TheStreet

SEC Probes China Stock Fraud Network

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NEW YORK (TheStreet) -- The **Securities and Exchange Commission** is investigating allegations that U.S. firms and individuals have joined with partners in China to steal billions of dollars from American investors through stock fraud, according to people familiar with the probe.

Individuals with direct knowledge of the investigation say that the SEC is focusing on stock promoters, investment bankers, auditors and law firms that have been active in recruiting Chinese companies to U.S. stock exchanges and raising capital for those companies by selling new shares.

On Monday, the SEC made an example of an auditing firm that it said had failed to protect U.S. investors from overstatement of revenue by a Chinese firm. The commission said it had reached a settlement with the firm -- Moore Stephens Wurth Frazer & Torbet -- and with Kelly Dean Yamagata, a partner. As part of the settlement, the firm will be temporarily barred from accepting new auditing assignments in China and will pay $129,500.

The case relates to audits the firm did for China Energy Savings Technology, a China-based company that has been the focus of a series of SEC fraud complaints since 2006.

John Heine, a spokesman in the SEC's public affairs office, would neither confirm nor deny a new investigation, citing agency policy against commenting on active investigations. But the questions that SEC investigators are asking hint at their direction. Those questions suggest a suspicion that stock manipulators have devised a kind of template for stock fraud -- one that exploits fundamental weaknesses in the regulatory apparatus of the two countries -- and now use the template to cheat investors in deal after deal.

Word of an SEC probe surfaced during the course of a three-month analysis by *TheStreet*, which included interviews with scores of investment professionals focused on China stocks, together with reviews of SEC documents, company statements and market data. Some of the same sources later provided information to the SEC.

Of special concern to the commission is a class of company brought public in the U.S. through a back-door process known as a reverse merger, sources directly involved in the investigation have told *TheStreet*.

Recently, many reverse merger companies have been buffeted by a series of allegations of fraud. The allegations have had repercussions across the sector. Investors in the U.S. have suffered related losses in excess of $34 billion, a review by analysts at *TheStreet* showed. That total adds up all the market-cap losses for 150 stocks that appear to have been used to bring Chinese companies to U.S. exchanges. The list of 150 included stocks damaged by association with such allegations as well as those directly implicated. Losses were measured from a stock's peak price at any time over the past five years to its present price.

Over the past year, the SEC has received multiple calls for investigation of fraud among China-based stocks. Many investment professionals believe an investigation is due. One is Peter Humphrey, a corporate investigator and due-diligence expert based in Beijing. Humphrey estimates that as many as a third of Chinese companies listed on major U.S. exchanges -- the Nasdaq, Amex and **New York Stock Exchange** -- are likely reporting fictional profits. He said he bases that estimate on due diligence research done for clients and on discussions with client, in connection with acquisitions and investments in Chinese companies. If the estimate is wrong, it's likely too low, Humphrey says.

While investors who own individual stocks have the greatest exposure to the type of fraud alleged, millions of other American investors also are at risk, through investments in China-oriented ETFs and mutual funds.

To be sure, many Chinese small-cap companies have established the strength of their businesses with financial statements that withstand the tough scrutiny of investment professionals. But frequently lack of transparency and full disclosure -- along with the formidable barriers of language, distance and culture -- make it difficult for individual investors to tell the good from the bad.

Concern about a lack of protection for U.S. investors prompted Congress to ask the SEC for action earlier this year.

In a letter dated Sept. 9, the House Financial Services Committee complained about a general lack of rigor in the auditing of Chinese companies. Addressed to SEC Chair Mary Schapiro and her counterpart at the Public Company Accounting Oversight Board, the letter asked how the agencies planned to tackle the problem.

"American investors deserve high-quality and independent financial reporting so that all market participants can trust the accuracy of the audit work for U.S. publicly-traded companies," the letter said. It was signed by Reps. Chris Lee of New York and Spencer Bachus of Alabama, who will take up his new role as chairman of the Financial Services Committee in January. The rest of the letter communicated a broad concern about fraud among China-based companies.

Until now, many investors buying China-based stocks traded on U.S. exchanges have felt abandoned by regulators.

To date, Wall Street has seen only one major SEC prosecution in the sphere. That was the case of China Energy Savings Technology -- the subject of yesterday's action.

