

CHINA'S SHORTCUT TO WALL STREET

How U.S. middlemen paved the way for troubled foreign listings on America's stock exchanges



Chinese "reverse merger" stocks have lost at least \$18 billion in value. REUTERS/LUCAS JACKSON

SHELL GAMES: *A Reuters Investigation*

Articles in this series are exploring the extent and impact of corporate secrecy in the U.S.

**BY NANETTE BYRNES AND
LYNNLEY BROWNING**
AUGUST 1

A SPATE OF SPECTACULAR collapses of Chinese stocks listed on American exchanges has cost U.S. investors billions of dollars. The fiasco has sparked multiple investigations. Accusations are swirling in Washington and Beijing.

It all began with an email sent out of the blue a decade ago to a Texas businessman named Timothy Halter.

The email came from Shanghai native Zhihao "John" Zhang. The former medical student introduced himself and asked: Was Halter interested in helping bring Chinese companies to the U.S. stock market? Zhang proposed using a backdoor method that the Texan had mastered for American firms: buying dormant shell companies listed on U.S. exchanges.

Soon, Halter and Zhang brought two Chinese firms to market in America: a manufacturer of power-steering systems and a maker of vitamins, weight-loss supplements and household cleaners.

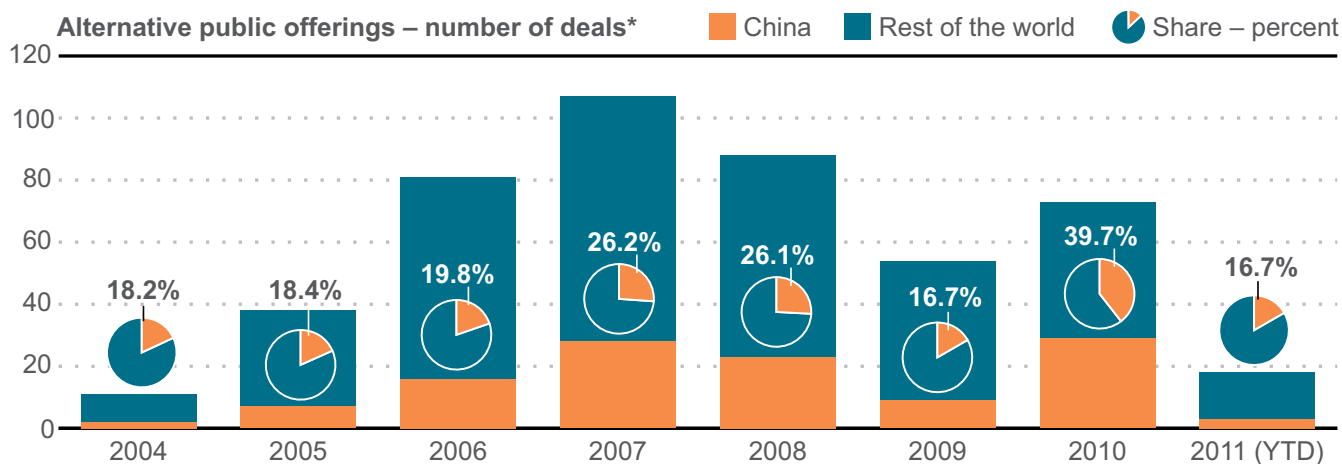
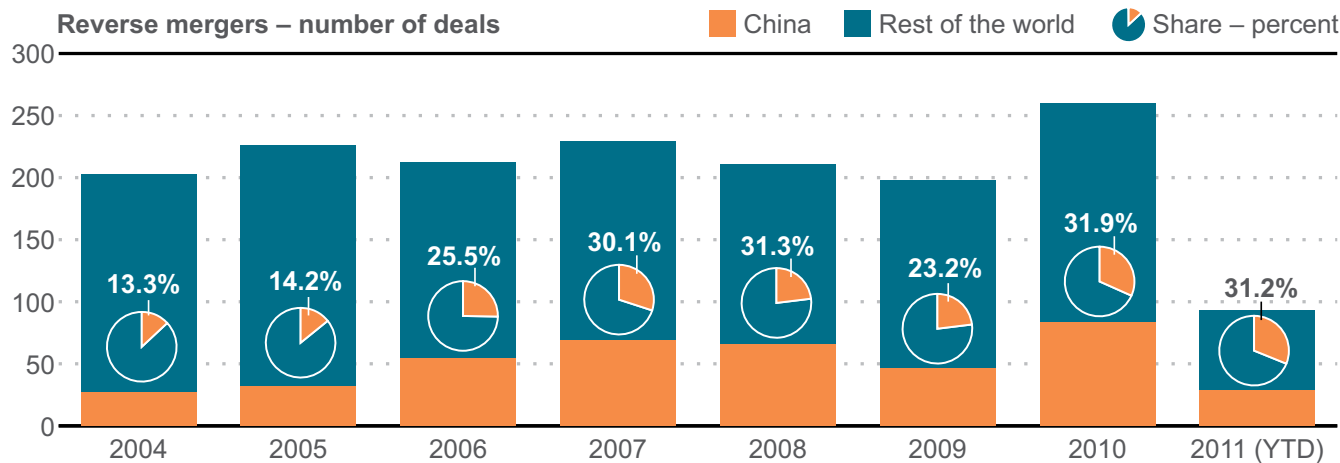
The email led to a boom for a niche industry of advisers who specialize in a brand of deals, called the "reverse merger," that use shell companies to give clients easy entry into U.S. capital markets. More than 400 Chinese companies seized the chance.

