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

Administrative Proceedings Rulings
Release No. 6452 / February 12, 2019

Administrative Proceeding
File No. 3-17950

In the Matter of

David Pruitt, CPA

Order Denying Respondent's Motion for Judgment on the Pleadings

Respondent David Pruitt, CPA, moves for a ruling on the pleadings and asks that I dismiss all charges against him. Because he has not shown that he is entitled to a ruling as a matter of law,[1] Pruitt's motion is denied.

Background

The Securities and Exchange Commission initiated this proceeding in April 2017; however, in June 2018, the Supreme Court decided *Lucia v. SEC*, which essentially required this proceeding to begin anew.[2] In the order instituting proceedings (OIP), the Division of Enforcement alleges that Pruitt caused a violation of Section 13(b)(2)(A) of the Securities Exchange Act of 1934 and willfully violated Exchange Act Section 13(b)(5) and Exchange Act Rule 13b2–1.[3] Pruitt now moves for a ruling on the pleadings.[4]

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1 17 C.F.R. § 201.250(a).

2 *See* 138 S. Ct. 2044, 2055 (2018).

3 OIP ¶¶ II.M.43–45. 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). Section 13(b)(5) prohibits "knowingly circumvent[ing] or knowingly fail[ing] to implement a system of internal accounting controls or knowingly falsify[ing] any book, record, or account described in" Section 13(b)(2). 15 U.S.C. § 78m(b)(5). Rule 13b2–1 states that "No person shall,

(continued…)

Pruitt first argues that because the Division now knows that at least four factual allegations in the OIP are false, I should not accept the truth of the allegations but should instead dismiss this proceeding.[5] Second, he argues that the claims under Section 13(b)(2)(A) and Rule 13b2–1 are flawed because the Division does not allege that the books and records at issue "were not maintained in the 'reasonable detail' required by law."[6] Finally, Pruitt argues that the claim under Section 13(b)(5) fails because he "cannot be charged with knowingly circumventing a control that lacks clarity and does not clearly require the delivery of an invoice."[7]

Discussion

A motion for a ruling on the pleadings is governed by Rule of Practice 250(a), which requires the movant to show that "even accepting all of the non-movant's factual allegations as true and drawing all reasonable inferences in the non-movant's favor, the movant is entitled to a ruling as a matter of law."[8] Rule 250(a) "is analogous to" Federal Rules of Civil Procedure 12(b)(6) and 12(c).[9] In deciding Pruitt's motion, therefore, I may not consider facts outside the pleadings unless they are attached to,

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directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A)." 17 C.F.R. § 240.13b2–1.

[4] I denied Pruitt's previous motion in August 2017. *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 4937, 2017 SEC LEXIS 2309 (ALJ Aug. 1, 2017). I declined to reconsider that order in February 2018, when I ratified all prior actions taken in this case. *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 5599, 2018 SEC LEXIS 470 (ALJ Feb. 14, 2018). Following *Lucia*, those orders are no longer operative. *See Pending Admin. Proc.*, Securities Act of 1933 Release No. 10536, 2018 WL 4003609, at *1 (Aug. 22, 2018).

[5] Mem. at 4–6.

[6] *Id.* at 6–13.

[7] *Id.* at 14.

[8] 17 C.F.R. § 201.250(a).

[9] Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50,212, 50,224 n.110 (July 29, 2016).

incorporated into, or necessarily relied on by the pleadings.[10] I may take official notice of matters which may be judicially noticed by a district court,[11] such as an issuer's filings with the Commission.[12]

1. *I cannot determine the truth or falsity of the OIP's allegations in ruling on a Rule 250(a) motion.*

Pruitt's argument that I should dismiss because at least four factual allegations in the OIP are false must fail. The argument is contrary to Rule 250(a), which requires that I accept the truth of the allegations. It also necessarily requires consideration of facts outside the pleadings.