Three China-based reverse merger companies so far have disclosed current SEC investigations: **China Sky One Medical**(CSKI), **Fuqi International**(FUQI) and **Rino International**(RINO). China Sky One Medical has conceded inaccuracies in filings in China in a press release. Fuqi has received a delisting notice from the **Nasdaq**, but has not yet been delisted. Rino recently admitted that some of its claims about contracts were false, and Nasdaq has delisted that stock. China Sky One and Rino declined to comment for this article. Through a spokesman, Fuqi said it is "fully cooperating with the SEC" and that it has no further comment.

Sources with knowledge of the current SEC investigation say that the commission has shown interest in at least six additional companies. The agency's interest is not focused narrowly on individual cases, informed sources have told *TheStreet*. Rather, enforcement officials seem to view individual cases as manifestations of a systemic problem.

Reverse mergers -- sometimes called reverse takeovers, or RTOs -- are perfectly legal in the U.S., and have been used in the past to give birth to solid public companies, including the parent company of the New York Stock Exchange itself. If there is a flaw in the process, the flaw is that it allows stock manipulators to circumvent regulatory scrutiny.

The process is complex. First, the sponsors find a Chinese company with a plausible growth story and sell the founders on the idea of raising capital in the U.S. They then gain control of a U.S. company that is little more than a shell, but a living shell, with stock that remains listed on a public exchange in the U.S. The U.S. company buys the Chinese company, essentially taking the Chinese company public in the U.S. with little regulatory oversight. The sponsors and company founders can then use optimistic growth projections to float new issues of stock among American investors eager to participate in the economic miracle of China.

Frequently the prime movers in the process are Chinese, and never leave China. They enlist the help of bankers, auditors and stock promoters in the U.S. with promises of huge profits in the event of success. Often, the promoters -- some Chinese and some American -- are bailing out just as the public gets in.

The SEC is focusing its investigative efforts on the American end of the network. The agency lacks the power to compel compliance with subpoenas in China -- a fact that has not escaped the notice of dealmakers in China.

A distance of 8,000 miles, together with formidable language and cultural barriers, makes it tough for any investor to get to the bottom of a business scenario in China. Even sophisticated investment professionals spending millions on due diligence have been duped. For the moment, the frequent lack of transparency between the two countries is seen as camouflage for stock cheats. But recurring allegations of fraud and new stock blow-ups have raised questions about the reliability of accounting practices at China-based companies generally.

Some well-known blow-ups suggest the character of the broader problem:

China Energy Savings Technology: This company -- the focus of yesterday's SEC action -- billed itself as a manufacturer of "energy savings products." It agreed to sell $50 million in stock through a PIPE (private investment in a public equity) in January 2006 and soon registered to sell 10 million additional shares in a public offering. A month later, the company disclosed that the SEC had opened an "informal" inquiry into its operations. Within weeks, many of the top people in the company resigned -- directors, executives, all the key participants -- and the company went dark in China, SEC records show. In April, 2009, the SEC obtained judgments finding four of the principals liable for fraud, on the basis that they had used a phony shareholder base and phony stock transactions to boost the price of stock that was essentially worthless, pocketing more than $25 million from American investors. The judgments ordered them to disgorge their profits and to pay penalties. The company is defunct.

Bodisen Biotech(BBCZ): This maker of organic fertilizers saw its shares delisted from the American Stock Exchange in March 2007, partly based on alleged inaccuracies in its filings regarding the role of stock promoter Benjamin Wey, president of New York Global Group. Shareholders filed lawsuits accusing Bodisen of securities fraud, but their complaints were dismissed. Wey has claimed that irresponsible short-sellers sent the company into a tailspin. The stock peaked at about $20 in 2006. Its OTC shares traded recently at about 50 cents. Bodisen did not respond to requests for comment.

Shanghai Medical Technology: This operator of dialysis clinics raised $12.5 million in a 2007 PIPE deal. The money never made it to the clinics -- it was transferred instead to the personal account of one of the company's directors, according to a source involved in the deal. The company appears to be defunct. Multiple attempts to reach company officials were unsuccessful.

Fuwei Films(FFHL): This manufacturer of industrial plastic films went public in 2006 through an IPO on Nasdaq. In 2009, the company disclosed that three executives had been convicted in China on charges that they had illegally taken control of the business there. Shareholders alleged in a lawsuit that Chinese authorities were investigating the hijacking of the company while stock promoters in the U.S. hyped the new issue. The suit charged that company officials had provided false and misleading informaton relating to the company's IPO. One of the executives arrested in China has been sentenced to death there, and the two others to life imprisonment, the company has said. In September, Fuwei and its co-defendants -- senior officials and directors of the company -- settled the shareholder suit, agreeing to pay $2.15 million. Fuwei still maintains that the allegations in the suit are "without merit." The stock, as high as $15 in 2006, now trades around $2.

