TheStreet

China RTO Regulation Shows Cracks

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NEW YORK (TheStreet) -- When allegations of fraud torpedoed the stock of China-based **Rino International**(RINO) last month, investor J.M. Hughes lost 56% of his investment -- or nearly $19,000 -- in less than a week.

The attack came from a short seller -- a firm betting that the stock would decline -- so at first Hughes wondered whether the source ought to be "held accountable." It turned out that the allegations were on target, and that the short seller had uncovered accounting discrepancies that U.S. regulators, auditors and exchanges had missed.

Rino came clean, acknowledging in a filing with the **Securities and Exchange Commission** that two customer contracts questioned by the shorts had not in fact been signed. Worse, the company said there might be problems with 20% to 40% of its other customer contracts. Rino shares, which had traded near $19 before the trouble started, dropped to $6 when trading was halted Nov. 18. The Nasdaq then delisted the stock, and Rino now trades on the Pink Sheets, recently at around $3.50. All told, investors saw more than $400 million in market value wiped out.

Today, Hughes wonders where the regulators and auditors were.

"Something that simple should have been picked up by the auditors," he wrote to TheStreet.

Thousands of investors hurt by the collapse of China-based companies are raising the same kinds of questions. Blow-ups of this kind among China-based small caps have cost investors at least $34 billion, over the past five years, a study by TheStreet showed. Most of the losses relate to companies that have gained access to U.S. exchanges through a back-door process known as a reverse takeover, or RTO. Rino is one example.

The RTO process folds a China-based company into an American shell company whose stock is publicly traded. Essentially, the combination of the two companies brings the Chinese company public in the U.S. without regulatory review, allowing the promoters to avoid the regulatory scrutiny normally applied to an initial public offering or a request for a listing of American Depositary Receipts.

The increasing frequency of the blow-ups among RTOs -- together with related charges and counter-charges of fraud -- have prompted the Securities and Exchange Commission to launch an investigation. The SEC has declined to comment, but sources directly involved say the agency is asking questions about a complex web of enduring business relationships and not limiting the focus to a few isolated cases.

Among recent RTO-related headlines:

- **Orient Paper**(ONP) shares tumbled sharply in July, when a short seller's research note alleged fraud and misappropriation of millions. Shares rebounded modestly after the company announced a positive result from an internal review aided by Deloitte & Touche. Drew Bernstein, chairman of Orient Paper's audit committee and a partner with accounting firm Bernstein & Pinchuk, said no evidence of any wrongdoing was found. Still, the stock is down nearly 40% this year.
- **China Green Agriculture's**(CGA) stock has plunged more than 35% this year, following allegations in June that the fertilizer manufacturer reported one set of sales and net income numbers to the SEC and a different set to the Chinese government. Requests for comment were directed to a press release issued in September, where China Green Chairman and CEO Tao Li said the company would avoid such inconsistencies in the future. China Green shares have recovered very little since Li's statement.
- Chinese specialty chemical products maker **Gulf Resources**(GFRE) issued a press release on Dec. 8 denouncing an "anonymous report" that called into question the accuracy of its filings to the SEC and raised due diligence concerns. The company continued to fight back with a detailed rebuttal last week. Its stock has held up well. The company declined to elaborate on the press release.

Sources with direct knowledge of the SEC probe have have told TheStreet that the commission has raised specific questions about at least six companies that have yet to disclose inquiries.

To be sure, charges of fraud against Chinese companies are not always borne out. Some seemingly solid companies have been targeted with "research" that has proven flimsy or downright false. Investment bankers experienced in managing RTOs -- and the stock deals that frequently follow -- worry that the entire RTO business has been gravely damaged by a few "bad apples."

