Exchange-Listed Chinese Company Fraud

Beginning in 2007 and continuing into the present, more than 150 Chinese companies have obtained listings on both U.S. and foreign stock exchanges via reverse mergers, a process by which a company is able to go public by purchasing or merging with a preexisting shell corporation which is already publicly traded. An unprecedented wave of alleged frauds pertaining to governance and accounting "irregularities" involving many of these companies subsequently occurred (see sidebar).[14]

> *"As these companies are scrutinized, investors will uncover the facts behind the 'Chinese Curtain'. Many of these stocks may prove to be valueless."* [15]
>
> - James Kaplan, Chairman, Audit Integrity Inc.
>
> *"It's unbelievable how the sucker born every minute keeps on wanting to line up and throw their money at these 'opportunities of a lifetime.'"* [16]
>
> - John Bird, private investor and expert on U.S.-listed Chinese corporate frauds
>
> *"But I'm also sure that this onslaught of Chinese reverse merger companies represents the single biggest white collar crime wave in existence right now."* [17]
>
> - Joshua M. Brown, New York City-based investment advisor

Readers interested in following the so-called "Chinese 'fraudcap' space" may find the following resources to be of interest: Absaroka Capital Management; Alfred Little; Bronte Capital; Buyersstrike: Citron Research; Glaucus Research; Kerrisdale Capital; and Muddy Waters.[18] Kerrisdale Capital, a private investment management firm specializing in identifying fraudulent U.S.-listed Chinese companies, has profitably exploited the opportunity created in part by the Skadden Arps law firm, achieving a 400%+ total return in 2011 by shorting Nasdaq-listed Chinese companies.[19]

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[14] U.S. Securities and Exchange Commissioner Luis Aguilar states that a growing number of Chinese 'reverse merger' companies traded in the U.S. are "vessels of outright fraud." Examples include one company admitting to inventing manufacturing contracts and another standing accused of staging fake production of biodiesel when investors visited its plant.

[15] "Texas Short Seller Fights China Fraud in $20 Billion U.S. Shares" by Dune Lawrence, Bloomberg (January 13, 2011).

[16] Id.

[17] Short-Sellers vs. the Chinese Reverse Merger Scam

[18] In late 2010 the acerbic Zero Hedge financial blog created a Chinese fraud short basket, generating a 75% annualized profit within 4 months.

[19] Skadden advised the PRC on its first sovereign bond issuance in the U.S. in 1994, and deliberately withheld disclosure of the PRC's refusal to honor repayment of China's defaulted international sovereign debt.

Cautionary Note

Chinese Corporate Fraud Contagion

In January 2010, Skadden Arps Slate Meagher & Flom, the same law firm which assisted the People's Republic of China in gaining access to U.S. capital markets despite its repudiation and refusal to honor repayment of China's defaulted full faith and credit international debt, co-sponsored a conference encouraging Chinese 'small cap' companies to utilize reverse mergers with U.S. publicly-listed companies in order to gain access to the U.S. financial markets, thereby opening the door to unprecedented capital markets serial fraud in what one commentator calls "the single biggest white collar crime wave in existence right now." Investors have lost over $7 billion in 2011 alone from numerous frauds involving Chinese companies listed on U.S. exchanges, accounting for over 80% of Nasdaq permanent trading halts.

