

## Herbalife: There is Huge Risk in Those SEC / DOJ Probes Involving China

If we alert you to the existence of an undisclosed SEC probe, that means we filed a Freedom of Information Act (FOIA) request with the SEC on the company in question and have a response, in black-and-white, on government letterhead that supports our statement. Other interpretative guidance and disclosures appear below.

**Analyst Summary:** Our sense is that few investors recognize the extent to which China has now become a material risk for Herbalife. We fully expect it will weigh on the shares until cleared. This report breaks it down.

Herbalife management knows the company has a China problem. They also know it's serious. At year-end 2015, China represented 18.9% of Herbalife's net sales. That's why, tucked within an exhibit to an 8-K filed on 20-Jan-2017, they did what their lawyers told them to do when faced with a risk that investors would consider potentially material to the entire company; that is, Herbalife made a clear disclosure of an SEC investigation which also involves the Department of Justice.

From the Herbalife 8-K of 20-Jan-2017 –

The SEC has requested from the Company documents and other information relating to the Company's anti-corruption compliance in China and the Company is conducting its own review. The Company has discussed the SEC's investigation and the Company's review with the Department of Justice. The Company is cooperating with the SEC's investigation and cannot predict the eventual scope, duration, or outcome of the matter at this time.

Though the company did not say it directly, we interpret this to be a joint SEC/DOJ Foreign Corrupt Practice Act, or "FCPA" probe. What makes this new disclosure especially meaningful is that we have consistently criticized Herbalife management in recent years for evasive and unclear (shoddy) disclosure practices when it comes to SEC investigative activity. For example, not once in the period Feb-2013 to Nov-2016 did we find a disclosure that would make it clear to investors the SEC was investigating Herbalife itself. But we did find multiple occasions within this same general span of time wherein the company claimed to have previously disclosed an SEC inquiry. As if wanting it both ways, we also observed the following text started showing up repeatedly in Herbalife SEC filings between 03-Nov-2014, and the 10-Q filed 01-Nov-2016:

**"If we believe any governmental or regulatory inquiry or investigation is or becomes material, it will be disclosed individually."**

Though lacking the kind of detail needed to one to independently assess the underlying risk posed by the disclosure of 20-Jan-2017, it clearly represents investigative activity "disclosed individually." That means management, who has perfect information relative to what you as an outside investor will ever have, is telling you that it believes China now represents a material risk for the company. This has added meaning compared to other companies we cover because of this management's evasive disclosure proclivities in the past. You definitely should trust their deeds on this one.

We suggest you prepare for near-term operating challenges, earnings shortfalls, and maybe even eventual restatements and/or executive turnover. You are already seeing slowing in China. In that same 8-K of 20-Jan-2017, the company also warned it expects, "... fourth quarter guidance to be toward the low end of guidance provided on November 1, 2016."

*(Why FCPA Investigations Matter, next page)*

In the balance of this report we explain the way FCPA probes can hurt a company, what to watch for, and we review the disclosure history to show how we know this new SEC/DOJ exposure represents a bigger SEC risk than earlier matters.

## **Why FCPA Investigations Matter**

We routinely find FCPA matters are blown-off by too many investors as meaningless noise of little consequence to a company's fundamentals. That thinking misses the point that FCPA investigations are really about deficiencies in accounting and internal controls. They also possess the capacity to bring about meaningful negative changes in how companies conduct business in certain markets.

**When it comes to FCPA probes, we encourage you to reflect on the following –**

- Just what is the proper accounting treatment for a bribe?
- Who has to sign off on it?
- Bribery is an illegal act, so what's that say about a company's internal controls, as well as the tone at the top?
- And, what is the auditor going to say when they find out?
- Finally, what happens to fundamentals when a company that previously viewed bribery as a necessary tool of commerce is no longer able to do so? We have yet to have a company come out and plainly state as much, but this may explain why you are already seeing slowing in China and a recent bout of downward guidance.

**With the above in mind, we recommend asking Herbalife management these questions –**

1. Is any entity beyond the SEC and DOJ involved in these probes? If so, which and what is the extent of their involvement?
2. What are all the issues to these probes? By this point, the company will have answers.
3. Where do they stand? For example, is the SEC probe formal? If so, to whom have the subpoenas been sent and what do they seek in terms of records, testimony, etc.?
4. When did the company first have contact with the SEC and, separately, the DOJ over this matter?
5. Are the reviews and investigations limited to China?
6. What has your auditor had to say?
7. What prompted the SEC and DOJ to open investigations?
8. Why was this investigation disclosed?
9. When and how did you first learn of this problem in China?
10. When was your last contact with each of the SEC and the DOJ?
11. Is the internal review complete? If not, why not, and when is completion anticipated? If yes, what was learned?
12. What is the probability for a restatement?
13. Were any personnel related to the company aware of ongoing bribery in foreign markets? If so, what are their positions and are they still there today?
14. What internal controls are in place to prevent bribery in foreign markets?
15. How are these probes going to impact your operations in China and other foreign markets?

