

2012

Funding Entrepreneurial Ventures in China: Proposals to More Effectively Regulate Chinese Foreign Private Issuers

Alexander E. Csordas

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/bjil>

Recommended Citation

Alexander E. Csordas, *Funding Entrepreneurial Ventures in China: Proposals to More Effectively Regulate Chinese Foreign Private Issuers*, 38 *Brook. J. Int'l L.* (2012).

Available at: <https://brooklynworks.brooklaw.edu/bjil/vol38/iss1/10>

This Note is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Brooklyn Journal of International Law by an authorized editor of BrooklynWorks.

FUNDING ENTREPRENEURIAL VENTURES IN CHINA: PROPOSALS TO MORE EFFECTIVELY REGULATE CHINESE FOREIGN PRIVATE ISSUERS

“Laws are useless when men are pure, unenforceable when men are corrupt.”¹

INTRODUCTION

Over the past thirty years, the People’s Republic of China has emerged into an economic juggernaut.² China has leveraged its population of 1.3 billion people³ to industrialize at an incredible rate.⁴ Three decades of 9 percent average annual growth in gross domestic product (“GDP”)⁵ resulted in China supplanting Japan as the world’s second largest economy in 2010.⁶ Moreover, by focusing on infrastructure spending and

1. Chinese proverb.

2. See, e.g., Fan Gang, *China’s Economic Growth in a Context of Globalization*, 7 ASIE VISIONS (Institut Français des Relations Internationales, Paris, France), July 2008, at 3, available at http://www.ifri.org/downloads/AV7_FanGang_US.pdf; Gordon G. Chang, *China After 30 Years of Reform*, FORBES (Dec. 16, 2008), http://www.forbes.com/2008/12/16/china-economic-reform-oped-cx_gc_1216chang.html; Graeme Wearden, *Chinese Economic Boom Has Been 30 Years in the Making*, GUARDIAN (Aug. 16, 2010), <http://www.guardian.co.uk/business/2010/aug/16/chinese-economic-boom>.

3. CENTRAL INTELLIGENCE AGENCY (CIA), THE WORLD FACTBOOK, EAST & SOUTHEAST ASIA: CHINA, (2011), available at <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html> [hereinafter WORLD FACTBOOK] (follow “Download Publication” hyperlink). Data accurate as of July 2011. *Id.*

4. China’s economy today is ninety times larger than it was in 1978. Kevin Hamlin & Li Yanping, *China Overtakes Japan as World’s Second-Biggest Economy*, BLOOMBERG (Aug. 16, 2010), <http://www.bloomberg.com/news/2010-08-16/china-economy-passes-japan-s-in-second-quarter-capping-three-decade-rise.html>.

5. Zulu Hu & Mohsin S. Khan, *Why Is China Growing So Fast?*, 8 ECON. ISSUES (Int’l Monetary Fund, Washington, D.C.), Apr. 1997, at 1, available at <http://www.imf.org/external/pubs/ft/issues8/issue8.pdf>.

6. *Becoming Number One: China’s Economy Could Overtake America’s Within a Decade*, ECONOMIST (Sept. 24, 2011), <http://www.economist.com/node/21528987> [hereinafter *Becoming Number One*].

the export of consumer goods to drive economic growth,⁷ China has managed to largely avoid the financial turmoil that has roiled developed economies, particularly the United States and the European Union, since late 2007.⁸

The vibrancy of China's economy has led to the emergence of a middle class and a generation of "budding entrepreneurs"⁹ who seek to build new businesses and raise capital.¹⁰ Western investors have been eager to seek investment opportunities in these fast-growing Chinese businesses¹¹ and to enter a market that, a generation ago, was off-limits to outsiders.¹² Foreign investment in Chinese firms, however, has been plagued with problems.¹³ Regulators have discovered numerous instances of corruption and fraud, often perpetrated through deceptive accounting practices, within Chinese companies publicly listed in the United States.¹⁴ These revelations have resulted in international finger pointing between the United States Securities and

7. Colin Speakman, *China Must Be Cautious in Raising Consumption*, CHINA DAILY (Nov. 21, 2008), http://www.chinadaily.com.cn/bizchina/2008-11/21/content_7228346.htm.

8. China is "basically carrying the world economy." Kenneth Rapoza, *What's So Great About China?*, FORBES (July 31, 2011), <http://www.forbes.com/sites/kenrapoza/2011/07/31/whats-so-great-about-china>. While the rest of the world struggles, China's economy is projected to grow by 9.1% in 2011, down from 10.5% in 2010. *Id.*; WORLD FACTBOOK, *supra* note 3.

9. David Barboza, *Attention Shifts to China for Private Equity Industry*, N.Y. TIMES, Nov. 19, 2009, at B1.

10. *Id.*

11. See, e.g., Peter Fuhrman, *How Big Can the PE Industry in China Grow?*, SEEKING ALPHA (Apr. 15, 2011), <http://seekingalpha.com/article/263654-how-big-can-the-pe-industry-in-china-grow> (citing a McKinsey & Company study finding that private equity capital flowing into private Chinese companies could reach thirty billion dollars in the next five years).

12. See generally David Finn, *Peering over the Great Wall: Extraterritorial Securities Regulation and U.S. Investment in China's State Owned-Banks*, 7 U.C. DAVIS BUS. L.J. 277, 281-82 (2006) (describing how the opening of China's financial market has attracted interest from U.S. investors).

13. *Id.* at 286.

14. *Markets in China Are Barely Fazed by Scandal, Unless the State Is Involved*, ECONOMIST (Aug. 20, 2011), <http://www.economist.com/node/21526407> [hereinafter *Markets in China*].

Exchange Commission ("SEC") and the China Securities Regulatory Commission.¹⁵

This Note explores the issues raised by such tainted firms and suggests policy changes that may result in more effective regulation of Chinese public companies. Specifically, this Note argues that by implementing legislation that mirrors provisions of the United States' Sarbanes-Oxley Act of 2002, China may be able to develop and, more importantly, enforce a stricter regulatory regime that will reduce corporate fraud. Part I of this Note provides an overview of the Chinese economy's transition from an inward, state-controlled system to a global power. Part II describes the opportunities attracting Western investors to China and the advantages to Chinese business of seeking Western capital. Part III outlines the deficiencies of the current Chinese regulatory system and reviews several recent transactions that have failed due to its insufficiency. Finally, Part IV suggests a regulatory framework that will allow Chinese businesses to access the Western capital markets while assuring investors that the companies are making fully honest and transparent disclosures.

I. THE RISE OF CHINA

A. *The Centralized Economy*

One of the most remarkable aspects of China's rise to the global economic stage is the speed with which it occurred.¹⁶ Following the ascendancy of the Communist Party of China ("CPC") in 1949,¹⁷ Chairman Mao Zedong instituted a series of reforms that sought to institute a command economy in China similar to that of the Soviet Union.¹⁸ The government seized

15. William Pentland, *Deloitte Squeezed by SEC, Chinese Regulators*, FORBES (Sept. 10, 2011), <http://www.forbes.com/sites/williampentland/2011/09/10/deloitte-squeezed-by-sec-chinese-regulators>.

16. See William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalistic Securities Market*, 27 BROOK. J. INT'L L. 477, 479 (2002).

17. *Id.* at 477.

18. Todd Kenneth Ramey, *China: Socialism Embraces Capitalism? An Oxymoron for the Turn of the Century: A Study of the Restructuring of the Securities Markets and Banking Industry in the People's Republic of China in an Effort To Increase Investment Capital*, 20 HOUS. J. INT'L L. 451, 453-54 (1998). See Friedman, *supra* note 16, at 477.

control over land ownership and implemented harsh restrictions on human rights and business policies.¹⁹ In 1953, all private businesses officially came under state control.²⁰ The economy became centrally planned and rapidly focused on manufacturing and industry.²¹ However, this approach had many disadvantages that ultimately suppressed growth²² and China morphed into a “dormant economic giant.”²³

B. The Beginnings of a Privatized Economy

Following Mao's death, Deng Xiaoping came to power and, in 1978, began a series of major economic reforms known as the “Open-Door Policy.”²⁴ The Open-Door Policy advocated the use of “market mechanisms and foreign resources . . . to speed up the growth and modernization of the economy.”²⁵ These reforms were a stark departure from the rigid planning of the command economy under Mao and generally followed a theme of “market-oriented socialism.”²⁶ The new economic plan included banking and securities market reforms as well as a strengthening of the national economy by providing both domestic and foreign investment capital to Chinese industries.²⁷

“Limited privatization”²⁸ was an important part of Deng's Open-Door Policy and was promoted by the Chinese govern-

19. Ramey, *supra* note 18, at 454. Mao theorized that “this type of planned economy would result in maximum productivity and efficiency, since the entire population would be employed for the good of the country.” Friedman, *supra* note 16, at 477.

20. *China 1949 to 1953*, HIST. LEARNING SITE, http://www.historylearningsite.co.uk/china_1949_to_1953.htm (last visited Nov. 24, 2012).

21. Ramey, *supra* note 18, at 454.

22. *Id.* “[The] state-run economy produced few incentives for its people to pursue operational efficiency, and no accountability for the profits or losses of their businesses. As a result, the Chinese economy generated massive waste and losses.” Friedman, *supra* note 16, at 477.

23. Hu & Khan, *supra* note 5, at 1.

24. Ramey, *supra* note 18, at 456.

25. *Id.* Deng Xiaoping characterized his reforms as “socialism with Chinese characteristics.” Friedman, *supra* note 16, at 478.

26. Ramey, *supra* note 18, at 456–62 (describing “market-oriented socialism” as a mixture of capitalist notions and social ideals).

27. *Id.* at 456.

28. “Limited privatization” refers to “minority private equity participation in state-owned enterprises so as to enable the government to retain majority control of the market.” Friedman, *supra* note 16, at 478.

ment as a means to attract capital into the economy.²⁹ By privatizing some industries, the government was able to sell its stake to private interests while using the proceeds to reinvest capital into the economy.³⁰ The state still retained a controlling interest in the “privatized” entity, however.³¹ The concept of “limited privatization” thus allowed the government to achieve two objectives.³² First, the government was able to infuse capital into the economy, thereby promoting growth.³³ Second, the government was able to retain a position in these “privatized” businesses to promote its socialist agenda and goals,³⁴ while retaining full control of select industries such as the media.³⁵ By achieving these two feats, “limited privatization” set the stage for China’s economic renaissance.³⁶

C. A Global Economic Power

The results of China’s economic reform were rapid.³⁷ Since 1978, when Deng Xiaoping removed hard-line Communist policies and began to promote the free-market, China’s economy has increased in size ninety times over.³⁸ During this time, China has seen an average growth of more than 9 percent per year, with several peak years exceeding 13 percent growth in

29. Matthew D. Bersani, *Privatization and the Creation of Stock Companies in China*, 1993 COLUM. BUS. L. REV. 301, 305. The CPC’s initiative has been so successful that China now ranks second to the United States in terms of inflows of foreign direct investment. Friedman, *supra* note 16, at 478.

30. Ramey, *supra* note 18, at 462.

31. *Id.* Some sectors of the economy were never subject to “limited privatization.” *See id.* at 464; Rick Carew, *New Rules for Private Equity Investors in China*, WALL ST. J. (Jan. 18, 2010, 8:25 AM), <http://blogs.wsj.com/deals/2010/01/18/new-rules-for-private-equity-investors-in-china>. These included any enterprises involved with defense, mining, television or publishing, each deemed to be an industry of “strategic value” to the government. *Id.*

32. *See* Friedman, *supra* note 16, at 478–79.

33. *Id.*

34. *Id.* The percentage of this controlling interest held by the state generally varies from 51-80% for exchange-listed companies. Ramey, *supra* note 18, at 463.

35. Ramey, *supra* note 18, at 464; Carew, *supra* note 31.

36. *See* Friedman, *supra* note 16, at 479.

