UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-17950

In the Matter of,

David Pruitt, CPA

Respondent.

RESPONDENT DAVID PRUITT'S MOTION FOR RECONSIDERATION OF THE ORDER DENYING HIS MOTION FOR A RULING ON THE PLEADINGS AND MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

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Respondent David N. Pruitt, through his undersigned counsel, respectfully requests that the Court exercise its inherent authority and discretion to reconsider the order (the "Order")[1] denying his motion for a ruling on the pleadings (the "Motion on the Pleadings"), on grounds of intervening change in law and/or error of law, and dismiss the charges in the Order Instituting Proceedings ("OIP")[2] alleging violations of Section 13(b)(5)[3] and Rule 13b2-1.[4]

Reconsideration is proper here for two reasons. First, the plain language of Section 13(b)(5) limits liability to conduct performed with scienter and the legislative history confirms that the statute is not meant to police unintentional or inadvertent conduct. To give effect to the plain language of Section 13(b)(5), the Division of Enforcement (the "Division") must plead and prove that Mr. Pruitt was aware of the specific controls allegedly at issue and knowingly engaged in conduct with the intended purpose of circumventing the specific controls. This Court stated in the Order, however, that "liability does not depend on whether [Mr. Pruitt] knew the contents of a specific control" and it instead depends on whether Mr. Pruitt "consciously undertook the actions that resulted in the circumvention of L3's internal controls."[5] The Order further sustained the 13(b)(5) charge on the basis that the OIP alleged sufficient facts to support the inference that Mr. Pruitt "knew or should have known that he was violating L3's internal

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[1] *See* Order Denying Respondent's Motion for Judgment on the Pleadings, Admin. Proc. Rulings Release No. 6452, *In the Matter of David Pruitt, CPA*, Admin. Proc. File No. 3-17950 (Feb. 12, 2019).

[2] *See* Order Granting Motion to Amend Order Instituting Proceedings, Admin. Proc. Rulings Release No. 6551, *In the Matter of David Pruitt, CPA*, Admin. Proc. File No. 3-17950 (Apr. 26, 2019).

[3] References to specific sections or rules refer to sections of or rules under the Securities Exchange Act of 1934.

[4] Mr. Pruitt's Motion on the Pleadings sought dismissal of the Rule 13b2-1 charge on the ground that it was inextricably linked to the OIP's Section 13(b)(2)(A) charge and that, if the latter charge failed as a matter of law, *a fortiori* the former would fail as well.

[5] Order at 9-10.

controls."[6] A "knew or should have known" standard sounds in negligence, as opposed to scienter, and is not consistent with the "knowing circumvention" language of Section 13(b)(5). Similarly, one cannot knowingly circumvent a control that is unclear or unknown, and a violation requires more than just consciously undertaking actions that result in a control not being followed.

Applying the proper legal standard to the OIP makes clear that the allegations regarding the alleged controls circumvention fall far short of what is required and must be dismissed. The Court's application of a much lower negligence-like standard permitted the Division to plead Mr. Pruitt's liability under Section 13(b)(5) without alleging that Mr. Pruitt acted with the requisite scienter. Even if the Court determines that the allegations in the OIP are facially sufficient, it should correct the legal standard articulated in the Order to accurately reflect that "knowingly" in the context of Section 13(b)(5) requires the Division to prove knowledge and intent in order to establish a violation.

Second, the D.C. Circuit Court's decision in *Robare Group, Ltd. v. SEC*, 922 F.3d 468 (D.C. Cir. 2019)—which issued four days after the Order and was not considered during the prior motion—clarified the law applicable to allegations of "willfulness," raising the bar the Division must clear to plead and prove willful violations of Section 13(b)(5) and Rule 13b2-1 here. For the Division's willfulness charges to survive, the Division must plead that Mr. Pruitt subjectively intended to knowingly circumvent internal controls or that he subjectively intended to falsify books and records. The OIP does not even approach, much less meet this higher standard, which provides a separate basis for the dismissal of these charges as a matter of law or at a minimum a dismissal of the willfulness portion of each charge.

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[6] *Id.* at 10.

