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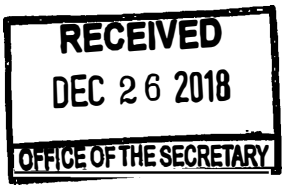
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-17950

In the Matter of

David Pruitt, CPA

Respondent.



DIVISION OF ENFORCEMENT'S MEMORANDUM IN OPPOSITION TO RESPONDENT'S MOTION FOR A RULING ON THE PLEADINGS

Paul G. Gizzi (gizzip@sec.gov)
Steven G. Rawlings (rawlingss@sec.gov)
Alexander M. Vasilescu (vasilescua@sec.gov)
Division of Enforcement
Securities and Exchange Commission
200 Vesey Street, Suite 400
New York, NY 10281
212-336-1100

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The Division of Enforcement ("Division") respectfully requests that the Court deny Respondent David Pruitt's motion for a ruling on the pleadings under Commission Rule of Practice 250(a) ("Motion"). Respondent previously filed a Rule 250(a) motion for a ruling on the pleadings after filing his first answer to the Order Instituting Proceedings ("OIP"). The Court denied the motion. In June 2018, the Commission stayed this proceeding following the Supreme Court decision in *Lucia v. SEC*, 138 S. Ct. 2044 (2018). After the stay was lifted in August 2018, the Court entered a new scheduling order, and Respondent filed a second answer to the OIP, as well as a second motion for a more definite statement, which the Court granted in part.

For the present Rule 250(a) Motion, accepting all of the OIP's factual allegations as true, as the law requires, and drawing all reasonable inferences in the Division's favor, Respondent is plainly not entitled to a ruling as a matter of law. The OIP states claims for relief that Respondent committed or caused violations of the books and records and internal controls provisions of the securities laws. And, Respondent has failed to show that the Division would not be entitled to relief against Respondent under facts consistent with the OIP.

Despite the OIP alleging that he engaged in knowingly improper conduct, falsely recognizing $17.9 million in revenue at the end of the fiscal year in December 2013, which was also reflected in the first quarter of 2014, Respondent argues that, because his misconduct did not result in a misstatement of revenue that was material *to the issuer*, he should be exonerated as a matter of law (all the while dismissing his knowing circumvention of internal controls as either "de minimis" or non-existent). Such a proposition does not and cannot stand. First, in making this argument Respondent essentially reads in a materiality requirement where none exists (and thereby misstates the law). Second, it ignores Respondent's knowing circumvention of internal controls. Simply put, if the law requiring gatekeepers properly to record a public company's

transactions to serve its intended purpose, *i.e.*, to ensure accurate financial reporting for our nation's investors, then the law cannot allow such gatekeepers falsely to recognize revenue – no matter the amount. But, in any event, $17.9 million is by no measure *de minimis* and the chief accounting officer for a multi-million dollar division within a public company should not get a free pass on the books and records provisions of the U.S. securities laws simply because he or she works for an enormous public company. Respondent's other arguments similarly fail. The Motion should be denied.

BACKGROUND

On April 28, 2017, the Commission issued the OIP in this matter against Respondent David Pruitt ("Pruitt" or "Respondent"). The OIP alleges that Pruitt's misconduct resulted in three violations of the securities laws: (i) Pruitt caused L3 Technologies, Inc.'s ("L3") violations of Section 13(b)(2)(A) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78m(b)(2)(A), which requires issuers, such as L3, to make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the issuer's transactions and dispositions of assets; (ii) Pruitt violated Section 13(b)(5) of the Exchange Act, 15 U.S.C. § 78m(b)(5), which prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record or account of an issuer; and (iii) Pruitt violated Rule 13b2-1 of the Exchange Act, 17 C.F.R. § 240.13b2-1, which prohibits any person from, directly or indirectly, falsifying or causing to be falsified any book, record or account of an issuer. (OIP ¶¶ 43-45.)[1]

[1] On January 11, 2017, the Commission issued a settled order as to L3. *Matter of L3 Technologies, Inc.*, No. 3-17769, Rel. No. 34-79772 (Jan. 11, 2017). The settled order found that L3 violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A) & (B), by failing to maintain adequate books and records and failing to maintain sufficient internal controls, based in part on Pruitt's misconduct. On April 28, 2017, the Commission issued a settled order as to Mark Wentlent, Pruitt's former immediate supervisor and president of L3's Army Sustainment Division subsidiary, for causing L3's violation of Section 13(b)(2)(A) of the Exchange Act

Under Rule of Practice 250(a), all of the allegations in the OIP are deemed true for purposes of deciding the Motion, including the facts highlighted below. In addition, the Division is entitled to all reasonable inferences that can be drawn from the undisputed facts, including the inferences set forth below.

A. Select facts from the OIP, which are deemed true for purposes of deciding the Motion

L3 is a Delaware corporation with its principal place of business in New York, NY, and its securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act, 15 U.S.C. § 78*l*(b). (OIP ¶ 5.) L3 is a prime contractor for various foreign and U.S. Government agencies, including the U.S. Department of Defense. L3 is a prime contractor in aerospace systems and national security solutions. For fiscal year 2013, L3 reported net sales of $12.6 billion and operating income of $1.2 billion. Pruitt, a certified public accountant, certified management accountant, certified government financial manager and certified defense financial manager,[2] served as Vice President of Finance of L3 subsidiary Army Sustainment Division ("ASD") from January 2013 until January 2014. (OIP ¶¶ 2, 4.)

