NEW YORK UNIVERSITY
JOURNAL OF LAW & BUSINESS

VOLUME 11 FALL 2014 NUMBER 2

MISMATCHED REGULATORY REGIMES: HOW CHINESE REVERSE MERGERS—AND CHINA MEDIAEXPRESS HOLDINGS, INC.—EVADED SCRUTINY THROUGH REGULATORY CONFLICTS AND LOOPHOLES

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As a result of a growing Chinese economy and the need to access capital, Chinese Reverse Mergers (CRMs) became a popular phenomenon in recent years. However, due to financial reporting problems on the part of CRMs and a lack of U.S Securities and Exchange Commission (SEC) disclosure requirements for companies accessing stock exchanges through a reverse merger, many CRMs quickly collapsed amid claims of fraud. The U.S. market reacted to these claims with the New York Stock Exchange and NASDAQ quickly halting trading or delisting several CRMs, and the SEC beginning to conduct formal investigations. In 2011, CRMs were the target of one-quarter of all federal securities class actions. One of these companies, China MediaExpress Holdings, Inc., purported to sell television advertisements on a number of inter-city buses in China, but several investigations brought to light allegations of inflated earnings and fraud concerning the number of advertisements employed. This Note will provide background on Chinese Reverse Mergers, perform a case study on the China MediaExpress case, and explore divergences and loopholes in the Chinese and U.S. regulatory regimes that have allowed China MediaExpress and other CRMs to slip through the cracks.

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Introduction

Beginning in the late twentieth century, in response to China's economic reform and the remarkable rate of growth that followed, American investors developed an enthusiasm for Chinese investment opportunities,[1] and emerging Chinese firms likewise became eager for access to the capital available in U.S. markets. By 2005, the Chinese government had loosened restrictions and allowed domestic companies to access

1. *See* Comment, Jay Zhe Zhang, *Securities Markets and Securities Regulation in China*, 22 N.C. J. Int'l L. & Com. Reg. 557, 558–59 (1997); David Barboza & Azam Ahmed, *China to Wall Street: The Side-Door Shuffle*, N.Y. Times (July 23, 2011), http://www.nytimes.com/2011/07/24/business/global/reverse-mergers-give-chinese-firms-a-side-door-to-wall-st.html?pagewanted=all.

the foreign markets by listing on foreign national exchanges.[2] Thus began the rise of the Chinese Reverse Merger (CRMs), in which a Chinese company would merge with a shell company already listed on an American national exchange (such as the New York Stock Exchange (NSYE) or NASDAQ) in order to gain access to American capital without undertaking an initial public offering (IPO). In the United States, financial firms even began to offer specialization in reverse mergers and sent envoys to China to scout out Chinese firms to list on American exchanges.[3] CRMs became an ideal method for developing firms in China to gain access to capital in the United States both quickly and cheaply.

However, in 2011, nearly a quarter of federal securities class action lawsuits filed in the U.S. were related to Chinese Reverse Mergers.[4] The rapid rise and fall of CRMs has garnered the attention and ire of many U.S. investors,[5] and has led to questions regarding the compatibility of the securities and accounting regimes between the United States and China.[6] It is estimated that between 2005 and 2010, fraudulent

2. *See* Benjamin A. Templin, *Chinese Reverse Mergers, Accounting Regimes, and the Rule of Law in China*, 34 T. JEFFERSON L. REV. 119, 124 (2011); Barboza & Azam, *supra* note 1.

3. *See* Nanette Byrnes & Lynnley Browning, *Shell Games: A Reuters Investigation*, REUTERS (Aug. 1, 2011, 4:00 PM), http://www.reuters.com/article/2011/08/01/us-shell-china-idUSTRE7702S520110801.

4. Azam Ahmed, *Chinese Reverse-Merger Companies Draw Lawsuits*, N.Y. TIMES (July 26, 2011), http://dealbook.nytimes.com/2011/07/26/chinese-reverse-merger-companies-draw-lawsuits/.

5. *See* Byrnes & Browning, *supra* note 3; Kun-Chi Chen et al., *Does Foreign Firms' Shortcut to Wall Street Cut Short Their Financial Reporting Quality? Evidence from Chinese Reverse Mergers* 7–8 (Singapore Mgmt. Univ. Working Paper, Nov. 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstractid=2043899.

6. *See* Templin, *supra* note 2, at 121 ("While China has adopted laws that align with some modern accounting standards, lax enforcement and an ill-equipped accounting profession has led to material mistakes and, in some cases, fraud."); Janelle A. McCarty, Note, *Mergers & Accusations: Chinese Auditing and Corporate Disclosure Standards Indirectly on Trial in the United States*, 21 MINN. J. INTL L. 347, 348 (2012) ("U.S.-listed Chinese companies bring with them financial information for disclosure from operations in China, raising an array of accounting and auditing difficulties for auditors in the United States, and often fraudulent information is able to pass undetected.").

CRMs have cost U.S. investors upwards of $34 million.[7] As described by a member of the U.S. House Committee on Oversight and Government Reform, "[i]t appears that some Chinese firms have seen a way to access the strongest public markets in the world, but through the weakest area of enforcement."[8] As a result, "a growing number of [CRMs] are proving to have significant accounting deficiencies or being vessels of outright fraud."[9]

This Note seeks to provide a background on CRMs and to examine a case study on China MediaExpress Holdings, Inc.—a recent CRM that was delisted from NASDAQ in 2011, and is facing a securities class action lawsuit and an SEC investigation as a result of allegations of massive fraud. Part I will provide a general background on Chinese Reverse Mergers, their history, and why Chinese firms are motivated to list through CRMs. In Part II, China MediaExpress's rise and fall will be discussed, as well as the reasons why fraud was difficult to detect in this particular CRM. Part III will directly compare U.S. and Chinese disclosure requirements and antifraud provisions. Lastly, Part IV will analyze the differences in enforcement between the two regimes and several loopholes in regulation that have led to the high incidence of fraud with CRMs.

It should be noted that since the time that China MediaExpress was uncovered as a massive fraud, the regulatory regimes in the United States and China have since evolved. This Note seeks to examine the regulatory regimes of the United States and China at the time of the fraud in order to understand from a historical perspective the weaknesses in the regimes that led to these loopholes. While enforcement agencies are able, to in some instances, to tie up loopholes through new legislation, regulation, and sanctions, the SEC will have to contend with the perpetual innovation of new loopholes to its regulatory regime.

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7. Robert Holmes, *Loopholes from Here to China*, THE STREET (Dec. 22, 2010, 8:56 AM), http://www.thestreet.com/story/10953616/1/china-rto-regulation-shows-cracks.html.

8. Byrnes & Browning, *supra* note 3 (quoting Representative Patrick McHenry).

9. Sarah N. Lynch, *SEC Probing Fraud at U.S.-listed Foreign Companies*, REUTERS (Apr. 4, 2011, 3:22 PM), http://www.reuters.com/article/2011/04/04/us-sec-aguilar-idUSTRE7333U320110404.

I.
BACKGROUND ON CHINESE REVERSE MERGERS AND THEIR DISCLOSURE REQUIREMENTS

Generally, CRMs are performed by Chinese companies seeking to list on a U.S. exchange without having to undergo the disclosure, time requirements, and costs of a traditional IPO.[10] Instead, the company hires a promoter to seek out a shell company that is already listed and usually devoid of assets for the Chinese firm to merge with.[11] The shell company can be formed specifically for the purpose of merging with a CRM or can just be a listed company that no longer has assets.[12] Typically, a reverse triangular merger will be performed whereby the shell company will form a wholly owned subsidiary into which the private Chinese company will merge by buying the shares of the shell company.[13] In lieu of a triangular merger, the private company may instead choose to merge directly with the shell company.[14] Through the merger, the private company's shareholders will be given a majority stake, and the name, directors, and officers of the shell company will be replaced with those of the private company.[15]

According to U.S. securities regulations, transactions involving a merger through which securities of one corporation are exchanged for securities of another qualify as an "offer, offer to sell, offer for sale or sale."[16] This qualification subjects the issuer to the stringent public offering requirements of section 5 of the Securities Act of 1933 (Securities Act). However, CRMs are able to escape section 5 under a Rule 506 exemption under Regulation D of the Securities Act.[17] Regulation D protects private placements from the public offering requirements. Thus, reverse mergers are not overseen by regulators to

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10. *See* McCarty, *supra* note 6, at 350–51; Templin, *supra* note 2, at 123; Dan Givoly et al., *Importing Accounting Quality: The Case of Foreign Reverse Mergers* 25 (May 2012) (unpublished manuscript) (on file with author), *available at* http://recanati.tau.ac.il/Eng/Uploads/dbsAttachedFiles/Givoly.pdf.

11. *See* Templin, *supra* note 2, at 123; William K. Sjostrom, Jr., *The Truth about Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743, 743 (2008).

12. *See* Templin, *supra* note 2, at 123.

13. *See id.*; McCarty, *supra* note 6, at 746.

14. *See* McCarty, *supra* note 6, at 746.

15. *Id.* at 743.

16. 17 C.F.R. § 230.145(a)(2) (2013).

17. *See* Sjostrom, *supra* note 11, at 747.

the extent of IPOs or other public offerings because the shell company has already undergone registration, and the newly formed entity can escape any additional scrutiny through a Regulation D exemption.[18]

However, while avoiding the rigorous IPO process, the newly formed company must still comply with reporting requirements under section 13(a) of the Securities Exchange Act of 1934 (Securities Exchange Act), which requires periodic and episodic disclosure.[19] Also, in 2005, the SEC instituted a new requirement for reverse mergers whereby within four days, the surviving entity is required to file a more detailed Form 8-K that includes information that would be filed on Form 10 of the Securities Act—information required in an IPO registration statement.[20] This information includes business information, risk factors, financial information, information on directors and officers, and a description of the securities to be registered.[21] However, the disclosures on Form 10 are often perfunctory and fail to give an adequate picture of the real challenges a company faces.[22] Risk factors in particular are often boilerplate and uninformative to investors.[23] In addition, the mandatory Form 8-K is not required to be filed until 4 days *after* the transaction,[24] whereas in an IPO, filing precedes the effective date by twenty days.[25]

As a result of the disparity in the information and time costs between traditional IPOs and CRMs, far more Chinese companies have accessed U.S. markets through reverse merg-

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18. *See* Byrnes & Browning, *supra* note 3; McCarty, *supra* note 6, at 351. However, the CRM in a private placement must circulate a Private Placement Memorandum akin to Registration Statement if any of the shell company's shareholders do not qualify as "accredited investors" under Rule 501, and the CRM must also submit a Form D to the SEC. *See* STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 564–65 (Found. Press ed., 3d ed. 2012).

