

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 51920 / June 24, 2005

ACCOUNTING AND AUDITING ENFORCEMENT  
Rel. No. 2264 / June 24, 2005

Admin. Proc. File No. 3-9793

In the Matter of  
  
ROBERT W. ARMSTRONG, III

OPINION OF THE COMMISSION

CEASE-AND-DESIST AND RULE 102(e) PROCEEDINGS

Grounds for Remedial Action

Violations of Antifraud, Reporting, and Recordkeeping Provisions

Accountant for subsidiary computed and supplied figures necessary to execute parent company's scheme to achieve predetermined growth rates and convey false appearance of a smooth growth trend. Accountant willfully violated and was a cause of violations of the antifraud, reporting, and recordkeeping provisions of the federal securities laws and rules. Held, it is in the public interest to order that accountant cease and desist from committing or causing any violations or future violations of the applicable laws and rules.

APPEARANCES:

Marc B. Dorfman and Bryan B. House, of Foley & Lardner LLP, for Robert W. Armstrong, III.

Robert K. Levenson, for the Division of Enforcement.

Appeal filed: April 27, 2004  
Last brief received: July 2, 2004  
Oral argument: March 29, 2005

## I.

Robert W. Armstrong, III and the Division of Enforcement each appeal from the decision of an administrative law judge. The law judge found that Armstrong, formerly controller of National Medical Care, Inc. ("NMC"), a subsidiary of W.R. Grace & Co. ("Grace"), participated in a scheme to manipulate Grace's reported earnings to achieve predetermined targets. The scheme involved improperly recording excess earnings as reserves and later using the excess reserves to bolster earnings, thereby creating the false impression that Grace had a steady, consistent growth in income over a period of several years. The law judge found that Armstrong willfully violated Section 10(b) of the Securities Exchange Act of 1934 1/ and Exchange Act Rule 10b-5 2/ and that he was a cause of Grace's violations of those provisions.

The law judge also concluded that, as a result of the scheme to manipulate Grace's earnings, Grace's periodic reports during the relevant period included financial statements that were not in accordance with Generally Accepted Accounting Principles ("GAAP") and that were materially misleading in violation of the periodic reporting requirements contained in Exchange Act Section 13(a) 3/ and Exchange Act Rules 12b-20, 13a-1, and 13a-13. 4/ The law judge found that Armstrong was a cause of these violations. The law judge further found that the scheme resulted in Armstrong violating the recordkeeping requirements of Exchange Act Section 13(b)(5) 5/ and Exchange Act Rule 13b2-1, 6/ and causing Grace's violation of these provisions and of Exchange Act Section 13(b)(2). 7/ The law judge imposed a cease-and-desist order on Armstrong.

The law judge dismissed the charges brought pursuant to Commission Rule of Practice 102(e). 8/ The law judge recognized that Armstrong had willfully violated the federal securities laws and the Commission's rules within the meaning of Rule 102(e)(1)(iii), but held that Rule 102(e) applied only to persons appearing or practicing before the Commission. She concluded

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1/ 15 U.S.C. § 78j.

2/ 17 C.F.R. § 240.10b-5.

3/ 15 U.S.C. § 78m(a).

4/ 17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-13.

5/ 15 U.S.C. § 78m(b)(5).

6/ 17 C.F.R. § 240.13b2-1.

7/ 15 U.S.C. § 78m(b)(2).

8/ 17 C.F.R. § 201.102(e).

that Armstrong had not been appearing or practicing before the Commission and dismissed the Rule 102(e)(1)(iii) charges on this basis. <sup>9/</sup>

Armstrong argues that the law judge erred when she concluded that he violated and caused Grace's violations of the federal securities laws and the Commission's rules. Armstrong contends that he was in no position to assess whether Grace's financial statements complied with GAAP because he had no responsibility for Grace's statements and did not know the details of how Grace prepared those statements. Armstrong maintains that there is no basis in the public interest for the imposition of a cease-and-desist order.

The Division argues that the law judge erred when she implicitly concluded that Rule 102(e)(1)(iii) requires that a person be appearing or practicing before the Commission at the time of the violative conduct. The Division maintains that, in any event, Armstrong was appearing and practicing before the Commission within the meaning of Rule 102(e)(1)(iii) when he committed the alleged violations. The Division seeks to deny permanently to Armstrong the privilege of appearing or practicing before the Commission. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

## II.

### A. The Participants

#### Armstrong

Armstrong was vice president and controller of NMC from January 1985 until his resignation in May 1997. During this time, he was NMC's chief accounting officer and was responsible for NMC's financial reporting on a monthly, quarterly, and annual basis. Armstrong was also responsible for supervising NMC's internal audit department and for supervising the preparation and consolidation of the financial reports of NMC's operating subsidiaries. <sup>10/</sup>

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<sup>9/</sup> The law judge also dismissed the charges brought by the Division pursuant to Rule 102(e)(1)(ii) on the basis that the Division failed to establish the professional standards to which Armstrong was subject under that Rule. The Division has not appealed this ruling.

<sup>10/</sup> Armstrong was a certified public accountant ("CPA") in Massachusetts from 1977 through 1983 at which time he allowed his license to expire. Armstrong worked as an auditor and supervisor at Touche Ross & Company, a major accounting firm, from 1975 until 1980. Armstrong joined NMC in 1980 and held several positions, including managing the audit department and directing financial reporting and budgeting. In 1983, Armstrong briefly left NMC, but he rejoined the company in 1985 as vice president and controller.

After leaving NMC in 1997, Armstrong continued to work as a financial executive, holding positions as a chief financial officer, an accounting officer, and a consultant for large public and private companies. Since 2002, Armstrong has been the chief financial officer of a privately-held manufacturing company. He intends to continue working as a corporate financial executive in the future.

### NMC

NMC was founded in 1968. NMC first became a subsidiary of Grace in 1984 and was a non-reporting wholly-owned subsidiary of Grace throughout the period at issue in this proceeding. NMC's principal business was kidney dialysis services, but it also had divisions engaged in manufacturing specialized medical products and providing home health care services.

Constantine Hampers co-founded NMC. He was NMC's chief executive officer from 1973 through 1996, and he was a Grace director from 1985 through 1996. 11/ Miles Nogelo was a vice president and chief financial officer of NMC from 1984 until September 1995. 12/ Armstrong reported to Nogelo.

### Grace

Grace was a multinational public corporation with a variety of businesses. It had revenues of \$5 to \$6 billion during the relevant period. As a public corporation, Grace was required to file, and did file, quarterly and annual periodic reports with the Commission. Jean-Paul Bolduc was Grace's president and chief executive officer from 1991 through early 1995. 13/

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11/ On August 12, 2003, the Commission issued an order in which Hampers consented to cease and desist from committing or causing violations of the securities laws requiring the maintenance of accurate books and records and prohibiting false filings. Jean-Paul Bolduc, et al., Exchange Act Rel. No. 48325 (Aug. 12, 2003), 80 SEC Docket 3111.

12/ On August 12, 2003, the Commission issued an order in which Nogelo consented to cease and desist from committing or causing violations of the securities laws requiring the maintenance of accurate books and records. Jean-Paul Bolduc, et al., Exchange Act Rel. No. 48326 (Aug. 12, 2003), 80 SEC Docket 3115.

13/ On February 27, 2003, the Commission issued an order in which Bolduc consented to cease and desist from committing or causing violations of the antifraud provisions of the federal securities laws. Jean-Paul Bolduc, et al., Exchange Act Rel. No. 47416 (Feb. 27, 2003), 79 SEC Docket 2576.

Brian J. Smith was Grace's chief financial officer until August 1995. <sup>14/</sup> Richard Sukenik was Grace's controller. <sup>15/</sup> Phillip J. Ryan, III was Grace's assistant controller. <sup>16/</sup>

One of Grace's core businesses was its Health Care Group. Grace reported the Health Care Group as a separate business segment in its consolidated financial statements. The Health Care Group was Grace's fastest growing division; in 1991 and 1992 it contributed approximately 40 percent of Grace's revenue and 60 percent of its profit. Many analysts regarded the Health Care Group as the driving force behind Grace's stock price. Grace executives also publicly touted the significance of the Health Care Group's contributions to Grace's income.

NMC was Grace's main health care subsidiary. <sup>17/</sup> NMC submitted monthly, quarterly, and annual reports to Grace's financial reporting division. These reports included revenues, cost of revenues, operating expenses, and balance sheets. Armstrong directed the preparation of NMC's monthly, quarterly, and annual financial results. He also prepared and reviewed the Health Care Group's financial results at the end of each quarter during the relevant period.

#### Price Waterhouse

Price Waterhouse LLP was Grace's auditor at the time of the events in question in this proceeding. Accountants in Price Waterhouse's Boston office ("Price Waterhouse NMC") did not perform full scope audits on NMC's books and records from 1991 through the first part of

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- <sup>14/</sup> On July 15, 2002, the Commission issued an order in which Smith consented to cease and desist from committing or causing violations of the antifraud provisions of the federal securities laws. Jean-Paul Bolduc, et al., Exchange Act Rel. No. 46205 (July 15, 2002), 78 SEC Docket 60.
- <sup>15/</sup> On March 28, 2003, the Commission issued an order in which Sukenik consented to cease and desist from committing or causing violations of the antifraud, reporting, and recordkeeping provisions of the federal securities laws. Jean-Paul Bolduc, et al., Exchange Act Rel. No. 47597 (Mar. 28, 2003), 79 SEC Docket 3541.
- <sup>16/</sup> On July 15, 2002, the Commission issued an order dismissing the cease-and-desist proceedings against Ryan subject to certain conditions under which the Commission could reinstate the proceedings and impose a cease-and-desist order. Jean-Paul Bolduc, et al., Exchange Act Rel. No. 46206 (July 15, 2002), 78 SEC Docket 65.
- <sup>17/</sup> Hampers testified that "It [NMC] was the healthcare group." Nogelo testified that NMC constituted most of the Health Care Group and that "it was well over 90 percent" of the Health Care Group. Ryan testified that "[i]f you looked at it from a revenue perspective, it [NMC] was all of the revenue [of the Health Care Group]. There were no sales and revenues reported from the other three components. And in terms of income, be it measured net income or pre-tax income, it was probably greater than 100 percent of the healthcare group given that two of those three components were expenses . . . ."

