The Wall Street Journal

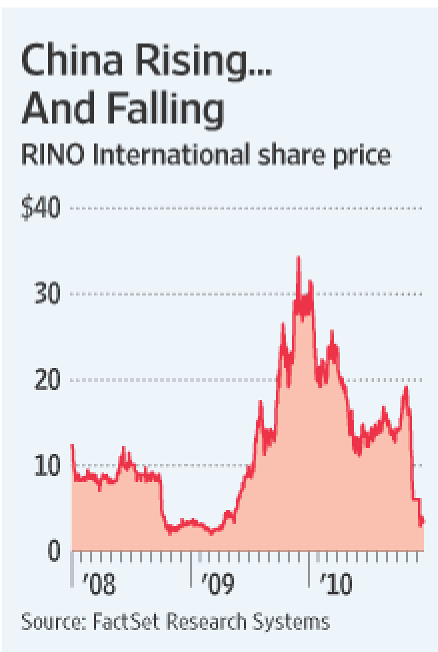
December 20, 2010

Congress and SEC Hit Stocks Made in China

By Dennis K. Berman

One of China's least-noticed exports to the U.S. has been hundreds of Chinese companies that slipped onto U.S. stock exchanges through back-door mergers with dormant shell companies.

Many of these small, high-growth, companies, including industrial companies RINO International Corp. and China Energy Savings Technology Inc., have minimal revenues, questionable accounting and inscrutable corporate governance.



Now, that back door may be starting to close. The Securities and Exchange Commission has begun a crackdown on the practices of the "reverse takeover" market for Chinese listings, according to people with knowledge of the probe. Specifically, the SEC's enforcement and corporation-finance divisions have begun a wide-scale investigation into how networks of U.S. accountants, lawyers, and bankers have helped bring scores of Chinese companies onto the U.S. stock markets, these people say.

The SEC has also begun homing in on individual Chinese companies for accounting violations and lax auditing practices, these people say, beyond a number of previously announced investigations.

On Tuesday, the SEC filed a case in the area, settling a lawsuit against accounting firm Moore Stephens Wurth Frazer & Torbet LLP and one of its partners for its audits of China Energy, which was listed on Nasdaq in 2005.

Behind the scenes, the House financial-services committee is also revving into gear, and may hold hearings on Chinese-company accounting in 2011, according to a person familiar with the matter. The committee's fear is that some companies are rife with self-dealing and potential fraud, and weak international standards have let it go largely undetected.

Hundreds of Chinese companies have back-doored their way onto the NYSE and NASDAQ in recent years using old shells of listed U.S. companies. That has Congress and the SEC up in arms. Money & Investing Deputy Editor Dennis Berman suggests that the main problem with these "reverse mergers" is a lack of oversight.

More broadly, "the integrity of the data could be flawed, and I don't want this to be a junior Madoff scandal," Rep. Chris Lee (R., N.Y.) said in an interview. "China is the second-largest economy, and it's growing at such a rapid pace there is an opportunity for exploitation and fraud."

The Chinese stock markets remain a deeply inefficient place, where government minders must approve a company's listing plans on a domestic exchange. Getting a listing on a U.S. exchange is therefore a quick and relatively easy way to gain credibility.

Today, most of the reverse takeover stocks carry market capitalizations of under $500 million. And all the companies tap into the global fascination with Chinese markets, which are creating dozens of new, high-growth firms in everything from agriculture and food to engineering and chemicals.

The problems stem, in part, from the way many small Chinese companies are audited. A company listing on a U.S. stock exchange must be audited by a firm registered with the "auditor's auditor"—known as the Public Company Accounting Oversight Board.

By this spring, some 340 Chinese companies listed on U.S. stock exchanges were using small, largely unknown auditing U.S. firms, who in turn may have been contracting the work back out to local Chinese firms, according to the SEC's chief accountant.

It is perfectly legal for an approved auditor to subcontract the work to local accountants in China or elsewhere. But troubles are starting to pop up, given the big geographical distances and language barriers.

In the case of China Energy, a Chino Hills, Calif., auditor Kerry Dean Yamagata failed to "exercise professional skepticism and due professional care" in reviewing company filings in 2004 and 2005, according to an SEC proceeding that ordered the disgorgement of $129,500. In 2006, the SEC sued China Energy for violating federal securities laws soon after its shares stopped trading on Nasdaq.

More is coming. "The SEC has certainly been focusing on it," says Greg Scates, deputy chief auditor at the PCAOB. "Some work papers are in Chinese and the U.S. auditors can't even read them. And so there is no way that the auditor can conduct a review or perform appropriate supervision of staff."

Such fears became real after Nasdaq-listed RINO International, a Dalian, China maker of environmental products, disclosed accounting flaws earlier in the fall. RINO was delisted, and it withdrew its 2008 and 2009 financial statements. Today its shares trade on the Pink Sheets.

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