

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-20394

In the Matter of

PAUL L. CHANCEY, JR., CPA

Respondent.

**DIVISION OF
ENFORCEMENT'S
OPPOSITION TO
RESPONDENT'S MOTION FOR
A MORE DEFINITE
STATEMENT**

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The Division of Enforcement of the Securities and Exchange Commission (“Division”) opposes Respondent Paul L. Chancey, Jr.’s (“Chancey” or “Respondent”) Motion for a More Definite Statement (“Motion”) for the reasons set forth below. The Division respectfully requests permission to exceed the 10 page limit of Rule of Practice 154(c), in order to respond to Respondent’s 12 page Motion.

PRELIMINARY STATEMENT

The OIP alleges that Chancey, a certified public accountant (“CPA”) and the lead audit engagement partner for Cherry Bekaert, LLP’s (“CB’s”) audits of MiMedx Group, Inc.’s (“MiMedx’s”) 2015 and 2016 financial statements, engaged in improper professional conduct. This improper conduct violated Rule 102(e) of the Commission’s Rules of Practice and caused the violation of Rule 2-02(b)(1) of Regulation S-X by CB.

Specifically, the Division alleges that Chancey ignored and/or failed to make adequate inquiry into and document in the CB work papers several facts that were brought to his attention that impacted CB’s audit report on MiMedx’s financial statements. Those facts should have prompted a reasonable auditor to investigate whether sales to MiMedx’s largest distributor were not made under the terms of the written distributor agreement, but were in fact made on a consignment basis, thereby rendering the recognition of revenue improper and financial statements false. As recognized by MiMedx’s restatement of its 2015 and 2016 financials, MiMedx’s accounting for those sales was improper and contrary to generally accepted accounting procedures (“GAAP”) due to a side arrangement that made the sales contingent on resale and subject to return. Due to this conduct, Chancey violated several Public Company Accounting Oversight Board (“PCAOB”) audit standards and caused CB to issue audit reports in which it

represented that CB had conducted the audits in accordance with standards of the PCAOB and MiMedx's financial statements presented fairly, in all material respects, the company's financial condition and results of its operations in conformity with GAAP.

Chancey's Motion seeks information that is already clearly pled in the OIP. In addition, the Motion, as well as his concurrently filed answer, misconstrues the Division's allegations and claims that "the Division faults Mr. Chancey for failing to detect a side arrangement that the Division itself alleges was purposefully withheld from him." Motion at 10. But that is not the Division's claim. Rather, the OIP makes specific allegations demonstrating that Chancey violated multiple auditing standards, which are also specifically identified in the OIP. OIP ¶¶ 44-72. The Division brought this proceeding because Chancey failed to take the actions required of an auditor in view of what he did know. As alleged in the OIP, what Chancey knew included:

- (i) "CB and Chancey identified revenue as one of MiMedx's most significant financial statement accounts and an area with heightened risk of material misstatement due to both error and fraud" (OIP ¶ 22);
- (ii) Distributor was one of MiMedx's largest distributors (*id.* ¶ 2);
- (iii) an email during the 2015 audit from MiMedx's controller raised concerns about revenue recognition for sales to Distributor (*id.*);
- (iv) "Distributor's confirmation response during the 2016 audit, indicat[ed] that MiMedx and Distributor had a side arrangement" (*id.* ¶ 63);
- (v) audit "procedures concerning the DSO [days sales outstanding] metric, the sales returns allowance, and sales commissions provided evidence suggesting that the arrangement MiMedx had with Distributor could be a consignment" (*id.*);
- (vi) "Chancey learned that Distributor made the same representation (of payment due to MiMedx only upon the issuance of a PO from the VA) during a MiMedx Audit Committee internal investigation into allegations of fictitious sales" and "further represented that:
 - a. MiMedx had historically given Distributor credit for lost, dropped, and missing inventory; and

- b. MiMedx applied Distributor’s payments to the oldest invoices first, regardless of whether the VA made payments to Distributor for the products reflected in those invoices” (*id.* ¶ 40); and
- (vii) “Chancey failed to document, or ensure the documentation of, any analysis of the consignment issues raised and the basis for CB’s audit conclusions in light of those issues” (*id.* ¶ 70).

