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Worthless Stocks from China

When a retiree in Texas discovered that some Chinese companies listed in the U.S. are frauds, he unleashed an army of short-sellers

By Dune Lawrence

On an April afternoon in 2009, in his home office outside Austin, Tex., John Bird was hunched over his computer trying to figure out if a Chinese company some 6,500 miles away was anything close to what it claimed to be. Silver-haired and retired, Bird, 62, likes to project an air of relaxed amusement. His personal philosophy is reflected in a sticker from *The Big Lebowski* over his office door: "The Dude abides..."

Some things, however, Bird takes very seriously, including what he calls the "sanctity of math," which on that afternoon was being defiled in his eyes by the claims of China Sky One Medical (CSKI), a maker of products such as "magnetizing" hemorrhoid ointments and patches that would "dispel fat." Sky One, according to its annual report filed just a few days earlier, was selling out of its inventory every seven days.

Bird's first business venture—before real estate development, a music venue called Club Foot, and a direct-mail marketing firm—was a chain of nine movie theaters in Austin in the 1970s. Audiences ate through stocks of popcorn and candy every three days or so, but supplies of cups and buckets took months to run through, adding up to an average turnover of eight to 10 days. Sky One's inventory, Bird figured, ought to move more slowly, since things like cardboard boxes for packaging and adhesives for patches are bought and stored in bulk and used bit by bit as orders come in.

They're turning their inventory over faster than a doughnut shop, thought Bird. Or, as he later put it, "It's like somebody telling you they just drove over here at 600 miles per hour. It's not going to happen."

Sky One, Bird would find, wasn't the only stock recently arrived from China, and it wasn't the only one seemingly exceeding financial speed limits. Sky One, which declined to comment for this story, is one of more than 350 small Chinese companies to have listed in the U.S. since 2004 through a process called a reverse merger, in which an operating Chinese company takes over an all-but-defunct publicly traded U.S. shell company.

The capital at stake is significant. Shares of such reverse mergers are held by many funds available to retail investors, including Oppenheimer Main Street Small Cap Fund (OPMSX) and the PowerShares Golden Dragon Halter USX China Portfolio, and are scooped up by small-cap index funds. Roth Capital Partners, an investment bank in Newport Beach, Calif., that has been one of the most active in helping such Chinese companies raise money, recently tried to measure the Chinese reverse merger market. It came up with a list of 94 companies with market capitalizations of between $50 million and $1 billion that trade an average of at least 50,000 shares daily, with a total stock market value of more than $20 billion.

Bird's involvement would evolve from irritation that a company could get away with making a claim that so obviously defies basic business logic to the conviction that many pieces of the Chinese miracle that trade in the U.S. are, in his words, "flat-ass" frauds. And what started as a retiree looking into a company has turned into a dispute that has drawn in other shorts, the Securities and Exchange Commission, auditors, and, according to recent reports, the U.S. House Committee on Financial Services. It has also revealed significant flaws in U.S. markets and how they are regulated. Although the stocks trade on U.S. exchanges, and thus project a sense of having to play by American rules, the assets and the principals of many of the companies reside in China. The companies operate on their terms, leaving injured parties and the SEC powerless. Bird says the carnage is just beginning. "The whole thing has no place to go but to blow up," he says. "That's a rational position for an investor to start with, that every one of these Chinese reverse mergers is a fraud."

Bird didn't start out on a mission against Chinese stocks, but he doesn't believe in doing things by halves. His art collection includes a nine-ton copy of a Babylonian horse figurine from 600 BC that sits next to his pool and two six-foot-tall mosaic eggs that spin in the field beyond; those are two of 18 large sculptures that dot his 70-acre property northeast of Austin. His wife of 39 years, Jenny, gave him a backgammon set a few years ago, and he now travels to Las Vegas to compete in tournaments.