2. *Pruitt's has not shown that the $17.9 million in revenue qualifies as de minimis as a matter of law.*

Pruitt's challenge to claims under Section 13(b)(2)(A) and Rule 13b2–1 also fails. Paragraph (2) was added to Section 13(b) as part of the Foreign Corrupt Practices Act of 1977.[13] The Senate bill that contained the proposed new paragraph (2) would have required issuers to "make and keep books, records, and accounts which *accurately and fairly* reflect" the "transactions and dispositions of" the issuer's assets.[14] Concerned that the emphasized language would require an "unrealistic" "degree of exactitude and precision," the conference committee rejected the phrase *accurately and fairly* in favor of the phrase *in reasonable detail*.[15] The conference committee believed the adopted language made "clear that [an] issuer's records should reflect transactions in conformity with accepted methods of recording economic

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[10] *L-7 Designs, Inc. v. Old Navy, LLC*, 647 F.3d 419, 422 (2d Cir. 2011) (Rule 12(c) motion); *DiFolco v. MSNBC Cable LLC*, 622 F.3d 104, 111 (2d Cir. 2010) (Rule 12(b)(6) motion).

[11] *See* 17 C.F.R. § 201.323; *cf. Oran v. Stafford*, 226 F.3d 275, 289 (3d Cir. 2000) (taking judicial notice when deciding Rule 12(c) motion).

[12] *See Am. Stellar Energy, Inc.*, Exchange Act Release No. 64897, 2011 WL 2783483, *6 n.27 (July 18, 2011) (taking official notice under Rule of Practice 323 of Commission filings); *cf. Oran*, 226 F.3d at 289.

[13] *See* Pub. L. 95-213, § 102, 91 Stat. 1494.

[14] S. Rep. No. 95-114, at 16 (1977) (emphasis added).

[15] H.R. Conf. Rep. 95-831, at 10 (1977).

events and effectively prevent off-the-books slush funds and payments of bribes."[16]

The Commission provided guidance about Section 13(b)(2)(A) through an address delivered in 1981 by then-Chairman Harold M. Williams.[17] Chairman Williams addressed the perception that "technical and insignificant errors in corporate records or weaknesses in corporate internal accounting controls" could lead to civil or criminal liability.[18] Noting the use of the word *reasonable* in paragraph (2), Chairman Williams stated that paragraph (2) did not require "absolute exactitude or that a company's control system meet some absolute ideal."[19] Section 13(b)(2) was instead subject to "a de minim[i]s exemption, though not in absolute, quantitative terms."[20]

Chairman Williams also explained that Congress considered but rejected materiality as the appropriate standard under Section 13(b)(2).[21] He described materiality as both "inadequate" and "[un]realistic," noting that for large companies, a materiality standard would permit misstatements in corporate books and records "in the millions of dollars."[22] Indeed, Congress enacted Section 13(b)(2)(A) because of "off-book expenditures, slush funds, and questionable payments," involving amounts that would fall far below a materiality threshold.[23]

Chairman Williams then explained that the Commission would look to a variety of factors to decide whether a violation occurred. It would consider "the adequacy of the [issuer's] internal control system …, the involvement of top management in the violation, and the corrective actions taken once the violation was uncovered."[24] Further, "intentional circumventions … of

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16 *Id.*

17 *See* Foreign Corrupt Practices Act of 1977, 46 Fed. Reg. 11,544, 11,544–45 (Jan. 29, 1981).

18 *Id.* at 11,544.

19 *Id.* at 11,546.

20 *Id.*

21 *Id.*

22 *Id.*

23 *Id.*

24 *Id.* at 11,547.

accounting controls by a low-level employee would not always be considered violations of the Act by the issuer," if the violations were committed "without the knowledge of top management, with an adequate system of internal control, and with appropriate corrective action taken by the issuer."[25] Excepting situations in which senior officials are complicit, if "discovery and correction expeditiously follow, no failing in the company's internal accounting system would have existed."[26] Instead, "routine discovery and correction would evidence" the system's "effectiveness."[27] But Chairman Williams cautioned that:

> there can be no relaxation of the proscription against the creation or maintenance of any fund that is designed to be used for 'off-books' payments outside the issuer's system of internal accounting control, or against obstructing or circumventing in any significant respect the issuer's system of internal controls by misstatement to auditors or related means.[28]

In 1988, Congress added paragraph (7) to Section 13(b).[29] Paragraph (7) defines *reasonable detail*, as used in Section 13(b)(2)(A), as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[30] House and Senate conferees adopted the term *prudent officials* to make clear that an "unrealistic degree of exactitude or precision" was not required.[31] The conferees also explained that they deleted proposed cost-benefit language because "[t]he concept of reasonableness"

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[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] Foreign Corrupt Practices Act Amendments of 1988, Pub. L. 100-418, § 5002, 102 Stat. 1107 (Aug. 23, 1988).