SEC Fraud Contagion Warning Bulletin

Alleged and confirmed Chinese frauds include: Advanced Battery Technologies Inc. ● Advanced Refractive Technologies Inc. ● AgFeed Industries Inc. ● Bodisen Biotech Inc. ● Chaoda Modern Agriculture ● China Agritech Inc. ● China-Biotics ● China Century Dragon Media ● China Changjiang Mining & New Energy Co. ● China Education Alliance ● China Electric Motor ● China Expert Technology ● China Finance ● China Forestry Holdings Co. Ltd. ● China Green Agriculture ● China Integrated Energy Inc. ● China Intelligent Lighting and Electronics Inc. ● China Marine Food Group Ltd. ● China MediaExpress Holdings Inc. ● China Medical Express Holdings ● China Natural Gas Inc. / Xi'an Xilan Natural Gas Co. ● China Ritar Power ● China Sky One Medical Inc. ● China Yingxia International ● Deer Consumer Products ● Digital Youth Network Corp. ● Duoyuan Global Water Inc. ● Duoyuan Printing ● Focus Media Holding Ltd. ● Gulf Resources Inc. ● Harbin Electric Inc. ● Heli Electronics Corp. ● HiEnergy Technologies Inc. ● Jiangbo Pharmaceuticals ● Keyuan Petrochemicals ● Lihua International Inc. ● L&L Energy Inc. ● Longtop Financial Technologies Ltd. ● NIVS IntelliMedia Technology Group Inc. ● Orient Paper Inc. ● Puda Coal Inc. ● RINO International Corp. ● ShengdaTech Inc. ● Silvercorp Metals Inc. ● Sino Clean Energy Inc. ● Sino-Forest Corp. ● Sinotech Energy Ltd. ● SkyPeople Fruit Juice Inc. ● Skystar Bio-Pharmaceutical Co. ● Spreadtrum Communications Inc. ● Subaye Inc. ● Universal Travel Group ● Wonder Auto Technology Inc. ● Yongue International ● Yuhe International

Complicity of Chinese Banks

The recent instance involving Longtop Financial Technologies Ltd. and the company's auditor, Deloitte Touche Tohmatsu is particularly noteworthy, as it evidences an emerging trend of mutual complicity and collusion between U.S.-listed Chinese companies and various Chinese banks in an effort to deceive auditors and defraud U.S. and foreign investors. Longtop was a $2.4 billion NYSE-listed company, until its auditor resigned following discovery of fraud as a result of comparing company cash balance confirmations obtained from the main headquarters of the bank(s) with the confirmations previously provided by local bank branches. The confirmations provided by the local banks were all phony.[20] According to Deloitte, Longtop's chairman, Jia Xiao Gong, told a Deloitte partner that there was "fake cash recorded on the books" because there had been "fake revenue in the past." Just two weeks prior to the resignation of the company's auditor and the revelation of management fraud, a Morgan Stanley analyst recommended Longtop's stock, stating: "Longtop's stock price has been very volatile in recent days amid fraud allegations that management has denied. Our analysis of margins and cash flow

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[20] Longtop Financial Technologies obtained its U.S. listing via an IPO underwritten by Goldman Sachs Group Inc. and Deutsche Bank AG. Following the resignation of auditor Deloitte Touche Tohmatsu Limited and the subsequent resignation of the company's chief financial officer and delisting of the company by the New York Stock Exchange (NYSE), the alleged fraud reportedly cost Maverick Capital Ltd., which held a 9.9% stake in the company, an estimated $200 million. See the following Bloomberg news article: http://www.bloomberg.com/news/2011-05-23/longtop-says-auditor-deloitte-resigns-as-sec-initiates-inquiry.html

Another prime example of alleged frauds committed by Chinese companies listed on U.S. securities exchanges is Sino-Forest Corp., which caused an estimated loss of $500 million to $750 million (based on information obtained from FactSet Research) to the Paulson & Co. hedge fund managed by John Paulson, resulting in $1.5 billion in subsequent fund redemptions thus far by investors according to Institutional Investor (October 31, 2011). Paulson's Advantage Plus fund lost over 50% of assets under management during 2011. See the following:

http://www.zerohedge.com/article/john-paulson-loses-half-billion-under-24-hours

Also: http://www.zerohedge.com/article/paulson-dumps-all-sino-forest-holdings-750-million-realized-loss

And: http://www.zerohedge.com/news/paulson-flagship-fund-loses-more-half-aum-2011