Bird has never been to China; his closest brush came on a visit to Hong Kong in 1959. He came to shorting Chinese companies through a website run by Manuel P. Asensio. Now a financial adviser, Asensio was barred from the brokerage industry in 2006 by the National Association of Securities Dealers (now known as Financial Industry Regulatory Authority) for failing to cooperate with an investigation into misleading research reports. (The noirish world of short-selling is full of such compromised figures; Bird himself declared bankruptcy in 1985.) Asensio.com publishes short-selling ideas. It initiated coverage of Sky One in April 2009, questioning a history of restatements and frequent changes in auditors and sparking Bird's own investigation.

Sky One, Bird found, was a combination of Comet Technologies and American California Pharmaceutical Group. Comet Technologies was a "blank check" company, incorporated in Nevada, with no business other than finding a promising acquisition. American California Pharmaceutical Group was a holding company for Harbin Tian Di Ren Medical Science and Technology, which had been making over-the-counter medicines based on Chinese herbal remedies since 1994 in the northern city of Harbin. The shares of the new company, merged and renamed China Sky One Medical, finished 2006 at $8 and climbed 75 percent in 2007, to $14, as the company promised it was stepping upmarket from wart-removal spray to gene recombination techniques; the stock also likely benefited from the seemingly unquenchable enthusiasm for China's prospects. In 2008, Sky One moved from the OTC Bulletin Board to the American Stock Exchange and then to the Nasdaq Composite Index.

Bird turned up credit reports on Harbin Tian Di Ren from providers in Britain, India, and China. The numbers in all three matched each other, but they did not match the SEC filings. After two months of e-mails and phone calls, Bird reached a woman named Terry at Qingdao Inter-Credit Services, a credit report provider, who sent Bird the filings it used. They were from a Chinese agency called the State Administration for Industry & Commerce (SAIC). For Bird and those who followed him, the SAIC filings were "like getting X-rays of a terminal patient," he says. "It was dead stock walking."

The SAIC is the Chinese government agency responsible for market supervision, regulation, and enforcement. According to the filing, Sky One's operating unit, Harbin Tian Di Ren, had 2008 sales of 6.93 million yuan, roughly $1 million at 2008 exchange rates. Yet to the SEC, Sky One reported 2008 sales of $91.8 million, with Harbin Tian Di Ren accounting for at least 65 percent, or $59.7 million. Bird ordered reports to trace Sky One customers and suppliers; the paperwork showed companies too

small to generate the orders or inventory Sky One posted.

By August 2009, Bird was ready to place a serious bet. From his home office, he logged on to his account and sold short 30,000 shares at $15.70. The natural next step of a short-seller is to get the word out, and Bird soon posted a selection of his evidence on the Web. Bird chose the URL waldomushman.com, Waldo Mushman being the occasional pseudonym of Steve McQueen, at least according to Bird.

Bird also sent his evidence to the SEC, to Sky One, and to Sky One's auditor, Cranford (N.J.)-based Moore Stephens P.C. (now known as MSPC Certified Public Accountants and Advisers). An SEC official in Los Angeles, Junling Ma, called him about the SAIC documents, as did a Nasdaq enforcement official, according to Bird. He also made regular posts to sites such as Seeking Alpha and Yahoo! Finance (YHOO), arguing his case. None of it, at first, proved much of a setback for Sky One, whose price mainly climbed, along with Chinese shares in general.

But Bird's method of checking Chinese-American stocks through SAIC filings did interest other investors, who began to use it as well. This disparate, far-flung crew included short-sellers such as Andrew Left of Citron Research in Los Angeles, the eccentrically named Muddy Waters Research, based in Hong Kong, and Sahm Adrangi, a 29-year-old Yale graduate running tiny hedge fund Kerrisdale Capital in New York.

Listing in the U.S. through a reverse merger is easier than joining the main exchanges in Shanghai and Shenzhen, where local companies face a long waiting period and profitability requirements. A public market for startups, ChiNext, only started in October 2009. A Hong Kong listing on the Growth Enterprise Market also presents hurdles, with minimum thresholds for cash flow and expected market capitalization.

