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Differing U.S. and Chinese Financial Disclosures Enough to Plead Fraud?

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Over the past year and a half, there has been a new wave of Chinese companies listing their shares on U.S. exchanges.[1] Unlike the earlier trend of Chinese companies listing through reverse mergers with U.S.-listed companies, more recently Chinese companies have begun directly issuing securities publicly on U.S. exchanges.[2] By listing shares on U.S. exchanges, many of those companies are for the first time subjecting themselves to U.S. securities laws, including periodic filing requirements and potential liability for material misstatements under Section 10(b) of the Securities Exchange Act and similar provisions.

Chinese companies that go through the intensive regulatory process of a U.S. public offering are unlikely to face the extraordinarily high level of securities litigation faced by Chinese reverse-merger companies over the last several years.[3] Nonetheless, given the percentage of public companies typically subject to federal securities class actions in any given year and the high correlation between initial public offerings and federal securities litigation, at least some of these newly-listed Chinese companies may face securities fraud lawsuits in the coming months and years.[4]

And, if the recent experience of Chinese reverse-merger companies is any guide, plaintiffs asserting claims against Chinese issuers will likely include allegations of discrepancies between the information contained in Securities and Exchange Commission filings and information contained in Chinese regulatory filings, particularly filings with the Chinese State Administration for Industry and Commerce (SAIC), which regulates industry and commerce in China. Indeed, while litigation against Chinese reverse-merger companies has slowed, a complaint was filed in the last month in the Southern District of New York alleging securities fraud based on alleged differences between a Chinese company's reported revenue in SEC and in SAIC filings.[5]

The Private Securities Litigation Reform Act requires a federal securities fraud complaint to "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading."[6] In other words, a plaintiff must "explain why the [challenged] statements were fraudulent."[7] Simply pointing to an alleged discrepancy between U.S. and Chinese regulatory filings is insufficient to "specify the reason why" the statements in the U.S. filing were misleading, as courts facing this question have consistently confirmed.

> To establish a true discrepancy between U.S. and Chinese regulatory filings, plaintiffs must demonstrate that they are comparing "apples to apples."

Rather, as discussed below, a company sued for securities fraud based on an alleged discrepancy between its U.S. and Chinese regulatory filings should be able to successfully attack a complaint that does not both (1) allege facts demonstrating that there is a true discrepancy—that is, that any variation between the two filings is not attributable to variations in reporting requirements or accounting standards—and (2) if a true discrepancy exists, allege facts showing that the U.S. filing, and not the Chinese filing, is false.[8] We address these two pleading requirements in turn below.

Reporting Requirements

Multiple courts have dismissed complaints based on alleged discrepancies between SEC and SAIC filings because plaintiffs failed to demonstrate that the alleged discrepancies could not have been the result of differences in reporting requirements or accounting standards. Regulators in different countries frequently have different reporting requirements. For example, revenue may differ significantly when reported under U.S. generally accepted accounting principles (GAAP) international financial reporting standards (IFRS), or local accounting standards used in other countries. As a result, the fact that two different regulatory filings state different revenue figures, for example, does not by itself demonstrate that the two figures are inconsistent with one another. Thus to establish a true discrepancy between U.S. and Chinese regulatory filings, plaintiffs must demonstrate that they are comparing "apples to apples."[9]

For example, in *In re China Valves Tech. Sec. Litig.*, No. 11 Civ. 796, 2012 WL 4039852, at *6 (S.D.N.Y. Sept. 12, 2012) (*China Valves I*), a court in the Southern District of New York dismissed a securities fraud complaint that "[did] not allege what accounting standards, if any, are required for [SAIC] filings [or] the similarities or differences between those standards and U.S. GAAP."[10] The plaintiffs subsequently filed an amended complaint and alleged that the Committee of European Securities Regulators (CESR) had determined that there are no "significant differences between U.S. GAAP and [IFRS] [or]…IFRS and Chinese GAAP on revenue recognition."[11]

After reviewing the underlying CESR report, however, the court determined that the CESR had concluded "only that, based on limited information, Chinese GAAP is similar to IFRS, and U.S. GAAP may or may not have been similar to IFRS by 2008/2009."[12] As a result, the court again dismissed claims based on alleged discrepancies between SEC and SAIC reports for failure to adequately allege that the differences could not have been caused by differences in the two countries' accounting standards.

