REUTERS/ALY SONG

CHINESE STOCK SCAMS ARE THE LATEST U.S. IMPORT

Short-sellers are exposing China dream investments as nightmares. As more cases of fraud come to light, exchanges and regulators are finally waking up.

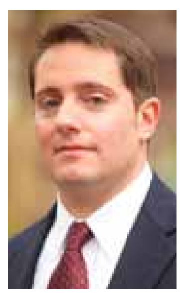
BY RYAN VLASTELICA AND DANIEL BASES
NEW YORK, MAY 11

IT SEEMED LIKE THE perfect China play, a way for investors to cash in on the world's fastest growing economy.

China MediaExpress Holdings Inc, which provides advertising on buses that clog the smog-choked streets of the country's largest cities, was on a tear on the Nasdaq stock exchange. After rising 45 percent in 2009, the stock gained another 49 percent in 2010.

That came to a halt in late January. In a research report, Andrew Left, an investor who runs Citron Research from his Los Angeles home, termed the company a "phantom" that was literally "too good to be true." The stock plummeted 14.4 percent after Left's comment, to $17.84 from $20.86 in one day.

Citron's report was followed by similarly damning charges from Carson Block of Muddy Waters Research, who called the stock a "'pump and dump' scheme."



CARSON BLOCK

Soon after, Roddy Boyd, the editor of thefinancialinvestigator.com in Wilmington, North Carolina, visited the company's offices and posted videos that he said made it "exceptionally clear" the place was bogus.

China MediaExpress' stock hasn't recovered. Shares lost 47 percent in four days, and were trading at $11.88 on March 11 when the stock was halted on the Nasdaq stock exchange. It hasn't traded since.

In March, the company delayed its year-end filings and its finance chief resigned. The Hong Kong-based company said on March 11 its auditor, Deloitte Touche Tohmatsu Hong Kong, a member firm of the "Big Four" accounting company's global network, severed ties to the company.

The story of China MediaExpress has become an increasingly common one as U.S. investors chase the next hot Chinese stock -- only to find themselves victims of scams.

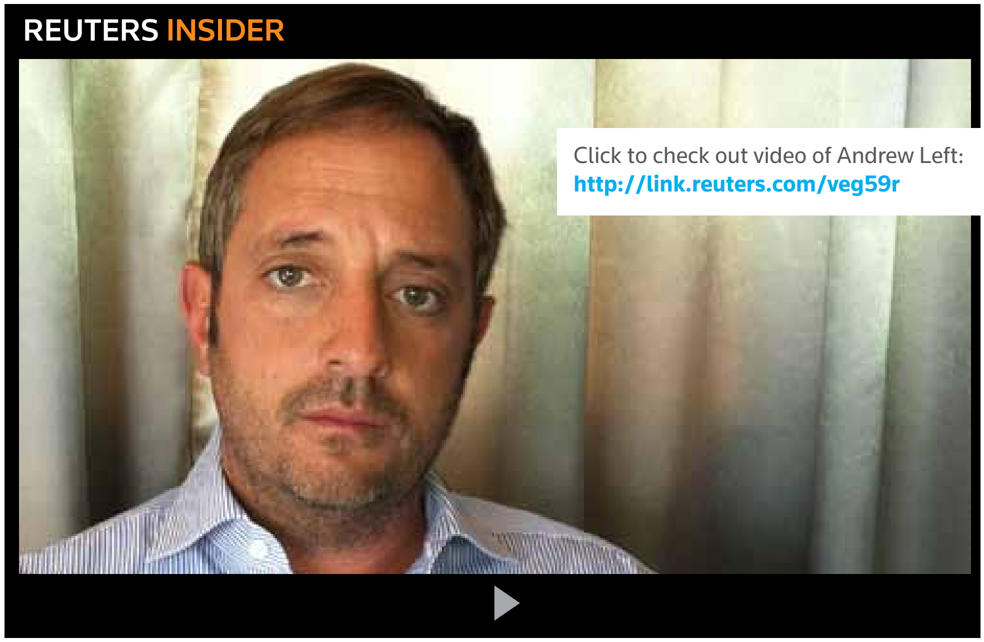
Many of the questionable Chinese companies gain access to U.S. capital markets through a back door. In what's known as a reverse merger, a private company buys enough shares of a public firm to essentially become publicly traded. That allows the company to pay a much lower fee to be listed than it would with an initial public offering -- not to mention sidestep the more rigorous filing demands of an IPO.

