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Key Takeaways from SEC Fraud Charges Against the CEO, CFO, and Audit Committee Chair of Kubient

Client Alerts

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Earlier this month, the SEC brought accounting fraud charges in the U.S. District Court for the Southern District of New York against the CEO, CFO, and Audit Committee Chair of Kubient, a company that purported to use AI services to detect fraud in digital advertising.[1] The charges focused on the CEO's scheme to inflate the company's revenues in connection with its IPO and subsequent stock offering, and the concomitant failures by the CFO and Audit Committee Chair to investigate and report the CEO's misconduct to the company's outside auditors.

The SEC's fraud charges against the CFO and Audit Committee Chair are significant. While recognizing that the accounting fraud scheme was "initiated" by the CEO, an SEC official noted in the agency's accompanying press release that the case "should send an important signal to gatekeepers like CFOs and audit committee members that the SEC and the investing public expect responsible behavior when critical issues are brought to their attention."[2] This client alert analyzes the SEC's case and provides key takeaways for officers and directors in the context of financial reporting issues.

Background

The SEC's complaint focused on revenue that Kubient reported in its securities filings under allegedly dubious circumstances. The alleged fraud arose from contracts that Kubient signed in 2019 in connection with beta testing the company's flagship product, Kubient Artificial Intelligence ("KAI"), which purportedly detected real-time fraud during digital advertising auctions.[3] As part of the contracts, Kubient agreed to provide two customers with a KAI fraud analysis of the customers' data for $1.3 million.

The SEC alleged that the KAI deal was critical to the success of Kubient's August 2020 IPO. In early 2020, Kubient recorded $1.3 million in revenue for the KAI deal, which represented nearly all of the company's first quarter 2020 revenue and approximately 45% of the company's annual revenue.[4] The CFO also provided a memorandum to Kubient's independent auditor regarding the company's accounting treatment of the KAI deal.[5] At the time of the company's August 2020 IPO, Kubient's offering materials stated it had successfully provided KAI fraud analysis to the customers in beta testing.[6] Kubient continued to report the $1.3 million in revenue in subsequent public filings, including the company's Secondary Offering Materials, 2020 Form 10-K, and earnings releases.[7]

Notwithstanding the above representations, the customers never provided Kubient with data for KAI fraud analysis. Instead, when the CFO asked the CEO for the KAI reports, the CEO created fictitious reports to support the revenue.[8] In March 2020, the CEO instructed a Kubient employee to create two electronic folders, to label the folders with the customers' names, and to populate the folders with "our own data."[9] The CEO then instructed another employee to create "sample" KAI reports, using data that the CEO provided.[10] The CEO sent the sample reports to the CFO, who noticed a discrepancy between the quantity of data allegedly analyzed in the sample reports and the quantity of data for which the customers had been invoiced the previous quarter.[11] The CEO told the CFO to change the numbers to match the invoices.[12] The CFO then revised the numbers and emailed the reports, along with the underlying contract and invoices, to the independent auditor.[13]

While recognizing that the CEO "initiated" the scheme, the SEC's complaint noted that concerns were raised internally about the KAI deal directly to the CFO and Audit Committee Chair. Specifically, in December 2020, a Kubient employee who had co-developed KAI discovered the data for the KAI deal did not originate from the customers.[14] The employee attempted to report this issue to the CFO, who apparently responded that he was "too busy to talk."[15] The employee then informed the Audit Committee Chair that Kubient had not scanned the customers' data as agreed in the KAI deal, and that Kubient might need to restate its earnings.[16] After the employee communicated his concerns, the Audit Committee Chair discussed the issue with the CEO, CFO, and Kubient's outside securities counsel. The CEO emailed the customers, copying the CFO, offering to retest the data using KAI, but the customers responded that they were satisfied with the reports they received.[17]