1995, but they did conduct certain reviews of NMC's financial statements during this period at the instructions of Price Waterhouse accountants auditing Grace. 18/ George Jamieson was the Price Waterhouse partner who oversaw the reviews of NMC's financial statements. Accountants in Price Waterhouse's New York and Fort Lauderdale offices ("Price Waterhouse Grace") audited Grace's consolidated financial statements. Price Waterhouse Grace provided unqualified opinions on Grace's consolidated financial statements throughout the relevant period. Eugene Gaughan was the Price Waterhouse partner who oversaw the audits of Grace's consolidated financial statements from 1989 through 1994. 19/ Thomas Scanlon became the lead Price Waterhouse partner on the Grace audit for 1995. 20/

## B. The Scheme

       The facts underlying the scheme to defraud are not in dispute. Neither is Armstrong's conduct as part of the scheme. 21/

### Decision to Record Excess Income as Reserves

Beginning in late 1990 or early 1991, NMC began to realize income in excess of budgeted amounts ("excess income") due to changes in Medicare reimbursement for treatment of dialysis patients. NMC recorded this increased revenue in the physicians' compensation accrual account ("Compensation Account") within the dialysis services division. 22/ This account represented a reserve account for NMC's potential obligations under its incentive compensation

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18/ Armstrong testified that Price Waterhouse NMC conducted "a level two examination or review, which is where they would go in and review certain balance sheet accounts in certain areas . . . ." Warren Barnes, a Price Waterhouse NMC accountant, described the review as "agreed-upon procedures based on instructions from [the] PW Grace audit team." These procedures focused on examining revenues and receivables.

19/ On June 30, 1999, Gaughan consented to the entry of an order directing him to cease and desist from committing or causing violations of the securities laws relating to the maintenance of books and records and false filings with the Commission. Eugene F. Gaughan, C.P.A., Exchange Act Rel. No. 41580 (June 30, 1999), 70 SEC Docket 177.

20/ On June 30, 1999, Scanlon consented to the entry of an order directing him to cease and desist from committing or causing violations of the securities laws relating to the maintenance of books and records and false filings with the Commission. Thomas J. Scanlon, C.P.A., Exchange Act Rel. No. 51481 (June 30, 1999), 70 SEC Docket 184.

21/ As discussed infra, no one disputes that the accounting treatment of the income at issue violated GAAP or that the use of the income to manipulate growth rates constituted fraud. Rather, the sole issue in this case is Armstrong's legal liability for his admitted conduct.

22/ NMC did not indicate the source of these deposits on its books and records.

agreements with the physicians who managed NMC's dialysis clinics, and the excess income recorded in this reserve account was in addition to amounts projected as necessary to cover potential obligations ("excess reserves"). Hampers, Armstrong, and other managers at NMC decided not to report the excess amounts as revenue to Grace until the dialysis services division determined how much additional revenue NMC might earn and for how long.

By August 1991, at least \$10 million in excess income had accumulated in the Compensation Account, and the dialysis services division determined that the account would continue to accumulate excess income at a rate of \$4 million to \$5 million per month. Armstrong concluded that the excess reserves would cause a material misstatement of NMC's financial statements if they were not reported as revenue and discussed this fact with Hampers and Nogelo. Hampers then instructed Armstrong and Nogelo to disclose the existence of the additional revenue and excess reserves to Smith, Grace's chief financial officer.

In approximately September 1991, Armstrong and Nogelo called Smith and told him about the excess income. Smith ordered Armstrong and Nogelo to report only enough income to establish the Health Care Group's earnings at a 24 percent growth rate for 1991 and to record any revenue that would result in a growth rate above 24 percent as reserves in the Compensation Account. According to Armstrong, Smith told him and Nogelo that "Grace would not get credit for additional growth rate beyond that 24 percent." Nogelo testified that Smith wanted earnings that were not needed to achieve that growth rate put into reserves to be used to achieve future growth rate targets. Ryan testified that Smith did not believe that NMC's extraordinary growth rate in the early 1990s could be sustained, and that Smith was concerned about a future drop in earnings. Nogelo said that Smith "wanted to report consistent earnings for Grace and the healthcare segment rather than have volatile earnings," and that Smith "felt that Wall Street and investors valued consistency."

#### Armstrong's Role in Implementing the Scheme

Armstrong executed Smith's instruction to meet the 24 percent growth rate target. He calculated the amount to be held in excess reserves and instructed his staff accordingly. Armstrong then supplied Grace with NMC financial reports that contained these misstated income figures. Armstrong knew that Grace used the numbers that he submitted with respect to NMC's earnings to compile drafts of Grace's public filings related to the Health Care Group. Armstrong reviewed drafts of the Health Care Group's disclosures that were included in Grace's financial statements and confirmed that the financial results included in those disclosures reflected the numbers he had submitted to Grace.

The excess reserves in the Compensation Account reached approximately \$22 million by the end of 1991. Without diverting the revenue to the reserve account, the Health Care Group would have reported enough revenue to show a 35 percent growth rate in 1991 rather than the 24 percent growth rate targeted by Smith.

### Armstrong's Communications with Price Waterhouse Concerning the Excess Reserves

In approximately November 1991, Price Waterhouse NMC discovered the excess reserves in the Compensation Account while reviewing NMC's books and records. At the conclusion of its review, Price Waterhouse NMC prepared a net effects schedule containing all accounting entries in NMC's financial statements with which it disagreed. 23/ The 1991 NMC net effects schedule contained an entry noting that the excess reserves should be eliminated from the Compensation Account. 24/ George Jamieson discussed this schedule at a meeting with Armstrong, Nogelo, and Hampers, and Armstrong admits that he knew that Price Waterhouse NMC had indicated that the excess reserves should be eliminated. Neither Hampers, Nogelo, nor Armstrong effectuated the change recommended by Price Waterhouse NMC. Consequently, the results that NMC sent to Grace, Grace's consolidated financial statements, and the segment disclosure for the Health Care Group in Grace's financial statements contained the targeted income figures achieved by diverting actual income to the Compensation Account. 25/

### Armstrong Continues to Record Excess Reserves

Smith continued to instruct Armstrong to manipulate reported income in 1992. Smith directed NMC to report a growth rate of between 27 and 28 percent for the Health Care Group's income for 1992. To comply with Smith's directive, Armstrong increased the excess reserves in the Compensation Account to \$48.7 million. Armstrong and other NMC officers also recorded

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23/ A net effects schedule documents the significant accounting issues uncovered by the auditor during its review of a client's books and records and lists proposed adjustments.

24/ The parties agree that the applicable accounting standards are contained in Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 5 ("FAS 5"). FAS 5 permits the non-recognition of revenue or the accrual of income in a reserve account when two conditions related to a future contingency are met: the contingency is both probable and reasonably estimable. Armstrong admitted that no probable or reasonably estimable liabilities justified accruing the excess income in the Compensation Account and that he could not justify the excess reserves in that account on the basis of any actual contingencies.

25/ Price Waterhouse NMC informed Price Waterhouse Grace about the excess reserves. In November of 1991, Eugene Gaughan, the Price Waterhouse partner in charge of the audit of Grace's financial statements, first relayed to Smith his concerns that the excess reserves were not justified under GAAP. In early 1992, Gaughan and Thomas Scanlon, another Price Waterhouse accountant, met with Smith and Bolduc and told them that the reserves were not justified under GAAP and should be reported as income. Price Waterhouse Grace ultimately concluded, however, that the total effects of the excess reserves were not material to Grace's financial statements and issued an unqualified audit opinion. Armstrong knew Price Waterhouse Grace issued clean opinions but did not know Price Waterhouse Grace's rationale for allowing the reserves.



an additional \$7.1 million of excess reserves in NMC's home care division, resulting in total excess reserves of almost \$56 million. As a result, Grace reported a 27 percent growth rate for the Health Care Group in 1992 as Smith had directed.

During 1992, Price Waterhouse NMC continued to express concern over the excess reserves. In July 1992, Jamieson met with Armstrong and Nogelo and told them that the excess reserves would be a problem if they were significantly higher than in 1991. When Jamieson became aware that the 1992 excess reserves were almost \$56 million, he told Armstrong and Nogelo that the excess reserves were so large that he would be unable to issue an audit report containing an unqualified opinion on NMC's stand-alone financials were he required to do so. 26/ Price Waterhouse NMC again made entries on its year-end net effects schedule noting that it believed the excess reserves were improper and should be eliminated. 27/

Beginning in 1993, the excess reserves were used from time to time pursuant to Smith's instructions to bolster earnings. 28/ For example, NMC and Grace took \$2.5 million from the excess reserves and recorded it as income in each of the second, third, and fourth quarters of 1993. In addition, Grace and NMC used an additional \$6 million in excess reserves during that year to mask revenue shortfalls. As a result of the excess reserves being added to income, the Health Care Group was able to report a growth rate of 34.6 percent in 1993 instead of a growth rate of 14 percent. 29/

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26/ No audit opinion was required because NMC was a wholly-owned subsidiary of Grace and not itself a reporting company.

