

SEC SETTLES CHARGES AGAINST BMW AG FOR INACCURATE SALES DISCLOSURES IN RULE 144A BOND OFFERINGS

In September 2020, the U.S. Securities and Exchange Commission (the "**SEC**") settled allegations that the German automaker Bayerische Motoren Werke AG ("**BMW AG**") and two of its U.S. subsidiaries (collectively, "**BMW**") made inaccurate and misleading disclosures about BMW's retail sales volume in the United States in connection with several Rule 144A bond offerings. As part of the settlement, BMW agreed to pay an \$18 million penalty and to cease and desist from future violations of these relevant provisions.

This enforcement action is unusual, in as much as the SEC rarely brings enforcement actions related to exempt offerings relying on Rule 144A under the Securities Act of 1933, as amended (the "**Securities Act**"). It highlights the risk that a non-U.S. issuer (and non-SEC registrant) may still be investigated for inaccurate disclosures, including those relating to non-financial key performance indicators, made in connection with a private offering of securities to institutional investors in the United States.

Summary of the SEC's allegations

According to the SEC, between 2016 and 2019, BMW AG raised an aggregate of \$18 billion through seven Rule 144A bond offerings by its U.S. subsidiary, BMW US Capital, LLC ("**BMW USC**"). The SEC alleged that these offerings were materially misleading because from 2015 to 2019 BMW AG's domestic subsidiary, BMW of North America, LLC ("**BMW NA**"), inflated its reported retail sales volume in the United States, which helped BMW AG to close the gap between its actual retail sales volume and internal retail sales targets. Specifically, the SEC alleged that BMW NA had engaged in the following three problematic reporting practices, which resulted in inaccurate reporting of U.S. retail vehicle sales volume data:

- **Use of demonstrator and loaner designations to inflate retail sales volume.** The SEC alleged that from January 2015 through March 2017 BMW NA sought to have dealers improperly designate vehicles as

What is Rule 144A?

Rule 144A is a resale exemption under the Securities Act. Rule 144A offerings typically involve offering securities to one or more financial institutions (often referred to as initial purchasers), who then resell the securities to qualified institutional buyers. An offering memorandum is typically prepared to market the securities sold prospective investors in reliance on Rule 144A.

demonstrators or loaners to boost BMW NA's reported retail sales. According to the SEC, as part of this conduct, BMW NA would offer financial incentives to U.S. dealers to encourage them to report vehicles as demonstrators or service loaners, which BMW NA subsequently reported as retail sales even though these vehicles were not sold to customers at that time. During this period, demonstrators and loaners accounted for 27% of BMW NA's reported retail sales. These incentive programs also impacted year-over-year retail sales volume comparisons. For instance, a July 2015 internal study found that, even though BMW NA had publicly reported 7% year-over-year growth in retail sales volume between the first half of 2014 and the first half of 2015, it had in fact experienced a 0% growth rate between these periods.

- **Banked retail sales.** The SEC alleged that from 2015 through 2019 BMW NA underreported retail sales in some months in order to create a reserve of unreported sales that it could use later in subsequent monthly reports. According to the SEC, as part of this conduct, in months that total retail sales reported by dealers exceeded BMW NA's internal sales targets, BMW NA selected which retail sales number to report publicly and "banked" (*i.e.*, held back) the remaining retail sales. Conversely, the SEC alleged that, in months that total retail sales reported by dealers fell short of internal sales targets, BMW NA management used retail sales from the bank to help close the gap to its internal targets. Such adjustments using the bank often exceeded 10% of the total retail sales in a month. The use of the bank was planned and approved by BMW NA management, and BMW AG was aware of this practice.
- **Improper changes to its sales reporting calendar.** The SEC alleged that in 2015 and 2017 BMW NA improperly modified its sales reporting calendar. According to the SEC, in both 2015 and 2017, BMW NA failed to follow the industry standard sales reporting calendar, which reports sales through January 2 as having occurred in the prior year. The SEC alleged that in 2015 BMW NA improperly extended the 2014 calendar year until January 5 in order to inflate December 2014 sales. The SEC alleged that BMW NA took the opposite approach in 2017 and improperly shortened the 2014 calendar year as an alternative method of creating a bank of January 2017 sales.

In addition to these three problematic practices, the SEC alleged that BMW failed to implement recommendations from its internal audit team, which would have rectified these issues. Specifically, in March 2015, BMW's internal audit team identified BMW NA's use of "banked" retail sales. Shortly thereafter, in May 2015, this team also identified the use of demonstrators and loaners to increase sales numbers. Despite the identification of these issues, BMW NA failed to take measures to rectify these practices.