37. *See id.*

38. Hamlin & Yanping, *supra* note 4.

GDP.³⁹ From a broader perspective, the economy has successfully transitioned from an agrarian economy into an industrial and service-based economy.⁴⁰ Three developments—out of many more—are particularly illustrative. First, four out of five Chinese were employed in agriculture in 1978; by 1994, that number dropped to only one in two.⁴¹ Second, four of the world's top ten companies today, as measured by market capitalization, are from China.⁴² Third, in August 2010, Agricultural Bank of China Limited closed the largest initial public offering ever at \$22.1 billion.⁴³

By focusing on areas like infrastructure spending, China has largely avoided the worst of the “Great Recession” that continues to plague much of the developed world as of mid-2012.⁴⁴ In fact, China's growth rate in 2009—the very height of the crisis—stood steady at 8.7%.⁴⁵ Though there may be a number of

39. Hu & Khan, *supra* note 5, at 1. Before 1978, China saw annual growth of about 6 percent per year, but with “painful ups and downs along the way.” *Id.*

40. See generally Finn, *supra* note 12, at 285. See also Hu & Khan, *supra* note 5, at 5 (reciting that the reforms began with the decollectivization of agriculture and the development in rural areas of a non-agricultural employment sector).

41. Hu & Khan, *supra* note 5, at 5.

42. Hamlin & Yanping, *supra* note 4. These companies are PetroChina Company, Industrial & Commercial Bank of China Limited, China Mobile Limited, and China Construction Bank Corporation. *Id.*

43. *Id.* Five years after China's first state-owned lender went public, the country is now home to four of the world's ten largest banks by market capitalization. *Id.* Throughout this Note, “\$” refers to U.S. Dollars unless otherwise stated.

44. Geoff Dyer, *China Embarks on Infrastructure Spending Spree*, FIN. TIMES (June 7, 2010, 5:55 PM), <http://cachef.ft.com/cms/s/0/dc65a5c8-6fc2-11df-8fcf-00144feabdc0.html#axzz1acBNCaZZ>. “New roads have been built and gleaming airline terminals constructed, but the biggest emphasis has been on rail, especially the rapidly expanding high-speed network. . . . China plans to lay 18,640 miles of track by the middle of the decade at a cost of as much as Rbm4,000 bn.” *Id.* China's economic performance during the Great Recession has been described as “the envy of the Western world.” Jeremy Page, *Many Rich Chinese Consider Leaving*, WALL ST. J. (Nov. 1, 2011), http://online.wsj.com/article/SB10001424052970204394804577011760523331438.html?mod=WSJ_hp_MIDDLENexttoWhatsNewsTop (describing annual GDP growth of 9.1% in the third quarter of 2011 and an International Monetary Fund estimate of 9.5% GDP growth for all of 2011).

45. *China Economy Shows Strong Growth in 2009*, BBC NEWS (Jan. 21, 2010, 13:14 GMT), <http://news.bbc.co.uk/2/hi/8471613.stm>.

factors for China's success during the recession, China's role as a "resource vacuum" has played an undeniably important role.⁴⁶ For example, China is the world's number one buyer of iron ore and copper and number two importer of crude oil.⁴⁷

With China's 1.8 billion people, three decades of 9 percent average growth in GDP per year, and an apparent immunity to the global economic downturn occurring outside of its borders, it is unsurprising that China has been quickly ascending the International Monetary Fund's ranking of countries by GDP.⁴⁸ China, with a GDP of \$5.9 trillion, surpassed Japan in 2010 to become the world's second largest economy.⁴⁹ In the next decade, China is projected to overtake the United States and become the largest economy in the world.⁵⁰ As the United States struggles with debt-financing entitlement obligations and national security,⁵¹ China holds about \$1.2 trillion of United States Treasury bills,⁵² making it the largest financier of U.S. debt outside of the United States.⁵³ The tremendous investment China has accumulated in the United States makes certain that its rise will have a significant impact on the global economy going forward.

46. Rapoza, *supra* note 8.

47. Hamlin & Yanping, *supra* note 4.

48. *Becoming Number One*, *supra* note 6.

49. *Id.*

50. *Id.* This determination assumes an average annual growth rate of 2.5% for the United States. *Id.* Depending on the calculation of exchange rates, the date could be even sooner. *Id.* The current calculation using purchasing power parity, which takes into account the relative cost of goods in the various countries, shows that the United States and China are actually very close in economic might and that China will overtake the United States by 2016. *Id.* Calculation using current market prices leaves China further behind, though, as does any formula involving GDP per person metrics. *Id.*

51. Jack Welch & Suzy Welch, *Who Will Rule The 21st Century?*, BLOOMBERG BUS. WK. (July 1, 2007), http://www.businessweek.com/perm/content/07_27/b40410889.htm ("If not dealt with, entitlements like Social Security, Medicare, and Medicaid will create a budget deficit that will explode over the next 20 years.")

52. Tom Murse, *How Much U.S. Debt Does China Really Own?*, ABOUT.COM, <http://usgovinfo.about.com/od/moneymatters/ss/How-Much-US-Debt-Does-China-Own.htm> (last visited July 15, 2012). This equates to about 8 percent of publicly-held U.S. debt. *Id.* China is the third-largest holder, behind the Social Security Trust Fund and the Federal Reserve. *Id.*

53. See Rapoza, *supra* note 8.

II. THE CHINESE ENTREPRENEUR AND WESTERN OPPORTUNITIES FOR INVESTMENT

The introduction of “limited privatization” has had two sociological effects on the nation.⁵⁴ First, market economic policies have led to the rise of a large, wealthy middle class.⁵⁵ Second, an entrepreneurial spirit has developed within that middle class,⁵⁶ to which an increasingly educated Chinese populace is seeking to cater by using research and technology to develop fast-growing new ventures.⁵⁷ This is a self-perpetuating effect that will be central to China’s ability to sustain its incredible rate of development.⁵⁸

A. *The New Middle Class*

Since the state began to move towards “market-oriented” socialism, the United Nations estimates that China has lifted 300 million of its citizens out of poverty.⁵⁹ Further, according to the World Bank, China’s poverty rate has gone from 6% in 1996 to 2.8% in 2004.⁶⁰ Presently, China’s middle class consists of 300 million people, or approximately 25% of the population.⁶¹ Ac-

54. See, e.g., Kenneth Rapoza, *Two Funds To Profit off China’s Growing Middle Class*, FORBES (Mar. 30, 2011, 3:43 PM), <http://www.forbes.com/sites/kenrapoza/2011/03/30/if-chinas-middle-class-is-growing-richer-why-cant-we>; Linda Yueh, *China’s Entrepreneurs*, CENTREPIECE, Spring 2008, at 15, available at <http://cep.lse.ac.uk/pubs/download/cp253.pdf>.

55. Rapoza, *supra* note 54.

56. Yueh, *supra* note 54, at 15–18.

57. See Kathrin Hille, *China Searches for the Next Steve Jobs*, FIN. TIMES (Oct. 21, 2011, 1:50 PM), <http://www.ft.com/cms/s/2/7621faf6-fad5-11e0-8fe7-00144feab49a.html#axzz1hFOuCSNA>.

58. Simeon Djankov et al., *Who Are China’s Entrepreneurs?*, CEPR Discussion Paper no. 5706, CTR. FOR ECON. POL. RES., June 2006, available at <http://elsa.berkeley.edu/~groland/pubs/AERChina.pdf>.

59. Hamlin & Yanping, *supra* note 4. “The country remains a developing nation, with its per capita gross national income ranked 127th in the world . . . behind Angola and Azerbaijan, according to the World Bank.” *Id.* The large size of China’s population, however, does not work to its benefit when measuring that metric. *Id.*

60. Rapoza, *supra* note 54.

61. Peter Ford, *In China, Middle-Class Affluence, Not Political Influence*, CHRISTIAN SCI. MONITOR (May 20, 2011, 1:00 PM), <http://www.csmonitor.com/World/Asia-South-Central/2011/0520/In-China-middle-class-affluence-not-political-influence>. This figure is projected to double by 2025, according to a study by McKinsey & Company. *Id.*

ording to the Chinese Academy of Social Sciences, families with assets valued from RMB150,000 (\$18,137) to RMB300,000 (\$36,275) are to be classified as middle class.⁶² This middle class is composed of “a range of different sorts of white-collar people—entrepreneurs, employees of large state-owned enterprises and multinational companies, CPC officials, lawyers, doctors, and teachers.”⁶³ The ascent of this middle class may perhaps be most clear when considering that many children of parents who were assigned manual labor jobs by the CPC a generation ago now work at start-up companies.⁶⁴ The philosophy of the new Chinese middle class is that money may be the only possible means of achieving personal autonomy in a nation where political freedoms are still very restrained.⁶⁵

B. The Chinese Entrepreneur

Entrepreneurism in China has been a catalyst for the nation's economic growth since the late 1990s.⁶⁶ Rising expectations and the constant drive for money has driven a new generation of Chinese, many of whom were not even born at the time of the 1978 reforms, to become entrepreneurs.⁶⁷ The reforms under Deng Xiaoping and the Open-Door Policy granted greater autonomy to enterprise managers,⁶⁸ allowing them to truly control their businesses by pricing goods at competitive levels, hiring efficient workers and firing inefficient workers, and re-

62. Xin Zhigang, *Dissecting China's 'Middle Class'*, CHINA DAILY (Oct. 27, 2004), http://www.chinadaily.com.cn/english/doc/2004-10/27/content_386060.htm. While these numbers may seem low, it is important to remember the purchasing power parity discrepancy between China and Western nations, as well as China's per capita GDP rests around \$2000. Gang, *supra* note 2, at 10. Throughout this Note, “RMB” refers to Chinese Renminbi unless otherwise stated.

63. Ford, *supra* note 61.

64. *See, e.g., id.* (describing the youngest generation of Chinese as being able to afford luxuries, such as cars and vacations, which were unknown to their parents' generation).

65. *Id.* One “middle class” woman interviewed for the article stated her belief in the power of money to ensure well-being. *Id.* As an example, she cited the tainted infant milk scandal of 2008, where over 12,000 babies were poisoned by adulterated milk. *Id.* Middle class families, she says, were able to afford imported baby formula. *Id.*

66. Yueh, *supra* note 54, at 15. In 2006, the World Bank estimated that there were 40 million small- and medium-sized enterprises in China. *Id.*

67. *See generally id.* at 15–18.

68. Hu & Khan, *supra* note 5, at 5.

taining corporate earnings for future investment.⁶⁹ These enterprises have developed new products, created jobs, paid taxes, and have “g[iven] the national economy a flexibility and resiliency” that was absent under Mao’s leadership.⁷⁰ As the CPC relinquishes its control of business, the emergence of entrepreneurs has “transformed the economy into one increasingly driven by competition, innovation and productivity,”⁷¹ resulting in private company growth of over 30 percent per year.⁷²

A major challenge faced by those seeking to start their own businesses in China has been access to credit.⁷³ It is estimated that less than 0.5 percent of Chinese small- and medium-sized businesses can obtain loans from local banks.⁷⁴ Chinese banks, despite the “limited privatization” movement, remain state-owned and prefer to issue credit to “politically favored government companies.”⁷⁵ In addition, seed investment capital, money typically available in mature markets to fund start-up ventures, is almost non-existent in China.⁷⁶ To some extent, this unwillingness to lend reflects a more conservative Chinese investment philosophy.⁷⁷ Chinese venture capitalists, a nascent industry itself,⁷⁸ prefer companies with fully developed prod-

69. *Id.*

70. *Id.*

71. Yueh, *supra* note 54, at 18.

72. Fuhrman, *supra* note 11 (“[These companies] have the scale, experience, management and market leadership to continue to double in size every two to three years.”).

73. Yueh, *supra* note 54, at 16.

74. *Id.* A survey shows that only 7 percent of entrepreneurs have adequate funding to capitalize their businesses. *Id.*

75. Joe McDonald, *China Promises More Loans for Small Companies*, BOSTON GLOBE (Oct. 12, 2011), http://www.boston.com/business/articles/2011/10/12/china_promises_more_loans_for_small_companies. Approximately 70 percent of bank loans finance companies controlled by the state, despite the fact that the state sector produces only 34 percent of total industrial output. Ramey, *supra* note 18, at 483.

76. *China’s Emerging Venture Capital Opportunities*, ESCAPEARTIST.COM, http://www.escapeartist.com/OREQ29/Chinas_Emerging_Venture_Capital_Opportunities.html (last visited Oct. 3, 2012).

