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Qingxiu Bu

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# **THE CHINESE REVERSE MERGER COMPANIES (RMCs) REASSESSED: PROMISING BUT CHALLENGING?**

*Qingxiu Bu*<sup>\*</sup>

## **ABSTRACT**

A reverse merger is perceived to be a quicker and less expensive method of going public than a traditional underwritten initial public offering, which many Chinese companies have used to gain access to United States (“U.S.”) capital markets. A string of fraud allegations involving U.S.-listed Chinese reverse merger companies (RMCs) has unearthed numerous regulatory loopholes, challenging the efficacy of the Securities and Exchange Commission’s (“SEC”) supervision. This surge of securities lawsuits has come to exemplify investor concerns with RMCs’ accounting, audits and controls. The focus should have been put on developing an effective cross-border audit oversight system to ensure integrity and investor protection. The ostensible sovereignty issue and China’s vague State Secrets Law have stifled hopes of reaching an agreement on the joint inspection between the two jurisdictions. The unreliability of the judicial remedies at the current stage protrudes the imminence for the SEC and the Exchanges to impose more stringent listing standards, which may be the only realistic measures that can be taken to restore the investors’ confidence.

## **INTRODUCTION**

A reverse merger provides a more economical and efficient access to the U.S. capital markets. With the balance of commercial power shifting eastward inexorably, many Chinese companies have gone public in lieu of undergoing the traditional initial public offering (IPO). Recently, such a transaction has been the subject of increased greater public scrutiny and regulatory focus because of serious accounting fraud allegations and irregularities.<sup>1</sup> Private securities class actions and the SEC enforcement proceedings have been looming over many Chinese RMCs. The scandals highlight investor concerns with the companies’ governance and the audits’ quality and adequacy, in particular the issue that the companies’ financial statements do not reflect their true financial situation. Allegations have included charges of overstated assets or revenues and discrepancies between regulatory filings made to the Chinese and US regulators. A significant number of China-based RMCs have been suspended or even delisted from trading by the SEC as a result of discoveries of fraud.

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<sup>\*</sup>PhD, University of Birmingham, Senior Lecturer (Associate Professor) Sussex Law School, University of Sussex.

<sup>1</sup> See SEC Investor Bulletin, Reverse Mergers, at 3 (June 9, 2011), <http://www.sec.gov/investor/alerts/reversemergers.pdf>. See also PUB. CO. ACCOUNTING OVERSIGHT BD., RESEARCH NOTE NO. 2011-P1, ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION: JANUARY 1, 2007 THROUGH MARCH 31, 2010, at 2 (2011) [hereinafter NOTE NO. 2011-P1]; PUB. CO. ACCOUNTING OVERSIGHT BD., STAFF AUDIT PRACTICE ALERT NO. 8, AUDIT RISKS IN CERTAIN EMERGING MARKETS, at 2 (2011).

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The U.S. regulators face formidable procedural and jurisdictional challenges in actually prosecuting an action against entities located in China. This paper aims to address that thorny issue by exploring the feasibility to parallel the US regulators' more stringent listing standards with the potential cross-border joint oversight regime.

Part I provides contextual insights of the reverse merger and how the inherently lawful vehicle has been abused by Chinese RMCs. Part II discusses the emerging lawsuits initiated by both the SEC and investors against the perpetrators with respect to the prevalent fraud and irregularities. Part III examines why the Public Company Accounting Oversight Board ("PCAOB") registered but China-based audit firms should not be immune from the liability resulting from their involvement in the fraudulent scandals. Part IV highlights how the recent rash of accounting scandals has raised the stakes for the SEC and PCAOB to work out a protocol with their Chinese counterparts. In light of the PCAOB's invalid attempt to seek an extritorial joint inspection and the controversial test of the SEC's subpoena enforcement action, Part V considers how the US regulators and the Exchanges<sup>2</sup> have been "seeking to close the barn door before future livestock runs away with investors' money"<sup>3</sup> and justifies the tougher requirements prior to the RMCs' listing. A tentative conclusion is given in the final part.

#### **A. The Reverse Merger and Its Major Concerns**

Many Chinese private companies seek to access U.S. capital markets by acquiring control of existing public companies.<sup>4</sup> In a reverse merger transaction, a Chinese private company merges into a public "shell entity",<sup>5</sup> which finally survives the transaction despite its lack of meaningful assets or operations.<sup>6</sup> The shareholders and management of the Chinese entity typically gain a controlling interest in the voting power and take over the board of directors and management. As such, the reverse merger enables Chinese private companies not to be subject to the lengthy and more expensive registration process of an underwritten traditional IPO, but instead to quickly gain access to the public markets.<sup>7</sup> It is worth examining the rationale of the transaction and the major concerns arising from the reverse merger.

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<sup>2</sup> These are the three major U.S. Exchanges – the NYSE, NYSE Amex and NASDAQ.

<sup>3</sup> Francis H. Byrd, *Proxy Access Heats Up for 2012*, HARVARD L. BLOG (Jan. 17, 2011, 10:07 AM), <http://blogs.law.harvard.edu/corpgov/2012/01/17/proxy-access-heats-up-for-2012/> (last visited Dec. 28, 2012).

<sup>4</sup> See NOTE NO. 2011-P1, *supra* note 1, at 2-3. Normally, the Exchanges look to Exchange Act Rule 12b-2 to determine what constitute a "shell company." *Id.* Over 600 private companies have "gone public" through reverse mergers with shell companies, *id.* at 2. One in three U.S. reverse mergers involved a Chinese operating company. *Id.* More than 150 companies are principally based in China Since 2007. *Id.* at 3. In 2010, 260 reverse mergers were completed, of which 83 deals inversed operating companied in Mainland China. *Id.*

<sup>5</sup> See Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Exchange Act Release No. 33-8587, 4 (July 15, 2005).

<sup>6</sup> See Securities Exchange Act of 1934, 17 C.F.R. § 240.12b-2 (2007). A "shell company" is "a public reporting company with few or no operations." SEC Investor Bulletin, *supra* note 1, at 1.

<sup>7</sup> See Exchange Act Release No. 34-64633, § 5005(a)(35) (June 8, 2012); N.Y.S.E. GUIDE (CCH) § 101(e)(1); N.Y.S.E. LISTED COMPANY MANUAL (CCH) § 102.01F(1), § 103.01E(1).

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### 1. Rationale behind the Reverse Merger

There are many reasons why a company seeks a cross-border listing in a more established stock market. On the one hand, a reverse merger may allow a private company to go public which, otherwise, would never have been allowed through a traditional IPO. On the other hand, it increases the private company's intangible value out of listing in a more credible Exchange while crystallising the raising of capital.

#### (a) *Facilitate Raising Capital and Enhance Intangible Value*

Because they have access only to private forms of equity, many private Chinese companies are facing difficulties in raising capital. On the other hand, public companies potentially have access to funding from a broader pool of public investors. The U.S. capital markets remain the first choice for most mainland Chinese companies seeking to raise capital.<sup>8</sup> "The bonding effect – that is, the commitment to abide by the standards and laws of a strict investor protection regime – rewards companies located in [Chinese] markets without developed investor protection regimes."<sup>9</sup> The listing in the U.S. signals to investors that its management has the capacity to comply with higher governance standards than those operating domestically. Within a more established legal and regulatory framework, Chinese firms may virtually mitigate their weak governance regime by bonding to the better disclosure and higher standards. Overall, the prestige and credibility in a U.S. listing is perceived to increase a company's intangible value in the eyes of the public.

#### (b) *Less Restrictive Mechanism to Go Public*

The standard for going public is high in the U.S. Certain Chinese private companies may not be able to conduct a traditional IPO because of legitimate issues ranging from such concerns as integrity of management, accounting irregularities and exaggerated future prospects.<sup>10</sup> Those overseas companies legally domiciled in offshore havens, like the Cayman Islands or the British Virgin Islands,<sup>11</sup> should never have been allowed to list in America in the first place. The onerous and critical procedures to underwrite a traditional IPO have caused them to search for a more efficient and less restrictive route. A most attractive

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<sup>8</sup> Elizabeth Fry, *Investor Alert Over Suspect Chinese IPO Prospectuses*, FIN. TIMES, Feb. 28, 2010, <http://www.ft.com/intl/cms/s/0/f669486e-2308-11df-a25f-00144feab49a.html#axzz29y7tJ6te>. The primary benefits a company enjoys from going public through an IPO is a large infusion of additional equity capital and share liquidity, William Sjostrom, *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L. J. 743, 744 (2008).

<sup>9</sup> James R. Doty, *Auditing in the Decade Ahead: Challenge and Change*, HARVARD L. BLOG (Jan. 8, 2012, 10:03 AM), <http://blogs.law.harvard.edu/corpgov/2012/01/08/auditing-in-the-decade-ahead-challenge-and-change> (last visited Feb. 7, 2012).

<sup>10</sup> John J. Huber & Jennifer A. Hull, *Scaling the Great Wall of Accounting Issues in Chinese Reverse Mergers*, FTI CONSULTING 1, 3 (2011), <http://www.fticonsulting.com/global2/media/collateral/united-states/scaling-the-great-wall-of-accounting-issues.pdf>.