Leading the way was Halter, a slim, salt-and-pepper-haired man who played a direct or indirect part in 23 deals; staked his name on at least 20 other deals done by his Shanghai partner, Zhang; and paved



Reverse mergers: China and the world

Before accounting questions caused a sharp drop this year, Chinese reverse mergers—in which a private firm gets a stock listing by buying a shell company—were a booming business.



* Alternative Public Offerings (APOs) are private investments made in a company at the time of its reverse merger.

Source: PrivateRaise, a DealFlow Media Service



07/07/11

the way, through conferences in China, for dozens of other deals.

It was a lucrative gambit: Halter lives with his family on a 50-acre ranch in Texas, where he breeds bass. His firm, Halter Financial Group, threw splashy “summits” to promote the industry, including a gathering headlined by former President George W. Bush in 2010. Its website boasts: “Reverse Merger Experts!”

But deals birthed by Halter and his imitators are now blowing up.

Investors have alleged widespread accounting irregularities and other problems at dozens of the Chinese companies that reverse-listed in the U.S., causing share prices to nosedive. Since March, some 30

Chinese firms have seen their auditors resign and at least 25 have been delisted from U.S. exchanges.

\$18 BILLION GONE

A REUTERS EXAMINATION of a cross-section of 122 Chinese reverse mergers on U.S. markets found that between each stock’s peak trading price and July 10, 2011, those companies saw a total of \$18 billion of their market capitalization vanish.

Reuters interviewed nearly 100 industry participants and examined financial records of dozens of Chinese companies to paint the most detailed picture yet of the network of dozens of players involved in the reverse-

mergers boom.

That industry hinges on a handful of leading “shell brokers” such as Halter who purvey paper companies; investment banks who specialize in financing a firm after a reverse merger; and auditors, usually small shops, who are lightly regulated in the U.S.--and not at all in China and Hong Kong.

The controversy has stirred up new tensions between Washington and Beijing, which held talks on the matter in July. The Public Company Accounting Oversight Board, the U.S. auditing watchdog, issued a report in March about potential problems with the audits of Chinese companies formed through reverse mergers. The Securities and

BLOG

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Exchange Commission has set up a working group to examine Chinese reverse mergers, and the Federal Bureau of Investigation has opened its own broad investigation, say people familiar with the situation.

The Chinese reverse-merger boom and bust offer insight into a little-understood corner of American business: the widespread use of shell companies, which can offer their owners a way to minimize regulatory scrutiny. The U.S. in recent years has called for much greater transparency in global business transactions. But on American shores, opaque shell companies are rife.

"It 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," says Republican Rep. Patrick McHenry, a member of the House Committee on Oversight and Government Reform.