19. *See* Chen et al., *supra* note 5, at 7.

20. *See* Form 8-K, Item 2.01(f), *available at* http://www.sec.gov/about/forms/form8-k.pdf; *see also* McCarty, *supra* note 6, at 352; Sjostrom, *supra* note 11, at 754–55.

21. Form 10, *available at* http://www.sec.gov/about/forms/form10.pdf.

22. *See* CHOI & PRITCHARD, *supra* note 18, at 402–04.

23. *Id.*

24. *See* Form 8-K, *supra* note 20.

25. Securities Act of 1933, § 8(a).

ers than through IPOs.[26] Between 2007 and 2011, 159 Chinese firms accessed U.S. markets through a reverse merger, while only 56 IPOs were performed in the same period.[27] Chinese companies in particular have dominated the reverse merger market in the United States: CRMs have accounted for almost half of the reverse mergers performed in the United States since 2002, and comprise more than two-thirds of all foreign reverse mergers in the United States in the same time period.[28] However, recent empirical studies found that Chinese reverse mergers had poorer financial reporting quality compared to other Chinese firms issuing shares in the United States.[29] Even among reverse mergers, CRMs fared worse in reporting quality. [30] Although reverse mergers as a class of transactions face less demanding disclosure requirements than public offerings, not all reverse mergers have had the same problems endemic to many CRMs. By 2011, nineteen CRMs had been suspended or delisted from NASDAQ,[31] CRM cases constituted a quarter of all federal securities class actions,[32] and the SEC issued press releases warning the investing public of the dangers of accounting fraud associated with CRMs.[33] In addition to the resultant critical scrutiny of CRMs, the promoters and auditors of CRMs have also been subject to government investigation and inquiry. New York Global Group—a corporate advisory firm that specializes in CRMs—had its offices searched by the F.B.I. in January 2012.[34] This event seems

26. *See* Templin, *supra* note 2, at 125; McCarty, *supra* note 6, at 351–52.

27. Templin, *supra* note 2, at 125.

28. Givoly et al., *supra* note 10, at 5.

29. Chen et al., *supra* note 5, at 3; Givoly et al., *supra* note 10, at 3. ("[W]e find that the reporting quality of RM companies is considerably inferior to that of the quality of accounting information provided by a matched control group . . . Further, the accounting quality is not even within the group of RM firms. The quality of accounting numbers . . . is considerably lower for the Chinese RM firms.").

30. Givoly et al., *supra* note 10, at 3.

31. Barboza & Ahmed, *supra* note 1.

32. *See* Ahmed, *supra* note 4.

33. RESEARCH NOTE 2011-P1 ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES IN THE CHINA REGION, PCAOB (2011), *available at* http://pcaobus.org/research/documents/chinese_reverse_merger_research_note.pdf.

34. David Barboza, *F.B.I. Looks into Adviser on Chinese Reverse Mergers*, N.Y. TIMES (Jan. 27, 2012, 8:41 PM), http://dealbook.nytimes.com/2012/01/27/f-b-i-searches-offices-of-n-y-adviser-on-chinese-reverse-mergers/.

to indicate that federal authorities are interested in investigating and perhaps prosecuting those companies that aided the rise of CRMs.[35] Furthermore, the accounting firm Deloitte Touche Tohmatsu has found itself in an international battle for audit papers, the disclosure of which is simultaneously demanded by the SEC and refused on grounds of secrecy by Chinese authorities.[36]

The rapid rise and fall of Chinese reverse mergers necessitates investigation into how fraudulent companies were able to access the strongest capital markets in the world, how reputable auditors and promoters were effectively pulled into the fray, and how such damage to investors was allowed to occur before anyone realized many of these companies were wholly fraudulent. To answer these questions, a good starting point will be to perform a case study to help put these difficulties into perspective.

II.
CHINA MEDIAEXPRESS: RISE AND FALL

China MediaExpress, Inc. presents an interesting case study because it exhibits some of the most confounding issues concerning disclosure and scrutiny: it was a client of "Big Four" auditing firm Deloitte Touche Tohmatsu, most of its operations were based in China, and it effectively fooled not only small investors, but purportedly reliable institutional investors.

A. *China MediaExpress's Beginnings and Claims to Investors*

China MediaExpress Holdings, Inc. (CCME) was founded in 2003 as a majority shareholder in Fujian Fenzhong, a company that China MediaExpress claimed to own and operate the largest television advertising network on public buses in China.[37] China MediaExpress claimed that it had installed its equipment on 27,200 buses in eighteen regions of China[38] and

35. *Id.*

36. Peter J. Henning, *Deloitte's Quandary: Defy 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/.

37. *Corporate Profile*, CHINA MEDIAEXPRESS HOLDINGS, INC., http://www.ccme.tv/eng/about/profile.php (last visited Nov. 18, 2012).

38. *Corporate Overview*, CHINA MEDIAEXPRESS HOLDINGS, INC., http://www.ccme.tv/eng/ir/irprofile.php (last visited Nov. 18, 2012).

its coverage extended to 81% of buses equipped with hard disk drive players. [39] China MediaExpress operated its business by entering long-term contracts with bus operators, paying the operators a fee to install its television displays and to play advertisement content.[40]

In 2009, China MediaExpress performed a reverse merger with the shell company TM Entertainment & Media Inc., which was listed on the NASDAQ stock exchange.[41] At the time, China MediaExpress claimed to have such advertisers as Coca-Cola, Pepsi, Lenovo, Toyota, Kentucky Fried Chicken, Procter & Gamble and Apple,[42] and that its target audience consisted of middle-class professionals with disposable income.[43] China MediaExpress also touted a coveted government deal that allowed it to have a near monopoly on the bus advertising business.[44] Through its subsequent SEC filings, China MediaExpress reported increases in income from 2009 to 2010 of 143% for the first quarter[45] and of 244% for the second quarter.[46] In a press release, China MediaExpress similarly claimed third-quarter increases from 2009 to 2010 of 118%.[47] What was even more amazing was China MediaExpress's spread between revenues and costs: in 2010, they claimed third-quarter revenue of $57 million with only $13 million in costs.[48] As a result of these astonishing figures, on

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39. Chaudhuri v. China MediaExpress Holdings, Inc., 2011 W.L. 928872 ¶¶ 2, 18 (S.D.N.Y. 2011) [hereinafter *Complaint*].

40. *Complaint*, *supra* note 39, ¶ 21.

41. Nikolaj Gammeltoft & Dune Lawrence, *China MediaExpress CFO Quits, Auditor Call for Inquiry of Bus Advertiser*, BLOOMBERG (Mar. 14, 2011), http://www.bloomberg.com/news/2011-03-14/china-mediaexpress-cfo-resigns-auditor-calls-for-investigation.html.

42. *See* CCME*: Taking the Short Bus to Profits*, MUDDY WATERS RESEARCH 2, 13 (Feb. 3, 2011), http://www.muddywatersresearch.com/research/ccme/initiating-coverage-ccme/ [hereinafter MUDDY WATERS Feb. 3 Report]; Letter from Zheng Cheng, CEO and President of China MediaExpress, to shareholders of China MediaExpress 5 (Feb. 7, 2011), *available at* http://www.ccme.tv/eng/ir/ceo_letter.pdf; *see also Complaint*, *supra* note 39, ¶ 22.

43. MUDDY WATERS Feb. 3 Report, *supra* note 42, at 3.

44. Steven Halpern, *Top Picks 2011: China MediaExpress (CCME)*, BLOGGINGSTOCKS (Jan. 3, 2011, 10:40 AM), http://www.bloggingstocks.com/2011/01/03/top-picks-2011-china-media-express-ccme/.

45. *Complaint*, *supra* note 39, ¶ 24.

46. *Id.* ¶ 25.

47. *Id.* ¶ 26.

48. Halpern, *supra* note 44.

January 10, 2011, Forbes China declared China MediaExpress number one on its annual list of best small businesses,[49] and China MediaExpress's stock (CCME) rose in early 2011 from an average between $5 to $10 a share to just above $20 per share.[50]

B. *Falling Apart*

In early 2011, three short seller reports proclaimed China MediaExpress a fraud. On January 30, 2011, Citron Research published a Report claiming that China MediaExpress stock was too good to be true.[51] In particular, the report questioned the accuracy of China Media's income statements given that China MediaExpress had put little money into its infrastructure,[52] asserting that, "[i]f true, this [return on investment] would be one of the highest in the world, and a complete outlier in the Chinese advertising market . . . outpacing all of their competition by a landslide, despite their smaller footprint."[53] Citron then pointed to the fact that very few in the advertising industry in China had ever heard of China MediaExpress and given the high degree of visibility associated with the advertising business, this made the company's story implausible.[54] Citron claimed that China MediaExpress was conspicuously missing from industry articles directly discussing inter-city bus advertising, as well as from any substantial analyst coverage.[55] Lastly, Citron "debunked" China MediaExpress's alleged government deal, which turned out to be a contract with a government-affiliated production company—an entity without the authority to affect advertising on inter-city buses.[56]

49. Russell Flannery, *Forbes China's Raymond Liu Discusses Accounting Woes in China*, FORBES (Jan. 30, 2012, 5:05 PM), http://www.forbes.com/sites/russellflannery/2012/01/30/forbes-chinas-raymond-liu-discussesaccounting-woes-in-china/.

50. Glen Bradford, *China MediaExpress Holdings: All Eyes on Deloitte*, SEEKING ALPHA (Mar. 7, 2011, 3:22 PM), http://seekingalpha.com/article/256843-china-mediaexpress-holdings-all-eyes-on-deloitte.