<sup>11</sup> See Sally Painter, *Cayman's are Just Tip of the Iceberg*, POLITICO (Aug. 9, 2012, 4:29 AM), <http://www.politico.com/news/stories/0812/79507.html> (last visited Oct. 15, 2012). Many multinationals have made use of offshore havens, like Cayman Islands as one of the world's favourite places for the seriously wealthy to park their money. See *id.*

alternative, i.e. the reverse merger, avoids the due diligence of a traditional IPO.<sup>12</sup> It presents not only a valuable alternative, but also a legitimate way to gain access to capital for those that cannot afford a full-fledged IPO. Some firms unlikely to attract venture capital or facing a considerable wait for listings on the Shanghai and Shenzhen Stock Exchanges can benefit immensely from the quicker, cost-saving advantages. China has tightly restricted private companies from buying stocks and bonds from foreigners directly, which has held off exposure to the fluctuations of international financial flows.<sup>13</sup> Only the most powerful state-owned enterprises (SOEs) can be allowed to do so. However, through reverse mergers, many firms get around the restrictions to gain access to the Western capital market. Unfortunately, it is the widespread allegations of fraudulent accounting that have put the Chinese RMCs under fire. Recently, there has been an increase in the concerns with the visibility into, and reliability of, some RMCs' financial statements.

## **2. Chinese Companies under Fire for Accounting Fraud**

The use of a reverse merger as a financing or going-public technique is a generally accepted mechanism, as well as a more cost-effective and streamlined means for a private company. Although there is nothing inherently wrong, many RMCs have taken improper advantage of aspects of the reverse merger process. Significant accounting deficiencies and other corporate governance issues have heightened the awareness of risks that can go along with investing in Chinese companies. In particular, there is a heightened awareness with regard to the RMC's governance structure, and the inaccuracy, and transparency, of its financial statements.

### *(a) Inaccuracy and Non-Transparency*

When Chinese companies list, they earn a documented cross-listing premium for bonding themselves to U.S. institutions and committing to U.S. compliance activities aimed at protecting minority investors.<sup>14</sup> Anxiety has grown as a string of RMCs have been accused of fraud with a particular regard to Chinese RMCs' related-party transactions. This caused the RMCs' share price to drop, damaging investors who bought in at what they had considered to be an artificially high price. Warning shareholders about the risks of investing in Chinese RMCs, the SEC has launched aggressive enforcement actions to address the misuse of the reverse merger as a vehicle to commit fraud, and also to prevent them from abusing the regulatory process. Since the beginning of 2010, the SEC and the three Exchanges have suspended trading, halted trading, or delisted the securities of at least 29 U.S.-listed Chinese

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<sup>12</sup> Reverse Mergers Offer a Strategic Alternative to IPOs, TOUCHSTONE ADVISORS, [http://www.touchstoneadvisors.com/documents/PDF\\_Files/Reverse%20Mergers%20Offer%20a%20Strategic%20Alternative%20to%20IPOs%20-%202012.pdf](http://www.touchstoneadvisors.com/documents/PDF_Files/Reverse%20Mergers%20Offer%20a%20Strategic%20Alternative%20to%20IPOs%20-%202012.pdf) (last visited Oct. 21, 2012). The legal and accounting fees associated with a reverse merger are lower than for an IP. *See id.* There are no registration requirements under the Securities Act of 1933 as there would be for an IPO. *See id.*

<sup>13</sup> *See* Daniel H. Rosen, *The U.S. and China: Friends or Foes? - Part II*, YALE GLOBAL ONLINE (Apr. 20, 2006), <http://yaleglobal.yale.edu/content/us-and-china-friends-or-foes-%E2%80%93-part-ii>.

<sup>14</sup> *See* Craig Doidge, George Andrew Karolyi & Rene M. Stulz, Has New York Become Less Competitive Than London in Global Markets? Evaluating Foreign Listings Choices Over Time, 91 J. FIN. ECON. 253, 254 & n.4 (2009).

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companies when significant concerns arose regarding the accuracy of their financial reporting.<sup>15</sup>

These scandals have revealed that the RMCs' governance is inherently weak. Substantial financial results, following an IPO, were allegedly significantly different from the financial statements provided in their prospectuses. For instance, some financial figures have been pumped up dramatically in the previous year before they applied for a stock exchange listing. Although one of the keys to public confidence is transparency,<sup>16</sup> Chinese RMCs appear to be reluctant to provide proper disclosure. The reverse merger enables them to avoid the detailed disclosures required in an IPO. Investors may have little publicly available financial information so as to make informed investment decisions. "International regulators, lawyers, and auditors face formidable obstacles in getting clear-cut information on Chinese [RMCs], let alone freezing assets or enforcing court orders if fraud can ever be proved."<sup>17</sup> Under the current depression in the capital market, it is crucial to call for much greater transparency in RMCs' genuine financial situation.

## (b) Deficient Process of Scrutiny

The use of reverse mergers has facilitated many Chinese companies to access the strongest public markets, but through the channel of weakest enforcement. Normal-listed companies are subject to stringent securities laws, with their books being relatively transparent. Through a backdoor method that circumvents the scrutiny of a conventional IPO, the widespread use of shell companies offer their owners a way to minimize regulatory scrutiny, and thus the transaction is not subject to the same level of due diligence review. The major concern is the absence of registration requirements under the Securities Act of 1933<sup>18</sup> and the related lack of detailed operational and financial disclosure, as well as the lower level of scrutiny of the SEC review process.

The RMCs may take improper advantage of the remoteness of their operations to engage in fraud, as their unique structure complicates the ability of the PCAOB and the SEC to dig into the accounts of the resulting firms. The operating part of the RMC and the U.S.-

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<sup>15</sup> *Investigations and Litigation Related to Chinese Reverse Merger Companies Financial, Economic and Accounting Questions*, CORNERSTONE RESEARCH 2 (July 26, 2011), <http://www.cornerstone.com/chinese-reverse-mortgage-litigation/> [hereinafter *Investigations and Litigation*]. The SEC has recently suspended or revoked trading in the securities of a great number of RMCs due to allegations of fraud and other regulatory concerns, such as Heli Electronics Cor. (HELI), China Changjiang Mining & New Energy Co, (CHJI) and RINO International Corporation (RINO). See *id* at endnote 15.

<sup>16</sup> Sheila C. Blair, *Lessons of the Financial Crisis: The Dangers of Short-Termism*, HARVARD L. BLOG (July 4, 2011, 10:32 AM), <http://blogs.law.harvard.edu/corpgov/2011/07/04/lessons-of-the-financial-crisis-the-dangers-of-short-termism>.

<sup>17</sup> Robert Cookson, *Hazard Lights Flash on Road to Chinese Riches*, FIN. TIMES, Jun. 16, 2011, <http://www.ft.com/intl/cms/s/0/e27f4814-983a-11e0-ae45-00144feab49a.html#axzz29y7Uj6te>.

<sup>18</sup> See *Registration Under the Securities Act of 1933*, SEC. EXCH. COMM'N, <http://www.sec.gov/answers/regis33.htm> (last modified Sept. 2, 2011). "Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: [(i)] To require that investors receive financial and other significant information concerning securities being offered for public sale; and [(ii)] To prohibit deceit, misrepresentations, and other fraud in the sale of securities." *Id*.

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listed part are technically two separate legal entities.<sup>19</sup> “The Chinese-owned part signs ... contracts with the listed entity to transfer revenues in a way that allows the books of the two [former] companies to be consolidated under U.S. [securities laws and] accounting rules. It’s a risky structure since the U.S. shareholders don’t actually own the Chinese company.”<sup>20</sup> The lack of scrutiny presents a loophole resulting in potential fraud. The wave of scandals has prompted a much deeper rethink about Chinese listing in the U.S. markets. It seems unclear as to why the RMCs have been allowed to list prior to the potential problems being eliminated. As an observer held, the Western accountants and underwriters have been too quick to bring companies to market before they are ready.<sup>21</sup> Inevitably, there has been increased scrutiny of Chinese firms that gained access to U.S. equity markets via a reverse merger.<sup>22</sup> It is worth examining how shareholders have been resorting to the U.S. courts against Chinese RMCs and their auditing firms.

### B. Emerging Litigation against US-Listed Chinese RMCs

With China’s extraordinary economic growth, many U.S. investors have been investing heavily in Chinese RMCs with the hope of gaining substantial returns. A spate of collapse has cost them billions of dollars and has triggered shareholder litigation, as well as U.S. regulatory probes. More proactively, investors have alleged widespread accounting fraud and improper transactions, thus causing share prices to nosedive.<sup>23</sup> Most firms have just slipped into U.S. stock exchanges, bypassing the scrutiny of an IPO and a regular review by the Financial Industry Regulatory Authority (FINRA). They are simply not prepared for the strict corporate governance standards, nor have they realized that the U.S. shareholders are not as averse to litigation as their Chinese counterparts. “[U.S.] [s]hareholders are likely to be much more rigorous in their examination of [the RMCs’] control regimes.”<sup>24</sup> They contend companies invented sham businesses, inflated revenue, or gave vastly different information to U.S. and Chinese regulators. The lack of adequate risk control and proper understanding of rules expose them to litigation risks. The number of securities class action filings has risen steadily against Chinese RMCs,<sup>25</sup> such as China MediaExpress Holdings Inc.,<sup>26</sup> RINO

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<sup>19</sup> Paul Gillis, *A Chinese Listing Fitness Test*, WALL ST. J. ASIA, Sept. 15, 2011, <http://online.wsj.com/article/SB10001424053111904060604576570121071633988.html>.

<sup>20</sup> *Id.*

<sup>21</sup> *See id.*

<sup>22</sup> *Investigations and Litigation*, *supra* note 15, at 1; see David Barboza & Azam Ahmed, *Muddy Waters Research Is a Thorn to Some Chinese Companies*, N.Y. TIMES, June 9, 2011, <http://dealbook.nytimes.com/2011/06/09/muddy-waters-research-is-a-thorn-to-some-chinese-companies/>.

<sup>23</sup> *See The SEC Approves New Rules for Reverse-Merger Companies to Become Listed on the Major U.S. Exchanges*, PATTON BOGGS LLP (Nov. 16, 2011), <http://www.pattonboggs.com/news/detail.aspx?news=1612> (last visited Dec. 28, 2012). “[S]hares of Chinese RMCs collectively fell approximately 50 percent during the first six months of 2011.” *Id.*

<sup>24</sup> Byrd, *supra* note 3.