27/ Gaughan and Scanlon, the lead Price Waterhouse Grace accountants, continued to object to the excess reserves. Nevertheless, the Price Waterhouse audit team issued audit reports containing unqualified opinions that Grace's consolidated financial statements were in accordance with generally accepted auditing standards ("GAAS") and GAAP. Gaughan and Scanlon each consented to entry of an order directing them to cease and desist from committing or causing violations or future violations of the securities laws relating to maintenance of books and records and false filings with the Commission. See supra notes 19 and 20.

28/ Accordingly, the amount of excess reserves in the Compensation Account remained relatively steady from 1993 to the first quarter of 1995, increasing in some quarters and decreasing in others, but generally remaining at approximately \$50 million. The excess reserves totaled \$49.9 million at the end of 1993 and \$48.9 million at the end of 1994.

29/ The use of the reserves to bolster earnings was effectuated by Armstrong instructing his staff to make entries reducing the amount of the excess reserves by the amount of additional income Grace said it required to meet its target. The record is not entirely clear about where the income was recorded, but it indicates that Armstrong would also instruct his staff to make entries increasing the income of the Health Care Group.

In this way, Smith was able to use the excess reserves to reduce the fluctuations in the Health Care Group's reported earnings and to present a picture of a steadier earnings trend. From 1991 through 1995, Grace reported income growth for the Health Care Group of 22.7 percent to 37.1 percent. Without using the reserves to adjust income, the Group's income would have ranged from a loss of 7.9 percent to a gain of 60.5 percent.

Armstrong voiced concerns to Price Waterhouse NMC accountants and his superiors at NMC and Grace about the excess reserves throughout the period at issue. <sup>30/</sup> Armstrong did not believe that the reserves were recorded in accordance with GAAP or with FAS 5, and he would not have recorded the reserves had Smith not instructed him to do so. He nevertheless achieved the required earnings targets by determining the amount of revenues that should be recorded as reserves and instructing his staff accordingly. He did so even though he believed that no probable or reasonably estimable liabilities or exposures justified those reserves in the Compensation Account. Armstrong was aware that Smith's only reason for recording the excess reserves was to achieve a targeted growth rate.

### III.

The Division alleges that Armstrong participated in Grace's scheme to manipulate reported earnings by preparing books and records that falsely reported NMC's income and by providing these false figures to Grace. The Division contends that Armstrong violated, and was a cause of Grace's violations of, the antifraud provisions of the federal securities laws as a result of this conduct. It further contends that through this conduct Armstrong violated or was a cause of Grace's violations of various recordkeeping requirements and of Grace's periodic reporting requirements. The Division asks that we enter a cease-and-desist order against Armstrong. It also seeks an order denying Armstrong the privilege of appearing or practicing before the Commission pursuant to Rule of Practice 102(e)(1)(iii) on the basis of Armstrong's alleged willful violations of the federal securities laws.

#### A. Violations of the Antifraud Provisions

Exchange Act Section 10(b) authorizes the Commission to prescribe rules, "as necessary or appropriate in the public interest or for the protection of investors," making it "unlawful for any person, directly or indirectly," to "use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." <sup>31/</sup> Consistent with Section 10(b), Exchange Act Rule 10b-5(a) makes it unlawful for "any person," "directly or indirectly," to "employ any device, scheme, or artifice to defraud." Rule 10b-5(c) makes it

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<sup>30/</sup> In 1995, NMC filed a Form 10 with the Commission in connection with Grace's plan to spin off NMC. The Form 10 contained stand-alone financial statements for NMC for the previous three years. The excess reserves were returned to income in the financial statements filed with the Form 10 at Armstrong's insistence.

<sup>31/</sup> 15 U.S.C. § 78j.

unlawful for "any person," "directly or indirectly," to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . ." 32/

The Supreme Court has stated that Section 10(b) encompasses deceptive "practices," 33/ deceptive "conduct," 34/ and deceptive "acts," 35/ and that its prohibition against employing "any manipulative or deceptive device or contrivance" includes a scheme to defraud. 36/ A person's conduct as part of a scheme constitutes a primary violation when the person directly or indirectly

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32/ 17 C.F.R. § 240.10b-5.

33/ Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475-76 (1977).

34/ United States v. O'Hagan, 521 U.S. 642, 659 (1997).

35/ Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173 (1994).

36/ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976); see also Cooper v. Pickett, 137 F.3d 616, 624-25 (9th Cir. 1997) (holding that plaintiffs could allege primary liability through a scheme to defraud because Rule 10b-5(a) makes it unlawful to employ any device, scheme, or artifice to defraud); Greenberg v. Bear Stearns & Co., 220 F.3d 22, 28 (2d Cir. 2000) ("Knowing participation in a fraudulent scheme may render a participant liable under Section 10(b).").

Armstrong contends that misrepresentation cases must allege that a defendant made a material misstatement or omission while market manipulation cases can be proved by a showing that a person participated in a fraudulent scheme, citing Thomson Kernaghan & Co. v. Global Intellicom, Inc., 2000 WL 640653 at \*4-5 (S.D.N.Y.), an unreported decision. The significance of this assertion is unclear. A plaintiff may state a claim for a fraudulent scheme under subsections (a) and (c) of Rule 10b-5 even when not alleging "market manipulation." See In re Global Crossing Ltd. Sec. Litig., 322 F. Supp. 2d 319, 336-37 (S.D.N.Y. 2004). Subsections (a) and (c) encompass much more than the illegal trading activity typically involved in a manipulation of the market for a stock: they encompass the use of "any device, scheme or artifice," or "any act, practice, or course of business" used to perpetrate a fraud on investors. Id. at 336 (emphasis original). Schemes used to artificially inflate the price of stocks by creating phantom revenue fall squarely within both the language of section 10(b) and its broad purpose, to "prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded," and nothing in the language of section 10(b) or Rule 10b-5 or in the case law interpreting them shields a defendant from liability for direct participation in such a scheme. Id. at 337 (citations omitted).

engages in a manipulative or deceptive act as part of the scheme. <sup>37/</sup> Accordingly, a person may be primarily liable for violating Section 10(b) and Rule 10b-5 when he (1) engages in a manipulative or deceptive act as part of a scheme to defraud (2) with scienter. <sup>38/</sup>

1. Fraudulent scheme

Allocating a portion of NMC's income to excess reserves in 1991 to 1992 and using the reserves to inflate falsely and materially <sup>39/</sup> Grace's stated income in 1993, 1994, and the first

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- <sup>37/</sup> See, e.g., Cooper, 137 F.3d at 624 (stating that Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme); In re Enron Corp. Sec. Litig., 258 F. Supp. 2d 576, 627 n.56 (S.D. Tex. 2003) (holding that a plaintiff must allege that each defendant in a scheme committed a manipulative or deceptive act in furtherance of the scheme to state a claim against that defendant); In re Lernout & Hauspie Sec. Litig., 236 F. Supp.2d 161, 173 (D. Mass. 2003) (authorizing primary liability for "any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device . . . intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market").
- <sup>38/</sup> See, e.g., In re Global Crossing Ltd. Sec. Litig., 322 F. Supp. 2d 319, 336 (S.D.N.Y. 2004); Brown v. Kinross Gold, U.S.A., 343 F. Supp. 2d 957, 963 (D. Nev. 2004); see also In re Enron Corp. Sec. Litig., 235 F. Supp. 2d 549, 592 (S.D. Tex. 2002) ("If a plaintiff meets the requirements of pleading primary liability as to each defendant, i.e., alleges with factual specificity (1) that each defendant made a material misstatement (or omission) or committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud, (2) scienter, and (3) reliance, that plaintiff can plead a scheme to defraud and still satisfy Central Bank."). The Division is not required to prove reliance. SEC v. North American Research and Development Corp., 424 F.2d 63, 84 (2d Cir. 1970); SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985); SEC v. Rana Research, Inc., 8 F.3d 1358, 1363-64 (9th Cir. 1993).
- <sup>39/</sup> A fact is material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). A reasonable investor would have considered the true volatility of Grace's earnings to be important. The Division's expert testified that the value of a corporation's shares depends heavily on its growth rate and the smoothness of the trend of that growth rate. As a result of the false income figures Armstrong submitted to Grace, Grace reported income growth for the Health Care Group of 22.7 percent to 37.1 percent from 1991 through 1995, but would have reported a loss of 7.9 percent to a gain of 60.5 percent without using the
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quarter of 1995 constituted a fraudulent scheme. The purpose of the scheme was to create publicly-filed financial statements that deceived analysts and investors by portraying the Health Care Group's rate of income growth as steadier than in reality, and as consistent with analyst expectations.

