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Reverse mergers test US regulators

By Kara Scannell in New York



The Securities and Exchange Commission has launched an inquiry to better understand the size of the market related to Chinese reverse listings

US authorities have stepped up scrutiny of Chinese groups listed on their shores but remain hamstrung by a lack of access to data and limits to what they can do should they find wrongdoing.

In recent months, short-sellers have descended on a large number of Chinese companies listed on international stock exchanges including New York, Toronto and Hong Kong, accusing them of fraud or other wrongdoing.

The spotlight in the US has fallen on the companies themselves and the promoters, brokers and auditors who help them list shares on stock exchanges through **so-called reverse mergers, which allow businesses to bypass the scrutiny of an initial public offering.**

The Securities and Exchange Commission, the main markets regulator, and the US Public Company Accounting Oversight Board, a federal body that inspects auditing firms, both launched inquiries last year to better understand the size of this market.

As a result, some stocks have been delisted, auditors have been censured where wrongdoing has been found and the watchdogs have begun to pick away at the Byzantine structure of the groups that are listed on their doorstep but have most – if not all – of their operations overseas.

In spite of these efforts, Perrie Weiner, a partner at DLA Piper, one of two US law firms that have established task forces to aid Chinese companies now under scrutiny, says the US is a “paper tiger” because of numerous legal hurdles it faces when trying to investigate beyond its borders.

In normal investigations, the SEC inundates a company, its vendors and other associates with subpoenas seeking e-mails, documents, witnesses and other records to verify financial statements.

But without support from a local regulator, the SEC cannot serve companies with subpoenas outside the US. During the SEC’s investigation into China Yuchai International’s finances, the SEC said it “experienced significant difficulty and delay” in efforts to obtain work papers from foreign auditors.

At least 20 stocks have been halted this year and as many as eight registrations have been revoked. But some recent cases show that even when the SEC wins judgments against companies and individuals, the regulator is not able to collect. The SEC filed fraud charges against China Energy Savings Technology in 2006 and won a judgment requiring the company and its executives to pay \$34m in ill-gotten gains and penalties. The SEC has been unable to collect the money.

Meanwhile, the oversight board has censured auditors found to have turned a blind eye to the questionable accounting of reverse-merger companies but it is also limited as its inspectors are unable to enter China to examine auditing firms located there.

James Doty, chairman of the federal body, said in a recent speech that the watchdog’s “inability to inspect the work of registered firms from China is a gaping hole in investor protection”.

In 2009, the body sanctioned Clancy and Co, an auditing firm in Arizona, and two auditors for relying on a Hong Kong audit firm for a significant amount of work without coordinating adequately with that firm. This year, the board sanctioned Chisholm, Bierwolf, Nilson & Morrill, an auditing firm in Utah, and two individuals for using inexperienced,

Chinese-speaking assistants to conduct audit work of companies with operations in China without adequate supervision.

In June, the board for the first time rejected an application made by Zhonglei, a Hong Kong auditing firm, to register with the board citing these hurdles.

“In light of the apparent obstacles to PCAOB inspections of audit work” the board said it was unable to determine that approval of the registration would be consistent with its duties to protect investors.

While there is nothing inherently wrong with raising money through reverse mergers – it is a cost-efficient way to gain access to US investors – the regulatory pressure could well throw up further problems.

The board scoured regulatory filings to produce a report which found that, over three years, 215 companies with operations in China listed on US exchanges and a majority of the companies came to list through reverse mergers.

Auditors have resigned from at least two dozen Chinese companies after identifying problems.

Lawyers for companies based in China say there has been an overreaction by the market and regulators, putting some of the perceived problems down to cultural differences.

That light touch may not be enough for investors who have filed private lawsuits against some of the companies alleging fraud and mismanagement.