<sup>25</sup> *Securities Class Action Filings: 2011 Mid-Year Assessment*, CORNERSTONE RESEARCH 13, [http://securities.stanford.edu/clearinghouse\\_research/2011\\_YIR/Cornerstone\\_Research\\_Filings\\_2011\\_Mid\\_Ye\\_ar\\_Assessment.pdf](http://securities.stanford.edu/clearinghouse_research/2011_YIR/Cornerstone_Research_Filings_2011_Mid_Ye_ar_Assessment.pdf) (last visited Dec. 1, 2011). In the first half of 2011, more than 25% of all class-action lawsuits alleging securities fraud were filed against Chinese RMCs. Filings related to Chinese issuers increased dramatically between 1 January and 30 June of 2011 with 25 such filings, including 24 filings associated with reverse merger companies. *Id.*

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International<sup>27</sup> and Orient Paper, Inc.<sup>28</sup> The plaintiffs, whose lawsuits reflect increased shareholder scrutiny, have sought to recover damages for violations of U.S. securities laws, such as Section 10(b) and Rule 10b-5.<sup>29</sup>

**1. Henning v. Orient Paper, Inc.**

Through a reverse merger, Orient Paper, Inc. became a Nevada corporation with equity traded on the N.Y.S.E. Amex in December 2007.<sup>30</sup> The case was filed in the District Court of Central District of California on January 28, 2011.<sup>31</sup> The plaintiff alleged that the RMC failed to disclose material party-related transactions with its main suppliers<sup>32</sup> and misstated its financials in its 2008-09 annual report.<sup>33</sup> The financial statements were based on alleged differences between the company's SEC and Chinese regulatory filings.<sup>34</sup> It was also alleged that a disbarred and unlicensed auditor had audited the misleading financial statements.<sup>35</sup> The Federal District Court rejected the RMC's motion to dismiss the complaint that alleged that the company materially misstated its financial information in two filings with the SEC.<sup>36</sup> It is arguably the first time that plaintiffs have survived a dismissal motion involving a Chinese RMC. In the denial of the Defendant's Motion to Dismiss the Plaintiffs' Amended Complaint, Judge Valerie Backer Fairbank ruled that the plaintiffs adequately plead a securities violation with particularity under Section 10(b), Rule 10b-5 under the Exchange Act, Section 20(a) of the Exchange Act, and the heightened standard of the Private Securities Litigation Reform Act.<sup>37</sup>

This ruling signals the willingness of the court to hear reverse merger securities fraud actions. Interestingly, the effect of the U.S. Supreme Court's decision in *Morrison v. National Australia Bank*<sup>38</sup> shows that investors value the U.S. enforcement of its laws on cross-listed companies.<sup>39</sup> A number of settlements seem to indicate the extent to which

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<sup>26</sup> Am. Consolidated Compl., *McIntire v. China Mediaexpress Holdings, Inc.*, No. 1:11-cv-00804-VM (S.D.N.Y. Oct. 31, 2011).

<sup>27</sup> Class Action Compl. for Violation of the Federal Securities Laws, *Chau v RINO Int'l Corp., et al.*, No. CV10- 09517-RGK (PJWx) (C.D. Cal. Dec. 10, 2010).

<sup>28</sup> Am. Compl., *Henning v. Orient Paper, Inc.*, No. 2:10-cv-05887-VBF-AJW (C.D. Cal. Jan 28, 2011).

<sup>29</sup> See Securities Exchange Act of 1934 §10(b), 15 U.S.C. § 78j(b) (2012); Houston Adair, *Chinese Reverse Mergers Raise Concerns*, COLUM. BUS. L. REV. ONLINE (Sept. 19, 2011, 10:40 PM), <http://cblr.columbia.edu/archives/11775>.

<sup>30</sup> Am. Compl., *Henning v. Orient Paper, Inc.*, *supra* note 28, at ¶ 35-37.

<sup>31</sup> *Id.* at 1.

<sup>32</sup> *Id.* at ¶ 47

<sup>33</sup> *Id.* at ¶ 44-45.

<sup>34</sup> *Id.* at ¶ 51-60.

<sup>35</sup> *Id.* at ¶ 10.

<sup>36</sup> *Henning v. Orient Paper, Inc.*, No. CV 10-5887-VBF (AJWx), 2011 WL 2909322, at \*1, \*6 (C.D. Cal. July 20, 2011).

<sup>37</sup> *Id.* at \*1-26; see Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in 15 U.S.C. §§ 78a-78ee (1998)).

<sup>38</sup> *Morrison v. National Australia Bank*, 130 S.Ct. 2869, 2886 (2010).

<sup>39</sup> See Louis Gagnon & G. Andrew Karolyi, *The Economic Consequences of the U.S. Supreme Court's Morrison v. National Australia Bank Decision for Foreign Stocks Cross-Listed in the U.S. Markets*, in SOCIAL



*Morrison* may operate to reduce the magnitude of securities class action lawsuits filed against non-U.S. companies, even those whose shares trade on U.S. exchanges.<sup>40</sup>

## 2. Judicial and Procedural Hurdles

Whether shareholders are successful in efforts to obtain damages for the fraud will likely have a significant impact on future investments in Chinese RMCs. The overall cumulative impact of the Court's interest in taking up securities cases has been favorable to RMCs and unfavorable to plaintiffs, and so to have the Supreme Court's recent securities law decisions. The *Janus Capital*<sup>41</sup> and *Morrison* decisions represent significant defense victories that have or will have a significant impact on a plaintiff's ability to pursue securities claims. In September 2010, Judge Victor Marrero entered a significant ruling in *In re Alstom SA Securities Litigation*,<sup>42</sup> in which he granted the defendants' motion, relying on *Morrison v. National Australian Bank*. The Court dismissed the claims of the Alstom shareholders who had bought their shares in the French company on a foreign exchange.<sup>43</sup>

In addition, lawsuits against the RMCs may pose unique hurdles and add expenses to the defense of shareholder claims. Plaintiffs face numerous obstacles, such as difficulty in pursuing evidence gathering in China, and limitations on their ability to collect judgments or legal awards. Plaintiffs would have to look at the auditors' work papers and communications with the company. The individual defendants, corporate documents, and key witnesses in the RMC-related cases often reside in China. This makes it exceedingly difficult for plaintiffs to collect evidence against those entities which have either most of their operations in China or legal homes in the Cayman Islands. Plaintiffs have complained that their cases have been thwarted because of the difficulty of gathering crucial evidence from Chinese audit firms, which partly results in the defense costs escalating rapidly. Furthermore, given that most Chinese RMCs have limited insurance coverage, plaintiffs are always facing difficulty in collecting judgments against entities which have primary operations in China. Not to mention the thorny issue that U.S. courts' rules on evidence-gathering are often not honored.<sup>44</sup> With the high surge of lawsuits against Chinese RMCs, the auditors are increasingly exposed to special challenges, including fraud risks, due to their materially misleading or deficient statements. Suits against audit firms may also find deeper pockets than the potentially non-responsive, underinsured, and non-liquid Chinese RMCs themselves. Thus, many plaintiffs seek a monetary judgment not against the company, but the auditor, which could pay large judgements or settlements.

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SCIENCE RESEARCH NETWORK, at 8, 17-18 (Johnson School Research Paper Ser. No. 50-2011, 2012), available at <http://ssrn.com/abstract=1961178>.

<sup>40</sup> See *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 471-472 (S.D.N.Y. 2010).

<sup>41</sup> See *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2298-2299 (2011).

<sup>42</sup> See *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d at 473.

<sup>43</sup> *Id.*

<sup>44</sup> Carlyn Kolker & Martin Howell, *Analysis: Auditors Face Suits Over US-Listed Chinese Blowups*, REUTERS, June 9, 2011, available at <http://www.reuters.com/article/2011/06/10/us-china-auditors-lawsuits-idUSTRE75902L20110610>.

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### C. Challenges: Should auditing firms be immune from the scandal?

China has become the biggest source of cross-border listings and mergers, where the Big Four<sup>45</sup> have been expanding rapidly.<sup>46</sup> A number of factors may undermine the auditors' ability to undertake their auditing effectively. Foreign auditing firms are forbidden to set up their own auditing offices in China and must operate through Chinese affiliates. This concern has been aggravated since some small U.S. auditing firms may lack sufficient resources to conduct adequate overseas audits, and to meet auditing obligations when a substantial portion of the RMCs' operations are located in China.<sup>47</sup> Although the Sarbanes-Oxley Act of 2002 requires an audit firm to be registered with the PCAOB,<sup>48</sup> some accounting firms may not have conducted audits or performed sufficient due diligence in accordance with PCAOB standards.<sup>49</sup> Such small audit firms, which may not be familiar with accounting and auditing principles for SEC registrants, are only inspected by the PCAOB once every three years.<sup>50</sup> They may have simply based their audit opinion on the work of unreliable Chinese auditing firms, to which the audit had been outsourced. Some firms just lend their reputation by signing off on books and records without verifying the accuracy, even if they do not have any affiliates in China.<sup>51</sup> As a general rule, the basic purpose of an audit is to give investors insight about the financial position and viability of a company. Investors having suffered a drubbing from accounting scandals at U.S.-listed RMCs would be looking to maximize their recovery and to sue the auditors who blessed their financial statements. Some auditors have found themselves targeted for alleged complicity in the misstatements.<sup>52</sup>

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<sup>45</sup> These are the Big Four auditing companies: PricewaterhouseCoopers (now PwC), Deloitte, Ernst & Young, and KPMG.

<sup>46</sup> Dinny McMahon & Michael Rapoport, *Challenges Auditing Chinese Firms*, WALL ST. J., July 12, 2011, <http://online.wsj.com/article/SB10001424052702304584404576439902614628750.html>.

