UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-17950

In the Matter of,

David Pruitt, CPA

Respondent.

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF RESPONDENT DAVID PRUITT'S MOTION FOR A RULING ON THE PLEADINGS

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Pursuant to Rule 250(a) of the Securities and Exchange Commission's ("SEC" or the "Commission") Rules of Practice, Respondent David N. Pruitt ("Mr. Pruitt") submits this memorandum of points and authorities in support of his Motion for a Ruling on the Pleadings (the "Motion") as to certain allegations in the Order Instituting Administrative and Cease-and-Desist Proceedings ("OIP") pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 102(e)(1)(iii) of the Commission's Rules of Practice dated April 28, 2017. The Affidavit of Margaret E. Hirce ("Hirce Aff.") is also submitted in support of the Motion.

PRELIMINARY STATEMENT

The Division of Enforcement (the "Division") has pleaded a case that alleges two violations. First, that an employee of an issuer can be held liable for books and record violations as small as 14/100th of one percent (.0014); and second that the same employee can be held liable for circumventing an internal control that does not exist. Both allegations fail as a matter of law and require the dismissal of the OIP.

First, the OIP fails as a matter of law to allege facts demonstrating that the books and records of L3 Technologies, Inc. ("L3") were not maintained with the "reasonable detail" required by law. While the Division might wish for a standard that requires perfection, the law does not require that books and records be kept with such precision. The Division ignores the legislative history and the Commission's own policy on the limited reach of the "books and records" provision of Section 13(b)(2)(A) of the Exchange Act by bringing this proceeding. Recognizing that a standard which requires absolute precision would be unworkable and unreasonable, Congress deliberately only required an issuer 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."[1] Acknowledging that the plain meaning of the statutory language does not mandate perfection, then SEC Chairman Harold M. Williams described the "reasonable detail" standard as establishing a *de minimis* exemption to 100 percent accuracy, a statement of SEC policy codified in the Code of Federal Regulations. This codified position has been ignored by the Division. The revenue alleged to be improperly recognized and the cause of the purportedly inaccurate books and records is 14/100th of one percent ($17.9 million out of $12.622 billion)[2] of L3's reported net revenue for year ended December 31, 2013. Even if the Division were to amend its OIP, it would not change the fact that the amount at issue here is a mere *de minimis* fraction of L3's annual revenue and cannot support an argument that the records were not maintained in "reasonable detail." As discussed below, federal agencies routinely find small percentages larger than this to be *de minimis*. Thus the Division's claim under Section 13(b)(2)(A) fails as a matter of law, as do its claims under Rule 13b2-1 and Section 13(b)(5).

Second, the Division fails to adequately plead a violation under Section 13(b)(5) of the Exchange Act for "knowingly circumventing a system of internal controls." The Division's sole allegation regarding the internal controls violation concerns the circumvention of a control that purported to require the delivery of invoices to the customer. However, not one of the sixteen internal controls recently cited by the Division requires the delivery of invoices before revenue can be recognized and many are irrelevant on their face. Mr. Pruitt cannot violate Section 13(b)(5) by knowingly circumventing an internal control that did not exist.

For each of these reasons, the Division's OIP is legally invalid and the Court should rule as a matter of law in favor of Mr. Pruitt and dismiss the OIP in its entirety with prejudice.

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[1] Exchange Act Section 13(b)(2)(A) (emphasis added).
[2] Hirce Aff. Ex. B at 2.

ARGUMENT

I. LEGAL STANDARD

Mr. Pruitt moves for a ruling on the pleadings pursuant to Rule 250(a) of the Commission's Rules of Practice. Pursuant to Rule 250(a), a "party may move for a ruling on the pleadings on one or more claims or defenses, asserting 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."[3]

II. THE DIVISION'S SECTIONS 13(b)(2)(A), (b)(5), AND RULE 13b2-1 CLAIMS FAIL AS A MATTER OF LAW BECAUSE AT ALL TIMES THE BOOKS, RECORDS, AND ACCOUNTS REFLECTED TRANSACTIONS IN "REASONABLE DETAIL"

The OIP is facially invalid as a matter law because the Division does not—and cannot—allege that L3's books and records were not maintained with the "reasonable detail" required by law and as such Mr. Pruitt could not have caused any violation. The plain meaning of the term "reasonable detail" cannot credibly include something as miniscule as the purportedly improper revenue the Division claims caused the alleged inaccuracies. The legislative history of the relevant provisions and subsequent statements from the Commission itself confirms this common sense meaning of the law. Even if the revenue at issue in this action was improperly recognized (which it was not), the books and records of L3 were still maintained in reasonable detail and there can be no violation of the books and records provisions.