The SEC's allegations further emphasized that the CFO and Audit Committee Chair were required to take more affirmative steps—including investigating the employee's concern and reporting the issue to the company's outside auditors—because each had disclosure and reporting obligations with respect to the company's financial statements. For instance, the SEC focused on a January 2021 Audit Committee meeting in which the Committee allegedly discussed the employee's concerns regarding the KAI deal.[18] The SEC detailed in its allegations that the company's independent auditor was not invited to or informed of the meeting.[19] Although the company had a practice of keeping minutes for Audit Committee meetings, no minutes were prepared following the January 2021 meeting, and the Audit Committee apparently did not identify this session as a formal meeting to the company's outside auditors.[20]

Moreover, in connection with the 2020 year-end audit, the CFO signed representations to the company's outside auditors that the 2020 financial statements conformed with GAAP and that he was not aware of any risks that the financial statements may be materially misstated. Similarly, as part of the year-end audit, the Audit Committee Chair affirmed to the auditors that the Audit Committee had no knowledge of any fraud or suspected fraud affecting the company.

The reporting issues with the contracts ultimately became apparent when Kubient's outside auditors resigned, and the company announced its intention restate its financial statements.[21]

Analysis

The SEC's accounting fraud case hinged on the misconduct of Kubient's CEO and included classic hallmarks of fraud. For instance, the allegations indicated that the CEO directed others to create fictitious reports to support the company's revenue for the KAI deal. This revenue represented more than 90% of the company's total revenue at the time of its IPO and ultimately misled investors as to the true financial condition of the company.

In contrast to the CEO's affirmatively deceptive acts, the SEC's fraud charges against Kubient's CFO and Audit Committee Chair focused on their purported *inaction* after an employee raised red flags about the deal. In particular, the SEC alleged that "[d]espite their senior roles in the company, neither [the CFO nor the Audit Committee Chair] properly investigated what they learned or took any steps to correct the offering materials."[22] For example, the CFO initially analyzed the $1.3 million in KAI beta testing revenue under the revenue recognition standards under GAAP, but did not perform a new analysis after learning that the customers' data had not been scanned as required by the contracts.[23]

The SEC's complaint acknowledged that the Audit Committee Chair discussed the employee's concerns with the CEO, CFO, and outside counsel, and that the CEO subsequently took seemingly remedial steps with the relevant customers, who acknowledged their satisfaction with Kubient's services. However, the SEC faulted the CFO and Audit Committee Chair for signing the relevant securities filings that overstated revenues from the KAI deal, and for not doing more after concerns were raised. Specifically, the complaint noted that the CFO and Audit Committee Chair failed to "conduct due diligence to understand the circumstances," to take "meaningful" steps to understand the employee's concerns, or to determine if the company satisfied its performance obligations for purposes of recognizing revenue for the deal.[24]

Moreover, the SEC's Rule 13b2-2 charges (*i.e.*, lying to the auditors) against the CFO and Audit Committee Chair were premised on their respective failures to disclose the employee's concerns in connection with the company's year-end audit. The SEC alleged that the CFO and the Audit Committee Chair "perpetuated" and "continued the CEO-initiated scheme,"[25] by representing to the auditors that they had no knowledge of fraud or suspected fraud with respect to Kubient's 2020 financial statements, and by excluding the independent auditor from the January 2021 meeting where the Audit Committee apparently discussed the relevant employee's concerns.[26] While it is unclear what the Audit Committee discussed (and whether the discussion was in good faith), the SEC viewed the January 2021 meeting as a departure from the Audit Committee's prior practice and as evidence that the Audit Committee endeavored to conceal financial reporting concerns from the auditors.

Takeaways

- **When a significant financial reporting issue arises, the SEC will expect a company to investigate and confirm that material transactions are being recorded appropriately, document its findings, and be upfront with its auditors**. The SEC's complaint focused on misconduct with respect to two contracts that represented more than 90% of the company's revenue at the time of its IPO. This issue first arose with an employee who raised significant concerns about the deal and the potential for a restatement, but the company overall failed to respond appropriately to these issues. The SEC's case made clear that a company must take material financial reporting concerns seriously by demonstrating a commitment to thoroughly investigating and resolving these issues, substantiating and documenting any conclusions, and being transparent with the outside auditors.