In late December 2013, Pruitt instructed a subordinate to create 69 invoices in L3's internal accounting system (called "SAP") related to unresolved claims under L3's fix-priced aircraft maintenance contract, the "C-12 Contract," with its customer the U.S. Army, but to withhold delivery of the invoices to the Army. (OIP ¶ 2.) Other than a handful of invoices delivered to the Army in early 2014, the vast majority of the invoices were not submitted to the Army. By entering the invoices in SAP, ASD (and L3) improperly recognized approximately $17.9 million in additional revenue at the end of 2013 and in Q1 2014.

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and violating Rule 13b2-1, based on, among other things, Wentlent's failure to follow up on red flags that should have alerted him that Pruitt was improperly recognizing revenue. *Matter of Mark Wentlent*, No. 3-17949, Rel. No. 80547 (Apr. 28, 2017).

[2] According to the State of Kentucky Board of Accountancy License Lookup website (available at: https://secure.kentucky.gov/formservices/cpa/licenserenewal/search), Pruitt's CPA license is still active.

The unresolved claims related to services L3 provided, through ASD and previously through L3 subsidiary Vertex, to the Army under the C-12 Contract for a five year term beginning in June 2010. (OIP ¶ 7.) ASD was formed at the beginning of 2013 to take over the C-12 Contract and improve L3's performance under the contract. In the summer of 2013, the C-12 business manager informed Pruitt and ASD's President that ASD had $30-35 million in unaccounted for costs on the balance sheet related to the C-12 Contract, which represented a potentially large loss for ASD. (OIP ¶ 8.)

In September 2013, Pruitt, ASD's president and the C-12 business manager reported the problem to the president of Logistics Solutions, ASD's corporate parent, and thereafter were in constant communication with the Logistics Solutions president. (OIP ¶ 9.) Pruitt and the ASD president were aware during September 2013 that ASD would likely not meet its annual operating plan for EBIT (earnings before interest and taxes) and that ASD was at risk of not even attaining 75% of plan required to receive management incentive bonuses. The ASD president then directed a review of the C-12 Contract and, by mid-November 2013, the C-12 contract manager identified approximately $50.6 million in work that ASD believed it had performed under the C-12 Contract that had not been billed to the Army. (OIP. ¶ 10.) Pruitt and the ASD president understood that the Logistics Solutions president expected ASD to achieve some accounting benefit from the $50.6 million by the end of 2013, and on November 8, 2013, the Logistics Solution president sent Pruitt and the ASD president an email directing that the ASD president identify, in coordination with the CFO of L3's Aerospace Systems, which of the $50.6 million costs would be deferred and factor that into the expected EBIT for 2013. (OIP ¶ 11.)

Pruitt and the ASD president participated in discussions concerning whether revenue could be recognized on the $50.6 million in claims based on a concept called "legal entitlement"

even though the claims had not been resolved with the Army (OIP ¶ 12.) At Pruitt's request, the general counsels for ASD and Logistics Solutions estimated that ASD was likely to recover approximately $30 million of the $50.6 million. (OIP ¶ 14.)

In early December 2013, Pruitt was notified that he was being reassigned from his role as VP of Finance at ASD after the end of January 2014. (OIP ¶ 16.) Pruitt failed to prepare estimates at completion for the C-12 Contract, which were relied upon to create forecasts and operating plans, and Pruitt falsely represented that such estimates had been properly completed. (OIP ¶ 17.) ASD presented the $50.6 million in claims to the Army in late November and early December 2013, and the Army planned to meet internally on December 17, 2013 and then meet with L3 starting in 2014 with the intent to resolve the disputes outside of the formal dispute process. (OIP ¶19.) Neither Pruitt nor the ASD president expected to resolve the disputes before the end of 2013.

In late December 2013, Pruitt asked the C-12 business manager how revenue was recorded on ASD's books, and Pruitt was told that it was either billed or accrued. (OIP ¶ 20.) Pruitt then asked when revenue was recognized, and he was told that for revenue to be recognized a sales order had to be created and then released to the billing clerk, who then generated an invoice in L3's accounting system, at which point the revenue was recognized. The invoices were then supposed to be submitted into the "WAWF" (Wide Area Work Flow), which transmits invoices to the customer.

On or about December 20, 2013, Pruitt and the Aerospace Systems CFO discussed the items making up the $50.6 million, and the Aerospace Systems CFO instructed Pruitt which items to invoice and which to accrue. (OIP ¶ 21.) On December 23, 2013, Pruitt sent the C-12 business manager "billing amounts" for seven of the items making up the $50.6 million, and the

business manager in turn emailed ASD's controller (copying Pruitt) asking the controller to add planned revenue for the billings the business manager had done that day. (OIP ¶ 22.) The business manager further stated that he believed "the current course of action is that they are not to be released to the government." The invoices were generated by clerks at Vertex due to an absence at ASD, and the controller of Vertex, who understood that not submitting the invoices in WAWF violated certain work procedures, called Pruitt after one of the clerks conferred with the controller. (OIP ¶ 23.) Pruitt told the controller that, based on an agreement with the Army, the Army was to negotiate each invoice before submission through WAWF. Based on this conversation, 69 invoices were generated in L3's accounting system but withheld from WAWF, and ASD recognized approximately $17.9 million in revenue without delivery of the invoices to the Army. Generating the invoices in L3's accounting system without delivering the invoices to the Army violated L3's internal controls requiring delivery of invoices to the customer. (OIP ¶ 39.)

