
Problems of Chinese Companies on U.S. Securities Exchanges

Presented by

Mr. James C. Lin

Ms. Bonnie Chan

November 25, 2011

Davis Polk

Davis Polk & Wardwell LLP

Related News: [Law](#) · [China](#)

Want to save this for later? [Add it to your Queue!](#)

Longtop Financial Technologies Sued by Investor Claiming Securities Fraud

By Karen Gullo - May 26, 2011 6:22 AM GMT+0800

[ADD TO QUEUE](#)

The Street

GET JIM CRAMER'S ACTUAL PORTFOLIO FOR FREE!

GET FREE NEWSLETTERS

HOME MARKETS NEWS RESEARCH STOCK PICKS TECH

Industrials

SEC Probing China Green Ag

By Scott Eden [✉](#) [📄](#) [📱](#) [📺](#) 01/12/11 - 05:48 PM EST

» Print

This copy is for your personal, non-commercial use only. To order presentation-ready distribution to colleagues, clients or customers, use the Reprints tool at the top of any visit: www.reutersreprints.com.

Sino-Forest, auditors facing class-action lawsuits

Tue, Jun 21 2011

Islamic Finance Industry leaders share insights on Islamic financial markets

Solar Energy Outlook The Long Term Outlook for Solar Energy

Home | Portfolio | Market Currents | Long & Short Ideas | Investing for Income | ETFs & Portfolio Strategies

China Sky One Medical: Debunking Allegations of Fraud

[🗨️](#) 19 comments | July 10, 2011 | about: CSKI

Related News: [China](#) · [Stocks](#) · [Media](#)

China MediaExpress CFO Quits, Auditor Calls for Inquiry of Bus Advertiser

By Nikolaj Gammeltoft and Dune Lawrence - Mar 15, 2011 7:21 AM GMT+0800

The Street

GET JIM CRAMER'S ACTUAL PORTFOLIO FOR FREE!

GET FREE NEWSLETTERS

HOME MARKETS NEWS RESEARCH STOCK PICKS TECH PERSONAL FINANCE LIFESTYLE

Industrials

SEC in Fraud Probe of China RTO Duoyuan Printing

By Scott Eden [✉](#) [📄](#) [📱](#) [📺](#) 03/18/11 - 01:26 PM EDT

Overview

- I. Overview - Chinese Companies Accessing U.S. Securities Exchanges**
- II. Problems with Reverse Mergers**
- III. Problems with U.S.-Listed Chinese Companies via Initial Public Offerings (IPOs)**
- IV. Public Company Accounting Oversight Board (PCAOB) and the U.S. Securities and Exchange Commission (SEC) vs Chinese Securities Regulatory Commission (CSRC) – Regulatory Standoff on Accounting Oversight**

Overview - Chinese Companies Accessing U.S. Securities Exchanges

Chinese State-Owned Enterprises (SOEs) Listing in the U.S. (1992-2003)

- Chinese companies have been accessing the U.S. public markets since the 1990s with wave of SOE dual listings on NYSE and HKSE.
 - H-Shares listed and traded on the HKSE, American Depositary Shares (ADSs) representing such H-shares listed and traded on the NYSE.
 - The U.S. public markets provide capital needed for large SOE IPOs.
 - A dual listing was viewed as a way to “lift” the corporate governance standards of SOEs.
 - SOE dual listings included China Eastern, China Southern, China Mobile, China Unicom, China Telecom, Sinopec Corp., CNOOC, and Aluminum Corporation of China.

Chinese State-Owned Enterprises (SOEs) Listing in the U.S. (1992-2003)

- In December 2003, China Life Insurance became the last SOE to go public in the U.S.
 - Raised US\$3.46 billion, the world's largest in 2003.
 - In March 2004, a class action lawsuit was filed claiming, among other things, failure to disclose an audit by China's National Audit Office that had uncovered irregular or illegal behavior at China Life's predecessor company involving RMB5.4 billion (US\$652 million).
 - In April 2004, China Life received an informal inquiry from the SEC; the informal inquiry was terminated in June 2006 and no enforcement action was recommended by the SEC.
 - The class action lawsuit was dismissed in September 2008.
 - ***It is reported that PRC regulators took offense that a SOE is subject to the SEC's investigatory powers and have discouraged SOEs from listing in the U.S.***

Chinese Privately-Owned Companies Listing in the U.S.

