35.

values and an increased value—would not have affected the 2008 financial statements in their professional judgment. *See* AU § 561.05 (RX-63).[12] It is for that reason that the auditing standard was not triggered. *See* Bennett Opening-38-39; Bennett Opposition-27-28. The Division's expert did not dispute this at the hearing, Tr.-1158-59 (Barron), and the Division's Opposition does not address that showing here. Accordingly, there is no evidence that Mr. Bennett violated AU § 561, which is consistent with the judgment of Mr. Bennett's supervisors at the time, JPF ¶421, and with the expert opinion of Ms. Johnigan, a member of the Auditing Standards Board, Tr.-2049.

D. Mr. Bennett Did Not Engage In Highly Unreasonable Conduct Or Repeated Instances Of Unreasonable Conduct.

Previously, Mr. Bennett demonstrated that the Initial Decision nowhere addressed Rule 102(e)'s requirements for a determination of "highly unreasonable conduct," *i.e.*, based on "'the degree of the departure from professional standards'" that "'conclusively demonstrates that the accountant lacks competence to practice before it.'" Bennett Opening-40. Mr. Bennett demonstrated that the Initial Decision conflated the two separate standards for a determination of "improper professional conduct," *id.* at 40-42, and there was no basis for a determination of multiple instances of unreasonable conduct, *id.* at 42. The Division does not call these conclusions into question.

First, the Division ignores the separate elements necessary to establish "highly unreasonable conduct" under Rule 102(e). Rule 102(e) requires both (1) "a single instance of highly unreasonable conduct that results in a violation of applicable professional standards," *and* (2) "circumstances in which an accountant knows, or should know, that heightened scrutiny is

[12] In the aggregate, the new appraisals represented approximately $4 million in additional losses compared to 2008 financial statements reflecting a $93 million pretax loss and an $84 million loan loss reserve. JPF ¶¶423, 425.

warranted." Rule 102(e)(1)(iv)(B)(1). As to this first element, the Commission "rais[ed] the threshold for improper professional conduct from one instance of 'unreasonable' conduct to one instance of 'highly unreasonable' conduct," Rule 102(e) Release, 68 Fed. Reg. at 57,168, and explained that whether conduct rises to the level of "'highly unreasonable'" must be "measured by the degree of the departure from professional standards," *id.* at 57,167-68. In this way, the Commission sought to address concerns that imposition of liability for a single instance of "unreasonable" conduct "'would chill accountants' use of their best judgment." *Id.* And, in explaining the second element, the Commission further required that the circumstances that make "[h]eightened scrutiny ... appropriate" would include evidence that "matters are important or material, or when warning signals or other factors should alert an accountant of a heightened risk." *Id.* at 57,168.

Notwithstanding these limitations, the Division argues that Mr. Bennett's conduct qualifies as "highly unreasonable conduct" because he "violated basic audit standards requiring due care, professional skepticism and competent evidence." Div. Opposition-42. The Division, like the Initial Decision, makes no effort to "measure[] ... the degree of the departure from professional standards" or to distinguish between the lower standard of "unreasonable conduct" and the heightened showing of "highly unreasonable conduct" necessary under Rule 102(e)(1)(iv)(B)(1). Rule 102(e) Release, 63 Fed. Reg. at 57,168. The lengthy quotation offered by the Division addresses the second element—reasons that "heightened scrutiny was warranted." Div. Opposition-42. As to whether Respondents' conduct qualified as "highly unreasonable," the quotation states only that Respondents' "'procedures in testing TierOne's internal control over financial reporting and evaluating the FAS 114 estimates failed to sufficiently address these issues.'" *Id.* (quoting ID-36). That assessment draws no distinction between purportedly "unreasonable" and "highly unreasonable conduct."

The Division's reliance upon the Commission's decision in *In re McCurdy* is likewise misplaced. Exchange Act Release No. 34-49182, 2004 WL 210606 (Feb. 4, 2004). There, the Commission addressed a "related-party transaction" between an investment fund (Fund) and its investment advisor (Bagwell) that was reported as a receivable that accounted for 25 percent of the subject Fund's assets. Although McCurdy knew that additional procedures were necessary to assess whether the receivable was collectible, he "performed virtually none." *Id.* at *8. The Commission concluded that McCurdy's conduct was highly unreasonable because he "failed to undertake such simple, obvious steps as contacting Bagwell or the Trustees for more information, or reviewing copies of Bagwell's tax returns or credit reports" to make an assessment whether the Fund could collect the receivable from Bagwell. *Id.* at *9. Here, in contrast, the Commission identifies no "simple, obvious steps." Div. Opposition-28. Instead, the Division advances an ordinary negligence claim, arguing that Mr. Bennett "should have followed basic standards, applied professional skepticism, and gathered sufficient, competent evidence in one of the highest-risk areas of the audit." *Id.* at 42. As shown above, that assessment is mistaken, and, in all events, the Division's argument cannot support a heightened finding of "highly unreasonable conduct."