77. *See id.*

78. Venture capitalists typically raise funds from institutional investors, such as pension funds, endowments, and foundations. *FAQ*, NAT’L VENTURE CAPITAL ASS’N, http://www.nvca.org/index.php?Itemid=147&id=119&option=com_content&view=article (last visited Oct. 3, 2012). China currently lacks “experienced pen-

ucts, a customer base, and a sales history when evaluating an investment.⁷⁹ Because of the unwillingness of banks to lend and the absence of early-stage “angel” investors, Chinese businesses have been forced to turn to a high-interest underground credit market akin to loan-sharking.⁸⁰

C. Reverse Mergers as a Means to Access the American Capital Markets

Chinese companies seeking a stable source of funding are eager to bypass the local funding regime entirely.⁸¹ These businesses often seek to access the broad capital markets of the United States.⁸² At the same time, due to China’s confluence of a large population, increasingly educated populace, and rising standards of living, American investors are eager to provide capital to Chinese companies that offer access to the burgeoning Chinese market.⁸³ The potential for growth investment in China is illustrated by the Halter USX CHINA Index,⁸⁴ which posted a gain of 60% in 2009.⁸⁵ Following the dot-com boom of

sion funds and other big institutional investors that provide the backbone of private-equity funding in the West.” Carew, *supra* note 31.

79. *China’s Emerging Venture Capital Opportunities*, *supra* note 76.

80. McDonald, *supra* note 75. An economist at Credit Suisse recently valued the Chinese “informal lending” market at four trillion yuan (\$615 billion) and growing at a rate of approximately 50 percent a year. *Id.*

81. *Barbarians in Love: Global Private-Equity Firms Are Seduced by the China Dream*, *ECONOMIST* (Nov. 25, 2010), <http://www.economist.com/node/17580583> [hereinafter *Barbarians in Love*].

82. Robert G. DeLaMater, *Recent Trends in SEC Regulation of Foreign Issuers: How the U.S. Regulatory Regime Is Affecting the United States’ Historic Position as the World’s Principal Capital Market*, 39 *CORNELL INT’L L.J.* 109, 109 (2006) (“Since World War II, the United States has been the world’s principal capital market . . . with substantial retail participation by individual investors and small institutions, plentiful capital for equity financing and a willingness to hold long-term debt securities.”).

83. *Barbarians in Love*, *supra* note 81 (describing China as particularly “seductive” for Westerners).

84. “The Halter index is composed of U.S.-listed Chinese companies, ranging from the American depositary shares of well-known names like Internet giant Baidu.com (ticker: BIDU) and telecom power China Mobile (ticker: CHL) to small-cap reverse mergers.” Bill Alpert & Leslie P. Norton, *Beware This Chinese Export*, *BARRON’S* (Aug. 28, 2010), <http://online.barrons.com/article/SB50001424052970204304404575449812943183940.html>.

85. *Id.*

the early 2000s,⁸⁶ Western investors have been excited to explore similar speculation in alternative markets such as China.⁸⁷

The result of Western investment interest and the Chinese desire to access the more developed Western capital markets has been the rapid emergence of Chinese companies choosing to list their securities on American stock exchanges.⁸⁸ The most common route chosen to list in the United States by these companies has been the reverse merger.⁸⁹ A reverse merger occurs when a private Chinese company is merged into an existing American public shell company.⁹⁰ The American shell company's board resigns, and then the new Chinese board assumes control, changes the company's name, and begins to issue

86. In the 1990s, speculation over new technology, particularly the rise of the Internet, led stock market prices to climb rapidly, in what became known as the "dot-com boom." ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 136 (3d ed. 2009). On March 10, 2000, the NASDAQ closed at 5,048.62, and the bubble promptly burst. Tony Long, *March 10, 2000: Pop Goes the NASDAQ!*, WIRED (Mar. 10, 2010, 12:00 AM), <http://www.wired.com/thisdayintech/2010/03/0310nasdaq-bust>. As late as March 2010, the NASDAQ remained approximately 50 percent below its all-time high. Jim Zarroli, *A Decade Later, NASDAQ Is Half Its All-Time High*, NPR (Mar. 10, 2010), <http://www.npr.org/templates/story/story.php?storyId=124537450>.

87. See Finn, *supra* note 12, at 285–86. The small business start-up scene in China has been described as having a "frenetic feel" to it, similar to the dot-com boom days. Ron Gluckman, *Seeding China's Start-Up Scene, With a Nod to Silicon Valley*, N.Y. TIMES (Dec. 15, 2011, 8:22 PM), <http://dealbook.nytimes.com/2011/12/15/seeding-chinas-start-up-scene-with-a-nod-to-silicon-valley>.

88. Alpert & Norton, *supra* note 84.

89. Jamil Anderlini, *Investing: Problems Flagged Up*, FIN. TIMES (July 4, 2011, 8:26 PM), <http://www.ft.com/cms/s/0/6f5c9c8e-a671-11e0-ae9c-00144feabdc0.html>.

90. Aden R. Pavkov, *Ghouls and Godsend? A Critique of "Reverse Merger" Policy*, 3 BERKELEY BUS. L. J. 475, 478 (2006). A shell company is a company with no assets, only access to a public market for its securities. *Id.* For example, Chinese medical-device vendor Winner Group merged into Las Vegas Resorts, a liquidated American shell company. Alpert & Norton, *supra* note 84. Chinese tire maker Zhongsen International merged into Rub A Dub Soap. *Id.* Chinese chemical company Keyuan Petrochemicals merged into Silver Pearl, a failing furniture import business based in Rockwall, TX. Walter Pavlo, *Fraud in Chinese Reverse Mergers on American Exchanges—And We're Surprised?*, FORBES (Apr. 8, 2011, 4:50 PM), <http://www.forbes.com/sites/walterpavlo/2011/04/08/fraud-in-chinese-reverse-mergers-on-american-exchanges-and-were-surprised>.

shares to the public.⁹¹ A reverse merger allows a company to start accessing the U.S. public markets without going through the lengthy initial public offering (“IPO”) formalities controlled by the SEC.⁹² By not having to officially file for an IPO, companies avoid the legal and auditing fees associated with negotiating with underwriters.⁹³ More significantly, companies listing by reverse merger are not required to file a registration statement for review by the SEC.⁹⁴

About 350 Chinese reverse mergers have closed since 2003.⁹⁵ Though deals of this nature rarely exceed one billion dollars in market capitalization, these 350 transactions have a combined capitalization of over fifty billion dollars.⁹⁶ Because of this strategy, Chinese foreign issuers are able to access American capital markets without regulatory review of their disclosure and without oversight as to whether their financial statements were properly audited.⁹⁷ In the late 2000s, a combination of American regulators, auditors, and activist investors began to unveil many Chinese companies listing in the United States as frauds, threatening American investors, tarnishing the reputa-

91. Bruce Einhorn & Frederik Balfour, *Going Public, Chinese Style*, BLOOMBERG BUS. WK. (Mar. 5, 2007), http://www.businessweek.com/magazine/content/07_10/b4024067.htm. For example, Ticketcart Inc., a defunct online retailer of printer cartridges, was merged with Tieli Xiaoxinganlin Frog Breeding Company, a Chinese nutritional supplements retailer, to allow the Chinese company to go public in the United States. *Id.*

92. Floyd Norris, *The Audacity of Chinese Frauds*, N.Y. TIMES, May 26, 2011, at B1; *Double Due Diligence Efforts Before Investing*, CHINA L. & PRAC. (Sept. 2, 2011), available at 2011 WLNR 18879796.

93. Norris, *supra* note 92.

94. *Id.*

95. Alpert & Norton, *supra* note 84.

96. *Id.*

97. Francine McKenna, *Chinese Reverse Merger Companies: The Auditor Angle*, FORBES (Mar. 15, 2011, 4:29 PM), <http://www.forbes.com/sites/francinemckenna/2011/03/15/chinese-reverse-merger-companies-the-auditor-angle>. U.S. federal securities law requires publicly registered companies to file financial statements with the SEC that are audited by PCAOB-registered auditing firms. *Q&A: Small Business and the SEC*, U.S. SEC. AND EXCHANGE COMMISSION, <http://www.sec.gov/info/smallbus/qasbsec.htm> (last visited Sept. 7, 2012). A PCAOB study concluded that, following the closing of a reverse merger, the shell company’s auditor is frequently dismissed and replaced with the Chinese operating company’s auditor. McKenna, *supra* note 97.

tion of the Chinese economy, and ultimately harming the interests of Chinese entrepreneurs seeking foreign capital.⁹⁸

III. DEFICIENCIES IN THE CHINESE REGULATORY SYSTEM AND CORPORATE FRAUD

Some have described the oversight of “foreign private issuers,” including Chinese companies listed on U.S. securities exchanges, as a “regulatory vacuum,”⁹⁹ with neither the United States nor China effectively monitoring those companies that list via reverse merger. The lack of oversight has resulted in massive losses by international investors, which continue as of this writing. This Part describes the current regulation of securities in the United States and China and the deficiencies that the Chinese system faces with regards to enforcement. It then provides an explanation for the underperformance of Chinese reverse merger listings and the instances of corporate fraud that regulators and investors have unveiled. Lastly, this Part examines both the current regulatory abyss in which Chinese foreign private issuers find themselves and the inability of American and Chinese regulators to find compromise.

A. A Tale of Two Regulatory Regimes

In the United States, the federal securities laws “establish mandatory disclosure of the business and financial conditions

98. It is important to note that many well-established Chinese companies list on American exchanges through means other than reverse mergers. Steve Dickinson, *Thinking Clearly About Chinese Companies Listed on US Stock Exchanges. Or, If a Tree Falls in a Sino-Forest . . .*, CHINA L. BLOG (July 1, 2011),

http://www.chinalawblog.com/2011/07/thinking_clearly_about_chinese_companies_listed_on_us_stock_exchanges.html. They are typically government-controlled companies that concurrently trade on either the Shanghai or Shenzhen stock exchanges. *Id.* These companies form the heart of the Chinese industrial and service economy. Examples include China Eastern Airlines Corporation, China Life Insurance Company Limited, China Mobile, and China Unicom. *See id.* These companies are considered Chinese “blue-chips” and have not been implicated in any fraudulent activity. *See id.* Companies pursuing the reverse merger route tend to be small-cap technology companies operating under unique structures such as the VIE (variable interest entity). *See id.*

99. Anderlini, *supra* note 89.

of public companies.”¹⁰⁰ Congress set forth the regulatory regime for securities issuers primarily through two pieces of legislation that together constitute the U.S. federal securities laws: the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”).¹⁰¹

The Securities Act applies to an issuer’s initial offering of securities.¹⁰² Domestic companies wishing to issue their securities to the public must have the approval of the SEC.¹⁰³ Prospective issuers gain such approval through a multistep process, typically beginning with the company filing a registration statement on Form S-1¹⁰⁴ and disclosing information about the issuer, the security offered, and any potential underwriters.¹⁰⁵ Under the Securities Act, companies must make full disclosure of all pertinent information to potential investors in the registration statement.¹⁰⁶ Further, the SEC requires that financial statements, audited by an independent certified public accountant, accompany the registration statement.¹⁰⁷ The registration statement is reviewed by the SEC and, in the event the SEC makes comments about the filing, subsequently revised by the issuer.¹⁰⁸ Once the SEC fully approves the document, it is

100. James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 3 STAN. J.L. BUS. & FIN. 51, 53 (1997).

101. *Q&A: Small Business and the SEC*, *supra* note 97.

102. Fanto & Karmel, *supra* note 100, at 53.

103. Securities Act of 1933, 15 U.S.C. § 77c (2011) (amended 2012). Companies cannot offer their securities for sale until the SEC staff declares the company’s registration statement “effective.” *Q&A: Small Business and the SEC*, *supra* note 97.

104. All forms are SEC forms unless otherwise stated.

105. 15 U.S.C. § 77g.

106. *Q&A: Small Business and the SEC*, *supra* note 97 (defining “full disclosure” as “the facts investors would find important in making an investment decision.”). Supreme Court Justice Louis Brandeis once observed that “sunshine is the best disinfectant, electric light the best policeman.” PINTO & BRANSON, *supra* note 86, at 167. One of the main purposes of the “full and fair disclosure” philosophy is to prevent fraud by eliminating three mechanisms through which fraud manifests itself: “non-disclosure, half-truth, [and] disclosure in a misleading way.” *Id.* at 168. Full and fair disclosure encourages efficient public capital markets and protects prospective investors. Pavkov, *supra* note 90, at 496.

