

**It's About the Gatekeepers,
Stupid:
The Problems of Chinese
Companies Listed in Overseas
Markets**

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1. What happened?

- ❖ China! China! China!

- ❧ China-concept stocks in overseas markets

- ❖ US; HK...

- ❧ China growth story:

- ❖ second largest economy;

- ❖ high growth rate

- ❖ 1.3 billion people cannot be wrong!

What happened?

- ❖ Story after story of corporate fraud
 - ❧ Fraudcaps: Chinese small cap companies listed abroad and accused of financial misreporting
 - ❖ From reckless negligence to outright fraud
 - ❖ From misstated assets, fake client lists to concocted bank statements

What happened?

❖ As of July:

- ❧ About 25 Chinese companies have disclosed auditor resignations and accounting problems
- ❧ NYSE made 11 suspensions of Chinese companies and revoke the registrations of 8 others
- ❧ At Nasdaq, 15 of 19 companies on the suspension list are Chinese
- ❧ The Bloomberg Index tracking 78 small-cap Chinese companies listed in the US was down 44%
 - ❖ Foreign investors lost a total of USD34 billion

Sino-Forest Corp scandal



❖ Profile:

- ❧ Listed on the Toronto Stock Exchange;
- ❧ Commercial forest plantation operator in Yunnan Province, China

❖ Problems:

- ❧ Lost 60% of its value, or CAD 2.5 billion in market cap, within two weeks of fraud allegation by a boutique research firm Muddy Waters
 - ❖ Fabricated USD231.1m worth of timber sale
 - ❖ Exaggerated assets by USD900m

China MediaExpress Holdings

❖ Profile

- ❧ Bus-advertising company based in Fuzhou
- ❧ Listed in NYSE Amex

❖ Problem:

- ❧ its auditor (Deloitte Hong Kong) quitted after failing to gain access to relevant information
- ❧ Share price plummeted 33% in one day

It hurts...everybody...

❖ John Paulson:

- ❧ Hedge fund manager—the man behind the ‘most successful trade in history’
- ❧ Held 14% stake in Sino-Forest, representing a full 2% of the USD18 billion in his two flagship funds
- ❧ Realized losses amount to almost USD 0.5 billion



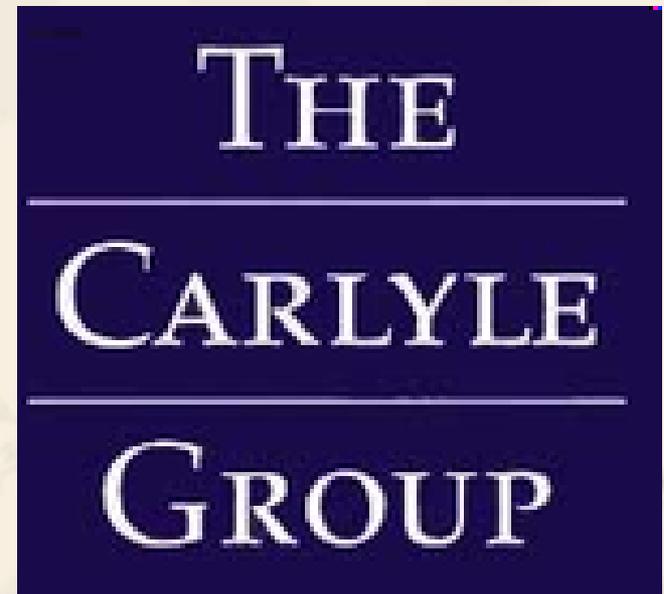
❖ Anthony Bolton:

- ❧ Britain's most famous fund manager
- ❧ Suffered his worst year by far due to his heavy investment in two fraudulently-suspected China-based companies through the 'China Special Situations Fund' he manages for Fidelity Investments



❖ Carlyle Group:

- ❧ The 2nd largest PE firm in the world, managing USD106 billion worth of assets
- ❧ Had an 11% and 22% stake in China Forestry and China Agritech, respectively, both of which saw their shares collapse following fraud allegations



2. What went wrong?

Hypothesis 1

❖ Chinese are not trustworthy?



❖ But...

❧ Enron, Worldcom in the US

❧ Parmalat in Europe

OLYMPUS®



❖ Olympus in Japan, now...