51. *The China Reverse Merger Stock That Is "Too Good to Be True,"* CITRON RESEARCH (Jan. 30, 2011), http://www.citronresearch.com/citron-research-reports-on-china-media-express-nasdaqccme/.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

The next blow came soon after, on February 1, 2011, from Bronte Capital, the blog of former hedge fund manager, John Hempton. Hempton—although making it clear he had no evidence of fraud—referenced a previous blog post questioning the viability of China MediaExpress's price-earnings ratio.[57] Hempton ultimately stated that, if something looks too good to be true, it probably is, and also described China MediaExpress's SEC filings as painting a picture of the advertising company as "frighteningly profitable."[58]

Finally, on February 3, 2011, Muddy Waters Research released a report alleging that China MediaExpress was engaged in a "pump and dump" scheme seeking to inflate the price of its stock so that insiders could sell.[59] The investigation revealed several cases of fraud, including with respect to China MediaExpress's revenue, the number of buses that included China MediaExpress equipment, and the number of buses that actually played China MediaExpress ad content. First and foremost, Muddy Waters estimated that China MediaExpress's revenues for 2009 had been inflated by 464%.[60] Also, while CCME claimed to have a network of 27,200 buses, Muddy Waters revealed that China MediaExpress's account to advertisers consisted of 12,565 buses.[61] Muddy Waters also undertook a survey of 50 CCME buses and found that the majority of buses played other content using CCME equipment in lieu of the authorized content since the equipment could easily play other DVDs.[62] Muddy Waters further alleged, among other things, that CCME lied about doing business with Apple,[63] that many purported clients had never even heard of China MediaExpress,[64] that those who should have been China MediaExpress's main competitors had also never heard of the company,[65] and that the main demographic viewing CCME's

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57. John Hempton, *China MediaExpress: The Wall Street Drama Continues*, BRONTE CAPITAL (Feb. 1, 2011, 2:21 PM), http://brontecapital.blogspot.com/2011/02/china-media-express-wall-street-drama.html.

58. *Id.*

59. MUDDY WATERS Feb. 3 Report, *supra* note 42, at 2.

60. *Id.* at 2.

61. *Id.* at 3.

62. *Id.*

63. *Id.* at 12.

64. *Id.*

65. *Id.* at 14.

advertisements was of low income instead of mid to high income.[66]

In the aftermath of Muddy Waters's report, on February 3rd, China MediaExpress's stock fell by 33%.[67] China MediaExpress's CEO, Zheng Cheng, responded to these claims in a letter dated February 7, 2011.[68] The letter characterized the recent allegations as attacks on China MediaExpress by short sellers who were looking to make a profit by driving down the price of CCME.[69] Cheng categorically denied allegations of fraud, insinuating that Muddy Waters had doctored fake financial statements, and pointing to the verification by both a reputable auditing firm and a Chinese market research firm as to the accuracy of China MediaExpress's financials and the number of buses it had in operation.[70] Cheng's defense laid out the major allegations of fraud and attempted to discredit each, often with conclusory statements to the effect that China MediaExpress did not understand why Muddy Waters would make such a contention in the first place.[71]

By March 2, 2011, Muddy Waters had released an additional report stating that it had "amassed irrefutable evidence that China MediaExpress Holdings, Inc. (CCME) is a substantial fraud, and that management is engaging in a cover-up replete with further dissemination of fraudulent information."[72] Muddy Waters went further to demonstrate that the information provided by Chairman Cheng in his February 7th letter offering license plates as proof of the buses it had in operation was fabricated.[73] The report also detailed a recorded conversation with a CCME representative admitting that China MediaExpress regularly and fraudulently doubled the number

66. *Id.* at 17.

67. Gammeltoft & Lawrence, *supra* note 41.

68. Letter from Zheng Cheng, *supra* note 42.

69. *Id.* at 1.

70. *Id.* at 2–3.

71. *Id.* at 3–7.

72. *CCME: Irrefutable Evidence of Fraud*, MUDDY WATERS (Mar. 2, 2011), http://www.muddywatersresearch.com/research/ccme/irrefutable-evidence/.

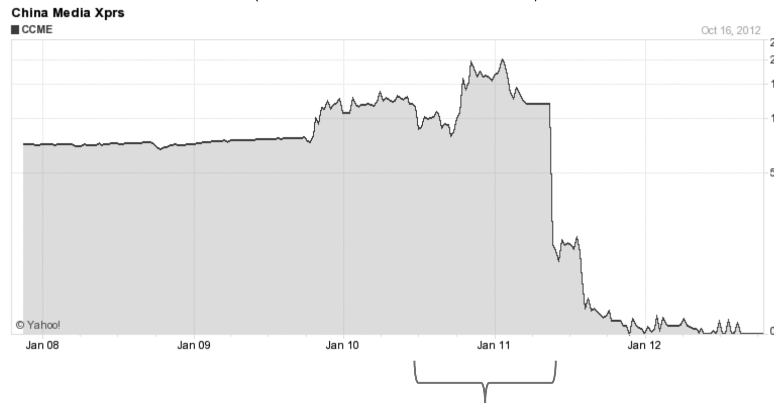
73. *Id.*

of buses it reported to be in operation to regulatory authorities.[74]

On March 11, 2011, Deloitte Touche Tohmatsu resigned from China MediaExpress, stating its concerns that prior financial statements and the assertions of management could no longer be relied upon.[75] Also on March 11, 2011, China MediaExpress's CFO, Jacky Lam, resigned and CCME's stock was halted after losing 48% of market value in six weeks.[76]

On March 13, a securities class action complaint was filed in the Southern District of New York for violations under antifraud provision Rule 10b-5 of the Securities Exchange Act.[77] The class period extended from May 14, 2010 (the release of China MediaExpress's Form 10-Q allegedly inflating revenue figures) to March 11, 2011 (the day of the resignation of Deloitte and CFO Lam).[78] The complaint alleges that China MediaExpress inflated CCME's stock price through fraudulent statements regarding the scope of China MediaExpress's oper-

FIGURE 1:
CCME STOCK PRICE, JANUARY 2008–PRESENT
(*Source: Yahoo! Finance*)



Class Period:
May 14, 2010–March 11, 2011

74. *Id.* at 3–4.
75. Gammeltoft & Lawrence, *supra* note 41.
76. *Id.*
77. *Complaint*, *supra* note 39, ¶ 67.
78. *Id.* ¶ 1.

ations and its revenue.[79] In particular, the complaint stated that China MediaExpress had misrepresented the number of buses in operation, had fabricated its business contracts, and had misrepresented its financial figures.[80] The complaint further alleged that on March 11, 2011, CCME's stock experienced a "precipitous decline in market value" that led investors during the class period to lose millions of dollars.[81]

The same day of the class action complaint, the SEC instituted an order to begin administrative proceedings against China MediaExpress for failing to file required financial reports with the SEC.[82] China MediaExpress was later de-listed from the NASDAQ stock exchange in May of 2011.[83]

C. *How China MediaExpress Fooled American Investors*

China MediaExpress was able to effectively fool experienced investors, regulators and a national exchange. Several factors convinced American investors that China MediaExpress was legitimate despite its improbable financial success. First, listing on a national exchange created the illusion of legitimacy since ordinary investors often presume that listing on a national exchange is a naturally vetting process for fraudulent companies.[84] Listing on a national exchange such as NASDAQ implies that the company is in compliance with NASDAQ's continued listing requirements. These consist of minimum financial requirements including at least $50 million in both revenue and assets and $500,000 in net operating income as well as the presence of an audit committee and the mandatory disclosure of material news.[85] However, CCME was not delisted from NASDAQ until May of 2011, months after the initial allegations of fraud surfaced, and by then, the investing public had already been substantially harmed due to

79. *Id.* ¶¶ 18–41.
80. *Id.* ¶ 42.
81. *Id.* ¶¶ 4, 41.
82. China MediaExpress Holdings, Inc., Release No. 66-586, Order Instituting Administrative Proceedings (Sec. & Exch. Comm. Mar. 13, 2012) [hereinafter SEC Order].
83. SEC Order, *supra* note 82.
84. Holmes, *supra* note 7.
85. Continued Listing Guide, NASDAQ (lasted visited Nov. 27, 2011), *available at* https://listingcenter.nasdaqomx.com/assets/continuedguide.pdf.

the stock's sharp decline in March 2011. In the case of China MediaExpress, NASDAQ's listing requirements—and the lack of enforcement of these requirements—were unable to bar entry against a company allegedly replete with fraudulent practices and financials.[86]

Second, one of the most persuasive factors convincing American investors of China MediaExpress's legitimacy and its soaring revenue was the retention of Deloitte Touche Tohmatsu as its auditor. The manager of a New York-based hedge fund stated that Deloitte was the most convincing factor for many investors in determining that China MediaExpress was legitimate.[87] A study of 116 CRMs revealed that hiring one of the Big Four auditors correlated with better financial reporting quality[88]—a likely assumption made by many shareholders of China MediaExpress. Also, top investors in China MediaExpress included the investment company of a former AIG CEO and the New York investment management firm, D.E. Shaw & Co.[89] In November 2010, Bronte Capital had described China MediaExpress's stock as "outrageously attractive—and unlike all the other U.S. listed China stocks it has a reputable auditor Deloittes [*sic*] and a major shareholder with some credibility (Starr International of AIG/Hank Greenberg fame)."[90] When allegations of fraud began emerging with the release of the Citron Report in January 2011, investors still cast doubt on whether a company could perpetrate a fraud of this magnitude given the due diligence performed by Deloitte and the presence of more reputable top investors of China MediaExpress.[91] China MediaExpress had even garnered the top spot in Forbes China's annual list of the best small busi-

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86. One conflict of interest that investors must bear in mind is the competition between national exchanges—especially NYSE and NASDAQ—for the listing of Chinese companies. New listings translate to new revenue for the exchanges, so the level of scrutiny may be decreased when exchanges compete for hot new companies, and during this time, Chinese companies were the popular trend for the investing public.

87. Gammeltoft & Lawrence, *supra* note 41 (quoting Sahm Adrangi of Kerrisdale Capital, LLC).

88. Chen et al., *supra* note 5, at 3–4.

89. *Id.*

90. John Hempton, *China MediaExpress: A Wall Street Drama*, BRONTE CAPITAL (Nov. 15, 2010, 2:17 AM), http://brontecapital.blogspot.com/2010/11/china-media-express-wall-street-drama.html.

