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Part III: The SEC and Chinese Issuers: Transparency And Accountability

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This is the third segment of a five part series examining issues arising in SEC Enforcement Actions relating to issuers from the PRC whose shares are traded in the U.S.

Corporate governance

A number of PRC based issuers have been named as defendants in SEC enforcement actions. These cases involve a range of issues including financial fraud, manipulation and misuse of assets.

Misrepresentations and financial fraud are the central allegations in *SEC v. SinoTechEnergy Ltd.*, Civil Action No. 2:12-cv-00960 (W.D. Louisiana Filed April 23, 2012). The defendants are the company, a Cayman Island corporation based in the PRC, its chairman and controlling shareholder, Qingzeng Liu, its CEO, Guoqiang Xin, and the former CFO, Boxun Zhang.

The complaint alleges that the defendants mislead investors about the use of the \$120 million raised in its IPO. Company filings claimed that it purchased key equipment carried on the balance sheet at \$94 million. In fact it made only limited purchases worth less than \$17 million. A separate count charges the Chairman with misappropriating over \$40 million from the company. The complaint alleges violations of Securities Act Sections 17(a)(2) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) and seeks to impose liability under Section 20(a) as to the individuals. The case is in litigation.

SEC v. Li, Civil Action No. CV-11-1712 (D. Ariz. Filed Aug. 30, 2011) is another action based on financial fraud allegations. The defendants are James Li, Thomas Chow, Wayne Pratt, Christopher Liu and Roger Kao. Mr. Li is a director, president and COO of Syntax-Brilliant Corporation, a developer and distributor of H-D LCD TVs. Mr. Chow is a director and chief procurement officer of Syntax-Brilliant while Mr. Pratt is the CFO. Messrs. Liu and Kao are executives with Taiwan Kolin, Co. Ltd.

The complaint centers on a financial fraud orchestrated by defendants Li and Chow. According to the SEC, from at least mid-2006 through early 2008 defendants Li and Chow executed a complex scheme to record revenue from the sale of TV sets in China when in fact the sales never occurred. As the scheme progressed, a circular cash flow was developed involving Syntax's primary manufacturer, Taiwan Kolin and defendants Christopher Liu and Roger Kao. Syntax CFO Wayne Pratt ignored red flags of improper revenue recognition and participated in preparing backdated documentation that were later provided to the outside auditors to support the fictitious sales, according to the Commission's allegations. The complaint alleges violations of Securities act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 13(b)(5).

Each defendant settled with the Commission with the exception of Mr. Chow. Mr. Li consented to the entry of a permanent injunction prohibiting future violations of Securities Act Section 17(a) and Exchange Act Sections 10(b) and 13(b)(5) and from aiding and abetting violations of the other sections cited in the complaint. He also consented to the entry of an officer and director bar. The court will determine disgorgement and a civil penalty.

Mr. Kao consented to the entry of an injunction based on Exchange Act Sections 10(b), 13(b)(2)(A), 13(b)(2)(B) and 13(b)(5). He also agreed to pay a civil penalty of \$100,000. Mr. Liu consented to an injunction based on Securities Act Section 17(a) and Exchange Act Section 10(b) and 13(a) and to an order imposing an officer and director bar. Mr. Pratt consented to the entry of an injunction based on Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 3(b)(5). He also agreed to pay disgorgement in the amount of \$88,000 along with prejudgment interest and a civil penalty of \$90,000 and to

a five year officer and director bar. In a related administrative proceeding he agreed to the entry of an order suspending him from appearing or practicing before the Commission as an accountant for a period of five years.

SEC v. AutoChina International Ltd., Case No. 1:12-CV-01643 (D. Mass. Filed April 11, 2012) is an action centered on manipulation claims. The complaint names as defendants the China based company, eight individuals and two entities. The individual defendants include Hui Kai Yan, a member of the board of directors.

In order to facilitate obtaining financing using company stock as collateral, the defendants and others are alleged to have engaged in a scheme to increase its trading volume to enhance the appearance of liquidity. Using numerous accounts, many of which were opened on the same day, the defendants and their cohorts engaged in manipulative trading such as wash sales and matched orders. The trading created the appearance of activity, increasing volume from about 18,000 shares per day in the summer of 2010 to over 139,000 shares per day in the late fall of that year. In February 2011 an entity controlled by AutoChina's Chairman and his spouse obtained about \$120 million in financing. The only asset of the entity was AutoChina stock. The complaint alleges violations of Securities Act Section 17(a) and Exchange Act Sections 9(a) and 10(b). The case is in litigation.

The complaint in *SEC v. Ming Zhao*, Case No. 12 CV 1316 (S.D.N.Y. Filed Feb. 22, 2012) is based on allegations concerning the misuse of company assets. The action is against the former Chairman and CEO of the company as well as its current CEO. It focuses on Puda Coal, Inc., a Delaware corporation with a principal office in Taiyuan, Shanxi Province, PRC. Shares were traded on the NYSE from September 2009 through August 2011. Its primary asset was Shaux Coal, a coal mining company that was an indirect subsidiary 90% owned by Puda.

On September 28, 2009, Puda announced that Shanxi Coal was one of the entities selected by the Shanxi provincial government to become a coal mining consolidator. This was an extremely lucrative opportunity for the company. Earlier in September, however, Puda's CEO, defendant Ming Zhao, transferred all of the company's interest in Shanxi Coal to himself. Subsequently, a series of steps were taken which culminated with U.S. investors buying shares in a shell company.

First, in July 2010 Mr. Zhao transferred 49% of the coal company to CITIC Trust Co., a Chinese private equity fund. That fund was controlled by CITI Group, the largest state-owned investment firm in the PRC. Mr. Zhao also arranged to have Shanxi Coal pledge 51% of its assets to CITI Trust as collateral for a loan of about \$370 million. Second, during the summer of 2010 CITI Trust sold shares to the Chinese public in a trust which held a 49% interest in Shanxi Coal. Third, in 2010 Puda conducted two public offerings in the United States of shares to raise capital for the operations of Shanxi coal, its supposed sole source of revenue. Those shares were sold to U.S. investors. As a result Chinese investors received shares in a trust which owned part of the coal company. U.S. investors received shares in a company which was a shell.

After the Commission's investigation began, defendant Liping Zhu forged a letter supposedly from CITIC Trust which falsely disclaimed any interest in Shanxi Coal. The letter was produced to the SEC staff by U.S. counsel. After it was disclosed in a filing with the Commission, the letter was exposed as a fraud. Mr. Zhu then admitted the forgery and resigned. Mr. Zhao became CEO. The share price of Puda dropped from \$17 to a few cents. The Commission's complaint alleges violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 12(b)(2)(B), 13(b)-5 and 14(a). The action is pending.

Next: The FCPA

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