After the C-12 business manager raised concerns about Pruitt's invoicing request, the C-12 contract manger spoke with Pruitt, who said that invoicing without submitting the invoices to the Army was a technique to use because L3 corporate had forbid ASD from accruing the $50.6 million. (OIP ¶ 25.) Pruitt said that he did not know if L3 corporate was aware of and approved the technique, that the Aerospace Systems CFO had directed him to do this, and acknowledged that he did not have the direction in writing.[3] On December 30, 2013, Pruitt told the C-12 business manager and ASD controller that the year-end numbers needed to be whatever they had to be for ASD to make $40 million EBIT. (OIP ¶ 26.) ASD, with revenue from the invoices Pruitt directed be created, met the required 75% of plan to achieve management incentive

[3] As described below, the Aerospace Systems CFO, Timothy Keenan, initially stated during the investigation that preceded this proceeding that no such direction had occurred, but has now apparently changed his story.

bonuses, and Pruitt received a bonus of $62,100 on his salary of $189,673 attributable to achieving 75% of plan. (OIP ¶ 27.)

As part of closing the books for 2013, Pruitt directed that the C-12 business manager enter $8.8 million in accruals related to the $50.6 million. (OIP ¶ 28.) After L3's corporate controller refused to allow the accrual, on January 7, 2014, the Aerospace Systems CFO instructed Pruitt to reverse the accrual, and to record as billed accounts receivable and revenue a total of approximately $3.2 million representing only amounts for work during 2013 because costs for prior years could not be recognized under SEC Staff Accounting Bulletin 104. (OIP ¶ 29.) After L3's corporate controller's office requested a letter from the Army indicating that ASD had permission to bill for the $3.2 million for 2013, the C-12 contract manager provided Pruitt two email chains with Army personnel, neither of which Pruitt had been copied on previously, that mentioned invoicing, but neither of which mentioned generating invoices in L3's SAP system but withholding the invoices from the Army. (OIP ¶ 30.)

During the 2013 audit, L3's external auditor sampled ASD invoices and requested the WAWF acceptance document or proof of cash receipt as proof L3 had billed the Army. (OIP ¶ 31.) Pruitt prepared a misleading explanation for the auditor that failed to disclose that no invoices had been delivered to the Army, whether through WAWF or otherwise, and falsely indicated that the Army had requested that 2013 invoices be coordinated with the Army before submission through WAWF. (OIP ¶¶ 31-32.) On January 17, 2014, the Army sent an email to the general counsel of ASD indicating that "[i]t would be an exercise in futility to submit invoices" through WAWF "as they would be rejected." (OIP ¶¶ 33-34.) Pruitt first asked the ASD general counsel to delete the sentence from the email and forward the doctored email to L3 corporate, and when the general counsel refused, Pruitt and the ASD president convinced the

general counsel to ask the Army to resend the email removing the sentence. (OIP ¶ 35.) The revised email, which was provided to L3 corporate and L3's auditor, gave the impression the Army gave ASD permission to invoice the Army for the disputed items when that was not in fact the case, as Pruitt knew. (OIP ¶ 36.) In April 2014, Pruitt drafted an explanation to L3's auditor to explain why accounts receivable had grown by $18.5 million as of Q 1 2014, which explanation misleadingly suggested that the invoices had been delivered to the Army. (OIP ¶ 37-38.)

In June 2014, L3 discovered the invoices during an investigation, which were sitting on a shelf and had not been delivered to the Army despite L3's internal controls requiring delivery of invoices. (OIP ¶¶ 2, 39.) On July 30, 2014, L3 terminated Pruitt's employment. (OIP ¶ 4.)

By failing to deliver the invoices, ASD's recognition of $17.9 million in revenue failed to comply with U.S. Generally Accepted Accounting Principles ("GAAP"), which provide that revenue can only be recognized when it is realized or realizable and earned, and that collectability must be reasonably assured and the amount of revenue fixed or determinable to recognize revenue. (OIP ¶ 40.) L3 made inaccurate filings on Form 10-K for 2013 and Form 10-Q for Q1 2014, and in October 2014 made amended filings that, among other things, reflected adjustments of $15.4 million in pre-tax income related to the creation of invoices as Pruitt's direction. (OIP ¶¶ 41-42.)

B. Inferences the Division is entitled to for purposes of deciding the Motion

In ruling on the Motion, the Court draws all reasonable inferences in the Division's favor. Among the reasonable inferences that flow from the undisputed facts, as alleged in the OIP, are the following:

First: Pruitt had full knowledge of the books and records and internal controls

requirements, US GAAP, and L3 accounting policies and internal controls. It is reasonable to infer that, as a CPA and ASD's Vice President of Finance, Pruitt was fully aware the books and records and internal controls provisions of the securities laws. Similarly, Pruitt was fully aware of US GAAP revenue recognition requirements and L3's accounting policies concerning revenue recognition.[4] Finally, Pruitt was fully aware of L3's internal controls designed to ensure proper revenue recognition and accountability for assets, including requiring that invoices be delivered to customers.

Second: Pruitt knew there was no agreement with the Army to pay the invoices he created. The fact that Pruitt directed that the invoices not be submitted into WAWF shows that Pruitt knew the Army had not agreed to pay the invoices at the time he instructed subordinates to create them, but withhold delivery. This inference also flows from Pruitt's contrary contemporaneous justifications for why he directed the unusual act of invoicing the Army but not delivering the invoices through WAWF: he told the Vertex controller – who knew nothing about what the Army had asked – that the reason was because the Army had requested it (which was false); in contrast, he told the C-12 contract and business managers – who knew the Army had not requested invoices – that "Aerospace" had directed that invoices be run, but not delivered to the Army, as a "technique" to recognize the revenue, but that Pruitt did not know if L3 corporate approved. This inference also flows from the two emails that Pruitt was shown reflecting communications with the Army during 2013 that neither mentioned invoicing in L3's SAP system but withholding the invoices from the Army. It also flows from Pruitt's role in misleading L3 corporate and L3's auditors in January 2014 and concealing the truth that the invoices were not delivered to the Army.