107. *Q&A: Small Business and the SEC*, *supra* note 97.

108. *Id.*

declared “effective” and the issuer is free to become a public reporting company.¹⁰⁹

The Exchange Act governs the subsequent issuance and trading of securities by requiring public companies to file timely reports with the SEC relating to their ongoing financial performance and operations.¹¹⁰ These reports include an annual report with audited financial statements on Form 10-K, as well as quarterly reports with unaudited financial statements on Form 10-Q and current reports concerning certain episodic events on Form 8-K.¹¹¹

Compliance with the federal securities laws, particularly the initial registration of securities by a new issuer under the Securities Act, entails significant cost.¹¹² Section 11 of the Securities Act imposes liability upon every person who signed the registration statement for “any untrue statement of a material fact” contained “in any part of the registration statement.”¹¹³ Due to the considerable degree of liability involved, issuers are wise to retain legal counsel and an accounting firm that will “credibly audit and certify financial statements.”¹¹⁴

109. Marshall Brain, *How NASDAQ IPOs Work*, HOWSTUFFWORKS, <http://money.howstuffworks.com/nasdaq-ipo.htm> (last visited Sept. 7, 2012).

110. Fanto & Karmel, *supra* note 100, at 53; Pavkov, *supra* note 90, at 496.

111. Securities Exchange Act of 1934, 15 U.S.C. § 78m (2011) (amended 2012). *See* PINTO & BRANSON, *supra* note 86, at 162–63. Episodic events triggering an 8-K filing include “a change in control, bankruptcy, [and] resignation or dismissal of the outside auditors . . .” *Id.* at 163.

112. PINTO & BRANSON, *supra* note 86, at 172. Aside from legal expenses, fees include auditing expenses, SEC registration fees, and the cost of printing copies of the issuer’s prospectus once finalized. *Id.*

113. 15 U.S.C. § 77k; PINTO & BRANSON, *supra* note 86, at 171. Section 11 liability is vast.

Defendants under [Section 11 of the Securities Act] include the issuer, every person who signed the registration statement (the principal executive officer, chief financial officer, comptroller or other chief accounting officer, and a majority of directors *must* sign), every person who was a director, those named as becoming a director, and every accountant, engineer, appraiser or “other person whose profession gives authority to a statement made by him” who “expertises” or certifies a portion of the registration statement. The issuer is strictly liable.

Id. (emphasis in original).

114. PINTO & BRANSON, *supra* note 86, at 171.

The accountancy firms reviewing the financial statements of public reporting companies in the United States are themselves regulated by the Public Company Accounting Oversight Board (“PCAOB”).¹¹⁵ The PCAOB is a nonprofit organization that provides regulatory oversight to the audits of public companies.¹¹⁶ The organization seeks to “protect the interests of investors” and ensure the dissemination of “informative, accurate and independent audit reports.”¹¹⁷ The PCAOB was created as part of the reforms promulgated under the Sarbanes-Oxley Act of 2002 (“SOX”) in response to a wave of corporate and accounting scandals in the United States.¹¹⁸

China’s securities regulatory regime, particularly with respect to enforcement, is decidedly primitive as compared to

115. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7211 (2011).

116. *See id.*

117. *Id.* The SEC oversees the PCAOB and approves the rules, standards, and budget proffered by the PCAOB. *About the PCAOB*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/About/Pages/default.aspx> (last visited Sept. 7, 2012). The PCAOB is funded by annual fees assessed to public reporting companies according to their market capitalization. *See id.* The PCAOB is managed by a board appointed to staggered five-year terms by the SEC, in consultation with the Federal Reserve and the Secretary of the Treasury. *See id.* Potential sanctions, which the PCAOB may levy on audit firms for violations of its standards, include “fines, censures, removal from client arrangements, limitations on activities, and suspension from audit functions on a temporary or permanent basis.” John Paul Lucci, *Enron—The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley*, 67 ALB. L. REV. 211, 223 (2003).

118. *About the PCAOB*, *supra* note 117. The most prominent of the corporate and accounting scandals of 2001-02 was the December 2001 collapse of Enron. *See* Lucci, *supra* note 117, at 211–12 (“Financial scandals involving WorldCom, Qwest, Global Crossing, Tyco, and Enron ultimately cost shareholders \$460 billion.”). Enron was a Houston, TX-based corporation engaged in energy and commodities trading. Gary M. Cunningham & Jean E. Harris, *Enron and Arthur Andersen: The Case of the Crooked E and the Fallen A*, 3 GLOBAL PERSP. ON ACCT. EDUC. 27, 31 (2006). Enron was once the seventh largest company in the United States by market capitalization. Dan Ackman, *Enron the Incredible*, FORBES (Jan. 15, 2002, 12:00 PM), <http://www.forbes.com/2002/01/15/0115enron.html>. Enron’s auditor, Arthur Andersen LLP, was considered one of the most prestigious accounting firms in the world. Cunningham & Harris, *supra* note 118, at 31. Enron imploded in the fall of 2001 after the revelation of a series accounting irregularities and instances of insider trading amongst Enron senior executives. *See id.* at 34, 40–44. Arthur Andersen was convicted in June 2002 of obstruction of justice for shredding accounting working papers in connection with the Enron audit and eventually dissolved. *See id.* at 34, 44–45.

what exists in the United States.¹¹⁹ This has resulted in a Chinese securities market that has been described as “notoriously corrupt and ‘casinolike [sic].”¹²⁰ The primary government regulator in China is its equivalent of the SEC,¹²¹ the China Securities Regulatory Commission (“CSRC”).¹²² The powers of the CSRC are delineated in the Securities Law of the People’s Republic of China (“Chinese Securities Laws”),¹²³ which sets forth the regulatory regime for both initial and subsequent offerings of securities by Chinese companies.¹²⁴ The CSRC’s basic functions, similar to the SEC, include general supervisory powers over the securities markets;¹²⁵ verification, examination, and approval of public offerings of securities;¹²⁶ and, notably, “supervis[ing] the securities market behaviors of the listed compa-

119. See Friedman, *supra* note 16, at 484. China adopted its first national securities law on December 29, 1998. *Id.* The Securities Law of the People’s Republic of China took effect on July 1, 1999. *Id.* The law has subsequently been amended, most recently in October 2005. Baoshu Wang & Hui Huang, *China’s New Company Law and Securities Law: An Overview and Assessment*, 19 AUSTL. J. CORP. L. 229, 229 (2008). The revisions took effect on January 1, 2006. See *id.* See also Finn, *supra* note 12, at 286 (“The relative immaturity of China’s legal system poses a number of obstacles to its effectiveness.”).

120. Dina Jie Yin, Note, *Investor Regulations: An American Answer to a Chinese Problem*, 57 RUTGERS L. REV. 397, 412 (2004) (quoting Kevin Hamlin, *China’s Iron Lady: Premier Zhu Rongji Hired Laura Cha To Rein in China’s Casinolike Stock Markets. Critics Say She’s Hurting the Economy—But She’s Not Backing Down*, INSTITUTIONAL INVESTOR (INT’L ED.), Vol. 27, Issue 5, May 1, 2002).

121. See Friedman, *supra* note 16, at 484 (discussing how the CSRC, a regulatory body “subordinate to the State Council,” is similar to the United States scheme, in which the SEC is “subordinate to the executive branch.”). In addition, the CSRC draws its regulatory authority by a grant from the legislature through their promulgation of the Chinese Securities Laws. *Id.* at 485. Similarly, the SEC was created through Congressional passage of the Exchange Act. See 15 U.S.C. § 78d.

122. See Friedman, *supra* note 16, at 484.

123. See Zhonghua Renmin Gongheguo Zhengquan Fa [ZHENGQUAN FA] [Securities Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 29, 1998, effective July 1, 1999, amended Aug. 28, 2004 and Oct. 27, 2005), art. 166–74 (China), available at http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/statelaws/200904/t20090429_102757.htm.

124. See *id.* art. 10–77 (China).

125. See *id.* art. 166 (China).

126. See *id.* art. 10, 167(5) (China).

nies and their shareholders who shall fulfill the relevant obligations according to the relevant laws and regulations.”¹²⁷

As under the Securities Act in the United States, the registration of new securities in China must be accompanied by legal, accounting, and financial reports.¹²⁸ Similar to the Exchange Act in the United States, public companies in China must file periodic reports with the CSRC disclosing their financial condition and performance.¹²⁹ However, there is no independent accounting oversight body similar to the PCAOB in China.¹³⁰ Therefore, the responsibility to police companies' disclosures and enforce the submission of accurately audited financial statements rests with the CSRC alone.¹³¹

Structurally, the CSRC is an institution within the State Council, China's most powerful executive body.¹³² Some have

127. *China Securities and Regulatory Commission*, CHINA SEC. REG. COMMISSION, http://www.csrc.gov.cn/pub/csrc_en/about/who/intro (last visited Sept. 7, 2012). Further, the CSRC's mandate states that the body will “regulate, according to law, the securities business activities of . . . those law firms, public accounting firms and asset appraisal organizations that are engaged in securities business.” ZHENGQUAN FA, art. 167(3) (China).

128. ZHENGQUAN FA, art. 58 (China).

129. *See id.* art. 60–62 (China). However, while the Exchange Act requires annual, quarterly, and current reports, the Chinese Securities Laws require annual reports, “interim” reports every six months, and “ad hoc” reports upon certain triggering events. 15 U.S.C. § 78m; ZHENGQUAN FA, art. 60–62 (China).

130. *See* Andrea Shalal-Esa & Sarah N. Lynch, *Exclusive: Justice Department Probing Chinese Accounting*, REUTERS (Sept. 29, 2011), <http://www.reuters.com/article/2011/09/29/us-china-usa-accounting-idUSTRE78S3QM20110929> (quoting Robert Khuzami, Director of Enforcement at the SEC, that inadequate accounting and audit review in China is “a big issue” and “not acceptable”). Interestingly, the Chinese constitution does contemplate accounting oversight, as evidenced by the constitution's establishment, within the State Council, of an Auditor-General position that oversees an independent auditing body. XIANFA art. 86, 91 (1982) (China). However, the auditing body's jurisdiction is limited to regulating the “auditing [of] revenue and expenditure of departments under the State Council” and local municipalities. *Id.* art. 91, § 3 (China). This limited jurisdiction of the Auditor-General is further clarified in the Chinese Securities Laws, which describe the Auditor-General's authority over “stock exchanges, securities companies, securities registration and clearing institutions and the securities regulatory authority.” ZHENGQUAN FA, art. 9 (China).

131. *See* ZHENGQUAN FA, art. 65 (China).

132. *Id.* art. 7 (China). The State Council is “the executive body of the highest organ of state power[and] the highest organ of state administration.” XIANFA art. 85 (China). The membership of the State Council consists of the

recognized this lack of independence as being problematic for enforcement purposes.¹³³ A survey of mature economies shows that the chief regulatory body is typically structured independently to ensure enforcement efficacy.¹³⁴ In China, though, the government has dual interests, only one of which is regulation.¹³⁵ Since the CPC still has a large presence in some industries that were deemed off-limits to the “limited privatization” movement, the government remains a dominant shareholder in many companies.¹³⁶ The CSRC, as a State Council agency, is therefore placed in the position of regulating a securities market in which the government is a significant participant.¹³⁷ It is not difficult to imagine situations where the government “encourages” the CSRC to back off of a regulatory enforcement ac-

Premier, Vice-Premiers, State Councilors, State Ministers, the Auditor-General, and the Secretary-General. *Id.* The State Council can be compared to the executive branch of the U.S. government. *See* K.C. FUNG ET AL., U.S. DIRECT INVESTMENT IN CHINA 37 (2006) (commenting that “the State Council . . . represents the executive branch.”). The State Council “carr[ies] out the principles and policies of the [CPC] as well as the regulations and laws adopted by the [National People’s Congress], and dealing with such affairs as China’s internal politics, diplomacy, national defense, finance, economy, culture and education.” *The State Council*, PEOPLE’S DAILY ONLINE, <http://english.peopledaily.com.cn/data/organs/statecouncil.shtml> (last visited Sept. 7, 2012).

