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SEC Enforcement: Focus on Corporate Disclosure

Amidst the flurry of SEC enforcement cases settled at the end of the SEC's fiscal year, three cases brought against companies with household names serve as a reminder that disclosure – whether of financial information or non-financial key performance indicators (KPIs) – matters. Moreover, a significant decline in a company's stock price is not a prerequisite for bringing a case.

BMW

In *Bayerische Motoren Werke Aktiengesellschaft (BMW),*[1] the SEC charged that BMW improperly increased reported retail sales and created a misleading impression of its sales performance in the U.S. market. BMW allegedly increased retail sales volume (a non-financial KPI) by including vehicles that it offered to its independent dealers as demonstrators or service loaners without regard to dealer need for such vehicles. This practice, the SEC alleged, made these figures misleading.

BMW is not a public reporting company in the U.S. It did, however, raise $18 billion through seven bond offerings under Rule 144A from 2016 to 2019, forming the basis for the charge, and the offering memoranda included this allegedly misleading retail sales KPI. The case was brought under Securities Act Sections 17(a)(2) and 17(a)(3), non-scienter-based antifraud provisions, which relate to misleading statements or other fraud or deceit in the offer or sale of securities.

Although the order presents no evidence of investor harm, BMW paid $18 million to settle the case. While the SEC does not connect the dots to whistleblower awards, a $1.8 million (10% of the settlement) award was announced around the time of the settlement. The order appears simply to assume that investors were harmed by the misleading disclosure.

Fiat Chrysler

In *Fiat Chrysler Automobiles N.V.*,[2] Fiat settled charges that it had misleadingly stated that an internal audit found its diesel cars complied with emission regulations when that audit had only determined that the automaker's diesel cars were not equipped with "defeat devices."[3] The statements appeared during 2016 in press releases and in Fiat's annual report, both of which were furnished on Form 6-K. In 2017, the EPA charged Fiat with violations of the Clean Air Act, alleging that some of their vehicles had software that had the "effect of bypassing, defeating, or rendering inoperative engine control systems and/or after-treatment control systems installed in the vehicles." Fiat settled these charges in early 2019 without admitting or denying liability.

The SEC charged that Fiat's statements and omissions violated Section 13(a) of the Exchange Act and Rules 13a-16 and 12b-20 under that Act. Fiat settled the SEC case and paid a civil money penalty of $9.5 million. As with BMW's violations, these violations are not scienter-based.

HP

Finally, in *HP Inc.*,[4] the SEC charged that HP failed to disclose a practice that reoccurred over three quarters related to pulling sales into a current period by granting substantial discounts to partners at quarter end would have a material adverse effect on future periods and, thus, failed to disclose "known trends and uncertainties" reasonably likely to affect

[1] https://www.sec.gov/litigation/admin/2020/33-10850.pdf.
[2] https://www.sec.gov/litigation/admin/2020/34-90031.pdf.
[3] A defeat device is software that detects when a laboratory is testing an engine for emissions and puts the appropriate emission controls in place. These were the devices that Volkswagen was found to have had in its diesel cars.
[4] https://www.sec.gov/litigation/admin/2020/33-10868.pdf.

future results. At the end of the third quarter, in significant part because of the buildup of excess inventory at channel partners, HP announced a change in its selling practices and a noted that it expected revenues to be impacted by $225 million in each of the two following quarters. While this case is bit of a stretch on the facts, as most companies engage in similar activities to some extent so drawing lines may be challenging, it is much more of a classic "MD&A" case and should remind companies that disclosure of known trends and uncertainties is not optional.

The SEC alleged that HP provided discounts on printing supplies to channel partners near the end of a quarter for three quarters in a row to accelerate sales into that quarter. They did this, the SEC alleged, to meet quarterly sales targets and internal metrics. The SEC also alleged HP engaged in out-of-region, gray market sales that had a similar effect. The SEC did not allege that these sales were improper or that the accounting was incorrect. Instead, the SEC asserted that HP failed to identify, in its annual and quarterly reports and in press releases and on conference calls during the period, the impact of the sales practices on the erosion on profit margin associated with the discounts and the build up of excess channel inventory at second tier resellers. The SEC also charged that these alleged disclosure failures reflected disclosure control deficiencies in violation of Exchange Act Rule 13a-15(a).

In addition to the charges under Section 13(a) of the Exchange Act, the SEC charged negligent violations associated with the material misrepresentations made to the market under Section 17(a)(2) and 17(a)(3) of the Securities Act in connection with the offer and sale of securities. The sales cited were issuances of securities pursuant to employee benefit plans during the period.

Without admitting or denying the SEC's findings, HP agreed to pay a fine of $6 million and to cease and desist from committing violations of the securities laws under which they were charged.

Takeaways

These cases demonstrate that the SEC Enforcement Division does not shy away from bringing disclosure cases against large, established companies. The BMW case is particularly interesting in that none of the disclosures were filed with or furnished to the SEC, but instead were included in offering memoranda in Rule 144A offerings. The statutory provisions that BMW was alleged to have violated do not require scienter, and the order is silent on investor harm associated with the alleged misrepresentations.

These cases also serve as a reminder of the importance of effective disclosure controls and procedures. Copies of each of these three cases should be required reading for members of the disclosure committee of every public company.

Finally, the cases demonstrate the strength of the SEC's Whistleblower program. It seems pretty clear that the BMW case was the result of a whistleblower and the other two may have been as well. Whistleblower awards provide a powerful incentive for those inside a company to report perceived problems to the SEC.

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