[4] The relevant GAAP requirements come from Staff Accounting Bulletin 104, which established four criteria for revenue recognition – each of which had to be satisfied before revenue could be recognized. As a public company, L3 was required to follow GAAP.

Third: Pruitt could have corrected the improper revenue recognition before L3 filed its Form 10K for 2013 and Form 10Q for Q1 2014. Pruitt had plenty of opportunities to reverse the improper revenue recognition during January 2014 before L3 filed its form 10K for 2013 and certainly before L3 filed its Form 10Q for Q1 2014.

Fourth: Pruitt was fired by L3 because of his misconduct in generating the invoices and misleading L3 and its auditors. The timing of Pruitt's firing, one month after the invoices were discovered sitting on a shelf, strongly suggests that he was fired for his misconduct, including improperly generating the invoices and recognizing revenue and misleading L3 corporate and L3's auditors. In addition, Pruitt was fired one day before L3 filed a current report on Form 8-K on July 31, 2014 (available at: https://www.sec.gov/Archives/edgar/data/1039101/000119312514288209/0001193125-14-288209-index.htm).[5] The Form 8-K indicated that L3 was conducting an internal review after making adjustments primarily related to "contract cost overruns that were inappropriately deferred and overstatement of net sales" related to the C-12 Contract, and that the "amounts associated with these adjustments are the result of misconduct and accounting errors at the Aerospace Systems segment." Further, the Form 8-K indicated that L3 "is committed to the integrity of its financial statements, and maintaining effective internal controls and ethical conduct," and that "management has taken and expects to continue taking remedial actions, including the termination of certain employees in the Aerospace Systems segment."

Fifth: Pruitt stood to gain personally by the improper generation of invoices and misleading L3 corporate and L3's external auditors. Pruitt had a personal motive in instructing the invoices to be generated and the revenue recognized. In the months leading up to December 2013, Pruitt knew there was an expectation that ASD would recognize some

[5] The Court can take official notice of information in L3's public filings under Rule of Practice 323.

accounting benefit from the "Revenue Recovery Initiative" that had required intense daily meetings to identify amounts to recover. Adding to this extreme pressure, in early December 2013, Pruitt learned that he was being reassigned from his role as Vice President of Finance effective after January 2014, unwelcome news that might reasonably cause an executive to take extreme measures to reverse or forestall such an unwelcome demotion. And such a reassignment obviously created uncertainty about his future, including whether he would be in a position to obtain a management incentive bonus, or indeed even be employed, as of is next chance for a bonus at the end of 2014. Pruitt thus had multiple motives to direct ASD's premature and improper recognition of revenue at the end of December 2013, even though proof of a motive, *per se*, is not required for any of the violations with which Pruitt is charged.

C. Respondent's Current Motion for a Ruling on the Pleadings

After the Commission lifted the *Lucia* stay that was in place from June to August 2018, the Court entered the current scheduling order. Respondent has now filed another answer to the OIP, as well as a new motion for a more definite statement, which the Court granted in part.[6] Respondent has now filed the present Motion, which is Respondent's second motion for a ruling on the pleadings.[7] Respondent's current Motion makes three arguments: *first*, the OIP is not entitled to deference; *second*, the books and records charges fail because $17.9 million was "de minimis" to the conglomerate L3's revenue; and *third*, the internal controls violations fail as a matter of law. (Motion Br. at 1-2.) The Motion fails to meet the requirements of Rule 250(a) to show that Pruitt is entitled to a judgment as a matter of law. The Motion should be denied.

[6] On June 23, 2017, the Court entered an order granting, in part, Respondent's first motion for a more definite statement (https://www.sec.gov/alj/aljorders/2017/ap-4888.pdf), and on June 30, 2017, the Division provided additional detail as called for by the Court's order (https://www.sec.gov/litigation/apdocuments/3-17950-event-26.pdf). On December 20, 2018, the Court issued an order granting in part the second motion for a more definite statement, and directed the Division to supply Respondent with certain information by January 3, 2019.

[7] On August 1, 2017, the Court denied Respondent's original motion for a ruling on the pleadings (https://www.sec.gov/alj/aljorders/2017/ap-4937.pdf).

ARGUMENT

The Commission amended the Rules of Practice in 2016 to permit either party, after an answer to the OIP is filed, to move for a ruling on the pleadings on one or more claims or defenses. *See* Amendments to the Commission's Rules of Practice, File No. S7-18-15, 2016 WL 3853756 (July 13, 2016). To prevail on such a motion, the movant must establish 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." Rule of Practice 250(a). As the Commission explained in adopting this provision, the hearing officer is directed to grant or deny such motions "promptly" "to help ensure that such motions do not serve to delay proceedings." 2016 WL 3853756, at *22. The Commission further explained that motions under the amended rule "generally correspond to certain dispositive motions that may be filed in federal court under the Federal Rules of Civil Procedure," *id.*, and that Rule 250(a) "is analogous to Rules 12(b)(6) and 12(c)," *id.* n.110.

