Senator Robert P. Casey

to Galleries

Wednesday, September 17, 2014

Casey Presses Regulators on Protections for U.S. Investors in IPOs of Chinese Companies

In July, Casey Pressed SEC on Safeguards, Response from Chair Mary Jo White Raises More Questions / According to SEC Response, Public Company Accounting Oversight Board (PCAOB) Continues to Face Difficulties In Getting Access to Chinese Companies' Audit Work Papers / Similar Gimmicks Such as 'Reverse Merger' Structures from Chinese Companies Resulted in U.S. Investors Losing $18B

Washington, DC- Ahead of Alibaba's New York Stock Exchange (NYSE) debut U.S. Senator Bob Casey has pressed the Chairwoman on protections for U.S. investors investing in Chinese IPOs. His current letter follows previous correspondence raising questions about the SEC's efforts at investor protection. Senator Casey has raised a number of additional questions about access to audit work papers, the SEC's previous experiences preventing fraud related to other questionable corporate structures and the resources available to protect American investors.

"Rarely in history has there been an IPO of this size for a company that we know less about," Senator Casey said. "I continue to be concerned that about the level of transparency from

Chinese firms listing in our markets. The SEC has an obligation to step up its enforcement efforts and press these firms for additional information so that investors are protected."

The full text of Casey's letter can be seen below:

Dear Chair White:

Thank you for your September 11, 2014 reply to my letter on Chinese companies that list on U.S. stock exchanges using Variable Interest Entity (VIE) structures. I appreciate learning more about the SEC's efforts to limit the risks posed by these structures, and I am glad that these efforts have resulted in improved disclosures by some China-based firms.

As you know, this week the Chinese e-commerce company Alibaba is expected to list on the New York Stock Exchange in an initial public offering (IPO) that could be the largest in U.S. history. Alibaba will join more than 200 other Chinese VIEs listed on major American exchanges. Given the scale of this trend, I remain concerned about the dangers that these structures pose. I am specifically concerned that improved disclosures alone may be insufficient to address these risks.

In your letter, you cite an illustrative example of an earlier trend of Chinese companies listing on U.S. exchanges using opaque "reverse merger" structures. As you note, the SEC took valuable measures to study the risks posed by reverse mergers and improve disclosures by companies that used these structures. However, despite these enhanced disclosures, reverse mergers continued to provide fertile ground for fraud and abuse. An investigation found that American investors lost $18 billion in reverse-merger companies between 2001 and 2011.

These significant losses reflect the dangers posed when opaque corporate structures combine with fraudulent accounting practices. Like the reverse merger structure, the VIE structure is, by design, an opaque regulatory workaround. Paul Gillis, an expert on Chinese accounting practices at Peking University, has written that VIEs are "trying to tell Chinese regulators that the business is owned by Chinese and [tell] foreign investors that it is owned by foreigners." The nature of this structure puts Americans' investment in VIEs at risk. Alibaba's own SEC Form F-1 filing notes that if Chinese regulators deem their VIEs to be in non-compliance with Chinese law, the company could be "forced to relinquish our interest" in those VIEs.

This risk is compounded by accounting irregularities remain all too common at Chinese firms. For example, I was troubled to learn from your letter that the Public Company Accounting

Oversight Board (PCAOB) continues to face difficulties in getting access to Chinese companies' audit work papers.

The risks posed by VIEs are therefore similar to those posed by reverse mergers. A June 2014 report by the U.S.-China Economic and Security Review Commission found that American investors face "major risks from the complexity and purpose of the VIE structure." The Commission, which was created by Congress to study the national security implications of our economic relationship with China, goes on to suggest that if the VIE system collapses – for example, if Chinese shareholders choose not to honor VIE agreements – the consequences could match or exceed the $18 billion lost as a result of reverse mergers.

In order to prevent a repeat of these losses, I believe improving disclosures should be one part of a broader preventative strategy to control the risks posed by VIEs. I understand that following the discovery of fraud by companies using reverse merger structures, the SEC's Cross-Border Working Group identified reverse mergers as posing a significant risk, and the agency eventually brought charges against several Chinese firms' executives and their advisors. I would therefore urge the SEC's Cross-Border Working Group to consider making a similar determination about the risks posed by VIE structures.

Given the large number of Chinese companies listed on American exchanges, including over 200 using VIEs, I also ask that you provide me with detailed information about whether the SEC, particularly the Division of Enforcement, has enough resources and personnel to adequately pursue securities law violations by Chinese companies. Specifically, I would like to know if the SEC is actively engaged in investigative work on the ground in China.

Finally, I would appreciate information about the resources and personnel the SEC is dedicating to investigating the role of brokers, accountants and consultants who facilitate VIE listings by Chinese firms. As you know, these third parties played a leading role in the dramatic growth of reverse merger listings by fraudulent companies based in China. It is essential that as we evaluate the risks posed by VIEs, we monitor the activities of external advisors to Chinese firms.

I appreciate the SEC's continued attention to this problem and I look forward to continuing to work together to ensure American investors are adequately protected from these risks.

Sincerely,

Robert P. Casey, Jr.

United States Senator

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Press Contact

John Rizzo 202-228-6367

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