Armstrong is primarily liable for his role in this deception. It was Armstrong who calculated the amounts of income necessary to be held as excess reserves in order to achieve the falsified earnings and who recorded the excess reserves on NMC's financial statements. Armstrong then directed his staff to make entries booking the necessary reserve amounts when NMC's income exceeded Grace's targets. Later, he also instructed his staff to reduce reserves and increase income for the Health Care Group by the necessary amounts when Grace needed to use the reserves to meet earnings targets. Finally, Armstrong submitted this inaccurate revenue information to Grace knowing that Grace would incorporate it into its financial statements and that the incorporation of this information would materially alter Grace's revenue as stated in its public filings. Armstrong's conduct in thus falsifying NMC's revenues was the mechanism by which Grace achieved its goal of deceiving investors and analysts as to its income stream. The principal purpose of these actions, reporting figures with respect to NMC's revenues and earnings that Armstrong knew to be false, was to create the false appearance that Grace had steady, consistent growth in income over a period of several years. Armstrong also reviewed drafts of the Health Care Group's disclosures that were included in Grace's financial statements and confirmed that the financial results included in those disclosures conformed with the false and misleading numbers he had submitted to Grace. The materially misleading revenue amounts reported in Grace's financial statements were caused entirely by the false figures reported by Armstrong. We conclude that Armstrong engaged in deceptive acts as part of a scheme to defraud. 40/

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39/ (...continued)

excess reserves. Armstrong does not contest the materiality of this information to Grace's financial statements.

40/ See, e.g., Cooper, 137 F. 2d at 624 (holding that plaintiffs stated a claim against company and analysts for primary liability under Section 10(b) where company made false statements to analysts and analysts issued reports based on statements that they knew were false as part of scheme to defraud company's shareholders by falsely presenting the company's current and future business prospects); Cf. Global Crossing, 322 F. Supp. 2d at 336 (holding that plaintiffs stated a claim against accounting firm for primary liability under Section 10(b) where accounting firm directed misleading accounting scheme and sham swap transactions used to circumvent GAAP and inflate companies' revenues, actively participated in structuring each swap, and directly participated in the creation of misleading numbers that concealed these practices from investors); Lernout & Hauspie, 236 F. Supp. 2d at 172-74 (holding that plaintiffs stated a claim against defendants for primary liability under Section 10(b) where defendants participated in scheme to hide research and development expenses, create fictitious revenue, and ultimately overstate

(continued...)

Armstrong contends, relying principally on Wright v. Ernst & Young LLP <sup>41/</sup> and Shapiro v. Cantor <sup>42/</sup>, that the Division's case against him fails because the Division did not establish that Armstrong directly made a false or misleading statement to Grace's investors. The Supreme Court has rejected the contention that Section 10(b) "covers only deceptive statements or omissions." <sup>43/</sup> Since Wright and Shapiro are limited to analyses of culpability for misleading statements and do not address liability with respect to a fraudulent scheme, they are of limited relevance here. <sup>44/</sup>

Moreover, even if Armstrong's liability were examined under Rule 10b-5(b) – which makes it unlawful for any person to “directly or indirectly” “make any untrue statement of a material fact” “in connection with the purchase or sale of a security” – Wright and Shapiro offer little to further his argument. In Wright, the court held that an accounting firm was not primarily liable under Section 10(b) for misstatements in its client's press release when the firm had done nothing more than orally assure the company that its financial results were accurate. The court held that the press release disseminating those financial results attributed no assurances to the accounting firm and explicitly stated that the results were unaudited. Here, Armstrong actually calculated the false data, recorded it, and submitted it to Grace knowing that it would be incorporated into Grace's financial statements and make them materially false and misleading, and he reviewed drafts of documents included in Grace's financial statements and confirmed that

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<sup>40/</sup> (...continued)

profits by setting up, funding, and operating shell companies knowing that these companies were designed solely to inflate profits artificially).

<sup>41/</sup> 152 F.3d 169 (2d Cir. 1998), cert. denied, 525 U.S. 1104 (1999).

<sup>42/</sup> 123 F.3d 717 (2d Cir. 1997).

<sup>43/</sup> United States v. O'Hagan, 521 U.S. 642, 664 (1997); see also Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972) (stating that court of appeals erred when it held that there was no violation of Rule 10b-5 unless the record disclosed evidence of reliance on material fact misrepresentations because, although Rule 10b-5(b) requires the making of an untrue statement of material fact or the omission to state a material fact, Rule 10b-5(a) and (c), addressing schemes, devices, and courses of business, are not so restricted).

<sup>44/</sup> See SEC v. U.S Environmental, Inc., 155 F.3d 107, 112 (2d Cir. 1998) (distinguishing Shapiro and Central Bank and holding defendant primarily liable because he "participated in the fraudulent scheme" by "himself committ[ing] a manipulative act") (citations omitted).

those documents conformed with the false data he had previously submitted. <sup>45/</sup> In Shapiro, the court held that an accounting firm was not primarily liable for its client's failure to disclose the material information that one of the client's principals had been convicted of fraud. The court held that the accounting firm had no duty to disclose such information, and that the only information prepared by the firm in the client's offering memoranda, the client's financial projections, did not include any material misstatements. Again, this case is distinguishable from the instant case, where Armstrong calculated, recorded, and then submitted to Grace the materially false information that was incorporated into Grace's financial statements. A person can be primarily liable under Section 10(b) and Rule 10b-5 for directly or indirectly making an untrue statement of fact if that person, acting alone or with others, creates a false statement that reaches investors. <sup>46/</sup>

Armstrong further argues that he cannot be held liable for violating Section 10(b) or Rule 10b-5 because he merely followed Smith's directions to carry out the fraudulent acts. Case law does not support Armstrong's claim. Courts have repeatedly affirmed that someone who participates in a fraudulent scheme by following his superior's instructions to carry out fraudulent

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<sup>45/</sup> The Wright court's requirement that a false statement be publicly attributed to the defendant was motivated by a desire not to undermine the reliance element of a private action under Rule 10b-5(b). As noted, see supra note 38, the Division, unlike a private plaintiff, is not required to prove reliance. Thus, the principal basis for the attribution requirement in Wright is not present here.

<sup>46/</sup> See, e.g., In re Enron Corp. Sec. Litig., 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002) (adopting Commission's proposed test for liability under Rule 10b-5(b) that a person is primarily liability when he, acting alone or with others, creates a misrepresentation or writes misrepresentations for inclusion in a document to be given to investors); In re ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994) (holding that anyone intricately involved in the creation of misstatements and the resulting deception to investors should be liable under Rule 10b-5(b)); In re Software Toolworks, 50 F.3d 615, 628 n.3, 629 (9th Cir. 1994) (holding that accounting firm could be primarily liable under Section 10(b) when it reviews and plays a significant role in drafting and editing letters to the Commission containing misstatements); Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 432 (N.D. Ill. 1995) (holding that accounting firm may be primarily liable for its central role in the drafting and formation of misstatements incorporated into company's prospectus); McNamara v. Bre-X Minerals Ltd., 57 F. Supp. 2d 396, 429 (E.D. Tex. 1999) (stating that, in amending their complaint, plaintiffs will adequately state a claim against defendants who allegedly played a significant role in developing allegedly false statements made by issuer). In this case, Armstrong, by communicating the false information to Grace, was, if not directly, at least indirectly, making the false statements that appear in Grace's financial statements.

acts can be liable as a primary violator under Section 10(b) and Rule 10b-5. <sup>47/</sup> Armstrong carried out Smith's instructions to make fraudulent entries in NMC's books and records. As discussed above, Armstrong's calculation of the false figures constituted deceptive acts as part of a fraudulent scheme.

Armstrong suggests that finding him liable will result in horrific consequences since any individual who discovers misstatements and investigates or inquires about them but fails to prevent their publication will henceforth be liable for antifraud violations. Armstrong ignores a critical distinction between this hypothetical conduct and his own. Armstrong did not merely discover potential misstatements; he determined the amounts necessary to be held in reserve, he prepared NMC's fraudulent financial results, and he provided these figures to Grace. He also reviewed Grace's financial statements and confirmed that the fraudulent results he had submitted were included in the Health Care Group segment disclosures. Thus, Armstrong was an active participant in the fraudulent scheme rather than an innocent bystander.

## 2. Scienter

Scienter is a necessary element of a violation of Exchange Act Section 10(b) and Exchange Act Rule 10b-5. <sup>48/</sup> Scienter has been defined by the United States Supreme Court as a "mental state embracing intent to deceive, manipulate or defraud." <sup>49/</sup> The record contains abundant undisputed evidence that Armstrong acted with scienter. Armstrong testified that he knew that Smith's sole reason for establishing the NMC excess reserves was to create the appearance of a growth rate for Grace's income that was different from Grace's true rate. <sup>50/</sup>

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<sup>47/</sup> See SEC v. U.S. Environmental, Inc., 155 F.3d at 112 (holding that someone who participates in a fraudulent scheme by committing manipulative acts may be liable as a primary violator despite the fact that someone else directed the scheme); see also In re Enron Corp. Sec. Litig., 235 F.Supp. 2d at 588 (holding that a person can be a primary violator provided the person writes misrepresentations for inclusion in a document to be given to investors even if the person did not initiate the misrepresentations and the idea for the misrepresentations came from someone else).

<sup>48/</sup> See Aaron v. SEC, 446 U.S. 680, 695, 697 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); Steadman v. SEC, 603 F.2d 1126, 1134 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981).

<sup>49/</sup> Ernst & Ernst v. Hochfelder, 425 U.S. at 193. Reckless behavior satisfies the scienter requirement. See, e.g., SEC v. Dain Rauscher, Inc., 254 F.3d 852, 856 (9th Cir. 2001); C.E. Carlson, Inc. v. SEC, 859 F.2d 1429, 1435 (10th Cir. 1988); see also SEC v. U.S. Environmental, 155 F.2d at 111.

<sup>50/</sup> For this reason, we find disingenuous Armstrong's arguments that he lacked scienter because he did not know NMC's false financial results would cause Grace's periodic

(continued...)



