

CORNERSTONE RESEARCH

ECONOMIC AND FINANCIAL CONSULTING AND EXPERT TESTIMONY

# Investigations and Litigation Related to Chinese Reverse Merger Companies

Financial, Economic, and Accounting Questions

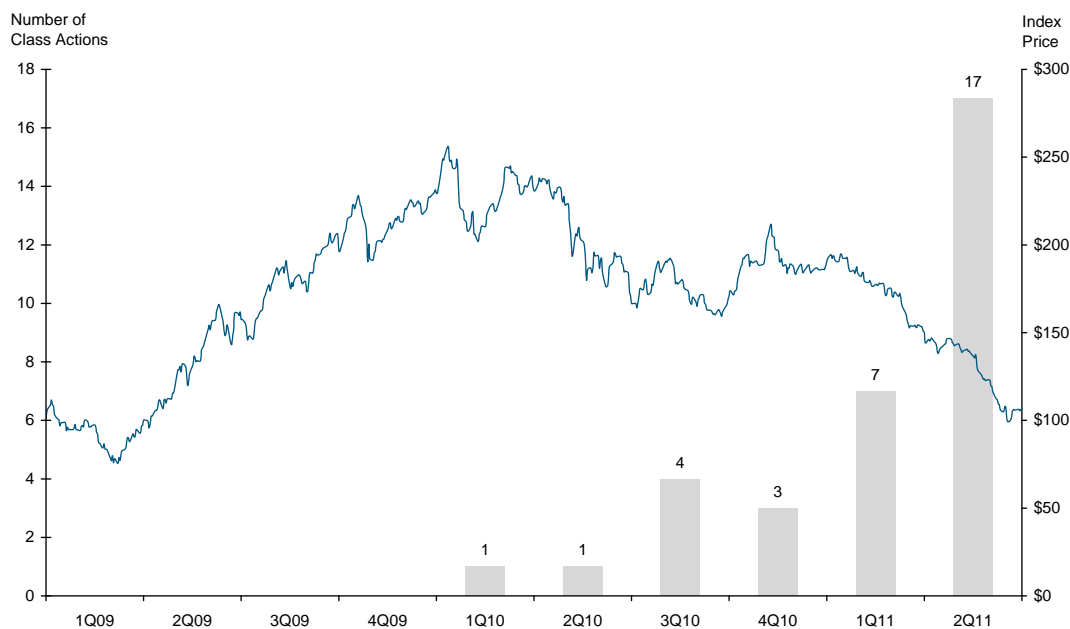


## INVESTIGATIONS AND LITIGATION RELATED TO CHINESE REVERSE MERGER COMPANIES

Shares of Chinese reverse merger companies (CRMs) listed on U.S. exchanges have fallen almost 50 percent<sup>1</sup> in 2011 as CRMs have come under increased scrutiny from U.S. regulators. The Securities and Exchange Commission (SEC) has issued an investor warning<sup>2</sup> related to the accounting and disclosure practices of CRMs, and the Public Company Accounting Oversight Board (PCAOB) has published a research note identifying potential concerns in audits performed by U.S.-registered accounting firms.<sup>3</sup> The SEC has also launched a number of investigations against and suspended trading in some CRMs.<sup>4,5</sup> Many of these companies are also being named in shareholder class actions.

Since the beginning of 2010, plaintiffs have filed at least 33 securities class actions alleging violations of Section 10(b), Rule 10b-5, or Section 11 in matters involving CRMs.<sup>6</sup> For the CRMs named in these complaints, the aggregate market capitalization decline during the putative class periods was greater than \$8 billion, and the average market capitalization decline was \$250 million. Seven out of the 33 complaints name an investment bank as codefendant, including five complaints that allege violations of Section 11.

QUARTERLY NUMBER OF CHINESE REVERSE MERGER CLASS ACTIONS  
AND BLOOMBERG CHINESE REVERSE MERGERS INDEX  
2009–2011 H1



Source: Cornerstone Research, *Securities Class Action Filings—2011 Mid-Year Assessment*; Bloomberg

Since the beginning of 2010, plaintiffs have filed at least 33 securities class actions in matters involving CRMs.



