

**Securities and Exchange Commission Historical Society
Interview with Claudius Modesti
Conducted October 22, 2019 by Kenneth Durr**

Lucy Harvey: Hi, I'm Lucy Harvey. I'm here at the Washington DC offices of Akin Gump with Claudius Modesti. It's Tuesday, October 22nd, 2019 and we're doing an oral history on the founding of the Public Company Accounting Oversight Board for the SEC Historical Society. Claudius, thanks for joining us.

Claudius: Hi Lucy. It's a pleasure to be here.

Lucy Harvey: Claudius, tell us about your early career and your path to the PCAOB.

Claudius: Certainly. I was a Georgetown University undergrad and from there I eventually made my way to law school at Georgetown. I started at a large corporate law firm in New York City, but in my third year of law school I decided I wanted to clerk for a federal judge, and I was privileged enough to clerk for a federal judge in Baltimore. And then out of that clerkship, I was speaking to a former college and law school classmate who was working at SEC Enforcement, and I told him I was heading back to New York to my law firm and he said, "Why don't you come down or stay here in the Washington area and do SEC Enforcement work? It's a great time to be at the SEC."

Claudius: So, I talked my wife into not moving back to New York City. We went to SEC Enforcement for four years. I had the great privilege of working there with terrific people, doing very important work. I wanted to litigate so I went to the Criminal Division of the Department of Justice. Then from there I became an AUSA in the Eastern District of Virginia, US Attorney's Office. And that was my last stop before I made it to the PCAOB.

Lucy Harvey: Tell me about your interview at the PCAOB.

Claudius: It all started when I got a call from Board Member Charley Niemeier. Charley and I didn't know each other. I met him I think a year before in a five-minute conversation. And he called me and said, "Are you interested in being the Director of Enforcement, the PCAOB. I told him I was highly flattered, but I thought I was working the best job I could've ever have asked for as an AUSA. He said, "Well, let's just chat and see where it goes from there."

Claudius: So, we talked and he talked me into coming in to meet Bill McDonough, the Chairman and the other Board Members. And I'm very glad I did that and I'm very glad Charley Niemeyer called me that day.

Lucy Harvey: Describe your first day of work.

Claudius: So, the first day of work, I arrived at the PCAOB here on K Street, at their offices. We had four employees. I had met some of them during my interview process. We didn't have any rules in place. The SEC hadn't approved our rules. We had our own fax machine. That was a good start. And we got to work. And we started figuring out how to build the house. And I felt like the general contractor. I had to find people and processes to make it all come together.

Claudius: We slowly but surely started to do that. We started a tips and complaints process because the board wanted people to have access to our oversight programs. And we started to develop processes for investigations and preparing for litigation and things along those lines.

Claudius: So, it was a very heady time. It was a very exciting time and I think we all felt that if we all rowed in the same direction, the boat would keep moving forward.

Lucy Harvey: You told me a very funny story earlier about getting to your desk and you had just that, a desk.

Claudius: Yeah, so on the second day I was there, I had to give a speech at what was then called PCAOB Speaks, something that I believe PLI had sponsored. And the staff had prepared my speech before my arrival. I think I had a couple of hours to review it. They did a terrific job. And there I was in front of maybe 250 people at PLI, under the spotlight, being introduced as the Enforcement Director. So, I gave my speech, I threw in a line from a Bob Dylan song, The Times They Are Changing. I think I said something about if you don't start swimming, you're going to sink like a stone.

Claudius: And in the course of that speech, I was asked some questions. And one of my former colleagues at the SEC raised his hand and said, "Claudius, what do you think about this... Congressional investigation regarding the... Audit firm." I had no idea what he was talking about. I immediately deflected the question. I turned it to a subject I knew something about, and I came off that platform at PLI thinking, I've got a lot of work to do to be even better prepared for this job.

Lucy Harvey: That's pretty good. You are credited with building the enforcement team from its inception. So, who were you looking for? What type of person were you looking to hire and was it difficult to connect people?

Claudius: So, one reason I took the job was because I wanted the entrepreneurial opportunity to work in the public interest and get the chance to lead people. Initially, I think a lot of people did not think working for the PCAOB was the best opportunity, we were a fledgling regulator with a relatively unknown future about where all this would go. But over time, I attracted the people that could do investigative work because we had to start investigations. And with the help of my initial employees, we started to attract more and more people with strong investigative skills, many of which had come out of SEC Enforcement.

