SEC's Cross-Border Working Group Continues to Target China-Based Issuers

Introduction

A pair of recent enforcement actions brought by the U.S. Securities and Exchange Commission (the "SEC") reflect the SEC's continued focus on China-based issuers listed in the U.S. In the most recent case filed against a China-based issuer, the SEC charged China Media Express ("China Media") and its Chairman and CEO on June 20, 2013 with fraudulently misrepresenting its financial condition to investors in SEC filings dating back to November 2009. The China Media action comes on the heels of the SEC's May 15, 2013 filing against RINO International Corporation ("RINO"), a China-based manufacturer and servicer of equipment for the Chinese steel industry, and its Chairman and CEO. Both companies initially listed on U.S. exchanges via reverse takeover transactions ("RTOs") – China Media in November 2009, and RINO in October 2007.

These actions demonstrate yet again that the SEC is committed to heavily scrutinizing and often charging China-based businesses, particularly those that listed in U.S. markets via RTOs. These two cases also highlight the SEC's focus on pursuing individually the senior executives at the companies who are allegedly behind the fraud. This ongoing trend continues to have implications not only for investors in RTO companies but for all investors in China-based, U.S.-listed issuers. This includes private equity investors that are considering take-private transactions involving such companies. Particular care should be exercised with respect to such transactions where there are plans for the target's founders or other executives to remain with the company following the transaction's closure.

Background

The China Media and RINO actions are just the latest from the SEC's Cross-Border Working Group (the "Working Group"). As we have reported previously, the Working Group targets companies with substantial foreign operations that are publicly traded in the U.S. Since its inception, the Working Group has been behind the SEC's filing of fraud cases against more than 65 foreign issuers or executives and deregistration of the securities of more than 50 companies.

The speed and lack of third-party oversight inherent in RTOs has attracted SEC scrutiny since such transactions first gained popularity among Chinese companies in 2007. In 2010 and 2011, a series of auditor resignations, civil lawsuits, and allegations by short sellers that RTO companies employed fraudulent accounting practices led to an increase in related SEC enforcement activity in 2012. Those actions included allegations against RTO companies and associated individuals for misconduct ranging from violations of securities and broker registration provisions to fraud, manipulation, insider trading and illegal short selling. Such enforcement activity has also extended to China-based issuers that listed in the U.S. markets through a traditional underwritten offering, including Longtop Financial, which conducted its IPO in 2007 and was subsequently charged by the SEC in November 2011 with years of financial reporting irregularities following the resignation of its auditor.

These latest actions represent a continuation of what has become a well-established playbook for the SEC: initiating an investigation of China-based issuers whose auditors resign or raise allegations of accounting improprieties, seeking to deregister or suspend trading in their securities, and initiating enforcement actions based on the alleged disclosure violations. Both RINO and China Media have already been subject to trading suspensions or deregistration. The SEC issued a trading suspension against RINO in April 2011 and filed an action against China Media to deregister its securities in March 2012. In both instances, the companies' securities had already been delisted by NASDAQ.

The China Media and RINO Actions

On June 20, 2013, the SEC announced that it had charged China Media with falsely reporting significant increases in its business operations, financial condition, and profits almost immediately upon becoming a publicly-traded company in 2009. The China Media action also names China Media's CEO and Chairman, Zheng Cheng, as a defendant. The complaint alleges that the China Media defendants committed a number of securities violations, including: (i) falsely stating in public filings and press releases that two multi-national corporations were advertising clients; (ii) overstating cash on hand on several occasions, once by as much as 40,000%; and (iii) lying to China Media's auditors.

In the RINO action, announced on May 15, 2013, the SEC similarly alleged a series of disclosure violations based on accounting improprieties. The SEC also named RINO's CEO, Dejun Zou, and Chairman, Jianping Qiu, as defendants. Specifically, the SEC alleged that the defendants committed securities violations by failing to disclose Zou's and Qiu's diversion of $3.5 million in company funds to purchase a luxury home. The RINO defendants consented to an entry of judgment on the same date that the SEC's complaint was filed.

These actions suggest an increased interest on the part of the SEC in the conduct of China-based executives – particularly where those individuals had also served as executives or founders of the pre-RTO predecessor entity. In the RINO action, the SEC alleged that Zou and Qiu falsely told auditors that they intended the $3.5 million as a down payment on a U.S. joint venture. In China Media, the SEC alleged that Cheng initially hid the discrepancies between China Media's reported and actual cash balances from the company's auditors. The China Media complaint also alleged that Cheng subsequently disclosed the discrepancies and attempted to pay off a senior accountant assigned to the internal accounting investigation on the evening before the accountant was scheduled to visit China Media's banks. Critically, in *both* actions, the individual defendants were the founders or senior managers of the businesses and the largest shareholders before and after the RTO.

Implications for Investors in China-Based Businesses

That certain China-based issuers have been the subject of fraud or similar allegations and SEC enforcement actions has been widely reported for some time now, and the various allegations raised in the China Media and RINO cases were first publicized more than a year ago. Nonetheless, the SEC's actions in May and June 2013 against these companies offer a timely reminder to investors in a number of respects. First, these recent actions demonstrate yet again that the SEC is committed to heavily scrutinizing China-based businesses that list on U.S. exchanges, including in particular issuers which list via an RTO. Second and perhaps equally importantly, the SEC's actions against the individual members of management shine a spotlight on what is often one of the most problematic aspects of investing in China-based issuers, namely, that the top manager(s) are also frequently the founders and largest shareholders of the issuers. As a result, the success or failure of the issuers' businesses can be inherently dependent on such managers, making it difficult to remove them while keeping the business intact.

These risks are relevant not only to investors who are looking to make pre- or post-IPO investments in China-based issuers, but also to investors involved in take-private transactions of such issuers. Take-privates of China-based, U.S.-listed issuers have been particularly popular in recent years as the valuations of many such issuers have been depressed due to a number of reasons, including overall negative market sentiment toward Chinese businesses resulting from the types of problems experienced by companies like China Media and RINO.

As we have advised previously, private equity or other investors considering a take-private transaction should be aware that an issuer's transition from public to private status may not end the SEC's jurisdiction related to activities while the issuer was public nor prevent the agency from causing the newly private company to incur substantial costs responding to investigatory requests. The SEC has in similar circumstances pressed enforcement actions against private successor entities and former officers involved in problematic conduct while the company was public. Any such outcome might impact the ability of such a company to relist in Hong Kong or another Asian market.

One way for deal teams considering a transaction with a China-based, U.S.-listed issuer to mitigate and better understand the relevant risks is to go the extra mile in diligencing these targets and their founders and senior executives. This approach would include an in-depth review of any target's reported cash balances, revenues and receivables, and other accounts, including a detailed discussion with the outside auditors and possible third party confirmation of key information (e.g., bank accounts, receivable balances) and any related party transactions. It is also often important to complete thorough background checks and anti-corruption reviews of the target's executives, especially those who may have been associated with the company prior to its listing on a U.S. exchange. Of course, deal teams and their legal advisors will need to assess each situation on a case-by-case basis and adjust their diligence procedures accordingly.

We will continue to monitor any further developments in this area.