China Yingxia(CYXI): This health-food company was founded by a nurse-turned-entrepreneur. It reached a market cap of more than $900 million and then in 2009 stopped filing statements to the SEC. Information remains scarce, but according to one person familiar with the company, the nurse is now in jail in China for selling unregistered securities to individuals there, a violation of the country's securities laws. Attempts to reach the company were unsuccessful.

Asia Time(TYM): This watchmaker started trading on the American Stock Exchange at $8.50 a share in February 2008. Without warning, the company stopped filing SEC statements a year later, prompting the Amex to delist its stock. It occasionally trades on the Pink Sheets and last traded Nov. 26 for a penny. Attempts to reach the company were unsuccessful.

China Water & Drinks: This bottled-water company merged into a U.S.-listed shell in 2005. Two years later, it was acquired by a special-purpose acquisition company run by Richard Heckmann, a veteran U.S. investor based in Southern California. Four months after the deal closed, Heckmann charged -- a charge repeated in court papers -- that the Chinese CEO had embezzled millions of dollars and that the company's customer list was mostly fiction. The CEO has denied the charges and countered with a lawsuit claiming Heckmann owes him millions of shares of stock.

In some quarters, China-based stocks are now discussed with near scorn. Famed hedge-fund manager Jim Chanos, who uncovered the accounting fraud at **Enron** nearly a decade ago, says that accounting irregularities are more the norm than the exception at the Chinese companies researched by his firm, **Kynikos Associates**.

Chanos has been a vocal critic of China stocks. During an investment conference in New York in October, Chanos argued that investment bankers with strong links to China tend to view U.S. investors as a short-term source of capital, not as long-term partners. Chanos has described Chinese stocks as a "short seller's dream."

The SEC's interest follows a host of damaging accusations by short-sale investors -- those who sell borrowed shares and later profit from a decline in a stock's price. The shorts routinely publish damaging research on the Internet, sometimes causing steep declines in the prices of stocks and occasionally provoking charges of stock manipulation from investors with long positions in those same stocks.

As one Chinese small-cap after another has imploded, the resulting profits have allowed short investors to redouble their efforts. They have been developing databases, scheduling regular trips to China, and hiring experts in forensic accounting.

Their work has been aided by the adroit use of computer technology. Where cultural, language, and legal barriers have prevented U.S. regulatory authorities from knitting together a complete picture of a company's activities, the shorts have succeeded, on occasion, using Internet portals and emails to obtain photocopies of documents filed with Chinese authorities, then comparing those documents with documents filed in the U.S.

Short investors often get embroiled in heated public debates with long investors who are betting on the success of the Chinese companies whose shares they own. Defenders of Chinese investment opportunities caution that fraud and stock blow-ups are common in any volatile sector, often coinciding with exciting growth stories.

"We've had less fraud with Chinese companies than we've had with similar-sized U.S. companies," says Peter Siris. Siris runs **Guerrilla Capital**, a hedge fund. The fund has invested in some 150 Chinese businesses that have come public on America exchanges, many through reverse mergers.

Siris argues that a lot of the accusations percolating through the sector have been trumped up by short investors to increase the value of their own positions. He concedes that inexperienced Chinese executives have made what he calls innocent mistakes as they learn how to become good corporate citizens in the U.S.

Crocker Coulson, whose investor-relations firm represents some 50 Chinese companies, acknowledged that there has been financial chicanery by some reverse merger companies. Coulson said that the attention given to the bad seeds is overblown and that "people have seized on that to go out and attack high-quality companies that have done nothing wrong -- on thin evidence." Coulson and many others on Wall Street have faith that the Chinese economy will continue to reward investors with rapid growth.

Lawyers experienced in the litigation of securities fraud cases believe that the current investigation by the SEC could well come to nothing in the end, leading into the same quagmire that has frustrated a lot of American investors. Ultimately, the truth about the operations of Chinese companies lies in China, where U.S. regulators lack authority.

-- Reported by Scott Eden and Robert Holmes in New York