<sup>47</sup> Peter J. Henning, *The Importance of Being Audited*, N.Y. TIMES, June, 13 2011, <http://dealbook.nytimes.com/2011/06/13/the-importance-of-being-audited/>.

<sup>48</sup> Sarbanes-Oxley Act of 2002 §102(a), 15 U.S.C. §7212 (2010). Accounting firms that audit public companies must register with the PCAOB. *See id.*

<sup>49</sup> PUB. CO. ACCOUNTING OVERSIGHT BD., STAFF AUDIT PRACTICE ALERT NO. 6, AUDITOR CONSIDERATIONS REGARDING USING THE WORK OF OTHER AUDITORS AND ENGAGING ASSISTANTS FROM OUTSIDE THE FIRM 1 (2010).

<sup>50</sup> PUB. CO. ACCOUNTING OVERSIGHT BD., ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION: JANUARY 1, 2007 THROUGH MARCH 31, 2010 n. 4 (March 14, 2011), *available at* [http://pcaobus.org/research/documents/chinese\\_reverse\\_merger\\_research\\_note.pdf](http://pcaobus.org/research/documents/chinese_reverse_merger_research_note.pdf). U.S. registered firms audited 74% of the Chinese reverse merger companies with the remainder being audited by Chinese and Hong Kong registered firms. *Id.* There are 110 auditing firms in China and Hong Kong that are registered at the PCAOB. *PCAOB Announces Some Progress in Impasse Over Audit Oversight in China*, 43 SEC. REG. & L. REP. ONLINE (BNA) NO. 1720 (Aug. 15, 2011).

<sup>51</sup> "After the SEC found that Moore Stephens Wurth Frazer & Torbett, LLP (MSWFT), a U.S.-registered PCAOB accounting firm and auditor of several CRMs, had failed to follow professional standards, it issued a cease and desist order against the firm. More than 24 CRMs subsequently announced auditor resignations." Adair, *supra* note 29.

<sup>52</sup> *See* Kolker & Howell, *supra* note 44.

### 1. Carlos Munoz v. China Expert Technology, et. al.

In this case, the plaintiff accused the auditors of failing to detect an alleged \$132 million fraud carried out by the company.<sup>53</sup> It was alleged that two units of PKF New York and PKF Hong Kong had failed to verify the existence of 16 contracts to build government computer systems in China, as well as failing to identify an overstatement of revenue and accounts receivable in the audit.<sup>54</sup> Two of the most contentious issues that are to be examined below are whether the auditor could be regarded as the “maker,” and how to strike a balance between the policy of China and the U.S. Federal policy regarding the auditors’ obligation.

#### (a) Maker

A most contentious issue arose as to whether the auditor should be liable for the misleading or fraudulent statement. To prevail against auditors, plaintiffs must prove that the auditors knowingly made false statements when issuing reports affirming a company’s financial statements.<sup>55</sup> It seems indisputably clear that only the actual “maker” of an allegedly fraudulent statement may be subject to a private securities claim. In *Janus Capital Group Inc. v. First Derivative Traders*,<sup>56</sup> the U.S. Supreme Court held that “the maker of a statement is the person with ultimate authority over the statement, including its content and whether and how to communicate it.”<sup>57</sup> PKF New York’s Motion to Dismiss cited to this, which limited the exposure of advisers who assisted but were not the “maker” of a misleading statement.<sup>58</sup> Judge Alvin K. Hellerstein denied the Motion to Dismiss by the firm involving China Expert Technology Inc., which had sold securities in the U.S. with a prospectus containing the PKF audit opinion.<sup>59</sup> As to whether the defendant had “final authority” over the opinions before it was signed and citing language in the engagement letter, the judge innovatively observed that the allegations against the auditor “create genuine issues of fact as to whether [the defendant] explicitly or implicitly controlled sufficiently – and thus ‘made’ – the statements in question.”<sup>60</sup> The judge held that discovery is required to determine such an issue.<sup>61</sup> Although the Court did not rule on the merits of the case, it instead allowed shareholders’ claims to

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<sup>53</sup> Carlyn Kolker, *U.S. Judge Allows Lawsuit Over China Audits*, REUTERS, July 20, 2011, available at <http://www.reuters.com/article/2011/07/20/china-accounting-ruling-idUSN1E76J0CG20110720>. See *Munoz v. China Expert Tech., Inc.*, No. 07Civ.10531(AKH), 2011 U.S. Dist. LEXIS 128539, at \*2 (S.D.N.Y. 2011) (denying defendant PKF N.Y.’s motion to dismiss the fourth amended complaint).

<sup>54</sup> Fourth Am. Compl., *Munoz v. China Expert Tech., Inc.*, No. 07Civ.10531-AKH, at ¶ 9 (S.D.N.Y. 2011).

<sup>55</sup> Securities Exchange Act of 1934 § 10(b), 15 U.S.C.A. § 78j(b) (2012).

<sup>56</sup> *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

<sup>57</sup> *Id.* at 2298.

<sup>58</sup> *Id.*

<sup>59</sup> *Munoz*, 2011 U.S. Dist. LEXIS 128539, at \*2-5. The prior history of the motion to dismiss indicates how courts may apply case law to fact patterns involving Chinese companies and accounting firms. *Id.* at \*3. A hand-written note by Judge Alvin K. Hellerstein in *Munoz* granted a rehearing on a motion to dismiss a shareholder class action by PKF New York. *Id.* Rehearing was granted on the basis of the Supreme Court’s decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 131 (2011). See *id.* While plaintiff’s assertion of *Janus* was sufficient to gain a rehearing, the defendants’ reliance on *Janus* did not win the day on the motion to dismiss. *Id.* at \*5.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

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proceed to the next phase; the ruling is likely to have significant implications for other cases over accounting problems of Chinese RMCs. Hellerstein's ruling signals a "potentially lucrative channel for shareholders" to initiate lawsuits against auditors of Chinese RMCs.<sup>62</sup>

### (b) *The China Law vis-à-vis The U.S. Federal Policy*

Another most controversial issue is whether a PCAOB-registered but China-based audit firm is obliged to file an SEC report. The defendant argued that Chinese State Secrets Law criminalizes the disclosure of information that relates to Chinese national security and other potentially sensitive interests.<sup>63</sup> Nevertheless, the Court found that "the national interest of the United States is observably strong; China's is speculative."<sup>64</sup> The judge cited the U.S. Supreme Court's ruling in *Societe Nationale* stating that "[i]t is well settled that [foreign 'blocking'] statutes do not deprive an American court of the power to order a party subject to its jurisdiction to produce evidence even though the act of production may violate that statute."<sup>65</sup>

The Court also pointed out that the fact that China Expert Technology is obligated to file disclosure statements with the SEC puts into question any claim that may arise under China's State Secrets Law.<sup>66</sup> It is essential to strike a balance between preserving the policies of China's laws on state secrets, and U.S. federal policy in relation to accountants' obligations. To look into the issue's insights, it is worth anatomizing how the SEC recently brought a subpoena enforcement proceeding against an audit firm for obstructing a probe of reverse merger transactions.

## 2. SEC v Deloitte Touche Tohmatsu CPA Ltd.

A series of alleged fraud in Chinese RMCs has spotlighted the roles of the Big Four auditors in the fastest-growing market. The SEC has taken enforcement actions against a number of reverse merger entities and their audit firms, alleging concerns regarding the accounting fraud contained in their public filings. In September 2011, the SEC sued the

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<sup>62</sup> Kolker, *supra* note 53.

<sup>63</sup> Order Regulating Discovery, *Munoz v. China Expert Tech.*, 07-CV-10531-AKH, 2011 WL 5346323, at \*1 (S.D.N.Y. Nov. 7, 2011)[hereinafter "Munoz Discovery Order"]. See also *Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa* (中花人民共和国保守国家秘密法) [Law of the People's Republic of China on Guarding State Secrets] (promulgated by Order No. 6 of the President of the People's Republic of China, September 5, 1988, effective Sept. 5, 1988), ch. 1, art. 1.

[S]tate secrets shall include the following: (i) secrets concerning major policy decisions on State affairs; (ii) secrets in the building of national defence and in the activities of the armed forces; (iii) secrets in diplomatic activities and in activities related to foreign countries as well as secrets to be maintained as commitments to foreign countries; (iv) secrets in national economic and social development; (v) secrets concerning science and technology; (vi) secrets concerning activities for safeguarding State security and the investigation of criminal offences; and (vii) other matters that are classified as State secrets by the State secret-guarding department.

*Id.* at ch.2, art. 8.

<sup>64</sup> *Munoz Discovery Order*, *supra* note 63, at \*2. A balance test of "national interests" has been used to determine such a finding regarding disclosure issues. *Richmark Corp. v Timber Falling Consultants*, 959 F.2d 1468, 1476 (9th Cir. 1992).

<sup>65</sup> *Societe Nationale Industrielle Aerospatiale v. U.S. Dist. Court, S.D. Iowa*, 482 U.S. 522, 544 n. 29 (1987).