Armstrong calculated the amounts to be allocated to the excess reserve accounts in order to achieve the income growth rate targeted by Smith and provided NMC's financial results to Grace knowing that they contained the falsely calculated income and reserve figures. Armstrong conceded that no known contingencies justified the excess reserves and that the excess reserves did not accord with GAAP. Armstrong also knew at the time he recorded the excess reserves that those reserves would be used to increase income artificially at some later point. He was also aware that Grace used the NMC reports containing the misleading figures that he submitted to compile its financial statements and the Health Care Group segment disclosures in its Forms 10-K and 10-Q. Armstrong reviewed Grace's draft Forms 10-K and 10-Q and confirmed that they contained the earnings numbers that NMC submitted to Grace. He also knew that Price Waterhouse NMC believed that the excess reserves should be eliminated. We conclude that Armstrong knowingly participated in the fraudulent scheme.

Armstrong argues that a finding that he acted with scienter is inappropriate because he repeatedly discussed his belief that the excess reserves did not accord with GAAP with his supervisors at NMC, senior management at Grace, Grace's internal audit staff, and Price Waterhouse NMC. Armstrong's expressed concerns about the scheme, however, while establishing that he perhaps acted reluctantly, make clear that he acted knowingly. <sup>51/</sup> Armstrong's testimony about his conversations with others at NMC, Grace, and Price Waterhouse demonstrates that he knew that the excess reserves did not accord with GAAP but he nevertheless recorded the reserves and submitted reports to Grace that included these entries.

Armstrong next contends that he reasonably relied on the auditors at Price Waterhouse who issued unqualified audit opinions with respect to Grace's consolidated financial statements. This argument is without merit. When a respondent knows financial statements are false and misleading, he cannot "rely" in good faith on an auditor's willingness to issue an unqualified

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<sup>50/</sup> (...continued)

reports to contain material misstatements, he did not know what other liabilities existed for which the excess reserves might be needed, and he could reasonably assume that Grace's consolidation process would result in financial statements that did not contain material misstatements. Armstrong knew that the principal purpose and effect of the scheme was to deceive investors by creating materially false financial statements.

<sup>51/</sup> We also note that the record does not indicate that Armstrong ever raised his concerns specifically with Price Waterhouse Grace.

audit opinion with respect to those statements. 52/ Armstrong knew that the excess reserves did not accord with GAAP and that the excess reserves caused misstatements of the Health Care Group's results in Grace's financial statements. Armstrong also knew that Price Waterhouse NMC believed that the excess reserves did not accord with GAAP and wanted them removed and returned to earnings. 53/

Armstrong recorded the excess reserves and submitted them to Grace knowing that they did not accord with GAAP and that Grace desired the reserves for the purpose of earnings management. He also made entries reducing the reserves and increasing income when Grace instructed NMC to provide it with more income. Armstrong also knew that Grace used the numbers he submitted to compile drafts of its public filings related to the Health Care Group. He admits that he reviewed these drafts to confirm that the financial results included in those disclosures reflected the numbers he had reported to Grace. Finally, he acknowledges that he knew that the financial statements that Grace filed with the Commission reflected the excess reserves. Based on this extensive record evidence, we conclude that Armstrong participated with scienter in the fraudulent scheme to falsify Grace's earnings.

Armstrong committed deceptive acts as part of a scheme to defraud. He engaged in these acts with a high degree of scienter. Accordingly, we find that Armstrong willfully violated Section 10(b) of the Exchange Act and Rule 10b-5. 54/

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52/ United States v. Erickson, 601 F.2d 296, 305-06 (7th Cir. 1979); see also Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1314 n.13 (C.D. Cal. 1996); SEC v. DCI Telecommunications, Inc., 122 F. Supp. 2d 495, 500 n.2 (S.D.N.Y. 2000); Cf. Howard v. SEC, 376 F.3d 1136, 1147 (D.C. Cir. 2004) (stating that where respondent can show that he relied reasonably on the advice of an attorney, this may be evidence that respondent acted in good faith).

53/ See, e.g., United States v. Evangelista, 122 F.3d 112, 117 (2d Cir. 1997) (rejecting good faith reliance defense in tax evasion case where defendant's conduct was contrary to accountant's advice).

54/ Armstrong acted willfully in violating the antifraud provisions. Acting willfully means intentionally committing the act that constitutes the violation. There is no requirement that the actor also be aware that he is violating one of the Rules or Acts. Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976) (quoting Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965)); Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)); V.F. Minton Securities, Inc., 51 S.E.C. 346, 352 (1993), aff'd, 18 F.3d 937 (5th Cir. 1994) (Table). Armstrong acted willfully because he intentionally committed the deceptive acts.

B. Causing Violations of the Antifraud Provisions

Armstrong also was a cause of violations of the antifraud provisions of the securities laws. An individual is a cause of a violation if 1) a primary violation occurred; 2) the individual committed an act or omission that was a cause of the violation; and 3) the individual knew or should have known that his conduct would contribute to the violation. <sup>55/</sup> Armstrong participated in and caused a fraudulent scheme in violation of Section 10(b) of the Exchange Act and Rule 10b-5, whereby Grace issued financial statements that contained material misstatements. Armstrong was a cause of these violations by calculating and providing Grace with the figures that enabled it to report the fraudulent growth rates. Armstrong knew that his conduct would contribute to these violations because he knew that Grace incorporated these figures into its financial statements. As a result, Armstrong is liable as a cause of violations of the antifraud provisions.

C. Periodic Reporting Requirement Violations

Exchange Act Section 13(a) and Exchange Act Rules 13a-1 and 13a-13 require public companies whose securities are registered pursuant to Exchange Act Section 12 to file annual and quarterly reports with the Commission. The obligation to file these reports includes an obligation that the filings be accurate. <sup>56/</sup> The rules require that the reports comply with Regulation S-X, which in turn requires that financial statements be prepared in conformity with GAAP. <sup>57/</sup> Rule 12b-20 requires an issuer to provide any additional information in the reports necessary in order to make the reports not misleading. <sup>58/</sup>

Grace violated Exchange Act Section 13(a) and Rules 12b-20, 13a-1 and 13a-13 because its Form 10-K and Form 10-Q filings included financial statements that were materially false and misleading and that did not accord with GAAP. Armstrong was a cause of these violations because he calculated and recorded the excess reserves, submitted financial reports containing the effect of the reserves to Grace and, through his subsequent review of Grace's financial statements, ensured that his false figures had been incorporated into those statements. Armstrong knew that his conduct would contribute to the violations because he knew that Grace used these

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<sup>55/</sup> Robert M. Fuller, Exchange Act Rel. No. 48406 (Aug. 25, 2003), 80 SEC Docket 3539, 3545.

<sup>56/</sup> United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991).

<sup>57/</sup> The Rockies Fund, Inc., Exchange Act Rel. No. 48590 (Oct. 2, 2003), 81 SEC Docket 703, 729, reconsideration denied, Exchange Act Rel. No. 49788 (June 1, 2004), 82 SEC Docket 3764.

<sup>58/</sup> See SEC v. Falstaff Brewing Corp., 629 F.2d 62, 72 (D.C. Cir.) (holding that company violated Rule 12b-20 by failing to update Form 10-K that did not disclose certain material facts related to litigation), cert. denied, 449 U.S. 1012 (1980).

statements in preparing its public filings. As a result, we find that Armstrong was a cause of Grace's violations of its periodic reporting requirements.

D. Recordkeeping Violations

Exchange Act Section 13(b)(2)(A) requires issuers of securities registered pursuant to Exchange Act Section 12 to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the issuer. <sup>59/</sup> Exchange Act Section 13(b)(5) provides that no person shall knowingly falsify any book, record, or account subject to Section 13(b)(2)(A). Exchange Act Rule 13b2-1 provides that no person shall, directly or indirectly, falsify or cause to be falsified any book, record or account subject to Section 13(b)(2)(A).

Grace violated Exchange Act Sections 13(b)(2)(A) and 13(b)(5) and Rule 13b2-1 by recording the false and misleading entries concerning the excess reserves on its books and records and therefore maintaining books and records that did not accurately and fairly reflect its transactions and assets. Armstrong was a cause of Grace's violations of these provisions because he recorded the excess reserves on NMC's books knowing that they misstated NMC's financial results and transmitted these entries to Grace knowing that Grace would incorporate this information into its own books and records. Armstrong himself violated Exchange Act Rule 13b2-1 because he caused Grace's books and records to be falsified as a result of these actions.

E. Rule 102(e)

Rule 102(e)(1)(iii) provides that the "Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who . . . (iii) willfully violated . . . any provision of the Federal securities laws or the rules and regulations thereunder." Armstrong contends that, even if he is found to have willfully violated the securities laws, the Rule is nevertheless inapplicable to his conduct in this matter. Armstrong argues (1) that the Rule requires that he appear or practice before the Commission at the time of the misconduct underlying the willful violations and that his actions did not constitute appearing or practicing before the Commission; and (2) that the Rule applies only to licensed accountants and that he was no longer licensed as an accountant at the time of the misconduct.

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<sup>59/</sup> The law judge cites both Exchange Act Section 13(b)(2)(A) and 13(b)(2)(B) before concluding that Armstrong caused violations of Section 13(b)(2). Section 13(b)(2)(B) of the Exchange Act requires every reporting company to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. The Order Instituting Proceedings charged Armstrong with being a cause of Grace's violations of Section 13(b)(2) generally, and the parties did not address whether Armstrong was a cause of a violation of Section 13(b)(2)(B). Accordingly, we do not reach the issue of whether Armstrong caused a violation of Section 13(b)(2)(B).