Similarly, in *In re A-Power Energy Generation*

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Sys. Sec. Litig., a court in the Central District of California dismissed securities fraud claims "founded upon the belief that figures reported to the SEC are drastically different from figures [the defendant corporation] reported to the SAIC in China."[13] In *In re A-Power*, the plaintiff had alleged "that the SAIC/SEC discrepancies cannot be explained by the differences in U.S. and Chinese accounting standards."[14] But, even assuming for purposes of its decision that U.S. and Chinese GAAP were "effectively the same for current purposes," the court dismissed the complaint because the plaintiffs "[did] not appear to have alleged that compliance with PRC's [People's Republic of China's] GAAP is even required when filing with the SAIC or that A-Power's subsidiaries prepared their filings in compliance with GAAP."[15]

Courts have required specific allegations that the U.S. and Chinese reports purported to provide the same information or discrepancies between the filings so large that they overwhelmed any potential difference caused by different reporting standards. For example, in a recent decision in *In re Silvercorp Metals Inc. Sec. Litig.*, a court in the Southern District of New York considered a complaint based on alleged discrepancies between the defendant company's reporting to the SEC and Chinese regulatory authorities on resource levels in a Chinese silver mine that was the company's chief asset.[16] The plaintiffs alleged that the U.S. filings reflected "dramatically higher" resource quantities than the company's SEC filings.

In seeking dismissal, the defendants relied on the decisions in *China Valves*, arguing that the U.S. filing included more recently updated information and, thus, comparing the Chinese and U.S. filings was not an "apples-to-apples" comparison. The court rejected this argument, however, explaining that "[t]he parties strenuously contest the identity of the fruit here. But whether the [Chinese regulatory filing] is apple, orange, or lychee, plaintiffs have adequately pleaded that it uses the same denominator as the SEC filings."[17] Despite any potential differences in the time periods reflected in the different filings, the court held that the plaintiff had adequately alleged that the two figures purported to represent the same information and, thus, any discrepancy in the reports could not be explained by different regulatory requirements.

The court in *China Valves* also noted that, even if the reports referred to resources during different time periods, the differences in timing still would not explain the "enormous gap" between the resources reported in the two filings.[18] Generally speaking, however, cases that permit plaintiffs to plead a discrepancy between results reported under different standards based on the magnitude of the difference have rested on truly staggering differences between the information presented in the U.S. and Chinese reports. For example, in one recent case, the plaintiff alleged that the defendants reported asset values in U.S. filings 118 times greater than those they reported in Chinese filings.[19]

Alleging Filings Are False

It is not enough to "allege only that differences exist in the SEC and [SAIC] filings and assume[ ] or conclude[ ] the SEC filings must be false."[20] Accordingly, even where the plaintiff has adequately alleged a discrepancy that cannot be explained by differences in reporting requirements or accounting standards, courts have dismissed claims where the plaintiff "fails to plead how [the] discrepancy makes the [U.S. filing] untrue or misleading."[21]

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Plaintiffs often attempt to plead the falsity of the U.S. filing by simply asserting that SEC filings are more likely to be false because China allegedly imposes harsher penalties for misstatements in regulatory filings.[22] Such generalized allegations that penalties for misreporting are harsher in China have been found insufficient to allege U.S. filings are false.[23] Without some independent indication that the U.S. filings were false, such as independent audit reports corroborating the information contained in the Chinese filings, a discrepancy between U.S. and Chinese regulatory filings is not sufficient to plead securities fraud.[24]

Conclusion

As more Chinese-based companies access U.S. capital markets and come within the orbit of U.S. securities laws, those companies will have to confront the risk of U.S. securities litigation. In the past, such litigation has often arisen from alleged inconsistencies between U.S. and Chinese regulatory filings. Under the heightened pleading requirements for securities fraud claims, however, it should not be enough to simply point to such a discrepancy and claim fraud. Courts should continue to insist that plaintiffs plead particular facts demonstrating that statements in U.S. regulatory filings are false, rather than permitting plaintiffs to simply point to other, seemingly inconsistent, statements in Chinese regulatory filings and conclude that the statements in U.S. filings were false.