A U.S. reverse merger, by contrast, can take as little as three months and cost under $1 million in fees, according to CCG, a Los Angeles investor relations firm that specializes in Chinese companies. In 2010, 78 Chinese companies listed in reverse mergers, according to DealFlow Media figures as of Jan. 6, adding to the 294 that did so from 2004 through 2009.

The Sky One deal cost between $600,000 and $800,000, according to Charles Hung Jr. of American Eastern Group, the Los Angeles investment firm that set it up. According to Hung, he and his father, Charles Sr., visited the company for more than a week to see the products on store shelves and meet the management. The company was led then and now by Chairman and Chief Executive Officer Liu Yan-qing. Liu's background was in drug marketing, journalism, and research and development, and he has a bachelor's degree from Harbin Medical University as well as an executive MBA from Tsinghua University, according to his biography on the company website.

Starting in the early 2000s, the Hungs engineered four Chinese reverse mergers, the last one for China Shen Zhou Mining & Resources (SHZ) in 2006, soon after Sky One's. In three of the deals, including Sky One's, the Hungs paired off the Chinese companies with shell company vehicles linked to Utah businessman Jack M. Gertino. Filings list Gertino as investing in real estate and having run a car tune-up franchise. He received 163,581 shares of Sky One, warrants for more shares, and a consulting deal for "financial and management planning" covering the two years after the merger. Gertino says he passed on dozens of deals before pursuing the China Sky One reverse merger, for which he visited the company in China twice. He adds that it's a "terrific" company.

The Hungs also paired Sky One with E-Fang Accountancy, a two-partner firm in City of Industry, Calif., that prepared two years of U.S.-audited financials. Hung remembers E-Fang as being "very thorough." In December 2008, the California Board of Accountancy suspended E-Fang's license for 30 days and imposed three years' probation for gross negligence and violating professional standards, without specifying which company work triggered the action. Hung now says that he wouldn't do a reverse merger unless the company agreed to a top 10 auditor.

Others in the business include Benjamin Wey, who has built a career bringing companies over from China and onto exchanges such as Nasdaq. Wey was born in China and likes to recount how he arrived in the U.S. in 1992 with $62 in his pocket and worked part-time as a Chinese chef while attending Oklahoma Baptist University. He now has offices on Wall Street, 60 employees in China, and says he accepts just 1 percent of the companies that seek him out.

Wey says that his clients don't want to wait to list at home, and a full-blown initial public offering in the U.S. is expensive and difficult, partly because banks don't want to underwrite tiny companies. "The reason these companies do reverse mergers is not because it's good or bad...they have no alternative," he says.

From a 38th-floor conference room overlooking the silver and grey glints of lower Manhattan, he describes how a typical deal works: List via reverse merger with private funding from his company, New York Global Group, jump up to a name exchange such as Nasdaq, then raise much larger amounts of money with a secondary offering once the company has established credibility. He says he assigns up to nine Chinese local staff members to lead a company through seven to 11 months of due diligence before a U.S. listing. "There's a lot of traps to try to avoid," he says.

In 2007, the American Stock Exchange delisted a fertilizer company that Wey had brought over, Bodisen Biotech, for incomplete and inaccurate disclosures related to share ownership by officers as well as payments to Wey's company. The move came in the wake of a series of stories in the *New York Post* and MarketWatch. The Oklahoma Securities Dept. also censured Wey in 2005 for not advising customers of the risks of stocks he sold and not disclosing consulting relationships with some of the companies. Wey agreed to a ban on working in the securities business in the state without admitting to the allegations.

A couple of weeks after waldomushman.com went live, Sky One acknowledged that its SAIC and SEC filings were "materially different" but assured investors of the accuracy of its U.S. filings. Its shares slid gradually from almost $15 to under $12 by November, then began to climb again. Bird was disappointed.