Many experienced securities attorneys tend not to buy the "bad apples" argument. They say that the problems with RTOs have illuminated some fundamental weaknesses in the regulatory environments that govern them. They cite the following weaknesses as key:

- **China's insularity**: The U.S. Public Company Accounting Oversight Board, or PCAOB, says it has sought to review the work of Chinese auditors but has been blocked by the Chinese government. American auditors say that their Chinese counterparts have been slow to learn American standards.
- **Laxity in China**: Professionals with direct experience of auditing practices and government filings in China say that corruption is a problem -- particularly the understating of revenues to keep taxes down -- and that regulatory standards are shoddy compared to standards in the U.S.
- **Manpower limits**: U.S. regulators lack the staff necessary to process a heavy volume of RTO deals. They rely mostly on fear of the occasional prosecution as a deterrent, but that doesn't work on entrepreneurs in China, who know that U.S. authorities can't touch them.

Where the possibility of fraud is an issue, Wall Street professionals look primarily to the SEC. The SEC declined to comment for this story, saying that staff at the commission are not authorized to confirm or deny investigations.

On Monday, the SEC took what appeared to be a critical first step in addressing investor concerns over the legitimacy of Chinese reverse merger companies. The Commission slapped U.S.-based accounting firm Moore Stephens Wurth Frazer & Torbet, LLP with a cease-and-desist order, a fine and instructions that it can't take on any more Chinese clients.

Experts say that the agency's most potent option in connection with the RTOs would be to recommend criminal charges against U.S. citizens, but quickly add they don't expect to see criminal charges.

Peter Henning, a former senior attorney at the SEC's enforcement division and now a professor at Wayne State University Law School in Detroit, said that individuals charged with fraud will often claim ignorance. Henning suggested that that kind of defense might be particularly effective in regard to the China-based RTOs.

"If you don't have access to the people in China, or wherever they're from, then it's very difficult to prove a fraud case against them," Henning said.

Henning discussed the possibility of criminal charges as a kind of last resort. He suggested that other options present other kinds of difficulties. Lawyers familiar with SEC enforcement strategies point out that the sheer volume of RTO deals is a problem for the agency. It has hundreds of deals to review, thousands of related financial statements, and no easy way to verify financial statements that relate to operations in China.

"It's extremely difficult to police the small-cap market," said Jacob Frenkel, a former SEC attorney who is now a partner at Shulman Rogers Gandal Pordy & Ecker. "It would take assigning all of the SEC Enforcement division's resources for two years to make a meaningful dent. If you had 800 attorneys suddenly looking at the sector, things would change."

At the heart of the controversy over RTOs is the notion that Chinese companies are "cooking the books" to hold down taxes in China while simultaneously appealing to growth-oriented investors in the U.S. David Gentry, CEO of stock research firm RedChip Companies, says it is not unusual for Chinese companies to have two to three sets of books. "They have one for the banks, one for the [State Administration For Industry & Commerce] and, if they're public, one for the SEC," says Gentry, whose firm handles investor relations for Chinese reverse merger companies.

Requests for comment from China's State Administration for Industry & Commerce brought no response. A spokesman for the Chinese embassy in Washington said there is no systemic misreporting of business results in China.

"It's not true," said Wang Baodong, on behalf of the embassy. "Like any other country in the world, there may be some loopholes. But the Chinese government has been working hard to improve the tax system by focusing on building a mature market economy."

Baodong said that the People's Republic is encouraging Chinese enterprises to strictly abide by the local laws and regulations in countries where they do business, "to combine the pursuit of benefit with social responsibilities."

The SEC and its counterpart in China, the China Securities Regulatory Commission, signed a memorandum of understanding in April 1994 and then enhanced it in May 2006. The agreement calls for improved cooperation between the agencies, particularly in the area of enforcement, but has so far produced little in the way of concerted action.

Drew Bernstein, chairman of Orient Paper's audit committee and a partner with accounting firm Bernstein & Pinchuk, says the sheer complexity of compliance with two different regulatory systems in two very different languages represents a major challenge, both for small companies based in China and for regulators in the two countries.

"If these [Chinese] companies are having problems, how many problems do you think the SEC is having?" Bernstein said. "It's a combination of lack of resources and being overwhelmed."

