

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Administrative Proceedings Rulings
Release No. 5599 / February 14, 2018

Administrative Proceeding
File No. 3-17950

In the Matter of

David Pruitt, CPA

Order Ratifying Prior Actions

The Securities and Exchange Commission initiated this administrative proceeding in April 2017.¹ The order instituting proceedings (OIP) alleged that Respondent David Pruitt, CPA, caused an issuer's violation of Section 13(b)(2)(A) of the Exchange Act and willfully violated Exchange Act Section 13(b)(5) and Exchange Act Rule 13b2-1.² During the course of the proceeding, I granted in part Pruitt's motion for more definite statement but denied his motion for a ruling on the pleadings.³

In November 2017, the Commission ratified the appointments of its administrative law judges and directed them to reconsider the record in each pending case, permit the submission of new evidence, and decide whether to ratify or revise their prior actions.⁴ Because this proceeding was stayed

¹ *David Pruitt, CPA*, Securities Exchange Act of 1934 Release No. 80548, 2017 WL 1539857 (Apr. 28, 2017).

² *Id.* at *10–11; *see* 15 U.S.C. § 78m(b)(2)(A), (5); 17 C.F.R. § 240.13b2-1.

³ *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 4937, 2017 SEC LEXIS 2309 (ALJ Aug. 1, 2017); Admin. Proc. Rulings Release No. 4888, 2017 SEC LEXIS 1945 (ALJ June 23, 2017).

⁴ *Pending Admin. Proc.*, Securities Act of 1933 Release No. 10440, 2017 WL 5969234, at *1–2 (Nov. 30, 2017).

pending settlement at the time,⁵ I ratified my stay order and determined that the deadlines established in the Commission's ratification order did not apply.⁶

The parties, however, soon notified me that their settlement had fallen through.⁷ As a result, I gave the parties an opportunity "to submit any new evidence [they] deem relevant to [my] reexamination of the record," and offered the parties the chance to brief whether I should ratify or revise any action I took prior to the Commission's ratification order.⁸

In response to my order, the Division of Enforcement submitted a letter asking me to ratify all prior actions. Pruitt has a different perspective. In a memorandum in support of his motion to revise, he argues that I should revise the order denying his motion for a ruling on the pleadings.⁹

Pruitt asserts that because Exchange Act Section 13(b)(2)(A) is subject to a de minimis exception, he could not have caused a violation of that section.¹⁰ Specifically, as he has argued before, he believes that because the \$17.9 million in allegedly improperly recognized revenue at issue is only .14% of the issuer's total revenue, the amount in question is de minimis and thus not actionable.¹¹ Pruitt asserts that a contrary ruling ignores the fact that an

⁵ *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 5229, 2017 SEC LEXIS 3596 (ALJ Nov. 15, 2017).

⁶ *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 5251, 2017 SEC LEXIS 3787 (ALJ Dec. 4, 2017).

⁷ *See David Pruitt, CPA*, Admin. Proc. Rulings Release No. 5362, 2017 SEC LEXIS 4030, at *1 (ALJ Dec. 11, 2017).

⁸ *Id.* at *2 (quoting *Pending Admin. Proc.*, 2017 WL 5969234, at *1).

⁹ Mem. at 6–16.

¹⁰ *Id.* at 7. Section 13(b)(2)(A) requires issuers to "make and keep books, records, and accounts, which, *in reasonable detail*, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C. § 78m(b)(2)(A) (emphasis added). In 1981, Commission Chairman Harold M. Williams announced that as a matter of Commission policy, the emphasized language created a "de minimis exemption" to the prohibition in the section. *See Foreign Corrupt Practices Act of 1977*, 46 Fed. Reg. 11,544, 11,546 (Feb. 9, 1981).

