To List or Not to List
IPO Fraud in China

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Discussion Questions
In July, 2016 Dongdan Xintai Electric Co. Ltd. (Xintai) became the first company to be officially delisted from a Chinese stock exchange. Xintai was listed on the ChiNext board of the Shenzhen Stock Exchange after their Initial Public Offering (IPO) in March, 2014.

The company was delisted after it was found guilty of fraud during its IPO application. Xintai admitted to fabricating their financial records after a year-long investigation, launched by the China Securities Regulatory Commission (CSRC) after a routine audit revealed discrepancies in the firm’s financial data. According to Xinhua News Agency, Xintai began fabricating its accounts receivable, bad-debt provisions, and cash flow from operating activities data in 2011, after having a prior IPO application rejected due to a lack of profitability. From 2011 to 2014, the year of their IPO, the company propped up its financial position by forging bank drafts and receipts worth between RMB 70 million – 200 million (USD $10.5 million – $29.9 million). It was the “profitability” these forgeries suggested that granted them the approval of their subsequent IPO application.

The consequences from the CSRC investigation and decision have been severe:

- Xintai was delisted from the Shenzhen Stock Exchange, and will never again be eligible for listing on any stock exchange, Shenzhen or otherwise.
17 current and former Xintai executives were fined and punished, two of which were permanently banned from the securities market and from holding senior positions in any listed company.

Xintai was fined RMB 8.32 million (USD $1.3 million) for their actions.

Industrial Securities Co. Ltd. (Industrial Securities), the underwriter of Xintai’s IPO, was fined RMB 30 million (USD $4.5 million).

Industrial Securities had its fees from underwriting Xintai’s IPO, worth RMB 32.78 (USD $4.9 million), confiscated.

Industrial Securities has been required to pay RMB 500 million (USD $74.94 million) to reimburse investor losses.

Xintai’s Chairman, Wen Deyi, stated the firm has no choice but to file bankruptcy, due to a now unpayable debt load of over RMB 620 million (USD $92.9 million).
What are moral issues associated with this case?

*Dandong Xintai Electric Co. Ltd.*

Xintai fabricated their financial records to enable their IPO. They accomplished this primarily through forgery. Forgery is a form of lying. It is intentional, premeditated, and aimed at deceiving a specific person or group of people, in this case the financial industry regulators in China. It is also a form of cheating, which in business prevents fair competition among market players. Lastly, the end result of Xintai’s forgery, namely, the listing of their company on the Shenzhen Stock Exchange, was also a form of theft, whereby unknowing investors put their confidence in an unreliable and unstable company.

Lying, cheating, thieving. Why would Xintai engage in this kind of behavior? Can you think of any reasons? Does the possibility of achieving a good goal, namely, public listing on the Shenzhen Stock Exchange, ever justify producing fake financial reports and evidence to support them?

*Industrial Securities Co. Ltd.*

Industrial Securities underwrote Xintai’s IPO. The underwriting process for an IPO is supposed to be intensive and meticulous. IPO underwriters serve two general purposes. First, they ensure the firm planning to go public complies with all relevant laws and regulations, makes
transparent all necessary financial data, and files their application with the appropriate authority. Second, the underwriter finds potential investors for the company’s shares. Depending on the interest expressed by the potential investors, they determine the share price of the company’s initial offering. Oftentimes, the underwriter, based on the interest of the investors they pitched to, will guarantee to the company a given amount of shares sold. Due to the amount of work and the risks involved in IPO underwriting, the fees charged by the underwriter are typically substantial, in this case RMB 32.78 (USD $4.9 million).

Of importance from a moral standpoint are the statutory duties associated with IPO underwriting, namely, compliance, due diligence, and financial transparency. Industrial Securities was accused of failing to perform its statutory duties in the underwriting process of Xintai’s IPO, and have publicly submitted to an investigation by the CSRC.

It is unclear whether Industrial Securities was intentionally complicit in the fraud of Xintai, but it is clear that they did not exercise a proper amount of due diligence in their process of investigating Xintai’s financial integrity. This lack of due diligence failed to detect Xintai’s lack of financial transparency, resulting in compliance violations with the CSRC and the deception of investors. It ultimately led to Xintai’s delisting and a plethora of otherwise avoidable problems.
The Chinese government tightened their delisting regulations in 2014, in an effort to weed out shady behavior in China’s stock markets. Xintai is the first victim of this move. Zhang Xiaojun, spokesperson for the CSRC, stated that there is and will remain “zero tolerance” for financial fraud and violations of information disclosures in the process of applying for an IPO. Some say there could be a landslide of subsequent cases, similar in scope to Xintai’s. But is a crackdown driven by increased government regulation enough? Is there a limit to the effectiveness of such regulation? Is fear of fines or arrests or public embarrassment enough to deter such activity from the start?