REVERSE GEAR

A REVERSE MERGER hinges on a shell company—a firm without meaningful assets or operations, used as a vehicle for transactions—that's already listed on a stock exchange.

A deal typically starts with a so-called shell broker, anyone from a small shop to a larger firm such as Halter's. Brokers acquire shells, often domiciled in a secrecy-friendly state such as Delaware, Utah or Nevada. The broker then sells the U.S. shell to an operating company seeking to trade on a U.S. exchange—a transaction which, unlike an initial public offering, isn't overseen by regulators.

The acquiring firm thus becomes a publicly-traded company, with access to U.S. investors—but without the time, expense and scrutiny of a traditional initial public offering. Companies are incorporated under state rather than federal law, and so the federal overseer of stock flotations, the Securities and Exchange Commission, doesn't as a matter of course review reverse mergers until after the deal is done.

In Chinese deals, the buyer is often a holding company based in Delaware, the British Virgin Islands or other tax haven, which



RAINMAKER: Texas banker Timothy Halter pioneered the Chinese reverse-merger boom with deals in 2002 and 2003 that were widely imitated.

LISTED SHELL COMPANIES COST AS LITTLE AS \$30,000 APIECE.

in turn controls the actual operations on mainland China. This structure complicates the ability of U.S. regulators to dig into the accounts of the resulting firms.

In recent years, one in three U.S. reverse mergers involved a Chinese operating company. In 2010, 260 reverse mergers were completed, according to deal tracker PrivateRaise. Of those, 83 deals involved operating companies in mainland China.

There are more than 1,200 dormant public companies in the U.S., PrivateRaise says. They can be purchased for as little as \$30,000, then sold by shell brokers for as much as 10 times that amount or more. Brokers say that in 2007 and 2008, the peak of the market, Chinese firms would pay up to \$800,000 for a high-quality shell, one with no lingering liabilities.

Reverse mergers, to be sure, are a legitimate way to gain access to capital for smaller companies that can't afford a full-fledged initial public offering or don't need to raise large sums. The problem isn't the technique, defenders argue, but rather people who misuse it.

David N. Feldman, a New York lawyer and

author of a book about reverse mergers, notes that the large majority of Chinese deals are good ones, and that IPOs are also subject to abuses. Chinese software maker Longtop Financial Technologies Ltd. achieved a peak market value of \$2.3 billion on the New York Stock Exchange after its IPO, but came under regulatory scrutiny this spring and is now being de-listed from the Big Board.

COLORADO ROOTS

THE INDUSTRY HAS ROOTS in the Colorado mining boom and bust of the 1950s, when entrepreneurs bought up failed listed companies. Timothy Halter's breakthrough was to spread the tactic to China.

Halter, the founder and president of boutique firm Halter Financial Group in Argyle, an affluent suburb northwest of Dallas, did a handful of reverse mergers, all for American companies, in the seven years after opening his company in 1995.

Zhang, who lived in Toronto, found Halter by Googling "reverse mergers," according to people who know both men. China was the world's hottest economy, and Halter was intrigued by Zhang's email and subsequent calls, these people say.

Their first Chinese reverse mergers—involving household cleaning-goods maker Tiens Biotech in 2002 and China Automotive in 2003--caused a sensation.

"These were the two deals that really got

PITBULL RAPPED AS BIKINI-CLAD HOSTESSES SERVED COTTON CANDY.

everybody's attention," said Beau Johnson, managing director of Chinamerica Holdings, a financial advisory and investment fund in Richardson, Texas, which owns shells and has done several Chinese reverse mergers. "The industry just snowballed from there."

After the first two deals, the Texan sent Zhang back to Shanghai to open an outpost and scout Chinese firms ripe for an American listing.

Zhang, who once aspired to be a doctor and graduated from Fudan University Medical School in 1990, began scouring China for businessmen who dreamed of ringing the opening bell on Nasdaq. He set up New Fortress Group Ltd., a British Virgin Islands entity, to take stakes in deals. Zhang declined to comment for this article.