133. HUI HUANG, INTERNATIONAL SECURITIES MARKETS: INSIDER TRADING LAW IN CHINA 86 (2006).

134. *Id.* (citing the SEC in the United States, the FSA in the United Kingdom, and the ASIC in Australia as three examples of regulator independence). “It goes without saying in developed securities markets that a securities regulatory body should be structured independently to enable it to effectively carry out its regulatory role.” *Id.*

135. *Id.*

136. *See* Ramey, *supra* note 18, at 464; Carew, *supra* note 31. The state shows no sign of relinquishing control of certain sectors, such as “national securities-related industries, natural monopolies, sectors providing important goods and services to the public, and important enterprises in pillar industries and the high-technology sector.” Donald C. Clarke, *Law Without Order in Chinese Corporate Governance Institutions*, 30 NW. J. INT’L L. & BUS. 131, 144 (2010).

137. HUANG, *supra* note 133, at 86 (estimating that state-owned shares make up about two-thirds of all shares on the market). Further, the CSRC’s main enforcement tool is referral to the judiciary. *See* ZHENGQUAN FA, art. 173 (China). The judiciary branch in China is equally conflicted with respect to the CPC and government interests. *See* Clarke, *supra* note 136, at 182.

tion against a company illicitly making large profits where the CPC is the controlling shareholder.¹³⁸

Conflicts of interest aside, the enforcement power of the CSRC is rather limited.¹³⁹ There is evidence that the agency has trouble securing funding and retaining talent.¹⁴⁰ For one example, the CSRC employs only 1,465 staff despite China's enormous population.¹⁴¹ The agency's powers to investigate companies and collect evidence are therefore limited.¹⁴² To provide a second example of the CSRC's weak legitimacy, Chinese courts often do not cooperate with the agency's requests to freeze corporate assets.¹⁴³ The passive judicial response to CSRC inquiries is partially due to the fact that Chinese judges are the appointees of local political authorities.¹⁴⁴ Yet there is also a procedural element involved, as Chinese plaintiffs must file suit in the defendant's domicile.¹⁴⁵ A corporate defendant is likely either controlled by the local government or, if the company has been privatized under the 1978 reforms, by locally influential executives.¹⁴⁶ The local government and court officials may have an interest in the company's performance.¹⁴⁷ Therefore, due to locality interests, these courts are satisfied to allow a local company to continue operating without regulatory interference.¹⁴⁸ In sum, while the CSRC ostensibly appears to mirror the SEC's goals and regulations, the agency is largely

138. *See, e.g.*, Clarke, *supra* note 136, at 180.

If the securities markets are not paying good money for issues of [state-owned enterprises'] stock, then the CSRC is not doing its job, and if clamping down on abuses would hurt the markets—for example, by obstructing the flow of funds into the market from illegal sources—then the CSRC may not have the political will to do so.

Id.

139. *See* HUANG, *supra* note 133, at 84–86.

140. *See id.* at 84–85 (explaining that many Chinese view the CSRC has a training ground for private sector financial employment).

141. *Id.* at 84.

142. *Id.* at 86.

143. *Id.*

144. Clarke, *supra* note 136, at 182. In addition to corruption and vulnerability to political pressure, Chinese judges tend to have a low level of education. *Id.*

145. *Id.*

146. *Id.*

147. *See id.*

148. *See id.*

ineffective in enforcing the Chinese Securities Laws, thereby allowing investors and companies to pursue potentially fraudulent activity without fear of penalty.¹⁴⁹

One theory as to China's lack of effective oversight blames the relative youth of the Chinese securities industry.¹⁵⁰ While the American regulatory regime arose in response to the Great Depression,¹⁵¹ China has attempted to develop securities regulation in a time of prosperity.¹⁵² Its regulatory bodies, which oversee the banking and insurance industries, predate the growth of China's banks into some of the largest in the world.¹⁵³ Further, although the CSRC has been creating new regulations quickly,¹⁵⁴ it is too understaffed to enforce its own laws.¹⁵⁵ The current Chinese securities market consists of approximately 1,200 Chinese public reporting companies issuing securities to a market of 1.3 billion people.¹⁵⁶ Nevertheless, China does in fact have largely similar regulations to those found in Western economies.¹⁵⁷ Therefore, some academics con-

149. See *Markets in China*, *supra* note 14.

150. From 1989 to October 2002, China went from having no securities market to a securities market with over 1,200 publicly listed companies. These companies collectively constituted a market capitalization of 4.27 trillion yuan (\$514.3 billion). Ji Chen & Stephen C. Thomas, *The Ups and Downs of the PRC Securities Market*, 30 CHINA BUS. REV. 36, 36 (2003).

151. *Q&A: Small Business and the SEC*, *supra* note 97 (reciting that, in the United States, Congress enacted the federal securities laws in response to the Stock Market Crash of 1929 and tasked the SEC to administer them). The United States has a history of reactionary financial regulatory legislation beyond just the federal securities laws in the 1930s. The technology boom of the 1960s involving Xerox, IBM, and Polaroid led to the passage of the Williams Act (regulating corporate takeovers), ERISA (regulating employee benefit plans), the Hart-Scott-Rodino Act (amending existing antitrust law), and the Foreign Corrupt Practices Act (providing for further accounting transparency), all in the 1970s. DeLaMater, *supra* note 82, at 115.

152. Yin, *supra* note 120, at 409.

153. Dinny McMahon & Aaron Back, *Resignations Suggest Shift for China's Banks*, WALL ST. J. (Oct. 29, 2011), <http://online.wsj.com/article/SB10001424052970203687504577003734190522426.html>. Despite China's position as the world's second largest economy, the financial sector remains underdeveloped and regulators face major challenges. *Id.*

154. Yin, *supra* note 120, at 415.

155. See Chen & Thomas, *supra* note 150, at 39.

156. *Id.*; WORLD FACTBOOK, *supra* note 3.

157. Yin, *supra* note 120, at 412–13. China looked to the Western regulatory structure for guidance when drafting the CSRC's mandate. *Id.* In a sur-

tend that the source of problems found in Chinese companies is management, not government.¹⁵⁸ Due to the overwhelmingly centralized state of the Chinese economy a generation ago, these scholars argue, many Chinese falsely disclose information, manipulate markets, and trade on inside information due to their lack of experience with capitalism.¹⁵⁹

Putting aside the unlikely explanation of a cultural propensity towards deceitful behavior, the principal difference between the Chinese and American financial regulatory systems remains the principal regulator's willingness to pursue enforcement and independent accounting oversight of companies.¹⁶⁰ An examination of case studies confirms that accounting irregularities, as well as revelations of outright fraud, are frequently to blame for the underperformance of the many Chinese foreign private issuers listing in the United States via reverse mergers.

B. The Underperformance of Reverse Merger Listings

As discussed above, many Chinese small businesses that have sought to access American capital markets have done so through a reverse merger with an existing American shell company and subsequently listing either on an exchange, such as the New York Stock Exchange ("NYSE") or the NASDAQ, or on the over-the-counter ("OTC") bulletin board system.¹⁶¹ Since

prising move, Premier Zhu Rongji recruited a Shanghai-born, U.S.-educated woman to be Vice Chairperson of the CSRC. Some observers see this as an attempt to "fall in line with Western securities regulation standards." *Id.* For a comparison of United States and Chinese securities regulation, see *supra* notes 100–160 and accompanying text.

158. See, e.g., *id.* at 414; Finn, *supra* note 12, at 287.

159. See Yin, *supra* note 120, at 414 (noting "lack of experience in capitalistic economic policies" as a factor in regulatory problems plaguing China). See also Finn, *supra* note 12, at 287 (describing a "cultural grounds for acceptance of bribery" and frequent corruption). Finn draws a connection between corruption and the emergence of the post-1978 Chinese economy. *Id.* Further, he states that "corruption has an adverse effect on foreigners doing business in China." *Id.*

160. See, e.g., Robert Holmes, *China Reverse-Merger Regulation Looks Flawed*, CNBC (Dec. 23, 2010, 6:01 PM), http://www.cnbc.com/id/40787567/China_Reverse_Merger_Regulation_Looks_Flawed.

161. Anderlini, *supra* note 89. Public companies which are not listed on an exchange trade in the OTC market, a "securities quotation and trading system for broker-dealers." Pavkov, *supra* note 90, at 508, 510–11. The OTC

the goal of the Chinese company conducting a reverse merger is to find an easy means to access the American public markets, rather than the traditional merger motivation of finding a strategic partner, many of the reverse merger deals have involved odd corporate combinations.¹⁶² For example, Winner Group, a Chinese medical-device retailer, merged into the shell of Las Vegas Resorts.¹⁶³ Zhongsen International, a tire manufacturer, likewise merged into the American shell of Rub A Dub Soap.¹⁶⁴ Chinese foreign private issuers that have pursued this sort of “backdoor listing” are not subject to SEC review or reporting, nor are they subject to the rules and regulations issued by the individual exchanges on which they list their securities.¹⁶⁵

Despite Western enthusiasm over the wondrous growth in China, many of the Chinese companies listing via reverse merger have underperformed.¹⁶⁶ A *Barron's* study of 158 Chinese foreign private issuers in the United States shows that the median among them underperformed the benchmark Halter USX CHINA Index by 75% and the Russell 2000 small-cap stock index by 66%.¹⁶⁷ The American investor seeking to invest in the Chinese small-business boom and the Chinese entrepreneur seeking American growth capital bore the brunt of these losses.¹⁶⁸

marketplace does not have the trading floor of an exchange. *Id.* at 508 (explaining that securities in the OTC marketplace are traded by dealers known as “marketmakers.”). The OTC marketplace is particularly popular with Chinese foreign private issuers due to its lower standards for review and approval. *Double Due Diligence Efforts Before Investing*, *supra* note 92. *See also* Pavkov, *supra* note 90, at 511 (describing the OTC bulletin board system and the Pink Sheets as the “wild west of stock markets.”). The OTC marketplace requires only that companies are current in their Exchange Act filings and are not listed concurrently on any national securities exchange. *Id.* By contrast, the NYSE has the most stringent listing standards and often delists companies that “significantly reduc[e] operating assets or scope of operations and companies entering bankruptcy or liquidation.” *Id.* at 508. This makes the NYSE a less popular venue for Chinese reverse mergers. *See id.* (explaining that public shells are deterred from remaining on the NYSE).

162. *See* Alpert & Norton, *supra* note 84.

163. *Id.*

164. *Id.*

165. *Double Due Diligence Efforts Before Investing*, *supra* note 92.

166. *See, e.g.*, Alpert & Norton, *supra* note 84.

167. *Id.*

168. *Id.*

The group of Chinese foreign private issuers listing via reverse merger has been described as a “minefield”¹⁶⁹ of disappointment, often caused directly by accounting irregularities and fraud.¹⁷⁰ Examples of failed listings of this nature began almost as soon as the first Chinese companies came to market. Perhaps the most notable early case occurred in September 1997 when Asia Electronics Holding Company, a TV component manufacturer, raised forty-two million dollars on the NASDAQ before going “into a tailspin” following the arrest of its leader for “fraudulent investment schemes.”¹⁷¹ The scandal proved to be merely the tip of the iceberg, however, and the full scale of corporate fraud within Chinese foreign private issuers continues to emerge to this day.

C. Recent Cases of Corporate Fraud and Accounting Irregularities

Chinese small businesses listing in the United States via reverse mergers engage in fraudulent accounting in China in order to attract growth-focused American investors.¹⁷² One of the most-cited examples of this occurred in 2006 with China Expert Technology, whose audited financial statements showed \$175 million in revenue over four years.¹⁷³ Regulators discovered that the company was a sham, with no revenue and few, if any, customers.¹⁷⁴

169. *Id.* Even large-cap stocks listing on the NYSE have been implicated. The largest IPO of 2003, China Life Insurance, was quickly subject to a shareholders’ derivative action due to accounting discrepancies. Finn, *supra* note 12, at 287–88.

170. Anderlini, *supra* note 89.

171. Alpert & Norton, *supra* note 84. Asia Electronics was one of the first Chinese listings on the NASDAQ. *Id.* Today, the NASDAQ is the most popular venue for Chinese foreign private issuers, with 159 China-based companies on the exchange. Holmes, *supra* note 160.

