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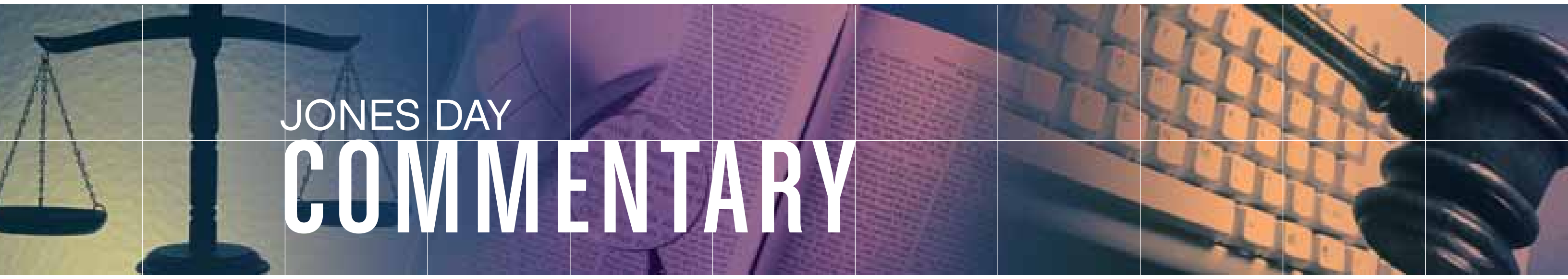

CHINESE COMPANIES TRADING IN U.S. FACE INCREASED SCRUTINY BY SEC, CONGRESS, AND PRIVATE PLAINTIFFS

Several Chinese companies brought onto public United States stock markets through reverse mergers with existing U.S. issuers have been the focus of recent investigations, enforcement actions, and private civil litigation. These actions demonstrate increased interest by the Securities and Exchange Commission ("SEC"), Congress, and the plaintiffs' class action bar in potential securities fraud by Chinese companies trading in the U.S. To protect themselves, Chinese companies should be sure to conduct thorough due diligence on any U.S. issuer with whom they may merge and on any related promoters, implement U.S.-style processes to develop their disclosures, and verify that their independent public accountants conducted the annual audits in compliance with U.S. rules. The consequences for not doing so can include government enforcement action, private civil liability, delisting from U.S. stock exchanges, and unfavorable media scrutiny.

REVERSE MERGERS

The much-touted growth in the Chinese economy has increased U.S. investor interest in Chinese companies. To take advantage of this interest, many Chinese companies have sought expedited access to the U.S. markets through reverse mergers, or reverse takeovers ("RTOs"), over the last several years. In an RTO, a private company gains control of a shell company listed on a U.S. exchange. The private Chinese company then merges into the U.S. shell, which can issue new shares. The web site TheStreet claims that investors have lost at least $34 billion over the past five years as the result of frauds associated with Chinese companies that engaged in reverse mergers. The allegations of fraud directly or indirectly touch 150 companies, including issuers and associated service providers. Not surprisingly, the SEC and Congress are scrutinizing everyone involved.

SEC INVESTIGATIONS AND ENFORCEMENT ACTIONS

To date, the SEC has prosecuted only one China-based reverse merger company, China Energy Savings Technology, Inc., but the SEC has shown interest in at least nine others.[1] China Sky One Medical admitted in a press release that it had made inaccurate filings with the SEC. Fuqi International has received a delisting notice from the NASDAQ but has not yet been delisted. Rino International conceded that some of its claims about contracts were false, and the company was delisted from the NASDAQ. Knowledgeable sources told TheStreet that the SEC has shown interest in at least six more companies.

The SEC's interest also extends to Americans—bankers, stock promoters, and auditors—who assist Chinese companies in going public through RTOs.[2] On December 20, 2010, the SEC brought a settled administrative proceeding against Moore Stephens Wurth Frazer and Torbet, a California accounting firm that served as an auditor for China Energy.[3] The SEC charged that Moore Stephens failed to exercise "due professional care" and "heightened skepticism" in conducting its audit. Indeed, Moore Stephens allegedly failed to take appropriate action even after it determined that the China Energy engagement entailed high risk, concluded that China Energy's internal controls were ineffective and unreliable, became aware of facts contradicting financial statements and public disclosures, and encountered difficulties in conducting audit procedures.

Moore Stephens and the individual audit partner agreed to the entry of a cease and desist order, disgorgement of their audit fees, and a prohibition from accepting any new issuer audit clients in China, Taipei, and Hong Kong until the firm retained an independent consultant to revise its audit procedures. It also adopted the recommendations of the independent consultant and certified to the SEC and the Public Company Accounting Oversight Board ("PCAOB") that it had implemented the recommendations of the consultant. The individual audit partner agreed to a two-year suspension from practicing before the SEC.

This action highlights the danger that awaits Chinese companies that rely on U.S. auditors who do not take active roles in audits but merely sign off on work done by a Chinese auditor. An independent accountant registered with the PCAOB must audit U.S. stock exchange-listed companies, no matter where they are based. On July 12, 2010, the PCAOB released an industry alert warning U.S. auditors against relying on foreign auditors in issuing audit reports on financial statements filed by issuers with most of their operations in China.[4] U.S. auditors must independently ensure that the work done by the Chinese auditors meets PCAOB standards. These concerns are not just for auditors; issuers that lack financial statements audited in compliance with U.S. rules face delisting of their securities.