- The first wave (2000): internet portal companies.
 - Sina, Sohu and Netease became listed on NASDAQ in 2000 before the burst of the first internet bubble.
- The second wave (2003-2011): broad range of industries; many backed by Silicon Valley style VCs.
 - Internet: Ctrip (2003), Baidu (2005), Youku (2010), Tudou (2011).
 - Online Games: Shanda (2004), Giant Interactive (2007), Taomee (2011).
 - Alternative Energy: Suntech (2005), Trina Solar (2006), Mingyang (2010).
 - Education: New Oriental (2005), Xueda (2010), TAL Education (2010).
 - Spin-offs: Shanda Games (2009), Changyou (2009), China Real Estate Information Corp. (2009)

Why Listing in the U.S.?

- Disclosure-based system.
 - An issuer is required to make full disclosure of its affairs to investors prior to investors' investment decisions.
 - SEC will not review the merit of the business or viability of the company's business model but will focus on disclosure of the known and foreseeable material risks.
 - Contrast with merit-based system, such as Hong Kong's substantive requirements: profit test, sufficient trading record, management continuity, ownership continuity, etc. or joining China main exchanges in Shanghai and Shenzhen with more stringent listing rules, where Chinese companies face a long waiting period and profitability requirements.
- Perceived better valuation in the U.S., particularly for certain industries.
- U.S. investors better appetite for risky, unproven businesses.
- SEC review process perceived to be more streamlined.

Problems with Reverse Mergers

Reverse Mergers: The Issue

- A “reverse merger” occurs when a private operating company merges with a publicly listed shell company.
 - The operations of the new company are primarily or entirely those of the former private operating company.
 - The new company’s stock is publicly traded under the former shell company’s listing, often with shares quoted on the Over the Counter Bulletin Board (OTCBB).
 - The new company eventually “migrates” to one of the main boards of NASDAQ or NYSE.

Reverse Mergers: The Issue *(cont.)*

- A U.S. “reverse merger” permits a company to access U.S. capital markets without the regulatory oversight involved in an IPO.
 - Less susceptible to market conditions and less stock dilution than IPOs.
 - A U.S. reverse merger can take as little as three months and cost under US\$1 million in fees.
- Since 2004, approximately 370 Chinese companies have listed in the U.S. through “reverse mergers”.
 - Between January 2007 and March 2010, at least 159 Chinese companies accessed the U.S. markets through reverse mergers.
 - In that time, only 56 Chinese companies conducted U.S. IPOs.

Reverse Mergers: A Wave of Scandals

- **China Natural Gas** – class action lawsuit filed in September 2010 alleging issuance of false and misleading financial statements; CFO resigned in December 2010.
- **China Agritech** – class action lawsuit filed in February 2011 alleging issuance of false and misleading financial statements; dismissed its auditor Ernst & Young Hua Ming in March 2011.
- **Duoyuan Printing** – dismissed its auditor Deloitte in September 2010 over the level of access to information while conducting an audit; class action lawsuit filed in September 2010; SEC began investigating the company for fraud in October 2011; NYSE delisted its shares on April 4, 2011.
- **China MediaExpress Holdings** – class action lawsuit filed in February 2011 alleging issuance of false and misleading financial statements; Deloitte resigned as auditor on March 11, 2011 because “no longer able to rely on the representations of management;” CFO resigned in March 2011; stock trading halted on March 11, 2011.

Reverse Mergers: Class Action Lawsuits and Loss of Shareholder Value

- The Bloomberg Chinese Reverse Mergers Index, an equity index that tracks the performance of nearly 80 Chinese-based firms that have completed reverse mergers, declined in value by 44.4% in the first six months of 2011.
- Since the beginning of 2010, Chinese reverse merger companies have been named in the 33 securities class actions alleging violations of U.S. securities laws. The aggregate market capitalization declined by more than US\$8 billion during the putative class periods, and the average market capitalization declined by approximately US\$250 million for the reverse merger companies named in the 33 securities class actions.
- Directors, auditors and investment banks also named as defendants.