1. Appearing and Practicing Before the Commission

The law judge found that Armstrong did not appear or practice before the Commission and that such a finding is necessary in order for the Commission to deny a person the privilege of appearing or practicing before it pursuant to Rule 102(e)(1)(iii). We reject that conclusion.

Even if Rule 102(e) is construed to require a person to have been appearing or practicing before the Commission while violating the securities laws, we reject the law judge's conclusion that Armstrong did not appear or practice because he was not an officer of a public company and did not prepare any of the reports that Grace filed with the Commission because he did not actually draft them. Rule 102(f) provides that "practicing before the Commission" shall include, but not be limited to:

- (1) Transacting any business with the Commission; and
- (2) The preparation of any statement, opinion or other paper by any attorney, accountant, engineer or other professional or expert, filed with the Commission in any registration statement, notification, application, report or other document with the consent of such attorney, accountant, engineer or other professional or expert. 60/

The text of the Rule does not specify that a person must sign a document filed with the Commission. Moreover, the term "preparation" of a document is, we believe, sufficiently broad to encompass the preparation of data to be included in a document filed with the Commission, at least where, as here, the data was prepared for the express purpose of being included in such a document.

The law judge's holding would allow accountants to escape discipline under Rule 102(e) simply by instructing someone else to draft, sign, and file fraudulent documents. The Rule, however, recognizes that financial statements often incorporate information created, compiled, or edited by accountants who are not responsible for signing or filing the financial statements. Thus, practicing before the Commission includes computing the figures and supplying the data incorporated into Commission filings and consenting to their incorporation. As a result, Armstrong appeared and practiced before the Commission because he computed the amounts of income needed to be held in reserve to achieve Grace's targeted growth rates, prepared the materially false financial reports based on these figures, and submitted this information to Grace knowing that Grace would incorporate it into its Commission filings. Armstrong consented to the inclusion of these figures because he reviewed Grace's draft financial statements containing these figures, confirmed that the figures reconciled with the numbers that he had submitted, and suggested no changes to the numbers.

Our conclusion comports with the remedial purpose of Rule 102(e). <sup>61/</sup> The Commission disciplines professionals pursuant to Rule 102(e) in order to "protect the integrity of its own processes." <sup>62/</sup> The Rule "provides the Commission with the means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence." <sup>63/</sup> The reliability of the disclosure process is impaired if incompetent or unethical accountants are permitted to certify financial statements. <sup>64/</sup> The reliability of the disclosure process is equally impaired if such accountants are permitted to participate in the preparation of financial statements certified and filed with the Commission. As a result, disciplining accountants pursuant to Rule 102(e) for effecting a fraudulent scheme by computing the figures and providing the information incorporated into Commission filings furthers the Rule's remedial purpose of protecting the integrity of the Commission's processes.

This interpretation also accords with the settled cases in which we have denied the privilege of appearing or practicing before the Commission to accountants serving as officers of privately-held subsidiaries of public companies who participated in fraudulent schemes to misstate the parent company's financial statements by providing fraudulent figures that were

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<sup>61/</sup> Congress embraced our application of Rule 102(e) by codifying the rule substantially verbatim in Section 4C of the Exchange Act as a result of the Sarbanes-Oxley Act of 2002. It is well established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the "congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress." Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 846 (1986) (citations omitted); see also Lorillard v. Pons, 434 U.S. 575, 581 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change[.] So too, where, as here, Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute.") (citations omitted); Cf. Herman & MacLean v. Huddleston, 459 U.S. 375, 384-85 (1983) (stating that Congress's decision to leave Section 10(b) intact while comprehensively revising the securities laws suggested that Congress ratified the well-established judicial interpretation of the implied private right of action under Section 10(b)); Davis v. Michigan Dep't of Treasury, 489 U.S. 803, 813 (1989) ("When Congress codifies a judicially defined concept, it is presumed, absent an express statement to the contrary, that Congress intended to adopt the interpretation placed on that concept by the courts.").

<sup>62/</sup> Touche Ross & Co. v. SEC, 609 F.2d 570, 582 (2d Cir. 1979).

<sup>63/</sup> Id.

<sup>64/</sup> Id. at 581.

incorporated into the parent company's reports filed with the Commission. 65/ Signing fraudulent statements filed with the Commission was not a prerequisite in any of these cases either for a person to have been appearing or practicing before the Commission or for a finding that discipline was warranted pursuant to Rule 102(e). 66/

In any event, the text of Rule 102(e) contains no requirement that a person must be appearing and practicing before the Commission at the time of the conduct on which the Commission's findings are based. Rule 102(e)(1) provides that a person may be denied the privilege of appearing or practicing before the Commission once the Commission makes one of three findings: (i) that the person does not possess the requisite qualifications to represent others; (ii) that the person lacks character or integrity or has engaged in unethical or improper professional conduct; or (iii) that the person has willfully violated or willfully aided and abetted

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65/ Robert S. Barton, Exchange Act Rel. No. 41181 (Mar. 18, 1999), 69 SEC Docket 1053 (denying privilege of appearing and practicing before Commission to vice president of finance of a private, wholly-owned subsidiary of a public reporting company who recorded fictitious assets and entries on the subsidiary's books to meet earnings targets); Maria Mei Wenner, Exchange Act Rel. No. 40290 (July 31, 1998), 67 SEC Docket 2157 (denying privilege of appearing and practicing before Commission to chief financial officer of privately-held subsidiary of public reporting company who prepared and sent to parent company monthly and quarterly reports that included fraudulent entries); Gary A. Prince, Exchange Act Rel. No. 38765 (June 24, 1997), 64 SEC Docket 2154 (denying privilege of appearing or practicing before Commission to accountant whose license had lapsed who served as officer of privately-held subsidiary of public reporting company and who participated in fraudulent scheme to overstate parent company's revenues).

The facts of Maria Mei Wenner are very similar to those presented here. Wenner was the chief financial officer of a privately-held subsidiary of a public reporting company who was responsible for compiling the subsidiary's sales and financial data which was then forwarded to the parent company. Wenner participated in a fraudulent scheme, orchestrated by her superiors, to overstate the parent company's revenue by booking millions of dollars of fictitious sales. She then prepared and sent to the parent company monthly reports and quarterly financial statements that included the fraudulent entries. The parent company's financial statements that were filed with the Commission included the effect of these fraudulent entries. We held that Wenner violated the federal securities laws and denied her the privilege of appearing or practicing before us as an accountant.

66/ While the cited authorities are settled cases, they reflect the Commission's established view that officers of privately-held subsidiaries of public companies who provide fraudulent figures that are incorporated into public company reports filed with the Commission are subject to Rule 102(e). See Herbert Moskowitz, Exchange Act Rel. No. 45609 (Mar. 21, 2002), 77 SEC Docket 481, 495-96 (rejecting respondent's suggestion that no precedent supported liability because settled cases reflected Commission's view that liability was appropriate in respondent's situation).

the violation of any provision of the federal securities laws or rules and regulations thereunder. Denying the person the privilege of appearing or practicing before the Commission is the authorized remedy once the Commission makes one of the findings specified in Rule 102(e)(1)(i)-(iii); appearing or practicing before the Commission at the time of the misconduct is not the precondition to imposing that remedy. Armstrong provides no compelling reason for imputing a requirement that a person must be appearing or practicing before the Commission at the time of the misconduct. Accordingly, we conclude that we have the authority to suspend Armstrong pursuant to Rule 102(e) because he willfully violated the federal securities laws.

We conclude that Armstrong in fact appeared or practiced before the Commission (assuming that Rule 102(e) imposes such a requirement) because he computed the figures and provided the data included in Grace's financial statements filed with the Commission and consented to the inclusion of this information. We further conclude that the Commission may discipline individuals pursuant to Rule 102(e) even if those individuals did not appear or practice before the Commission while committing willful violations of the securities laws.

## 2. Definition of Accountant

Armstrong's contention that Rule 102(e)(1)(iii) is limited to persons licensed to practice as accountants is incorrect. The text of the Rule contains no such restriction. Rule 102(e)(1)(iii) provides that the Commission may censure "any person" or deny "any person" the privilege of appearing or practicing before it if it finds that such person willfully violated the federal securities laws. The Rule does not limit the definition of "any person" to a person licensed to practice accounting. The integrity of the Commission's processes would be threatened, moreover, if unlicensed accountants or accountants whose licenses lapsed could escape discipline for willfully violating the federal securities laws. These accountants often serve as corporate officers, and the integrity of the Commission's processes is threatened when they execute fraudulent schemes by providing falsified financial information just as when licensed accountants engage in this conduct. We find that Armstrong's request that we limit the Rule to persons licensed to practice as accountants contradicts the plain language and the purpose of Rule 102(e).

Armstrong argues that the reference in subsection (e)(1)(iv) to "persons licensed to practice as accountants" indicates that the Commission intended to limit Rule 102(e) to licensed accountants. That subsection, however, merely defines the term "improper professional conduct" for purposes of Rule 102(e)(1)(ii). This definition is inapplicable to Rule 102(e)(1)(iii).