<sup>66</sup> *Munoz Discovery Order*, *supra* note 63, at \*2

Shanghai Office of Deloitte Touche Tohmatsu CPA Ltd. (D&T Shanghai) to enforce an investigation subpoena involving Longtop Financial Technologies.<sup>67</sup> The Cayman Islands corporation, with its principal businesses in China,<sup>68</sup> was listed on the New York Stock Exchange (NYSE) in 2007 for \$17.50 a share.<sup>69</sup> The NYSE delisted the securities as soon as the RMC was caught up in accounting scandals.<sup>70</sup> The PCAOB-registered D&T Shanghai was the auditor and found it difficult to obtain independent bank confirmation of Longtop's balances and major transactions.<sup>71</sup> After uncovering numerous improprieties during its audit for the year ended March 31, 2011, D&T Shanghai abruptly resigned on May 22, 2011, because it had identified numerous indicators of financial fraud at Longtop and further indicated that investors could no longer rely upon its prior year audit reports.<sup>72</sup>

"It is hard for investors to grasp how accountants can change their position with no prior warning, disclosing serious reporting issues that call into question the reliability of prior reports... It is worth considering whether accountants should be asked to provide a more nuanced view of a company's financial statements so that a sudden resignation or withdrawal of prior opinions does not come as a complete shock to the market."<sup>73</sup>

Apparently, D&T Shanghai's documents would reveal how any fraud schemes were able to continue undetected for years at the RMC. On May 27, 2011, the SEC served D&T Shanghai's U.S. counsel with a subpoena, requesting documents concerning its activities as the auditor of Longtop from January 2007 to the date of the subpoena.<sup>74</sup> Such a request is perfectly in line with the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act), which enhanced the SEC's ability to obtain audit documentation held by Chinese parties.<sup>75</sup> Nevertheless, D&T Shanghai refused to comply with the subpoena on July 8, 2011, contesting the SEC's ability to compel an audit firm to produce documents predating the Dodd-Frank Act and asserting that the production was prohibited under Chinese law.<sup>76</sup> On

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<sup>67</sup> Application for Order to Show Cause and for Order Requiring Compliance with a Subpoena, SEC v. Deloitte Touche Tohmatsu CPA, Ltd., No. 11-0512 (D.D.C. 2012); see Michael Rapoport, *SEC Probes China Auditors*, WALL ST. J., June 3, 2011, <http://online.wsj.com/article/SB10001424052702304563104576361422372121248.html>.

<sup>68</sup> *In re Longtop Fin. Tech. Ltd. Sec. Litig.*, 2012 WL 5512176, at \*1 (S.D.N.Y. Nov. 14, 2012).

<sup>69</sup> Lynn Cowan, *Longtop Financial Shares up 85% after U.S. IPO*, WALL ST. J., Oct. 24, 2007, available at <http://www.marketwatch.com/story/longtop-financial-shares-up-85-after-us-ipo>.

<sup>70</sup> *S.E.C. Asks Court to Force a Release of Papers from China*, N.Y. TIMES, Sept. 8, 2011, <http://travel.nytimes.com/2011/09/09/business/sec-asks-court-to-force-a-release-of-papers-on-longtop.html>.

<sup>71</sup> *In re Longtop Fin. Tech. Ltd.*, 2012 WL 5512176, at \*2.

<sup>72</sup> Press Release, SEC. EXCH. COMM'N, SEC Files Subpoena Enforcement Action Against Deloitte & Touche in Shanghai (Sept. 8, 2011), available at <http://www.sec.gov/news/press/2011/2011-180.htm>.

<sup>73</sup> Henning, *supra* note 47.

<sup>74</sup> Press Release, *supra* note 72.

<sup>75</sup> Sarbanes-Oxley Act of 2002 §106, 15 U.S.C. §7216(b) (2010), amended by Dodd-Frank Wall St. Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929(j) (2010).

<sup>76</sup> William McGrath, *SEC Ups the Ante in Subpoena Dispute with Deloitte Touche Shanghai by Filing an Administrative Proceeding Against the Chinese Accounting Firm Threatening Its Ability to Appear Before the Commission*, FED. SEC. L. BLOG (May 10, 2012, 12:47 PM), <http://www.fedseclaw.com/2012/05/articles/pcaob-news/sec-ups-the-ante-in-subpoena-dispute-with-deloitte-touche-shanghai-by-filing-an-administrative-proceeding-against-the-chinese-accounting-firm-threatening-its>

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September 8, 2011, the SEC filed its Motion for an Order To Show Cause.<sup>77</sup> The SEC sought the Federal Court order to force Deloitte's Shanghai branch to turn over its work papers on Longtop, with an attempt to enforce the subpoena in the U.S. District Court for the District of Columbia.<sup>78</sup> On January 4, 2012, a court granted the SEC's Show Cause Motion requiring D&T Shanghai to file a brief by mid-January 2012 and to appear at a hearing in early February, thereby compelling D&T Shanghai either to concede jurisdiction by appearing at the hearing or to risk default judgment.<sup>79</sup> As a result, a magistrate judge in Washington, D.C. has issued an order that permits the SEC to move forward on its request to require Deloitte Touche Tohmatsu CPA Ltd. to turn over documents.<sup>80</sup>

The SEC's enforcement of the subpoena represents a milestone with regard to the SEC's authority to "issue subpoenas to entities abroad."<sup>81</sup> The case underscores the difficulties of the U.S. regulators in probing the Chinese RMCs. The subpoena filed in the U.S. District Court marks "the boldest move yet" by the SEC in its crackdown on the RMCs' fraud.<sup>82</sup> The lawsuits have also escalated the diplomatic battle with regard to the U.S. auditor watchdog's access to PCAOB-registered, but China-based, auditing firms.<sup>83</sup> The ruling is largely procedural, but it does set in motion a round of briefing, and a hearing, to address whether the SEC can compel the Chinese accounting firm to respond to its subpoena. It also "has the potential to establish precedent ... when entities located abroad receive SEC investigative subpoenas."<sup>84</sup> Notably, one of the reasons Deloitte asserted its refusal to comply with the subpoena was the risk of sanctions under China's State Secrets Law,<sup>85</sup> which is to be examined below.

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ability-to-appear-before-the-commission/#axzz2AbmTDbXJ. Although the regulators have not yet developed plans for retrospective reviews of Dodd-Frank Act Regulations, it does apply retrospectively since 21 July 2010, when Dodd-Frank became law. *Id.* SEC should reinforce its commitment to these principles both retrospectively and prospectively.

<sup>77</sup> Press Release, *supra* note 72.

<sup>78</sup> See SEC's Memorandum of Points and Authorities in Support of Application for Order to Show Cause and Order Requiring Compliance with Subpoena, SEC v. Deloitte Touche Tohmatsu CPA Ltd., No. 11-0512 (D.C.Cir., Sept. 8, 2011).

<sup>79</sup> Memorandum Opinion and Order to Show Cause, SEC v. Deloitte Touche Tohmatsu CPA Ltd., No. 11-0512 (D.C.Cir. Jan. 4, 2012).

<sup>80</sup> *Id.*

<sup>81</sup> William McGrath, *Deloitte Touche Shanghai Subpoena Case - Parties Take Differing Views on Procedure to Resolve Dispute Over Whether the SEC Can Enforce Its Investigative Subpoena on a Chinese Accounting Firm*, FED. SEC. L. BLOG (Jan. 30, 2012, 11:38 AM), <http://www.fedseclaw.com/2012/01/articles/sec-enforcement-cases/deloitte-touche-shanghai-subpoena-case-parties-take-differing-views-on-procedure-to-resolve-dispute-over-whether-the-sec-can-enforce-its-investigative-subpoena-on-a-chinese-accounting-firm/#axzz2A4npc1XG>; see Unopposed Motion of Respondent Deloitte Touche Tohmatsu CPA Ltd. to Vacate Schedule Set Out in the Order to Show Cause and Require the Parties to Negotiate a New Schedule, SEC v. Deloitte Touche Tohmatsu CPA Ltd., No. 11-0512 (D.C.Cir. Jan. 11, 2012).

<sup>82</sup> Andrea Shalal-Esa & Sarah N. Lynch, *SEC Takes China-Based Deloitte Unit to Court*, REUTERS, Sep. 9, 2011, available at <http://www.reuters.com/article/2011/09/09/us-sec-deloitte-idustre78768r20110909>.

<sup>83</sup> See *id.*

<sup>84</sup> William McGrath, *D.C. Magistrate Judge Rules That Service by E-Mail of Show Cause Order on U.S. Counsel for Chinese Accounting Firm is Acceptable*, FED. SEC. L. BLOG (Feb. 1, 2012), <http://www.fedseclaw.com/2012/02/articles/sec-enforcement-cases/dc-magistrate-judge-rules-that-service-by-email-of-show-cause-order-on-us-counsel-for-chinese-accounting-firm-is-acceptable/#axzz2AbmTDbXJ>.

<sup>85</sup> *Id.*

#### **D. Extraterritorial Inspection of Chinese Auditors**

The growing interdependence of the international market has given rise to the demand for uniform regulation and enforcement. While a U.S. auditor normally signs audit reports for Chinese RMCs, the relevant work is often outsourced to its Chinese affiliates where the client operates. In the wake of the recent rash of accounting scandals, investors have no way of knowing whether audits can be relied upon. The continuing gaps in oversight of China-based audit firms put U.S. investors at risk. The grossly inadequate auditing, and the prevalent fraud, renders the building of an imminent stronger working relationship between the SEC and PCAOB and their Chinese counterparts, i.e. the Ministry of Finance (MoF) and the China Securities Regulatory Commission (CSRC). The cross-border oversight would facilitate meaningful inspection procedures and strengthen monitoring compliance with policy coordination measures. The PCAOB, the U.S. auditor watchdog, has been frustrated in searching for common ground on a joint inspection, since the CSRC has not taken action so far on the ground of the paradoxical violation of China's State Secrets Law and sovereignty.

##### **1. Subpoena Power**

Despite the extraordinarily broad subpoena power in the enabling statutes,<sup>86</sup> the SEC has encountered numerous procedural and jurisdictional hurdles endemic to litigating in China. One of the thorniest barriers is that Chinese authorities are unlikely to cooperate in seeing the U.S. court order honored. Theoretically, the power can reach beyond U.S. borders; since Longtop's shares were traded in the U.S.<sup>87</sup> The SEC could seek the court's issuance of an order compelling a deposition. Nevertheless, there is simply no way to enforce such an order upon the entity in China who refuses to comply with U.S. court proceedings. There is little that can be done if a Chinese firm declines to produce documents, unless the Chinese government chooses to cooperate. After all, ultimate delivery of a subpoena in China requires the assistance of local authorities, and there are no means to ensure that these local authorities will actually deliver a subpoena.