Fed. R. Civ. P. 12(b)(6) provides that a defendant can move to dismiss all or part of a complaint on the ground that it "fail[s] to state a claim upon which relief can be granted." Fed. R. Civ. P. 12(c) provides that, after an answer is filed, either party "may move for judgment on the pleadings." A complaint survives a motion to dismiss under Fed. R. Civ. P. 12(b)(6) if it contains sufficient factual allegations, "[which are] accepted as true, to state a claim for relief that is plausible on its face." *SEC v. Familant*, 910 F. Supp. 2d 83, 89 (D.D.C. 2012) (quoting *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2007)). A motion for judgment on the pleadings under Fed. R. Civ. P. 12(c) "is decided under the same standard applicable to motion to dismiss" under Fed. R. Civ. P. 12(b)(6). *Cobalt Multifamily Investors I, LLC v. Arden*, 46 F. Supp. 3d 357, 359 (S.D.N.Y. 2014) (citing *Johnson v. Rowley*, 569 F.3d 40, 43 (2d Cir. 2009)). A motion to

dismiss under either Rule 12(b)(6) or 12(c) "should not be granted unless the plaintiff would not be entitled to relief under any set of facts that he could prove consistent with the complaint." *Johnson v. Johnson*, 385 F.3d 503, 529 (5th Cir. 2004). In considering a motion to dismiss, a court cannot consider facts outside of the pleadings, but may consider documents attached to or incorporated by reference in the complaint and may take notice of matters subject to judicial notice, including documents filed with the Commission. *U.S. v. Wood*, 925, F.2d 1580, 1581-82 (7th Cir. 1991).

As explained further below, Respondent has failed to show that, accepting the OIP's factual allegations as true, and drawing all reasonable inferences in the Division's favor, he is nonetheless entitled to a ruling as a matter of law under Rule of Practice 250(a). The facts highlighted above, and the reasonable inferences flowing from those facts, show that Pruitt engaged in wrongdoing by creating invoices for disputed services so ASD could recognize the revenue in fiscal year 2013, knowing that there was not agreement with the Army to pay the invoices, and that he did so for his own, personal benefit. Pruitt has thus failed to establish that the Division has not asserted a plausible claim that Pruitt caused L3's books and records violations, falsified L3's books and records, and circumvented L3's internal controls, and has failed to establish that the Division would not be entitled to relief under any set of facts. Rather, the facts alleged, assumed true for the purposes of this Motion, constitute violations of the books and records and internal controls provisions with which Respondent is charged.

I. Respondent's contention that the OIP is not entitled to deference is misplaced and has no bearing on a Rule 250(a) motion.

As he did with his motion for a more definite statement, Respondent rehashes his challenge to the OIP as containing allegations that the Division "knows no longer have any basis and fact." (Motion br. at 3.) Respondent seeks to make much of three affidavits submitted

during discovery prior to the *Lucia* ruling, but as the Division has previously explained on two occasions – once before the Commission in opposing Pruitt's motion to the Commission to amend the OIP and a second time before the Court in opposing Pruitt's motion for a more definite statement – Pruitt's argument is nothing more than a premature, and improper, attempt to seek a ruling from the Court in advance of the hearing in this proceeding. (Div. Mem. in Op. to Mot. to Am. the OIP at 3 (June 18, 2018); Div. Mem. in Op. to Mot. for a More Definite Statement at 6 (Dec. 7, 2018).)

The argument has no place in this Rule 250(a) Motion, requires the Court to resolve all reasonable inferences in the Divisions favor. Where, as here, a witness has changed his story from a statement that was grammatically phrased in the present tense in the OIP, one quite plausible inference is that he was telling the truth when he provided statements under threat of a potential Commission enforcement action and/or criminal prosecution, and only now, several years later, is seeking to modify his story. The credibility of the witnesses will be determined by this Court at a hearing in light of cross-examination and with the benefit of the full record. The Court should decline to consider Pruitt's repeated efforts to seek a pre-hearing ruling on these matters of fact. Indeed, in the Court's December 20, 2018 Order Granting in Part Motion for More Definite Statement, the Court "reject[ed] Pruitt's argument that because, in his view, new evidence "irrefutably establish[es]" that "key" allegations in the OIP have "no factual basis," he is entitled to relief. His view of the strength or weakness of the Division's case is not a basis for a more definite statement," Order at 7, and certainly should not be a basis for a judgment as a matter of law on a motion under Rule 250(a).

II. Respondent has failed to demonstrate that he is entitled to a ruling as a matter of law to the books and records charges.

The OIP alleges that Respondent caused L3's violations of the books and records requirement of Section 13(b)(2)(A) of the Exchange Act, which requires issuers, such as L3, 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."[8] The OIP also alleges that Respondent violated Rule 13b2-1 of the Exchange Act, which states that "[n]o person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to" Section 13(b)(2)(A) of the Exchange Act. Finally, the OIP alleges that Pruitt violated Section 13(b)(5) of the Exchange Act, which, among other things, prohibits any person from "knowingly falsify[ing] any book, record, or account" of an issuer such as L3.

Section 13(b)(2)(A) of the Exchange Act "has three basic objectives": (i) reflecting transactions in conformity with GAAP; (ii) making, *inter alia*, misrepresentations, concealment, falsification and circumvention unlawful; and (iii) ensuring transactions are recorded properly to permit preparation of financial statements in conformity with GAAP. *SEC v. e-Smart Techs., Inc.*, 82 F. Supp. 3d 97, 108 (D.D.C. 2015) (quoting *SEC v. World-Wide Coin Invs., Ltd.*, 567 F. Supp. 724, 748 (N.D. Ga. 1983) (granting SEC summary judgment that defendant aided and abetted issuer's violations of Exchange Act Section 13(b)(2)(A)), *appeal dismissed*, No. 15-5143 (D.C. Cir. Oct. 27, 2015). The purpose of this provision "is to strengthen the accuracy of records and the reliability of audits." *Id.* (quoting *World-Wide Coin Invs.*, 567 F. Supp. at 749).

As an initial matter, although he requests that the Court dismiss the OIP in total, Respondent does not address the allegations in the OIP that he violated Section 13(b)(5) of the Exchange Act by knowingly falsifying L3's books, records and accounts (distinct from the

[8] The Exchange Act defines "reasonable detail" as "such level of detail . . . as would satisfy prudent officials in the conduct of their own affairs." Exchange Act Section 13(b)(7), 15 U.S.C. § 78m(b)(7).