Trading in Sino-Forest shares was halted by the Ontario Securities Commission, which stated that senior company officials appear to have misrepresented its revenues and exaggerated company assets. Following the Ontario Securities Commission's report alleging fraud and the resignation of the company's chief executive officer, Standard & Poor's Ratings Services withdrew its debt rating for the firm and Moody's Investors Service placed the company's credit rating on review. Simon Murray, chairman of commodities group Glencore, has been a board member and director of Sino-Forest since 1999, and Sino-Forest was at one time Canada's largest publicly-traded timber company with a market capitalization of over $6 billion. At the time of Muddy Waters' report on the company, Sino-Forest was covered by nine research analysts, all of whom maintained a "buy" or "overweight" rating. **An investor lawsuit was filed on February 21, 2012 by a former federal prosecutor against John Paulson's Advantage Plus fund in United States District Court for the Southern District of Florida. The suit, which seeks class action status, alleges that Paulson & Co. failed to conduct proper due diligence into Sino-Forest. The suit claims such failure constitutes gross negligence.** Paulson & Co. maintains that the fund relied on audits and underwriter due diligence, and stated that "Sino-Forest passed numerous legal and institutional controls and scrutiny," including eight securities offerings led by major securities firms. Large international private equity investors are also not immune to substantial losses resulting from Chinese company frauds, e.g., Carlyle Group and Partners Group which both had exposure to a $417 million loss following the suspension of trading in Hong Kong-listed shares of China Forestry Holdings Co. Ltd. As Ropes & Gray LLP attorney Scott Jalowayski notes, "Even careful and disciplined investors can run into problems with (Chinese) deals." According to Andrew Left, founder and owner of Los Angeles-based Citron Research, "We learned that there's no such thing as pedigree anymore in the Chinese market." Australian hedge fund manager John Hempton, whose fund holds positions in more than a dozen Chinese companies, observes that Carlyle employs a "Guanxi" (i.e., relationship-based) investment model in Asia and has hired the children of Chinese Communist Party officials to further the firm's quest for profits. Mr. Hempton notes, however, that "the Guanxi guys are likely to see Western funded private equity shops like Carlyle as piggy banks to loot" and predicts the collapse of the Asian Private Equity business, with Carlyle at the center of the collapse: http://articles.businessinsider.com/2011-02-14/wall_street/30018763_1_private-equity-connections-carlyle

According to a top equity banker, "There's a big *caveat emptor* sign on China now. Investors feel there are safer ways to lose money closer to home." Source: "Sino-Forest's Rating Cut After Review Delay," by Robin Wigglesworth, Financial Times (August 23, 2011). On April 10, 2012, the ISDA Determinations Committee issued a formal decision that a Sino-Forest bankruptcy credit event had occurred:

http://www.isda.org/dc/docs/AEJ_Determinations_Committee_Decision_10042012.pdf

gives us confidence in its accounting methods. We believe market misconceptions provide a good entry point for long-term investors." The very same month that Morgan Stanly recommended the company's stock, Deloitte resigned as auditor and revealed that the company's reported cash balances did not exist and that there were "significant bank borrowings" which were unrecorded in the company's books.[21] The company's stock is presently worthless. Unsurprisingly, Morgan Stanley acted as a lead manager for the company in a 2009 stock sale.

> *"We've long suspected at least some of China's supposed economic might would be revealed as nothing more than a new credit bubble. And now, we're more certain than ever that's the case. Furthermore, we're more and more convinced the next big blow to the world economy will be the growing recognition that China's banks are thoroughly corrupt."* [22]
>
> - Porter Stansberry, Founder and President, Stansberry & Associates Investment Research
>
> *"This means the Chinese banks were in on the fraud, at least at branch level. This is no longer a story about Longtop, and it is not a story about Deloitte. Given the centrality of Chinese banks to the global economy, it's a story much bigger than Deloitte or Longtop."* [23]
>
> - John Hempton, Chief Investment Officer, Bronte Capital

Participation of Local Government Officials in Common Fraud Variants

Examples of other alleged and confirmed frauds include "pump and dump" schemes whereby companies fabricate significantly inflated revenue and profits in order to enrich management via earn-outs and stock sales; claims of inflated or non-existent assets; phony bank balances; non-existent customer contracts or relationships; audited financial statements which misstate the subject company's financial condition; fraudulent SEC filings; embezzlement and misappropriation of funds by company management; and collusion between companies, banks (as noted above) and local customers to distort or conceal the truth regarding the company's actual business.[24] Such collusion may also include the participation of local Chinese government

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[21] A month previously, Deloitte resigned as the auditor of China MediaExpress due to concerns regarding bank confirmations. Another U.S. exchange-listed Chinese company, China Integrated Energy, engaged KPMG as auditor, and was thus able to raise $24 million from U.S. institutional investors. Six weeks after certifying the company's financials, KPMG repudiated the report and resigned as auditor following management's refusal to cooperate with an investigation into allegations that the company was a complete fraud. KPMG was also engaged as the auditor by yet another U.S.-listed Chinese company, ShengdaTech, prior to resigning for reasons related to "serious discrepancies" regarding bank balances and what appeared to be false confirmation letters from Chinese banks.