91. *Id.*

nesses in 2011. In an interview a year later, Raymond Liu, managing editor of Forbes China, stated that the decision was based on CCME's phenomenal figures from 2007 to 2009—figures, he added, which had been audited by Deloitte.[92] Liu further asserted that it is difficult to spot accounting fraud in these circumstances because U.S. national exchanges have difficulty supervising overseas companies and because accounting firms have the incentive to post positive financial figures in order to retain business with Chinese companies.[93] One of the most insightful responses to the early allegations of fraud was posted on Bronte Capital just days after the Citron 2011 Report: "[i]f this is a fraud they have pulled the wool over some very prominent eyes."[94] Indeed, China MediaExpress had been able to deceive the SEC, the Public Company Accounting Oversight Board (PCAOB), NASDAQ, Deloitte, the China Securities Regulatory Commission (CSRC), stock market analysts, and American investors. The reasons why China MediaExpress was so successful in deceiving investors are manifold. In particular, the divergence in the enforcement regimes of the United States and China and the manner in which they converge upon CRMs, create many opportunities to avoid disclosure and to conceal fraud.

III.
THE CHINESE AND U.S. REGULATORY REGIMES: A DIRECT COMPARISON OF DISCLOSURE REQUIREMENTS

A comparison of U.S. and Chinese regulatory regimes reveals that a number of statutory provisions are similar or even identical. In particular, the laws governing public offering disclosure as well as continuous disclosure contain similar requirements for the type of information that must be provided, and when and in what forms this information must be provided. However, the divergent motivations driving the securities regimes, the market-based approach of disclosure used in the United States versus the regulator-based system of disclosure used in China, and the differing availability of enforcement mechanisms in fact create completely different securities regulation environments in the United States and China. This

92. Flannery, *supra* note 49.
93. *See id.*
94. Hempton, *supra* note 57.

comparison is vital to understanding the context of CRMs because the intersection of the two contrasting frameworks and attitudes is where CRMs—China-based companies forced to comply with American securities laws—are ambiguously situated. Part III will focus on the underlying motivations for the securities laws and regulations in both countries and will briefly compare some of the relevant disclosure requirements. The subsequent section will show how these common legal requirements produce different real world results due to disparities in enforcement.

A. *Motivations for Regulation*

The United States and China had separate and distinct driving forces prompting the creation of each country's securities regulation regime. In response to the stock market crash and subsequent Great Depression in the 1930s, the U.S. Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, which are now the principal statutes in the U.S. securities regime.[95] The two main goals of the acts were to protect investors from abuses by issuers and to deter speculative frenzy through a system of disclosure.[96] As explained by the U.S. Supreme Court: "[t]his Court 'repeatedly has described the fundamental purpose of the [Securities] Act as implementing a philosophy of full disclosure.'"[97] In contrast to the United States' long history of disclosure and regulation, it was only in 1992 that China's State Council decided to create the CSRC, which promulgated the first securities regulations in 1993. [98] Like the SEC, the CSRC exercises significant control over the rules, operation, management and sanctioning of the two national exchanges in China, the Shanghai and

95. CHOI & PRITCHARD, *supra* note 18, at 2. The Securities Exchange Act created the U.S. Securities Enforcement Commission.

96. *See id.* at 1.

97. Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977)); *see also* Templin, *supra* note 2, at 122 ("[T]he system as a whole is designed to create liquidity and protect investors from fraudulent promoters by providing full and fair disclosure.").

98. *See* Benjamin Chun, *A Brief Comparison of the Chinese and United States Securities Regulations Governing Corporate Takeovers*, 12 COLUM. J. ASIAN L. 99, 104 (1998).

Shenzhen exchanges.[99] As its securities regime began to take shape, China executed a memorandum of understanding with the United States in 1994 whereby China adopted many of the United States' regulatory rules, including the expansion of the CSRC's authority and hierarchical structure to mirror the powers of the SEC.[100] However, unlike the United States' focus on solving information asymmetry and protecting investors, China's motivation for establishing the CSRC was to push for greater centralization of its securities markets and to refinance its public sector to ensure the continuing efficacy of the state party.[101] Even now, as China pushes to reform its capital markets to guarantee greater safeguards, its primary motivation is to elevate Shanghai as a global hub to rival New York and London by 2020.[102] While the Great Depression spurred the U.S. to focus on investor protection and disclosure, China's securities regime has been driven and influenced by political interests and opportunities for growth. Despite the fact that the underlying regimes have similar statutory language, such differing motivations inevitably affect how disclosure requirements are treated and enforced. In particular, as discussed below, Chinese regulators will consider factors such as economic growth and profitability as equal or superior to factors relating to investor protection and disclosure.

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99. *See* Zhang, *supra* note 1, at 565–66. *See also generally* Securities Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective Dec. 29, 1998), (China) [hereinafter China's Securities Law] (The CSRC is granted authority under article 166 of the China's Securities Law to implement regulation and enforcement of the securities markets under the supervision of the State Council.).

100. SEC, SEC RELEASE NO. IS-662, MEMORANDUM OF UNDERSTANDING BETWEEN THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION AND THE CHINA SECURITIES REGULATION COMMISSION REGARDING COOPERATING, CONSULTATION, AND THE PROVISION OF TECHNICAL ASSISTANCE, 1994 WL 163173 (1994); *see* William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 484 (2002).

101. *See* Zhang, *supra* note 1, at 563; *see also* Friedman, *supra* note 100, at 482.

102. Melanie Lee, *Morgan Stanley's Wei Says China IPO Regulators Should Protect Investors*, REUTERS (Sept. 12, 2012, 1:08 AM), http://www.reuters.com/article/2012/09/12/us-wef-china-ipo-idUSBRE88B05820120912.

B. *Public Offering and Continuous Disclosure Requirements*

Both the United States and China require certain disclosures when a company performs an initial public offering. When undergoing an IPO in the United States, the SEC requires that the issuer file a registration statement, and as part of the registration statement, a statutory prospectus.[103] In the statutory prospectus, the issuer must disclose risk factors, the use of proceeds, business information, management information, a description of the securities being offered, and audited financial information. Throughout the public offering process, the Securities Act and SEC regulations require preemptive and cautionary disclosures in the form of mandatory legends, and prospectus delivery requirements whenever the issuer makes statements that potentially condition the securities markets.[104] The disclosure requirements for companies listing on a Chinese national exchange are encompassed in the Companies Law of the People's Republic of China (Companies Law).[105] Article 86 requires the publication of a prospectus when a company offers shares to the general public. [106] The prospectus must include the price and number of shares offered, the purpose of the offering, the rights and obligations of subscribers, and the start and end date of the offering. [107] The prospectus must also include information similar to that in an American statutory prospectus: offering information, risk factors, background on the issuer, corporate governance, financing information, development objectives and industry competitors.[108]

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103. Securities Act of 1933, §§ 6, 10.

104. The SEC looks to protect investors by prohibiting information in the early stages of a public offering that may be incomplete or inconsistent with later statements or that may rouse speculative frenzy. After the filing of the registration statement, the securities laws then require prospectus delivery whereby issuers and underwriters must accompany offers, marketing, and sales of securities with a preliminary or statutory prospectus to ensure that investors have access to disclosure documents.

105. P.R.C. Laws on Securities [hereinafter Companies Law], *available at* http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/statelaws/200904/t20090428_102712.htm.

106. *Id.* art. 14.

107. *Id.* art. 87.

108. DELOITTE, STRATEGIES FOR GOING IPO 30 (2007), *available at* http://www.deloitte.com/assets/DcomChina/Local%20Assets/Documents/Services/Audit/IPO/cn_audit_StrategiesforgoingIPO_190310.pdf.

However, two interrelated factors detract from the protection of investors in China: the role of government and politics in the IPO process and the lack of a reliable underwriter in the vetting process.[109] Since the government exercises tight control over the securities markets in China, it is the political process—and not market demand—that ultimately determines which companies can perform an IPO.[110] A 2007 study sampling 790 firms that went public between 1993 and 2001 found that 27% of these firms had CEOs that were former government bureaucrats.[111] This emphasis on political connections in lieu of market demand in determining IPO eligibility responds to social and political motives rather than the more objective economic factors that can incentivize disclosure. The importance of political ties in obtaining public offering approval also seems to have damaged China's securities markets, since companies with politically affiliated CEOs tend to perform worse post-IPO compared to firms without political affiliation.[112] Moreover, because listing authorities in China take such an openly protective attitude, many Chinese companies find that it is easier to pursue an offering along with its attendant disclosure requirements in the United States—perhaps through a reverse merger—rather than find a way into domestic markets carefully guarded by politics.[113] Also, when considering IPO applications in China, potential profitability can overshadow disclosure and investor protection concerns. The co-chief executive of Morgan Stanley's Asia operations emphasized in a recent interview that going forward, China's regulators should be more focused on the protection of investors rather than on possible profits when determining the appropriateness of a public offering application.[114] This focus on profits and growth reflects the motivations China had in creat-

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109. JANE FU, CORPORATE DISCLOSURE & CORPORATE GOVERNANCE IN CHINA 157 (Kluwer Law International 2010), *available at* http://books.google.com/books?id=jpx_qqOB_kcC&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false.

110. Lee, *supra* note 102.

111. Joseph P. H. Fan et al., *Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms*, 84 J. FIN. ECON. 330, 331 (2007).

112. *See id.*

113. *See* OWEN NEE, SHAREHOLDER AGREEMENTS AND JOINT VENTURES: BUSINESS LAWS OF CHINA (2012).

114. *See* Lee, *supra* note 102.

ing its securities regime in the early 90s—when economic progress and gaining presence on the world stage take precedence, investor protection is reduced to a secondary goal, only pursued when urged by the international community or when necessary for further growth.

Another important form of investor protection that typically accompanies American IPOs is the presence of an underwriter in a firm commitment offering—a market-based protection independent from the opinion of government regulators. In a firm commitment offering, underwriters essentially screen the marketplace for unworthy investments because the underwriter bears the risk of failing to sell out the issue of shares. Over time, investors come to rely on underwriters as a screening mechanism in the marketplace and rely on underwriters' mere presence in making their investment decisions.[115] While listing in China does require the presence of a sponsor within an investment bank in order to apply to the CSRC for approval of a public offering, the public still mainly relies on the authority of the CSRC to screen out bad investments rather than on these sponsors.[116] This reliance on government stands in stark contrast with the American market where investors pay much closer attention to the choice of underwriter than to cues from the SEC. While China's securities markets are indeed attempting to undergo an evolution from a regulator-based system to a market-based system with more reliance on banks to enforce disclosure, bankers and lawyers in China agree that a system reliant on disclosure instead of on government is still years away.[117] With government ties driving the pronouncement of a company as a worthy investment, Chinese companies are incentivized to put more energy into promoting political affiliations and bending to the will of authorities rather than creating a robust system of financial disclosure to protect and inform private market actors.