¹¹ Mem. at 7; *see Pruitt*, 2017 SEC LEXIS 2309, at *7.

issuer's books need only be accurate in "reasonable detail," sufficient to satisfy "[p]rudent officials in the conduct of their own affairs."¹² In other words, the intent of an employee who falsely recognizes revenue should be irrelevant,¹³ so long as the issuer's "books and records accurately and fairly reflect[] its transactions and dispositions of assets in reasonable detail."¹⁴

As to the charge under Exchange Act Section 13(b)(5), Pruitt argues that I should ignore 14 of the 15 internal controls identified by the Division and focus on IR 4, which he says does not require delivery of invoices.¹⁵ Relatedly, Pruitt now asserts that I should essentially strike the Division's list of internal controls, limiting the Division to "the one specific internal control at issue."¹⁶

Analysis

I am not convinced by Pruitt's arguments. I adhere to my ruling that the de minimis exception of Section 13(b)(2)(A) does not allow an issuer's officers to "intentionally recognize revenue that they allegedly know should not be recognized."¹⁷ I cannot say, as a matter of law, that "prudent officials . . . conduct[ing] . . . their own affairs" would be "satisf[ie]d"¹⁸ that revenue was recorded in reasonable detail if those prudent officials knew that their company's internal controls prohibited recognizing almost \$18 million of that

¹² Mem. at 9–10; see 15 U.S.C. § 78m(b)(7) (defining the term *reasonable detail*).

¹³ For purposes of a motion for a ruling on the pleadings, I take as true the factual allegations in the OIP that the revenue in question should not have been recognized. See 17 C.F.R. § 201.250(a).

¹⁴ Mem. at 10–11.

¹⁵ *Id.* at 12–14. Section 13(b)(5) prohibits circumventing a system of internal accounting controls. See 15 U.S.C. § 78m(b)(5). When I granted in part Pruitt's motion for more definite statement, I directed the Division to provide him with a "list of the internal control or controls that it asserts are relevant to the alleged violation of Exchange Act Section 13(b)(5)." *Pruitt*, 2017 SEC LEXIS 1945, at *9. It responded with a list of sixteen controls, including one designated as IR 4. The Division later pared that list to fifteen.

¹⁶ Mem. at 15–16.

¹⁷ *Pruitt*, 2017 SEC LEXIS 2309, at *7–8.

¹⁸ 15 U.S.C. § 78m(b)(7).

revenue. This is particularly so because Congress’s concern about “off-book expenditures [and] slush funds”—often involving far less than \$18 million—was the impetus for the legislation that included Section 13(b)(2)(A).¹⁹

Pruitt essentially argues for a materiality standard.²⁰ Indeed, he says that when former Commission Chairman Williams first announced the de minimis exception, he recognized instances in which an issuer would not be liable under Section 13(b)(2)(A) for a low-level employee’s “intentional circumvention[]” of an internal control because Congress was unconcerned about “punishing insignificant mistakes.”²¹

But Pruitt takes Chairman Williams’ comments about Commission policy out of context. Before discussing the reasonableness standard, Chairman Williams explained why materiality was not the test used under Section 13(b)(2)(A).²² Chairman Williams explained that establishing a percentage threshold of the sort Pruitt proposes would not provide a “realistic standard” because “[p]rocedures designed only to uncover deficiencies in amounts material for financial statement purposes would be useless for internal control purposes.”²³ A set of controls that permitted “omissions or errors of many thousands or even millions of dollars would not represent, by any accepted standard, adequate records and controls.”²⁴ This was especially so because, as noted above, it was reports of “off-book expenditures [and]

¹⁹ See 46 Fed. Reg. at 11,546 (“The off-book expenditures, slush funds, and questionable payments that alarmed the public and caused Congress to act, it should be remembered, were in most instances of far lesser magnitude than that which would constitute financial statement materiality.”); see also H.R. Conf. Rep. 95-831, at 10 (1977) (“The amendment makes clear that the issuer’s records should reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes.”).

²⁰ Mem. at 7 (arguing that objectively, prudent officials would deem the issuer’s books and records accurate in reasonable detail because the misstated amount of \$17.9 million is only .14% of total revenue).