Although a Mutual Legal Assistance Agreement (MLAA) represents a significant milestone for bilateral cooperation in law enforcement matters,<sup>88</sup> there have been few notable examples of cooperation between China and the U.S. The MLAA itself contains a number of provisions that give both parties great flexibility to determine whether assistance should be granted or denied.<sup>89</sup> The SEC and the CSRC did sign a Memorandum of Understanding

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<sup>86</sup> Dena Aubin, *Analysis: U.S. Court Fight May not Solve Chinese Accounting Mess*, REUTERS, Sept. 13, 2011, available at <http://www.reuters.com/article/2011/09/13/us-sec-deloitte-idUSTRE78C6U220110913>.

<sup>87</sup> See *id.* Longtop's US depository shares began trading on the New York Stock Exchange (NYSE) after an initial public offering (IPO) in 2007. Press Release, SEC. EXCH. COMM'N, SEC Charges China-Based Longtop Financial Technologies for Deficient Filings (Nov. 10, 2011), available at <http://www.sec.gov/news/press/2011/2011-241.htm>.

<sup>88</sup> Agreement on Mutual Legal Assistance in Criminal Matters, U.S.-China, June 19 2000, art. 3(1)(a)-(c), T.I.A.S. 13102.

<sup>89</sup> See *id.*

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(MoU).<sup>90</sup> The MoU does not create any legally binding obligations, but rather consists largely of platitudes,<sup>91</sup> which is thus unlikely to result in the Chinese authorities ordering the production of documents. The SEC may attempt to effect service of a subpoena in China through the procedures set forth in the Hague Convention on Taking of Evidence Abroad in Civil or Commercial Matters (*Hague Evidence Convention*),<sup>92</sup> which may then add additional steps in the discovery process. However, serving a subpoena *via* the *Hague Evidence Convention* procedures may not ensure a response because China does not consider itself bound by the articles of *Hague Evidence Convention* which govern depositions.<sup>93</sup> China insists that cross-border supervision would breach its sovereignty and violate China's existing laws relating to state secrets.<sup>94</sup> The discrepancies in the two parties' approaches sets a backdrop for negotiations between U.S. and Chinese regulators.

### 2. Prohibition by Chinese State Secrecy Law

"Western markets rely [generally] upon contracts being enforced by courts and on investors, suppliers and customers all acting on the basis of audited accounts,"<sup>95</sup> while Chinese business is conducted on the basis of political and social relationships.<sup>96</sup> In China, the value of a company is tied more tightly to its relationship with the Chinese government than its investors. The legal redress may often hinge on a company's relationship with officials and thus outcomes are always uncertain.<sup>97</sup> Toward a market economy, it will more resemble the West when "the legitimacy of Chinese companies hing[es] upon their own accounts rather than their ties to the government."<sup>98</sup> This has been perfectly reflected in the case of *D&T Shanghai*. The Ministry of Commerce (MOFCOM) and the CSRC request accounting firms to report whether the firms had provided audit work papers, correspondence or other documentation concerning their audits of Chinese companies to overseas regulators.<sup>99</sup> D&T

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<sup>90</sup> Memorandum of Understanding between the SEC and CSRC Regarding Cooperation, Consultation and the Provision of Technical Assistance (April 28, 2004), *available at* [http://www.sec.gov/about/offices/oia/oia\\_bilateral/china.pdf](http://www.sec.gov/about/offices/oia/oia_bilateral/china.pdf).

<sup>91</sup> *See id.* *See also* Terms of Reference for Cooperation and Collaboration between the SEC and CSRC (May 2, 2006), *available at* [http://www.sec.gov/about/offices/oia/oia\\_bilateral/chinator.pdf](http://www.sec.gov/about/offices/oia/oia_bilateral/chinator.pdf).

<sup>92</sup> *See* Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, Mar. 18, 1970, 23 U.S.T. 2555. The treaty was negotiated in 1967-1968 and signed in The Hague on 18 March 1970. *See id.* It entered into force in 1972. China ratified the Convention on 8 December 1997. *See id.*

<sup>93</sup> Dan Harris, *How to Sue a Chinese Company. Part II. Discovery*, CHINA LAW BLOG (Nov. 9, 2010), [http://www.chinalawblog.com/2010/11/how\\_to\\_sue\\_a\\_chinese\\_company\\_part\\_ii\\_discovery.html](http://www.chinalawblog.com/2010/11/how_to_sue_a_chinese_company_part_ii_discovery.html).

<sup>94</sup> Michael Cohn, *PCAOB Makes Tentative Progress on Chinese Audit Firm Inspections*, ACCOUNTING TODAY (Sept. 24, 2012), <http://www.accountingtoday.com/news/pcaob-china-audit-firm-inspections-64051-1.html>.

<sup>95</sup> Mingyi Hung, T.J. Wong & Fang Zhang, *Chinese Financial Scandals: When It Matters*, ECONOMIST, Aug. 20, 2011, <http://www.economist.com/node/21526407>.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> Rachel Armstrong & Dena Aubin, *Exclusive: China Quizzes Audit Giants on Documents*, REUTERS, Oct. 19, 2011, *available at* <http://www.reuters.com/article/2011/10/19/us-china-accounting-idUSTRE79I16420111019>.



Shanghai's refusal was based upon the fear of repercussions for the violation of China's State Secret Laws, which forbid disclosure of "state secrets."<sup>100</sup>

It seems that D&T Shanghai was "caught in the middle of conflicting demands by two government regulators."<sup>101</sup> Arguably, Deloitte's Chinese branch is a separate legal entity that should be bound by Chinese law, but it has long benefited from its involvement in globalization and the securities institutions. The auditor should have a responsibility to exercise substantial control for the sake of audit quality conducted by its member firms in China. There is also a legal obligation for Deloitte to comply with an SEC subpoena; refusal to comply should result in serious legal consequences,<sup>102</sup> such as losing its registration with the PCAOB. An application of a China-based audit firm to become a PCAOB-registered auditor was rejected in June 2011, due largely to the PCAOB's inability to inspect such foreign-based auditors.<sup>103</sup> Judge Alvin K. Hellerstein observed that China's State Secret Law is viewed with some skepticism in U.S. courts because these laws "have broad sweep and can preclude disclosure of a host of [vaguely] defined categories of information."<sup>104</sup> "The scope and definition of state secrets ... are known to be broad and vague, and yet enforcement ... seems to have been intensified by Chinese authorities."<sup>105</sup> To say the least, any deference to State Secrets Laws should be decided by examining the facts on a case-by-case basis.<sup>106</sup> According to the State Secrets Law, only commercial information from "central enterprises", i.e. one hundred and twenty state-owned companies under the direct supervision by the State Assets Supervision and Administration (SASAC), could be classified as state secrets.<sup>107</sup> So far, there has not been an issue with the current controversies.<sup>108</sup> Evidently, this matter involves more than a private dispute between two litigants, but rather has an impact on the ostensible sovereignty issue of China.

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<sup>100</sup> Isabella Steger, *When the Auditor Meets China's 'State Secrets' Law*, WALL ST. J., Nov. 2, 2011, <http://blogs.wsj.com/deals/2011/11/02/auditing-in-china-what-construes-a-state-secret/>. A revised version of China's State Secrets Law went into effect on 1 October 2010. Laney Zhang, *China: State Secrets Law Revised*, LIBR. CONGRESS, May 7, 2010, available at [http://www.loc.gov/lawweb/servlet/lloc\\_news?disp3\\_l205401961\\_text](http://www.loc.gov/lawweb/servlet/lloc_news?disp3_l205401961_text).

<sup>101</sup> Isabella Steger, *How Should Auditors Handle China's State Secrets Law?*, WALL ST. J., Nov. 2, 2011, <http://blogs.wsj.com/chinarealtime/2011/11/02/how-should-auditors-handle-chinas-state-secrets-law/>.

<sup>102</sup> Press Release, *supra* note 72.

<sup>103</sup> Dune Lawrence & Jesse Hamilton, *Hong Kong Auditor Rejected by U.S.*, BLOOMBERG, June 10, 2011, available at <http://www.bloomberg.com/news/2011-06-09/hong-kong-auditor-rejected-by-u-s-.html>.

<sup>104</sup> *Munoz v. China Expert Tech. In.*, No. 07 Civ. 10531, 2011 WL 5346323, at\*1 (S.D.N.Y. Nov. 7, 2011).

<sup>105</sup> Jeffrey Kilduff, Seth Aronson, Bingna Guo & Yanhua Lin, *Door Opens of Discovery on Auditors of China-based U.S. Listed Companies in U.S. Securities Lawsuits*, O'MELVENY & MYERS LLP, Nov. 22, 2011, available at <http://www.omm.com/door-opens-for-discovery-on-auditors-of-china-based-us-listed-companies-in-us-securities-lawsuits-12-21-2011/>.

<sup>106</sup> *Id.*

<sup>107</sup> Stanley Lubman, *Unpacking the Law Around the Chinese Reverse Takeover Mess*, WALL ST. J., Jan. 24, 2012, <http://blogs.wsj.com/chinarealtime/2012/01/24/unpacking-the-law-around-the-chinese-reverse-takeover-mess/>.

<sup>108</sup> *Id.*

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### 3. Is sovereignty a paradoxical defence?