These public offering disclosure requirements, often accompanied by strict liability and few requirements in the plaintiff's cause of action, are what CRMs try to avoid in accessing

115. Prudence Ho & Nisha Gopalan, *In China, Debate on IPO Disclosure*, WALL ST. J. (Mar. 8, 2012, 12:45 PM), http://online.wsj.com/article/SB1000142405297020478180457726834038063264 0.html.

116. *Id.*

117. *Id.*

capital through the back door of a reverse merger. In the case of a CRM, there is no underwriter or sponsor screening the market for fraudulent companies. Instead, companies such as China MediaExpress can access the markets without any of the above disclosure requirements, the vetting process of the SEC or CSRC, or the evaluation by a firm commitment underwriter or sponsor. CRMs are only subject to continuous disclosure requirements as an Exchange Act reporting company. Section 13(a) of the Exchange Act requires three forms of mandatory continuous disclosure: annual, quarterly, and event filings.[118] Similarly, the Securities Law of the People's Republic of China of 1998 (China's Securities Law) also provides for continuous disclosure, requiring an annual report, a semi-annual report, as well as a major event report.[119] An annual report under China's Securities Law must state the general situation of the company, name its largest shareholders, give a description of the directors and senior managers, and disclose financial statements and accounting reports.[120] Form 8-K, as per the Exchange Act, requires disclosure on the occurrence of specified events.[121] China's corresponding Article 67 of the China's Securities Law also requires disclosure of a major event affecting share price.[122] Both Form 8-K and Article 67 require disclosure for specific events including those that significantly affect the assets and liabilities of the company, [123] changes in management,[124] and changes in control.[125] One notable omission from Article 67, which is present in Form 8-K, is the event of a change in outside auditors or modifications of previously issued financial statements.[126] This is worth noting since auditing and inflated financials have been the woes of CRMs subject to American class actions. Although the continuous disclosure requirements appear similar between the United States and

118. CHOI & PRITCHARD, *supra* note 18, at 176.
119. China's Securities Law, *supra* note 99, arts. 65–67.
120. *Id.* art. 66.
121. CHOI & PRITCHARD, *supra* note 18, at 176.
122. China's Securities Law, *supra* note 99, art. 67.
123. Form 8-K, *supra* note 20, § 2; China's Securities Law, *supra* note 99, art. 67(3).
124. Form 8-K, *supra* note 20, § 5; China's Securities Law, *supra* note 99, art. 67(7).
125. Form 8-K, *supra* note 20, § 5; China's Securities Law, *supra* note 99, art. 67(9).
126. Form 8-K, *supra* note 20, § 4.

China, the manner of their enforcement varies greatly causing vast disparity in companies' attitudes towards compliance.

C. *Accuracy of Disclosed Information*

Both the United States and China provide for antifraud liability in connection with securities. This is an important mechanism for enforcement for both regulatory authorities and for private parties. The United States provides for antifraud liability "in connection with the purchase or any sale of security" in Rule 10b-5, a broad antifraud provision in the Exchange Act.[127] Though applicable to both primary and secondary market transactions, Rule 10b-5 includes many hurdles for plaintiffs, which derive from the elements of the cause of action.[128] In addition to Rule 10b-5, the securities laws also provide for antifraud liability under section 11 and section 12(a)(2) of the Securities Act for fraud in the registration statement and the prospectus.[129] The securities laws vigorously protect investors during the public offering process through section 11 and section 12—neither requires the pleading of scienter which is seen as the greatest barrier to litigation for plaintiffs.[130] Section 12(a)(2) establishes liability for any person who offers or sells a security by means of a prospectus with any false or misleading statement to the person purchasing the security.[131] Similar to 12(a)(2) of the Securities Act, Article 63 of China's Securities Law provides that:

> If the share prospectus . . . financial or accounting report [or other reports] announced by an issuer or [underwriter] contain or contains any falsehood, misleading statement or major omission, thus causing losses to investors in the course of securities trading, the issuer or the company shall be liable for the losses and the responsible director(s), supervisor(s) and/or the manger [*sic*] of the issuer or the company shall be jointly and severally liable for such losses.

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127. 17 C.F.R. § 240.10b-5 (1948).

128. Choi & Pritchard, *supra* note 18, at 239. A plaintiff must plead materiality, scienter, reliance, loss causation, and damages. *Id.*

129. *Id.* at 468.

130. *Id.* at 478.

131. 15 U.S.C.A. § 77l (2000).

One important political difference regarding disclosures mandated by Article 63 is that such disclosures are required to be published on state-owned media, which diminishes investor confidence in the accuracy and objectivity of such content in the first place.[132] Another important difference between Article 63 and the American antifraud provisions is the historical availability of the private right of action. China's Securities Laws for many years lacked an explicit right of action under Article 63's antifraud liability for false statements in the prospectus.[133] By contrast, explicit private rights of action are available under sections 11 and 12(a)(2) of the Securities Act, and there is an implied private right of action established under U.S. common law under Rule 10b-5.[134] Though China has recently allowed for private actions under Article 63, the developing nature of the private right of action in China can have a great impact in supplementing the overall enforcement regime.

Both the United States and China provide for secondary liability (or aiding and abetting liability) for fraud in securities document—though in the case of the United States, secondary liability is only available through SEC enforcement actions. The availability of secondary liability is important in order to ensure the accuracy of financial statements. In China MediaExpress's case, the harm to investors stemmed from inflated revenues—an inaccuracy that should have passed through the lens of the auditor prior to filing with the SEC. Because audits by reputable firms such as Deloitte give a prestigious stamp of approval to the financials of a company like China MediaExpress, and investors rely on such audits, Deloitte and any other auditor in similar situations should face liability in order to ensure the adequate protection of investors. Secondary liability can also prove important if the CRM turns out to be judgment proof or is shielded from liability by the Chinese government.

132. China's Securities Law, *supra* note 99, art. 64 ("Announcements to be made in accordance with laws or administrative regulations shall be published in the newspapers, periodicals or the dedicated gazette specified by the relevant department of the State."); *see* Friedman, *supra* note 100, at 511.

133. Friedman, *supra* note 100, at 510, 512–13.

134. CHOI & PRITCHARD, *supra* note 18, at 210.

While both the United States and China provide for secondary liability, the scope of that liability and the language of the statutes somewhat vary. Section 11(a)(4) of the Securities Act provides for liability in the registration statement for "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement."[135] These experts are liable for any part of the registration statement that was certified in their capacity as experts.[136] Article 202 of the China's Securities Law also provides for liability for false statements by professional institutions that produce documents "for the issuance or listing of securities or for securities trading activities . . . in the part of the contents for which it is responsible."[137] While secondary liability in section 11 is limited to the listed statutory defendants,[138] secondary liability is far broader under China's Securities Law since the transaction does not need to involve the registration statement, and on its face should provide greater liability for different actors certifying various documents produced for securities trading activities.

Despite similarities in the language of both countries' disclosure statutes and the seemingly broader antifraud provisions of China's securities laws relative to the U.S.'s securities laws, China's widespread and persistent enforcement problems render its securities regime ineffective. This futility accordingly influences compliance rates, Chinese companies'

135. 15 U.S.C.A. § 77k(a)(4) (1998).

136. 15 U.S.C.A. § 77k(b)(3)(B) (1998). Under Rule 10b-5, however, there is only primary liability for civil suits, though the SEC has authority through § 20(e) of the Exchange Act to pursue aiding and abetting actions. 17 C.F.R. § 240.10b-5 (1948); 15 U.S.C.A. § 78t(e).

137. China's Securities Law, *supra* note 99, art. 202 ("If a professional institution that produces documents such as audit reports, asset appraisal reports and legal opinions for the issuance or listing of securities or for securities trading activities makes false statements in the part of the contents for which it is responsible, its illegal gains shall be confiscated, it shall be fined not less than the amount of but not more than five times the illegal gains, and the relevant authority in charge shall order the said institution to suspend business and shall revoke the qualification certificates of the persons directly responsible therefor. If losses are caused, it shall bear joint and several liability for the losses.").

138. These include any person that signed the registration statement, directors, experts, and underwriters. 15 U.S.C.A. § 77k(a) (1998).

views on the need to comply with securities laws and regulations, and the preparedness and inclination of these companies to comply with disclosure requirements.

IV. THE ENFORCEMENT PROBLEMS

Several factors contribute to why CRMs have met major disclosure problems in U.S. markets. First, the experience in China is that China's Securities Laws and accounting principles will not be enforced. Accordingly, Chinese firms operating in China and listed on U.S. exchanges may operate under the assumption that fraud will largely go undetected, and are thus given greater incentive to overstate their revenue. Second, there are several loopholes in the particular case of CRMs that shield them from the scrutiny of U.S. and Chinese regulators alike. These gaps in the law create an environment where companies are further disinclined to release mandatory information. Weak enforcement in China, loopholes in the convergence of the Chinese and U.S. regimes, and a lack of enforcement in the U.S. have led to unchecked and rampant fraud in disclosure-averse CRMs leading to millions of dollars in losses by American investors. Part IV will first discuss why enforcement is so weak in China, and then will discuss the many loopholes that CRMs have taken advantage of to escape both sets of securities laws.

A. *Weak Enforcement in China*

China's securities regime relies on government enforcement without much aid from the private right of action.[139] Because civil action has been recognized as one of the most important mechanisms in the enforcement of securities laws, the lack of a strong civil remedy has created a great enforcement weakness in China. A second deficiency consists of the CSRC's inability or reluctance to pursue securities violators, which results in weak government enforcement. Together, these deficiencies create an environment where Chinese firms do not expect consequences for securities violations.

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139. Sonja Opper, *Enforcement of China's Accounting Standards: Reflections on Systemic Problems*, 5 BUS. & POL. 151, 151 (2003).