²¹ Mem. at 9 (quoting 46 Fed. Reg. at 11,547).

²² 46 Fed. Reg. at 11,546.

²³ *Id.*

²⁴ *Id.*

slush funds”—not necessarily involving large sums—that prompted Congress to pass the legislation that included Section 13(b)(2)(A).²⁵

But even putting aside what prompted Congress to act, the question of whether prudent officials would deem it reasonable to be unconcerned about \$17.9 million out of \$12.62 billion is a factual question that is subject to proof. And Pruitt’s assertion raises the question of whether prudent officials would be as unconcerned as he claims if they knew the revenue was recognized by officers who knew they were violating company policy.

Pruitt says that failing to heed his warning will “render[] actionable each and every misstatement in an issuer’s books and records, no matter how miniscule.”²⁶ But as Chairman Williams explained, Congress was not concerned about small misstatements, such as a misstatement on a low-level employee’s travel claim.²⁷ A low-level employee’s misconduct would likely not be actionable—particularly if management did not contemporaneously know about it and took “corrective actions . . . once the violation was uncovered”²⁸—but a \$10 million intentional misstatement by an officer would be.²⁹

According to the OIP, during most of the relevant period Pruitt was the vice president of finance for the issuer’s subsidiary.³⁰ Later, he was “senior director of finance” for a portion of the subsidiary’s business.³¹ Without an evidentiary record, I cannot find that a person in either or both of these positions would be sufficiently “low-level” that the de minimis exemption would apply notwithstanding his intentional misconduct. The hearing will provide the parties the chance to address this factual question.

²⁵ *See id.*

²⁶ Mem. at 7; *see id.* at 8 (“every inflated expense voucher, fake sick day, and petty cash theft would result in liability for both the employee and the company”).

²⁷ 46 Fed. Reg. at 11,546 (“depending on the circumstances, intentional circumventions of a company’s system of records and of accounting controls by a *low-level employee* would not always be considered violations of the Act by the issuer”).

²⁸ *Id.* at 11,547.

²⁹ *See id.* at 11,546.

³⁰ *Pruitt*, 2017 WL 1539857, at *1.

³¹ *Id.*

Pruitt also argues that he is entitled to a ruling on the pleadings as to the charge under Section 13(b)(5). He argues that I should only consider IR 4, which his expert says does not apply,³² and that I should not consider the other 14 controls on which the Division relies.³³

At this stage, Pruitt's reliance on his expert's opinion is misplaced.³⁴ And Pruitt's argument that I should ignore the controls the Division identified is contrary to the position he took during the telephonic conference in September, during which his counsel affirmed that limiting the Division to the identified controls "would answer [his] request and [his] motion to compel."³⁵ Moreover, absent cause, the Division is limited to the controls it has already identified.³⁶ And under my order, the Division has submitted "a brief detailing the factual allegations in the OIP that support the 'system of internal accounting controls' charge."³⁷ Pruitt did not object during the conference or after receiving my order.

³² Mem. at 13–14.

³³ *Id.* at 15–16.

³⁴ Mem. at 13–14; *see* 17 C.F.R. § 201.250(a); Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50,212, 50,224 n.110 (July 29, 2016).

³⁵ Prehearing Tr. 30; *see* Prehearing Tr. 38 (confirming that limiting the internal controls to 16 would "satisfy [Pruitt's] concerns" and "would allow [him] to . . . inform [his] experts and . . . engage in formulating [his] defense").

³⁶ Prehearing Tr. 40.

³⁷ *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 5024, 2017 SEC LEXIS 2740, at *2 (ALJ Sept. 6, 2017).

Order

I have reconsidered the record. Based on that reconsideration and review of the parties' filings, Pruitt's motion to revise is denied. I RATIFY, and decline to revise, all prior actions I have taken in this proceeding.

I will adjudicate Pruitt's separately filed motion to stay by separate order. In the event I deny Pruitt's motion, I will resolve the parties' dispute about when the administrative hearing should begin.

James E. Grimes
Administrative Law Judge