The accounting provisions were added to the Exchange Act as part of the Foreign Corrupt Practices Act ("FCPA") and were not included in the original drafts of the FCPA.[4] Section

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[3] 17 C.F.R. § 201.250(a).

[4] *See A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934 (Section 102 of the Foreign Corrupt Practices Act of 1977)*, A Report by the American Bar Association Committee on Corporate Law and Accounting, 34 BUS. LAW. 307, 309 (1978) ("Congress moved hastily on the accounting provisions of the 1977 Act; technical

13(b)(2)(A) as originally proposed required issuers to "make and keep books, records and accounts, which accurately and fairly reflect the transactions and dispositions of the assets of the issuer[.]"[5] The House of Representatives then submitted an amendment requiring the phrase "in reasonable detail" be added to modify the term "accurately."[6] In considering the modification, the Conference Committee, citing concern that the proposed language would require unattainable perfection, accepted the proposal because the term "[accurately], if unqualified, might connote a degree of exactitude and precision which is unrealistic."[7] The term "reasonable detail" was specifically added to the statute to prevent the prosecution of the exact type of *de minimis* violation that the Division now alleges in the OIP.

A. The Alleged Improper Revenue Falls Within the *De Minimis* Exemption

The Commission itself has long recognized a *de minimis* limit to what is required of issuers under Section 13(b)(2)(A).[8] The Division entirely ignored this limit when bringing this proceeding and it is not legally possible to establish a violation even if the conduct alleged occurred exactly as stated in the OIP. Published in the Code of Federal Regulations as the Commission's formal policy statement on the FCPA, then Chairman Williams addressed the "degree of exactitude" required by Section 13(b)(2)(A), highlighting that the statutory requirements on issuers are "modified by the key term 'reasonable,'" which "allows flexibility in

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problems of day-to-day accounting were pale stuff compared to the red-hot moral-political issues of bribery that commanded the attention of the Congress. The House version of the bill did not contain the accounting provisions at all, and they were never debated on the House floor or in a House committee.").

[5] S. 3133 and S. 3134, 94th Cong. (1976).

[6] H.R. Rep. No. 94-831, 95th Cong., 1st Sess. at 10 (1977).

[7] *Id.*

[8] *See, e.g.*, Management's Reporting on Internal Control Over Financial Reporting, Release Nos. 33-8762; 34-54976; File No. S7-24-06 (proposed Dec. 20, 2006) (to be codified at 17 C.F.R. Parts 210, 240 and 241) ("The Commission has long held that 'reasonableness' is not an 'absolute standard of exactitude for corporate records.'") (citing Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544]).

responding to particular facts and circumstances. Inherent in this concept is a toleration of deviations from the absolute."[9] Critically, Chairman Williams expressly recognized that the "in reasonable detail" language of Section 13(b)(2)(A) "does provide a *de minimus*[10] [sic] exemption" to the accuracy requirement.[11]

Here, 99.86% of L3's reported net revenue for year ended December 31, 2013 was unconnected to the conduct alleged to be improper by the Division. From any objective quantitative basis, 14/100th of one percent (.0014—the amount of the allegedly improper revenue) is *de minimis*. While Chairman Williams did not quantify the limit provided by the exemption and that threshold may vary by context, federal agencies overwhelmingly find percentages higher than the 14/100th of one percent at issue here to be *de minimis*.[12]

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[9] 17 C.F.R. Part 241 at 11546 (1981).

[10] The plain meaning of the term *de minimis* itself supports the conclusion that an error that amounts to 14/100th of one percent falls within its ambit. Merriam-Webster defines *de minimis* as "lacking significance or importance; so minor as to merit disregard." The Division's position ignores the age-old maxim *de minimis non curat lex*: "the law does not care for, or take notice of, very small or trifling matters." *de minimis non curat lex*, Black's Law Dictionary (10th ed. 2014).