"Here I put the SAIC documents out and I expect to shake the world, and nothing much happens," Bird says. "So I thought, 'This is going to take more effort.'" Bird found a private investigator in Harbin who charged $59 an hour to take photos of Sky One's facilities and investigate land records, which Bird hoped would turn up incriminating evidence. It didn't. He also began delving into the company's patents, which Sky One valued at $1.6 million in 2007. The same seven patents were valued at $15.1 million in 2008. In the meantime, Sky One shares rose to a high of $24.25 on Dec. 28, 2009. and ended the year up 42 percent.

The rise meant Bird needed cash to cover his losses, as brokerages call for a cushion or "margin" to ensure that short sales can be settled. At the time of the stock's climb, Bird was in New Zealand with his wife and, because of the time difference, had to make trades at 3 and 4 a.m. to cover the margin call.

He returned home exhausted and down almost $90,000. Instead of cutting his losses, however, he filed suit in March against the company's auditor, MSPC, for failing to acknowledge misrepresentations in Sky One's financial statements and errors in its audit work. Bird didn't sue Sky One directly because the U.S. company's assets are in China. "I just got pissed-off, and I'm a stubborn man," he says. Michael G. Mullen, the head of MSPC's audit department, declined to comment on the ongoing litigation. MSPC audits three U.S.-listed Chinese companies and some that want to list, according to Richard J. Montalbano, a partner in the firm who focuses on China-related work. MSPC has had other problems in the field. In an April 2009 inspection report, the Public Company Accounting Oversight Board (PCAOB), part of

the SEC, noted "audit deficiencies" in one case so significant that the team declared MSPC didn't have enough evidence to support its opinion on the issuer's financial statements.

By May 2010, other shorts began to emerge, waving SAIC filings, just like Bird. A Detroit forensic accountant, Steven R. Chapski, citing Sky One, posted an analysis of the 2009 SAIC and SEC filings for another company, cable- and wire-maker Lihua International, on Seeking Alpha. Lihua responded by making its 2009 SAIC filing and a reconciliation with SEC filings available on its website. Lihua gained 7.6 percent last year, but Chapski continues to question the company. "It just doesn't add up, and I've never heard anybody tell me a good reason why my thinking is wrong," he says.

In June, Chinesecompanyanalyst.com, a blog run anonymously by Kerrisdale Capital's Adrangi, accused China Marine Food Group (CMFO) of fabricating SEC financial statements, citing SAIC documents that showed 2008 revenue 85 percent lower than reported in the U.S. Adrangi also questioned China Marine's acquisition of Shishi Xianghe Food Science and Technology in January 2010 for $27.8 million, pointing out that Xianghe's proprietary algae drink formula had been worth just $8,776 in 2009, when Xianghe purchased it. China Marine shares slumped 30 percent in June. The company says that for 2009 its SAIC filings were consistent with its U.S. filings.

In November, Adrangi went after China Education Alliance (CEU), an online education company. After meeting with its executives in August, he asked a Chinese friend to look at the company's website. Nonfunctional, the friend reported. So Adrangi followed in Bird's footsteps: "If there's any person who started this, it's John Bird," he says. "He's the reason anybody is looking at the SAIC filings."

Adrangi obtained China Education's SAIC filings and sent locals to look for its products in stores and to check out its training center. The allegations seemed, by then, familiar. Local SAIC filings showed online revenue of less than $1 million in 2008, vs. $16 million in revenue from "online education" in its SEC filings. The company also had a cast of four auditors in six years and financial metrics that strain credulity when compared with those of competitors. Adrangi's report, published on Nov. 29, sent China Education shares tumbling 39 percent in two days, helping his fund to a more than 30 percent gain for the month. China Education, whose stock has lost 59 percent in 2010, denied all the allegations made in the Kerrisdale report, launched a stock repurchase program, and filed documentation of its bank balances to the SEC.

In June 2010, Hong Kong research outfit Muddy Waters took on Orient Paper (ONP), a paper maker based in Baoding, Hebei province, whose stock had surged from 24 cents to $10.48 in 2009. Muddy Waters was the brainchild of Carson C. Block, a lawyer and founder of Love Box Self Storage in Shanghai ("Get Self Storage Without BS") who also consults for his father's company, W.A.B. Capital, which promotes small companies to investors.