Section 13(b)(5) violations for circumventing internal controls). (OIP ¶ 44.) As summarized above, the OIP plainly alleges that Pruitt did just that.

As alleged in the OIP, and deemed true for purposes of the Motion, Pruitt's conduct caused L3 impermissibly to recognize $17.9 million in revenue at the end of 2013 and Q1 2014, which was reflected on L3's books and in L3's financial statements contained in its 2013 Form 10K and Q1 2014 Form 10Q. In *SEC v. DiMaria*, 207 F. Supp. 3d 343, 360 (S.D.N.Y. 2016), the district court denied a motion to dismiss alleged violations of Section 13(b)(5) of the Exchange Act and Rule 13b2-1 where, among other things, the complaint alleged defendant made misrepresentations to the auditor, "thus ensuring that the improper entries would be reflected in [the issuer's] second quarter financial statements." Similarly, Pruitt's misrepresentations to L3's auditors ensured that the improperly recognized revenue would be reflected in L3's 2013 and Q1 2014 financial statements. Further, defendant in *DiMaria* advised that revenue be recorded in a certain way to "avoid questions." *Id.* Pruitt, similarly, explained that recording the revenue without submitting the invoices through WAWS was a "technique." *See also SEC v. RPM Int'l, Inc.*, 282 F. Supp. 3d 1, 34-35 (D.D.C. 2017) (denying motion to dismiss Rule 13b2-1 claim against individual defendant; allegations that defendant communicated with auditor, among others, "sufficiently alleged that [defendant] indirectly or directly caused [the issuer's] records to be falsified'); *SEC v. Espuelas*, 579 F. Supp. 2d 461, 487 (S.D.N.Y. 2008) (denying motion to dismiss Rule 13b2-1 claim against several defendants, including vice president of finance).

Respondent's assertion that he is entitled to judgment as a matter of law boils down to an improper materiality argument; *i.e.*, that the $17.9 million in revenue L3 recognized on the fictitious invoices he created was not material to L3 because the fictitious invoices represented

only the "early recognition of 14/100th of one percent of revenue ($17.9 million/$12.62 billion)." (Motion Br. at 6.) Pruitt thus contends that these "discrepancies" in L3's records are within a "de minimis" exemption to the requirement to maintain accurate books, records and accounts, and cannot result in liability. (Motion Br. at 6.) Thus, even treating (as he must) the allegations in the OIP as being true, Pruitt contends that L3's books and records, even including the $17.9 million in fictitious invoices, were "objectively accurate in reasonable detail" and "satisfactory to prudent officials in the conduct of their own affairs." (Motion Br. at 6.)

As a threshold matter, whether or not L3's records were sufficiently accurate "is a question of fact, and not appropriate to consider on a motion to dismiss." *SEC v. Lucent Techs. Inc.*, 363 F. Supp. 2d 708, 719 (D.N.J. 2005) (decided before *Ashcroft v. Iqbal*; denying motion to dismiss claims charging Sections 13(b)(2)(A) and 13(b)(5), and Rule 13b2-1, violations).

But, Pruitt's lengthy argument hinges on an incorrect notion that there can be no liability, as a matter of law, because the $17.9 million in revenue Pruitt improperly recognized accounted for only a small, de minimis percentage of L3's full year 2013 revenue. (Motion Br. at 6-12.) Pruitt is mistaken. In enacting Section 13(b)(2)(A) of the Exchange Act, Congress rejected the notion that the requirement for accurate books "be subject to a materiality test so that inaccuracies involving small dollar amounts would not be actionable." *SEC v. World-Wide Coin Invs., Ltd.*, 567 F. Supp. 724, 749 (N.D. Ga. 1983). As the *World-Wide Coin* court noted, Congress made clear that "[t]he term 'accurately' in the bill does not mean exact precision as measured by some abstract principle. Rather, it means that an issuer's records should reflect transactions in conformity with accepted methods of recording economic events." *Id.* (quoting S. Rep. No. 94-1031, 94th Cong., 2d Sess. 1976).[9]

[9] Section 13(b)(2)(A) of the Exchange Act was adopted as part of the Foreign Corrupt Practices Act of 1977 ("FCPA"), P.L. 95-213, 91 Stat. 1494. In proposing rules prior to the adoption of the FCPA, the Commission

Viewed against this standard, Pruitt's conduct cannot be seen as anything other than that he caused L3's records to be inaccurate. L3's records failed to reflect transactions with the Army in conformity with GAAP. GAAP requires that revenue can be recognized when it is realized or realizable and earned, that collectability must be reasonably assured, and that the amount of revenue is fixed or determinable. (OIP ¶ 40.) When Respondent created the 69 invoices, he knew that the services L3 purportedly performed were in dispute, and that the Army would reject invoices if they were delivered. Maintaining the revenue associated with the 69 fictitious invoices on L3's books for fiscal year 2013 and Q1 2014 meant L3's books were inaccurate.

Respondent relies on a 1981 policy statement on behalf of the Commission made by former Chairman Harold M. Williams, which refers to a "de minimis exemption" to the books and records requirements. As noted above, the books and records requirements require issuers such as L3 to maintain books, records and accounts that, "in reasonable detail," accurately reflect the issuer's transactions and dispositions of assets. In addressing the American Institute of Certified Public accountants, Chairman Williams discussed, among other things, the degree of exactitude called for by the books and records (and internal controls) provisions.