The SEC's theory of the violation

This enforcement action was brought by the SEC under Section 17(a) of the Securities Act, which includes antifraud provisions that prohibit fraud and misrepresentations in the offer or sale of securities. Section 17(a), unlike the more commonly used Rule 10b-5 under the Securities Exchange Act of 1934, as

amended (the "**Exchange Act**"), does not require a showing of "scienter," and liability under this section may be premised solely on a finding of negligence. Therefore, the SEC had a lower burden of proof.¹

Using this lower standard, the SEC alleged that the inflated sales volume was materially misleading even though the offering memoranda disclosed that:

- BMW's retail vehicle sales volume data (designated as a "non-financial key performance figure") did not correlate directly to BMW's revenue recognition; and
- vehicles delivered for dealer use or demonstration and service loaner vehicles were included in the retail sales data.

According to the SEC, these caveats were not sufficient because BMW failed to disclose:

- reliance on these problematic sales practices to increase retail sales volumes;
- the magnitude of the improper use of demonstrators and loaners; and
- the use of the bank or the retail sales reporting calendar modifications.

The SEC took specific issue with the use of demonstrators and loaners solely for the purpose of artificially increasing sales numbers, without regard to business need.

As a result, the SEC determined that the retail sales volume figures provided to investors were misleading in violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

Key Takeaways

The BMW enforcement action raises several key concerns that non-U.S. issuers of Rule 144A bonds will want to consider.

- **Extraterritorial reach of SEC enforcement.** Case law under Rule 10b-5 presents certain limitations on the extraterritorial reach of Rule 10b-5 for private rights of action by investors. The SEC is, however, not constrained by this case law when it initiates enforcement proceedings against non-U.S. issuers under Section 17(a) of the Securities Act or Rule 10b-5. As demonstrated by this enforcement action against BMW, the reach of the U.S. securities law may be expansive. Moreover, the recent ruling in *Stoyas v. Toshiba Corp.* further highlights the potentially broad reach of U.S. securities law liability for non-U.S. issuers, even in the context of private rights of action brought under Rule 10b-5. For additional information on the *Toshiba* case, see our recent [client alert](#).

Comparison of Section 17(a) of the Securities Act and Rule 10b-5 of the Exchange Act

Section 17(a) of the Securities Act renders it unlawful, in connection with the offer or sale of any security or security-based swap agreement, to:

- employ any device, scheme, or artifice to defraud;
- obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Rule 10b-5 of the Exchange Act renders it unlawful, in connection with the purchase or sale of any security, to:

- employ any device, scheme, or artifice to defraud;
- make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
- engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Violations of Sections 17(a)(2) and (a)(3) do not require "scienter" and may be premised on a finding of negligence. In contrast, courts have interpreted Rule 10b-5 to require scienter and, accordingly, negligent conduct is insufficient to create liability under the rule. Scienter in this context means the intent on the part of the defendant to deceive, manipulate or defraud. Reckless conduct, however, may nevertheless meet the scienter requirement, though the degree of recklessness may vary by court. While the U.S. Supreme Court has not opined on whether reckless conduct meets the scienter requirement under Rule 10b-5, many courts have interpreted Rule 10b-5 as extending liability to such conduct.

¹ Section 17(a), unlike Rule 10b-5, does not create a private right of action for investors.

- **Importance of preparing accurate and materially complete disclosures.** Non-U.S. issuers seeking to access the U.S. capital markets should bear U.S. disclosure standards in mind when preparing investor-targeted disclosures, including not only the offering documents that are specifically prepared for prospective investors but also the issuer's public announcements that are made close in time to an offering. As highlighted in this enforcement action, problematic reporting practices related to non-financial information, such as key performance indicators (*i.e.*, sales volume data), can give rise to violations of U.S. antifraud provisions. To facilitate preparation of accurate and materially complete disclosures, an issuer who is undertaking an offering to U.S. investors should collaborate with the initial purchasers to subject its disclosures to potential investors, including any relevant press releases, to a due diligence review. In addition, issuers will want to consider whether they have put in place effective controls and procedures related to reporting material financial and non-financial information to ensure the consistency as well as accuracy of such disclosures.
- **The importance of cooperating with the SEC.** In its Order, the SEC noted that the SEC considered the degree to which BMW offered substantial and extensive cooperation with its investigation, notwithstanding challenges presented by the COVID-19 pandemic, in agreeing to a reduced penalty. In addition, the SEC considered BMW's voluntary undertaking of remedial measures during the investigation, including ending the use of "banked" retail sales and publicly issuing revised U.S. retail sales volume data.

Conclusion

The SEC's enforcement action against BMW serves as a reminder to non-U.S. issuers of Rule 144A bonds of the broad extraterritorial reach of U.S. antifraud protections and the importance of preparing accurate and materially complete disclosures for potential investors. In the event of an SEC enforcement action, an issuer would likely benefit from cooperating with the investigation, and the degree of cooperation could lead to a correspondingly reduced penalty

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