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Is the SEC Increasing Scrutiny of Chinese Reverse Mergers?

asensio.com <a href="http://www.asensio.com/Reports/ReportView.aspx?ReportId=1048&CompanyId=165&CompanyName=China+Sky reported that China Sky One Medical, Inc. (NASDAQ: CSKI) was the subject of an SEC investigation. The SEC investigation of CSKI has been ongoing since at least September 2009, when the SEC sent a subpoena to CSKI's auditor, MSPC; the subpoena was made public as part of a lawsuit against MSPC alleging securities fraud in connection with MSPC's audit of CSKI. Since that time, it appears that the SEC may have started taking steps to increase scrutiny of all Chinese reverse mergers.

The SEC "is paying close attention to a 'growing trend' of companies listing their principal places of business in China but using small U.S.-based accounting firms," according to an article published by the Accounting and Policy Practice Report, dated April 30, 2010. The article cited a speech by an SEC staffer, Wayne Carnall, chief accountant in the SEC's Division of Corporation Finance, who discussed "companies [that] list their principal place of business in the People’s Republic of China but incorporate elsewhere – including the United States, the Cayman Islands, and other locations" and the practice by these firms of hiring "accounting firms that often employ only a few professionals in the United States as their auditors."

The article also states, "…the SEC has identified approximately 340 firms fitting that fact pattern, and is looking into how those accounting firms can adequately conduct audits and perform meaningful due diligence of the Chinese concerns…. [T]he SEC has launched discussions with the Public Company Accounting Oversight Board [PCAOB] about the topic."

While these remarks are encouraging in terms of improving investor protection, a review of recent SEC press releases and regulatory actions shows no record of official regulatory measures along the lines discussed in the article. However, the PCAOB issued a "Staff Audit Practice Alert" targeting auditors of Chinese reverse mergers in July, citing instances of US-based auditors who do not even travel to China in auditing the financial statements of US-listed companies based in China.

The article and PCAOB action mentioned above came more than a year after asensio.com began reporting on several accounting and corporate governance issues at CSKI, which itself has hired a string of small, US-based auditors with troubled histories. The article also came about one year since asensio.com made complaints about CSKI and other Chinese reverse mergers to staff of the SEC, the PCAOB, and FINRA, along with evidence suggesting that the NASDAQ in particular may be deficient in listings oversight.

NASDAQ listed 16 companies from China in the second quarter of 2010 alone, "bringing the total number of NASDAQ listed-companies headquartered in Greater China to 144, more than any other U.S. exchange," according to the second quarter earnings release for The NASDAQ OMX Group, Inc. (NASDAQ: NDAQ), issued July 27, 2010.

The SEC announced on August 6th a fraud judgment against an individual involved in "an elaborate stock manipulation scheme involving China Energy Savings Technology, Inc. [formerly NASDAQ: CESV]" according to an SEC press release. The SEC also entered an order against China Yuchai International Limited (NYSE: CYD) on June 7th for "China Yuchai's violations of the reporting, books and records and internal controls provisions of the securities laws." The SEC also began a formal investigation into Fuqi International, Inc. (NASDAQ: FUQI), according to a FUQI press release dated September 10th.