Regarding whether the statute "mandates that business records and controls conform to a standard of absolute exactitude or that a company's control system meet some absolute ideal," Chairman Williams said that "[t]he answer is 'no.'" Foreign Corrupt Practices Act of 1977, Statement of Policy, SEC Rel. No. 17500, 1981 WL 36385, at *5 (Jan. 29, 1981). "In essence,

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agreed with Congress's observation that "accurately" means that "an issuer's records should reflect transactions in conformity with accepted methods of recording economic events," and expressed the Commission's belief that "to require a lesser standard in defining the obligation to keep books and records could lead to the argument that falsification or omissions below a certain dollar amount may be tolerated." Promotion of the Reliability of Financial Information, SEC Release No. 13185, 1977 WL 174077, at *4 n.6 (Proposed Amendments to Rules and Schedules Jan. 19, 1977).

therefore, the [FCPA] does provide a de minimus (sic) exemption, though not in absolute, quantitative terms." *Id.*

Pruitt seizes on this comment to seek to avoid liability for his misconduct. But Pruitt should have read the Chairman's comments in full to understand the context of the exemption. Contrary to Pruitt's contention, the de minimis exemption is *not* the same as a requirement that the inaccuracy must be material. In fact, materiality is decidedly *not* to be considered.

As Chairman Williams explained, Congress considered and determined not to include a materiality test, and that it was correct in doing so because "[i]nternal accounting controls are not only concerned with misconduct that is material to investors but also with a great deal of misconduct which is not." *Id.* After noting that materiality is a concept that persons such as Respondent are experienced and comfortable with, and noting that materiality is appropriate as a threshold standard for determining disclosure obligations, it "is totally inadequate as a standard for an internal control system" because it is "too narrow—and thus too insensitive – an index." *Id.* Tellingly, Chairman Williams ruled out materiality because it might require transactions to be in the millions of dollars to be material: "For a particular expenditure to be material in the context of a public corporation's financial statements . . . it would need to be, in many instances, in the millions of dollars." *Id.* Chairman Williams easily dismissed this as unworkable: "Such a threshold, of course, would not be a realistic standard." *Id.* Of course, ironically, here the alleged inaccuracy *is* in the millions of dollars – $17.9 million – but the only reason it is not material is because L3 is such a large consolidated entity.

Chairman Williams continued:

> Procedures designed only to uncover deficiencies in amounts material for financial statement purposes would be useless for internal control purposes. Systems which tolerated omissions of errors of many thousands or even millions

> of dollars would not represent, by any accepted standard, adequate records and controls.

Id. Chairman Williams concluded that "[r]easonableness, rather than materiality, is the appropriate test," and that "[i]nherent in this concept is a toleration of deviations from the absolute."

Undeterred, Pruitt nonetheless contends that a prudent man would not be troubled by $17.9 million, but the only justification he can hinge this on is the size of L3:

> Prudent officials in the conduct of their own affairs simply would not deem books and records that contain an alleged early recognition of $14/100^{th}$ of one percent of revenue ($17.9 million/$12.62 billion) to be inaccurate or not kept in reasonable detail. There being no primary violation by L3, the state of mind of L3's employee is irrelevant—Mr. Pruitt can have no liability for allegedly intending to cause something that *objectively never happened.*

(Motion Br. at 6 (emphasis added).) Common sense dictates that Pruitt is just plain wrong. The argument, if taken to its logical conclusion, bears an absurd result. In essence, Pruitt argues that all accounting officers of any exceedingly large public company should be given a free pass with respect to compliance with the books and records provisions of the U.S. securities laws because most errors – even in the tens of millions, as here – would be considered de minimis when compared to that entity's enormous revenues. Such a ruling would turn consolidated financial reporting on its head and potentially lead to even materially inaccurate financials, as hundreds of lax financial officers report up sloppy financials relying on their companies' sheer size to exonerate the errors as de minimis. No prudent official would deem L3's books and records accurate or maintained in reasonable detail that improperly reflected $17.9 million in fictitious revenue, which was recorded in contravention of GAAP. L3 certainly did not think so when it revised its financial statements.

And it is beyond credulity for Pruitt to contend that the generation of fictitious invoices and illegal recording of $17.9 million in revenue, in fact, "objectively never happened." But in making such a ridiculous statement, Pruitt has unwittingly shown the absurdity of his position. For one thing, the quoted language, while purporting to be a humorous, yet truthful, statement, is not, in fact, true: the recognition of $17.9 million in fictitious revenue as a result of Pruitt's conduct *did*, in fact, happen – so much so that L3 was forced to file an amended Form 10-K for 2013 and Q1 Form 10Q for 2014 to remove from its records what Pruitt says "objectively never happened."[10] More to the point, it shows what would happen if the Court were to accept Pruitt's position: it would eviscerate Congress's intent that records of issuers such as L3 "should reflect transactions in conformity with accepted methods of recording economic events."

To be sure, the books and records requirements do not require conformity to a standard of "absolute exactitude," as Chairman Williams explained. But to be equally sure, whatever that exactitude should be quantitatively is something the Court need not reach in this case because $17.9 million is large by any reasonable measure and, moreover, the books and records requirements prohibit precisely the type of conduct Pruitt indisputably engaged in: recording transactions and assets that did not yet exist (regardless of whether they subsequently came into existence). Pruitt was motivated by his own personal interests, rather than serving L3's interest in complying with the securities laws, as any prudent official conducting her own affairs would have expected a gatekeeper and CPA to have done under the circumstances.

[10] Pruitt does, however, express the truth, albeit the opposite of what Pruitt intended: by instructing the generation of the $16.9 million in fictitious invoices and improper revenue recognition, Pruitt did indeed cause L3's books to reflect "something that objectively never happened," *i.e.*, to reflect a non-existent agreement by the Army to pay the invoices.