1. *China Lacks an Effective Civil Remedy for China's Securities Law Violations*

One of the most important mechanisms of enforcement—civil action—remains relatively underdeveloped and underutilized in China, leading to lax implementation and compliance. Effective private remedies have been described as "an indispensable and essential part in any regime of securities law enforcement."[140] The implied right of action under Rule 10b-5 of the Securities Exchange Act was famously described by Justice Rehnquist as "a judicial oak which has grown from little more than a legislative acorn," [141] underscoring the great significance of this judicial creation for the American securities regime.[142] After historically disallowing private actions, in 2002, the Supreme People's Court of China held that citizens could bring private suits with the caveat that class actions were still barred.[143] The first successful private action for fraud in a financial statement occurred in 2004.[144] The absence of such a remedy for so many years in China has likely produced an environment where investors are unfamiliar and perhaps hesitant to use this resolution tool.

More significantly, the effectiveness of the new private right of action may be hindered by three flaws: the corruption and bias in China's courts, complications with the bureaucracy, and the lack of a class action mechanism. First, the Chinese judiciary is popularly known to be susceptible to bribery and has been described as the most corrupt government body in China.[145] Chinese courts exhibit such rampant corruption

140. Wenhai Cai, *Private Securities Litigation in China: Of Prominence and Problems*, 13 COLUM. J. ASIAN L. 135, 136 (1999); *see also* HUI HUANG, INTERNATIONAL SECURITIES MARKETS: INSIDER TRADING LAW IN CHINA 255 (2006) ("Many Chinese scholars have argued that due to the absence of civil remedies, the Securities Law has failed to fulfill its stated purposes, namely that of protecting investors, deterring unlawful behavior, and promoting the healthy development of the market.").

141. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

142. *See also* HUANG, *supra* note 140 ("[I]n the US, private remedies in securities cases are considered to have created important incentives for individuals to sue, and have been widely accepted as a necessary complement to government enforcement.").

143. McCarty, *supra* note 6, at 355–56; HUANG, *supra* note 140, at 254 n.6.

144. Givoly et al., *supra* note 10, at 9–10.

145. Zou Keyuan, *Judicial Reform Versus Judicial Corruption: Recent Developments in China*, 11 CRIM. L.F. 323, 328 (2000).

because they are unaccountable and lack independence from the central government.[146] Although this lack of independence cripples a judiciary's ability to render impartial decisions, it is consistent with a popular viewpoint in China that many citizens and politicians continue to believe that the judiciary should follow the will of the state.[147] In the current system, judicial budgets are apportioned and judges are appointed by the central and local governments,[148] an arrangement that creates major problems for separation of powers. These ties to politics spawn corruption in the judiciary such that: "[c]ourt officers are appointed . . . by the local governments, which guarantees a certain degree of local favoritism. Lawsuits involving local companies and affecting local interests are therefore usually handled in favor of local interests. Political interests prevail over legal justice . . ."[149] These political and social interests are even openly acknowledged by courts when rendering decisions. In the *Guangxia Industry Co.* case, China's Supreme Court froze the lawsuits of 1,000 shareholders alleging accounting fraud.[150] A director of the Supreme Court admitted that the socio-political consequences of the lawsuits, rather than the legal issue itself, had been "a major consideration" when deciding to freeze the lawsuits.[151] Provided that a company maintains good political standing with the local government and its contributions to the locality are apparent, the company may feel at ease that any fraud they commit will go unpunished. Another disastrous flaw with the courts is their refusal to allow shareholders' cases to go forward if the case has not already been brought by the CSRC and decided against the listed company.[152] Although both the CSRC and private parties may technically bring an action against a listed company for securities fraud, the private party's action is entirely contingent upon a successful prosecution by the CSRC, further increasing the necessary prerequisites for a

146. Ting Gong, *Dependent Judiciary and Unaccountable Judges: Judicial Corruption in Contemporary China*, CHINA REV. (Fall 2004).

147. *See* Jianli Song, J., *China's Judiciary: Current Issues*, 59 ME. L. REV. 141, 147 (2007).

148. *See id.*

149. Opper, *supra* note 139, at 168.

150. *See id.* at 167.

151. *See id.*

152. *See id.*

successful private action. The CSRC is extremely understaffed given the amount of fraud in China, and as is discussed in the following paragraph, is not an effective regulatory body when it comes to detecting, investigating and prosecuting fraud. Thus, the power to punish fraud effectively remains in the hands of government without an independent private alternative in the courts.

Interference by the state also restricts the effectiveness of civil action to detect and deter fraud by limiting CSRC power and by not incentivizing private investors through hindrances on the ability to obtain damages. First, the CSRC—the effective originator of civil suits—has been characterized as unsophisticated,[153] wary of judicial review, and not likely to start a securities action without incontrovertible proof.[154] Because the central government has a tendency to interfere with transactions in the securities markets,[155] the CSRC may be wary of instigating investigations or lawsuits, especially against a state-owned enterprise (SOE), without approval from the central government. Regulatory bodies in China, such as the CSRC, are known to be susceptible to pressures from the state, so any signals from the government discouraging investigation or prosecution will likely be heeded by the commission.[156]

Second, investors may lose their incentive to sue through the private right of action due to a restrictive provision in the China's Securities Law. For instance, Article 209 requires that the illegal gains from the offering and trading of securities be turned over to the state.[157] This provision prioritizes state confiscation over the claims of shareholders and can effectively leave investors without damages.[158] In a 1997 case, the CSRC decided that the illegal gains Hainan Mingyuan Modern Agriculture Development Co. had amassed from an inflated stock

153. Cai, *supra* note 140, at 151 ("As Anthony Neoh, the former Chair of the Securities and Futures Commission in Hong Kong, noted: 'The Chinese market is very unsophisticated; and so are its regulators.'").

154. Friedman, *supra* note 100, at 512.

155. Opper, *supra* note 139, at 153.

156. *See id.* at 161.

157. China's Securities Law, *supra* note 99, art. 209 ("All the illegal gains from, and fines for, illegal offering and trading of securities which are confiscated and imposed pursuant to this Law shall be turned over to the State treasury.").

158. Cai, *supra* note 140, at 149.

price would be given to the state treasury in lieu of compensating the 107,000 investors who had paid for Mingyuan stock at the inflated price.[159] While this case occurred prior to an explicitly recognized private right of action, it demonstrates that Article 209 can deprive investors of the incentive to sue. Given the uncertainty of whether the CSRC will decide to allow compensation to shareholders in any given case, potential plaintiffs will not have sufficient motivation to incur the costs of litigation. It does not bode well for the enforcement of the securities laws if the CSRC has disabled both itself (through heeding the will of government instead of the market) and potential plaintiffs (by disallowing damages) from acting as potential safeguards against securities fraud.[160]

Lastly, class actions—one of the strongest enforcement mechanisms in the United States for securities fraud—may not be feasible in China.[161] Chinese courts require that there be similar claims and defenses between members of the same class as well as individualized reliance for a class action to proceed.[162] Whereas American law has created the fraud-on-the-market theory in order to allow a plaintiff to fulfill class-wide reliance consistent with the commonality requirement in Rule 23 of the Federal Rules of Civil Procedure,[163] Chinese law has not explicitly addressed this presumption of reliance. In 1998, a shareholder attempted to bring an action against Chengdu Hongguang Holdings Co.[164] While the CSRC had determined that the company had indeed been engaged in fraud, the court rejected the shareholder's argument that she had relied upon the misrepresentations in the prospectus and dismissed her case.[165] Without a presumption of reliance on the market price reflecting public misrepresentations, individual actions

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159. *Id.*

160. *Id.*

161. *See id.*; Ho & Gapalan, *supra* note 115.

162. Cai, *supra* note 140, at 147.

163. *See* Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988) ("The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements."). *Id.* at 241–42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160–61 (1986)).

164. *See* Cai, *supra* note 140, at 146.

165. *Id.*

and class actions in particular are most likely doomed to fail. For all these reasons, there is an inadequate amount of "active civil litigation" capable of ensuring the enforcement of China's securities laws and disclosure requirements.[166]

2. *Government Corruption and Weak Enforcement Give Chinese Companies the Impression They Do Not Need to Comply with China's Securities Laws*

Despite disclosure requirements in China's Securities Law, companies listed on national exchanges often do not realize that they are required to comply with the rules and as a result, they choose to disclose as little as possible.[167] This belief that non-compliance is acceptable is cultivated by the corruption of China's bureaucracy and the complete lack of an accounting system capable of detecting and deterring accounting fraud by listed companies.

As part of the rampant bureaucratic inefficiency in China, companies are accustomed to giving bribes as a necessary part of doing business. As a result of the Communist Party's desire to retain control over all aspects of the economy including the securities markets, their insistence "on the vast number of approvals, permits, and certificates required to carry on the simplest business means that the opportunities for bribery as a method to either skirt the law or speed up the bureaucracy are endless."[168] Thus, Chinese firms that rely on corruption in the Chinese government in order to list more quickly on national exchanges may not be prepared to comply with rules in the United States they had previously skirted in China. For example, in the 2005 *Lucent* case, the SEC sought an enforcement action against the Chinese firm Lucent Technologies Inc. for securities fraud and violation of the accounting provisions of

166. Ho & Gopalan, *supra* note 115.

167. Fu, *supra* note 109, at 210.

168. Owen Nee, Mergers & Acquisitions in China: Business Laws of China 415 (2012) ("Any discussion of disputes with government entities is hardly complete without mentioning the settlement mechanism all too commonly employed in China: bribery of public officials. Despite vigorous efforts to stamp out official corruption and the severe penalties for being caught, bribery appears to continue as an everyday occurrence.). Nee, Shareholder Agreements, *supra* note 113, § 17:19.

the securities laws.[169] While Lucent admitted to corrupt payments by four of its senior employees to the SEC, China chose not to investigate these admissions.[170] This propensity to avoid enforcement even when the fraud has clearly been perpetrated and successfully prosecuted elsewhere gives future securities law violators little incentive to stop engaging in fraudulent practices. In addition, any corruption in the CSRC or other securities authorities is unlikely to be detected and successfully prosecuted considering the corruption of the judiciary.

Accounting in China is also fraught with enforcement issues. This is troubling because the danger with CRMs stems from their fraudulent inflation of revenue, a practice that should be deterred through effective accounting oversight and methodology. In China, the State Audit Authority is in charge of overseeing the securities exchanges and securities companies,[171] and financial and accounting reports are required annually and semi-annually.[172] China has not completely adopted U.S. Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standards (IFRS), but has instead created a hybrid system.[173] While this hybrid system has been increasingly harmonized across China, actual practices in China have failed to become standardized.[174] While many accounting standards in China align with U.S. practices, enforcement issues and lack of expertise detract from China's ability to uphold its new regime.[175]

First, professional accountants in China often lack independence from the government—a necessary component for high auditing standards.[176] In the absence of independence, the probability of detecting malfeasance decreases. Accounting firms in China have only been formally independent from

169. *Release No. 2004-67: Lucent Settle SEC Enforcement Action Charging the Company with $1.1 Billion Accounting Fraud*, SEC. & EXCH. COMM'N (2004), *available at* http://www.sec.gov/news/press/2004-67.htm.

