E-ALERT | Anti-Corruption

May 17, 2013

SEC CHARGES CHINA-BASED RINO INTERNATIONAL AND SENIOR EXECUTIVES WITH FRAUD-RELATED VIOLATIONS OF FEDERAL SECURITIES LAWS

On May 15, 2013, the SEC charged RINO International Corporation ("RINO") and two of its executives with violations of the anti-fraud, reporting, books and records, and internal control provisions of the federal securities laws. According to the complaint filed by the SEC ("the SEC Complaint"), RINO and its two executives — Dejun "David" Zou, the Chief Executive Officer, and his wife Jianping "Amy" Qiu, the Chairman of the Board — maintained two different sets of financial records, one of which included "significantly inflated entries" that served as the basis for the company's SEC filings. Mr. Zou and Ms. Qiu, both Chinese nationals, also allegedly diverted $3.5 million from RINO's December 2009 securities offering for personal use and initially failed to disclose and record this use of the money. The SEC's complaint follows on the heels in February of the first enforcement action against a China-based company for violations of the Foreign Corrupt Practices Act ("FCPA").

RINO, Mr. Zou, and Ms. Qiu have consented to a settlement that permanently enjoins them from violations of the implicated provisions of the securities laws, although they have neither admitted to nor denied the SEC's allegations. Mr. Zou and Ms. Qiu have also agreed to pay individual penalties and a disgorgement amount of $3.5 million into a related class action settlement.

Alleged Misconduct

RINO, which makes equipment for the steel industry in China, is a Nevada corporation based in Dalian, China that was formed through a 2007 reverse merger. The company's common stock was traded on NASDAQ until trading was halted in November 2010; RINO's stock was then delisted in December 2010. RINO disclosed in a public filing that the SEC was "...conducting a formal investigation relating to the Company's financial reporting and compliance with the Foreign Corrupt Practices Act...."

According to the SEC Complaint, RINO maintained two sets of records: the "Chinese Books" and the "U.S. Books." The SEC's investigation into these records alleged "material and significant discrepancies" between the two sets of books, with the U.S. Books showing a revenue of $491 million over a period of time in which the Chinese books reflected only $31 million in revenue. The SEC Complaint suggests that RINO's Chinese books constituted a more accurate depiction of the company's actual assets and operations because the U.S. Books reflected revenues from contracts that investigators could not confirm.

The SEC Complaint also alleges that Mr. Zou and Ms. Qiu diverted $3.5 million of a 2009 securities offering for personal use, including purchasing a home in California, buying luxury goods, and paying for other personal expenses. Mr. Zou and Ms. Qiu allegedly failed to record these expenses and disclose them in RINO's filings. When RINO's outside auditor sought information about these funds, Mr. Zou allegedly made false and misleading statements about how and why the money was used.

The SEC Complaint also argues that RINO lacked adequate recordkeeping and internal controls. According to the SEC Complaint, RINO's books and records were inaccurate because they failed to uncover the company's two sets of records, its false reports of revenue based on "fictitious contracts," and the improper recording and disclosure of the use of corporate funds for personal purposes. The SEC Complaint claims that these activities, along with Mr. Zou and Ms. Qiu's control over RINO's financial records, highlight the company's lack of adequate internal controls.

Consequences

To settle the SEC's claims:

- RINO, Zou, and Qiu are permanently enjoined from violating the federal securities law provisions implicated in the allegations;
- Mr. Zou must pay a $150,000 penalty;
- Ms. Qiu must pay a $100,000 penalty;
- Mr. Zou and Ms. Qiu must pay a disgorgement amount of $3.5 million into a related class action settlement; and
- Mr. Zou and Ms. Qiu must consent to the entry of an order prohibiting them from serving as officers and directors of a public company for 10 years.

Implications

Although the SEC's complaint does not allege bribery or corruption, several of the provisions cited in the allegations — failure to maintain accurate books and records, and failure to maintain a system of internal accounting controls — are found within the FCPA's accounting provisions. The case shows that even when US enforcement authorities cannot prove that bribery or corruption occurred, accounting-related shortcomings can provide sufficient evidence to bring an enforcement action.

The RINO settlement also reinforces lessons learned from other FCPA and anti-corruption cases, including:

- individuals, including senior executives, can be held personally liable for actions that violate US securities laws, including the FCPA;
- non-Chinese companies subject to the jurisdiction of the US securities laws can be targeted for enforcement, even when most or all of the company's business occurs outside of the United States;
- the need for an adequate system of internal controls to ensure accountability and accurate recordkeeping;
- the importance of careful oversight, monitoring, and control within the company, including at the executive level; and
- the need for accurate recording of transactions and disbursements in books and records.

If you have any questions concerning the material discussed in this client alert, please contact the following China-focused members of our Global Anti-Corruption Practice Group:

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