New SEC Enforcement Action Highlights the Unique Role Advisors Play in China-based Reverse Takeover Companies and Due Diligence Problems They Can Create for PE Investors

Introduction

A new enforcement action by the U.S. Securities and Exchange Commission (SEC) against a financial advisor who specializes in assisting China-based businesses that become U.S. public companies through reverse takeovers (RTO's) highlights how such advisors present a distinct – yet often poorly understood – risk for private equity investors. As more and more PE investors look at transactions involving RTO companies, it is crucial that due diligence focus not only on the quality of the underlying business and its management but also on the RTO advisor itself.

This client alert briefly summarizes the background of RTO companies and their advisors, the recent SEC enforcement action and implications for PE investors that are considering transactions involving RTO companies.

Background

With a relative dearth of high quality pre-IPO investment opportunities at reasonable valuations in China at the front end and the ongoing sluggish equity capital markets limiting exits for portfolio companies at the back end, many PE investors in Asia have been turning their spare attention and money to transactions involving Chinese businesses which have already become publicly traded in the U.S. As a result, transactions which were once fairly uncommon among U.S.-listed, China-based businesses – such as PIPEs and take private deals – are now being considered and executed by a wide range of companies and PE investors.

One recurring theme in this somewhat unusual environment is that some of the companies which may present the lowest valuations and highest potential for returns achieved their public trading in the U.S. through an RTO. In years past, particularly before RTO's gained their current somewhat negative reputation among investors and the media, the RTO market was driven by dozens of so-called "alternative IPO specialists" who scoured China looking for companies that were not big enough for a traditional underwritten IPO. When these advisors identified a target, they aggressively delivered a simple sales message: "you don't have to wait for a major bulge bracket investment bank to pay attention to your company; you can IPO immediately and we will provide you a turn-key solution to make it happen." Thus, the RTO advisor would provide its own lawyers and accountants to act on behalf of the company and would also provide the SEC-registered shell company for the reverse takeover and arrange for financing with PIPE investors, some of which may be affiliated with the RTO advisor, in exchange for shares and warrants of the company. There are now several hundred RTO companies with operations in China the shares of which are publicly traded in the U.S. In many instances, RTO advisors have acquired significant shareholding stakes in these companies.

Post-RTO, the founders and management of the Chinese business often have little understanding of their compliance obligations as a U.S. public company. They may also be oblivious to the activities of their RTO advisor and lawyers and accountants – whose interests may be at odds with those of management – or alternately management and the RTO advisors may be secretly acting in concert for some business purpose which is not disclosed to other investors.

SEC Enforcement Action

On July 30, 2012, the SEC announced that it had charged a New York-based investment manager Peter Siris and two of his firms with a host of securities law violations mostly related to Siris's activities with a Chinese RTO company, China Yingxia International Inc.

The SEC alleges that Siris was one of the original lead investors in China Yingxia and was highly involved in the company's operations, including providing drafting assistance for press releases and SEC filings, translation services, management preparation in advance of conference calls, and officer recommendations. In its announcement, the SEC described Siris as "… the go-to person when Chinese reverse merger companies wanted to raise capital or needed advice about operations." As a result of his close connections and degree of influence over China Yingxia, Siris allegedly engaged in a number of securities violations, including, among other things:

- making illegal trades based on inside information Siris acquired from the company,
- working with the company to create sham transactions so that shares Siris received from the company appeared to be freely tradable when in fact they were restricted under the U.S. securities laws, and
- causing the company to make materially misleading disclosure in SEC filings by failing to disclose his active role in the company.

Implications for PE Investors

The SEC's enforcement action highlights two important points. First, it demonstrates once again that the SEC is committed to heavily scrutinizing China-based businesses, even obscure small-cap RTO companies most investors would have never heard of.

Second, and perhaps of even greater interest to PE investors which are considering engaging in a transaction with an RTO company, this SEC action illustrates the fact that RTO companies are frequently highly intertwined with advisors who helped arrange the RTO itself and maintain significant control and influence over the company. Although the SEC only charged Siris and his affiliated companies (China Yingxia's business had already collapsed several years earlier), it is easy to envision a scenario where the company itself and its management and directors could also become subject to SEC action and shareholder litigation, thereby impairing the value of any PE investment in the company even if made after the improper conduct occurred. Moreover, in the context of a take private transaction, the mere fact that a company has transitioned from public to private company status would not end the SEC's jurisdiction nor prevent the agency from causing the newly private company to incur substantial costs associated with responding to investigatory requests. The SEC has in similar circumstances also pressed ahead with enforcement actions against private successor entities and former officers involved in problematic conduct. Any such outcome could severely negatively impact the ability of an RTO company to eventually relist in Hong Kong or another Asian market, which is typically the end goal of these transactions.

Therefore, it is crucial that PE deal teams and their legal advisors go the extra mile in diligencing RTO companies – and their advisors – to essentially separate the "good companies" from those riddled with compliance problems or even fraud. To avoid the trap of investing in a company with material undisclosed compliance problems, created either primarily by the RTO advisor by itself (as seems to be the case in the Siris action) or by the advisor and company acting together, PE sponsors need to view due diligence on RTO

companies as a two-front effort, focusing on both the company and any advisor. We would recommend addressing a number of fundamental questions upfront, including:

- Are the interests of the company's founder/management and the RTO advisor aligned with respect to the proposed transaction or does the RTO advisor have its own agenda?
- Interrelated with the first question, to whom do the company's legal counsel and auditors really report? The company or the RTO advisor? There's a niche industry for RTO lawyers and accountants in the U.S., as well as part-time CFOs who serve multiple RTO companies simultaneously, and their involvement in a company can itself be a red flag.
- What's the track record of the RTO advisor? RTO advisors often work with numerous companies so it can be informative to check whether the other RTO companies have been subject to SEC enforcement actions, shareholder litigation, delistings, or other problems.
- Under what circumstances did the shareholders at and after the RTO acquire their shares and how are they related to each other? In some cases, RTO companies have engaged in share placements to various investors who would appear to be independent of each other, but in fact the RTO advisor retains some undisclosed de facto control over the shares.
- What's the trading history of the RTO advisor and any affiliates in the company's shares?

Conducting diligence on RTO advisors is not necessarily a straight-forward exercise – many purposely operate under the radar and some recidivist securities law violators have been known to operate in this industry. We have also seen instances where a founder and RTO advisor seemingly have no communications or interaction whatsoever, but it is difficult to definitively ascertain whether this is because they really cannot or do not want to speak with each other or whether they are purposely obscuring a hidden objective which they do not want to disclose to investors or the SEC.

Despite these hurdles, we would recommend that for any proposed transaction involving an RTO company, the due diligence plan should be geared to identifying any RTO advisors and their affiliates and answering the key questions regarding the past, current and future role of any such advisor in the target company.

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