172. Many of these companies keep two sets of books: one for the Chinese regulators and one for SEC examination. Holmes, *supra* note 160. For example, NYSE Euronext-listed China Green Agriculture, a fertilizer manufacturer, was alleged to have reported one set of sales and net income figures to the SEC and a different set to the Chinese government. *Id.* The company’s stock proceeded to lose 35% of its value after it admitted to the veracity of the claims. *Id.*

173. *Id.*

174. *Id.* The company was later subject to a class action suit brought by its shareholders, who won a default judgment against China Expert Technology. *Id.* The company, however, was entirely judgment-proof. *Id.*

The vast scale of accounting scandals in Chinese foreign private issuers listing via reverse merger came to light in the spring and summer of 2011. Between March and May of that year, more than 24 Chinese foreign private issuers disclosed auditor resignations or accounting problems, such as the inability to confirm balance sheet figures.¹⁷⁵ In June 2011, Orient Paper, a cardboard manufacturer and NYSE Euronext-listed Chinese company, lost two-thirds of its market capitalization after analysts visited its factory and discovered it to be “idle and dilapidated.”¹⁷⁶ The analysts, employed by Hong Kong-based Muddy Waters Research (“Muddy Waters”)—which has built a reputation for being bearish on Chinese small-cap stocks¹⁷⁷—estimated that Orient Paper overstated the value of

All the assets are in China. The people are in China. [One] can't so much as serve a subpoena in China You can't get any discovery in China. The SEC would be completely blocked from any regulatory action against a Chinese person or entity. What can they do? Nothing.

Id. (quoting Laurence Rosen, an attorney who represents disgruntled shareholders of China Expert Technology).

175. Bill Alpert, *SEC Reports on China Reverse-Mergers*, BARRON'S (May 5, 2011), <http://online.barrons.com/article/SB50001424052970203390704576305100837510830.html>.

176. Alpert & Norton, *supra* note 84. Carson C. Block, founder of investment firm Muddy Waters Research, describes Orient Paper's headquarters as a “Potemkin Village, littered with ‘junk machinery’ and ‘trash.’” David Barboza & Azam Ahmed, *Muddy Waters Research Is a Thorn to Some Chinese Companies*, N.Y. TIMES (June 9, 2011, 9:20 PM), <http://dealbook.nytimes.com/2011/06/09/muddy-waters-research-is-a-thorn-to-some-chinese-companies>. Block describes a pile of scrap cardboard that the analysts found on the Orient Paper site, which the company had listed on their balance sheet as “raw material” worth millions of dollars. *Id.*

177. Barboza & Ahmed, *supra* note 176. The firm's name is derived from a Chinese proverb that says that “the easiest way to catch fish is by muddying the water, forcing it to the surface.” *Id.* “Muddy Waters . . . [is] taking direct aim at reverse mergers [it] say[s] have dubious practices. The organization [is] issuing research reports, posting surveillance videos and collecting corporate documents.” *Id.* “Small-cap” is shorthand for companies with a small market capitalization, generally considered to be between \$300 million and \$2 billion. *Small Cap Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/small-cap.asp> (last visited Aug. 19, 2012).

its assets by ten-fold and revenues by forty-fold in the course of its SEC disclosure.¹⁷⁸

That same month, the SEC halted trading and sought a “stop-order” to cancel the effectiveness of the registration statements of China Intelligent Lighting and Electronics Inc. and China Century Dragon Media Inc.¹⁷⁹ The SEC alleged that each company had failed to publicly disclose that their auditors had resigned after questioning the accuracy of each company’s financial statements and bank records.¹⁸⁰ Similarly, China-based RINO International, a sewer equipment manufacturer, was delisted by the NASDAQ¹⁸¹ after a short-seller uncovered accounting discrepancies involving customer contracts that had never been executed.¹⁸² RINO had gone through three auditors and four chief financial officers in four years.¹⁸³ Shares lost two-thirds of their value before the stock was delisted.¹⁸⁴

Some of the premier institutional investors in the United States have suffered losses when otherwise attractive deals implode.¹⁸⁵ The Carlyle Group, a private equity firm that has

178. Alpert & Norton, *supra* note 84.

179. Joshua Gallu, *SEC Seeks Halt To Sales of 2 China-Based Stocks*, BLOOMBERG (June 13, 2011), <http://www.bloomberg.com/news/2011-06-13/sec-seeks-halt-to-sales-of-2-china-based-stocks.html>.

180. *Id.* Resignation or dismissal of a company’s outside auditors requires disclosure through an 8-K filing with the SEC. PINTO & BRANSON, *supra* note 86, at 163.

181. Each stock exchange registered with the SEC under the Exchange Act has the authority to set listing standings, which issues must meet in order to be listed on that exchange. Pavkov, *supra* note 90, at 508. The penalty for failure to meet an exchange’s listing standards is often “delisting,” or removal from the exchange. *Id.* Listing standards often include a required “number of shareholders, trading volume, number of publicly held shares, aggregate market value of shares outstanding, and total global market capitalization.” *Id.* The NYSE has the most stringent listing standards, and therefore Chinese reverse mergers tend to occur on the regional exchanges and the OTC marketplace. *Id.*

182. Holmes, *supra* note 160.

183. Alpert & Norton, *supra* note 84. The company also restated its financial results twice during that time period. *Id.*

184. Holmes, *supra* note 160. Investors in RINO lost \$400 million. *Id.*

185. See Robert Cookson & Henny Sender, *Carlyle Faces Questions over China Investments*, FIN. TIMES (May 5, 2011, 8:03 PM), <http://www.ft.com/cms/s/0/7971bb26-773e-11e0-aed6-00144feabdc0.html> (describing The Carlyle Group’s problems with its Chinese investments). See also Barboza & Ahmed, *supra* note 176 (stating that Paulson & Company,

about \$153 billion under management,¹⁸⁶ bought a 22 percent ownership interest in China Agritech, a NASDAQ-listed fertilizer manufacturer that came to the market in 2005 via a reverse merger.¹⁸⁷ Yet as of mid-2012, China Agritech faces delisting from the exchange for failing to file its account on time¹⁸⁸ and the company has gone through three auditors in three years.¹⁸⁹ Such examples demonstrate that the failures seen in Chinese small-cap stocks are indicative of systemic problems with regulation and oversight in China, and are not due to inadequate due diligence on the part of the investor.

A significant dimension to the reversal merger scandals is the fact that most of the activities have initially come to light as a result of short-sellers' independent research, only to be followed by regulatory investigations.¹⁹⁰ Muddy Waters, one of the more high profile Chinese foreign private issuer short-sellers,¹⁹¹ views its role as filling a gap in regulatory oversight between the United States and China.¹⁹² RINO and China Media Express were each delisted after Muddy Waters accused them of fraudulent activities.¹⁹³ Similarly, regulators suspended Duoyuan Global Water after Muddy Waters made accusations of fraud against them.¹⁹⁴ At Duoyuan, four of its six independent directors resigned after claiming the company's management was obstructing its investigation into the corporation's internal controls and accounting.¹⁹⁵

Muddy Waters also targeted a forestry company named Sino-Forest, a company listed on the Toronto Stock Exchange¹⁹⁶ that

John A. Paulson's hedge fund, lost billions of dollars after the collapse of Sino-Forest).

186. The Carlyle Grp. L.P., Registration Statement (Form S-1) (Sept. 6, 2011), *available at* <http://sec.gov/Archives/edgar/data/1527166/000095012311082561/w83442sv1.htm>.

187. Cookson & Sender, *supra* note 185.

188. *Id.*

189. *Id.*

190. *See* Barboza & Ahmed, *supra* note 176.

191. *See generally id.*

192. *See id.* Muddy Waters describes itself as "regulat[ing] in an area with little oversight." *Id.*

193. Anderlini, *supra* note 89.

194. *Id.*

195. *Id.*

196. *Id.* Although Sino-Forest is not traded on a U.S. exchange, it is otherwise an apt case study of the issues and contentions raised in this Note.

has become the poster-child for Chinese accounting fraud.¹⁹⁷ On June 2, 2011, Muddy Waters released a research report¹⁹⁸ alleging that the company was a Ponzi scheme¹⁹⁹ in the range of \$900 million.²⁰⁰ The essence of the claim by Muddy Waters was that Sino-Forest vastly overstated its forestry holdings in China.²⁰¹ The stock slumped from a high of C\$25.30 (\$24.63) per share in March 2011 to a low of C\$1.99 (\$1.94) following the release of the Muddy Waters report.²⁰² Trading of the stock was thereafter halted by the Toronto Stock Exchange.²⁰³ Billions of dollars' worth of investment funds have been lost as a result of this series of Chinese reverse merger frauds, and the situation continues to unfold as of this writing.²⁰⁴

197. Kaitlin Shung, *Sino-Forest Sees Paulson & Co Sell Out As Fraud Allegations Linger*, CHINA BRIEFING (June 21, 2011), <http://www.china-briefing.com/news/2011/06/21/sino-forest-sees-paulson-co-sell-out-as-fraudulent-reporting-allegations-linger.html>.

198. Anderlini, *supra* note 89.

199. A "Ponzi scheme" is "a fraudulent investing scam promising high rates of return with little risk to investors." *Ponzi Scheme Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/ponziscHEME.asp> (last visited Aug. 19, 2012).

The Ponzi scheme generates returns for older investors by acquiring new investors. This scam actually yields the promised returns to earlier investors, as long as there are more new investors. These schemes usually collapse on themselves when the new investments stop.

Id.

200. Craig Stephen, *China's U.S.-Listed Stocks Are Junk*, MARKETWATCH (July 10, 2011, 10:48 PM), <http://www.marketwatch.com/story/chinas-us-listed-stocks-are-junk-2011-07-10>.

201. Ian Austen, *Sino-Forest Report Rejects Fraud Claims, With Caveats*, N.Y. TIMES (Nov. 15, 2011, 11:00 AM), <http://dealbook.nytimes.com/2011/11/15/sino-forest-report-rejects-fraud-claims-with-caveats>. Sino-Forest operated through a series of fifty-eight holding companies located in the British Virgin Islands and used third-parties to act as middlemen. *Id.* Sino-Forest contended that "while unusual by Western standards, [this is] an accepted way of doing business in China." *Id.*

202. *Markets in China*, *supra* note 14.

203. Austen, *supra* note 201.

204. Michael Rapoport, *Sen. Schumer Urges Audit Watchdog to Act on China*, WALL ST. J. (Nov. 22, 2011), <http://online.wsj.com/article/SB10001424052970203710704577052543850533540.html>.

D. The Regulatory Abyss

Scandals within the Chinese small-cap sector have cost American investors approximately thirty-four billion dollars in losses over the past five years.²⁰⁵ In response, American exchanges are suspending a number of Chinese companies from trading while inquiries proceed.²⁰⁶ Separately, the SEC is halting the offering of shares by these companies as they investigate claims of fraud against Chinese reverse merger listings. The contention amongst many American investors, however, is that these scandals should have never occurred in the first place.²⁰⁷ Aspects of corporate internal control such as the production of accurate of financial statements and bank account balances, as well as the elimination of accounting discrepancies, fit squarely within the realm of the auditors', regulators', and exchanges' responsibilities as gatekeepers.²⁰⁸ While the Chinese media contends that a few "bad apples" have tarnished the sector, U.S. securities experts maintain that it is a series of "fundamental weaknesses in the regulatory environment" surrounding reverse mergers that is to blame.²⁰⁹

Chinese foreign private issuers have fallen into a "regulatory vacuum" of market regulation.²¹⁰ The principal U.S. securities regulator, the SEC, is too understaffed to review the heavy volume of reverse merger activity.²¹¹ Further, the SEC cannot en-

205. Holmes, *supra* note 160. The majority of these losses occurred in Chinese companies gaining access to the U.S. market through reverse mergers. *Id.*

206. See Cookson & Sender, *supra* note 185. "Of the 19 NASDAQ stocks currently suspended from trading, 15 are Chinese." *Id.*

207. Holmes, *supra* note 160.

208. Some have argued that the Chinese lawyers, accountants, intermediaries, and stock promoters who bring these companies to market are small and inexperienced, therefore neglecting to conduct sufficient due diligence or proper audits. Anderlini, *supra* note 89. Nevertheless, ignorance cannot be accepted as an excuse given the massive losses seen in the Chinese small-cap space. Pavlo, *supra* note 90 (opining that the failure of Chinese company management to learn American compliance requirements is no excuse for fraud).