China's inaction on oversight is attributable to a difference in approach between Chinese and U.S. regulators. "The Chinese government has long rejected American requests to investigate Chinese auditing companies on the grounds of protecting China's sovereignty."<sup>109</sup> The demands of two governments seem to be potentially in conflict with such an issue. The U.S. regulators encounter problems trying to obtain reliable information based in China. "The SEC is wading into untested territory as it tries to compel [China-based auditors] to hand over documents."<sup>110</sup> Chinese MoF and the CSRC are reluctant to default to the PCAOB to evaluate the work of over fifty PCAOB-registered audit firms, including the affiliates of the Big Four accounting firms. They emphasize political credibility, even at the expense of transparent and accurate financial reporting. In this vein, sovereignty should not be used as a cover for inadequate financial transparency.<sup>111</sup> It is unlikely to be justified that China's national interests, in the name of sovereignty, are genuinely at stake. Theoretically, "a global economy puts a lot of limits on national sovereignty,"<sup>112</sup> and U.S. regulators must "work to convince the Chinese that conducting joint inspections of auditing firms will not infringe on China's authority."<sup>113</sup> "U.S. regulators appear to be on strong footing in a legal battle over the Chinese auditor's work paper"<sup>114</sup> so as to "resolve [the] widening international accounting mess."<sup>115</sup> The interest in obtaining D&T Shanghai's documents "far outweigh[s] China's [ostensible] secrecy interests."<sup>116</sup> The gaps render it enormously significant for U.S. and Chinese regulatory agencies to work out a protocol to resolve the controversies and put in place the joint inspections of PCAOB-registered firms.

### 4. Is a joint inspection the cure?

"As in the case of global audits themselves, reliance on high-level summaries of work performed by another regulator presents an unmitigated hand-off risk."<sup>117</sup> On February 24, 2010, the SEC issued a statement reaffirming its commitment to "the goal of a single set of high-quality global accounting standards."<sup>118</sup> These standards are vital to facilitate investor protection through intersecting and overlapping regulatory oversight of global audits.<sup>119</sup> Toward deeper cooperation for mutual benefits of the rigorous and joint auditor oversight, the

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<sup>109</sup> *Id.*

<sup>110</sup> Shalal-Esa & Lynch, *supra* note 82.

<sup>111</sup> See Lubman, *supra* note 107.

<sup>112</sup> Dena Aubin, Sarah N. Lynch & Andrea Shalal-Esa, *Exclusive: Regulators See More Meetings on China Audits*, REUTERS, Aug. 11, 2011, available at <http://www.reuters.com/article/2011/08/17/us-regulator-china-audit-idUSTRE77G4Q420110817>.

<sup>113</sup> *Id.*

<sup>114</sup> Aubin, *supra* note 86.

<sup>115</sup> *Id.*

<sup>116</sup> Shalal-Esa & Lynch, *supra* note 82.

<sup>117</sup> Doty, *supra* note 9.

<sup>118</sup> Press Release, SEC. EXCH. COMM'N, SEC Approves Statement on Global Accounting Standards (Feb. 24, 2010), available at <http://sec.gov/news/press/2010/2010-27.htm>.

<sup>119</sup> See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. EXCH. COMM'N, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 3 2012).

PCAOB and its China counterparts have been working on protocols,<sup>120</sup> thereby creating a forum that enables joint inspections to go forward the way they are in Europe.<sup>121</sup> The negotiations have not yet culminated in any agreements. The proposed joint-inspection has raised significant challenges, which virtually goes well beyond keeping PCAOB inspectors out of China. So far, the PCAOB has been “unable to convince the Chinese [regulator] to grant its inspectors the access they need to ensure that auditors are performing their duties.”<sup>122</sup> The SEC’s investigations are being stalled by their “inability to gather information in China.”<sup>123</sup> Thus, there currently is no reliable or effective tool to help U.S. regulators gather evidence from China.<sup>124</sup> Such inability has considerably **weakened investor protections in the U.S.**

Actually, China has a significant interest in curtailing the accounting scandals. Chinese RMCs have experienced a sharp decline in the securities market and “had \$4.1 billion wiped off their market value [in the first half of 2011] amid a wave of auditor resignations and fraud allegations by short-sellers”<sup>125</sup> alongside SEC and PCAOB’s investigations.<sup>126</sup> Chinese authorities need to make investors comfortable with the quality and extent of the audits.<sup>127</sup> The PCAOB’s failure to reach an inspection agreement with the CSRC may make it more difficult for Chinese companies to go public in the U.S. The listing of Chinese companies may be substantially vulnerable if the accounting firms have to withdraw.<sup>128</sup> The accounting scandals have raised the critical issue again as to whether companies, not subject to U.S. rules, should be selling shares in the U.S. It is not without concerns from U.S. courts that companies whose audit documents are outside their reach are allowed to list shares on U.S. exchanges.<sup>129</sup> Uncoincidentally, the SEC has become more

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<sup>120</sup> Sarah N. Lynch, *Audit Watchdog Aims for China Deal by Late 2012*, REUTERS, Jan. 11, 2012, available at <http://www.reuters.com/article/2012/01/11/us-pcaob-idUSTRE80A1SU20120111>.

<sup>121</sup> See EUROPEAN COMM’N INTERNAL MKT. & SERVICES DG, *PCAOB Rulemaking Docket Matter No. 027*, at 1 (Feb. 9, 2009); see also Jesse Hamilton, *U.S. Regulators Push Chinese to Resume Auditor-Inspection Talks*, BLOOMBERG, Nov. 23, 2011, available at <http://www.bloomberg.com/news/2011-11-23/u-s-regulators-push-chinese-to-resume-auditor-inspection-talks.html>.

<sup>122</sup> Lynch, *supra* note 120.

<sup>123</sup> *China Said to Discuss Allowing SEC Probes of Mainland Firms for the First Time*, BLOOMBERG, July 5, 2011, available at <http://www.bloomberg.com/news/2011-07-05/china-said-to-discuss-allowing-sec-probes-of-mainland-firms-for-first-time.html> [hereinafter “*Allowing SEC Probes*”].

<sup>124</sup> See Anna McCormack, *The United States, China, and Extradition: Ready for the Next Step?*, 12 N. Y. U. J. LEGIS. & PUB. POL’Y 445, 465-66 (2008).

<sup>125</sup> *Allowing SEC Probes*, *supra* note 123. “The Bloomberg Chinese Reverse Mergers Index, an equity index that tracks the performance of nearly 80 Chinese-based firms that have completed reverse mergers, declined in value by 44.4% in the first six months of 2011.” James C. Lin & Bonnie Chan, Davis Polk & Wardwell, LLP, Presentation at the Second Securities Law Colloquium: The Problems of Chinese Companies on US Securities Exchanges 12 (Nov. 25, 2011), available at [http://www.law.cuhk.edu.hk/research/cfred/download/CFRED's\\_Second\\_Securities\\_Law\\_Colloquium\\_Davis\\_Polk.pdf](http://www.law.cuhk.edu.hk/research/cfred/download/CFRED's_Second_Securities_Law_Colloquium_Davis_Polk.pdf).

<sup>126</sup> See PATTON BOGGS, *supra* note 23. “As a likely consequence of these compounding problems, shares of Chinese RMCs collectively fell approximately 50% during the first six months of 2011.” *Id.*

<sup>127</sup> Aubin, *supra* note 86.

<sup>128</sup> See Shalal-Esa & Lynch, *supra* note 82.

<sup>129</sup> See Aubin, *supra* note 86.

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aggressive in revoking some securities registrations of Chinese RMCs.<sup>130</sup> With its ambitious expansion into global markets for foreign financing, China cannot afford to resist such access in the longer run. It is also suggested that “Chinese auditors of financial reports used by U.S. investors ought to be subject to the same discovery obligations as an auditor here in the United States.”<sup>131</sup>

As mentioned above, at the current stage, the domestic courts are not effective tools. “Unless and until Chinese regulators and U.S. regulators agree to work cooperatively on enforcement issues, investors should not assume the same level of comfort in relying upon financial statements and disclosures of [RMCs] as they do traditional [IPOs].”<sup>132</sup> To combat the growing distrust of the reported financials of RMCs, there seems to have been only one viable option so far to toughen Exchanges’ listing standards via the SEC.

### E. New Roadblocks to Going Public through Reverse Mergers

“The PCAOB’s inability to conduct joint inspections of [China-based] audit firms weakens investor protections in the U.S. and abroad.”<sup>133</sup> The RMCs’ widespread fraudulent behaviors protrude the imminence more than ever for “increased transparency, strong risk management, and broad financial oversight.”<sup>134</sup> With an aim to restore confidence in the “embattled segment of public companies,” the Exchanges have placed tighter restrictions on RMCs prior to their listings.<sup>135</sup> SEC has subsequently approved heightened stock exchange listing standards so as to maintain fair and orderly markets.<sup>136</sup> A Chinese RMC must trade for a “seasoning period” and meet a minimum per share price requirement before being eligible for listing on the Exchanges.<sup>137</sup> The requirement for additional SEC filings is designed to strengthen investors’ confidence by improving the reliability of the reported financial statements and “aimed at increasing transparency for market participants and discouraging inappropriate behavior on the part of [RMCs] and promoters.”<sup>138</sup>

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<sup>130</sup> Client Alert, *Claims Against China-Based Reverse Merger Companies: A Tempest in a Teapot of Gunpowder or Green Tea?*, WILSON ELSEER MOSKOWITZ EDELMAN & DICKER LLP (June 2011), [http://www.wilsonelser.com/news\\_and\\_insights/client\\_alerts/649-claims\\_against\\_china-based\\_reverse\\_merger\\_companies](http://www.wilsonelser.com/news_and_insights/client_alerts/649-claims_against_china-based_reverse_merger_companies).

<sup>131</sup> Aubin, *supra* note 86 (internal quotations omitted).

<sup>132</sup> M. Norman Goldberger & Laura Krabill, *Crouching Tiger, Hidden Fraud*, 3 FIN. FRAUD L. REP. 714, 720-21 (2011).

<sup>133</sup> Doty, *supra* note 9.