Claudius: Later we started to attract people with litigation backgrounds because we had to start litigating cases. So, we tried to be anticipatory about what we needed in terms of the program, but with a lot of help from a lot of terrific people, and we were able to put the program together that way. Accountants and lawyers are not known for their risk taking. I felt the people who came on board at that time were willing to take on professional risks because of the uncertainties about where this organization would go. Would it have a significant place in the regulatory landscape? How would the audit firms react to regulation? How would the rest of the capital markets react to regulation? Could we make it happen?

Claudius: So those are the types of things we had to do. And there was a strong esprit de corps in our organization. We were scrappy. We held together well. We brainstormed a lot. We realized we were all in the same boat and that we needed to work well together. And I think that esprit de corps carried us forward for a long period of time.

Claudius: We went so far as to form a softball team. I don't recommend doing that as a new organization because there are a lot of organizations in this town that have excellent softball programs and a lot of stringers on those teams. But we went out there, we invited other divisions within the PCAOB to join us, and we even came up with a name, PCAOB SOX, S-O-X, which we thought was pretty clever given the name of the Act and the name of certain major league baseball teams.

Claudius: So, we did things like that to enhance the experience and to build morale. The only regret I have about that softball team is that Chairman Mark Olson came out for one of our games and believe it or not, I managed to strike out in front of Chairman Olson.

Lucy Harvey: Very good. You developed the PCAOB's policies and procedures for identifying matters for investigations and then eventually led more than a hundred investigations in a year. So how did you go about that process for conducting an investigation? Developing that?

Claudius: First thing we had to figure out is, what should we be considering as a source of an investigation? The Sarbanes-Oxley Act said that we could consider any source. We weren't limited in our sources. So we built a team to do what we called case intake. And it was a team made up of accountants. We had a very experienced accountant who took responsibility for that team. And what they did is they looked at restatements of SEC companies, they looked at other SEC filings, they looked at trends and the change of auditors. There were companies that would migrate from an auditor that was sanctioned by the SEC or the PCAOB to another auditor.

Claudius: We looked at short seller reports, obviously looked at the tips that came in. We got analysis from the Office of Risk Analysis, which is now the Office of Economic and Risk Analysis. And we got other referrals from other agencies. So

we used that process to give us the right inputs so we could decide how to investigate.

Claudius: And then there was a question of document demands, how to take effective testimony. And then we developed our version of the Wells process, which was important. Out of fairness, we weren't required to do it, but we decided we would give the other side a lot of detail about why we thought they did something wrong under the Board's standards and a fair and complete opportunity to respond to our preliminary allegations. So that, one, they felt they were being treated fairly, but two, we wanted to refine our thinking about what a good case was.

Claudius: And so those are the types of things we did. And then over time we had an extraordinary cooperation policy that the Board issued under Chairman Doty. And that gave people an idea about how they could get credit for voluntarily providing information that they didn't have to provide, self-reporting, remedial acts, things like that, which was very important to that aspect of the enforcement program.

Lucy Harvey: So, you really saw it grow over time.

Claudius: That was the arc, the benefit of being there as long as I was there was to see that arc, to see that narrative develop over time, and to see the progress and the evolution. Absolutely.

Lucy Harvey: How did you manage your external relationships and particularly with the SEC Enforcement division, because you had overlapping areas?

Claudius: Correct. So the Congress left that overlapping jurisdiction over the outside auditors and left it to us and the SEC to work out the most effective way to divide up the labor, so to speak, as to how to approach those matters that involve those outside auditors. Because I had come out of SEC Enforcement, I had such a high regard for the SEC Enforcement function and for the people there. And I told my initial staff and all the staff that came after them that I always wanted to make it a top priority, that we worked well in the sandbox with SEC Enforcement and with any counterparts we had, whether they be domestic regulatory counterparts or foreign regulatory counterparts.

Claudius: When I was a DOJ prosecutor, I had heard horror stories about regulators who did not work well and coordinate well with other regulators. And even when the leadership had changed over at those regulators, that negative reputation, it still stuck with them. I did not want to leave that legacy behind. And my staff worked very hard day to day working with the SEC Enforcement staff. So we had a lot of coffees, a lot of lunches, a lot of breakfasts, where I talk through with leadership at the SEC across the country, how can we add value to what we need to do to protect investors and improve audit quality? And what's the most effective way that we can share information and coordinate cases?