Of the more than 600 companies that obtained entry to U.S. exchanges this way between January 2007 and March 2010, a total of 159 were from the China region, according to the Public Company Accounting Oversight Board (PCAOB). While many are legitimate, some turn out to be outright pump-and-dump schemes and other scams.

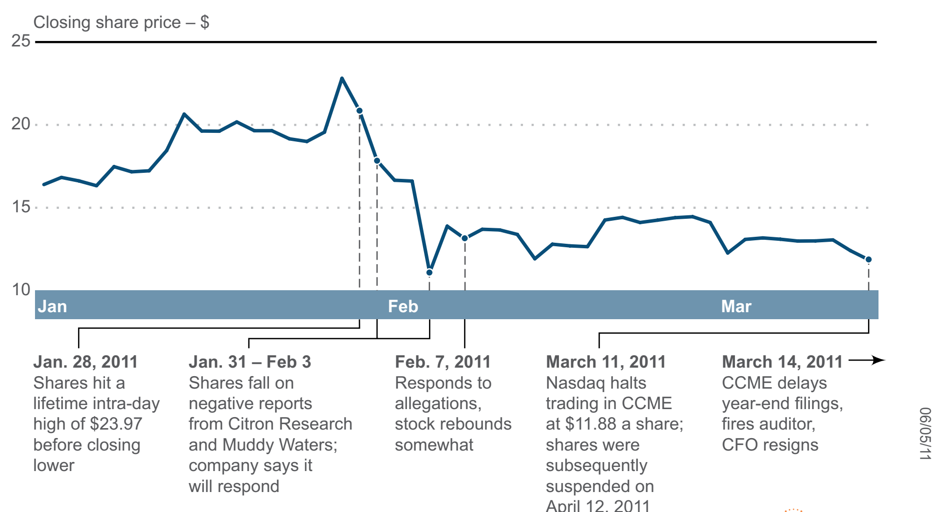
A study by financial web publication TheStreet indicated such schemes involving small-cap Chinese firms may have cost investors at least $34 billion over the past five years.

This has taken U.S. exchanges by surprise. NYSE and Nasdaq have delisted several companies and have a veritable "skid row" of more than a dozen firms that have been halted for weeks or months pending requests for information about accounting problems and late regulatory filings. (For an up-to-date list, see: http://www.nasdaqtrader.com/Trader.aspx?id=Tradehalts)

What are regulators doing about it? Although their stocks are traded on U.S. exchanges, the companies are based in China. That makes it unclear whose jurisdiction they fall under -- creating a regulatory void that



China MediaExpress timeline



Source: Thomson Reuters

REUTERS

Reuters graphic/Stephen Culp

companies can easily exploit.

On top of that, Beijing has barred America's PCAOB, established under Sarbanes-Oxley, from reviewing China-based accounting firms -- even if they are registered auditors with the accounting agency.

That loophole enables Chinese companies to hire big name and no-name firms locally; as a result, they face no redress from U.S. authorities for bad practices.

"There may be honest firms in China, but you can't monitor or control them," said Hamid Kabani, president of Kabani & Co in Los Angeles, a firm that has audited reverse merger stocks. "I can't see how a U.S. firm can satisfy whether the (Chinese) firm is (is legitimate)."

THE SHORTS

IN THE ABSENCE OF STRICTER regulation on companies and auditors, it is left to independent investors like Andrew Left or Carson Block to ferret out suspicious activity.

They, too, are not without controversy. Left, Block and their peers are short-sellers who profit when a stock collapses -- and critics point out that they can in theory benefit even if their research proves faulty.

"IT MAKES NO SENSE FOR CHINESE COMPANIES TO HAVE TO GO HALFWAY AROUND THE WORLD TO GET CAPITAL."

But it's also true that they face extraordinary business challenges.

"It's no secret we're interfering with scams that could net these chairmen tens of millions of dollars," said Block, who is 35. "Criminals deprived of such amounts will not take a kind stance towards people like me."