In short, much of what the Motion seeks a “more definite statement” about relates to a claim that the Division did not bring. The remainder of the Motion seeks information already contained in the OIP.

Far from being a “principal victim” (Motion at 3), given Chancey’s awareness of these facts, and the audit failures alleged in the OIP, the Commission can and will show that he failed to act reasonably in his role as an auditor and in accordance with PCAOB standards. If the Commission cannot make that showing, Chancey should prevail.

Without conferral or any disclosure to the Commission that Chancey believed the OIP was lacking in any regard, which would have likely obviated much or all of the Motion, he now seeks an order requiring the Division to provide a more definite statement as to nine specific allegations in the OIP. Motion at 1-2. Each of the nine identified allegations are separately addressed in the Argument section below, which identifies how the OIP provides sufficient notice of the Division’s claims to allow Chancey to prepare his defense. The Motion should be denied in its entirety.

LEGAL STANDARD FOR RULE 220(d) MOTIONS

An OIP that requires an answer “shall set forth the factual and legal basis alleged therefor in such detail as will permit a specific response thereto.” Commission Rule of Practice 200(b)(3). Although Rule 220(d) allows for the filing of a motion for a more definite statement when an OIP is alleged to fall short of Rule 200(b), the standard applicable to a motion for a more definite statement is clear: a pleading must only

“sufficiently inform[] [a respondent] of the nature of the charges so that he or she may adequately prepare a defense; however, a respondent is not entitled to a disclosure of evidence in advance of the hearing.” *Matter of Wolfson*, 103 S.E.C. Docket 1153, 2012 WL 8702983, at *1 (Mar. 28, 2012) (citation omitted); *see also Matter of optionsXpress, Inc.*, Rel. No. 710, S.E.C. Docket 419, 2012 WL 8704501, at *2 (July 11, 2012) (denying motion because the Division met the burden to inform “respondents of the charges against them so they can prepare a defense” and refusing to require Division to disclose evidence or theory of the case). “[O]nce the factual basis of the allegation is sufficiently known by a respondent, any additional information is considered evidence to which a respondent is not entitled prior to hearing.” *Matter of Western Pacific Capital*, 102 S.E.C. Docket 3633, 2012 WL 8700141, *2 (Feb. 7, 2012).

ARGUMENT

I. The OIP provides sufficient information to inform Chancey of the nature of the charges against him such that he may adequately prepare a defense.

Chancey’s Motion seeks a more definite statement as to nine allegations in the OIP. (Motion at 1-2). The Motion should be denied as to each of the nine requests because the OIP makes the allegations that Chancey claims are lacking. Below, we address each of the nine requests – in numbered sections corresponding to the nine requests made by Chancey – and, in each section, point to the specific sections of the OIP containing the allegations that Chancey claims have not been provided. In some of the numbered sections, we make additional arguments that defeat Chancey’s arguments.

1. The particular terms of the written distribution agreement that the Division alleges were replaced by an alleged “side arrangement” between MiMedx and Distributor in paragraph 13 of the OIP;

As an initial matter, the particular terms of the written distribution agreement that were replaced by the “side arrangement,” are not the issue. As alleged in the OIP, the issue is whether Chancey fulfilled his professional obligations to conduct the 2015 and 2016 audits in accordance with standards of the PCAOB, which require that the audit be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud. OIP ¶¶ 75, 76. Respondent does not argue that those allegations are unclear or incomplete in any way.

Regardless, the particular terms of the written distribution agreement replaced by the “side arrangement” between MiMedx and Distributor are set forth in, among other places, Paragraph 11 of the OIP, which alleges: “MiMedx and Distributor had a written distribution agreement that provided that risk of loss passed to Distributor upon shipment of product, that Distributor had a specific number of days to pay invoices, and that Distributor could return product only if it was defective.” Paragraph 13 alleges further that, contrary to the written distribution agreement, the side arrangement “excused Distributor from payment until the VA issued a purchase order (“PO”) to Distributor for the product, which occurred after the VA used the product.”