[22] Porter Stansberry, The S&A Digest (June 17, 2011).

[23] "The Audacity of Chinese Frauds" by Floyd Norris, New York Times (May 26, 2011).

[24] See, for example, Global Hunter Securities LLC's endorsement of China MediaExpress Holdings Inc. ("CCME"): "We were in China last week to conduct additional due diligence on CCME. We visited CCME's headquarters again, and reviewed all of its contracts with advertising clients and bus operators, tax filings, and bank statements for the last three years. We called or met 16 top advertisers, who verified a total of approximately $105MM of revenue or ~ 50% of our estimated 2010 revenue. We called China telecom, and the exclusive advertising agents for Coca Cola and L'Oreal, who confirmed they have placed ads on CCME's platform. We also spoke to 17 bus operators, who confirmed that they have signed in aggregate 14,191 buses with CCME, or 52% of the total number of buses CCME reported. The amount of revenues and buses these advertising customers and bus operators confirmed with us matched the numbers in the contracts we reviewed at CCME." "Based on our due diligence to date, our thesis remains unchanged: CCME is a leader in the inter-city bus advertising market with a unique business model and large growth potential." One month later, the company proved to be a total fraud: http://www.zerohedge.com/article/presenting-global-hunters-humiliating-february-17-maintain-buy-report-ccme

officials.[25] A somewhat different instance involving 'bank cash balance' fraud, as described in a statement released by the company's auditor, involves the scheme apparently employed by China Biotics in which the company is claimed to have created and then directed auditors to a fake bank website when they attempted to verify cash balances.[26]

Institutional Investors: Exposure to Chinese Fraud

The complexity and sophistication of such scams has entrapped numerous major U.S. institutional investors in the deceptions, including fund advisor **Wellington Management** (which reportedly held an 8% stake in China Biotics, 5% stake in Jiangbo Pharmaceuticals, 3.7% stake in Yuhe International, 2.2% stake in Puda Coal, and an 800,000 share position in China Electric Motor); **C.V. Starr** (which held a 15% stake in CCME); **Paulson & Co.** (which realized over a half-billion dollar loss on its 35 million share, 14% equity position in Sino-Forest); **Carlyle** (which held in excess of a 20% stake in China Agritech); **Glickenhaus & Co.** (1.6% stake in China Agritech); **Maverick Capital** (10% stake in Longtop Financial Technologies); **Tiger Global Management** (4.6% stake in

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Another example is China-Biotics ("CHBT"), as described by Citron Research: "The company's list of locations provided 80 locations. We visited 43 of these locations. A China-Biotics store was found at only 2 of these 43 locations. The remainder of the addresses were supermarkets, hotels, office buildings and empty lots. There were no smaller CHBT stores-within-a-store or kiosks at any of the locations." Visit the following website for additional information: http://chinesecompanyanalyst.com/2010/09/10/china-biotics-an-investigation-of-its-alleged-store-base/
Another example of U.S. exchange-listed Chinese company fraud is China Expert Technology ("CXTI"), which claimed to provide information technology network and infrastructure consulting services to government and corporations. The company's SEC filings showed steady annual growth in revenues and earnings. Then one day, the company stopped filing financial statements; the Chief Financial Officer quit and the Chief Executive Officer disappeared. The company vanished. Read more at:
http://seekingalpha.com/article/47467-china-expert-technology-return-to-priortrading-range-unlikely

