September 29, 2020

SEC Settles Charges against BMW AG for Failure to Provide Accurate Disclosure in Rule 144A Bond Offerings

On September 24, 2020, the SEC announced[1] settled charges against BMW AG and two of its U.S. subsidiaries for inaccurate and misleading disclosures included in offering memoranda for Rule 144A offerings of bonds in the United States. The enforcement action arose out of improper reporting of retail sales of BMW vehicles. The enforcement action was based on violations of Section 17(a)(2) and (a)(3) of the U.S. Securities Act of 1933 (the "Securities Act").[2]

This enforcement action is notable in that it is highly unusual for the SEC to pursue disclosure claims against a foreign issuer (that is not an SEC registrant) undertaking an offering of securities in the United States on a private basis. In 2003, the SEC brought an action against Parmalat Finanziara S.p.A. for violations of Section 17(a) in connection with debt offerings in the United States; the claims arose out of the financial scandal involving Parmalat and certain of its senior managers and directors.

Below we provide a brief summary of the action.

According to the SEC order, between 2015 and 2019, BMW of North America LLC ("BMW NA"), a U.S. subsidiary of BMW AG and its national sales company in the United States, engaged in three separate practices that resulted in inaccurate reporting of its retail vehicle sales volume.

- **Improper Use of Demonstrator and Loaner Programs** – from January 2015 to March 2017, BMW NA used the demonstrator and service loaner programs by incentivizing its U.S. dealers to designate vehicles as demonstrators or service loaners. BMW NA included the designated vehicles in its reported retail vehicle sales, even though the dealers had not sold the vehicles. This was done without regard to whether dealers had a legitimate business need for additional demonstrators and service loaners, or whether the dealers put those vehicles to use as demonstrators or service loaners. These incentive programs typically were put in place at the end of a month to "close the gap" between the

1 *See* SEC press release and order are available here.

2 Section 17 addresses fraudulent conduct in connection with the offer or sale of securities. Section 17(a)(2) proscribes obtaining "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." Section 17(a)(3) proscribes engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." Section 17(a)(1), which was not relied upon, proscribes employing "any device, scheme, or artifice to defraud."

actual retail sales and internal monthly targets. During that period, over 80% of demonstrator and loaner designations at BMW U.S dealerships were reported on the last day of the reporting month, with the designations accounting for the majority of retail sales on those days.

The excessive use of designation programs resulted in a buildup of dealer inventory of demonstrator vehicles and led to further difficulties in achieving internal monthly retail sales targets. Year-over-year retail sales volume comparisons also were impacted. One internal analysis found that reported 7% year-over-year growth in retail sales volume between the first half of 2014 and the first half of 2015 resulted principally from the significant increase in designations of vehicles as demonstrators and loaners. In reality, customer retail sales had a zero growth rate during that period. BMW's U.S. dealers expressed concerns regarding possible false reporting and, by April 2017, BMW NA discontinued the use of the designation incentive programs.

- **"Banking" of Unreported Sales** – between 2015 and 2019, BMW NA used the reserves of previously unreported retail sales to manage its reported retail sales volumes and close any gaps between actual retail sales and forecasted sales. If in any given month retail sales by dealers exceeded internal retail sales targets, the excess retail sales would not be reported and would be held for later reporting in the months when reported retail sales were lower than internal targets. The adjustments, which were planned and approved by BMW NA management, frequently exceeded 10% of total retail sales, with two months exceeding 20%. BMW AG was aware of and approved the use of the banking of retail sales by BMW NA.

- **Changes to Retail Sales Reporting Calendar** –BMW NA made changes to its retail sales reporting calendar in order to manage reported sales. In January 2015, BMW NA extended its normal reporting calendar, which allowed it to report three additional days of retail sales by dealers as 2014 sales. In January 2017, BMW NA did the opposite when it closed its December 2016 reporting period early (*i.e.*, as soon as its internal targets where achieved), allowing it to create a bank for any additional sales post-closure.

The designations and the banking of sales were identified by BMW's Internal Audit as early as March 2015 and recommendations were issued to discontinue the practices. However, BMW NA failed to implement the required changes and continued to use the designations practice until April 2017 and the banking practice until 2020.

During the periods in question, BMW AG, through a finance subsidiary, undertook seven bond offerings in the United States in reliance on Rule 144A, raising $18 billion.[3] The offering memoranda and investor

[3] Rule 144A was promulgated under the Securities Act and is the principal means by which non-U.S. issuers access the U.S. equity and debt capital markets, particularly if they are not SEC reporting companies. A "Rule 144A offering" typically involves an issuer selling its securities on a private placement basis to one or more financial intermediaries acting as initial purchasers,

presentations included information about retail vehicle sales in the United States. Additionally, BMW NA issued press releases disclosing monthly retail sales and provided information to credit rating agencies. The SEC viewed the disclosures of retail sales to be inaccurate and misleading because they improperly included vehicles that had been designated at month-end as demonstrators and loaners solely for purposes of artificially increasing reported sales, regardless of whether additional demonstrators and loaners were needed by dealers or were used as such, and failed to disclose the magnitude of the improper use of demonstrators and loaners, the extent to which the practices contributed to reported U.S. retail sales, and the use of the "banking" and retail sales reporting calendar modifications. The SEC concluded that BMW had provided materially incomplete and inaccurate information regarding its U.S. retail sales performance and customer demand for BMW vehicles in the U.S. market, in violation of Section 17(a)(2) and (a)(3).

The SEC attributed the reduced civil penalty of $18 million to the substantial cooperation provided by BMW during the investigation in spite of the constraints presented by COVID-19 and to remedial measures voluntarily undertaken by BMW during the SEC's investigation.

* * *

The starting point for the preparation of offering memoranda used in the Rule 144A market typically is the constellation of rules and guidance applicable to prospectuses prepared for use in public offerings in the United States. This enforcement action is a useful reminder that the anti-fraud provisions of the federal securities laws, including the Securities Act, apply to any offering of securities in the United States.

Although, based on case law starting with *Morrison* v. *National Australian Bank*, there are variables that may affect the jurisdiction of U.S. courts to hear securities fraud actions against non-U.S. issuers, those variables, by reason of the Dodd-Frank Act (which in effect overrides *Morrison* in this one respect), do not apply to enforcement actions brought by the SEC. Similarly, the fact that actions under Sections 11 and 12 of the Securities Act cannot be brought in cases involving Rule 144A offerings does not constrain the SEC from pursuing actions under Section 17(a)(2) or Section 17(a)(3) of the Securities Act or the anti-fraud provisions of the Securities Exchange Act of 1934 (Section 10(b) and Rule 10b-5) against issuers in Rule 144A offerings. Actions under Section 17(a)(2) and (a)(3) do not require *scienter* and may rest on a finding of negligence, while actions under Section 17(a)(1) and Section 10(b) and Rule 10b-5 do require a finding of *scienter*. Non-U.S. issuers accessing the U.S. capital markets should be mindful that the SEC monitors disclosure directed at investors in those markets, whether retail investors in the public markets or

who in turn resell the securities to qualified institutional buyers pursuant to Rule 144A. An offering memorandum typically is used to market the securities sold in a Rule 144A offering.

sophisticated institutional investors in the Rule 144A or other private offering markets, and it does not distinguish between equity offerings and debt offerings in terms of disclosure standards.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman	Richard A. Rosen	Tong Yu
+44-20-7367-1601	+1-212-373-3305	+81-3-3597-6306
mbergman@paulweiss.com	rrosen@paulweiss.com	tyu@paulweiss.com

Securities practice management attorney Monika G. Kislowska contributed to this Client Memorandum.