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1. See Denny Thomas and Elzio Barreto, "China Firms Head for U.S. IPOs, Not Fussed by Accounting Flap," Reuters (Feb. 10, 2014) (available at http://www.reuters.com/article/2014/02/10/us-china-ipos-usa-idUSBREA191XE20140210).
2. Lynn Cowan, "Chinese IPOs No Longer Sizzling," Wall Street Journal (May 17, 2011) (available at http://online.wsj.com/news/articles/SB10001424052748703509104576321401784373030) (noting that, as of publication date, "[o]ver the past eight months, 36 Chinese companies have tapped the U.S. capital markets for the first time").
3. See, e.g., Azam Ahmed, "China Reverse Merger Companies Draw Lawsuits," The New York Times (July 26, 2011) (available at http://dealbook.nytimes.com/2011/07/26/chinese-reverse-merger-companies-draw-lawsuits/).
4. See, generally Cornerstone Research, Securities Class Action Filings 2013 Year in Review (available at http://www.cornerstone.com/getattachment/d88bd527-25b5-4c54-8d40-2b13da0d0779/Securities-Class-Action-Filings%e2%80%942013-Year-in-Revie.aspx).
5. See *Yang v. Han*, 14 Civ. 5308 (S.D.N.Y. filed July 15, 2014).
6. 15 U.S.C. §78u-4(b)(1).
7. *ATSI Commc'ns v. Shaar Fund*, 493 F.3d 87, 99 (2d Cir. 2007).
8. See *In re China Valves Tech. Sec. Litig.*, No. 11 Civ. 796, 2012 WL 4039852, at *6 (S.D.N.Y. Sept. 12, 2012).
9. See *In re Silvercorp Metals Sec. Litig.*, No. 12 Civ. 9456 (JSR), 2014 WL 2839440, at *5 (S.D.N.Y. June 23, 2014).
10. Id.
11. *China Valve II*, 979 F.Supp.2d at 411.
12. Id. at 412.
13. *In re A-Power Energy Generation Sys. Sec. Litig.*, No. 11 MDL 2302, 2012 WL 1983341, at *8 (C.D. Cal. May 31, 2012).
14. Id. at *2.
15. Id. at *8.
16. *In re Silvercorp Metals*, 2014 WL 2839440.
17. Id. at *5.
18. Id.
19. *McIntire v. China Media Express Holdings*, 927 F.Supp.2d 105, 125 (S.D.N.Y. 2013); see also *Lewy v. Sky People Fruit Juice,* 11 Civ. 2700, 2012 WL 3957916 (S.D.N.Y. Sept. 10, 2012) (plaintiff adequately pleaded falsity by alleging that company reported revenue to SEC 10 times higher than revenue reported to SAIC); *Ho v. Duoyan Global Water*, 887 F.Supp.2d 547, 568 (S.D.N.Y. 2012) (where the defendant reported to the SEC operating income in the tens of millions of dollars for several straight years while reporting losses to the SAIC during the same period, the "[d]efendants' argument that the differences can reasonably be attributed to differences in U.S. GAAP and Chinese GAAP is unpersuasive given the large margins of disparity between the figures reported in the two filings").
20. *China Valves I*, 2012 WL 4039852, at *6.
21. *Arfa v. Mecox Lane*, No. 10 Civ. 9053, 2012 WL 697155, at *12 (S.D.N.Y. March 5, 2012); see also *In re A-Power*, 2012 WL 1983341, at *8 (plaintiff failed to "satisfactorily allege[ ] why the *SEC* filings were false as opposed to the *SAIC* filings" (emphasis in original)).
22. See, e.g., *China Valves II*, 979 F.Supp.2d at 411; *Yee v. NIVS Intellimedia*, No. 11 Civ. 8472, 2013 WL 1276024, at *5 (C.D. Cal. March 25, 2013) (allegation that the defendant "had a greater incentive to falsify its numbers" in SEC filings because "Chinese penalties for falsifying SAIC filings are substantially harsher than [defendant] would face for falsifying SEC filings").
23. *China Valves II*, 979 F.Supp.2d at 411.
24. See id.; *Duoyun Global*, 887 F.Supp.2d at 568.