Consider Xintai’s investors. Many have proposed what is called an “Investor Bill of Rights”, outlining both the rights that investors can and should expect and the duties of investees to protect these rights. An example of such a list of rights is from the North American Securities Administration Association (NASAA). NASAA says that every investor has the right to:

“Ask for and receive information from a firm about the work history and background of the person handling your account, as well as information about the firm itself.

Receive complete information about the risks, obligations, and costs of any investment before investing.

Receive recommendations consistent with your financial needs and
investment objectives.

**Receive** a copy of all completed account forms and agreements.

**Receive** account statements that are accurate and understandable.

**Understand** the terms and conditions of transactions you undertake.

**Access** your funds in a timely manner and receive information about any restrictions or limitations on access.

**Discuss** account problems with the branch manager or compliance department of the firm and receive prompt attention to and fair consideration of your concerns.

**Receive** complete information about commissions, sales charges, maintenance or service charges, transaction or redemption fees, and penalties.

**Contact** your state or provincial securities agency in order to verify the employment and disciplinary history of a securities salesperson and the salesperson’s firm; find out if the investment is permitted to be sold; or file a complaint.”

In China, the Securities Law of the People’s Republic of China, which was promulgated on October 25th, 2005 and went into effect on January 1st, 2006, also outlines provisions designed to protect investor interests and hedge against corruption, in IPOs or other transactions. Excerpts from articles and their associated provisions are below:
“Article 55
The relevant stock exchange may decide to suspend the listing of the shares of a listed company under any of the following circumstances:

(2) The company has failed to make public its financial situation in compliance with the relevant provisions or has recorded false information in its financial and accounting statements that may mislead the investors;

(3) The company is involved in major illegal acts;

Article 56
The relevant stock exchange may decide to terminate the listing of the shares of a listed company under any of the following circumstances:

(2) where the company has failed to make public its financial situation in compliance with the relevant provisions or has recorded false information in its financial and accounting statements, and the company refuses to make a rectification thereof;

Article 69
If the share prospectus, measures for offer of corporate bonds, financial and accounting statements, listing report document, annual report, interim report, ad hoc report or other information disclosure materials announced by an issuer or listed company contain any false record, misleading statement or major omission, thus causing losses to investors in the course of securities trading, the issuer or the listed company shall be liable for the losses; the directors, supervisors, senior executives and other personnel directly responsible therefore of the issuer or the listed
company, the sponsor, and the underwriting securities company shall be jointly and severally liable for such losses.”

Reflect upon these rights and laws in light of the behavior of both Xintai and Industrial Securities.

Now consider Xintai’s employees. What can they reasonably expect from their leadership? At the very least, can they not expect that the firm will act in their best interest by not engaging in illegal and/or unethical behavior that may jeopardize their employment? Their jobs are at risk because of this fraud, regardless of their performance or working relationships with other team members. The fact that Xintai’s leadership has indicated the firm will file for bankruptcy, which may lead to laying off their employees, sheds much needed light on the question of what constitutes moral leadership. What else can employees expect from the firm’s top management?

Lastly, consider the financial marketplace in general, in China or elsewhere. The more illegal and unethical behavior there is, the more common it is likely to become. When the rules of competition are seen as options instead of obligations, the game becomes inherently unfair and dangerous. When companies will go to any length to ensure victory, they have already given up on any commitment to true competition. These are ingredients for economic collapses, full-blown industry failures, and the ruining of livelihoods. If nobody wants this in theory, everyone should work towards fairness in practice, that is, commitment to fair competition. But how?
DISCUSSION QUESTIONS

What is IPO fraud?

In the “Investor Bill of Rights” in the ACTING section, which rights, if any, do you think Xintai and Industrial Securities violated? In what way were they violated?

In light of the articles and provisions of the Securities Law of the People’s Republic of China in the ACTING section, do you think the penalty imposed upon Xintai was fair? Why or why not?

Do you think investors should have rights in the first place? Why or why not?

Imagine you are an employee for a company like Xintai. What would you expect from your leadership? If you were asked to come up with an “Employee Bill of Rights,” what would it say?

Xintai’s CEO stated in response to their delisting that the penalty was too harsh and complained that the firm would now have to file for bankruptcy. Does that tell you anything about his leadership style? How would you define the term “Responsible Leadership” in light of his response?
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