## BACKGROUND ON CHINESE REVERSE MERGERS

The SEC defines a reverse merger (also known as a reverse takeover or RTO) as one in which an existing public shell company acquires a private company.<sup>7</sup> As a result of the acquisition, the private company's shareholders gain a controlling interest in the public shell company. The private company, in effect, becomes the SEC reporting entity with registered securities and thus can access U.S. capital markets.


A number of Chinese companies have used reverse mergers to access U.S. capital markets. Between January 2007 and March 2010, only 56 Chinese companies accessed U.S. capital markets through an initial public offering,<sup>8</sup> compared with an estimated 150 companies that gained access via a reverse merger.<sup>9</sup> Roughly two-thirds of these CRMs have stock traded on the OTC Bulletin Board, and the others are listed on NASDAQ or the NYSE.<sup>10</sup>

As SEC reporting companies with registered securities, CRMs are required to file audited financial statements with the SEC, and their auditors are required to be registered with the PCAOB. Typically, CRMs employ a U.S.-registered accounting firm as their auditor.<sup>11</sup> The audit practices of these accounting firms in conducting CRM audits and the accuracy of the audited financial statements issued by CRMs have been questioned by regulators and investors.

In July 2010, the PCAOB issued "Staff Audit Practice Alert No. 6" that highlights emerging trends in work performed for CRM clients by U.S.-registered accounting firms.<sup>12</sup> The alert noted that some accounting firms may not be conducting audits of CRMs in accordance with PCAOB standards, chiefly AU 543, "Part of Audit Performed by Other Independent Auditors" (AU 543). According to the PCAOB, this section establishes requirements that apply when an auditor uses the work and reports of other independent auditors or contractors.

In summer 2010, the SEC also began investigating the audit practices of Moore Stephens Wurth Frazer & Torbett, LLP (MSWFT), a U.S.-registered PCAOB accounting firm that had several CRM clients. In December 2010, the SEC issued a cease and desist order against MSWFT after finding the company had failed to follow applicable professional standards, including PCAOB standards, in reviewing the financial statements of China Energy Savings, Inc., a CRM.<sup>13</sup>

Following this SEC order, more than 24 CRMs announced auditor resignations, most of which were U.S.-registered auditors.<sup>14</sup> The SEC, NASDAQ, and the NYSE have suspended trading, halted trading, or delisted the securities of at least 29 CRMs citing, among other reasons, public interest concerns, removal of audit opinions, failure to respond to information requests, failure to comply with SEC requirements, and failure to evidence compliance with initial listing standards.<sup>15</sup> On June 9, 2011, the SEC issued an investor bulletin warning investors of the potential risks of investing in CRMs.<sup>16</sup>



Between January 2007 and March 2010, an estimated 150 Chinese companies gained access to U.S. capital markets via a reverse merger.

## QUESTIONS ARISING IN INVESTIGATIONS AND LITIGATION RELATED TO CHINESE REVERSE MERGERS

Below, we outline and address some of the questions that may arise in CRM-related SEC investigations and securities litigation and that require economic, statistical, and accounting analysis, and knowledge of industry customs and practices.

### Are the CRM-related securities traded in efficient markets?

In Section 10(b) claims, plaintiffs typically allege classwide reliance through a fraud-on-the-market claim. This claim requires that the CRM-related security trade in an efficient market. Whether the market is efficient is a rebuttable presumption that, given the securities involved, may warrant further investigation. For example, CRM-related securities may not be followed by many analysts, may experience low trading volume, or may be associated with few market-makers. In addition, CRM-related securities may exhibit other indicia of trading in an inefficient market.

### Are shareholder losses caused by the alleged misrepresentations?

In Section 10(b) and Section 11 claims, causation plays a central role in assessing alleged damages. Typically, an analysis of loss causation in a fraud-on-the-market claim under Section 10(b) examines the price change when the alleged truth is revealed to the market. Alternatively, an analysis of negative causation under Section 11 begins with an examination of any price decline occurring prior to the alleged truth being revealed to the market.