- ❧ 14 October 2011: it was disclosed that Olympus covered up investment loss up to USD 1.3b in the past 20 years
- ❧ Share price dropped 70% within one month of the disclosure, being the lowest in 33 years

Hypothesis 2

❖ Reverse-takeover (RT)

- ❧ Backdoor listing

- ❧ a private company, usually an overseas holding one, acquires and merges with a US public shell company so that it instantly becomes a public entity without going through the vetting process of a traditional IPO

❖ Is RT a problem per se?

☞ Very common in the US

❖ Not unique to Chinese companies

☞ It is a good business for the Americans:

❖ Shell companies trading on the OTC may cost between USD250,000 and USD800,000

❖ Shell companies listed on NASDAQ can fetch at least USD3m

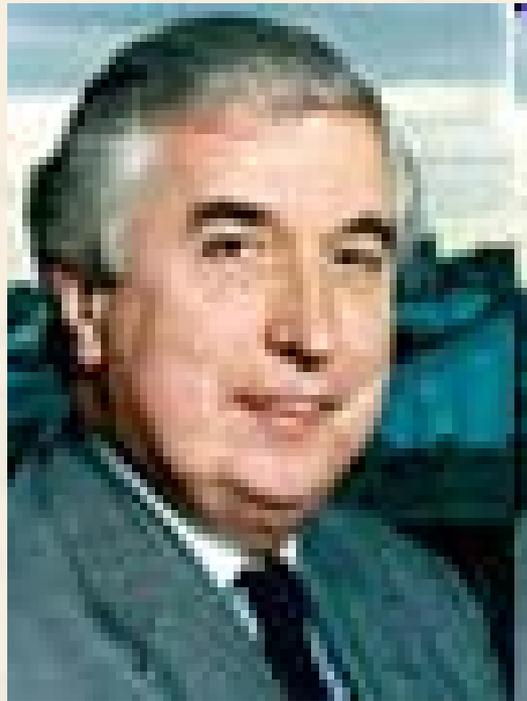
- ❖ Features of Chinese companies doing RT
 - ☞ Small caps: less than USD50m revenues
 - ☞ listed on less regulated exchanges: Pink Sheets; OTC Bulletin Board; NYSE Amex
 - ☞ Since Jan 2007, more than 150 Chinese companies have done this, representing 26% of total RT in the US from Jan 2007 to March 2010

Hypothesis 3

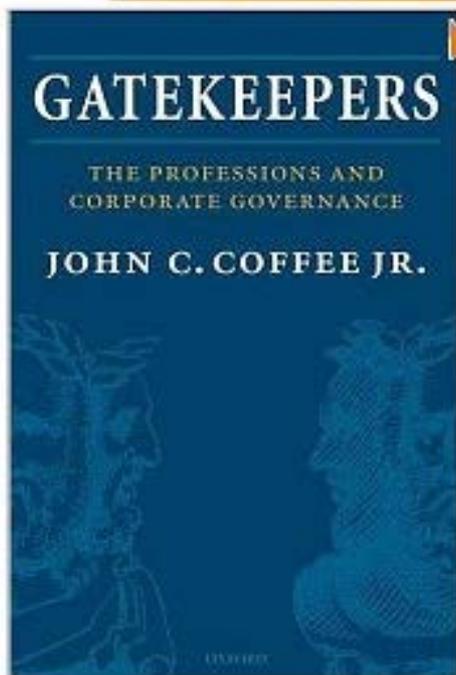
- ❖ “It is the companies who are committing fraud”

It's About the Gatekeepers, Stupid

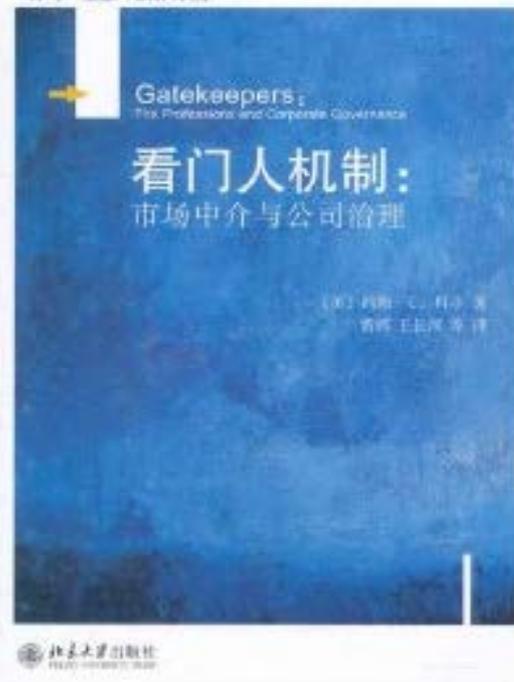
- ❖ accountants; lawyers; rating agencies...