In the next section we explain how we know, with conviction, that Herbalife's China exposure represents a material risk to the entire company. The questions above are designed to help you assess that risk. If you get excuses or anything less than complete answers, we recommend giving serious consideration whether you want to be involved with this company.

## The Herbalife Disclosure History That Tells Us the SEC/DOJ Probes Represent a Material Risk for the Company

In recent years, portfolio manager Bill Ackman loudly shared his negative investment thesis on Herbalife with the world. Along the way, we repeatedly warned of Herbalife's involvement in ongoing SEC investigative activity that we found was not clearly disclosed. Instead, you got language like the following, which left company supporters (or Ackman haters, take your pick) arguing that it was Mr. Ackman's firm that was under investigation, not Herbalife. The following is the first disclosure we found of Ackman-related, older SEC investigative activity:

From the Herbalife 10-K filed on 19-Feb-2013 –

Following December 2012 market events and a subsequent meeting we requested with the staff of the SEC's Division of Enforcement, the staff requested information regarding the Company's business and financial operations. Consistent with its policies, the Company is and will fully cooperate with these inquiries.

From experience we recognize the above as a stealth disclosure of an SEC probe, and we called it that in the past. This happens when a company feels it has to disclose something, but wants to leave investors guessing as to what is really going on. It worked. The narrative of Herbalife as "victim of the shorts, helping the authorities get the bad guys" prevailed. Again, as seen here in the Herbalife 10-K filed on 18-Feb-2014, we still do not see the company clearly state it is under investigation by the SEC.

From the Herbalife 10-K filed on 18-Feb-2014 –

In addition, in late 2012, **a hedge fund manager publicly raised allegations** regarding the legality of our network marketing program and announced that his fund had taken a significant short position regarding our common shares, **leading to intense public scrutiny and governmental inquiries**, and significant stock price volatility. We expect that negative publicity will, from time to time, continue to negatively impact our business in particular markets and may adversely affect our share price. [Emphasis added]

In the past we repeatedly criticized the company for using crafty language to talk around, but never directly acknowledge that Herbalife itself was under investigation by the SEC. This clever wordsmithing prevailed, all the way through the most recent 10-Q.

From the Herbalife 10-Q filed on 1-Nov-2016 –

Since late 2012, **a hedge fund manager has made and continues to make allegations** regarding the Company and its network marketing program. We believe these allegations are without merit and are vigorously defending ourselves against such claims, including proactively reaching out to governmental authorities about what we believe is manipulative activity with respect to our securities. Because of these allegations, we and others have received and may receive additional regulatory and governmental inquiries. For example, **we have previously disclosed inquiries from the FTC, SEC and other governmental authorities**. In the future, these and other governmental authorities may determine to seek information from us and other persons relating to these same or other allegations. **If we believe any governmental or regulatory inquiry or investigation is or becomes material, it will be disclosed individually**. Consistent with our policies, we have cooperated and will continue to fully cooperate with any governmental or regulatory inquiries or investigations. [Emphasis added]

In summary, we found multiple occasions between Feb-2013 and Nov-2016, wherein the company claimed to have previously disclosed an SEC inquiry. But we never found that disclosure that would make it clear to investors the SEC was investigating Herbalife itself. We did, however, find the following text show up repeatedly in Herbalife SEC filings between 03-Nov-2014 and the 10-Q, filed 01-Nov-2016:

**"If we believe any governmental or regulatory inquiry or investigation is or becomes material, it will be disclosed individually."**

This is the statement that tells investors the SEC/DOJ China probe is material. Despite the controversy surrounding the company, as well as our repeated warnings of confirmed, ongoing SEC enforcement proceedings, the company never once “individually” disclosed an SEC probe in recent years. In the above sentence they told you, over and over, why the SEC probe involving Ackman allegations was not individually disclosed. That’s not the case with the China probe.

**For More:** On 26-Jan-2017, we published an [SEC Investigation Update on Herbalife](#). At that time we removed the company from our Watch List of Companies with Undisclosed SEC Probes and cited our latest data from the SEC which confirmed enforcement proceedings were ongoing as of 15-Dec-2016; this was before the disclosure of the SEC/DOJ matter.