Muddy Waters dove right in and said in a June 28 report that Orient Paper's "purpose is to raise and misappropriate tens of millions of dollars." The report accused the company of overstating its 2008 revenue by 27 times and 2009 revenue by 40 times. Orient Paper denied the allegations, but its shares plunged 40 percent in the four trading days after the report was released. They rebounded briefly and then dropped again as the company announced in August that it had retained law firm Loeb & Loeb to coordinate an independent investigation.

In November, the audit committee released summary findings that largely dismissed the Muddy Waters report, including the SAIC/SEC mismatch, but did not make the full investigation public.

Orient's audit committee chair, Drew Bernstein, says that short-sellers are just exploiting the ignorance of U.S. investors and the inexperience of Chinese executives. "You have these Chinese chairmen, when they take green dollars from the U.S., I don't think they fully understand the obligations and responsibilities that come with it," says Bernstein, of auditor Bernstein & Pinchuk, which represents 40 U.S.-listed Chinese companies. Coupled with U.S. investors who "can't find China on a map," it's a "perfect storm" for shorts, says Bernstein.

Like many U.S.-listed Chinese companies, Orient Paper was underwritten by Roth Capital, which responded to the short attacks with a primer that aimed to explain the SAIC filings. "Divergent PRC [People's Republic of China] filings and U.S. filings do not, in and of themselves, establish error, misstatement, or fraud," researchers John Ma and Mark Tobin wrote in a July 2010 report. "This data should be viewed as one aspect of a broader due diligence process."

Since 2003, Roth, run by three brothers from Iowa, has made U.S.-listed Chinese companies (not all reverse mergers) into fully 24 percent of its business, raising $3.1 billion in capital. Its annual growth conference last year attracted more than 1,000 institutional investors who got three days of access to 350 companies, including 100 U.S.-listed Chinese companies, as well as a Billy Idol concert and an IMAX screening of *Avatar*.

In the past year and a half, Roth has run or helped manage share sales for China Green Agriculture, Harbin Electric, China Natural Gas, China-Biotics, Wonder Auto Technology, and Orient Paper, all targets of questions and allegations about some combination of mismatching Chinese and U.S. filings or inflated claims in U.S. filings, overpayments for acquisitions, and choosing small auditors. No regulatory action related to these companies has been announced.

Byron Roth, the company's chairman and CEO, says that as the short attacks continued, "everybody had that little moment of, 'Am I the sucker, or are they just full of it?' " Roth adds that there are doubtless cases of fraud among Chinese companies, but not enough of them to outweigh the investment opportunity. "There aren't that many companies in the U.S. growing at 20 percent-plus," Roth says. "You can't paint every Chinese company with the same brush." He also notes that, as Roth Capital's due diligence procedures "evolve," it checks SAIC filings now, too.

In August 2010, Bird learned through discovery in his suit against MSPC that the SEC was investigating Sky One. Bird promptly posted it to a Yahoo! chat room hosting conversations about Sky One, though MSPC would later get a court order making the discovery documents confidential. In August, Sky One revealed in its second-quarter report that the SEC had launched a formal investigation of its accounting.

Momentum appeared to be gathering. A July 12 audit alert from the PCAOB noted that some U.S. accountants were issuing opinions for companies without visiting China or reviewing the audit work done by local assistants. The examples cited were all companies based in China, Hong Kong, and Taiwan. In the 27 months ended Mar. 31, 2010, the report said, at least 40 U.S. accounting firms with fewer than five partners and fewer than 10 professional staffers had issued audit reports for Chinese companies. "If you're investing in a company whose operations are all in the China region, you may want to ask some questions about the quality of its audit," says Greg Scates, PCAOB deputy chief auditor.