Reverse Mergers: Increased Scrutiny from U.S. Regulators

- *“While the vast majority of these Chinese companies may be legitimate businesses, a growing number of them are proving to have significant accounting deficiencies or being vessels of outright fraud.”*

Commissioner Luis Aguilar (Apr. 4, 2011)

- *“Many companies either fail or struggle to remain viable following a reverse merger.”*

SEC Staff Investor Bulletin, *Reverse Mergers* (June 9, 2011)

- *“[A] number of [reverse merger] companies are suspected of providing false or misleading financial statements to investors.”*

Chairman Mary L. Schapiro (July 12, 2011)

Reverse Mergers: Increased Scrutiny from U.S. Regulators

- In July 2010, PCAOB issued “Staff Audit Practice Alert No. 6,” noting that some accounting firms may not be conducting audits of reverse merger companies in accordance with PCAOB standards (chiefly AU543, which establishes requirements that apply when an auditor uses the work and reports of another independent auditor or contractor.)
- In June 2011, the SEC issued an investor bulletin warning investors about reverse merger companies.
- On November 9, 2011, the SEC approved new NASDAQ, NYSE, and NYSE Amex rules imposing more stringent listing requirements for companies that become public through a reverse merger. The new rules prohibit a reverse merger company from applying to list until:
 - The company has completed a one-year “seasoning period” by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following the reverse merger, and filed all required reports with the SEC, including audited financial statements.
 - The company maintains the requisite minimum share price of US\$4 (US\$3 for NYSE Amex) for a sustained period, and for at least 30 of the 60 trading days, immediately prior to its listing application and the exchange’s decision to list.

Reverse Mergers: Increased Scrutiny from U.S. Regulators *(cont.)*

- SEC has launched a number of investigations against some Chinese reverse merger companies, including:
 - China Sky One Medical
 - Fuqi International (FUQI)
 - Rino International Corporation
 - China Green Agriculture
 - Duoyuan Printing
 - China Century Dragon
 - China Intelligent Lighting & Electronics
 - China Expert Technology, Inc.
 - China 9D Construction Group
 - China Media1 Corp.
 - China Digital Media Corporation
 - China Mineral Acquisition Corp.
 - China Technology Global Corp.
 - China Yuchai International Limited
 - Greater China Corp.
 - China Continental, Inc.
 - China Energy Savings Technology, Inc.

Reverse Mergers: Increased Scrutiny from U.S. Regulators *(cont.)*

- The SEC, NASDAQ, and NYSE have suspended trading, halted trading, or delisted the securities of at least 29 Chinese reverse merger companies citing, among other reasons, public interest concerns, removal of audit opinions, failure to respond to information requests, failure to comply with SEC requirements, and failure to evidence compliance with initial listing standards.

Problems with US-Listed Chinese Companies via IPOs

“Audacious Fraud” – Not Limited to Chinese Reverse Merger Companies

- U.S.-listed Chinese companies that have gone through the rigorous IPO process, underwritten by “bulge bracket” investment banks with financial statements audited by a “big four” auditor, may also be susceptible to fraud and accounting scandal.

Securities Fraud Case Study – Longtop Financial Technologies

- IPO on October 24 2007, underwritten by bulge bracket investment banks.
- Major owners of the stock included hedge funds run by people known as “tiger cubs” because they got their start at Julian Robertson’s Tiger Fund.
- “Big 4” auditor, Deloitte.
- Longtop was the subject of Citron Research and Muddy Waters short seller reports that alleged audacious fraud.
- On April 28, 2011, Longtop tried to assure analysts that the fraud claims were unfounded. Derek Palaschuk, a Canadian accountant who served as Longtop’s CFO, wrapped himself in Deloitte’s prestige, saying that those who questioned Longtop were “criticizing the integrity of one of the top accounting firms in the world.”
- On May 17, 2011, stock trading was halted. The final trade on the NYSE was for US\$18.93, a price that valued the company at US\$1.1 billion. At its peak in November 2010, it had a market capitalization of US\$2.4 billion.