2. Which of the four conditions for recognizing revenue under Generally Accepted Accounting Principles (“GAAP”) the Division alleges was not met due to the alleged side arrangement between MiMedx and Distributor in paragraph 15 of the OIP;

“[U]nder GAAP, MiMedx should have delayed recognizing revenue until it was realized or realizable and earned, which occurs only when each of the following conditions is met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the seller’s price to the buyer is fixed or determinable; and (iv) collectability is reasonably assured.” OIP ¶ 15. None of these four

conditions were met. Each was obviated by the side arrangement and MiMedx's and Distributor's actions under the side arrangement that were contrary to the written agreement as addressed herein and in the OIP.

3. At what time the Division contends that "MiMedx and Distributor agreed that Distributor's payments would be applied to the oldest outstanding invoice," as mentioned in paragraph 19 of the OIP;

The OIP alleges, among other things, that Chancey learned that Distributor represented that MiMedx applied Distributor's payments to the oldest outstanding invoices no later than "during the 2016 audit." OIP ¶ 40. The Division has alleged that the agreement between MiMedx and Distributor in this regard occurred before the 2016 audit and sometime at or after MiMedx and Distributor entered into the side arrangement in 2013. The Division is not aware of the exact date this occurred, and the exact date is not relevant to the Division's claims. What Chancey knew and when he knew it is relevant, and the OIP clearly alleges he was aware of this payment practice at least as early as the 2016 audit.

4. What "material changes" the Division alleges were made in the MiMedx restatement "for revenue prematurely recognized on sales to Distributor in 2015 and 2016" in paragraph 21 of the OIP;

The March 2020 Restatement, Item 6: Selected Financial Data – quantified the amount of misstatements. March 17, 2020 Form 10-K at 52-61. In 2015, net sales initially reported at \$187,296,000 were overstated by \$34,165,000, nearly 20%. *Id.* at 55. In 2016, net sales initially reported at \$245,015,000, had been overstated by \$23,303,000, nearly 10%. *Id.* While the Restatement included improperly recognized revenue from other, smaller, distributors, Chancey admitted, in his answer to paragraph 20 of the OIP, that

Distributor accounted for roughly 24% and 9% of MiMedx's total revenue in 2015 and 2016, respectively.

5. Which conduct the Division alleges was highly unreasonable and which conduct it alleges was unreasonable in paragraph 25 of the OIP;

The OIP alleges, among other things, that: "Chancey did not perform additional substantive audit procedures or obtain sufficient, appropriate audit evidence to reduce the risk of material misstatement to an appropriately low level as required by PCAOB standards. Chancey's conduct demonstrated the following audit failures in violation of PCAOB standards: (1) failure to exercise due professional care; (2) failure to obtain an understanding of MiMedx's business; (3) failure to plan the audits based on assessment of risk; (4) failure to obtain sufficient appropriate audit evidence; (5) failure to evaluate audit results; and (6) failure to document audit work." *Id.* ¶ 24. "As a result of these violations, Chancey engaged in (1) a single instance of highly unreasonable conduct in circumstances for which heightened scrutiny is warranted; and (2) repeated instances of unreasonable conduct that indicate his lack of competence." *Id.* ¶ 25. Each of Chancey's violations of audit standards was "a single instance of highly unreasonable conduct in circumstances for which heightened scrutiny is warranted," because revenue recognition was an audit area that required heightened scrutiny. *Id.* ¶ 22. Because there are multiple violations, there are also "repeated instances of unreasonable conduct that indicate his lack of competence."

6. At what time the Division alleges that Cherry Bekaert, LLP ("CB") "was in regular contact with the controller in the course of performing 2015 audit procedures" in paragraph 30 of the OIP;

The OIP alleges that CB and Chancey, the lead audit engagement partner, were "in regular contact with the controller in the course of performing the 2015 audit procedures."

Id. ¶ 30. As Chancey is aware, CB’s audit report for the 2015 audit was dated February 29, 2016.