BACKGROUND

On April 28, 2017, the Commission issued the OIP to (1) impose a cease-and-desist order and civil monetary penalties on Mr. Pruitt under Sections 21C and 21B, and (2) further punish Mr. Pruitt by barring him from practice before the Commission as an accountant under Section 4C and Rule of Practice 102(e)(1)(iii). Specifically, the Division alleged that in December 2013, Mr. Pruitt instructed a subordinate to create and withhold invoices for services that had previously been provided to the U.S. Army and thereby caused L3 Technologies, Inc. ("L3") to improperly recognize revenue for those services. Relevant to this motion, the Division charged that this conduct willfully violated Section 13(b)(5)'s prohibition against knowingly circumventing internal controls and Rule 13b2-1's prohibition against falsifying books and records.

On December 14, 2018, Mr. Pruitt filed his Motion on the Pleadings seeking dismissal as a matter of law of: (1) causing violations of Section 13(b)(2)(A); (2) the Section 13(b)(5) charge, because the OIP failed to identify any internal control that he could have knowingly circumvented; and (3) the Rule 13b2-1 charge, because alleged discrepancies in L3's financial statements that purportedly resulted from Mr. Pruitt's conduct were *de minimis* and therefore could not give rise to liability for falsification of books and records that were otherwise kept fairly and accurately in reasonable detail.

On February 12, 2019, the Court denied Mr. Pruitt's Motion on the Pleadings, declining to dismiss the OIP's 13(b)(5) charge because, according to the Order, Mr. Pruitt's "liability does not depend 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."[7]

[7] *See* at Order 9-10.

The Court further found that the OIP's allegations supported a "reasonable inference" that Mr. Pruitt "knew or should have known" that his actions violated L3's internal controls.[8] The Court also declined to dismiss the Rule 13b2-1 charge, and ruled that the alleged financial statement discrepancies were not *de minimis* as a matter of law.[9]

The OIP, as initially drafted, vaguely referenced only one internal control Mr. Pruitt allegedly circumvented and failed to identify with the required specificity the books or records he allegedly falsified. Subsequently, the Court granted Respondent's motion for a more definite statement and the Division moved to amend the OIP to include the specific internal controls Mr. Pruitt allegedly circumvented and books and records he purportedly falsified.[10]

Four days later, the D.C. Circuit Court issued its *Robare* decision imposing a more exacting "subjective intent" standard that willfulness allegations in enforcement proceedings must meet.

ARGUMENT

I. THE COURT MAY RECONSIDER ITS INTERLOCUTORY ORDER AS APPROPRIATE TO EFFECT JUSTICE

So long as Congress or the Commission has not provided otherwise, the Court has the authority to reconsider its interlocutory orders because "[t]he power to reconsider is inherent in the power to decide" and "it is the general rule that every tribunal, judicial or administrative, has some power to correct its own errors or otherwise appropriately to modify its judgment, decree or order." *Tokyo Kikai Seisakusho, Ltd. v. United States*, 529 F.3d 1352, 1360-61 (Fed. Cir. 2008) (internal quotation marks omitted); *see Glass, Molders, Pottery, Plastics & Allied*

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[8] *Id.* at 10.
[9] *Id.* at 6-7.
[10] *See* Order Granting Motion to Amend Order Instituting Proceedings, Admin. Proc. Rulings Release No. 6551, *In the Matter of David Pruitt, CPA*, Admin. Proc. File No. 3-17950 (Apr. 26, 2019).

Workers, Int'l Union, AFL-CIO, Local 1828B v. Excelsior Foundry Co., 56 F.3d 844, 846-47 (7th Cir. 1995) ("[E]very court, and every administrative agency that exercises adjudicative authority, has been understood to have . . . the inherent power to reconsider its decisions within a reasonable time." (citations omitted)). The Federal Rules of Civil Procedure Advisory Committee notes state that "interlocutory judgments . . . are subject to the complete power of the court rendering them to afford such relief from them as justice requires," Fed. R. Civ. P. 60(b) Advisory Committee notes (1946). Pursuant to Federal Rule of Civil Procedure 54(b), in an action involving multiple claims for relief, the court may reconsider any order that adjudicates fewer than all of the claims, prior to entry of final judgment adjudicating all of them. Thus, although the Rules of Practice do not specifically provide for the Court's reconsideration of its non-final orders, the practice is permitted, as further evidenced by the Court's consideration of another motion to reconsider an interlocutory order. *See* Order Ratifying Prior Actions and Denying Motion for Reconsideration, Admin. Proc. Rulings Release No. 5596, *In the Matter of Martin Shkreli*, Admin. Proc. File No. 3-18127, at 2-4 (ALJ Feb. 14, 2018).

