Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION —N.D. Cal.: Logitech officers unable to dodge SEC accounting fraud charges, (Oct. 28, 2016)

Securities Regulation Daily Wrap Up

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By Amy Leisinger, J.D.

The Northern District of California refused to dismiss the SEC's accounting fraud claims against former officers of Logitech International. According to the court, the Commission sufficiently pleaded material misstatements and scienter on the part of the officers in minimizing the write-down of excess component parts, as well as internal controls violations. The court did, however, grant the former controller's motion to dismiss the Commission's claim against her for a Securities Act Section 17(a)(2) primary violation and dismiss a Sarbanes-Oxley Act claim against the former CFO (*SEC v. Bardman*, October 27, 2016, Tigar, J.).

Accounting failures. The SEC brought actions against technology manufacturer Logitech and several of its executives for various accounting failures that left investors inaccurate views of the company's condition in connection with a less-than-successful new product. Logitech agreed to settle charges that it committed accounting-related violations, and two officers agreed to pay civil penalties totaling $75,000. The SEC filed a complaint against Logitech's former controller and former CFO alleging that they fraudulently minimized millions of dollars in write-downs in connection with inventory of the product and its components and that they engaged in a scheme to materially inflate the operating income reported to its investors. For the company's financial statements, according to the Commission, the two executives falsely assumed and stated that the company would build the components into finished products despite their knowledge of evidence to the contrary.

As an experienced professional, the CFO knew, or should have known, that GAAP does not allow management to decide when it will take a charge or to delay making a decision to achieve a particular accounting result, and the controller knew about the potential excess inventory and the related exposure, according to the SEC. Nevertheless, both officers continued to confirm false representations to the company's audit team, and the CFO knew, or should have known, that he was certifying materially false or misleading financial statements.

Shotgun pleading. The officers moved to dismiss the SEC's claims as impermissible "shotgun pleadings" that failed to state how the individual defendants violated the plaintiff's rights by using an unclear "mass of allegations." The court rejected this argument, finding that the Commission provided detailed information regarding each defendant's role in the alleged fraudulent transactions and how their acts constitute fraud. A complaint does not involve shotgun pleading just merely because it re-alleges factual paragraphs by reference, the court stated.

Fraud. The court also found that the SEC sufficiently alleged facts demonstrating scienter in connection with failure to comply with accounting rules. While the Commission does not cite the specific rule requiring recording of the "lower of cost or market" (LCM) charges with regard to the components, the complaint does show facts that the officers failed to record a larger LCM charge in an effort to mislead investors and had knowledge of the requirement.

The court rejected the defendants' argument that the SEC did not plead a materially false or misleading statement. The Commission has pleaded specific figures that sufficiently allege material misstatements of the company's inventory reserve and operating income and made allegations tending to demonstrate the materiality of the alleged misinformation in light of Logitech's overall financial picture, the court found.

The court also refused to dismiss the SEC's scheme liability claim under Rule 10b-5. "To be liable for a scheme to defraud, a defendant must have engaged in conduct that had the principal purpose and effect of creating

a false appearance of fact in furtherance of the scheme," the court stated, and the complaint alleges that the controller's analysis and discussions of the fictitious build-out plan were "inherently deceptive acts."

Internal controls. In addition, the court rejected the controller's argument that the SEC's internal controls claims under Exchange Act Section 13(b)(5) must be narrowed because the complaint failed to adequately allege circumvention of internal controls. The Commission alleges that the controller failed to adhere to policies concerning Logitech's excess and obsolete inventory reserves and to ensure preparation of an accounting memorandum for the inventory at issue. The CFO's objection to the claims must also fail, the court found, as the SEC adequately alleges that he knowingly circumvented an internal control that required the CFO to provide an agenda list for the audit committee containing specified information.

Dismissed claims. The court agreed to dismiss the Securities Act Section 17(a) claim against the controller, finding that the SEC failed to allege that she obtained money or property as a result of the alleged fraud. The court also dismissed the claim against the CFO for reimbursement in connection with an accounting restatement under Sarbanes-Oxley Section 304(a), agreeing with his contention that he could not satisfy the SEC's claim without knowing specifically the period at issue or the amount to be reimbursed.

The court granted the SEC 30 days to amend its complaint.

The case is No. 16-cv-02023-JST.

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Companies: Logitech International, S.A.

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