209. Holmes, *supra* note 160.

210. Anderlini, *supra* note 89.

211. The SEC has "hundreds of deals to review [in the small-cap space], thousands of related financial statements, and no easy way to verify financial statements that relate to operations in China." Holmes, *supra* note 160 (stating that even assigning the entire Enforcement division's resources for two

force its regulations relating to the disclosure produced by these companies as the fraudulent activities have occurred in China, which lies outside of the SEC's subpoena power.²¹²

The principal Chinese securities regulator, the CSRC, has no incentive to regulate shares of companies which are only bought and sold in the United States.²¹³ The CSRC has chosen not to enforce its disclosure standards for Chinese businesses trading on American exchanges in spite of its direct obligation to do so—one of the CSRC's codified functions is to “supervise the offering of securities *outside* of China by Chinese enterprises.”²¹⁴ In addition, despite the existence of a Memorandum of Understanding between the SEC and the CSRC that calls for enforcement cooperation between the two regulators, the CSRC has shown little willingness to collaborate.²¹⁵ Even within its own jurisdiction, the CSRC rarely brings enforcement actions against those companies defrauding investors and clients through dodgy accounting practices.²¹⁶

One of the most surprising aspects of the reverse merger scandals is the extent to which the auditors of these troubled companies are U.S.-registered accounting firms.²¹⁷ Some of these auditors are small American firms that outsourced their

years to Chinese foreign private issuer investigations would barely make a dent).

212. Alpert & Norton, *supra* note 84. Some have suggested that Chinese small business owners are aware of this jurisdictional constraint on the SEC and have acted accordingly. Holmes, *supra* note 160. Because of the number of legal challenges that American regulators face internationally, some have termed the United States a “paper tiger.” Kara Scannell, *Reverse Mergers Test U.S. Regulators*, FIN. TIMES (July 4, 2011, 9:17 PM), <http://www.ft.com/intl/cms/s/0/18338c8e-a65c-11e0-ae9c-00144feabdc0.html>.

213. Alpert & Norton, *supra* note 84.

214. Friedman, *supra* note 16, at 483 (emphasis added).

215. Holmes, *supra* note 160. This Memorandum ostensibly served to “formalize a cooperative and consulting relationship” between the two regulators, particularly with respect to technical and enforcement assistance. *SEC and China Securities Regulatory Commission Sign Memorandum of Understanding to Formalize Cooperative Relationship*, News Release No. 94-35, 1994 WL 150804 (Apr. 28, 1994) [hereinafter *SEC News Release*]. The Memorandum of Understanding between the United States and China was originally signed in April 1994 and subsequently reaffirmed in May 2006. Holmes, *supra* note 160.

216. *Markets in China*, *supra* note 14.

217. Anderlini, *supra* note 89 (stating that 74 percent of Chinese reverse merger companies were audited by U.S. firms).

audit work to local firms in China.²¹⁸ However, several Big Four²¹⁹ American accounting firms have also been implicated.²²⁰ In May 2011, Deloitte Touche Tohmatsu (“Deloitte”) resigned as auditor for Longtop Financial Technologies (“Longtop”), a Chinese financial software company with \$1.1 billion in stock market value.²²¹ In a letter filed publicly with the SEC, Deloitte explained that upon seeking confirmation of bank account balances, Deloitte auditors were harassed by company management, who “threat[ened] to stop [staff] from leaving the company premises unless [the staff] allowed the company to retain [Deloitte’s] audit files.”²²² These threats came after Deloitte had discovered that Longtop did not have any of the money that they had claimed in their books.²²³ Shortly after Deloitte’s letter was filed, Longtop’s stock was suspended from the NYSE and is now considered worthless.²²⁴ The fraud at Longtop is noteworthy because of the size of the company and the fact that Chinese banks were allegedly providing Deloitte with false bank statements supporting Longtop’s inaccurate disclosures.²²⁵

218. *Id.*

219. The “Big Four” public accounting firms in the United States are Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers. *Big Four Public Accounting Firms*, ABOUT.COM, <http://financecareers.about.com/od/publicaccountingfirms/a/BigFour.htm> (last visited Nov. 4, 2011).

220. For example, China Media Express’s auditor, Deloitte, quit when the accounting firm determined that they could “no longer . . . rely on the representations of [China Media Express] management.” Pavlo, *supra* note 90. In addition, both Sino-Forest and China Agritech had used Big Four firm Ernst & Young as their auditor. Floyd Norris, *Troubled Audit Opinions*, N.Y. TIMES (June 9, 2011), http://www.nytimes.com/2011/06/10/business/10norris.html?_r=1; James Sterngold, *Wall Street Scion Lost in China Agritech As Shorts Cry ‘Scam’*, BLOOMBERG (Apr. 26, 2011, 7:01 PM), <http://www.bloomberg.com/news/2011-04-26/wall-street-scion-lost-in-china-agritech-as-shorts-cry-scam-.html>.

221. Norris, *supra* note 92. Deloitte had signed off on Longtop’s financial statements for six years prior to their resignation. *Id.*

222. *Id.*

223. *Id.* (“Longtop’s chairman, Jia Xiao Gong, told a Deloitte partner that there was ‘fake cash recorded on the books because there had been ‘fake revenue in the past.’”).

224. *Id.*

225. *Id.* (“Just what, if anything, Chinese officials choose to do could provide an indication about whether defrauding foreign investors is deemed a serious crime in China.”).

The Longtop scandal exploded into a global episode of finger-pointing between the United States and China.²²⁶ Deloitte now finds itself in an uncomfortable bind between foreign regulators.²²⁷ Upon the revelation of the Longtop scandal, the SEC asked Deloitte's Shanghai office to produce its audit papers.²²⁸ The firm declined, stating that such production would place it afoul of Chinese secrecy laws.²²⁹ In October 2011, the SEC brought suit against Deloitte, seeking an administrative subpoena.²³⁰ Should Deloitte ignore the subpoena, they will face a criminal conviction for noncompliance.²³¹ Chinese regulators, however, are preventing Deloitte's Shanghai office from disclosing the information requested.²³² The PCAOB has also become embroiled in the mess, threatening to revoke Deloitte's registration.²³³

The PCAOB, established to police accounting firms engaging in poor gatekeeping of the exact type that has been occurring in the Chinese reverse merger space, has been powerless to flex its muscles as China will not let the PCAOB inspect local auditors engaged by American listed companies.²³⁴ In a comment

226. Pentland, *supra* note 15.

227. *Auditing in China: Chinese Stall*, *ECONOMIST* (Sept. 17, 2011), <http://www.economist.com/node/21529084> [hereinafter *Auditing in China*].

[T]he SEC is unlikely to back away from a case in which American investors suffered losses based on what appears to be a rather brazen accounting fraud. And the Chinese government is unlikely to accede to allowing the auditors to respond to a subpoena that would create a precedent for other firms being compelled to disclose their work papers.

Peter J. Henning, *Deloitte's Quandary: Deft the S.E.C. or China*, *N.Y. TIMES* (Oct. 20, 2011, 2:30 PM), <http://dealbook.nytimes.com/2011/10/20/deloittes-quandary-defy-the-s-e-c-or-china>.

228. Floyd Norris, *Shhh! Don't Name That Auditor*, *N.Y. TIMES* (Oct. 13, 2011, 2:03 PM), <http://economix.blogs.nytimes.com/2011/10/13/shhh-dont-name-that-auditor>.

229. Henning, *supra* note 227.

230. Norris, *supra* note 228.

231. Henning, *supra* note 227.

232. Pentland, *supra* note 15. "Deloitte China issued a press release stating: 'As a matter of national sovereignty, the law of the People's Republic of China precludes our firm from producing the requested documents to a foreign regulator without approval from [the CSRC].'" *Id.*

233. *Id.*

234. Alpert & Norton, *supra* note 84. This includes the Chinese affiliates of American Big Four firms. Norris, *supra* note 92. James Doty, chairman of the

letter sent to the SEC in May 2009, the CSRC stated that the PCAOB should “fully rely on the work of the CSRC.”²³⁵ Further, the Chinese government has expressed its disagreement with the PCAOB’s “unilateral basis” for foreign inspections,²³⁶ citing sovereignty concerns.²³⁷ As the scandals surrounding Chinese reverse merger companies escalated in the summer and fall of 2011, U.S. Senator Charles Schumer (D-NY) sent a letter to the PCAOB urging them to exert their enforcement authority to bar any Chinese accounting firms that are not subject to PCAOB inspection from performing audit work on Chinese companies listed in the United States.²³⁸ “This standoff,” Senator Schumer wrote, “has gone on long enough.”²³⁹

The SEC/PCAOB and the CSRC have come to a standstill, with each side waiting for the other to blink. Given the magnitude of the current crisis of confidence in the audits of Chinese foreign private issuers, initiative needs to be taken that goes beyond the exchange of letters and bypasses the use of diplomatic summits that may be futile, costly, and time-consuming.

IV. PROPOSALS TO REGULATE CHINESE FOREIGN PRIVATE ISSUERS

It is imperative that there be a regulatory framework that will allow Chinese companies to access the U.S. capital markets while assuring American investors that the issuer is transparent and fully honest in its disclosures. Further, any regulatory framework must be enforceable, an aspect that the Chinese have forgone in the past.²⁴⁰ As word of the troubles in

PCAOB, has termed this “a gaping hole in investor protection.” Michael Rapoport, *Progress Cited on Audits in China*, WALL ST. J. (Aug. 9, 2011), <http://online.wsj.com/article/SB10001424053111904140604576495290600231986.html>.

235. Elizabeth P. Gray & Jessica L. Matelis, *PCAOB Foreign Inspections—A Chinese Conundrum*, 44 REV. SEC. & COMMODITIES REG. 145, 150 (2011).

236. *Id.*

237. Rapoport, *supra* note 204.

238. *Id.* “The board’s failure to do what it was created to do—particularly in the face of Chinese corporate accounting scandals that have already cost U.S. investors billions—is deeply troubling.” *Id.*

239. *Id.*

240. *Markets in China*, *supra* note 14 (“Reports of prosecutions in China over dodgy accounting in cases where investors or clients are victims remain scarce.”). See also David A. Caragliano, Note, *Administrative Governance As Corporate Governance: A Partial Explanation for the Growth of China’s Stock*

the Chinese small-cap space spreads, and without any new regulatory schemes, American investors will inevitably be driven away from the market.²⁴¹ The losers, in the end, will be the many legitimate Chinese entrepreneurs who are deprived of fundraising opportunities abroad as well as international investors pursuing a growth-oriented investment strategy.²⁴²

The instinctive reaction is to suggest that American regulators enact an outright prohibition on reverse mergers. However, this proposal is not prudent. The reverse merger technique, effectuated properly, can provide benefits to both the company and investors.²⁴³ Small-cap, private companies have special financing needs that reverse mergers may be able to effectuate.²⁴⁴ For example, reverse mergers allow smaller companies to access new capital and to promote themselves to new investors in the public markets.²⁴⁵ Investors benefit from reverse mergers by gaining access to “embryonic companies with high growth potential.”²⁴⁶ Such access is typically only available to venture capital firms and their respective investors.²⁴⁷ Alt-

Markets, 30 MICH. J. INT'L L. 1273, 1311 (2009) (“Like most transition economies, China has exhibited under-enforcement of its securities laws, and companies have operated under non-market standards.”).

241. See Holmes, *supra* note 160 (describing how investors can no longer assume that a company’s presence on an American exchange represents any degree of integrity).

