SEC Charges Underwriter and Bankers in Connection with Offering by China-based Issuer

A Cautionary Tale of How Bad Facts and Weak Due Diligence Can Expose Advisors and Their Deal Teams

Introduction

On March 27, 2015, the U.S. Securities and Exchange Commission (SEC) announced charges against an investment bank and two of its bankers for failing to adequately review and escalate a due diligence report which contradicted statements about the ownership of certain assets contained in the marketing materials used in an underwritten public offering for now-defunct China-based Puda Coal, Inc. (Puda). This SEC action offers a number of important lessons for underwriters of offerings involving companies that operate in countries with heightened compliance risks.

Moreover, this is a reminder to private equity and strategic investors that incomplete diligence in connection with an investment – while not subject to the same legal obligations as underwriters in a U.S. public offering – can result in significant risk to the value of their investment and to their reputation, as well as potential governmental claims.

Background

Puda's story is fairly straight-forward (and will be familiar to those who have been following China-based, U.S.-listed companies over the last several years):

- Puda gained access to U.S. capital markets via a reverse-merger with a U.S. public shell company in 2005.
- In December 2010, Puda conducted a public offering, gaining net proceeds of approximately US$88.5 million, which was underwritten by Macquarie Capital (USA) Inc. (Macquarie) and another investment bank.
- In the offering materials, Puda claimed to own 90% of its principal asset, a Chinese coal company – a claim which Macquarie repeated in its marketing materials for the offering.
- In reality, Puda's chairman had previously transferred ownership of the coal company to himself and then sold almost half of his interest to a third party. As a result, at the time of the offering, Puda no longer had any ownership stake or source of revenue.
- The SEC charged Puda's chairman and chief executive officer in connection with this fraud in 2012.

SEC Enforcement Action

According to the SEC's complaint, Macquarie's underwriting committee had directed one of the investment bankers involved in the offering, William Fang, to retain an investigative firm to conduct independent due diligence on Puda, its officers, and directors, as part of due diligence efforts that it deemed necessary for China-based investments. The investigative firm's report noted that, based on Chinese government records, and contrary to the representations in the underwriting materials, Puda did not own any percentage of the Chinese coal company.

Within 30 minutes of receiving the investigative report, Fang emailed a copy of the report to Aaron Black, one of the managing directors involved in the offering, and the rest of deal team, stating that "[n]o red flags were identified." Fang then later emailed the report to an associate at Macquarie's outside legal counsel. The

SEC's complaint also states that Black reviewed the executive summary of the investigative report and learned that Puda did not own 90% of the coal company. The SEC alleged that neither Fang nor Black adequately responded to the issues identified in the report, in that they did not: (1) discuss the issues with other members of their deal team, (2) seek advice from their in-house or outside counsel, and (3) seek any follow up investigations concerning contradictory information found in the report. Instead, according to the allegations, Macquarie moved forward with the public offering.

The SEC alleged that because Macquarie and its employees were aware of heightened risks associated with business transactions in China and appreciated the need for enhanced diligence efforts, their failure to adequately respond to information about the transferred assets contained in an investigative report, and amend the underwriting materials accordingly, constituted fraudulent interstate transactions in violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933. Without admitting or denying the allegations, Macquarie agreed to settle the charges by paying US$15 million – compared to a net profit to Macquarie of US$4.2 million in underwriting commissions from the 2010 offering. Similarly, without admitting or denying the allegations, Black and Fang agreed to settle the charges by paying penalties of US$212,000 and US$35,000, respectively. Additionally, Black agreed to a to be barred from any supervisory position in the securities industry for at least five years and Feng agreed to be barred from the securities industry altogether for at least five years.

The SEC also alleged broader organizational failings with Macquarie's alleged negligent handling of the investigative report. Specifically, the SEC alleged that although Macquarie's due diligence policies required that it engage an investigative firm to prepare a written report, there were insufficient systems in place to ensure that this report was properly assessed and appropriate action was taken in response.

Implications for Underwriters, Deal Professionals and Others

This SEC action is noteworthy in that, in the context of fraud by China-based, U.S.-listed companies, the SEC has more commonly pursued actions against parties who allegedly were directly involved in the fraudulent conduct – for example, the action against Puda's chairman or the SEC's 2012 action against a reverse merger specialist firm which helped implement reverse mergers and then arranged sham transactions to boost an issuer's stock. In Macquarie's case, however, it commissioned an independent investigative report and had information about the fraud in hand, but the investment bankers involved in the offering had apparently failed to assess and discuss such information in any meaningful way. The SEC's action also highlights that individual team members can be significantly penalized for due diligence failures.

Looking forward, this case illustrates that it is imperative for investment banks to both design and implement thorough due diligence programs. Such programs must include not only the gathering of information (which Macquarie had done) but also ensuring that there is a thoughtful and active review of such information so that key issues are assessed and addressed (which Macquarie had not done). Furthermore, this case illustrates the importance of involving professionals with sufficient contextual knowledge regarding the complete transaction during the due diligence process to recognize the import of material information, even within a dense due diligence report. The combination of deal teams being under ever-increasing pressure to close transactions quickly and in-house legal teams often juggling multiple transactions simultaneously can make achieving these goals inherently difficult, but that only underscores the importance of a systematic due diligence program and proper training and supervision of relevant personnel.

More generally, outside the context of public offerings, this case indicates that the higher risk profile for transactions involving emerging markets requires even more robust due diligence, as this is the second time in a month that the SEC has charged companies in connection with what it deemed to be inadequate due diligence efforts. In its February 2015 cease and desist order against Goodyear Tire & Rubber Company, the SEC charged that Goodyear did not detect or prevent bribes to Kenyan officials by a retail tire distributor in which Goodyear held a minority interest because Goodyear "failed to conduct adequate due diligence." Thus, although strategic investors such as Goodyear, as well as private equity investors, are not subject to the same legal obligations as underwriters in U.S. public offerings, they are no less immune to due diligence problems arising from incomplete assessment and discussion of key issues, the consequences of which can be significant. Accordingly, investors are well-advised to also consider re-reviewing their due diligence programs to prevent the kind of scenario seen in the Puda offering and to properly train deal teams in due diligence best practices.

While due diligence has always been an important aspect of transactions involving companies operating in China and other markets, the SEC's demonstrated willingness to scrutinize the diligence process conducted by third parties such as underwriters, as well as individual members of deal teams, highlights the basic fact that diligence is much more than a check-the-box exercise.

If you have any questions, please contact your usual Ropes & Gray advisor.

Paul W. Boltz, Jr.
Kim B. Nemirow
Patrick Sinclair