According to some participants, there has been a market adjustment in the pricing of risk of Chinese stocks in general.<sup>17</sup> Careful economic and statistical analyses may be required to distinguish share price declines caused by the alleged fraud from general market or industry declines related to any general perception of fraud among China-related stocks. Analysis may also be required to separate the impact of short-sellers and press reports of unsubstantiated rumors posted on Internet bulletin boards on the price of CRM-related securities from the effects of the alleged fraud.<sup>18</sup>

### Did investment bankers perform a reasonable level of due diligence in these transactions?

A number of complaints list investment banks as codefendants. According to plaintiffs, these investment banks knowingly permitted false and misleading statements to be made in offering-related documents, including revised registration statements or prospectuses. Analysis that compares industry customs and practices with those applied to a CRM in question often plays an important role in assessing the conduct of the bank.

### Did the U.S.-registered auditor comply with PCAOB standards in performing its audit function?

The PCAOB has reported that post-merger, the public company frequently dismisses the auditor of the former shell company and retains the Chinese operating company's auditor, often a U.S. accounting firm.<sup>19</sup> In some situations, the U.S. auditor will engage the services of another firm to perform part of the audit. AU 543 governs the degree of reliance that U.S. auditors can place on the work and reports of other independent auditors. In brief, a firm cannot serve as principal auditor and report as such on the financial statements unless the firm's participation in the audit is sufficient.<sup>20</sup> Analysis that compares industry customs and practices with those applied to CRMs is often required to determine whether the degree of reliance was consistent with the regulatory requirement.

### Did the CRMs publish audited financial statements in accordance with GAAP?

Like other SEC registrants, CRMs are required to file audited financial statements with the SEC, and the auditors of those statements are required to certify that the statements are prepared in compliance with U.S. generally accepted accounting principles (GAAP). However, since CRMs are headquartered and operated in the China region, their existing accounting policies and systems in many cases are designed to comply with Chinese GAAP. Translating accounting reports and disclosures from non-U.S. to U.S. GAAP can introduce significant complexity into issues of GAAP compliance for CRMs. A deep understanding of the different accounting standards and the processes for mapping one set of accounts to the other is often necessary to determine whether the accounts published in the United States are compliant with U.S. GAAP.