170. NEE, M&A, *supra* note 168, at 416.

171. China's Securities Law, *supra* note 99, art. 9.

172. China's Securities Law, *supra* note 99, arts. 60, 61.

173. Templin, *supra* note 2, at 142.

174. *See* Opper, *supra* note 139, at 151–52.

175. *See* Templin, *supra* note 2, at 121; *See generally* Givoly et al., *supra* note 10.

176. *See* Opper, *supra* note 139, at 159.

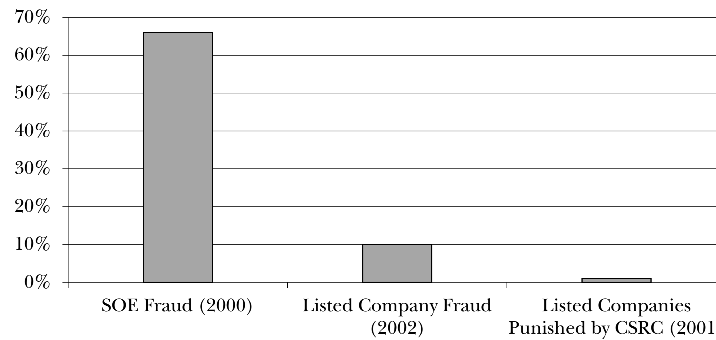
the Ministry of Finance and the central government since 1998, and personal networks between accounting firms and regulatory bodies remain despite their formal severance.[177] Furthermore, the government has a vested interest in preventing the sudden disclosure of accounting fraud in order to avoid a potential stock market crash or loss of confidence in Chinese investment opportunities, a result that would slow the government's efforts at reform and economic growth.[178] It would not be surprising if the government steps in to prevent an imminent disclosure that would threaten the market.

Second, the body tasked with ensuring accounting accuracy, the Chinese Institute of Certified Public Accountants (CICPA), lacks independence from the central government since the government provides its funding and appoints its members.[179] Because the majority of listed companies consist of SOEs, allegiance to the central government can deter CICPA from pursuing financial deficiencies in these companies. In addition, CICPA is not sufficiently staffed or adequately equipped to detect fraud.[180]

Third, the CSRC has completely failed to investigate or penalize companies that commit financial fraud with the exception of a small handful of cases. In 2000, two-thirds of the largest SOEs had falsified financial information.[181] Likewise, in 2002, the CSRC conducted a survey that showed one out of ten publicly listed companies falsified financial information.[182] Despite this shockingly high incidence of fraud, in 2001, the CSRC punished less than 1% of listed companies (a quarter of those investigated), and for a twenty-year period from 1981 to 2001, the CSRC barred only ten accountants from the profession.[183]

177. *See id.* at 159–60.
178. *See id.* at 160.
179. Opper, *supra* note 139, at 159.
180. *Id.*
181. *See* Templin, *supra* note 2, at 143.
182. McCarty, *supra* note 6, at 358.
183. Opper, *supra* note 139, at 157.

FIGURE 2:
INCIDENCE OF FRAUD COMPARED TO PUNISHMENT OF FRAUD IN CHINA



This utter lack of enforcement discourages accuracy in financial reporting since "[t]he probability that firms and auditors will be caught is low, the legal environment in China is loose, and the risk that an accounting firm will receive administrative punishment notices or be required to pay out civil damages is close to zero."[184] This environment furnishes companies with the complacency that they may fudge their financial data without consequence in China. It is likely that this outlook based on domestic experience gets exported with CRMs to foreign national exchanges.

B. *The Regulatory Loopholes for CRMs*

Nonconformity with the securities laws alone does not harm investors if the nonconforming companies are not allowed to enter the securities markets. However, when noncomplying CRMs succeed in getting past barriers to entry meant to weed out unsafe and fraudulent investments, the opportunity for harm emerges. Inconsistency in the enforcement of securities laws, differing accounting regimes, and the simple distance between U.S. actors and the headquarters of CRMs have led to loopholes whereby reverse mergers can avoid scrutiny

184. Songlan Pen & Kathryn Bewley, *Adaptability of Fair Value Accounting in China: Assessment of an Emerging Economy Converging with IFRS* 29 (Social Science Research Network Working Paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1326004.

and disclosure.[185] Although many actors in the securities regime are expected to ensure the accuracy and fairness of an issuer's disclosures, failures in administration, oversight and accountability in the case of CRMs have led to six distinct loopholes.

In the United States, the relevant accounting regime is the GAAP.[186] The Exchange Act requires that a registrant on a national securities exchange include financial information that is confirmed by a registered public accounting firm as conforming to GAAP.[187] The accounting firm must be registered with PCAOB, and the issuer must undergo regular PCAOB inspections in accordance with the Sarbanes-Oxley Act of 2002.[188] PCAOB was created by Congress in Sarbanes-Oxley, is overseen by the SEC, and is tasked with ensuring the accuracy of independent audit reports. If PCAOB uncovers evidence of deficiencies, it has the authority to require auditing firms to perform additional procedures.[189]

However, at the time China MediaExpress was operating, PCAOB had no jurisdiction over CRMs, thus creating the first regulatory hole for CRMs. Blocked by the Chinese government, PCAOB cannot inspect the work of registered accounting firms in China.[190] Therefore, as stated in a PCAOB press release, "investors or potential investors in U.S. capital markets who rely on the audit reports of PCAOB-registered firms in these jurisdictions are deprived of the potential benefits of PCAOB inspections of these auditors."[191] While three quarters of CRMs have a U.S. auditor,[192] this number may be misleading since PCAOB has noted that many of the registered firms auditing foreign companies chose to rely on foreign audit

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185. *See* 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/; Templin, *supra* note 2, at 144.

186. Templin, *supra* note 2, at 142.

187. 15 U.S.C. §§ 78(*l*)(b)(1)(J)–(K) (2012).

188. *Issuers That Are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions Where the PCAOB Is Denied Access to Conduct Inspections,* PUB. CO. ACCOUNTING OVERSIGHT BD., http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx [hereinafter PCAOB Report].

189. *Id.*

190. *Id.*; Holmes, *supra* note 7.

191. PCAOB Report, *supra* note 188.

192. McCarty, *supra* note 6, at 353.

firms that are geographically closer to the majority of the issuer's operations.[193] While this practice is condoned by PCAOB, there are strict guidelines as to when a U.S. audit firm may rely on the opinions of foreign audit firms.[194] Moreover, in China, securities regulators do not focus on these companies listed abroad, but only on domestic exchanges, which creates the second "regulatory hole" as far as CRMs are concerned.[195] The CSRC is in the better position to monitor audit firms that receive audit work outsourced from American accounting firms. However, the CSRC seems to take the position that when a domestic company lists on a foreign exchange, regulation is to be left in the hands of the foreign regulator. Indeed, on the CSRC's website, the list of relevant rules for listing on the NYSE is limited to references to the NYSE and SEC rules, with no distinct rules and guidelines that Chinese firms in particular must comply with.[196] In effect, neither PCAOB nor the CSRC regulates CRMs.

The third regulatory loophole is the lack of enforcement by the SEC when Chinese firms choose to list on U.S. national exchanges through a reverse merger. Due to the high volume of CRMs since 2005 and the lack of manpower at the SEC, many CRMs pass through unregulated. A former SEC attorney has commented that, "[i]t would take assigning all of the SEC Enforcement division's resources for two years to make a meaningful dent" in CRM fraud.[197] Since such manpower is impracticable, the U.S. regulators' only chance at enforcement is to hope that the occasional prosecution will act as a sufficient deterrent. However, CRMs knew that they might be immune from such prosecutions, especially if the Chinese government chose to protect them from U.S. regulators despite

193. *See* PUB. CO. ACCOUNTING OVERSIGHT BD., STAFF AUDIT PRACTICE ALERT NO. 6 (2010).

194. PUB. CO. ACCOUNTING OVERSIGHT BD., § 543 (1972), http://pcaobus.org/Standards/Auditing/Pages/AU543.aspx.

195. Templin, *supra* note 2, at 144.

196. *List of Relevant Rules for Listing on the NYSE in U.S.*, CSRC, http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/DepartmentRules/200901/t20090116_70269.htm (last visited Nov. 24, 2012).

197. Robert Holmes, *China Reverse-Merger Regulation Looks Flawed*, THE STREET (Dec. 23, 2010, 6:01 PM), http://www.cnbc.com/id/40787567#. *See also* Holmes, *supra* note 7. Commentators agree that the memorandum of understanding has done little to improve Chinese cooperation in the area of enforcement.

the 1994 memorandum of understanding between the U.S. and China, which declared the SEC and CSRC's intent to aid the other party in enforcing their respective securities laws.[198] In addition, private attorneys are hard pressed to go after fraudulent companies since the assets, witnesses, and discovery are all in China and thus not accessible.[199] As one New York investment attorney griped, "I 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."[200] The inability of plaintiffs' attorneys in the United States to effectively pursue CRM fraud creates a fourth loophole in enforcement.

Fifth, even when the SEC begins an investigation of a CRM, the Commission faces extreme difficulty in accessing audit papers in their investigation of Chinese firms because the Chinese government has maintained that audit papers cannot be released due to secrecy laws.[201] In one example, Deloitte recently refused to comply with an SEC subpoena requiring Deloitte to hand over the audit papers of another U.S.-listed Chinese company, Longtop Financial, which is also embroiled in allegations of fraud.[202] According to Deloitte, Chinese law prohibits them from delivering Longtop's working papers without the express consent of Chinese authorities due to secrecy laws.[203] Prior to the revelations of fraud at Longtop, Deloitte had specifically disclosed to the SEC and PCAOB that they might not be able to comply with all requests for information due to restrictions in Chinese law.[204] Thus, regulators were on notice of such a possibility, and as a Forbes Magazine article stated, "[t]he S.E.C. must consider how much longer

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198. *See* SEC Release No. IS-662, *supra* note 100, ¶ 4; *see also* Holmes, *supra* note 7. *Id.*

199. SEC Release No. IS-662, *supra* note 100, ¶ 4.

200. *Id.*

201. Richard Pearson, *Deloitte's China Problem Comes to a Head*, Forbes (Apr. 2, 2012, 8:14 PM), http://www.forbes.com/sites/richardpearson/2012/04/02/deloittes-china-problem-comes-to-a-head/.