Securities Fraud Case Study – Longtop Financial Technologies *(cont.)*

- On May 22, 2011, Deloitte sent a resignation letter to Longtop’s audit committee, stating that:
 - While auditing Longtop’s financials for year ended March 31, 2011, Deloitte sought confirmations from bank headquarters, rather than the local branches that had previously verified that Longtop’s cash really was on deposit and identified “a number of very serious defects.”
 - On May 17, 2011, “within hours” of a new round of confirmations, the confirmation process was stopped as a result of “intervention by the company’s officials including the chief operating officer.”
 - Longtop told banks that Deloitte was not really the auditor. It seized documents and made “threats to stop our staff leaving the company premises unless they allowed the company to retain our audit files.”
 - Despite Longtop’s efforts, Deloitte learned Longtop did not have the cash it claimed and that there were “significant bank borrowings” not reflected in its books.
 - A few days later, Longtop’s chairman, Jia Xiao Gong, told a Deloitte partner that there was “fake cash recorded on the books” because there had been “fake revenue in the past.”
- On May 23, 2011, Longtop announced resignation of its CFO, the initiation of a SEC inquiry, and commencement of independent investigation.

Securities Fraud Case Study – SinoTech Energy Limited

- IPO on November 2, 2010, underwritten by bulge bracket investment banks, both of whom have recently have “buy” ratings on the stock.
- “Big 4” auditor, Ernst &Young.
- On August 17, 2011, stock trading was suspended by NASDAQ. NASDAQ requested additional information in the matter of allegations made by Alfred Little, an acknowledged short seller of the company’s ADSs; among the allegations, its largest customers and suppliers are likely nothing more than empty shells with little or no sales or income.
- On September 21, 2011, received delisting notice from NASDAQ.
- On September 23, 2011, company reported that certain company officers, including the CFO resigned, and Ernst &Young resigned, citing concerns over a financial transaction with the company’s chairman, and withdrew its opinion on the company’s financial statement.
- Class action filed in 2011, alleging securities law violations of its officers and directors, certain underwriters and Ernst &Young.

SEC/PCAOB vs CSRC – Regulatory Standoff on Accounting Oversight

PCAOB Oversight in China: The Issue

- Companies publicly trading in the U.S. must be audited by an accounting firm registered with the PCAOB.
- Many Chinese companies trading in the U.S. use small accounting firms without the resources to properly audit operations in China.
 - These firms must rely on firms or agents in China.
 - The PCAOB is unable to inspect these Chinese accounting firms.
- Even where a Chinese firm uses a major U.S. accounting network with operations in China, the PCAOB is unable to inspect those operations.

PCAOB Oversight in China: Recent Statements by Regulators

- *“The PCAOB’s ability to inspect foreign registered firms is an important component of their oversight regime. . . . [D]espite audits by . . . uninspected firms, the veracity of some companies’ financial statements has been called seriously into question.”*

SEC Chairman Mary L. Schapiro (July 12, 2011)

- *“If we are not able to reach an agreement that will give the PCAOB access to firms in China that have registered with us, we will have to consider using the tools at our disposal . . . to protect investors.”*

PCAOB Chairman James R. Doty (Oct. 4, 2011)

Access to Documents

- U.S. regulators are often unable to obtain documents from sources inside China that they require for enforcement actions.
 - Chinese companies are unfamiliar with the U.S. discovery process.
 - No treaty exists under which U.S. regulators can seek the documents.
 - Companies believe that Chinese secrecy laws forbid production of requested documents.
- U.S. regulators might instead seek to compel production by auditors.

Access to Documents Case Study: Longtop Financial Technologies

- China-based company audited by Deloitte Shanghai.
- Deloitte resigned after uncovering evidence of fraud.
- Deloitte refused to comply with an SEC subpoena for related documents.
 - Claims that Chinese law forbids the production.
- The SEC has moved in U.S. federal court to compel production.
 - This motion is pending.

PCAOB Oversight in China: Efforts to Address the Concerns

■ Bilateral Efforts

- In July 2011, SEC and PCAOB officials visited China to meet with officials from the CSRC and the Ministry of Finance.
- SEC described the meetings as “very productive,” but they resulted in no agreement.
- No new meetings have been announced.

■ Unilateral Efforts

- The PCAOB has proposed new rules requiring audit firms to name any other firms contracted to do parts of an audit.
- The PCAOB has not yet deregistered any firm for lack of inspection of its Chinese operations.

Questions