[25] See, for example, the instance of Deer Consumer Products in which officials of the Wuhu Municipal Bureau of Land & Resources allegedly conspired to perpetuate the commission of fraud by the company through the use of a forged land use rights certificate bearing the official seal of the Municipal Bureau:
http://investmentwatchblog.com/from-alfred-little-research-another-reason-to-short-deer-consumer-products/
Another instance involving the willing participation of local government officials in perpetrating frauds upon both Chinese and foreign investors in Chinese companies is Xi'an Xilan Natural Gas Co., which was touted as an investment to Chinese investors by local officials prior to the company being listed in the U.S. on the Nasdaq exchange. An estimated half million Chinese investors bought shares in Xi'an and similar companies prior to U.S. listings. According to investor Lu Yafang, "We weren't cheated by an individual, it was an organized scheme. If 95% of the companies promoted by Shaanxi are bad, isn't that the government's responsibility?" Xiong Renzhi, another investor who lost his savings by investing in Chinese companies seeking to list on U.S. exchanges, stated, "The issue is like a container that will sooner or later explode." Investor Luo Yisheng attempted to commit suicide in the courtyard of a Shanghai government office after losing his savings in another Nasdaq listing scheme. "I haven't got a penny back," he wrote. "It's all fake. "They're all scams." A committee of Shaanxi officials labeled such stock sales "fraudulent" and "a huge social risk":
http://www.bloomberg.com/news/2011-08-18/chinese-protest-5-billion-losses-tied-to-u-s-reverse-mergers.html

[26] "China Biotics Fraud Casting Doubt on All Chinese RTOs," by Ian Bezek. Seeking Alpha (June 24, 2011). The article is accessible at: http://seekingalpha.com/article/276530-china-biotics-fraud-casting-doubt-on-all-chinese-rtos

Longtop Financial Technologies and equity positions in both Duoyuan Global Water and Duoyuan Printing); **Citadel Advisors** (Focus Media); **Prudential** (Focus Media); **UBS Global Asset Management** and **UBS Strategy Fund** (Focus Media); **Fidelity Management** (Focus Media); **Fred Alger Management** (Focus Media); **Baillie Gifford & Co.** (Focus Media); **BNY Mellon Asset Management** (Spreadtrum Communications); **Fidelity Investments** (Longtop Financial Technologies and Spreadtrum Communications); **HSBC Global Asset Management** (U.K.) Limited (Spreadtrum Communications); **Morgan Stanley** (Spreadtrum Communications); **CIBC Asset Management** (Spreadtrum Communications); **Charles Schwab Investment Management** (Spectrum Communications); **Baring Asset Management (Asia) Limited** (Spectrum Communications); the **State of Wisconsin Investment Board** (Spreadtrum Communications); **Citadel Investment Group** (Spreadtrum Communications); **SAC Capital Advisors** (Spreadtrum Communications; **Amaranth Advisors LLC** (China Natural Gas); et al.[27] Typically, and with the help of U.S. advisers, private Chinese companies are able to merge with U.S. publicly-traded shell companies listed on less regulated exchanges, e.g., the Pink Sheets; OTC Bulletin Board; or NYSE Amex. Having thus become public, the Chinese group can solicit private investments from early stage investors and then move onto a larger exchange, enabling the company to sell additional shares and allowing the founders and early investors to cash out. During the first half of 2011, over 25 New York-listed Chinese companies have disclosed accounting discrepancies or have had their auditors resign. The sheer number of investor frauds perpetrated by Chinese companies listed on the NYSE and Nasdaq Exchanges is expected to result in the emergence of a number of micro funds dedicated to exposing and shorting similar publicly-listed companies.

"This is all continuing to unfold. You will see a lot more scandals." [28]

- Violet Ho, Head of China for risk consultancy firm Kroll Inc.

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[27] "Bigtime Investors Lose Big on China," by Scott Eden.TheStreet.com (June 23, 2011). The article is accessible at: http://www.thestreet.com/story/11163573/1/bigtime-investors-lose-big-on-china.html
See also: http://www.zerohedge.com/news/fmcn-halted-over-60-down
And: http://www.zerohedge.com/news/thestreet-fmcn-8-hours-ago-upgrading-neutral-buy
In October of 2007, our firm wrote a letter to the United States Securities and Exchange Commission; the Financial Industry Regulatory Authority; and the Nasdaq and New York Stock Exchanges, warning of the risks posed to investors by Chinese companies entering the U.S. financial markets:
http://www.globalsecuritieswatch.org/Complaint_Filed_with_NYSE_and_NASDAQ.pdf
We have yet to receive any response to our letter.