Claudius: And over time we had great success because I think with the hard work of my staff, we convinced the SEC staff that we were people that can be trusted in that cooperative process.

Lucy Harvey: There were definitely times when there was tension with the SEC, wasn't there?

Claudius: Yeah. And I think the tension was born out of the fact that we were the new regulator. People weren't sure what our position was going to be in this regulatory world. And it was a function in terms of enforcement that the SEC had exclusively had over outside auditors. And so, I imagine there were people at the SEC disappointed about that outcome under Sarbanes-Oxley, that this other regulator had been stood up.

Claudius: And so there was, I would say, a healthy dose of skepticism, about whether we were going to be cooperative, whether we were going to try to get ahead of the SEC, were we going to ambush them by bringing cases without telling them about it. Were we going to embarrass them by bringing cases that we wouldn't tell them about? And so, I think we had overcome that initial dose of skepticism and concern. And I think we did that over time. But at first you felt like you had to prove yourself as being cooperative, that you weren't always going to get the benefit of the doubt. So, it was a process over time of relationship building. But I think it landed in the right place.

Lucy Harvey: Tell me, at what point did you feel like you had your core team in place?

Claudius: So, as we attracted people with investigative skills, litigation skills, other skills that we needed, including people who understood databases, document productions, I decided that we should build out our leadership team. And we had three deputy directors we hired, Jerry Decker who became our Chief Litigation Counsel, Kyra Armstrong who became Deputy Director as an enforcement attorney, and Ray Ham who was the Deputy Director of enforcement as an accountant.

Claudius: So, we were able to put that team together, which was a very solid and robust team. And then we added to that, we opened eventually a New York office. We wanted to attract talent there. We wanted to build a relationship with SEC Enforcement there, eventually with FINRA there as well. And then as we continued to build out the program, we attracted people like Mark Adler, who's as we speak today, the Acting Director of Enforcement and who became the Deputy Chief Litigation Counsel under Jerry Decker for the time, and eventually took Jerry's place.

Claudius: So, we felt like we had very experienced people who were public interest minded and very devoted and committed and hardworking for the purposes of the PCAOB mission.

Lucy Harvey: How do you think the profession viewed you and interacted with you?

- Claudius: When I first got there, I was expecting there to be a lot of resistance, because I don't think anyone who works in the private sector is particularly pleased about regulations. There're certain amounts of regulation that we accept for the good of society and the good of the markets, but I don't think anyone wished this development upon themselves if you're in the accounting industry. But I was surprised that the interactions I had with, especially with the larger firms, I thought they were very reasonable in their concerns and the points they raised. I remember meeting with each of the general counsels of the large firms and surprisingly, or maybe not surprisingly, I should say, they all had a consistent list of concerns they wanted to raise with me in terms of our processes and policies. You would expect that we did disagree on many points, but there were some points we agreed on. They asked me if we could provide prompt notice to people when we closed an investigation, bring finality to the situation in a fairness to them. And we agreed that was a sound policy and the Board was okay with that.
- Claudius: And so, I felt like that give and take was a healthy amount of give and take. We knew we had to maintain an independent perspective as the regulator, but I do think when you regulate people, you need to have that give and take to make sure you're considering other people's perspectives as you go about your job of overseeing an industry. And I felt like we accomplished that through some of those communications.
- Lucy Harvey: The first million-dollar penalty came on December 10th, 2007. Deloitte was sanctioned with a disciplinary order and *Treasure and Risk* magazine's headline was, the PCAOB Seems to Have Teeth. So, tell me about that first case and the reaction to it.
- Claudius: So that was our first case where we disciplined a large accounting firm. And it was a situation where the firm was aware of the quality, the poor quality of work being done by the audit partner on that audit. Eventually, another auditor took over the audit from the firm and the company had to go through a pretty significant restatement, and if I remember correctly. And as we were investigating and we discovered information to suggest that the firm was on notice, that this partner probably should not continue auditing public companies, but they didn't reassign him promptly. And we decided, and the Board agreed that that was an appropriate situation where the firms should be held accountable to send a deterrent message to firms that as they become aware of personnel who aren't making the grade in terms of audit quality, that they need to protect the audit and protect investors by making the right decision.
- Claudius: So, we brought that case for that message purpose. We also brought a case against the engagement partner because individual accountability is equally, and in many cases even more important for purposes of investor protection, improving audit quality. But that was certainly a significant milestone for us because I think people expected that that was the type of case the SEC would do. And that now that we were doing that type of case as to a large audit firm,

in some ways, we had arrived in terms of our enforcement function. And my staff did a terrific job on the case.

