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Regulatory Conflicts-of-Interest at the Heart of Chinese "Madoff Scandal"

SEC and congressional interest in investigating Chinese reverse mergers has been widely reported recently, with a Congressman comparing the Chinese reverse merger industry to a "junior Madoff scandal." Investors have lost as much as $34 billion on US-listed Chinese companies by some estimates. Some investigators also estimate that at least one third of US-listed Chinese companies are reporting "fictional profits," according to theStreet.com.

Little attention has been paid, however, to certain former and current employees of "self-regulatory organizations"* like the NASDAQ, the NYSE, and FINRA who appear to be incentivized to support questionable practices in the listing of Chinese companies on US exchanges through reverse mergers.

NASDAQ and the NYSE have the direct conflict of interest of seeking to make profits off of listing companies while also having to ensure investor protection and enforce compliance with securities laws and regulations. But one particular case raises questions of whether personal conflicts of interest on the part of a NASDAQ official may cause NASDAQ to protect certain Chinese reverse mergers that are likely to victimize US investors.

This case concerns Meyer S. ("Sandy") Frucher, vice chairman of NASDAQ and former head of the Philadelphia Stock Exchange (PHLX), certain former PHLX officials, and Benjamin Wey, one of the most notorious promoters of Chinese reverse mergers.

Several former PHLX officials and their associates have been repeatedly involved with Chinese companies whose reverse mergers have been reportedly arranged by Wey. A separate asensio.com report gives a detailed description of the dealings of PHLX officials with Wey's companies. Some of these former PHLX associates were directly involved in a scandal at the PHLX in 1996. The scandal was so drastic that the SEC stepped in, and Frucher was appointed to head the PHLX in an apparent effort to clean up after the scandal. Wey himself also reportedly worked for a company that was directly involved in the PHLX scandal.

The PHLX scandal resulted in the PHLX chairman, Frucher's predecessor, resigning under fire. The SEC and its then Chairman Arthur Levitt were reported to have "come down hard" on the PHLX after the scandal, according to the New York Times. Afterwards, the PHLX made Frucher its chairman and CEO. Frucher was reported to be a friend of Chairman Levitt and to have political connections, but had no stock exchange experience. Frucher was later involved in the acquisition of PHLX by the NASDAQ in 2008, and Frucher currently serves as NASDAQ's vice chairman.

Despite having previous experience with the individuals involved in the scandal, Frucher, it seems, has not stopped NASDAQ from listing Wey's companies when the PHLX individuals are involved. NASDAQ has appeared eager to continue listing companies organized by Wey, even in the face of SEC and congressional investigations. Frucher has been directly involved in NASDAQ's promotional efforts to recruit more Chinese companies, as discussed below.

The most recent example is CleanTech Innovations, Inc. (NASDAQ: CTEK). Two former PHLX officials serve on CTEK's board of directors. Last August, Barron's reported on Wey's involvement in CTEK's reverse merger, yet NASDAQ proceeded to list CTEK in December.

This raises substantial questions of whether NASDAQ has acted improperly in inadequately overseeing or even protecting Wey's companies in spite of both the public record and the personal knowledge of its high-ranking officials. That is, NASDAQ may have relaxed regulatory scrutiny in an effort to increase the number of listings on its exchange (which are extremely profitable), despite evidence of investors being victimized by Wey's companies, and despite vice chairman Frucher's past experience with a scandal involving a group of people now serving as officers and directors of a number of Wey's companies.

A prior <a href="http://asensio.com/Reports/ReportView.aspx?ReportId=1020&CompanyId=131&CompanyName=Commentary&IsA asensio.com report reviewed Wey's role in the blow-up of Bodisen Biotech, Inc. (OTC: BBCZ), and Wey's involvement with another NASDAQ official. While being paid by Bodisen, Wey reportedly used a pseudonym to publish buy recommendations on Bodisen stock, which investors took to be independent, according an article from theStreet.com. Bodisen was delisted in 2006 based on inaccurate disclosures concerning its relationship with Wey. Bodisen shares peaked around $20 in 2006, and last traded at $0.65.

NASDAQ has allowed more listings of Chinese companies than any other US exchange; a recent total is 159 companies, according to theStreet.com. Approximately 95 of these were listed through reverse mergers, as well as SPACs and micro-cap IPOs, according to asensio.com research. Chinese reverse mergers reportedly arranged by Wey have largely sought listings on NASDAQ – including AgFeed Industries, Inc. (NASDAQ: FEED), Shiner International, Inc. (NASDAQ: BEST), Deer Consumer Products, Inc. (NASDAQ: DEER), SmartHeat Inc. (NASDAQ: HEAT), and CTEK. Individuals formerly associated with the PHLX are involved with each of these companies.

Making matters worse, NASDAQ has been expanding its promotional efforts to recruit Chinese companies, and Frucher has been directly involved in those efforts. As detailed in a separate asensio.com report, NASDAQ is seeking to "incubate" companies in China to list on NASDAQ. According to statements by a NASDAQ official, this would involve NASDAQ introducing firms to the network of accountants, bankers, and lawyers responsible for arranging reverse mergers for Chinese companies.

This comes in the face of substantial allegations of fraud against a growing number of Chinese reverse mergers, news that the SEC is increasing scrutiny of Chinese reverse mergers and their accountants, and reported congressional interest in conducting an investigation to ensure that Chinese reverse mergers are not becoming a "junior Madoff scandal," according to the Wall Street Journal.

NASDAQ and other exchanges have a primary responsibility to conduct due diligence before approving listings and are required under the Securities Exchange Act to enforce compliance with the federal securities laws. This responsibility should include, at the very least, not creating conditions that encourage stock fraud using private Chinese companies. FINRA also performs regulatory work for NASDAQ. FINRA thus appears to share responsibility for failures and deficiencies in overseeing listings of Chinese companies. FINRA does not disclose information on the regulatory work it performs for stock exchanges like NASDAQ, or what compensation it receives.

Though investors would be served by the SEC investigating Wey's companies and the involvement of former stock exchange officials in those companies, the morass of regulatory conflicts evident in the Chinese reverse merger industry makes meaningful action by the SEC look doubtful.

* The term self-regulatory organization (SRO) is defined in the Securities Exchange Act of 1934 to include both stock

exchanges like NASDAQ and associations of broker-dealers like FINRA. The Exchange Act charges SROs with enforcing compliance with federal securities laws and regulations.