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❖ Gatekeepers:

☞ from willful ignorance to strategizing and actively managing fraud

❖ Securities analysts:

☞ On the day Sino-Forest's share price began its plunge, 9 analysts were covering the company, still recommending 'buy'!

❖ Auditors

- ❧ The first to blame for accounting problems
- ❧ Who are they?

AUDITORS OF THREE OR MORE CHINESE REVERSE MERGER COMPANIES

U.S./NON-U.S. AUDIT FIRMS			
CRM ISSUER ENGAGEMENTS AS OF 31 MARCH 2010			
AUDIT FIRM			
1	MaloneBailey LLP (formerly Malone & Bailey PC)	10	U.S.
2	Bernstein & Pinchuk LLP	9	U.S.
3	PKF	7	H.K.
4	Paritz and Company P.A.	6	U.S.
5	AGCA Inc.	5	U.S.
6	Albert Wong & Co.	5	H.K.
7	Frazer Frost LLP (formerly Moore Stephens Wurth Frazer and Torbet LLP)	5	U.S.
8	Goldman Kurland and Mohidin LLP (formerly Goldman Parks Kurland Mohidin LLP)	5	U.S.
9	Samuel H. Wong & Co. LLP	5	U.S.
10	HKCMCPA Co. (formerly ZYCPA Co.)	5	H.K.
11	Child, Van Wagoner & Bradshaw PLLC	4	U.S.
12	Friedman LLP	4	U.S.
13	Kabani & Company Inc.	4	U.S.
14	Patrizio and Zhao LLC	4	U.S.
15	Sherb & Co. LLP	4	U.S.
16	Weinberg & Company P.A.	4	U.S.
17	Acquavella, Chiarelli, Shuster, Berkower & Co. LLP	3	U.S.
18	BDO Ltd.	3	H.K.
19	Dominic K.F. Chan & Co.	3	U.S.
20	Etania Audit Group P.C. (formerly Davis Accounting Group PC)	3	U.S.
21	Kempisty & Company Certified Public Accountants PC	3	U.S.
22	Madsen & Associates CPA's Inc.	3	U.S.
23	MS Group CPA LLC	3	U.S.
24	UHY Vocation HK CPA Ltd.	3	H.K.
	Total	110	
	Total CRM companies	157	
	Percentage of total CRM companies	70%	

Source: PCAOB

❖ Features:

- ❧ Most are US firms

 - ❖ Also HK firms

- ❧ Most are small firms

 - ❖ Sino-Forest's auditor was Ernest & Young!

Why not hold those bastards accountable?

❖ Technical difficulties

❧ Hard and time-consuming to prove the auditors are guilty

❖ They are either just insider or outside of the line of illegality

Hypothesis 4

❖ Regulatory gaps:

☞ The US regulators have limited jurisdiction

❖ SEC cannot force the Chinese executive to come to the US

☞ The Chinese regulators are not responsive

❖ CSRC is only interested in fraud allegations if the company has a dual-listing in China (which is rare)

Enforcement

- ❖ China-Energy Savings Tech Inc.
 - ⌘ In 2006, the SEC filed fraud charges
 - ⌘ In 2009, the company's executives were fined USD35m
 - ⌘ In 2010, the company's former auditor was fined USD130,000
 - ⌘ The only case completed involving a Chinese RT company

3. What should work?

- ❖ Gatekeeper liability
- ❖ More stringent regulation of RT
- ❖ Regulatory cooperation
- ❖ Corporate governance in China:
 - ❧ law and enforcement

PS

❖ 15/November/2011

☞ The independent committee investigating Sino-Forest Corp. said it found no evidence of fraud at the company

❖ Also:

☞ the shares of some have rebounded after internal investigations found no wrongdoing

❖ Short seller's trick?

☞ Wait and see...