[11] 17 C.F.R. Part 241 at 11546 (1981). One case oft cited for Section 13(b)(2)(A) issues is *SEC v. World-Wide Coin Investments, Ltd.*, 567 F. Supp. 724 (N.D. Ga. 1983). The court stated "the FCPA provides no guidance, and this court cannot issue any kind of advisory opinion" regarding "in reasonable detail." *Id.* at 749. That court did not analyze the legislative history of the phrase "in reasonable detail," and it is thus not instructive. The only legislative history discussed was Senate Bill No. 708, then pending but never passed, which sought to impose a scienter requirement on the accounting provisions. *Id.* In addition, the breadth of the holding in *World-Wide Coin Investments* as to what constitutes a book or record is dubious at best and was not squarely challenged at the appellate level. At most, this holding is instructive but not binding on the Court in this proceeding.

[12] *See, e.g.*, 26 U.S.C. § 1273(a)(3), I.R.C. § 1273 (under U.S. Department of Treasury regulations, redemption price variations less than ¼ of one percent are deemed *de minimis*); 29 C.F.R. § 4231.7 (the U.S. Pension Benefit Guarantee Corporation deems *de minimis* fair market asset violations of less than 3 percent of total assets); Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 17 C.F.R. § 255 (Final Rule) (pursuant to rules promulgated under Dodd-Frank, variations in permitted investment limit of less than 3% are waived as *de minimis*).

Even assuming that all of the Division's allegations are true, 14/100th of one percent is conclusively *de minimis*, does not violate the "reasonable detail" standard required to maintain a cause of action under Section 13, and must be dismissed.

B. The Accounting Provisions Were Not Meant to Prosecute *De Minimis* Accounting Issues

The instant matter alleges conduct that has nothing to do with the original purpose of the books and records provisions—to prevent off-the-books arrangements and sham transactions used to facilitate those payments.[13] The Division instead seeks to stretch these provisions to cover not only the immaterial and *de minimis*, something not contemplated by Congress or the Commission, but situations where it is factually undisputed that the underlying transactions at issue were bona fide and legitimate.

The Division's own allegations in the OIP confirm the legitimate nature of the services underlying the invoices that generated the revenue. There was a signed arm's-length contract between L3 and the U.S. Army subject to a myriad of federal regulations applicable to government contracts.[14] The services were performed under the contract, but L3 had not billed or collected the money it was owed (though it later would).[15] There were at times daily or weekly meetings internally at L3 and updates provided to the U.S. Army during the relevant time period regarding the outstanding amount to be paid to L3 and the best way to bill and collect those funds.[16]

The OIP does not and cannot allege that the work underlying the invoices was not performed or in any way concealed from the customer. In contrast, the OIP makes clear that the

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[13] H.R. Rep. No. 94-831, 95th Cong., 1st Sess. at 10 (1977).
[14] OIP ¶ 1; *see, e.g.*, Federal Acquisition Regulation, C.F.R. Title 48; Department of Defense FAR Supplement.
[15] OIP ¶ 10.
[16] OIP ¶¶ 9, 12, 13, 15, 18, 19.

C-12 Contract Manager "identified approximately $50.6 million *in work performed by ASD* under the contract that was not billed to the Army" (emphasis added).[17] Nor can the Division allege that the invoices were fictitious since the services described therein were performed as described. In fact, the activity described in the invoices undeniably occurred and was accurately reflected therein. The facts of this case do not involve concealment or the creation of sham transactions intended to be prevented by the drafters of the accounting provisions. The OIP fails to allege a violation of Sections 13(b)(2)(A), (b)(5), and Rule 13b2-1 and should be dismissed as a matter of law.

III. THE DIVISION'S ALLEGED INTERNAL CONTROLS VIOLATION FAILS AS A MATTER OF LAW

In response to the Court's order to provide a more definite statement, the Division has submitted a laundry list of irrelevant internal controls, none of which support the sole allegation that Mr. Pruitt circumvented an internal control requiring delivery of an invoice to a customer. In fact, most of the controls identified do not apply to any of the issues alleged in the OIP. Mr. Pruitt could not have knowingly circumvented a non-existent control and as a matter of law, this violation must be dismissed.