[28] *"China Foreign Listings Dogged by Scandal,"* by Robert Cookson. Financial Times (June 05, 2011). Martin Wheatley, the former head of Hong Kong's Securities and Futures Commission, has reportedly warned that investors "could get burned if they rush into Chinese firms without putting their books under a microscope." Source:
http://www.channelnewsasia.com/stories/afp_asiapacific_business/view/1135318/1/.html
The United States Securities and Exchange Commission is probing accounting issues at a number of Chinese firms which trade in the U.S. and has suspended trading in the shares of several such companies. There are also rumors that Australia denied the ASX / Singapore stock exchange merger because of concerns over the quality of Chinese companies listed in Singapore. Part of the reason for the expected continuation of Chinese company frauds is that in mid-2011 the Chinese State Ministry of Finance reiterated its policy established in 2009 that "Chinese companies must select accounting firms capable of protecting national economic information." Paul Gillis, a professor of accounting at Peking University speculates that the rationale for this policy is that "…some CPA (certified public accountant) firms are better than others at protecting state secrets," adding that Beijing does not think that firms with foreigners can be fully trusted. The Bloomberg index of U.S.-listed Chinese reverse merger stocks finished 2011 down more than 60% YTD, representing a loss of approximately $15 billion in market value:
http://www.bloomberg.com/quote/CHINARTO:IND
Bloomberg chart showing Chinese reverse merger companies listed on U.S. stock exchanges:
http://www.bloomberg.com/news/2011-06-22/table-of-chinese-reverse-merger-companies-listed-on-u-s-stock-exchanges.html

Chinese Firms Not Subject to International Audit Standards

The Securities and Exchange Commission has begun investigating Chinese listings in the United States as well as the network of auditors and advisers which have promoted such companies to the investing public, but the agency has not received the cooperation of regulators in China. The Chinese government refuses to allow inspections by the Public Company Accounting Oversight Board of 110 Chinese audit firms affiliated with major international audit networks.

> *"Concurrently, I believe the 'Chinese Miracle' will be unmasked as mostly a fraud powered by a huge increase in bad lending from state-controlled banks. In addition, one Chinese company after another is being revealed as a fraud – and then crashing. These are not isolated events. I have studied Chinese companies for more than a decade. Out of all the stocks I've analyzed closely, I've only seen a handful I didn't believe were fraudulent. As fraud allegations spread into major Chinese financials, the entire underpinning of the Chinese boom will fall apart."* [29]
>
> - Porter Stansberry, Founder and President, Stansberry & Associates Investment Research

> *"On the other side of the world, China, the world's fastest-growing economy, now seems to be riddled by bad loans and a banking system that's so thoroughly corrupt that even its best companies – those allowed to list shares in New York – can't be trusted. Furthermore, we're more and more convinced the next big blow to the world's economy will be the growing recognition that China's banks are thoroughly corrupt. If Chinese banks are deeply involved in these corporate frauds…what can we believe about any of the other assets on their books? How long do you think investors will continue to keep their funds in Chinese banks that fabricate the cash balances of their corporate customers?"* [30]
>
> -Porter Stansberry, Founder and President, Stansberry & Associates Investment Research

Guanxi / Endemic Nepotism: Magnification of Risk Exposure

The risk of adverse consequences attributable to prevailing business practices and regulatory enforcement failure is exacerbated by the fact that Asian values differ markedly from those of the West, as exemplified by the following statement by the former head of the World Bank:

> *"In early 1997, I met with the Indonesian President Suharto in Jakarta. The president asked me ... what I was doing raising the subject of corruption as an issue. I told him we couldn't talk about development without addressing corruption. He replied, 'Well, you come out here from Washington with these high ideas to tell us about corruption. But what you call 'corruption' I call 'family values'."* [31]
>
> - James D. Wolfensohn, Former President of the World Bank

John Hempton, the Australian hedge fund manager, notes that various "Princelings" in China (i.e., children of Chinese Communist Party officials) have made hundreds of millions of dollars or more through nepotistic connections, evidencing profound implications as regards the ultimate

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[29] Porter Stansberry, The S&A Digest (June 17, 2011).
[30] Porter Stansberry, The S&A Digest (June 20, 2011).
[31] "Family Values in the Emerging Market Ruling Class." The article is accessible at: http://brontecapital.blogspot.com/2011/02/family-values-in-emerging-market-ruling.html
The quote by Mr. Wolfensohn appears in his book entitled, "A Global Life" published by Perseus Books Group (2010).

