Simpson Thacher

Regulatory and Enforcement Alert

SEC Accounting Case Highlights Key Role of Issuer Disclosure Committees and Flexibility of Section 17(a)(2) Settlements

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Yesterday, the Securities and Exchange Commission ("**SEC**") announced charges against alcoholic beverages company Diageo plc for failing to make required disclosures of known trends relating to the shipments of unneeded products by its North American subsidiary to distributors. Without admitting or denying the findings in the SEC's Order, Diageo agreed to cease and desist from further violations and to pay a $5 million penalty to settle the action.

According to the Order, employees at Diageo North America ("**DNA**"), Diageo's largest subsidiary, pressured distributors to buy products in excess of demand in order to meet internal sales targets in a flagging market. The resulting increase in shipments enabled Diageo to meet its performance targets and to report higher growth in key performance indicators that were closely followed by analysts and investors.

The Order finds that Diageo failed to disclose the trends that resulted from the "overshipping;" the positive impact the overshipping had on sales and profits; and the negative impact that the overshipping and the resulting inventory builds would have on future growth. The Order further finds that these failures left investors with the misleading impression that Diageo and DNA were able to achieve growth in certain key performance indicators through normal customer demand.

The Order finds as a result of this conduct that Diageo violated the antifraud provisions of Section 17(a)(2) and (3) of the Securities Act of 1933, as well as Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-1, which require reporting companies to file complete and accurate annual reports with the SEC.

Key Takeaways

While on the surface a conventional disclosure case, the Order reflects two key practice points:

First, with language seemingly calculated to send a broader message to the issuer community, the Order specifically pinpointed the purported failure of Diageo's disclosure committee to consider whether DNA's overshipping and the resulting inventory builds were material trends that should have been presented in the company's annual filings. Despite receipt of information showing substantial increases in distributor inventory, the committee lacked internal procedures to ensure that such information was incorporated into its review of Diageo's public filings. In light of this observation, issuers should ensure that their disclosure committees are

armed with key information about business trends and conduct a holistic—rather than mechanical—review of public filings against the backdrop of larger business trends.

Second, the case was resolved, in part, on the basis of negligence-based violations of Section 17(a)(2) and (3) of the Securities Act, which require an offering of securities as the basis for liability. In SEC cases alleging violations of Section 17(a), the requisite offering often involves the issuance of securities to *third parties*, who constitute the alleged victims of the misconduct. In *Diageo*, by contrast, the offerings were anchored to transactions involving employee benefit plans and the exercise of stock options. The Order highlights the significant charging flexibility available to the Staff under Section 17(a) in disclosure cases involving issuers. Because, however, most issuers utilize stock-based employee benefit plans, the Order also will provide a helpful reference point for issuers seeking to persuade the Staff to resolve a matter on a negligence theory under Section 17(a) rather than pursuant to intent-based charges under Section 10(b) of the Exchange Act.

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