

CLIENT UPDATE

SEC FOCUSES ON “GATEKEEPERS” IN RECENT ENFORCEMENT ACTIONS

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SEC Commissioners have recently articulated an Enforcement priority related to pursuing more cases against “deficient gatekeepers” who should be “serving as the neighborhood watch, but who fail to do their jobs.”¹ Two recent SEC enforcement actions highlight the Commission’s focus on those who serve in a gatekeeper function. In both actions, *SEC v. AgFeed Indus.*² —a case filed in federal court—and *In re Kiang*³—a settlement with the Commission, the SEC brought charges against directors who serve as chairs of their respective audit committee for “fail[ing] to perform [their] gatekeeper function in the face of massive red flags.”⁴ Although the facts underlying these two cases are egregious, they nevertheless serve as a useful warning and reminder to Audit Committee members and other gatekeepers that the SEC has and will continue to focus on the role of such gatekeepers in maintaining the integrity of the financial markets.

¹ Mary Jo White, Chair, SEC, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100>; see also Kara Stein, Commissioner, SEC, Remarks at the American Bar Association Business Law Section’s Federal Regulation of Securities Committee Fall Meeting (Nov. 22, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540403898>.

² Complaint, *SEC v. AgFeed Indus.*, No. 3:14-cv-00663 (M.D. Tenn. Mar. 11, 2014).

³ *In re Kiang*, Exchange Act Release No. 71824 (Mar. 27, 2014), available at <https://www.sec.gov/litigation/admin/2014/34-71824.pdf>.

⁴ Press Release, SEC, SEC Charges Animal Feed Company and Top Executives in China and U.S. with Accounting Fraud (Mar. 11, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541102314>.

SEC V. AGFEED INDUS.

In a case described by SEC Enforcement Director, Andrew J. Ceresney, as a “cautionary tale,” the SEC alleges in *SEC v. AgFeed Indus.* that K. Ivan Gothner, an AgFeed director and chair of the audit committee, not only missed numerous red flags that should have alerted him to accounting improprieties, but he aided and abetted the company’s fraudulent activity, violating Exchange Act Section 10(b), Rule 10b-5, and Securities Act Section 17(a).

According to the complaint, Gothner learned of several red flags beginning in 2010 and continuing through May of 2011 that indicated accounting problems in the company’s Chinese operations. These included significantly worse than expected quarterly results, an email from the COO describing operations as “completely out of control,” the CFO reporting concerns he had about the accuracy of the Chinese operation’s reported results, and reports from the COO that the Chinese unit maintained two sets of accounting books—one real and one fabricated (for reporting purposes).⁵ Gothner, in response, contacted a former director, who recommended Gothner hire outside investigators and counsel to look into the allegations. Rather than do so, he directed company management to investigate. Management’s investigation in June 2011 found that there had been fraud, but Gothner failed to inform AgFeed’s outside auditor, hire a professional firm to conduct a review or otherwise further investigate.⁶ In June 2011, an outside consulting firm further corroborated the fraud, yet Gothner failed to cause the company to disclose the fraud or correct reported numbers in public filings in July and August 2011. It was not until the end of September 2011 that a special board committee was formed, and publicly disclosed, to investigate the fraud.⁷

In addition to fraud charges, the SEC charged Gothner with multiple violations related to falsifying books and records, lying to auditors, and control person liability for false SEC filings. In the SEC’s press release, the Director of the SEC’s Denver Regional Office stated, “Officers and directors have an obligation to exercise diligence and ensure that their financial reporting is accurate. Despite learning about false and misleading financial information, AgFeed executives failed to come clean.”⁸ In its case against Gothner, the SEC is seeking civil penalties, an injunction, and a permanent bar from serving as an officer or director of a public company.

⁵ *SEC v. AgFeed Indus.*, ¶¶ 39 – 45.

⁶ *Id.* at ¶ 53.

⁷ *Id.* at ¶ 82.

⁸ *See supra* note 4.

IN RE KIANG

In a similar set of circumstances, the audit committee chair of L&L Energy, Inc., Shirley Kiang, settled with the SEC, agreeing to a cease-and-desist order and to permanently refrain from signing any public filing that contains any certification required by Sarbanes-Oxley, for violations related to making a false filing with the SEC.⁹

According to the SEC's Settlement Order, the purported CFO contacted Kiang in May 2009 and informed her that she had not, in fact, performed the work of CFO, and L&L's filings indicating that she had so acted were made without her knowledge.¹⁰ Kiang contacted the CEO who told her that the CFO was making false allegations to extort concessions from the company. Kiang did not investigate the CEO's explanation and took no further action. The purported CFO again contacted Kiang in June 2009 to inquire whether she had investigated her allegations, and this time supplied Kiang with email evidence that she had rejected a 2008 offer to serve as CFO. Kiang again contacted the CEO, who admitted that the purported CFO had not actually served as CFO and that he had used her name on L&L's filings without permission, but "told Kiang not to worry about it because it was in the past" and to not tell anyone because L&L's "reputation would be affected negatively and its stock price would drop."¹¹ Kiang took no further action and, in August 2009, signed L&L's Form 10-K, which contained false Sarbanes-Oxley certifications about the disclosure of fraud to auditors and the Audit Committee.

KEY TAKE-AWAYS

Both *SEC v. AgFeed Indus.* and *In re Kiang* provide reminders to individuals that serve on boards of directors and audit committees about the importance of their gatekeeping function and the potential consequences for failing to carry out that function with adequate diligence. Specifically, directors need to ensure that sound corporate governance practices are followed, provide robust oversight of the company's activities, and actively investigate red flags—with the assistance of outside counsel, as appropriate. As SEC Chair White said, "we will not be looking to charge a gatekeeper that did her job by asking the hard questions, demanding answers, looking for red flags and raising her hand."¹²

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Please do not hesitate to contact us with any questions.

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⁹ *In re Kiang*, at 5.

¹⁰ *Id.* at 3.

¹¹ *Id.*

¹² *See supra* note 1.