On Nov. 10, 2010, his fledgling firm published a strongly critical report on RINO International Corp, charging that many of the company's customers were nonexistent and that its accounting "has serious flaws that are clear signs of cooked books."

Shortly after, Block received threatening letters warning him to retract his allegations and explaining that "severe consequences may result if you do not act appropriately." An email received two days later mentioned his wife, Kathy: "Are you, Kathy and your dad ready for a bullet? Get ready. It could happen at any time now."

Less than a week later, RINO's auditors found accounting flaws. One month after the Muddy Waters report, the clean-tech company was delisted by Nasdaq. Its shares had fallen 96 percent from a 52-week high reached in October.

Block is based in Asia, though he would not say exactly where. He didn't contact the authorities, saying he was "more worried about the people whose threats I haven't received," but he did take additional security measures.

BLOG

Find more Reuters special reports at our blog The Deep End here:
http://link.reuters.com/heq72q

After his report on China MediaExpress, Block said he received more threatening e-mails. One of them was from an Auckland, New Zealand-based investor named Rick Page. He wrote in one email seen by Reuters that Block may meet "somebody's 'contract worker'. Who knows who, when or...where."

Reached by Reuters, Page acknowledged "acrimonious contact" with Block via e-mail but denied that he threatened Block. He says he regrets "having put money into this company and this space" and questions why regulators were not on top of the problem.

LOSE THE BATTLE, LOSE THE WAR

LATELY, THE U.S. SECURITIES and Exchange Commission has stepped up its interest in reverse-merger stocks. The SEC has an active probe into foreign companies listed on American exchanges, Commissioner Luis Aguilar noted in an April 4 speech.

U.S. exchanges, too, are belatedly tightening rules on reverse mergers.

Nasdaq, for one, is now considering adopting stricter listing requirements for reverse mergers. The proposal would require such companies to be traded for at least six months on the over-the-counter market or another national exchange, as well as maintaining a minimum bid price of $4 per share on at least 30 of the last 60 trading days immediately preceding the filing for the initial listing.

A source at Nasdaq, who could not be quoted on the record about rules under consideration, said the recommendation was expected to be enacted. When asked if it was undertaken due to the scandals, the source added that "we've had some feedback."

Then there is Beijing, whose policies play a crucial, albeit indirect, role in all this.

Paul Gillis, a professor of accounting who focuses on U.S.-listed Chinese companies at Peking University in Beijing, said China needed to make it easier for its firms to list on Chinese exchanges.

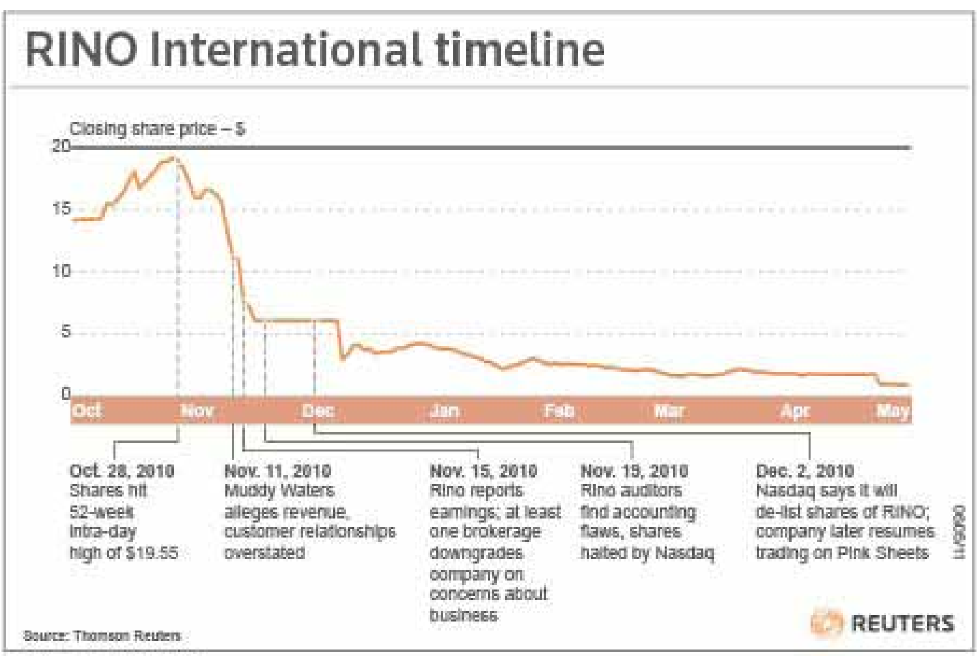
"It makes no sense for Chinese companies to have to go halfway around the world to get capital," he said, adding that China was in a better place to regulate them than the SEC or the Public Company Accounting Oversight Board.