II. SECTION 13(b)(5) REQUIRES SCIENTER

A. The Plain Language of Section 13(b)(5) Limits Liability to Conduct Performed with Scienter

It is a basic principle that "[t]he starting point in every case involving construction of a statute is the language itself," *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975), and in construing that language "we begin with the understanding that Congress says in a statute what it means and means in a statute what it says there." *Hartford Underwriters Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000). Section 13(b)(5) provides that "[n]o person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record or account described in [Section 13(b)(2)]." 15

U.S.C. § 78m(b)(5). Analysis of Section 13(b)(5)'s plain language demonstrates that there can be no liability for circumventing an internal control without a clear understanding of the nature and requirements of the control at issue and the wrongful consequences flowing from circumventing the control.[11] Nothing in the language of Section 13(b)(5) contemplates liability for unintentional acts that one "should have known" would, might, or happen to violate an internal control. Liability for knowingly circumventing an internal control requires intentionally evasive conduct performed with a state of mind that comprehends both the evasive nature of the circumvention and the consequences that follow.[12]

The plain language analysis in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), is instructive for determining the meaning of "knowingly circumvent" found in Section 13(b)(5). In *Hochfelder*, the court determined that the words of Section 10(b), which do not include the term "knowingly," prohibited "knowing or intentional misconduct." 425 U.S. at 197. Stated differently, violations of Section 10(b) require proof of scienter even where the statute did not specifically use the word "knowingly," a term commonly associated with knowing and

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[11] For the purposes of this motion, Respondent addresses the scienter requirement of Section 13(b)(5) in connection with the internal controls prong of the statute (as opposed to the knowing falsification of the books and records prong of the statute) as that is what was addressed by the Court in its Order. Under either prong, the scienter standard is the same because the statute prohibits a "knowing circumvention" or a "knowing falsification." The Division has failed to allege either in the OIP.

[12] The "knew or should have known" negligence standard the Court articulated in the Order is taken from Section 21C which on its face only applies to persons found liable for secondary violations, not primary violations. *See* Section 21C. The OIP charges Mr. Pruitt as a primary, not a secondary violator of Section 13(b)(5) and Rule 13b2-1. *Compare* OIP ¶¶ 50-51, *with* OIP ¶ 49. Here, the alleged violations of Section 13(b)(5) and Rule 13b2-1 both require proof of scienter so negligent conduct is never sufficient to set forth a violation. Even if Section 21C's "knew or should have known" standard could apply to a primary violation, the Division would still be required to prove, and the Court would still have to test the OIP's allegations against, the higher knowledge standard required by Section 13(b)(5), because the underlying primary violation requires scienter. *See Howard v. SEC*, 376 F.3d 1136, 1141-43 (D.C. Cir. 2004).

intentional conduct. As applied here, consciously undertaking actions that result in a circumvention is not enough.

1. "Knowingly" Limits Section 13(b)(5) Liability to Acts Performed with Knowledge and Intent

By combining "circumvention" with "knowingly" in Section 13(b)(5), Congress clarified its intent to limit liability to actions conducted with scienter. Scienter is defined as the "intention 'to deceive, manipulate, or defraud.'" *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (quoting *Hochfelder*, 425 U.S. at 194 & n.12). Knowingly means both "knowledge of what one is doing" and knowledge of "the nature and consequences of his actions." *See SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 77 (D.C. Cir. 1980); *Svalberg v. SEC*, 876 F.2d 181, 184 (D.C. Cir. 1989) (knowledge of what one is doing and the consequences of those actions suffices). In the context of a Section 13(b)(5) violation, the Division must plead and prove that Mr. Pruitt was (1) *aware* of the internal controls he was allegedly evading; (2) *aware* of the purposeful and evasive "conduct" he was allegedly engaged in; and (3) *aware* that the consequences of that purposeful and evasive conduct would be the circumvention of the internal controls at issue.[13] *See SEC v. Stanard*, No. 06 Civ. 7736(GEL), 2009 WL 196023, at *30 (S.D.N.Y. Jan. 27, 2009) ("Section 13(b)(5) does require a showing of scienter. As the plain language of the statute indicates, the standard is 'knowing,' not merely 'reckless.'"); *see also Falstaff Brewing Corp.*, 629 F.2d at 77; *Svalberg*, 876 F.2d at 184.