Lucy Harvey: How closely did you work with the other divisions and particularly inspection?

Claudius: One thing we prided ourselves in, and again I have to give the credit to my staff, is we wanted everyone in the building, particularly the Board, but the other divisions to know that we wanted to work well with them and coordinate well with them, help them do their jobs well and ask for their help to help us do our jobs well. Inspections, being the largest of the divisions with the most significant oversight function at the board, was critical in that type of mix. And so it was George Diacont at the time, I worked with him and his staff to come up with a process with my staff where we could identify the appropriate referrals that would come out of inspection findings, that they thought and ultimately we thought were significantly deficient and significantly serious so that it deserved enforcement scrutiny. So, we developed that process. Over time it evolved, but it became a very robust and significant process for our purposes.

Claudius: We also knew that vis-a-vis enforcement, we had a comparative advantage on identifying certain audit failures through the inspections process, and we wanted to make sure whatever signals were coming out of that inspections process indicating where some of the emerging areas of higher deficiency were, that we were on top of that. And I think over time, that worked really well.

Claudius: We also work with the International Affairs office closely on negotiating with our counterparts. And I think we can talk about that a little bit later but. We tried to integrate ourselves into all the functions of the Board so that we could work well together.

Lucy Harvey: So, you had a pipeline of information?

Claudius: That's right. That's right. So, we had a flow of information that came out of the inspections process that we could assess and use to determine whether we should open an investigation. We tried to use the data coming out of that process to corroborate the other things we knew about where there were emerging issues of risk.

Lucy Harvey: Let's move to international. Tell me the challenges you had with foreign enforcement actions.

Claudius: So, the first challenge is, if you open a case on a foreign auditor, is will they provide work papers? Will they cooperate? And most of the time the foreign auditors understood their obligations under the Sarbanes Oxley Act. If they are registered with us, they had to cooperate. But that didn't mean you didn't have to overcome privacy issues, data protection issues. If we had an agreement with our foreign counterpart to coordinate our investigations, we wanted to honor

that and work well with our foreign counterparts. So that was a process that had to be baked into our investigative timeline and so we would do that.

Claudius: And then if you want to talk to people abroad, usually you had to go abroad. And so, my staff was willing to go to all corners of the earth to take testimony. I don't believe they ever went anywhere that was a risk to them because we wanted to look out for their welfare. But there were long hours, difficult travel. Eventually we had an investigation involving a large firm's India Firms in the Satyam matter, and my staff had to go there and take testimony over several weeks.

Claudius: We eventually brought that case, which I believe was our first significant foreign audit case. We brought a case in parallel with the SEC. The SEC used the information that we developed to bring their case. So, it was opportunity for very strong coordination and cooperation, and I think it was an important message case in terms of our role among foreign auditors and audit quality.

Claudius: And then over time we had to engage with China. That issue came up. And I and members of my staff, the International Affairs office, we negotiated the memorandum understanding under Chairman Doty's leadership with the Chinese authorities. And then we had the going forward effort to try to implement that agreement. And so that was a work in progress. And I think I'll probably leave it at there. I know that's still an issue for both the SEC and the PCAOB as we speak, and I think that's probably as far as I'll go with that. But those are the types of things we were engaged in.

Lucy Harvey: Tell me, when did you feel that your division, which had grown from just a handful of people had reached maturity?

Claudius: Always a hard question to answer, so you tend to use case milestones to figure out whether you feel like all of your hard work has paid off in terms of what you were designed to achieve in terms of investor protection and improving audit quality. I would say that we came to our maturity when we brought the large firm affiliate in Brazil case. It started as an inspection referral. As it turns out, they were obstructing the inspection process by giving them false documents.

Claudius: And then we came in investigatively, they gave us false documents. And then my staff figured it out by looking at metadata and comparing documents, that the documents did seem to be the same. And we started picking at it and speaking to people at the firm. And then a cooperator came in and acknowledged that that what was going on. We had already identified the issue and we got the cooperation that was very helpful. And he even supplied audio tapes of the conversation he was having with one of the assurance partners and the assurance partner was telling him to take care of things on his computer, not to talk about it, and I gave a speech after the case was brought. I gave a speech at the AICPA where I read word for word in an English translation what was said on that audio recording. It was an iPhone recording. And you could've

heard a pin drop at the AICPA because I don't think people fully realized what type of shenanigans had been going on and how troublesome this behavior was.