[30] 15 U.S.C. § 78m(b)(7).

[31] H.R. Rep. 100-576, at 917 (1988). Although the conference report does not mention it, in his 1981 address, Chairman Williams used similar language when he said that the enactment of Section 13(b)(2) did "not establish any absolute standard of exactitude for corporate records." 46 Fed. Reg. at 11,546.

already implicates "the weighing of a number of relevant factors, including the costs of compliance."[32]

The OIP alleges that while vice president of finance at ASD, a subsidiary of L3 Technologies, Inc., Pruitt caused L3 to improperly recognize $17.9 million in revenue by generating invoices that were not submitted to L3's customer.[33] The Division claims that through this action, Pruitt caused L3's violation of Section 13(b)(2)(A).[34]

Pruitt argues that the Section 13(b)(2)(A) claim fails as a matter of law. He notes that $17.9 million was only 14/100th of one percent of L3's $12.62 billion in total revenue in 2013.[35] Because $17.9 million is insignificant in comparison to L3's total revenue, Pruitt argues that it is de minimis, as contemplated in Chairman Williams's statement of Commission policy, and thus not actionable.[36] I disagree.

As Chairman Williams noted, Congress was prompted to add paragraph (2) to Section 13(b) because of concerns about issuers' "off-book expenditures, slush funds, and questionable payments."[37] And because Congress was concerned about these *types* of payments and expenditures, not the *amount* of the payments and expenditures, "[s]ystems which tolerate[] omissions or errors of [only] many thousands or even millions of dollars would not" be acceptable—they would likely not detect the types of payments that led Congress to act in the first place.[38] But adopting a standard of the sort Pruitt

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32 H.R. Rep. 100-576, at 917.

33 OIP ¶ II.A.2., II.F.23.

34 OIP ¶ II.M.43.

35 Mem. at 6.

36 *Id*. at 11 ("Congress simply did not intend for a misstatement of 14/100th of one percent of the issuer's revenue to trigger a violation of the books and records provisions regardless of the underlying intent of the misstatements.").

37 46 Fed. Reg. at 11,546; *see* H.R. Conf. Rep. 95-831, at 10.

38 46 Fed. Reg. at 11,546.

proposes would permit such payments if, no matter the type, they amounted to a very small percentage of the issuer's revenue.[39]

Moreover, although a low-level employee's efforts to get around an issuer's system of controls "would not always be considered violations of the Act by the issuer," the determination of whether such efforts would be actionable will depend on several factors, including where the wrongdoer sits in the corporate hierarchy, whether senior management is involved, and how "expeditiously" management moves to address the problem.[40] Given that the legal determination depends on the resolution of a number of factual issues, Pruitt is not entitled to a ruling as a matter of law on this claim.

Pruitt also asserts that "[p]rudent officials in the conduct of their own affairs simply would not deem" such a minor discrepancy sufficient to render an issuer's books and records "inaccurate or not kept in reasonable detail."[41] But determining what constitutes reasonable detail requires "the weighing of a number of relevant factors."[42] And the $17.9 million discrepancy is only minor as a matter of law if considered using the sort of quantitative analysis that Chairman Williams rejected.[43] Moreover, Pruitt offers nothing to support his assertion. Perhaps he is correct as a factual matter, but it is not clear how one could conclude, as a matter of law, that prudent officials would deem unimportant the recognition of $17.9 million in revenue if the recognition allegedly violates an issuer's internal controls.

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[39] *See* 46 Fed. Reg. at 11,546. Pruitt initially argues for a materiality standard, asserting that then-Chairman John Shad proposed it to Congress in 1981. *See* Mem. at 8; *see also id.* at 9–11 (referencing and relying on materiality). Pruitt, however, disavows materiality as a standard in his reply to the Division's opposition. *See* Reply Mem. at 10 ("Respondent has never argued for a materiality standard or read one into Section 13."). Neither Section 13(b)(7) nor the 1988 conference report relevant to it mention a materiality standard.

[40] 46 Fed. Reg. at 11,546–47.

[41] Mem. at 6.

[42] H.R. Rep. 100-576, at 917.

[43] *See* 46 Fed. Reg. at 11,546 (stating that Section 13(b)(2) is subject to "a de minim[i]s exemption, though not in absolute, quantitative terms").

