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ACCOUNTING

Regulators Ramp Up China Reverse Merger Scrutiny



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The Securities and Exchange Commission is increasing its scrutiny of China-based companies with securities traded on U.S. stock exchanges. Particular emphasis is being placed on those companies that went public through a reverse merger transaction involving a publicly traded shell company (Chinese Reverse Merger companies or CRMs). As outlined in an August 8, 2011, press release, the SEC's efforts have included increased coordination with Chinese regulators and increased enforcement efforts, investor education, and increased scrutiny of companies' auditors by the Public Company Accounting Oversight Board (PCAOB).

In a speech to the Council of Institutional Investors on April 4, 2011, SEC Commissioner Luis Aguilar, on

the subject of capital formation, expressed his "concern that the U.S. capital markets are being exploited by certain foreign companies, not only harming U.S. investors, but also negatively effecting the environment for capital formation." Commissioner Aguilar further noted, "We have seen a spike in private companies merging with a public shell company as a way of going public. While it is Chinese companies that have grabbed recent headlines, the problems coming to the forefront would not necessarily be limited to companies based in China."

According to the SEC, since January 2007, there have been over 600 reverse mergers, over 150 of which involved companies based in the China region. Commissioner Aguilar commented that "while the vast majority of these Chinese companies may be legitimate busi-

nesses, a growing number of them are proving to have significant accounting deficiencies or being outright vessels of fraud.” He went on to outline several initiatives the SEC had undertaken or would soon undertake to address these issues.¹

Both before and after Commissioner Aguilar’s speech, the SEC took a number of steps to ramp up its scrutiny of CRMs, including the formation of an internal task force to investigate fraud in overseas companies with listings in the US.

Continuing that effort, on March 15, 2011 the PCAOB released a research note on CRMs, comparing those companies to China-based companies that went public in US markets through a traditional initial public offering. Among other things, the PCAOB found that (1) there were three times as many CRM companies as IPO companies, (2) the CRM company market capitalizations and revenues tended to be lower than the IPO company market capitalizations and revenues; and (3) 24% of the CRM firms were audited by China-based auditing firms, which the PCAOB was prevented from inspecting²

Subsequently, the Chairman of the PCAOB noted that it “continues to meet resistance to inspections in China” and stated that its “inability to inspect the work of registered firms from China is a gaping hole in investor protection”³

On June 8, 2011, the NASDAQ Stock Market filed a proposed rule change with the SEC that would impose additional listing requirements for CRMs.⁴ Under the proposed “seasoning” rule, a company would have to satisfy the following conditions in order to be eligible for a NASDAQ listing:

- (i) it must have traded for at least six months in the U.S. over-the-counter market, on another national securities exchange, or on a foreign exchange, following the filing with the Commission or Other Regulatory Authority of all required information about the transaction, including audited financial statements for the combined entity;
- (ii) it must have maintained a Bid Price of \$4 per share or higher on at least 30 of the most recent 60 trading days;
- (iii) in the case of a domestic issuer, it must have filed its most recent two required periodic financial reports with the Commission or Other Regulatory Authority (Forms 10-Q or 10-K) containing at least six months of information about the combined entity; or
- (iv) in the case of a Foreign Private Issuer, it must have filed comparable information on Forms 6-K, 20-F or 40-F, which must be presented in English.

On June 9, 2011 the SEC released an investor education bulletin warning potential investors of the risks associated with investing in foreign reverse mergers. While not singling out China-based companies, the SEC

listed several CRMs whose securities had been suspended from trading, leaving little doubt about the intended focus of the bulletin. The SEC listed the following risks associated with such investments: lack of public company experience by the foreign private company; no history of compliance with US securities laws and accounting rules; and the possibility of not being able to meet the SEC’s filing and internal control reporting requirements.⁵

The SEC’s foreign reverse merger bulletin followed closely on the heels of a related bulletin issued on June 1, 2011, explaining to investors the basis for, and impacts of, a stock trading suspension.⁶

On August 8, the SEC issued a press release describing the Sino-US Symposium on Audit Oversight held in Beijing on July 11 and 12 between representatives of the SEC and PCAOB and Chinese officials at the Ministry of Finance and the Securities Regulatory Commission to discuss cross-border inspections access in the context of CRMs. The regulators outlined their efforts to strengthen cross-border audit oversight and cooperation between the regulators, including sending staff to observe the inspection of accounting firms in each other’s jurisdictions.

On July 11 and 12, representatives of the SEC and PCAOB met with Chinese officials in Beijing at the Ministry of Finance and the Securities Regulatory Commission to discuss cross-border inspections access in the context of CRMs.⁷

Finally, China-based auditors now potentially face scrutiny from the SEC’s Enforcement Division for their audit work for US-traded Chinese issuers. On September 8, 2011, the SEC filed an action in federal court in Washington, D.C. to enforce an investigative subpoena issued to a Shanghai-based public accounting firm as part of an investigation into a China based client whose American depositary shares traded on the NYSE until trading was halted prior to delisting in August 2011. *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, U.S. District Court, District of Columbia, No. 1:11-mc-512. According to the SEC’s subpoena enforcement action, the auditor had not produced any documents in response to SEC subpoenas. The SEC takes the position that a United States Federal Court has jurisdiction over the Chinese auditor by virtue of the fact that the auditor consented that its audit reports could be filed with the SEC “knowing full well that they would be relied upon by U.S. investors.” If litigated to conclusion, this jurisdictional issue could have a major impact on the SEC’s enforcement efforts in the CRM context.

The rapid pace of change in the US regulatory landscape impacting CRMs has created uncertainty. The practical implications of the uncertainty and increased scrutiny are only now unfolding. For institutional investors that own positions in CRMs, there is an increased risk of loss of value in the event of a regulatory inquiry—even if such an inquiry does not result in any finding of wrongdoing, markets have tended to react unfavorably to the existence of an investigation. And, of course, if a CRM is delisted or has its trading sus-

¹ Speech available at <http://www.sec.gov/news/speech/2011/spch040411laa.htm>.

² PCAOB Research Note available at http://pcaobus.org/News/Releases/Pages/03152011_ResearchNote.aspx.

³ Speech available at http://pcaobus.org/News/Speech/Pages/04042011_DotyLookingAhead.aspx

⁴ NASDAQ proposed rule change available at <http://www.sec.gov/rules/sro/nasdaq/2011/34-64633.pdf>.

⁵ SEC bulletin available at <http://sec.gov/news/press/2011/2011-123.htm>

⁶ SEC bulletin available at <http://www.sec.gov/investor/alerts/tradingsuspensions.pdf>.

⁷ PCAOB statement available at http://pcaobus.org/News/Releases/Pages/07062011_China.aspx.

pending, institutional investors will face a loss of liquidity as well.

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To help avoid the risks, investors can incorporate into their due diligence some of the same questions that the regulators are asking:

- Is the company audited by a China-based auditing firm beyond the PCAOB's inspection ability?
 - How long has the company had its financial statements audited?
 - Do the company's management and directors have significant prior public company experience?
 - Do securities analysts of major brokerage firms provide coverage of the company?
 - Is the company current in its SEC periodic filings?
- Many CRMs will face regulatory issues and increased scrutiny, and robust due diligence can help institutional investors and others discern between those that will overcome those issues and survive the scrutiny and those that will not.