'PRESTIGE AND CREDIBILITY'

HALTER GAINED NOTE as a guru on the nascent market for Chinese mergers—and touted his new Halter USX China Index, the first to track Chinese companies trading on U.S. exchanges. In 2004, he told a Congressional panel on China that "there is prestige and credibility in a US listing. It is also understood by Chinese companies that our standards are high and it is not an easy task to comply with the requirements to be a public company in the U.S."

In 2008, Halter trademarked in the U.S. his secret sauce: a transaction he dubbed the APO, or Alternative Public Offering. It combined a reverse merger and a financing arrangement called a private investment in public equity, or Pipe, that allowed firms to go public and raise money in one fell swoop. Halter's trademark application said he had "instructed hundreds of attorneys, CPAs and professionals about the reverse merger process."

Reuters identified 17 deals arranged by Halter Financial Group, and six in which Halter brokered the shells used in transactions orchestrated by others. The firm consulted dozens more Chinese companies on preparing to go public, introducing them to auditors and lawyers needed for the deals. People in the industry estimate Halter has had a hand, direct or indirect, in one in eight Chinese deals listed on American exchanges.

Halter's deals sometimes use a dizzying array of shells. His firm arranged a reverse merger in 2010 for Long Fortune Valley Tourism, a Chinese company that describes

itself as focused on "cave tourism." The merger involved shell companies in Texas, Delaware, Hong Kong, the Cayman Islands and the British Virgin Islands. The original shell used in the deal was created years earlier by Halter to buy up a bankrupt chain of nursing homes.

In addition to taking stock in the shells used in his transactions, Halter also earned "finder's fees" through his affiliated broker-dealer firm, Halter Financial Securities. HFS referred Chinese companies to investment banks, which then raised money for them.

'MIAMI GLAM'

ONE OF THE LEADING banks in the game was Roth Capital Partners of Newport Beach, California. Led by Chairman Byron Roth, its specialty is to provide financing to Chinese clients after a reverse merger. Roth says it has raised more than \$3 billion for U.S.-listed Chinese companies. Such deals accounted for nearly half of the \$1.9 billion in capital Roth raised for clients in 2009.

Roth's heady success was reflected in the glitzy conferences it threw for the industry. In March, more than 3,000 hedge-fund managers, accountants, lawyers, bankers and financial advisers flocked to the Ritz Carlton Hotel in Dana Point, southern California.

Just hours after the Public Company Accounting Oversight Board issued its warning about Chinese reverse mergers, Roth threw a wear-only-white "Miami Glam" party

in an elegant tent. Guests stood surrounded by rhinestone-encrusted sculptures of leopards. Bikini-clad hostesses served cotton candy as rapper Pitbull put on a concert. For the more conservative Chinese guests, Roth organized a lavish banquet nearby at the posh Resort at Pelican Hill.

"They don't like our food.... And they don't like rap," explained one organizer.

Not all of Roth's deals have stood the test of time. One client, China Biotics, a maker of so-called pro-biotic food products, delisted from NASDAQ in June, 19 months after Roth helped it raise more than \$79 million from investors. China Biotics' auditor resigned amid accusations that the company forged documents and created a fake website that overstated its cash holdings. Byron Roth, Roth's chief executive, declined to comment.

THE ACCOUNTING TRAIL

JUST AS CRUCIAL TO THE industry were the accountants. To do a reverse merger, the acquiring company needs to hire an auditor registered with the PCAOB.

It became common for small audit firms far from China, often with no affiliates in the country, to sign off on books and records kept halfway around the world. In the U.S., the PCAOB reviews small auditing firms only once every three years.

In Bountiful, Utah, the small firm of Chisholm, Bierwolf and Nilson used its experience with U.S. shell companies to win referrals to a global client base. From

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U.S. REGULATORS TAKE TOUGH STAND AGAINST CHINA-BASED ACCOUNTING FIRMS

REUTERS WASHINGTON DC BUREAU

REUTERS

a suburb of Salt Lake City, the firm audited clients in China—and South Korea, Bolivia, El Salvador and Kazakhstan as well. CBN was a deal, charging about half the going rate for a comparable sized firm in New York or California.