success of both private and public foreign business ventures in China.[32] When a company such as Industrial & Commercial Bank of China Ltd. is taken public, majority ownership remains with the Chinese Communist Party, in which political objectives surmount economic governance decisions. Thus, it appears unreasonable to expect that a broad reappraisal of corporate governance practices at foreign-listed Chinese companies will began to emerge.[33]

> *"China is less of a market-based economy than a vast family-run business controlled by the political elite."* [34]
>
> - Fraser Howie, co-author of *Red Capitalism*

Over the past few years, mainland Chinese investors have lost an estimated $15 billion from frauds occurring on the Shanghai Stock Exchange, sparking protests on both the mainland and in Hong Kong.[35] In one of the most recent instances, a consortium of 26 brokerages headed by CITIC Securities is accused of stealing investors' money via the use of forged securities. When CITIC attempted to launch an initial offering of public shares in Hong Kong on October 06, 2011, defrauded mainland Chinese investors traveled to Hong Kong to protest the IPO. Cao Xiaohai from Kunming City said he lost over one million yuan as a consequence of purchasing NanHang securities. He stated that "26 securities firms in China banded together with the Shanghai Stock Exchange to forge credentials." The investment turned out to be worthless.[36]

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[32] See, e.g., the following statement: "In the same vein, commentators noted that Morgan Stanley had been dismissed in 1997 as financial adviser to Shandong International Power Development in China after publishing a negative research report and that retribution in the case of unfavorable research was hardly unusual in Asia, where links between government, private companies and powerful families are much closer than in some other parts of the world." Source: "Investment Banks Must Soothe Asian Sensibilities" by Mark Landler, *New York Times (*March 12, 1999), as cited in: "Rating Agencies: Is There an Agency Issue?" authored by Roy C. Smith and Ingo Walter, Stern School of Business, New York University (February 18, 2001).

[33] The effect of prevailing corporate governance practices may explain why Chinese stock markets are among the worst performing in the world, as well as the recent cancellation of an initial public offering on the Shenzhen Stock Exchange (Nanning Baling), the first failure of an IPO on China's stock exchanges. According to the Financial Times, "In markets rife with insider trading, the stunning first trading days were galling examples of how people with connections seemed to make all the money":
http://www.ft.com/intl/cms/s/0/886c88d0-92d3-11e0-bd88-00144feab49a.html
Société Générale has announced that it will no longer participate in Chinese initial public offerings, "because their quality has become too difficult to assess." Other bankers have cited legal and reputational risks as concerns. Source: "SocGen to stay away from China IPOs" by Simon Rabinovitch, Financial Times (December 30, 2011).

[34] "Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise" authored by Carl E. Walter and Fraser J.T. Howie and published by John Wiley & Sons (Asia) Pte. Ltd. (2011). While acknowledging that Asian sensibilities generally differ from those of the west, instances do occur which may be considered quite similar. For example, Porter Stansberry, a highly respected investment advisor, recently stated the following in response to a recent Bloomberg News article based on confidential sources describing how former Goldman Sachs CEO and U.S. Treasury Secretary Hank Paulson, after falsely testifying before Congress regarding the financial condition of Fannie Mae and Freddie Mac, conducted a secret meeting with the top 20 hedge fund managers in New York City in late July 2008 and provided non-public information contrary to his Congressional testimony a few weeks previously, enabling these hedge funds to enter into risk-free derivatives trades yielding billions of dollars in profits: "This was the most outrageous example of graft and corruption I have ever seen." Source: "The Corruption of America," Stansberry's Investment Advisory (December 2011).

[35] "Mainland Chinese Investors in Hong Kong Protest Securities Fraud" by the Epoch Times Staff (October 07, 2011).

[36] Id.

Mainland Chinese investors protested CITIC Securities for fraud on its initial public offering of shares in Hong Kong on Oct.6. The protestors said their losses totaled 100 billion yuan, calling on Hong King people to beware. (Pan Zaishu/ Epoch Times)

Intent on alerting Hong Kong residents to the fraud perpetrated by CITIC Securities, protestors urged people to demand that immoral and dishonest companies be delisted from the stock exchange.[37] In mid-March 2012, in yet another instance of alleged fraud by exchange-listed Chinese companies, Deloitte resigned as auditor of Hong Kong-listed Boshiwa International, citing corporate governance concerns.[38] Deloitte had previously resigned as auditor of Real Gold Mining, whose Hong Kong-listed shares remain suspended.