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[13] The Order cites *United States v. Reyes*, 577 F.3d 1069 (9th Cir. 2009), as support for the premise that consciously undertaking actions that lead to the circumvention of a control is sufficient to meet the scienter standard of Section 13(b)(5). Citing the legislative history of Section 13(b)(5), the *Reyes* court confirmed that the term "knowledge" requires a person to engage in deliberate conduct but to also be aware that the act the person is committing is false. *Id.* at 1081. Taken to its logical conclusion, in the context of an internal control circumvention, the actor must be aware of the control at issue and that the actor's conduct is intended to evade that control. The standard set forth in *Reyes* requires more than just a "conscious undertaking" in order to meet the scienter standard and set forth a violation.

A contrary standard that does not require the Division to plead that Mr. Pruitt was aware of the specific controls he is alleged to have circumvented would render the "knowingly" standard meaningless. It would allow inadvertent conduct to form the basis for a violation. It would also impose liability in situations where the actor was entirely unaware of the existence of a control so long as the actor "consciously undertook actions that resulted in" the circumvention of controls irrespective of the intent of those actions.

Other than a conclusory allegation that Respondent was "aware of L3's internal controls" because he circulated a list of almost 500 controls six and a half years ago, the OIP is devoid of any other allegations that specifically demonstrate that Mr. Pruitt was aware that he was engaging in conduct for the purpose of circumventing specific internal controls and that circumvention would result from his knowing conduct.[14] The OIP relies on conclusory allegations to set forth the purported controls that were circumvented and does not allege in any detail that Mr. Pruitt acted with the requisite scienter to support the 13(b)(5) charge.[15]

2. "Circumvent" Describes Scienter-Based Conduct

Like the statutory language analyzed in *Hochfelder*, the key words in Section 13(b)(5) – "circumvent" and "knowingly" – plainly describe conscious and purposeful conduct—which is distinct from consciously undertaking actions that happen to result in the circumvention of a control without the specific knowledge of doing so. The common and ordinary meaning of "circumvent" is "[t]o get the better of by craft or fraud; to overreach, outwit, cheat, 'get round,' 'take in.' Also, to evade or find a way around." Oxford English Dictionary (2d ed. 1989) ("OED"). By choosing to use the word "circumvent" in Section 13(b)(5), Congress clearly made unlawful—even without inclusion of the word knowingly—the purposeful evasion of internal

[14] OIP ¶ 47.

[15] *See, e.g., id.* ¶ 48(a)(i) & (v), (b)(i) & (iii), (c)(i), (d)(iii).

controls by intentional acts, and excluded liability for unintentional, negligent, or inadvertent failure to comply with such controls.

B. The Legislative History Confirms That Congress Intended to Exclude Unintentional Conduct from Liability Under Section 13(b)(5)

To the extent there is any doubt whether Section 13(b)(5) requires proof of scienter, the relevant legislative history puts that doubt to rest. Congress intended to limit liability to intentional conduct and exclude liability for unintentional acts.

The legislative history for the bill that became Section 13(b)(5) explained that the provision "establishes a scienter standard for violations of the accounting standards to prohibit knowing circumvention of the system of internal accounting controls." *See* 133 Cong. Rec. 3595, at 3654 (Feb. 19, 1987). The House conference report explaining the accounting standards' penalty provisions in the final language of Section 13(b)(5) explained that they were to be imposed on conduct "hav[ing] the purpose of falsifying books, records, or accounts or of circumventing the accounting controls set forth in the Act," including "deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement." H.R. Rep. No. 100-576, at 916-17 (Apr. 20, 1988). The report also affirmed that the new provisions were intended to codify the "enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct"—in other words, negligent conduct is not actionable under Section 13(b)(5). *Id.* at 916.[16]

The standard the Court set forth in the Order that liability "depends on whether [Mr. Pruitt] consciously undertook the actions that resulted in the circumvention of L3's internal

[16] The words "inadvertent" and "inadvertence" are generally synonymous with "negligent" and "negligence." *See, e.g., Fuhrmann v. Fanroth*, 254 N.Y. 479, 482-83 (N.Y. 1930) (Cardozo, C.J.); *Palsgraf v. Long Island R.R. Co.*, 248 N.Y. 339, 345 (N.Y. 1928) (Cardozo, C.J.); *see also Browder v. United States*, 312 U.S. 335, 341 (1941); *see also Inadvertent*, OED ("Not properly attentive or observant; inattentive, negligent; heedless").

controls"[17] and that Respondent knew or should have known he was violating the controls falls short of what Congress intended.