"We didn't ever have to do any advertising," said Todd Chisholm, a former managing partner at CBN.

Todd Chisholm prospered. An avid golfer, he and his then-wife built a \$1 million home on a golf course not far from his Bountiful office.

In 2006, Chisholm got a referral to a company called Hendrx, formed in 2004 through a reverse merger with a U.S. shell, with primary operations in China, according to Chisholm and two others directly involved.

Hendrx described itself as a manufacturer and distributor of devices that purify, filter and generate water from moisture in the air. But the business wasn't making money, executive turnover was high, and Hendrx had been sued for alleged contractual fraud and patent infringement, SEC filings show.

Over the next four years, Todd Chisholm audited Hendrx's books, giving a clean bill of health, though noting questions about the company's ability to continue as a going concern. Once a year, he visited the Chinese operations for week-long reviews.

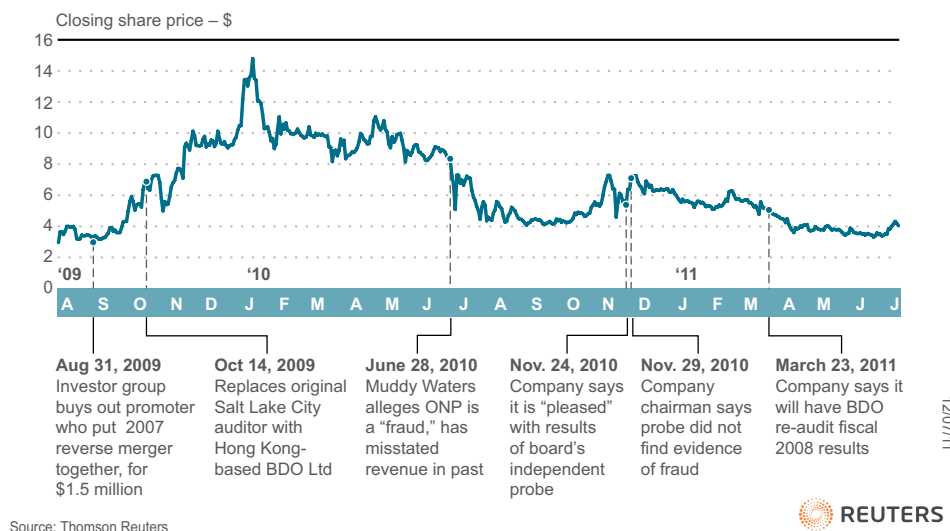
The PCAOB later found these audits to be grossly inadequate. According to an April 8 PCAOB disciplinary order, Chisholm and his partner, Troy F. Nilson, were each auditing on average 25 companies in 2006 and 2007. About half of those were shell companies, Chisholm says.

Neither Chisholm nor Nilson spoke Chinese, the PCAOB noted, and they relied on less-experienced native-speaking staff in the audit process. In January 2009, Hendrx lost its final appeal of the patent infringement case and, unable to pay a \$1.2 million judgment, turned over ownership of all its operations to its creditors. Worth \$37 million at its peak, Hendrx has lost nearly all its value, its thinly traded shares now fetching less than a penny apiece on the Over the Counter market.

The PCAOB found the audits at Hendrx and three other clients so troubled that it barred Todd Chisholm and his namesake firm from auditing U.S.-traded companies for life. His partner, Nilson, was banned for at least five years. Chisholm acknowledges that his staff was stretched thin, but stands by the effectiveness of the audits. Nilson didn't reply to requests for comment.

Orient Paper's crumble

Steps to address investor criticism have yet to raise the stock.



Despite his ban by the PCAOB, Chisholm is working on four or five planned Chinese reverse mergers through a new consulting firm, Fairway Mergers Inc. He says he is no longer acting as auditor of their financial statements, but is advising the companies and their investors on their numbers and how to prepare for a U.S. audit.

"I'm very much enjoying not being an auditor. I don't see myself ever going back there," Chisholm says. In the new venture, "I've got talent and expertise that I can use."