Claudius: So I felt that given the risks we took in going into these cases abroad with all of the dimensions and challenges we had talked about, and the hard gumshoe work that we did to determine that the documents had been improperly altered, and to bring the type of case we brought. So it's the most significant fine against a firm and I think sanctioning 14 people, including the former chairman and CEO of the firm, in that sense it was very monumental for the program and for the Board's interest in improving audit quality, holding people accountable and ultimately establishing the right deterrent message.

Lucy Harvey: You served as the, I think, Vice Chairman of the enforcement working group of IFIAR, which of course is the International Forum of Independent Audit Regulators. So, tell me about that collaboration. Was that useful?

Claudius: Absolutely. And it was one of my highest pleasures to work with my foreign counterparts. So, we had formulated an idea to form this enforcement working group in the context of IFIAR. And our Japanese counterparts were very interested in leading that and we were very interested in supporting them in that leadership. And we together combined with our other colleagues across the IFIAR membership to form this group.

Claudius: And over time, we held workshops where we did training of the enforcement function, shared ideas about what an effective enforcement function looks like, deal with issues of technology, things along those lines. And I think that relationship building we did and the confidence building we got out of that relationship building, was critical for us moving forward in our respective enforcement regimes. We in the United States in particular, had cases that were reaching into these different countries and it was important to have the right relationships with those counterparts so that they trusted what we were doing. Even though we had that extra territorial jurisdiction, it was important to have that trust and confidence in the people that were performing the function. So I consider that another high point of the enforcement division's efforts because it gave us an opportunity to demonstrate again our cooperative approach in a different setting.

Lucy Harvey: What are some of the changes that you saw over your 14 years in kind of the nefarious activities that were underlying your investigation?

Claudius: So, from the very beginning, we were looking at significant audit failures, independence matters, non-cooperation with inspections and enforcement. But I think the thing that surprised a lot of us was the prevalence of improper document alteration. We started to bring cases against individual partners at large audit firms for improperly altering documents ahead of inspections or connection with inspections. But then we started experiencing firm-wide behavior such as in Brazil. And we are just surprised how far that went.

Claudius: So, we started getting the message out that we were bringing these cases, we were looking at other cases. We had extraordinary cooperation policy and people started phoning in and explaining that they had uncovered improper document alteration, or they suspected improper document alteration, and they wanted to bring it to our attention. I believe most people make the calculus that there is a pretty strong likelihood they're going to get caught and they want to get credit for calling it in, given some of the punishments that could face.

Claudius: So I believe that evolution was very important because by making our mark that way, not only were we giving people a chance to get cooperation credit, but we were also altering behavior and people were taking this type of conduct more seriously. The message was getting out internally at the firms that the firms weren't going to tolerate it, and the regulator clearly wasn't going to tolerate it. And I think for the integrity of the profession, it was an important moment so that the profession had that opportunity to step up and say, "We're going to do the right thing here." And I think that came together in good measure, because of our regulatory efforts.

Lucy Harvey: So just to wrap it all up, what are you most proud about regarding the creation of the PCAOB enforcement division and your leadership of it?

Claudius: The thing I'm most proud of is how I believe we made an appropriate difference in improving audit quality and protecting investors. It was an evolution. It was through the hard work of my colleagues in PCAOB enforcement. I had the privilege of leading them, but it was their day to day hard work and smarts and talent and collegiality that made that all work. And I think over time, people understood that... And when I say people understood, you have the vast majority of people who act ethically in the profession and in the capital markets. And you have those few bad apples. And I think what we contributed to is the idea that there's a higher chance you're going to get caught if you're going to engage in shenanigans. And if you're going to get caught, you're going to get punished in a way that's going to make the misconduct not worth it.

Claudius: And realizing of course we're in this array of scrutiny, you have SEC Enforcement, you have DOJ, you have PCAOB and other regulators at work to establish that deterrent message. But I feel that we got ourselves a seat at the table because of that hard work. And so, I'm very proud of what my colleagues were able to accomplish and that they were willing to have me along for the ride.

Lucy Harvey: Thank you so much, Claudius. This has been fascinating.

Claudius: Thank you. My great pleasure.