- **The SEC has heightened expectations for gatekeepers, such as CFOs and Audit Committee Chairs, when allegations of financial improprieties arise**. In this case, the SEC recognized that the CEO alone initiated the scheme, and that the CFO and Audit Committee Chair took *some* steps, including consulting with outside counsel, once the issue came to their attention. However, the complaint against the CFO and the Audit Committee Chair made clear that these defendants should have taken more affirmative steps—*g.*, investigating the circumstances leading to the issue, confirming that the company properly recognized revenue in connection with the deal, and disclosing the issue to the outside auditors—particularly in light of their ongoing disclosure obligations with respect to the company's offering materials and SEC filings.

- **The SEC's fraud charges against the CFO and Audit Committee Chair signal a willingness to be more aggressive against officers and directors.** As noted above, the allegations against these defendants focused on their respective failures to investigate and analyze a concern raised by an employee that should have put them on notice of a significant revenue recognition issue. By focusing on their failures to act (versus alleging affirmatively deceptive acts), the SEC's charges are similar to the charges they brought against the CFO of View, which we wrote about in this client alert. In that case, the SEC brought negligence-based fraud charges against a CFO who failed to inform his team when their accounting presentation relied on a factual assumption that he should have known was incorrect.

- **Robust compliance functions that appropriately address significant employee complaints can help mitigate risks for companies.** Much of the SEC's case focused on the company's apparent deferral to the CEO in perpetrating the inflated revenue scheme, as well as the CFO and Audit Committee Chair's failures to respond appropriately to an employee's concern regarding the deal and to bring these issues to the outside auditors' attention. In this administration, the SEC has repeatedly emphasized the importance of compliance, and this case underscores the need for companies to ensure that they have appropriate channels to gather, investigate, and document employee concerns and any related analyses of these issues.

Footnotes

[1] In a parallel action, the U.S. Attorney's Office for the Southern District of New York announced securities fraud charges against the CEO, who subsequently pled guilty. Press Release, U.S. Attorney's Office, Southern District of New York, Former CEO Of Kubient, Inc. Charged And Pleads Guilty In Connection With Accounting Fraud Scheme (Sept. 16, 2024).

[2] Press Release, U.S. Securities & Exchange Commission, SEC Charges Former Chairman and CEO of Tech Co. Kubient With Fraud and Lying to Auditors (Sept. 16, 2024).

[3] Complaint ¶ 23, *SEC v. Weiss & Coen*, No. 24-cv-06988 (S.D.N.Y. Sep. 16, 2024), ECF No. 1.

[4] *Id.* ¶¶ 25, 92.

[5] *Id.* ¶ 53.

[6] *Id.* ¶ 82.

[7] *Id.* ¶ 46.

[8] *Id.* ¶ 27.

[9] *Id.* ¶ 28.

[10] *Id.* ¶¶ 29–32.

[11] *Id.* ¶ 33.

[12] *Id.* ¶ 34.

[13] *Id.* ¶ 35.

[14] *Id.* ¶ 37.

[15] *Id.* ¶ 38.

[16] *Id.* ¶¶ 39–40 .

[17] *Id.* ¶¶ 41–45.

[18] *Id.* ¶¶ 58–59.

[19] *Id.* ¶ 67.

[20] *Id.* ¶¶ 62–64.

[21] Kubient, Inc., Current Report (Form 8-K) (Sept. 19, 2024).

[22] Complaint ¶ 2.

[23] *Id.* ¶ 48.

[24] *Id.* ¶¶ 36, 49.

[25] *Id.* ¶¶ 4, 36.

[26] *Id.* ¶ 58.

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