The board has stepped up investigations and inquiries into audits of U.S.-listed Chinese companies since the alert and is coordinating with the SEC, according to its director of enforcement and investigations, Claudius B. Modesti. "Our inspectors continue to raise concerns in our inspections of certain U.S. audit firms regarding their audits of issuers either located in China or that have operations in China," he says.

Throughout the spring and summer of 2010, Bird added to his bet against Sky One and built positions against Orient Paper, China-Biotics, China Marine Foods, China Natural Gas, and China MediaExpress Holdings.

In September, Sky One lowered its 2010 revenue forecast from $160 million to $164 million to between $128 million and $136 million, citing the loss of major distributors. The distributors, Sky One said in a Sept. 3 statement, didn't want their business information disclosed in public SEC filings, which had led to increased scrutiny by the Chinese government. Its shares slumped 31 percent on the first trading day after the announcement. John Bird found himself with a profit of more than $1 million.

Soon, other bets would begin to pay off. In November, Muddy Waters issued a report on Rino International, which Bird was not shorting, accusing the maker of pollution-control equipment of fabricating some of its customer relationships and overstating its 2009 revenue by 17 times, based on SAIC filings. Days later, Rino admitted that some of its contracts did not, in fact, exist. Its shares plunged 85 percent in 2010.

Investors also dumped shares of companies that used Rino auditor Frazer Frost, including Harbin Electric, which Bird had shorted. Harbin dropped 15 percent in two days after trading in Rino shares was halted.

A couple of days later, governance research firm Audit Integrity, which rates almost 20,000 public companies, warned U.S. investors about Chinese stocks listed in the U.S. Its system for scoring companies on 100 different accounting and governance metrics had been turning up poor ratings, often a sign that companies are manipulating their numbers, says Audit Integrity's chairman, James A. Kaplan. "I noticed this issue well over a year ago," he says. "But in all candor, no one cared because of the brand of China. China was flying high. If it was branded as a Chinese company, it must mean it was going to be good and make money."

"As these companies are scrutinized, investors will uncover the facts behind the 'Chinese Curtain,' " Kaplan wrote in a Dec. 3 report. "Many of these stocks may prove to be valueless."

Still, there are believers. Bill Wells of Memphis-based Pope Asset Management, a major investor in Sky One and other reverse merger companies, says the China investment thesis still holds. "We see China, and correctly so for the last few years, as the major country with the largest amount of growth," says Wells, whose firm manages about $650 million. It started buying reverse merger Chinese companies in 2005 after large-cap Chinese stocks got expensive. "If you can work through these corporate governance issues, the valuations and the earnings growth on a lot of these companies look pretty attractive," he says. According to SEC filings, Pope Asset held 1,040,224 shares in Sky One as of June 30, 2010. As of the end of September, the fund owned 723,647 shares.

Jeff Papp, a senior analyst for the $300 million Oberweis China Opportunities Fund, which has less than 5 percent invested in reverse merger stocks, is also cautiously positive. "Right now, the whole group is trading at levels implying that they are all frauds, but those who can tell the difference will hit some home runs," he says. "We're either never going to see any of these types of Chinese companies listing here again, or we may be near a bottom in terms of valuations."

Bird did not vacation in New Zealand this past Christmas. Instead he was serenaded by the sound of waves while in a Hawaii beach rental, and he heard only good news from his short-selling experiments. Sky One's shares retreated 69 percent in 2010, and Bird put $500,000 of his $1 million-plus in profits into a startup involved in cancer drug research. His suit against Sky One's auditors drags on. Bird is still short 175,000 shares of the Chinese company and hopes the next salvo will come from the SEC. The commission did not respond to two requests for comment on this story. The SEC's Ma declined to comment.

"The story is not that murky at all. Sky One is a fraudulent company, and all the ticks on the dog are trying to make as much money as they can," says Bird. "When you know the stock is going broke, they're crooks, the SEC is going after them—where are you going to find a better short than that?" What Bird's not so clear on is why other investors don't see things the way he does, saying: "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.' "

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