Second, the Division also conflates the legal distinction between "a single instance of highly unreasonable" conduct and "repeated instances of unreasonable conduct" in Rule 102(e). It argues that "the alternative holding"—that Mr. Bennett committed repeated acts of "unreasonable" conduct—is fully supported by the "primary holding finding a single instance of highly unreasonable conduct." Div. Opposition-44. The Division's argument ignores the text of

Rule 102(e)(1)(iv)(B), which draws a clear distinction between a showing of "a single instance of highly unreasonable conduct" and "repeated instances of unreasonable conduct." As a matter of logic, a single instance of conduct is not the same as "repeated instances." As a legal matter, that distinction between the two different violations is important because, as the Commission has recognized, "an undue fear that an isolated error in judgment would result in a 102(e) proceeding could be counterproductive and could chill accountants' use of their best judgment." Rule 102(e) Release, 63 Fed. Reg. 57,168. Indeed, the Commission explained that "a single error that results in an issuer's financial statement being misstated in more than one place would not, by itself, constitute a violation" of the subparagraph addressed to "repeated instances of unreasonable conduct." *Id.* at 57,169.

That legal distinction is particularly important in this case. Here, the Initial Decision explained that the Division's charges "are based on [Respondents'] alleged improper practices related to TierOne's ALLL account in the year-end 2008 audit." ID-22. The Division's failure to prove "a single instance of highly unreasonable" conduct cannot be salvaged by subdividing the same conduct—all of which addressed the FAS 114 loans within TierOne's ALLL account—into "discrete parts." Div. Opposition-44. Indeed, there has been no showing that each of the "discrete parts" satisfied the requirement that the unreasonable conduct independently indicated "a lack of competence to practice before the Commission." Rule 102(e)(1)(iv)(B)(2).

Third, the Division is wrong when it asserts that Mr. Bennett remains liable "unless the Commission finds that the ALJ erred across the board." Div. Opposition-1. The Initial Decision's determination that Mr. Bennett engaged in "highly unreasonable conduct," is predicated on both "testing TierOne's internal control over financial reporting *and* evaluating the FAS 114 estimates." ID-36 (emphasis added). Likewise, with regard to the alternative determination of "repeated instances of unreasonable conduct," the Initial Decision relies upon that same conduct. *Id.* at 36 & n.38. As a result, the Commission's rejection of the Initial Decision's analysis as to either would undermine the Initial Decision's determination of a violation under both of the alternative grounds.[13]

III. THE PROPOSED SANCTION OF MR. BENNETT WOULD BE FUNDAMENTALLY UNFAIR AND CONTRARY TO THE PURPOSES UNDERLYING RULE 102(e).

With hindsight knowledge of TierOne's fraud and ultimate demise, the Initial Decision concludes that Mr. Bennett's conduct "fell short" of professional standards as to one component of one account in the context of a single audit during the Great Recession. ID-28, 31, 37. Even in that audit, however, there is no dispute that Mr. Bennett appropriately identified the ALLL as a high-risk account and, with the engagement team, designed and implemented significantly enhanced audit procedures, including engaging KPMG specialists and performing substantive procedures with respect to each impaired loan. JPF ¶¶180, 191, 200, 317-318, 322, 355-56. At every step, Mr. Bennett consulted with the engagement partner and SEC concurring review partner---experienced professionals within KPMG—who assured him that they concurred with his judgments and believed his conduct complied with professional standards. Suspension of a senior manager under these circumstances would be fundamentally unfair and would serve no legitimate remedial purpose under Rule 102(e). *See* Bennett Opening-42-45; Bennett Opposition-29-39. But it would have a punitive and devastating impact on Mr. Bennett.[14]

[13] The Initial Decision did not rely upon the claimed violation of AU § 561 as support for its determination of "a single instance of highly unreasonable conduct" or "repeated instance of unreasonable conduct." ID-36 & n.38. The Division did not appeal the Initial Decision's decision not to rely on the AU § 561 claim as a basis for finding a violation of Rule 102(e).

[14] Mr. Bennett expressly reserves for judicial review challenges to the constitutionality of these proceedings where the Commission lacks the power or jurisdiction to decide such challenges or where it

CONCLUSION

For the reasons set forth above and in Mr. Bennett's earlier briefs, the allegations leveled against Mr. Bennett should be dismissed, and, in the alternative, Mr. Bennett should not be suspended from practicing before the Commission under Rule 102(e).

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Respectfully submitted,

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would otherwise be unreasonable to raise such issues before the Commission. *See, e.g., Hettinga v. United States*, 560 F.3d 498, 506 (D.C. Cir. 2009).

RULE 450(d) CERTIFICATE OF COMPLIANCE

Pursuant to Commission Rule 450(d), I hereby certify that the foregoing Reply Brief of Respondent Darren M. Bennett In Support of His Petition for Review complies with the length limitation set forth in Commission Rule 450(c). The Brief is 6,981 words exclusive of the cover page, Table of Contents, Table of Authorities, Table of Record and Brief Citation Abbreviations, this Certificate, Certificate of Service, and signature block. This total was calculated using Microsoft Word 2007's word count function.

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