III. *ROBARE* REQUIRES THAT THE OIP ALLEGE THAT MR. PRUITT SUBJECTIVELY INTENDED TO KNOWINGLY CIRCUMVENT INTERNAL CONTROLS AND FALSIFY BOOKS AND RECORDS

By seeking to bar Mr. Pruitt under Section 4C from practicing before the Commission as an accountant, the Division must establish that his alleged violations of Section 13(b)(5) and Rule 13b2-1 were willful. As set forth above, in sustaining the OIP's charge of a willful violation of Section 13(b)(5), however, the Court stated that Mr. Pruitt's liability depended only "on whether he consciously undertook the actions that resulted in the circumvention of L3's controls."[18] This standard does not rise to the level of subjective intent required under *Robare*'s definition of willfulness, which the Court must apply in scrutinizing the OIP.[19] *Robare* imposes a more exacting standard for pleading and proving a "willful" violation of Section 13(b)(5) and Rule 13b2-1.

In *Robare*, the D.C. Circuit Court reversed the Commission's finding that the petitioners' negligence was sufficient to establish that they had willfully violated Section 207 of the Investment Advisers Act of 1940 (the "Advisers Act")[20] because the Forms ADV they consciously prepared and filed with the Commission "turned out to" have omitted material information. 922 F.3d at 479. To establish willfulness, the circuit court ruled that petitioners

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[17] Order at 9-10.
[18] *See* Order at 10.
[19] *See generally* Mary Jo White, & Andrew Ceresney *et al.*, *D.C. Circuit Gives New Meaning to "Willful" in Securities Statutes*, Law360 (May 14, 2019), *available at* https://www.law360.com/articles/1158858.
[20] Section 207 of the Advisers Act makes it "unlawful for any person *willfully* to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein." 15 U.S.C. § 80b-7.

must have "subjectively intended" to omit the specific material information in question. *Id.* The court made clear that negligent conduct cannot be willful or form the basis for a finding of willfulness and the mere fact that the petitioners in *Robare* consciously undertook actions that resulted in the filing of forms with material omissions was not sufficient. *Id.* at 480. Instead, willfulness required the Division to demonstrate that the petitioners subjectively intended to omit the material information or were subjectively aware that the omission was substantially certain to occur as the result of their conduct. *Id.* at 479.

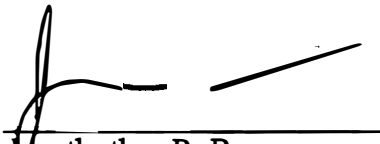
In this matter, in order to establish the "willfulness" of the alleged violations of Section 13(b)(5) and Rule 13b2-1, the Division must show that Mr. Pruitt *subjectively intended* to engage in knowing circumvention of L3's internal controls and *subjectively intended* to falsify its books and records. *See Robare*, 922 F.3d at 479 (citing *Wonsover v. SEC*, 205 F.3d 408, 413-15 (D.C. Cir. 2000)). The OIP fails to allege either. Similar to the petitioners in *Robare*, it is not sufficient that Mr. Pruitt consciously undertook actions that allegedly resulted in internal controls circumventions or the falsification of the books and records. The Section 13(b)(5) and Rule 13b2-1 charges should therefore be dismissed or in the alternative the Division should be precluded from attempting to prove willful violations of these two provisions because the OIP does not allege that Mr. Pruitt acted willfully.

CONCLUSION

For the reasons set forth herein, the Court should grant Mr. Pruitt's motion for reconsideration and dismiss the Section 13(b)(5) and Rule 13b2-1 charges. Even if the

allegations in the OIP withstand scrutiny, the Court should correct the legal standard necessary for establishing a "knowing circumvention" of internal controls as set forth herein.

Dated: August 23, 2019
New York, New York

By: 

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