A PCAOB report on reverse mergers published in March noted there were 56 initial public offerings from China, representing 13 percent of all IPO's in the United States in the three years from January 2007 to March 2010. IPO's require a greater degree of scrutiny and expense for companies to meet listing and filing requirements. They are an important source of income for such exchanges as NYSE Group and Nasdaq OMX.

As of the report date, the 159 China-region companies that gained access via reverse mergers had a combined market capitalization of $12.8 billion, less than half the $27.2 billion market capitalization of the China related IPO's.

By the end of the research period, 59 percent of Chinese reverse merger companies reported less than $50 million in revenues or assets as of their most recent fiscal year.

Analysts hastened to say that there was nothing inherently suspicious in a reverse merger, but Gillis said such operations "avoid much of the scrutiny that takes place in a



Reuters graphic/Stephen Culp

GOLD MINE? A worker pushes a cart at a coal mine owned by Puda Coal Inc. in Pinglu, Shanxi province March 24, 2011. **REUTERS/STRINGER**

normal IPO. That makes them the preferred route for fraudsters."

Once here, these companies attract retail investors who screen for stocks with high growth rates and low prices, and often run into companies such as this, seemingly diamonds in the rough overlooked by others.

"You see these Chinese companies that have these great numbers, they never miss a quarter of earnings. They are always right on. Their expenses are low. Their growth is tremendous, regardless of the economy. So you go, 'Hmm, this doesn't make sense'," said Left.

James Chanos, founder of the New York-based hedge fund Kynikos Associates LP, says the Chinese scams follow a classic pattern.

"The modus operandi by these stock promoters is to find what the hot area for retail investors is, so 15 years ago it would have been the dot-coms, a bunch of years ago oil and gas and now it is China. You sell the big story," he said.

CHINA NEEDS INVESTORS

DAVE GENTRY, PRESIDENT and chief executive officer of investor relations at research firm RedChip Companies, points out that 70 percent of China's double-digit economic growth is created by companies with less than 2,000 employees.

While some companies may be overstating their results to entice American investors, Gentry says in their homebase, Chinese firms more frequently under-report revenues to tax authorities -- a problem he said was "systemic."

"It comes down to the character of the CEO and the management team in these companies and there is fraud. We cannot be in denial about this," he said in a telephone interview while meeting clients in China.

Investor relations firms play a big role in helping companies navigate through the listing process, either through a reverse merger or an IPO.

Crocker Coulson is the president of CCG Investor Relations and Strategic Communications, a company which handles investor relations for some 35 companies, many of them Chinese.

One Chinese client, Puda Coal Inc., which provides coking coal for steel production, saw its stock plunge and halt on the NYSE Amex stock exchange less than a month ago after another investor, Alfred Little, took aim at the company.

His April 8 report alleges the chairman of the company "transferred the ownership of PUDA's sole Chinese operating entity, Shanxi

"WE HAVE NOT BEEN ABLE TO INSPECT ALL OF THE NON-U.S. FIRMS WE ARE REQUIRED TO."

Puda Coal Group Co., Ltd ("Shanxi Coal"), to himself in 2009 without shareholder approval according to official government filings."

Asked how he felt about companies he works for that have had their shares halted, Coulson paused, shifted his feet uncomfortably, and said: "I'm going to say no comment."

As for his client Puda, on April 11 the company said it would investigate the allegations. The chairman, Ming Zhao, agreed to cooperate in the investigation. That's not stopping law firms from sharpening their pencils as a handful have filed for class action status on behalf of investors.

By April 29, with the investigation still underway, the company issued a press release saying the board received a preliminary non-binding proposal from Zhao to buy 100 percent of the company's outstanding shares in a "going private transaction at up to $12 a share." Puda's shares were trading near $13 a week before Little's report but plunged to $6 on April 8. The stock was halted before trading started on April 11. In December 2010 the shares hit a closing high of $16.47.