## ENDNOTES

- 1 See, for example, Bloomberg Chinese Reverse Mergers Index (ticker symbol: CHINARTO).
- 2 *SEC Investor Bulletin: Reverse Mergers*, June 9, 2011.
- 3 “Activity Summary and Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010,” PCAOB, Research Note #2011-P1, March 14, 2011 (PCAOB Note 2011).
- 4 A definitive determination of whether a Chinese-based company is a CRM may require a meaningful review of multiple documents, including those related to the merger and the current registration status. For the purposes of this report, Cornerstone Research has compiled a database of potential CRMs based on research that is ongoing and subject to change.
- 5 The SEC has launched investigations into the disclosure practices of at least 17 CRMs, including (1) China Sky One Medical (CSKI), (2) Fuqi International (FUQI), (3) Rino International Corporation (RINO), (4) China Green Agriculture (CGA), (5) Duoyuan Printing (DYNP), (6) China Century Dragon (CDM), (7) China Intelligent Lighting & Electronics (CIL), (8) China Expert Technology, Inc. (CXTE), (9) China 9D Construction Group (CNAG), (10) China Media1 Corp. (CMDA), (11) China Digital Media Corporation (CDGT), (12) China Mineral Acquisition Corp. (CMAQU), (13) China Technology Global Corp. (CTGLE), (14) China Yuchai International Limited (CYD), (15) Greater China Corp. (GCHC), (16) China Continental, Inc. (CHCL), and (17) China Energy Savings Technology, Inc. (CESV) (see, for example, <http://sec.gov/litigation/admin.shtml>). The SEC has suspended trading in at least six companies, including (1) Heli Electronics Corp. (HEL), (2) China Changjiang Mining & New Energy Co. (CHJI), (3) RINO International Corporation (RINO), (4) Advanced Refractive Technologies (ARFR), (5) HiEnergy Technologies, Inc. (HIET), and (6) Digital Youth Network Corp. (DYOUN) (see *SEC Investor Bulletin: Reverse Mergers*, June 9, 2011).
- 6 For additional discussion of securities class actions associated with CRMs, see page 13 of Cornerstone Research’s *Securities Class Action Filings—2011 Mid-Year Assessment* (see <http://www.cornerstone.com/securities>).
- 7 See, for example, *SEC Investor Bulletin: Reverse Mergers*, June 9, 2011, and SEC Release No. 33-8587, July 15, 2005.
- 8 PCAOB Note 2011, p. 3.
- 9 *Ibid.*, p. 4.
- 10 According to PCAOB Note 2011, 101 CRMs traded on the OTC Bulletin Board and 49 were listed (as of the time of publication) on NASDAQ or the NYSE.
- 11 According to PCAOB Note 2011, 74 percent of CRMs hired U.S.-registered accounting firms to perform their audit work in association with SEC disclosure requirements.
- 12 See “Staff Audit Practice Alert No. 6: Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm,” PCAOB, July 12, 2010.
- 13 Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission’s Rules of Practice, Making Findings, and Imposing Remedial Sanctions and A Cease-and-Desist Order, *In the Matter of Moore Stephens Wurth Frazer & Torbett LLP and K. Dean Yamagata, CPA*, December 20, 2010.
- 14 “SEC Digs Deep in Long March to China,” *Business Law Currents*, June 1, 2011. In some cases, the CRM issuer is alleged to have “fired” the auditor over disagreements related to the quality of the audited financial statements.
- 15 The SEC had suspended trading in at least six companies. See endnote 5. NASDAQ has halted trading or delisted securities in at least 15 additional companies: (1) China Electric Motor, Inc. (CELM), (2) China Integrated Energy, Inc. (CBEH), (3) China Ritar Power (CRTP), (4) Harbin Electric, Inc. (HRBN), (5) Jiangbo Pharmaceuticals, Inc. (JGBO), (6) ShengdaTech, Inc. (SDTH), (7) Wonder Auto Technology, Inc. (WATG), (8) Subaye, Inc. (SBAY), (9) Keyuan Petrochemicals (KEYP), (10) China Agritech, Inc. (CAGC), (11) China MediaExpress Holdings, Inc. (CCME), (12) China-Biotics, Inc. (CHBT), (13) Fuqi International, Inc. (FUQI), (14) Yuhe International, Inc. (YUII), and (15) New Oriental Energy & Chemical Corporation (NOEC), (see <http://www.nasdaqomxtrader.com/Trader.aspx?id=TradeHalts>; public press). NYSE (including NYSE Amex) has halted trading, suspended trading, or delisted securities in at least eight additional companies: (1) HQ Sustainable Maritime Industries, Inc. (HQS), (2) NIVS IntelliMedia Technology Group, Inc. (NIV), (3) Puda Coal, Inc. (PUDA), (4) Universal Travel Group (UTA), (5) China Century Dragon Media, Inc., (6) China Intelligent Lighting and Electronics, Inc. (CIL), (7) Duoyuan Global Water Inc. (DGW), and (8) Duoyuan Printing, Inc. (DYNP) (see <http://www.nasdaqomxtrader.com/Trader.aspx?id=TradeHalts>; public press).
- 16 *SEC Investor Bulletin: Reverse Mergers*, June 9, 2011.
- 17 “Longtop Short-Sellers Show Mistrust Hurts China IPO Market,” Bloomberg, May 18, 2011.
- 18 See, for example, “The View from Hong Kong: Chinese Firms Need to Open Up,” *The Wall Street Journal*, June 20, 2011, and “Muddy Waters Research Is a Thorn to Some Chinese Companies,” *The New York Times*, June 9, 2011.
- 19 PCAOB Note 2011, p. 6.
- 20 AU 543, “Part of Audit Performed by Other Independent Auditor.”

**Boston**

617.927.3000

**Los Angeles**

213.553.2500

**Menlo Park**

650.853.1660

**New York**

212.605.5000

**San Francisco**

415.229.8100

**Washington**

202.912.8900

[www.cornerstone.com](http://www.cornerstone.com)

© 2011 by Cornerstone Research, Inc.  
All Rights Reserved. Cornerstone  
Research is a registered service mark  
of Cornerstone Research, Inc. C logo  
and design is a registered trademark of  
Cornerstone Research, Inc.