Even the harshest critics of the RTO category concede that there are plenty of Chinese companies -- even small caps -- offering solid opportunities for investors. At the same time, the skeptics caution that individual investors will likely find it difficult to separate the good from the bad.

"The problem is that it's difficult for investors and U.S. regulators to bridge the language, cultural, and structural barriers to understand what's really going on in China," says Carson Block, the short-oriented researcher who started the stir over Rino.

Block argues that a lot of surprises involving RTO companies stem from inadequate research by American investors.

"Chinese companies disclose in their U.S. filings that they have internal control weaknesses," Block says. "Investors would do well to take these disclosures seriously."

The Challenge for the Exchanges

Investors like J.M. Hughes may be forgiven for assuming that a company's mere presence on a major American stock exchange guarantees some degree of integrity. Chinese companies unable to secure a domestic listing have found it easier to get listed in the U.S. by exploiting the RTO as a loophole. When the legitimacy of one of those companies is brought into question, the exchanges have no option but to delist the company.

"Companies falling below or failing to meet the markets' continuing listing standards are notified and dealt with swiftly, in a transparent process that ensures timely information and updates to shareholders and all other constituents," a spokesperson for the NYSE explained.

In that event, the damage to investors can be even worse than it was for Hughes. When the NYSE Amex delisted shares of **Bodisen Biotech**(BBCZ) -- a stock that had once traded as high as $21.30 -- the stock tumbled to a low of 45 cents.

The exchanges try to filter out problem companies with requirements for listing that might seem perfectly adequate -- at first glance.

To secure either a new or upgraded listing on either the Nasdaq or the NYSE, a company must have a board of directors that meets regularly and includes a majority of outside directors. Companies must also establish an audit committee, consisting solely of independent directors with financial experience. Under the Sarbanes-Oxley Act of 2002, audit committees have very specific legal responsibilities in the U.S., including adequate oversight of financial reporting, hiring external auditors and maintenance of regulatory compliance with accurate financial statements.

U.S. exchanges diverge slightly in specific reporting requirements. According to the Nasdaq's listing standards and fees guide, updated in July, companies are required to meet standards related to pre-tax earnings, cash flows, market capitalization, revenue, bid price, number of market makers and, in some cases, total assets and stockholders' equity.

The NYSE Amex requires information about pre-tax income, market cap, minimum bid price, operating history, shareholders' equity and the market value of the public float. The exchange says that foreign issuer applicants may qualify for listing with 800 round-lot public shareholders worldwide, 1 million publicly held shares worldwide and a $3 million market value of public float worldwide.

The flip side to these criteria is that both the Nasdaq and the NYSE are eager to attract new listings and uplistings from smaller markets, as new listings mean new revenue for them. The result has been a battle between the major exchanges. Both exchanges announced in 2007 that they were setting up beachheads in China, to gain better access to potential applicants.

Of late, both exchanges have made it easier for companies to get listed. The Nasdaq lowered its share price threshold to $4 from $5 in April 2009, after the global economic crisis depressed the prices of many stocks. Subsequently, the Amex cut its share price requirement to $2 from $3.

The Nasdaq is leading in the competition for listings so far, with a total of 159 China-based companies now listed on its exchanges, including major names like **Baidu.com**(BIDU) as well as reverse-merger stocks like **China Natural Gas**(CHNG) and RINO International. The NYSE Euronext's exchanges say they have 92 companies listed from greater China, including a good many RTO stocks such as Orient Paper and **China Green Agriculture**(CGA).

The two major exchanges say that the existing listing requirements are applied uniformly, without exceptions. There are no special provisions for RTO companies, they say. A Nasdaq OMX regulatory official added that the exchange would give serious consideration to any suggestion of fraud. "If a short seller raised issues that we thought were credible and affected the company's listing status, we would look at them," the official added.

Both organizations report that the existing regulations are effective in screening out a number of weak applicants. On the other hand, one insider confided "it's not always going to be water tight."