7. Which “management representations about MiMedx’s transactions with Distributor” the Division alleges were contradicted by evidence Mr. Chancey had in paragraph 47 of the OIP;

The OIP alleges that: Chancey “improperly relied on MiMedx executives’ false representations that revenue recognition was appropriate” (*id.* ¶ 2); “MiMedx management made false representations to CB during each audit, in management representation letters and other documents, denying that MiMedx had a side arrangement with Distributor” (*id.* ¶ 23); and “MiMedx’s management misrepresented [that the written distribution agreement] controll[ed] the terms of the transactions with Distributor” (*id.* ¶ 34). The OIP further alleges that these representations were contradicted by, among other things: the controller’s allegation that Distributor “implicitly doesn’t pay MiMedx until the tissue has been implanted, so revenue should be recognized on a consignment model” (*id.* ¶ 27); the Distributor’s 2016 audit confirmation response, which stated that Distributor “does not pay MiMedx for tissues until such a time as the [VA] issues a purchase order to [Distributor]” (*id.* ¶ 39); Chancey learning during the 2016 audit “that Distributor made the same representation (of payment due to MiMedx only upon issuance of a PO from the VA) during a MiMedx Audit Committee internal investigation into allegations of fictitious sales,” wherein he also learned that Distributor represented that MiMedx gave credit for lost, dropped, and missing inventory and applied Distributor’s payments to the oldest invoices first (*id.* ¶ 40).

8. Which of Distributor’s representations stated “that payment terms with MiMedx were contingent on sales to the VA” according to the Division in paragraph 51(d) of the OIP;

The OIP alleges, among other things, that: “In its 2016 accounts receivable audit confirmation response to CB, Distributor specifically stated that Distributor “does not pay MiMedx for tissues until such a time as the [VA] issues a purchase order to [Distributor].” *Id.* ¶ 39. The OIP further alleges that: “For the 2016 audit, the Distributor itself explained the contingent payment terms for these transactions, demonstrating their consignment nature, in a confirmation response,” (*id.* ¶ 2) and “during the 2016 audit, that Distributor had described its contingent payment terms with MiMedx in its audit confirmation response” (*id.* ¶ 56). *See also supra* § I.7 quoting ¶ 40.

9. What “reliable evidence from MiMedx’s controller” the Division alleges Mr. Chancey obtained “during the 2015 audit,” per paragraph 63 of the OIP.

The OIP alleges, among other things, that: “For the 2015 audit, this evidence included written allegations from MiMedx’s controller that highlighted the consignment nature of these transactions and challenged MiMedx’s revenue recognition.” *Id.* ¶ 2. Moreover, of the reliability of these allegations is bolstered by the controller’s refusal to sign a management representation letter, a fact Chancey admits he knew. Answer ¶ 29 (“Mr. Chancey admits that the Audit Committee reported to Mr. Chancey that Controller once stated to them that he had not wanted to sign the management representation letter for the 2015 Audit.”).

* * *

As addressed above, the OIP “set[s] forth the factual and legal basis alleged therefor in such detail as will permit a specific response thereto” (Rule 200(b)(3)), and more. As such, the Division has informed “respondent[] of the charges against [him] so [he] can prepare a defense.” *Matter of optionsXpress, Inc.*, 2012 WL 8704501, at *2 (July

11, 2012). To require more would require the Division to disclose its evidence prematurely and expose its theories of the case. *Id.* “Respondent is not entitled to a disclosure of evidence in advance of the hearing.” *Matter of Wolfson*, 2012 WL 8702983, at *1 (citation omitted).

II. Neither the investigative file’s size nor the passage of time justifies a more definite statement.

The Division does not dispute the size of its file provided to Chancey or the passage of time, but neither supports his request for a more definite statement. Chancey claims that *J.W. Barclay & Co.*, Admin. Proc. File No. 3-10765, 2002 SEC LEXIS 3456 (June 13 2002) supports his argument. (Motion at 9-11). But *J.W. Barclay & Co.* involved nine Respondents and three motions for a more definite statement where

[t]he misconduct included, ‘among other things’ purchases and sales of securities on margin in the accounts of ‘at least’ eleven customers, churning the accounts of ‘at least’ twelve customers, making materially misleading statements or omissions to ‘at least’ two customers, making unsuitable purchases and sales in the accounts of ‘at least’ thirteen customers, and failing to execute sell orders for ‘at least’ four customers.