CONGRESSIONAL INVESTIGATION

The U.S. Congress has been quite vocal recently about investigating stock fraud involving Chinese companies. In a September 9, 2010 letter to the SEC and the PCAOB, the House Financial Services Committee questioned the accuracy of audits done for publicly traded Chinese companies and urged agencies to address the issue.[5] Rep. Spencer Bachus, the new chairman of the Financial Services Committee, and Rep. Chris Lee signed the letter. Rep. Lee later said, "China is the second-largest economy, and it's growing at such a rapid pace [that] there is an opportunity for

1 Scott Eden, "SEC Probes China Stock Fraud Network," TheStreet, Dec. 21, 2010.

2 *Id*.

3 *In re* Moore Stephens Wurth Frazer and Torbet, Order Instituting Public Administrative and Cease-and-Desist Proceedings, Securities Act Release No. 9166, Exchange Act Release No. 63,579, Dec. 20, 2010.

4 "Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm," Public Company Accounting Oversight Board, Staff Audit Practice Alert No. 6, July 12, 2010.

5 *See supra* note 1.

exploitation and fraud."[6] One source told *The Wall Street Journal* that the Committee might hold hearings during 2011 on accounting by Chinese companies.

CIVIL LITIGATION HIGHLIGHTS DISCREPANCIES BETWEEN FILINGS IN CHINA AND THE U.S.

Annual financial returns required to be filed by companies with the Chinese State Administration for Industry & Commerce ("SAIC") are another potential source of problems. Potential private plaintiffs will use any discrepancies between filings made with the SAIC and filings made with the SEC to support allegations of fraud by Chinese companies listed on U.S. markets.[7] Plaintiffs searching for discrepancies between SEC and SAIC filings can affect even companies with accurate SEC filings. In June 2010, a short-seller alleged fraud and misappropriation of millions of dollars by Orient Paper, Inc. ("ONP") based on a review of filings in China and with the SEC. In its SEC filings, ONP allegedly overstated its 2008 revenue by a factor of 27 and its 2009 revenue by a factor of 40.[8] After the allegations were made, shares of ONP dropped dramatically—almost 40 percent—even though an internal review by Deloitte & Touche found no evidence of wrongdoing.[9] Also, as a result of the allegations, ONP is facing a class action lawsuit that alleges the company misrepresented its financial performance, business prospects, and financial condition.[10]

Efforts by Chinese companies to reduce their domestic tax liabilities may account for some discrepancies between filings in China and the U.S. Richard Heckmann, a veteran investor and CEO of Heckmann Corp., told TheStreet that Chinese executives say that paying the full value-added tax of 17 percent is unrealistic.[11] Consequently, some companies may underestimate revenues in SAIC filings or delay making accurate filings to show increased profits.

Such misstatements, however, if made in SEC filings, may lead to severe civil penalties. For example, the SEC brought an action against China Energy, alleging that it prematurely recognized revenue from two customers and improperly recognized revenue from two others in its SEC filings for fiscal year 2005. These four customers allegedly accounted for more than 50 percent of China Energy's 2005 revenue. In March 2009, a federal district court entered a final judgment in the litigation enjoining China Energy from violations of the antifraud and registration provisions of the U.S. securities laws, and ordered China Energy and other defendants to pay $35 million in disgorgement and interest.

Especially in light of the increased regulatory scrutiny, 2011 is likely to bring sustained levels of private securities litigation against companies based in China. According to a recent study by National Economic Research Associates, approximately 12 percent of private securities cases filed in U.S. federal courts during 2010 were against non-U.S. issuers; of those, 38 percent were brought against Chinese companies.

U.S.-STYLE PROTECTIONS

The enhanced government and press attention addressed to U.S. securities law compliance by Chinese companies emphasizes the need to adopt U.S.-style protections, including the following:

Pre-RTO Diligence. While legal, reverse mergers with U.S. shell companies have been the subject of frauds for decades. Foreign companies considering such a merger should conduct thorough due diligence of everyone involved, particularly the promoters, and the shell company. This should include background checks and obtaining a detailed understanding of how the shell company became public, its outstanding securities, and who controls them.

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6 Dennis K. Berman, "Congress and SEC Hit Stocks Made in China," *The Wall Street Journal*, Dec. 20, 2010.

7 Scott Eden, "Short-Seller Cuts Through China Red Tape," TheStreet, Dec. 22, 2010.

8 Muddy Waters Research, Report on Orient Paper, Inc., June 28, 2010, http://www.muddywatersresearch.com/research/orient-paper-inc/initiating-coverage-onp/.

9 Scott Eden, "China RTO Regulation Shows Cracks," TheStreet, Dec. 22, 2010.

10 Orient Paper, Inc., Report of unscheduled material events or corporate changes (Form 8-K), Aug. 24, 2010.

11 Scott Eden, "Dealmaker's Long Trip Through China RTO," TheStreet, Dec. 22, 2010.

Understand All Requirements for U.S. Public Companies. U.S. accounting and audit rules can be complex, but issuers will face delisting of their securities, even if the auditor gets it wrong. Senior managers should be carefully trained, and annually updated, on all the requirements applicable to their responsibilities before the merger is consummated.

Adopt Comprehensive Procedures to Develop and Refresh Disclosures. The Sarbanes-Oxley Act and related SEC rules require issuers to implement disclosure controls and procedures. Typically, the procedures include steps to ensure that all public statements by the issuer, whether in management statements to the media or in regulatory filings, are consistent with the content of the SEC filings. Once drafted, disclosures need to be revisited and updated every time they are included in new filings with the SEC.

While implementing these steps may not eliminate the prospect of governmental scrutiny or private litigation, Chinese companies that have done so will be ready with answers to sometimes hard questions and will reduce the prospect of ultimate liability.

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