### **Select Historical Disclosure Excerpts**

From the Herbalife 10-Q filed on 1-Nov-2016 –

Since late 2012, a hedge fund manager has made and continues to make allegations regarding the Company and its network marketing program. We believe these allegations are without merit and are vigorously defending ourselves against such claims, including proactively reaching out to governmental authorities about what we believe is manipulative activity with respect to our securities. Because of these allegations, we and others have received and may receive additional regulatory and governmental inquiries. For example, we have previously disclosed inquiries from the FTC, SEC and other governmental authorities. In the future, these and other governmental authorities may determine to seek information from us and other persons relating to these same or other allegations. **If we believe any governmental or regulatory inquiry or investigation is or becomes material, it will be disclosed individually.** Consistent with our policies, we have cooperated and will continue to fully cooperate with any governmental or regulatory inquiries or investigations. [Emphasis added]

From the Herbalife 10-K filed on 25-Feb-2016:

For example, the Company has previously disclosed inquiries from the FTC, Securities and Exchange Commission and other governmental authorities. The Department of Justice sought information from the Company, certain of its Members and others regarding allegations being made about the business practices of the Company and its Members. In the future, these and other governmental authorities may determine to seek information from the Company and other persons relating to these same or other allegations. **If the Company believes any governmental or regulatory inquiry or investigation is or becomes material it will be disclosed individually.** Consistent with its policies, the Company has cooperated and will continue to fully cooperate with any governmental or regulatory inquiries or investigations. [Emphasis added]

From the Herbalife 10-Q filed on 5-Aug-2015:

Since late 2012, a short seller has made and continues to make allegations regarding the Company and its network marketing program. The Company believes these allegations are without merit and is vigorously defending itself against such claims, including proactively reaching out to governmental authorities about what the Company believes is manipulative activity with respect to its securities. Because of these allegations, the Company and others have received and may receive additional regulatory and governmental inquiries. For example, the Company has previously disclosed inquiries from the Federal Trade Commission, Securities and Exchange Commission and other governmental authorities.

From the Herbalife 10-K filed on 26-Feb-2015:

Since late 2012, a short seller has made and continues to make allegations regarding the Company and its network marketing program. The Company believes these allegations are without merit and is vigorously defending itself against such claims, including proactively reaching out to regulatory agencies and governmental authorities. Because of

these allegations, the Company has received and may receive additional regulatory and governmental inquiries. For example, the Company has previously disclosed inquiries from the FTC, SEC and other governmental authorities. **If the Company believes any governmental or regulatory inquiry or investigation is or becomes material it will be disclosed individually.** Consistent with its policies, the Company has cooperated and will continue to fully cooperate with any governmental or regulatory inquiries or investigations. [Emphasis added]

From the Herbalife 10-Q filed on 3-Nov-2014:

From time to time, the Company is subject to inquiries from and investigations by various governmental and other regulatory authorities with respect to the legality of the Company's network marketing program. Given the nature of recent allegations made by certain short sellers and related market events, the Company has received and believes it may receive additional state and federal governmental and similar inquiries (such as the previously disclosed inquiries from the FTC and SEC). To the Company's knowledge, there are no ongoing criminal investigations of the Company or its business model by any governmental authority. **To the extent any governmental or regulatory inquiry or investigation is or becomes material it will be disclosed individually.** Consistent with its policies, the Company has cooperated and will fully cooperate with any government or regulatory inquiries or investigations. [Emphasis added]

From the Herbalife 10-K filed on 18-Feb-2014:

In addition, in late 2012, a hedge fund manager publicly raised allegations regarding the legality of our network marketing program and announced that his fund had taken a significant short position regarding our common shares, leading to intense public scrutiny and governmental inquiries, and significant stock price volatility. We expect that negative publicity will, from time to time, continue to negatively impact our business in particular markets and may adversely affect our share price.

#### **Initial Disclosure of older SEC investigative activity –**

From the Herbalife 10-K filed on 19-Feb-2013:

Following December 2012 market events and a subsequent meeting we requested with the staff of the SEC's Division of Enforcement, the staff requested information regarding the Company's business and financial operations. Consistent with its policies, the Company is and will fully cooperate with these inquiries.

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**Notes:** *The SEC did not disclose the details on investigations referenced herein. All we know is that they somehow pertain to the conduct, transactions, and/or disclosures of the companies referenced. The SEC reminds us that its assertion of the law enforcement exemption should not be construed as an indication by the Commission or its staff that any violations of law have occurred with respect to any person, entity, or security. New SEC investigative activity could theoretically begin or end after the date covered by this latest information which would not be reflected here.*

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