202. Francine McKenna, *Deloitte Hides from S.E.C. Behind Chinese Wall over Longtop*, Forbes (Sept. 9, 2011, 2:36 PM), http://www.forbes.com/sites/francinemckenna/2011/09/09/deloitte-hides-from-s-e-c-behind-chinese-wall-over-longtop/2/.

203. *Id.*

204. *Id.*

they will allow companies to list in the U.S. if they honestly and clearly tell you they are out of the reach of U.S. courts when something goes wrong."[205] Another reason why U.S. regulators find it difficult to investigate financial reporting and accounting information in China is that, "Chinese business culture is highly insular and resists the sort of disclosure and openness that is the hallmark of U.S. securities laws."[206] As a result, these companies lack the requisite transparency for securities regulators to conduct oversight or investigation of Chinese companies listing in the United States.[207]

Lastly, U.S. auditors face many obstacles in performing adequate due diligence for companies with the majority of operations located in China. These problems include the language barrier, [208] a lack of understanding of Chinese business practices,[209] and the inability to confirm the accuracy of an outside auditor's (located in China) conclusions.[210] U.S. accounting firms tend to outsource audits of U.S.-listed companies abroad, and often, these outside firms do not follow accounting standards required by PCAOB. [211] Although U.S. regulations require that foreign private issuers adhere to GAAP or IFRS,[212] there is still "substantial divergence" between IFRS and the Chinese system of accounting, most notably regarding methods of valuation. [213] This lack of oversight from U.S. accounting firms creates the last loophole allowing CRMs to construct false financial information without raising red flags for their accountants or at the SEC. In the case of China MediaExpress, having adequate audit procedures would have required Deloitte to confirm that advertisements were indeed being viewed on a number of buses all over China. While this type of due diligence is difficult for a firm operating abroad, the result of the Muddy Waters investigation confirms that there were

205. *Id.*
206. *See* Templin, *supra* note 2, at 140; Holmes, *supra* note 7.
207. *See* Templin, *supra* note 2, at 140–41.
208. *Id.* at 141.
209. *See* McCarty, *supra* note 6, at 353; *see also* Templin, *supra* note 2, at 140–41 (stating that "Chinese business culture is highly insular and resists the sort of disclosure and openness that is the hallmark of U.S. securities laws.").
210. *Id.* at 353.
211. Templin, *supra* note 2, at 127.
212. 17 C.F.R. § 230.701(e)(4) (2008).
213. Templin, *supra* note 2, at 142.

many red flags to be discovered. However, the seemingly lackadaisical verification of business and financial figures may have been in response to weak U.S. enforcement. There may be little incentive for U.S. firms to perform rigorous audits when U.S. enforcement is weak because "legal enforcement actions against foreign firms are rare and often result in insignificant penalties. Such weak enforcement reduces managers' incentives to provide high-quality financial statements."[214]

Overall, the six regulatory loopholes have allowed for firms such as China MediaExpress to slip through both regulatory regimes and to commit massive fraud. Regulatory bodies on both sides of the Pacific have failed to create mechanisms to uncover fraud in CRMs, China's politics have stonewalled against accounting oversight, U.S. securities litigation, and the delivery of audit papers during investigation, and the sheer distance between U.S. accounting firms and Chinese businesses have created difficulties in performing adequate due diligence. While some loopholes are easier to close, U.S. regulators must ask whether, if others cannot be closed—notably, those requiring a fundamental change in Chinese bureaucracy and business culture—we should continue to allow companies with great growth potential but also with great fraud potential to enter U.S. markets. While fraudulent CRMs only make up a handful of Chinese companies listed on U.S. exchanges, the loopholes available to these companies are so gaping that the opportunity for fraud is disturbingly great.

FIGURE 3:
THE SIX REGULATORY LOOPHOLES FOR CRMS

1.	The PCAOB cannot audit CRMs
2.	The CSRC does not audit CRMs
3.	The SEC does not have the manpower to detect and deter CRM fraud
4.	Plaintiffs' attorneys cannot effectively pursue litigation against CRMs
5.	Chinese secrecy laws prevent access to audit papers during investigation
6.	U.S. auditors perform insufficient oversight

214. Chen et al., *supra* note 5, at 10.

CONCLUSION

Chinese Reverse Mergers once represented a unique tool for promising startup companies in China to quickly access capital, but CRMs are now blemished by the rampant fraud that has been discovered in numerous CRMs in recent years. While CRMs had the potential to fulfill a niche where American investors and Chinese companies could converge to raise capital, distrust and misgivings by the SEC, the national securities exchanges, short sellers, and the broader investing public seem to indicate that CRMs will no longer be a popular method of investment.

Discrepancies between the Chinese and U.S. regulatory regimes and the opening of several loopholes enabled companies such as China MediaExpress to fall through the cracks of regulation and mandatory disclosure. Chinese companies have very little experience with the enforcement of securities laws in China and as such, a culture has grown where there is little concern of consequences when financials are inflated. However, the divergence in the enforcement of similar securities laws would not alone have created the investment calamity that has occurred in recent years with CRMs. Instead, CRMs' non-compliance slipped through six regulatory holes: PCAOB's lack of jurisdiction, CSRC's failure to regulate CRMs, insufficient manpower at the SEC, the inability of American plaintiffs to go after CRMs, Chinese secrecy laws impeding SEC investigations, and the inability of U.S. auditors to perform adequate due diligence. These loopholes certainly seem to have aided China MediaExpress's alleged fraud—a U.S. auditor was unable to perform sufficient due diligence, the SEC only caught on to China Media's fraud after independent short sellers performed investigatory research, the CSRC did not recognize or detect China MediaExpress's fraud, and it is unclear whether members of the class action against China MediaExpress will ever see recovery.

Fortunately, several of these regulatory loopholes are closing. In late 2011, the SEC approved a rule change proposed by NASDAQ to instate more stringent listing requirements for reverse mergers. [215] Now, reverse mergers must first list on an

215. SEC & EXCH. COMM., SECURITIES ACT RELEASE NO. 34-65708, 2011 WL 5434020, at *1 (2011).

over-the-counter exchange, a national exchange, or a foreign exchange for six months prior to applying to list on NASDAQ.[216] The reverse merger must also maintain a minimum price on the relevant exchange, and file both audited financials and its two most recent financial reports with the SEC prior to application.[217] While this is a step in the right direction, it must be remembered that the closing of some loopholes may open others. In particular, because the listing process in China is fraught with political affiliation and bribery, listing on the Shenzhen and Shanghai exchanges may not be sufficient to protect against a lack of accounting or financial fraud when the reverse merger arrives in U.S. markets.

Also, in the case of China MediaExpress, audited financials were provided to the SEC, the company had been current in its section 13(a) filings, and its share price had hit over $20/share on NASDAQ. Based on the case study of China MediaExpress, fraudulent companies may still be able to pass the listing requirements while gaining another stamp of approval in the eyes of investors. The problem with China MediaExpress and other CRMs was on the enforcement end—China's history of non-enforcement and the impotency of the regulatory bodies and U.S. plaintiffs have allowed CRMs to avoid disclosure without raising alarm. These deficiencies also created a culture where CRMs did not expect to be caught. While it is certainly advisable to increase the barriers to entry, it is important to remember that the back end—i.e., the threat of and actual enforcement—rather than the front end—i.e., entry costs—can often prove to be the most powerful in improving disclosure, deterring fraud and protecting investors.

However, in other areas of enforcement, the landscape is improving. In January 2014, the SEC issued a decision censuring the Big Four accounting firms for their practice of failing to produce work papers for Chinese companies despite the accounting firms' contentions that revealing work papers would run afoul of China's secrecy laws.[218] The decision sanctioned

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216. *Id.* at *2.

217. *Id.*

218. Brian V. Breheny, *SEC Judge Issues Initial Decision Regarding Chinese Affiliates of the Big Four Accounting Firms,* SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & ASSOCIATES (Jan. 23, 2014), http://www.skadden.com/insights/sec-judge-issues-initial-decision-regarding-chinese-affiliates-big-four-accounting-firms.

Chinese affiliates of the Big Four, barring them from practice for six months—in effect, the Chinese counterparts cannot issue audit reports from the time the final decision is handed down.[219] This decision removes the shield accounting firms and their Chinese clients utilize to avoid scrutiny. While the SEC acknowledged the tension between the U.S. and Chinese regimes that accounting firms may find difficult to navigate, the SEC nevertheless decreed that compliance by accounting firms with the SEC's disclosure regime is paramount.[220]

Further promoting the production and disclosure of audit papers, in May 2014, PCAOB and the CSRC entered into a new Memorandum of Understanding on Enforcement Cooperation with the stated goal of improving the reliability of audit reports and protecting investors.[221] The scope of the Memorandum includes assisting one another in compliance with the other's regulations and laws, providing audit working papers held by audit firms, and providing further information to evaluate auditor review, practices and quality control.[222] Assuming China chooses to implement and comply with the Memorandum of Understanding, this could remove the additional hurdle of China claiming audit papers violate secrecy laws. However, it should not be assumed that China would fully observe the spirit and practices prescribed by the Memorandum of Understanding. It has been noted by commentators that the 1994 Memorandum of Understanding had done little to improve Chinese cooperation in the area of enforcement.[223] Twenty years later, PCAOB will have to wait to see whether China will indeed assist the U.S. market to more fully and accurately evaluate Chinese firms and their financials. Fuller transparency on the part of China and Chinese firms can lead to a result that mutually benefits both nations—a more open market that protects investors thereby facilitating greater U.S. investment into China.

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219. *Id.*

220. *Id.*

221. MEMORANDUM OF UNDERSTANDING ON ENFORCEMENT COOPERATION BETWEEN THE PUB. CO. ACCT'ING OVERSIGHT BD. OF THE U.S. AND THE CHINA SEC. REG. COMM'N AND THE MINISTRY OF FIN. OF CHINA (May 13, 2013).

222. *Id.*

223. *See* Holmes, *supra* note 7.