III. Respondent has failed to establish that he is entitled to a ruling on the pleadings as a matter of law on the internal controls charges.

The OIP charges that Pruitt violated the internal controls requirements of the Exchange Act. Section 13(b)(5) of the Exchange Act prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record or account of an issuer. Pruitt violated Section 13(b)(5) of the Exchange Act by knowingly circumventing L3's internal controls when he instructed the 69 fictitious invoices to be created and L3 improperly to recognize $17.9 million in revenue. As the court observed in *World-Wide Coin*, "[t]he maintenance of financial records and internal accounting controls are major every-day activities of every registered and/or reporting company." 567 F. Supp. at 747. "Internal controls safeguard assets and assure the reliability of financial records." *Id.* at 749. "The internal controls requirement is primarily designed to give statutory content to an aspect of management stewardship responsibility, that of providing shareholders with reasonable assurances that the business is adequately controlled." *Id.* Of course, those purposes are frustrated when stewards, such as Pruitt, take it upon themselves to override the controls for their own, personal purposes.

As he did in moving for a more definite statement, Respondent again argues that the Division should be limited to contending he circumvented only *one* of L3's internal accounting controls. (Motion Br. at 1-2, 7 n.8.) As the Division has previously explained (Div. Mem. In Op. to Mot. for a More Definite Statement at 11-12 (Dec. 7, 2018)), this argument is without merit. The OIP, in describing the investigation that led to the discovery of Pruitt's misconduct, referenced "a specific internal control of L3 that required delivery of invoices" in the context of describing that L3 discovered in June 2014 that the fictitious invoices had not been delivered. (OIP ¶ 39.) But the OIP further alleges that Pruitt's conduct violated the internal controls

provisions of the securities laws, and is not limited to circumvention of only one internal control. (OIP ¶ 44 ("As a result of the conduct described above, Pruitt willfully violated Section 13(b)(5) of the Exchange Act, which prohibits any person from knowingly circumventing or knowingly failing to implement *a system of internal accounting controls*.") (emphasis added).)

As also explained in the Division's opposition to the motion for a more definite statement, the Division's opposition to Respondent's original motion identified (among others) three of L3's specific Internal Controls Over Financial Reporting, IR4, IR5 and FR4A. Finally, the Division's opposition to the motion for a more definite statement reiterated each of the internal controls, which the Division had identified in June 2017 in response to the Court's order on Respondent's original motion for a more definite statement and which are relevant to this proceeding: Period-end Financial Reporting controls 4A, 4B, 5A, 5B, 5C, 8A, 9, 10, 23 and 25B; Invoicing and Receivables controls 2, 3A, 4, 5 and 6; and Contract Estimating control 14.[11]

The OIP – whether viewed on its own or as voluntarily supplemented by the Division – plausibly alleges a violation of the prohibition on circumventing internal controls. The OIP's allegations and the reasonable inferences flowing from those allegations demonstrate that Pruitt knowingly circumvented L3's internal controls when he directed the generation of 69 invoices and improperly recognized $17.9 million in revenue. Through his conduct, Pruitt interfered with the purpose of internal controls: to provide shareholders with reasonable assurance that the business is being adequately controlled.

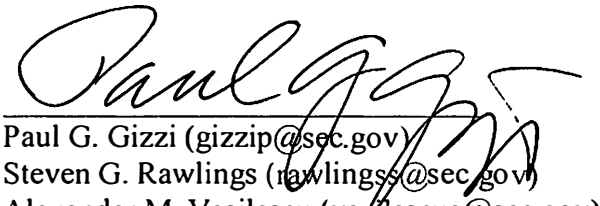
[11] As the Division also noted, Pruitt distributed L3's controls and associated process narratives to a group of L3 employees by email on March 30, 2013. (Div. Mem. in Op. to Mot. for a More Definite Statement at 11 n.7.).

CONCLUSION

For the foregoing reasons, the Division respectfully requests that Respondent's motion for a ruling on the pleadings be denied.

Dated: December 21, 2018
New York, NY

DIVISION OF ENFORCEMENT

By: 

Paul G. Gizzi (gizzip@sec.gov)
Steven G. Rawlings (rawlingss@sec.gov)
Alexander M. Vasilescu (vasilescua@sec.gov)
Securities and Exchange Commission
200 Vesey Street, Suite 400
New York, NY 10281
212-336-1100

CERTIFICATE OF SERVICE

I hereby certify that on December 21, 2018, I caused the original and three copies of the foregoing DIVISION OF ENFORCEMENT'S MEMORANDUM IN OPPOSITION TO RESPONDENT'S MOTION FOR A RULING ON THE PLEADINGS to be filed with:

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE, Mail Stop 1090
Washington, DC 20549

I further certify that I caused to be served a copy of the foregoing via email upon:

David Pruitt
c/o John J. Carney, Esq.
BakerHostetler
45 Rockefeller Plaza
New York, NY 10111

I further certify that I caused a courtesy copy of the foregoing to be provided by email to:

The Honorable James Grimes
Administrative Law Judge
Securities and Exchange Commission
100 F Street NE, Mail Stop 2582
Washington, DC 20549

Paul G. Gizzi

CERTIFICATE OF COMPLIANCE

I hereby certify that the foregoing DIVISION OF ENFORCEMENT'S MEMORANDUM IN OPPOSITION TO RESPONDENT'S MOTION FOR A RULING ON THE PLEADINGS complies with the length limitation in Rule of Practice 250(f)(1) because it consists of approximately 8,564 words, which is less than the 9,800 word limit.

Paul G. Gizzi