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[37] The CITIC Group is a state-owned investment company of the People's Republic of China. Until July 26, 2006, the CITIC Group was chaired by Mr. Wang Jun, who simultaneously served as chairman of Poly Technologies, a subsidiary of China Poly Group Corporation, founded and controlled by the People's Liberation Army. In May 1996, Poly Technologies attempted to smuggle 2,000 fully automatic AK-47 assault rifles into the United States for distribution to West Coast drug rings and street gangs. The attempt was exposed in a sting operation jointly conducted by the U.S. Customs Service and the Federal Bureau of Alcohol, Tobacco and Firearms, and resulted in the largest seizure of fully operational automatic weapons in U.S. history. In addition to the assault rifles, the participants in the scheme allegedly sought to smuggle shoulder-launched surface-to-air missiles into the United States. Source: *"Anatomy of a Sting"* published by Time Magazine (June 3, 1996). Poly Technologies was also involved in an attempt to deliver weapons to Zimbabwe during the 2008 election crisis. The ship transporting the weapons was refused entry into South African Ports shortly before docking. Source: *"Zimbabwe Arms Shipped by China Spark an Uproar"* published by the New York Times (April 19, 2008). In an attempt to enable the PRC to repudiate and circumvent repayment of China's international sovereign debt and subsequently re-enter the international financial markets, the China International Trust and Investment Company in 1982 arranged the creation of a yen-denominated external sovereign debt obligation of The People's Republic of China, privately offered and subscribed by 30 Japanese financial institutions, by which action The People's Republic of China selectively defaulted on the Chinese Government's existing full faith and credit sovereign debt which remains an unpaid obligation of The People's Republic of China as the internationally recognized government of China.

[38] Boshiwa International raised $321 million in a 2010 Hong Kong IPO arranged by UBS, Credit Suisse and Bocom.

Chinese Investment Bank Alleged to Operate 'Fraud School' to Prepare Fraudulent Listings on U.S. and Overseas Exchanges

A recent research report by analytics firm Muddy Waters, LLC alleges the existence of a "financial fraud school" in China, operated for the purpose of creating phony Chinese companies to be listed on U.S. and overseas stock exchanges.[39] The report alludes to a Chinese network comprised of small investment banks, financial consultants and auditors which counsel small and medium-size enterprises through an "Investment and Financing Advisory Network" in order to train company management to take the first step onto the U.S. OTCBB market through a reverse merger. The network then continues to counsel the company and assists in the manufacture of various types of fraudulent reports and documents, and the falsification of financial data so that the company is able to expand in order to acquire a stock listing on the Main Board. The report makes reference to Chief Capital Ltd., a Hong Kong-based investment bank allegedly at the center of the fraud school, which assists Chinese companies in gaining overseas stock exchange listings.[40]

Video: Chinese Investment Bank Operates Fraud School for Overseas Listings

The report includes evidence of what appear to be forged SAIC filings and phony auditor 'seals' which have apparently been glued onto pages of company financial statements.

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[39] *"The Fraud School, RINO and FSIN (Fraud University),"* authored by Muddy Waters, LLC (April 10, 2012). The full presentation is accessible at:
http://www.muddywatersresearch.com/wp-content/uploads/2012/04/MW_FraudSchool_20120410.pdf
The report is also accessible at: http://www.scribd.com/doc/88760273/MW-FraudSchool-20120410
The above report follows the publication of an article entitled, *"Unmasking the Disaster of 'China Concept' Stocks,"* by John Caines, Fortune Today (April 2012). The article is accessible at:
http://www.webcitation.org/67AfP8FO7
See also, *"Chinese Companies Go To Fraud School,"* by Matthew Robertson, Epoch Times (April 24, 2012). The article is accessible at:
http://www.theepochtimes.com/n2/china-news/chinese-companies-go-to-fraud-school-226634.html
Related article authored by New York securities lawyer Jacob H. Zamansky is accessible at:
http://www.zamansky.com/blog/2012/03/chinese-fraud-hiding-in-plain-sight.html

[40] The company's website is accessible at: http://www.chiefcapital.com.hk/english/