The case of **China Energy Savings Technology** illustrates how master manipulators can circumvent such requirements.

Manipulators Beat the Nasdaq

The story of China Energy is a case study in RTO fraud, fully documented in reams of paperwork relating to fraud charges brought by the SEC in 2006. The agency has since obtained final judgments against five executives associated with the company. All were held to be liable for fraud. The judgments require the executives to pay more than $30 million.

When the promoters behind the company originally sought to uplist with the Nasdaq in 2004, they knew they needed a base of at least 400 shareholders as well as an active market in the company's shares.

According to the SEC, they acquired the necessary shareholders through a stock giveaway orchestrated by a promoter named Jason Genet. He was paid in shares. They then pumped up the trading volume with a special offer: China Energy Savings would grant one additional share of stock for every share purchased on the open market by an existing shareholder. Because this offer was not disclosed to the SEC and to the public, it was illegal, the court decided.

Both the shareholder base and the trading volume materialized out of thin air. Having met the Nasdaq's requirements, the company gained a listing on Nasdaq and issued new stock in what the SEC dubbed a "pump and dump" scheme, taking about $25 million from investors. Meantime, Genet and others in the company's inner circle were selling, according to the SEC's complaint.

The first hints of China Energy's elaborate scheme came to light in the spring of 2006. Abruptly, all of the leading officers of the company quit, the company's headquarters in Hong Kong was shuttered, and its phones lines were disconnected. The company's collapse was documented by the SEC in court. On May 19, 2006, the Nasdaq delisted China Energy Savings' stock. Shares that had once traded as high as $28 were soon worth less than 50 cents.

The Nasdaq declined to comment specifically on China Energy Savings Technology, but noted that there have been no allegations of fraud brought against newly listed companies since 2006. Kara Brockmeyer, an assistant director with the SEC, declined to comment on China Energy Savings beyond what was disclosed in documents published by the SEC.

The exchanges have requirements that control the activities of their own staff, as well. Staff are not permitted to trade in stocks that are seeking a listing. While there have been no flagrant conflicts of interest among staff, shorts have called attention to staff entanglements that raised questions, particularly for Nasdaq. The exchange declined to discuss those entanglements, treating them as a personnel matter.

The Pros Look to the SEC

Wall Street professionals tend to downplay the importance of the exchanges in guarding against fraud. Professionals point out that the securities traded on a major exchange must be registered with the SEC. They look to the SEC for oversight.

"[Chinese companies] have to go through a registration process with the SEC. That means that they have to have U.S.-approved accounts," said one seasoned Wall Street pro familiar with the problems of RTOs. "That's the first step. It has nothing to do with the exchanges."

Problems with audits coming out of China are of particular concern. Wall Street professionals are skeptical about audits done in China, questioning both the skill and the integrity of auditors there.

Knowledgeable pros are apt to bring up the case of **China Expert Technology**(CXTI), where audited financial statements portrayed a robust and growing business in 2006.

"The auditors signed off and certified $175 million in revenue over a four-year period, and none of it existed. Not an iota of it," says Laurence Rosen, managing partner of the Rosen Law Firm in New York. The firm represents unhappy shareholders. "In some cases, the customers didn't even exist."

Attempts to reach the company for comment did not succeed. The company appears to have ceased operations. The stock is still traded occasionally, but last traded at $0.01 a share.

The SEC didn't act on China Expert Technology until Oct. 1, 2007, when it announced a temporary suspension of trading in the company's securities. While the commission noted questions about the accuracy and adequacy of China Expert's financial statements at the time, no fraud charges were ever filed. Rosen says he understands why. His firm later won a default judgment against China Expert, a judgment that Rosen believes to be virtually worthless.

"All of the assets are in China. The people are in China. I can't so much as serve a subpoena in China," Rosen says. "You can't get any discovery in China. The SEC would be completely blocked from any regulatory action against a Chinese person or entity. What can they do? Nothing."

-- *Written by Robert Holmes in Boston*.