Another company fighting allegations from Little is Deer Consumer Products. It has accused Little of being a "fictitious character," and said in a press release there is evidence of illegal short-selling on the part of hedge funds distributing false information through web sites, including the popular Seeking Alpha, where Little has published articles.

At the Shenzen headquarters of Deer, located in a six-story building in an industrial part of town, officials would not answer questions.

A security guard repeatedly asked a Reuters reporter to leave before eventually finding a representative, who would not provide a business card but gave his name as Jevin He. He said he was "not in a position to answer" questions, and calls to headquarters have not been answered.

LAST LINE OF DEFENSE

SOME OF THE WORST breaches may be at the auditing and accounting level.

"It is no secret that we have not been able to inspect all of the non-U.S. firms we are

REUTERS INSIDER

Interview with PCAOB chairman James Doty
http://link.reuters.com/wyb59r

COMPANY HQ: Front door of the Deer Consumer offices in the southern Chinese boomtown of Shenzhen. Situated on the ground floor of a building in the city's leafy and fast-developing High Tech Industrial Estate, home to a number of leading Chinese technology firms including ZTE. The Deer offices were just around the corner from a BMW dealership. **REUTERS/BOBBY YIP**

required to," PCAOB chairman James Doty told the Council of Institutional Investors on April 4.

At the same meeting, SEC Governor Aguilar raised the issue of how companies are raising capital, a situation he said he finds himself "increasingly concerned about."

"PCAOB-registered accounting firms based in the United States audited 74 percent of the Chinese reverse merger companies, while China-based registered firms audited 24 percent," the agency said in March.

Top officials from both the United States and China concluded their once-a-year Strategic and Economic Dialogue meeting in Washington on Tuesday, saying they would work toward enhancing "mutual trust and strive to reach agreement on cross-border oversight cooperation."

Efforts to inspect Chinese auditing firms have met resistance from Chinese authorities, but Doty told Reuters this week he expected progress this year, in part because the various problems with Chinese firms had shown authorities in Beijing the importance of credible auditing. "We will make progress in getting access to those audits," he said.

Drew Bernstein, the co-managing partner of Marcum Bernstein & Pinchuk, a New York-based audit and accounting firm, said he sometimes has to go to extremes to get Chinese company officials to understand the ramifications of shoddy auditing and accounting.

Instead of bowing to the intransigent company chairmen or boards, he explains that if they don't cooperate and own up to problems, he will be forced to tell the local authorities of alleged fraud, therefore making it a Chinese problem.

Switching the jurisdiction changes the calculus. Executives have been executed in China for fraud and corruption.

"A lot of the answers, you know, get down to dealing with the Chinese in a Chinese way," he said.

Fears for personal safety are not limited to short-sellers like Carson Block.

George Qin, head of the Chinese audit practice at Houston-based MaloneBailey, says he has to think twice now about future travel within China.

According to documents filed with the SEC, MaloneBailey resigned its auditing duties from four companies that have subsequently been halted for trade on the NYSE Amex and Nasdaq stock exchanges.

The companies are: China Century Dragon Media, China Electric Motor, China Intelligent Lighting, and NIVS IntelliMedia Technology Group.

"I'm afraid for my personal safety in some areas of China," Qin said.

He told Reuters that some companies colluded with employees at major Chinese state-owned multinational banks to provide false bank statements, though he would not specify which ones. In interviews with various actors in the field, there was a lot of finger-pointing about competitors, to which Qin said: "Are they (competitors) all fraud free? We found the fraud by ourselves. If there were more serious firms there would be more fraud discovered. Where there's one roach, there are many roaches."

"IT HAS NOT BEEN DIFFICULT FOR THE SHORTS TO MAKE WILD ALLEGATIONS OF FRAUD AND PROFIT HANDSOMELEY FROM THEIR PRE-ESTABLISHED SHORT POSITIONS."

MEETING RESISTANCE

SHORT SELLERS LIKE LEFT will say he and others on this side of the markets are just following up on information and data to help explain things that "just don't make sense."