242. “Even the harshest critics of the [reverse merger] category concede that there are plenty of Chinese companies—even small caps—offering solid opportunities for investors. At the same time, the skeptics caution that individual investors will likely find it difficult to separate the good from the bad.” *Id.*

243. See, e.g., Pavkov, *supra* note 90, at 513.

244. *Id.*

245. *Id.* at 489. As the company’s exposure grows, it may find additional opportunities to finance its operations through equity as a result of its use of the reverse merger mechanism. *Id.*

246. *Id.*

247. *Id.* Venture capital funds escape registration requirements under the Investment Company Act of 1940 by limiting their investors only to those who are “qualified purchasers.” Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(7) (2011). A “qualified purchaser” is defined as an individual with at least five million dollars in investments. *Id.* at § 80a-2(a)(51). Therefore, the majority of retail investors do not have access to venture capital funds. See Pavkov, *supra* note 90, at 489. Further, small businesses have difficulty pursuing IPOs through the traditional process of seeking investment bankers to underwrite their securities. *Id.* This is attributable to the fact that investment bankers prefer to underwrite lower-risk companies. *Id.* Therefore, “non-

ough substantial due diligence may be required, retail investors should not be impeded from pursuing a growth investment strategy through investment in reverse merger companies.²⁴⁸

There is a better course than prohibiting reverse merger transactions. The essence of an improved regulatory framework capable of confronting these challenges is a stronger regulation of the accounting firms that have certified these troubled companies. The extent to which the “reputational intermediaries” or gatekeepers, on whom investors have traditionally relied to verify disclosure, have participated in the frauds is troubling.²⁴⁹ Since PCAOB-led examinations of the audits of Chinese foreign private issuers are being frustrated by the Chinese government, the answer must come from within China’s borders. Simply put, if the Chinese will not allow the American regulators to properly execute their mandate, then the burden should be on the Chinese to oversee those Chinese accountancy firms that are signing off on the audits of companies listing on American exchanges. The first step towards effective regulation of these listings is the creation, by the Chinese government, of an organic independent auditing oversight body that will internally regulate Chinese gatekeepers. The creation of the PCAOB through the passage of SOX in the United States could provide a template for the Chinese establishment of a new counterpart to the PCAOB. Such an organization would ideally work with the PCAOB to set international standards.

An independent auditing oversight body in China is needed because China’s accounting firms themselves are failing inves-

elites are unable to invest in riskier startups.” *Id.* In sum, the reverse merger provides an alternative to venture capital funded IPOs for small businesses to go public and allows the average investor to potentially profit. *See id.*

248. *Double Due Diligence Efforts Before Investing*, *supra* note 92. Diligence on Chinese foreign private issuer investments should include “working closely with experienced legal counsel, accountants and, occasionally, private investigation firms to affirm an investee’s representations, as well as speaking with its clients. . . . [A] visit to the investee’s operations should be conducted.” *Id.* China is a very promising market, but effort is required to find investments of true value. *Id.*

249. Caragliano, *supra* note 240, at 1311. Dan David, vice president at GeoInvesting, another Chinese small-cap short-seller, stated: “We had counted on the fee collectors—the investment banks, the accountants and the lawyers—to tell us what was right Now, we’re doing our own due diligence, and hiring people in China to investigate.” Barboza & Ahmed, *supra* note 176.

tors in their capacities as gatekeepers.²⁵⁰ China's accounting firms bear few, if any, penalties for their failure to produce accurate financial reports.²⁵¹ In addition, the CSRC has shown a "general unwillingness to enforce its standards in its core competence of securities regulation."²⁵² The lack of regulation and enforcement by the CSRC is in direct opposition to its mission of "supervis[ing] the offering of securities *outside* of China by Chinese enterprises."²⁵³ The CSRC's nonfeasance also runs against its commitment to work with the American regulators in the area of "technical and enforcement assistance."²⁵⁴ It appears inevitable that any oversight of auditing, which relies on the CSRC for implementation and enforcement, "may not turn out to be terribly meaningful" to Chinese companies listing in the United States.²⁵⁵

Opponents to the creation of such an organization, however, will argue that the implementation of SOX-like legislation abroad is unwarranted because SOX unfairly burdens foreign private issuers.²⁵⁶ On a general level, SOX has been challenged

250. Clarke, *supra* note 136, at 161. The legal and accountancy professions in the United States are considerably more developed and sophisticated than their Chinese equivalents. *Id.* China has few lawyers and its law schools do not emphasize the goals of investor protection that the United States believes is at the heart of securities law. *See id.* Further, Chinese accountants "are not trained to handle complex financial matters." *Id.*

251. Caragliano, *supra* note 240, at 1304 ("Chinese lawmakers have struggled to articulate a workable liability standard for accountants."). The CSRC has not made the sanctioning of accounting firms a priority. Clarke, *supra* note 136, at 161–66 (describing only seven civil actions in the last ten years brought against accounting firms, each of which concerned creditors lending to companies on the basis of inaccurate financial certifications). Litigation in response to investor complaints relating to inaccurate certifications is non-existent. *See id.* at 165.

252. Clarke, *supra* note 136, at 180. Clark suggests that the CSRC's unwillingness to regulate "stems from its dual mission as market regulator and market promoter for the state." *Id.*

253. Friedman, *supra* note 16, at 483 (emphasis added).

254. *SEC News Release*, *supra* note 215. *See also* Yin, *supra* note 120, at 412.

255. Clarke, *supra* note 136, at 180.

256. *See, e.g.*, Christopher Hung Nie Woo, *United States Securities Regulation and Foreign Private Issuers: Lessons from the Sarbanes-Oxley Act*, 48 AM. B. L.J. 119, 174 (2011); Lee J. Potter, Jr. & Eberhard Röhm, *SEC Extends Sarbanes-Oxley Deadline for Some Foreign Companies*, ARENT FOX LLP (Sept. 14, 2006),

on the grounds that its initiatives conflict with other nations' local regulatory practices.²⁵⁷ Specifically with respect to foreign private issuers, SOX opponents contend that the compliance costs required are prohibitive for smaller companies.²⁵⁸ There is evidence that some foreign private issuers exited the American market following the passage of SOX and that the legislation caused other foreign companies to opt not to list in the United States.²⁵⁹ While SOX remains controversial as applied to foreign private issuers, it has resulted in the creation of an enforcement and regulatory body for auditing firms, the PCAOB, a necessary evil in an industry that has proven to be incapable of self-regulation.²⁶⁰ If China continues to cite sovereignty concerns as the basis for barring PCAOB inspections within its borders,²⁶¹ then the best solution is the creation by China of an independent body similar to the PCAOB to regulate its auditing firms.

This proposed regulatory structure has already proven successful in the United States. The PCAOB has worked effectively as a regulator of gatekeepers because SOX provided for stringent enforcement of the increased regulation, which is something the current Chinese regime refuses to do.²⁶² To provide one important example, SOX and the PCAOB make individuals personally accountable for the accuracy of financial disclosures.²⁶³ Corporate officers are subject to severe civil or even

http://www.arentfox.com/publications/index.cfm?content_id=602&fa=legalUpdateDisp.

257. Woo, *supra* note 256, at 141–42. For example, during SOX's public comment period, Germans raised the issue that the law's certification requirements are premised on an issuer having one CEO. *Id.* at 142 (noting that, in German companies, multiple directors may jointly represent the company in a capacity similar to the American CEO).

258. Potter & Röhm, *supra* note 256. At issue in particular is Section 404, which requires that companies produce an assessment of the effectiveness of their internal controls in their Annual Report on Form 10-K. *Id.*

259. Woo, *supra* note 256, at 144.

260. See Cunningham & Harris, *supra* note 118, at 46. Prior to the Arthur Andersen scandal, the accounting profession in the United States was subject to self-regulation or limited oversight on the state-level. See *id.*

261. See Rapoport, *supra* note 204.

262. See *Markets in China*, *supra* note 14.

263. Cunningham & Harris, *supra* note 118, at 46. Corporate officers must certify that "the financial statements . . . fairly present in all material respects the financial condition and results of operations of the issuer." 15 U.S.C. § 7241. This motivates senior officers to become more actively involved

criminal liability for inaccurate financial statements.²⁶⁴ Financial statement certifications are required to accompany every annual and quarterly report filed in accordance with the Exchange Act.²⁶⁵ Officers are also required to certify their company's internal control structure.²⁶⁶ A separate certification must be made by the auditor to "attest to, and report on, the assessment made by the management of the issuer . . . in accordance with standards for attestation engagements issued or adopted by the [PCAOB]."²⁶⁷ These initiatives have proved successful in reinstating integrity into American financial reporting.²⁶⁸ If the Chinese are willing to implement the certification requirements of SOX and an independent accounting oversight board similar to PCAOB, the plan could be effective in enforcing more stringent regulation of corporate officials and gatekeepers.²⁶⁹

In addition, increased collaboration between the United States and China could supplement China's creation of an accounting oversight board and certification standards.²⁷⁰ To foster such collaboration, though, it will be necessary to update and utilize the Memorandum of Understanding between the SEC and the CSRC.²⁷¹ The current version of the agreement dates to 1994 and needs to be revised to reflect actual procedural and information-sharing initiatives between the two regulators.²⁷² In July 2011, in a positive signal for future collabo-

in the disclosure process and to "take personal responsibility for their financial documents." Lucci, *supra* note 117, at 229–30. *See also* Cunningham & Harris, *supra* note 118, at 46.

264. Cunningham & Harris, *supra* note 118, at 46; Lucci, *supra* note 117, at 230. "These stiff punishments [are] designed to send a strong message to corporate executives." Lucci, *supra* note 117, at 230.

265. Woo, *supra* note 256, at 139.

266. 15 U.S.C. § 7262.

267. *Id.* at § 7262(b).

268. Kevin W. Kelley, *The Sarbanes-Oxley Act and Foreign Private Issuers*, in *U.S. SECURITIES LAWS AND FOREIGN PRIVATE ISSUERS* 211, 227 (Brian Lane ed., 2007).

269. The SEC has used the certification requirements of SOX in post-Enron enforcement actions. *See* PINTO & BRANSON, *supra* note 86, at 164. For example, the SEC successfully prosecuted the CFO of HealthSouth on charges of false and reckless SOX certifications. *Id.*

270. Finn, *supra* note 12, at 313 ("The SEC recognizes that international cooperation is vital to the SEC's ability to regulate international securities transactions.").

271. *Id.* at 319.

272. *Id.* at 314.

ration, a delegation of SEC and PCAOB officials met in Beijing with China's Ministry of Finance and the CSRC.²⁷³ However, the Chinese cancelled a subsequent meeting scheduled to take place in Washington, D.C. in October 2011 and talks have since stalled.²⁷⁴

The problems presented by poor auditing standards are threatening the financial stability of the small-cap market and demand redress. Implementation by China of an independent accounting oversight board and certification standards providing personal liability to corporate officers can help to regulate the audits coming out of China. The regulators on both sides of the Pacific, however, need to work together. The United States wants to protect its investors and China wants to ensure easy access to financing for its firms that wish to list abroad.²⁷⁵ An alliance between these two economic powers is necessary for investors to have faith in Chinese audits.²⁷⁶

CONCLUSION

The Chinese regulatory regime continues to be troubled by a "high degree of corruption and a low degree of transparency."²⁷⁷ The instances of accounting irregularities and corporate fraud that were uncovered in the summer and fall of 2011 highlight the problems China faces as it continues its ascent as a global economic power. By refusing to properly enforce the production of accurate financial information by its companies listed abroad, and thwarting American efforts to do the same, China is hurting foreign investors, damaging the reputation of its economy and national character, and ultimately, hurting many of its own citizens who seek foreign capital to fund their new businesses. The SEC and the CSRC are currently at an impasse, harming each of their interests. The implementation of an independent accounting oversight board in China, along with more stringent certification requirements, will cause the Chinese to be more proactive in regulating gatekeepers and allow for investor confidence in the audits of Chinese foreign pri-

273. Tammy Whitehouse, *SEC, PCAOB Send Delegation to China*, COMPLIANCE WK. (July 7, 2011), <http://www.complianceweek.com/sec-pcaob-send-delegation-to-china/article/206996>.

274. Rapoport, *supra* note 204.

275. *Auditing in China*, *supra* note 227.

276. *Id.*

277. Finn, *supra* note 12, at 315.

vate issuers. Finally, the U.S. and Chinese regulators need to work together to ensure that the fraudulent activities of American-listed Chinese issuers are eliminated, thereby ensuring a free and efficient flow of capital between the two nations.

*Alexander E. Csordas**

* B.A., Washington and Lee University (2008); J.D., Brooklyn Law School (expected 2013); Executive Articles Editor of the *Brooklyn Journal of International Law* (2012–2013). I am grateful to the *Journal* staff and editors for their constructive criticism and editing of this Note from proposal through publication. I am also indebted to the countless teachers and professors who have taught me throughout my academic career. Finally, thank you to my family and friends who have supported and encouraged me in all of life's endeavors. All errors and omissions are my own.