3. *The OIP sufficiently alleges a knowing violation of L3's system of accounting controls.*

The OIP alleges that Pruitt willfully violated Section 13(b)(5) by knowingly circumventing L3's system of internal accounting controls.[44] According to the OIP, Pruitt learned that in order to recognize revenue for certain unresolved claims, a sales order had to be created and released to a billing clerk, who would generate an invoice.[45] Once the billing clerk generated the invoice, revenue would be recognized.[46] But at the same time, the invoice was supposed to be submitted through a web-based system used by Defense Department vendors that would deliver the invoice to L3's customer.[47]

According to the OIP, Pruitt instructed a subordinate to generate 69 invoices but to withhold delivery of the invoices to the customer.[48] When asked about this practice by the controller of another L3 subsidiary that was temporarily assisting ASD, Pruitt said the practice resulted from an agreement with the customer to negotiate each invoice before submission.[49] Pruitt was later told the practice violated corporate policy and that the relevant contract manager was concerned that the practice was being used to "hide" the undelivered invoices from auditors.[50] Pruitt responded that he had been instructed by "Group" to take this course of action.[51]

L3's external auditor later inquired about invoices that were "pending coordination," and Pruitt drafted a false and misleading explanation, which mollified the auditor.[52] The recognition of revenue entitled Pruitt to an earnings-based bonus.[53] Relevant to this charge, the OIP alleges that the

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44 OIP ¶ II.M.44.

45 OIP ¶ II.F.20.

46 OIP ¶ II.F.20.

47 OIP ¶ II.F.20.

48 OIP ¶ II.A.2.

49 OIP ¶ II.F.23.

50 OIP ¶¶ II.F.24–25.

51 OIP ¶ II.F.25.

52 OIP ¶ II.H.31–32.

53 OIP ¶ II.F.27.

failure to deliver invoices to L3's customer violated "a specific internal control of L3 that required delivery of invoices."[54]

Although the OIP does not identify the specific internal control, the Division previously pointed to control IR 4.[55] Pruitt argues that IR 4 does not require delivery of invoices to customers.[56] IR 4 requires that L3's finance department post an invoice to its ledgers "upon its preparation and distribution to the customer."[57] Pruitt contends that IR 4 does not make delivery of an invoice "a pre-requisite"[58]—that is, Pruitt implies that the purpose of the control is to ensure that every invoice distributed to a customer is recorded in the company's books. But the control might instead ensure that the recording and distribution of an invoice are invariably linked. Taking the language in the light most favorable to the Division, IR 4 requires delivery of an invoice to a customer at the same time the invoice is generated and the transaction that is the invoice's subject is recorded. Absent further evidence, such as testimony about industry and company practice, I cannot resolve the ambiguity at this point.

Pruitt also argues that he could not have knowingly circumvented an unclear control that does not require delivery.[59] But liability does not depend

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54 OIP ¶ II.K.39.

55 *See* Mem. at 13 (noting that the Division previously identified IR 4). IR 4 says:

> The Finance Department posts each invoicing transaction upon its preparation and distribution to the customer to a separate subsidiary ledger or general ledger account for each type of billing method used by the Financial Reporting Location, which records information about the invoice (for example, the relevant information listed above in Control No. (3)). Alternatively, batch processing of invoices may be utilized.

Id. at 13–14.

56 *Id.* at 14.

57 *Id.* at 13.

58 *See id.* at 14.

59 *Id.* at 14.

on whether he knew the contents of a specific control; it depends on whether he consciously undertook the actions that resulted in the circumvention of L3's internal controls.[60]

Further, the OIP alleges facts sufficient to collectively support the reasonable inference that Pruitt actually knew or should have known he was violating L3's internal controls. It alleges that Pruitt (1) was ASD's vice president of finance, a certified public accountant, certified management accountant, certified government financial manager, and certified defense financial manager; (2) had a motive—a bonus; (3) was told recognizing revenue without delivering invoices violated corporate policy; and (4) took action to prevent detection. Taken together, these factual allegations support the reasonable inference that Pruitt knew or should have known he was allegedly circumventing L3's internal controls.[61]

Pruitt's motion for a ruling on the pleadings is DENIED.

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James E. Grimes
Administrative Law Judge

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[60] *See United States v. Reyes*, 577 F.3d 1069, 1080–81 (9th Cir. 2009).

[61] *See SEC v. Egan*, 994 F. Supp. 2d 558, 565–66 (S.D.N.Y. 2014).