"Me? I'm out to make money. I don't consider myself a short seller. I consider myself a market opportunist. Would you be asking me this if I was writing about stocks that I take a long position in? People are so ready to hate short sellers," Left told Reuters.

Many agree the presence of short sellers and the research they provide are useful. As soon as they attest to that, though, they point fingers at unidentified "dishonest" short sellers operating at the behest of hedge funds looking for an edge.

Winston Yen, CFO of Orient Paper, which is based in the city of Baoding in China's Hebei province, said his company and investors "feel totally victimized" by the negative research published by Block in 2010, which caused a sharp decline in that company's stock.

Shares in the company closed at $8.33 before Block's first report published on June 28, 2010. They fell precipitously in the next session and have never fully recovered, currently trading at around $4 a share.

Orient's audit firm, Davis Accounting Group, also known as Etania Audit Group P.C., was not correctly licensed, forcing the paper maker to hire new auditors.

Bernstein, the accountant with Marcum Bernstein & Pinchuk, is chairman of Orient Paper's audit committee. He said Orient was by now perhaps the most vetted company in China.

Speaking on the sidelines of a China investment conference in New York, he said he saw the battle between Block and Orient as "a war of credibility."

Bernstein said the Muddy Waters report was full of "enormous allegations" that were untrue and that he is now "highly confident that the financials of the company materially represent what they say." He added that a lawsuit against the research firm is probably justified.

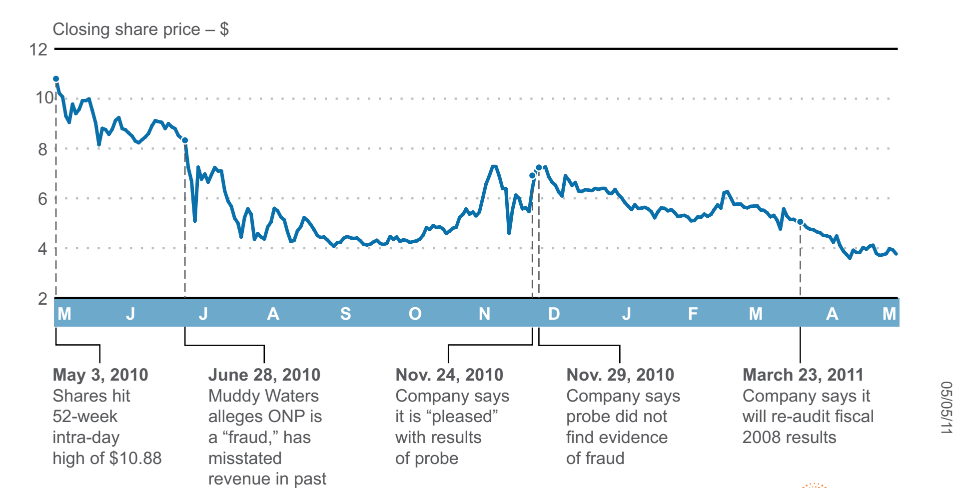
"I don't think they were right on anything, to be honest with you," Bernstein said, explaining that Orient Paper hired 15 to 20 professional services firms to investigate.

Because investors don't have the ability to conduct similar due diligence, they "tend to panic" when negative research appears, Yen said.

"It has not been difficult for the shorts to make wild allegations of fraud and profit handsomely from their pre-established short positions," he said.

Orient Paper defended itself, saying an internal investigation found no evidence of problems.

Orient Paper timeline



Source: Thomson Reuters

Reuters graphic/Stephen Culp

"When you put a company under an enormous amount of scrutiny, as we did, you find imperfections. We did find areas that we can improve upon, but none that misrepresented the financial statements," Bernstein said.

However on March 23 the company said it would have to re-audit results from 2008 though it maintained that doing so would not impact financial statements for fiscal years 2009 and 2010. The re-audit results are expected at the start of the third quarter of 2011.

Block isn't buying the company's view.

"It is not surprising that a probe conducted by the company on itself, under the umbrella of the attorney-client privilege conferred by having the inquiry managed by one of the most prolific issuer's counsel of Chinese RTO (reverse takeover) companies, enabled the company to issue a press release stating that it determined it wasn't defrauding investors," Block said.