HALTER'S REVERSAL

LAST YEAR IN SHANGHAI, where he had built up a staff of 40, Halter staged his own answer to rival Roth Capital's gatherings. His firm brought in former President George W. Bush and former Bush Treasury secretary John Snow as featured speakers on the global economy. Spokespeople for Bush and Snow declined to comment.

This year, the boom turned bust. Last summer, short sellers, who bet that a share will decline in price, began targeting Chinese reverse merger stocks. Those stocks started crumbling, regulators began opening probes, and a host of auditors resigned, often citing concerns about cash balances and management integrity.

Three companies Halter has worked with are among those that hit the rocks.

ShengdaTech, a KPMG-audited chemicals maker in which Goldman Sachs took a 7.6 percent stake, saw auditor KPMG resign in April, citing "serious discrepancies" in its

ORIENT PAPER:

THE PRICE OF ADVICE

Consultants, investment bankers, lawyers and accountants prospered on Chinese reverse mergers. Here's a tally of fees earned on one troubled deal, Orient Paper.

SHELL PROMOTER: Max Time Enterprises - at least \$1.3 million.

AUDITOR: Davis Associates of Utah: 2008 audit - \$49,000

AUDITOR: BDO Ltd.: 2008 re-audit, 2009 audit - \$300,000

INVESTMENT BANKER: Roth Capital: 2010 secondary offering - \$1.7 million

LAW FIRM LOEB & LOEB: legal review of accusations - \$1.4 million

Data: SEC filings; Orient Paper

bank statements and representations of customers. ChinaAgritech, a fertilizer maker that garnered investments from private-equity giant Carlyle Group, was delisted from Nasdaq in May for not filing its annual report on time, three months after a short seller said a visit had shown the company's factories idle and suppliers non-existent.

Also in trouble is China Automotive, one of the two Halter deals that set off the boom.

In April 2007, the PCAOB issued a report faulting China Automotive's Toronto-based auditor, Schwartz Levitsky Feldman, for "deficiencies of such significance that it

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BACKS UP: The implosion of Chinese reverse-merger stocks has strained ties between U.S. and Chinese officials; here, flags are arranged for U.S.-China economic talks in Washington this May. **REUTERS/KEVIN LAMARQUE**

appeared to the inspection team that the firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements." The agency did not identify the audit clients in question, but last April it reported finding the same problems in a new inspection.

In December, Schwartz Levitsky Feldman resigned as China Automotive's auditor. In March, the company said it would restate earnings for 2009 and the first three quarters of 2010. That drew a warning from Nasdaq that it was in danger of not being compliant with SEC requirements on timely filing of financial reports. China Automotive did manage to submit its filings, but has seen its stock fall by two-thirds since January 2010, wiping out \$471 million in market value.

Halter has not been accused by the SEC or PCAOB of any wrongdoing. "Our business model is to work with the companies that seek to access the US capital markets and that represent to us that they meet

certain financial requirements," Halter said in an email in response to queries. "We then introduce these companies to PCAOB-registered accounting firms and multinational law firms."

A NEW WORLD

THE WORLD THAT Timothy Halter helped create may be in for serious change.

In recent months, the SEC has begun taking a much closer look at the filings that follow a reverse merger, according to investment bankers and lawyers whose clients are being reviewed. The agency has suspended trading in at least three stocks. Representatives from the SEC and the PCAOB recently visited China to discuss better cooperation on the auditing side.

John Zhang, still in Shanghai, is focusing on getting Chinese firms listed in Germany and Hong Kong. A spokesman declined to provide further details about his work or his early career.

Timothy Halter, for his part, is distancing himself from the industry.