Armstrong's suggested reading of Rule 102(e) is contrary to principles of statutory construction. Drafters are presumed to act intentionally and purposely in including particular language in one section of a statute or rule but omitting it in another section of the same statute or rule. <sup>67/</sup> Where one subsection of a statute contains a phrase limiting that subsection and other subsections do not, courts generally have been reluctant to limit the other subsections because the drafters could have included the phrase had they intended the other subsections to be

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<sup>67/</sup> See Duncan v. Walker, 533 U.S. 167, 173 (2001).



similarly circumscribed. <sup>68/</sup> Thus, the fact that the drafters of the Rule included the phrase "person licensed to practice as accountants" in one subsection, even assuming that phrase was meant to limit the meaning of accountants rather than delineate the application of "improper professional conduct," does not mean that other subsections should be similarly limited. As a result, we reject Armstrong's contention that Rule 102(e)(1)(iii) applies only to persons licensed to practice as accountants and hold that he may be disciplined pursuant to that Rule. <sup>69/</sup> The Commission therefore has the ability to deny Armstrong the privilege of appearing or practicing before it pursuant to Rule 102(e).

#### IV.

Armstrong challenges our authority to decide this action on two grounds. Armstrong first contends that the five-year statute of limitations provided in 28 U.S.C. § 2462 and applied in Johnson v. SEC precludes us from considering violations that occurred before December 22, 1993. <sup>70/</sup> He states that the Commission instituted this proceeding on December 22, 1998, but the fraudulent scheme began before December 22, 1993. Armstrong's argument is without merit. We may consider acts outside the limitations period as evidence of a respondent's motive, intent, or knowledge in committing violations within the limitations period. <sup>71/</sup> The violations in this case were ongoing, and substantial portions of the misconduct underlying the findings of willful

<sup>68/</sup> See Florida Public Telecommunications Ass'n, Inc. v. FCC, 54 F.3d 857, 860 (D.C. Cir. 1995) (refusing to circumscribe subsection's applicability where other subsections contained a phrase limiting those subsections because Congress could have included the same phrase had it intended to circumscribe similarly that subsection).

<sup>69/</sup> This reading of the Rule also conforms with past settled cases in which we have suspended accountants under Rule 102(e)(1)(iii) who either were not licensed or who had allowed their licenses to lapse at the time of their misconduct. James A. Terrano, Exchange Act Rel. No. 39485 (Dec. 23, 1997), 66 SEC Docket 494 (lapsed license); Elliot Stumacher, Exchange Act Rel. No. 39124 (Sept. 24, 1997), 65 SEC Docket 1356 (not licensed); Gary A. Prince, 64 SEC Docket 2154 (lapsed license); Aura Systems, Inc., Securities Act Rel. No. 7352 (Oct. 2, 1996), 62 SEC Docket 2814 (lapsed license); Gerald M. Kudler, Exchange Act Rel. No. 36598 (Dec. 18, 1995), 60 SEC Docket 2871 (not licensed); Alan S. Goldstein, Exchange Act Rel. No. 34641 (Sept. 6, 1994), 57 SEC Docket 1544 (lapsed license).

<sup>70/</sup> Section 2462 provides a five-year statute of limitations for "an action, suit, or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." In Johnson v. SEC, the D.C. Circuit held that Section 2462 applied to a Commission administrative proceeding imposing a censure and suspension. 87 F.3d 484 (D.C. Cir. 1996).

<sup>71/</sup> See Sharon M. Graham, 53 S.E.C. 1072, 1089 n.47 (1998), aff'd, 222 F.3d 994 (D.C. Cir. 2000).

violations occurred within the limitations period. <sup>72/</sup> In fact, the misconduct occurring within the limitations period resulted in the deception of investors by grossly inflating Grace's income. As a result, Armstrong committed willful violations within the limitations period, and neither the cease-and-desist nor Rule 102(e) proceedings are time barred. <sup>73/</sup>

Armstrong next argues that the Commission should dismiss this proceeding because it has not been decided within a "reasonable period of time" as required by Section 555(b) of the Administrative Procedure Act ("APA"). <sup>74/</sup> He contends that the two and a half year delay occasioned by the Commission's interlocutory review of the law judge's dismissal of the Rule 102(e) charges constituted unreasonable delay. Armstrong contends erroneously that the interlocutory review served no purpose. The Commission's order directing the law judge to reinstate the Rule 102(e) charges avoided a subsequent second hearing on those charges after the conclusion of the initial hearing and the appeal therefrom. Armstrong's reliance on Section 555(b), moreover, is misplaced. <sup>75/</sup> The requirement that agencies act within a reasonable period of time is enforced through Section 706(1) of the APA which permits courts to compel

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<sup>72/</sup> The pre-1994 conduct may be used to establish Armstrong's motive, intent, and knowledge. Moreover, Rule 102(e) proceedings and cease-and-desist proceedings are remedial in nature. See, e.g., McCurdy v. SEC, 396 F.3d 1258, 1264-65 (D.C. Cir. 2005); Herbert Moskowitz, Exchange Act Rel. No. 45609 (Mar. 21, 2002), 77 SEC Docket 481, 500. Such proceedings are not subject to Section 2462. See Johnson, 87 F.3d at 489-90.

<sup>73/</sup> Armstrong observes that the Commission recently dismissed charges against a respondent based on the potential applicability of Section 2462 to all but a brief period of respondent's conduct. See Clarke T. Blizzard, Investment Advisers Act Rel. No. 2253 (June 23, 2004), 83 SEC Docket 362, 377-78. In Blizzard, we exercised our equitable discretion and dismissed charges against one of the respondents because of the potential applicability of Section 2462 to all but one week of the alleged misconduct and because we concluded that the conduct that occurred during that week was insufficient to find the respondent liable. Here, in contrast, at least a year of Armstrong's conduct occurred inside the limitations period and that period included some of Armstrong's most egregious misconduct in which he deceived investors by using excess reserves to inflate Grace's income.

<sup>74/</sup> To the extent Armstrong is arguing that this proceeding is barred by laches, the defense of laches is not available against federal agencies acting to protect the public interest. See United States v. Alvarado, 5 F.3d 1425, 1427 (11th Cir. 1993); David Disner, 52 S.E.C. 1217, 1223 (1997). Armstrong would also be required to establish prejudice if laches applied. See Danjac LLC v. Sony Corp., 263 F.3d 942, 954-56 (9th Cir. 2001).

<sup>75/</sup> Section 555(b) provides that "[w]ith due regard for the convenience and necessity of the parties or their representatives and within a reasonable time, each agency shall proceed to conclude a matter presented to it." 5 U.S.C. § 555(b).

agency action. 76/ These provisions typically are used to ensure agency action in rulemaking proceedings. 77/ Section 555(b) may not authorize dismissing enforcement proceedings. 78/

In any event, Armstrong has not made the required showing of prejudice resulting from a delay. 79/ Neither Armstrong's claim that the proceeding's pendency harmed his career 80/ nor his generalization that the long delay rendered witnesses unavailable and caused memory lapses establishes prejudice. 81/ Armstrong specifies three witnesses who became unavailable due to death or disability. He alleges that their testimony that Grace's senior management and auditors vetted the reserves would have bolstered his defense. Our finding that Armstrong acted with

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76/ Section 706(1) provides that a court shall "compel agency action unlawfully withheld or unreasonably delayed." 5 U.S.C. § 706(1).

77/ See, e.g., In re International Chemical Workers Union, 958 F.2d 1144 (D.C. Cir. 1992) (ordering OSHA to issue rule); see also Public Citizen Health Research Group v. Comm'r, Food and Drug Administration, 740 F.2d 21, 32 (D.C. Cir. 1984) ("These provisions give courts authority to review ongoing agency proceedings to ensure that they resolve the questions in issue within a reasonable time."), disapproved on other grounds, TRAC v. FCC, 750 F.2d 70 (D.C. Cir. 1984).

78/ See United States v. Popovich, 820 F.2d 134, 138 (5th Cir.) (stating that the plain language of the APA indicates that Section 555 and 706 may be used to compel but may not be used to dismiss agency action unreasonably delayed), cert. denied, 484 U.S. 976 (1978). But see Kenneth Sebren, 1998 EPA ALJ Lexis 116 (Oct. 7, 1998) (dismissing enforcement action for violating Section 555(b)); Health Care Products, 1996 EPA ALJ Lexis 142 (June 13, 1996) (same).

79/ Panhandle Coop. Ass'n v. EPA, 771 F.2d 1149, 1153 (8th Cir. 1985).

80/ See Feeley & Willcox Asset Management Corp. and Michael J. Feeley, Order Denying Motion for Reconsideration, Securities Act Rel. No. 8303 (Oct. 9, 2003), 81 SEC Docket 919, 923 n.15 (finding no prejudice from respondent's assertion that years-long delay rendered his professional livelihood and ability to continue making a living uncertain).

81/ See Anthony A. Adonnino and Thomas Cannizzaro, Exchange Act Rel. No. 48618 (Oct. 9, 2003), 81 SEC Docket 981, 997 (finding no prejudice despite applicants' claim that delay rendered witnesses unavailable and impaired memories because applicants did not identify witnesses who became unavailable or point to specific instances of material memory lapses), aff'd, No. 03-41111 (2d Cir. 2004). Armstrong cites one witness's faded memory but fails to show that this lapse prejudiced his case. See Jacob Wonsover, Exchange Act Rel. No. 41123 (Mar. 1, 1999), 69 SEC Docket 694, 715 ("[N]ot every loss, and particularly not every loss of memory, will prejudice the defense of a case.") (citation omitted), petition denied, 205 F.3d 408 (D.C. Cir. 2000).

scienter despite any reliance on Grace's management or auditors belies this notion. <sup>82/</sup> As a result, dismissal is unwarranted because Armstrong demonstrates no prejudice from any alleged delay.

V.