<sup>134</sup> *Mind the GAAP: Chinese Companies Under Fire for Accounting Fraud*, GARDERE SEC. L. BLOG (June 21, 2011), <http://www.fromthesoxup.com/corporate-governance/mind-the-gaap-chinese-companies-under-fire-for-accounting-fraud/>.

<sup>135</sup> PATTON BOGGS, *supra* note 23.

<sup>136</sup> *Id.*

<sup>137</sup> Press Release, SEC. EXCH. COMM’N, SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies (Nov. 9, 2011)[hereinafter “SEC Approves New Rules”], available at <http://www.sec.gov/news/press/2011/2011-235.htm>.

<sup>138</sup> *U.S. Securities Law Briefing U.S. Exchanges Tighten Requirements for Listing by Reverse Merger*, LINKLATERS (Aug. 15, 2011), <http://www.linklaters.com/pdfs/mkt/newyork/A13860971.pdf> (last visited Mar. 3, 2012).

## 1. Seasoning Period

“A ‘seasoning period’ would lead to an increased likelihood that a [RMC] has ‘a more *bona fide* shareholder base,’ and will help assure that the initial listing bid price was not obtained through manipulative trading practices.”<sup>139</sup> Chinese RMCs cannot be listed unless they have filed audited financial statements covering at least a full fiscal year, commenced after the filing of specified initial documentation.<sup>140</sup> The applying RMC must complete a “one-year ‘seasoning period’ by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following the [consummation of the] reverse merger.”<sup>141</sup> The new rules are intended to provide investors with easier access to financial reports issued by RMCs. All material information will have been made public and simultaneously demonstrate the RMC’s ability to meet its filing and disclosure obligations. This period will also “allow for additional market and regulatory scrutiny of [the RMCs]”<sup>142</sup> and provide time to detect and address any potential financial irregularities or internal control weaknesses that “could otherwise preclude listing eligibility.”<sup>143</sup> “Such [a] period will provide greater assurance that the [RMCs’] SEC reports are accurate and reliable since auditors and the company will have reviewed at least several quarters of the company[ies’] operating results prior to listing.”<sup>144</sup> Furthermore, “the seasoning period will increase the integrity of the [RMCs’] financial and operations related reporting and allow auditors and company management to adequately evaluate and address accounting irregularities and internal controls deficiencies.”<sup>145</sup>

## 2. Minimum Stock Price

The RMC must maintain a requisite minimum share price for a sustained period of at least 30 of 60 trading days immediately before its listing application and the Exchange’s subsequent decision to list the company.<sup>146</sup> This is intended to “make it more difficult for [RMCs] to devise [quick and] manipulative schemes to inflate their stock price for purposes of meeting the Exchanges’ minimum share price requirements.”<sup>147</sup> The minimum stock price requirement generally does not apply if the RMC has satisfied the “seasoning period” requirement and “has filed at least four annual reports with the [SEC] which each contain all

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<sup>139</sup> Michael L. Zuppone, Yariv C. Katz & Keith C. Gartner, *NYSE and Nasdaq Propose Additional Listing Requirements for Reverse Merger Companies*, PAUL HASTINGS 5 (Sept. 2011), <http://www.paulhastings.com/assets/publications/2002.pdf>.

<sup>140</sup> *Id.* at 3.

<sup>141</sup> *SEC Approves New Rules*, *supra* note 137.

<sup>142</sup> Zuppone, Katz & Gartner, *supra* note 139, at 1.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at 5.

<sup>145</sup> *Id.* at 1.

<sup>146</sup> Spencer G. Feldman, *SEC Approves Additional Listing Requirements for Reverse Merger Companies*, NAT’L L. REV. (Nov. 18, 2011), <http://www.natlawreview.com/article/sec-approves-additional-listing-requirements-reverse-merger-companies>.

<sup>147</sup> Mike Gorback & Teresa Pahl, *SEC Approves Heightened Stock Exchange Listing Standards for Reverse Merger Companies*, HANSON BRIDGETT BUS. PRAC. GROUP 3 (Nov. 2011), <http://www.hansonbridgett.com/~media/Files/Publications/Business-alert-SEC-approves-2011-11-11-.pdf>.

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required audited financial statements for a full fiscal year.”<sup>148</sup> Notably, even if a company meets these requirements, the Exchanges may nevertheless deny listing based on their authority to apply additional or more stringent criteria in order to maintain the quality of and public confidence in the market, to prevent fraud and manipulation.<sup>149</sup> The Exchanges reserve such an authority at their discretion and even deny listings based on a case-by-case basis upon disclosure of a material weakness in RMCs’ internal controls. The heightened listing standards are consistent with the provision of the Securities Exchange Act of 1934, requiring that the rules of the national stock exchanges be designed to prevent fraudulent and manipulative acts and practices, and to generally protect investors and the public interest.<sup>150</sup> The Exchanges’ discretionary powers are conducive to promoting just and equitable principles of trade, and to protecting investors.

### 3. Impact on Chinese RMCs

The additional requirements provide more transparency and reduce the level of risk, serving as a roadblock for, and deterring, suspicious transactions. The proactive measures help reinstate public confidence among potential investors by creating “reliable reporting track records.”<sup>151</sup> Meanwhile, the new rules “raise the level of regulatory security on RMCs] and delay their access to U.S. exchanges.”<sup>152</sup> In substance, they reduce the benefits traditionally associated with going public through a reverse merger, i.e. greater speed and lesser expenses, and thus “reduce the ease of accessibility to U.S. markets through a reverse merger.”<sup>153</sup> There might be some concern about losing Chinese firms to another stock market, but this would not result in granting exemption from higher listing standards. However, the reverse merger will continue to be a viable alternative for Chinese companies seeking access to capital markets in the West. Some brokers are even attempting to get Chinese firms into Europe, such as in Germany and the United Kingdom. China’s weak corporate governance practices may be exported to the foreign listing environment.<sup>154</sup> The additional criteria, which came at a time of heightened scrutiny, would adequately protect investors with respect to RMCs’ potential dangers. Subject to a more robust legal regime, Chinese RMCs should be cognizant of these enhanced rules and thus need to manage their accounting books according to higher standards. Failure to conduct adequate due diligence could expose them to unnecessary risks. Put differently, the RMCs should be well aware “of the risks they face and more honest about their financial statements.”<sup>155</sup> “Their reports must fairly present their

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<sup>148</sup> Notice and Order Granting Accelerated Approval to Propose Rule Change, as Modified by Amendment No. 2, Exchange Act Release No. 34-65709, 9 (Nov. 8, 2011).

<sup>149</sup> NAT’L ASS’N SEC. DEALERS, MARKETPLACE RULES, RULE 4330(a)(3) (2012).

<sup>150</sup> Securities and Exchange Act of 1934 § 6, 15 U.S.C. §78f(b)(5) (2010).

<sup>151</sup> Zuppone, Katz & Gartner, *supra* note 139, at 5.

<sup>152</sup> SEC Announces Tighter Listing Standards for Companies Seeking to Enter the U.S. Market Through Reverse Mergers, WINSTON & STRAWN LLP (Nov. 2011), [http://www.winston.com/siteFiles/Publications/SEC\\_Reverse\\_Merger\\_11\\_18\\_11\\_v2.pdf](http://www.winston.com/siteFiles/Publications/SEC_Reverse_Merger_11_18_11_v2.pdf).

<sup>153</sup> *Id.*

<sup>154</sup> See generally CURTISS J. MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM: WHAT CORPORATE CRISIS REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD 125-148 (2008).

<sup>155</sup> Fry, *supra* note 8.

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financial position...[and both] deficiencies and material weaknesses in internal controls.”<sup>156</sup> Nevertheless, the inherently troubling issue still remains as to how the Exchanges can adequately confirm the accuracy of those Chinese affiliates’ audits if the U.S. regulators are denied access to accounting information on the RMCs that may have engaged in fraudulent conduct. It remains to be seen whether these heightened listing standards will eliminate the alleged fraudulent and manipulative practices that have been committed by the RMCs.

### CONCLUSION

Many Chinese companies have been increasingly pursuing a reverse merger so as to facilitate its access to the capital markets in a manner that is perceived as quicker and less costly than a traditional IPO. It allows Chinese companies to avoid the scrutiny of their finances and operations, and to avoid having its prospectus reviewed by the SEC. Since RMCs have not typically been subjected to the enhanced scrutiny associated with an IPO, concerns have arisen about the accuracy of the RMC’s financial statements. Some auditors for Chinese RMCs resigned because of concerns about management misrepresentations and falsified audit documentation. Thus, Chinese RMCs have been targeted by regulators, as well as investors, for purported securities and accounting fraud. The existing rules aimed at ensuring the eligibility of companies for listing are not adequate and have failed to protect investors from huge risks. Due to the ostensible sovereignty issue and conflicts with China’s State Secrets Law, the PCAOB remains unable to inspect auditors that perform or participate in audits of companies that access capital through U.S. markets, but reside in China. As a gaping hole in investor protection, the lack of joint inspection has caused significant concerns for Chinese companies attempting to go public by way of a reverse merger. The greatest solution probably lies with improving the Exchanges’ listing standards. The new rules establish more rigorous conditions that companies, going public through a reverse merger, must meet before they can be listed on the three major U.S. exchanges. Chinese RMCs must wait for a one-year seasoning period to elapse and maintain a minimum share price for a sustained period of time before they are permitted to list on a U.S. exchange. These additional requirements are designed to strengthen investors’ confidence in, and ability to rely upon, RMCs’ audited financial statements. Perhaps the combination of stricter listing requirements, enhanced SEC watchdog efforts, and increased investor scrutiny will be all that is needed to fix the problem. Only time will tell whether these proposed solutions will succeed in reducing the instances of fraudulent reverse merger companies.

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<sup>156</sup> *Id.*