Section 13(b)(5) of the Exchange Act requires that a respondent "knowingly" circumvent an internal control to commit a violation. Implicit in the knowledge requirement is that there existed a clearly identified internal control that applied and was knowingly circumvented. The Division's sole allegation on this claim is the conclusory statement that "invoices had not been delivered to the U.S. Army, in violation of a specific internal control of L3 that required delivery of invoices."[18] Having failed to properly identify an applicable internal control in the OIP, the Court ordered the Division to provide a more definite statement identifying the specific internal

[17] OIP ¶ 10.
[18] OIP ¶ 39.

controls it alleges were circumvented.[19] The Division complied, providing a list of sixteen internal controls as "relevant to the violation of Exchange Act Section 13(b)(5)."[20] Even after being provided this second opportunity to identify the purportedly circumvented internal controls, the Division's claims still fail as a matter of law.

None of the internal controls identified by the Division and attached as Exhibit A to the affidavit of Margaret E. Hirce require the delivery of invoices to a customer. The plain language of the controls reflects that they are inapplicable or entirely irrelevant to the allegations in the OIP.

For example, one of the controls that relates to Estimates-At-Completion ("EAC") pertains to a class of contracts whose accounting treatment is entirely different from the accounting applicable to the C-12 Contract.[21] FR *5A applies to "revenue arrangements within the scope of Corporate Accounting Policy No. 101 (SOP 81-1 contracts [])."[22] The C-12 Contract—a fixed-price services contract—was not subject to SOP 81-1 accounting treatment as that typically applies to construction-type and production-type contracts. In a comment letter response to the Commission made during the relevant time period, L3 notified the SEC that the C-12 Contract was not subject to SOP 81-1 (ASC 605-35-15-3c) accounting standards but instead was "correctly accounted for in accordance with ASC 605-10-S99 (formerly SAB No. 104), *Revenue Recognition.*"[23] As such, similar controls requiring EACs were entirely irrelevant to the C-12 Contract and could not be circumvented by Mr. Pruitt. None of the remaining

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[19] Order Granting in Part Motion for More Definite Statement, Admin. Proc. Rulings Release No. 4888, *In the Matter of David Pruitt, CPA*, Admin. Proc. File No. 3-17950 (June 23, 2017).
[20] Letter from Paul G. Gizzi, Senior Trial Counsel, SEC, to John J. Carney, Esq. dated June 30, 2017.
[21] "C-12 Contract" means the fixed-price aircraft maintenance contract between L3 and the U.S. Army, No. W58RGZ-10-C-0107, commencing on December 1, 2010 and terminating on January 31, 2015
[22] Hirce Aff. Ex. A at 4-5 [L3-DOJ-SEC-0000478766-67].
[23] *See* Hirce Aff. Ex. C at 4.

controls require delivery of an invoice to a customer prior to revenue recognition, with many running far afield of what the Division has alleged in the OIP.[24]

No matter how many internal controls the Division throws together in a futile attempt to justify this charge, there was simply no control that required the delivery of invoices. Vague assertions of "relevant" internal controls that "may" apply are an admission by the Division that an applicable control does not exist. As such, the OIP fails to set forth a violation of Section 13(b)(5). Having premised the entire violation on a non-existent control, the charge must be dismissed as Mr. Pruitt could not circumvent, no less knowingly circumvent, a control that did not exist.

CONCLUSION

For the foregoing reasons, Mr. Pruitt respectfully requests that the Court grant the motion for a ruling on the pleadings and dismiss the OIP with prejudice.

Dated: July 14, 2017
New York, New York

By: _____

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[24] The remaining controls identified relate to irrelevant items such as Management Certifications or other items that are not applicable to the allegations in the OIP.

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CERTIFICATE OF SERVICE

I, Bari R. Nadworny, an associate of the law firm of Baker & Hostetler LLP located at 45 Rockefeller Plaza, New York, New York 10111, hereby certify that on the 14th day of July, 2017, I caused to be served a true copy of Respondent David Pruitt's Motion for a Ruling on the Pleadings, the Memorandum of Points and Authorities in Support of Respondent David Pruitt's Motion for a Ruling on the Pleadings, and the Affidavit of Margaret E. Hirce with its accompanying exhibits via electronic mail upon the following parties and other persons entitled to notice:

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