The Commission has broad discretion to set sanctions in administrative proceedings. <sup>83/</sup> Armstrong maintains that there is no basis in the public interest for the imposition of a cease-and-desist order. <sup>84/</sup> He contends that he had no responsibility for Grace's financial statements and that he acted reasonably under the circumstances. Conversely, the Division contends that the cease-and-desist order imposed by the law judge is warranted and that we should also deny Armstrong the privilege of appearing or practicing before the Commission. The Division contends that Armstrong remains a threat to the integrity of the Commission's processes.

A. Cease-and-Desist Order

In KMPG Peat Marwick LLP, we stated that the range of traditional factors relevant to a determination that a sanction is in the public interest guide our discretion in imposing a cease-and-desist order. <sup>85/</sup> These factors are:

the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future

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<sup>82/</sup> See Mark H. Love, Exchange Act Rel. No. 49248 (Feb. 13, 2004), 82 SEC Docket 686, 695-96 (finding no prejudice from death or infirmity of potential witnesses because NASD based its decision on undisputed facts and therefore these individuals' testimony was immaterial); Kingsley, Jennison, McNulty & Morse, Inc., 51 S.E.C. 904, 911 (1993) (finding no prejudice from death of key potential witness because Commission based its findings on other testimony).

<sup>83/</sup> See, e.g., Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 188-89 (1973) ("The fashioning of an appropriate and reasonable remedy is for the Secretary [of Agriculture], not the court. The court may decide only whether under the pertinent statute and relevant facts, the secretary made 'an allowable judgement in [his] choice of the remedy.'") (quoting Jacob Siegel Co. v. FTC, 327 U.S. 608, 612 (1946)).

<sup>84/</sup> Section 21C provides that the Commission may order any person who violated any provision of the Exchange Act or rule or regulation thereunder, or caused such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. 15 U.S.C. § 78u-3(a).

<sup>85/</sup> KPMG Peat Marwick LLP, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 74 SEC Docket 384, 436, reconsideration denied, Exchange Act Rel. No. 44050 (Mar. 8, 2001), 74 SEC Docket 1351, petition denied, 289 F.3d 109 (D.C. Cir. 2002).

violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. In addition, we consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings. This inquiry is a flexible one and no one factor is dispositive. 86/

Moreover, we held that, in imposing a cease-and-desist order, we must determine that there is some risk of future violation. 87/

Applying the above factors to Armstrong's violations, we find that most of them weigh in favor of a cease-and-desist order. The principal purpose and effect of Armstrong's conduct was to deceive investors through the filing with the Commission of materially misstated financial statements for Grace for all of its required periodic filings from the end of 1991 until the first quarter of 1995. 88/ As discussed above in finding that Armstrong violated the antifraud provisions, he acted with the highest degree of scienter. He knowingly engaged in conduct that he knew would result in materially false filings with the Commission. He knew that the purpose of the fraudulent scheme was to mislead investors as to Grace's true income growth rates.

Armstrong has not offered any assurances against future violations. In fact, his failure to recognize the wrongful nature of his conduct and his continued insistence that he acted appropriately raise troubling questions about his understanding of his obligations under the securities laws. His occupation presents ample opportunities to commit future violations.

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86/ Id.; see also Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981).

87/ KPMG Peat Marwick LLP, 74 SEC Docket at 429. The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction. Id. at 435. We consider the entire record because 28 U.S.C. § 2462 does not apply to cease-and-desist proceedings. See Edgar B. Alacan, Exchange Act Rel. No. 49970 (July 6, 2004), 83 SEC Docket 842, 870.

88/ See Geiger v. SEC, 363 F.3d 481, 489 (D.C. Cir. 2004) (affirming cease-and-desist order because respondent's egregious conduct justified inference that violation would be repeated and respondent's assertion that he did nothing wrong did little to dispel this inference). In Geiger, respondent acted egregiously even though others devised the scheme because he participated despite numerous indicators suggesting an unregistered distribution. See Charles F. Kirby, Exchange Act Rel. No. 47149 (Jan. 9, 2003), 79 SEC Docket 1081, 1104-06. Similarly, Armstrong acted egregiously even though Grace directed the scheme because he created the fraudulent entries despite several indications that his conduct constituted growth rate manipulation. See also Alacan, 83 SEC Docket at 868 (imposing cease-and-desist order based on respondent's egregious conduct raising a sufficient risk of future violation).

Armstrong currently works as a chief financial officer for a private company and intends to continue working as a financial executive.

The harm to investors and the marketplace when corporate officers misrepresent company earnings cannot be overstated. <sup>89/</sup> Investors who buy or sell stock based on the erroneous information are harmed greatly. The public's confidence in the marketplace erodes when the fraudulent scheme is exposed. <sup>90/</sup>

The only KPMG factor that militates against imposition of a cease-and-desist order is that Armstrong's violations are not recent. We find, however, that this consideration is outweighed by the other factors previously discussed. <sup>91/</sup> An additional factor, not mentioned in KPMG, deserves consideration here. While we disagree with Armstrong that his efforts to express his concerns about the impropriety of the excess reserves absolves him of liability for his participation in the scheme, there is no dispute that he did make such efforts. Given, however,

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<sup>89/</sup> Dissemination of false or misleading information by companies to members of the investing public may distort the efficient workings of the securities markets and injure investors who rely on the accuracy and completeness of the company's public disclosures. SEC v. Dresser Indus., Inc., 628 F.2d 1368, 1377 (D.C. Cir.), cert. denied, 449 U.S. 993 (1980). Indeed, in addition to the heavy sanctions obtained against the other corporate officers of both Grace and NMC, the Commission obtained a cease-and-desist order against Grace together with an order requiring Grace to establish a fund of \$1 million to be used to further awareness and education relating to financial statements and generally accepted accounting principles. W.R. Grace & Co., Exchange Act Rel. No. 41578 (June 30, 1999), 70 SEC Docket 170.

<sup>90/</sup> Cf. Schellenbach v. SEC, 989 F.2d 907, 913 (9th Cir. 1993) ("An action brought by the Commission, however, unlike a private damage suit, need not include proof of harm. Securities regulations are designed to protect the general public. Schellenbach's falsification of records exposed Brook's customers to undue risk and it deprived investors of the protections that Congress and the executive branch have put in place . . . . Thus, Schellenbach's depiction of his crime as a victimless offense is inaccurate.") (citations omitted).

<sup>91/</sup> See, e.g., City of Miami, Florida, Exchange Act Rel. No. 47552 (Mar. 21, 2003), 79 SEC Docket 3362, 3382-83 (imposing cease and desist order despite age of the misconduct because cease-and-desist order helps prevent future violations where respondent made repeated misrepresentations in its financial statements, respondent's misstatements caused investors to purchase respondent's bonds without full information, and respondent shifted blame to others without taking any responsibility for its own conduct).

that no additional sanctions have been sought against Armstrong 92/ and the degree to which the other factors weigh in favor of a cease-and-desist order, we believe that the public interest warrants a cease-and-desist order. 93/

We conclude that Armstrong's misconduct demonstrates a sufficient risk of future violations and that it is in the public interest to order Armstrong to cease and desist from committing or causing any violations or future violations of the applicable provisions of the federal securities laws and the Commission's rules.

B. Rule 102(e) suspension

These same factors could provide a basis for us to conclude that Armstrong should be disciplined pursuant to the Commission's Rule 102(e). Rule 102(e) is designed to protect the integrity of the Commission's processes, and we fulfill this mandate by suspending accountants who violate the antifraud provisions of the securities laws. Nonetheless, in light of the unique

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92/ The Commission does not have the authority to seek additional sanctions against Armstrong in an administrative proceeding, see Exchange Act Section 15, 15 U.S.C. § 78o, but the Commission could have sought injunctive and further relief in court. See Exchange Act Section 21, 15 U.S.C. § 78u. Rule 102(e) is not used as an additional weapon in the Commission's enforcement arsenal but rather to determine whether a person's professional qualifications, including his character and integrity, are such that he is fit to appear and practice before the Commission. Touche Ross, 609 F.2d at 579.

93/ See Charles K. Seavey, Advisers Act Rel. No. 2119 (Mar. 27, 2003), 79 SEC Docket 3455, aff'd, 111 Fed. Appx. 911 (9th Cir. 2004). In Seavey, we imposed sanctions, including a cease-and-desist order, on a mutual fund manager who sent investors a letter knowing that the letter contained material misstatements and omissions. We recognized that the respondent attempted to persuade his supervisors to disclose the problems with the fraudulent transaction and tried to undo the damage caused by the fraudulent scheme, but we imposed the sanctions because the respondent's arguments demonstrated a lack of appreciation for his responsibility as an associated person of an investment adviser.

circumstances here, we have determined, as an exercise of our equitable discretion, not to impose any suspension pursuant to Rule 102(e)(1)(iii) here.

An appropriate order will issue. 94/

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID, ATKINS, and CAMPOS).

Jonathan G. Katz  
Secretary

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94/ We have considered all of the parties' contentions. We have rejected or sustained these contentions to the extent that they are inconsistent or in accord with the views expressed in this opinion.



UNITED STATES OF AMERICA  
before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Rel. No.51920 / June 24, 2005

ACCOUNTING AND AUDITING ENFORCEMENT  
Rel. No. 2264 / June 24, 2005

Admin. Proc. File No. 3-9793

In the Matter of  
ROBERT W. ARMSTRONG, III

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that Robert W. Armstrong, III cease and desist from committing or causing any violations or future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rules 10b-5 and 13b2-1 thereunder; and from causing any violations or future violations of Sections 13(a), 13(b)(2), and 13(b)(5) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

By the Commission.

Jonathan G. Katz  
Secretary