2002 SEC LEXIS 3456, at *1. Under those circumstances, the Administrative Law Judge (“ALJ”) ordered the Division to provide “a complete list of customers it alleged were defrauded,” identify the sales practices it alleged were violated, and identify the securities at issue in the OIP. *Id.* at *2.

Here, in contrast, the OIP alleges that Chancey’s conduct demonstrated six, specific audit failures in violation of PCAOB standards. OIP ¶ 24. For this reason, and those set forth above, neither the size of the investigative file nor the passage of time justifies a more definite statement.

Respondent's references to *David Pruitt*, Admin. Proc. File No. 3-17950, 2017 SEC LEXIS 1945 (June 23, 2017) and *Donald T. Sheldon*, Admin. Proc. File No. 3-6626, 1986 SEC LEXIS 2293, (June 9, 1986) are no more availing in that each involved indefinite allegations that are not present here. In *Pruitt*, ALJ Grimes ordered the Division to provide a list of the internal control or controls that it asserted were relevant to the alleged Rule 13(b)(5) violation; and "[a]n explanation of the categories of documents that are implicated by the phrase 'books, records, and accounts.'" 2017 SEC LEXIS 1945 at *9. *Donald T. Sheldon*, like *J.W. Barclay & Co.*, involved nine respondents. 1986 SEC LEXIS 2293 at *1. There, the ALJ found that "given the magnitude of the investigatory file and the multiplicity of respondents and allegations, the boundaries of the allegations need to be reasonably precise in order to give respondents a reasonable opportunity to prepare their defense." *Id.* at *6. Under those circumstances, the Division was ordered to be more definite as to the particular securities and time periods in which each movant was alleged to have engaged in fraud; "[t]he books and records which were allegedly incorrect and incomplete;" and the names of the persons who were alleged to have been improperly supervised. *Id.* at *8-10.

Notably, the ALJ did not require the Division to specify all "statements and activities of similar purport and object," reading that language as simply permitting the Division to introduce "evidence relating to statements or activities not precisely in the form stated in those subparagraphs but of the same import." *Id.* at *9. Thus the ALJ ordered the Division to specify the facts it alleged constituted violations, but not all evidence the Division planned to use to prove its case.

Chancey points to no facts similar to those involved in the cited proceedings that the Division has failed to identify here, where the allegation is that one accountant failed to act reasonably in conducting two annual audits and the OIP explicitly identifies six specific audit failures (and their factual bases) and the PCAOB auditing standards those failures violated. Instead, Chancey asks the Commission to use the tool of a more definite statement to require the Division “to interpret the Division’s allegations in the OIP.” Motion at 11. This improper attempt to require the Division to disclose its evidence prematurely and expose its theories of the case should be denied. *See Matter of optionsXpress, Inc.*, 2012 WL 8704501, at *2.

III. The Commission should not exercise its discretion to order a more definite statement, despite finding it is not required under the law.

As addressed above, the OIP identifies the claim against Respondent, the two audits he is alleged to have improperly conducted, and the reasons his audits failed to comply with identified auditing standards. Respondent’s Motion does not specify how having the Division provide additional information “will have the effect of expediting the proceedings.” Motion at 12, quoting *Robert M. Winston*, Admin. Proc. File No. 3-6986, 1988 SEC LEXIS 5252, at *2 (Apr. 28, 1988). For these reasons, a more definite statement should not be ordered in the Commission’s discretion.

CONCLUSION

For the reasons set forth above, the Motion should be denied.

Respectfully submitted this 17th day of August, 2021.

s/ Stephen C. McKenna
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CERTIFICATE OF SERVICE

I hereby certify that a true copy of the Division's Opposition to Motion for a More Definite Statement was served on the following on this 17th day of August, 2021, in the manner indicated below:

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