Claiming security concerns, Muddy Waters removed the firm's phone number from its website, along with a phony mailing address that had created controversy about the location of the firm's headquarters. "I felt that the sort of attention I was getting wasn't the kind we wanted," Block said.

Thefinancialinvestigator.com's Boyd, who does not short shares he is writing about, has some reservations himself about shorts.

The reports "were brilliantly reported and laid out, but you can never get past the fact that they're doing this for money," he said. "If something doesn't work out - and I'm not just talking about (Muddy Waters) - these guys could have a situation where they went after a company and made money but couldn't substantiate their claims."

Until the auditing problems are cleaned up and greater responsibilities are shared by U.S. and Chinese regulators, however, folks such as Block and Left will have ample opportunity in their chosen business.

"Just because it is China doesn't mean it is a path to riches," Left said.

(Reporting by Daniel Bases and Ryan Vlastelica in New York; additional reporting by Zhao Bing and James Pomfret in Hong Kong; editing by David Gaffen, Jim Impoco and Claudia Parsons)

TOP RIGHT PHOTO: Migrant workers walk past an advertising billboard for a Chinese construction company in central Beijing April 6, 2011. **REUTERS/ DAVID GRAY**

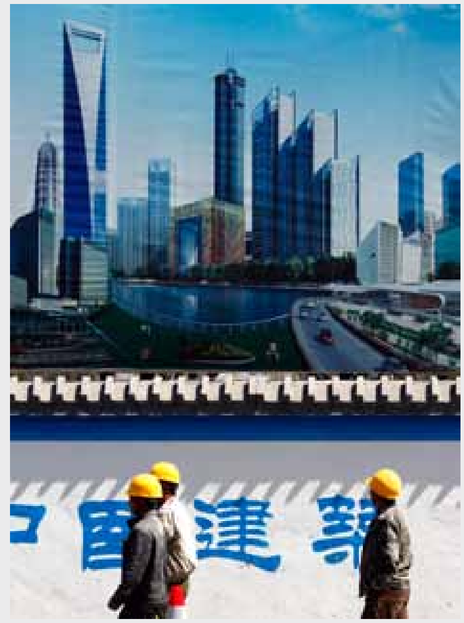
FACTBOX

THERE ARE MORE THAN 600 companies on U.S. exchanges that were listed by way of so-called reverse mergers. Of those, more than 150 are from the China region.

U.S. exchanges have had to delist a number of companies in recent months and many issues have also been halted pending more information.

Nasdaq OMX Group's frequently updated list of trading halts is unusually large at this point. Normally there are only a few companies on the list, but the current list has 16 names, some of which have not traded for weeks.

The most recent list can be viewed here: http://www.nasdaqtrader.com/Trader.aspx?id=Tradehalts



REUTERS/DAVID GRAY

Here are a list of recently halted shares, along with some de-listed companies as well.

COMPANY	TICKER SYMBOL	HALT DATE
Rino International	RINO.O	delisted
Duoyuan Printing	DYNP.PK	delisted
ChinaINS Online	n/a	delisted
Xinhua Sports & Entnmnt	XSELY.PK	delisted
Tongxin International	TXIC.PK	delisted
China MediaExpress Hldings	CCME.O	March 11
China Agritech	CAGC.O	March 14
ShengdaTech	SDTH.O	March 15
China Century Dragon Media	CDM.A	March 21
NIVS IntelliMedia Tech	NIV.A	March 24
China Intelligent Lighting	CIL.A	March 24
China Electric Motor	CELM.O	March 31
HQ Sustainable Maritime	HQS.A	April 1
Keyuan Petrochemicals	KEYP.O	April 1
Subaye Inc	SBAY.O	April 7
Puda Coal	PUDA.A	April 11
Universal Travel Group	UTA.N	April 12
China Ritar Power	CRTP.O	April 18
Duoyuan Global Water	DGW.N	April 20
China Integrated Energy	CBEH.O	April 20
Wonder Auto Tech	WATG.O	May 6

Source: Nasdaq OMX, NYSE Euronext Inc.

STOP AND GO: Vehicles stop at a red light in downtown Shanghai January 10, 2011. **REUTERS/ CARLOS BARRIA**

COVER PHOTO: People look at an electronic board at a brokerage house in Shanghai February 25, 2011. **REUTERS/ALY SONG**

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