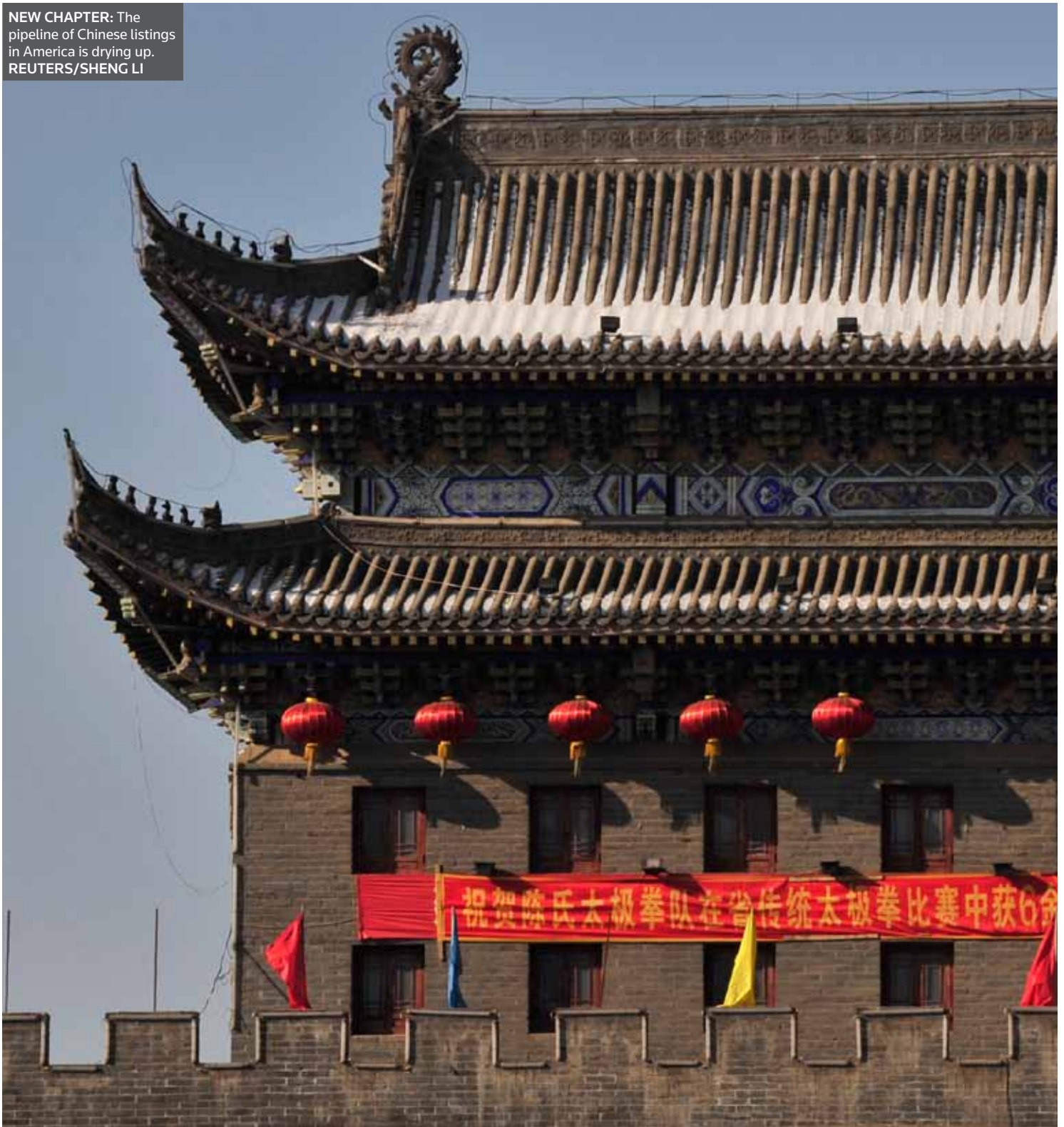
"Our model has not changed," he told Reuters in an email exchange. But he did "not anticipate doing any Chinese APOs in the near future."

Last month, Tiens Biotech, one of Halter's two breakthrough Chinese clients, said it was changing course. It's now de-listing and taking itself private.

The method? A series of mergers--with shell companies registered in Delaware and the British Virgin Islands.

(Editing by Howard Goller, Martin Howell and Michael Williams; additional reporting by Mary Slosson and Clare Baldwin in Los Angeles, Brian Grow in Atlanta, Dena Aubin in New York, Sarah Lynch in Washington, Michael Flaherty in Hong Kong and Kazunori K. Takada in Shanghai)

NEW CHAPTER: The pipeline of Chinese listings in America is drying up.
REUTERS/SHENG LI



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