BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C.

In the Matter of the Application of

SmartHeat, Inc.

For Review of Action

Taken By

The NASDAQ Stock Market LLC

File No. 3-15508

BRIEF OF THE NASDAQ STOCK MARKET LLC IN OPPOSITION TO APPLICATION FOR REVIEW

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I. INTRODUCTION

SmartHeat, Inc. ("SmartHeat") is a Nevada corporation formed in 2008 through the merger of a Nevada shell company with a Chinese manufacturer of heat exchange products. SmartHeat operates as a holding company, and its only revenue-generating activities are conducted by its subsidiaries, largely operating in China, outside of SmartHeat's managerial direction. SmartHeat was listed on the stock exchange operated by The NASDAQ Stock Market LLC ("NASDAQ") in January 2009.

In May 2012, SmartHeat disclosed that its entire executive management team had resigned, that it had hired a restructuring consultant to assist with liquidity issues, and that its cash reserves had been completely drained, from a cash balance of more than $33 million in

January 2011 to just under $30,000 in June 2012—at the same time it was transferring more than $25 million to a "subsidiary" over which it had no control. SmartHeat's response to this crisis was to hire new managers for the holding company and to enter into a $1 million revolving credit agreement with SmartHeat insiders—the very executives who had suddenly left the holding company but retained management control over SmartHeat's Chinese subsidiaries.

NASDAQ is charged by law with helping to protect the investing public by listing only transparent and responsible companies on the exchange. *See* 15 U.S.C. § 78f(b)(5). After carefully investigating SmartHeat, NASDAQ Staff ("the Staff") determined that there were substantial and persistent concerns about the company's suitability for continued listing on the exchange. Pursuant to its broad discretion under NASDAQ Rule 5101, NASDAQ determined to delist SmartHeat. SmartHeat appealed that determination through two levels of independent review, contending that the conditions that warranted concern had changed and that NASDAQ should not delist the company, but both reviewing bodies affirmed the Staff's determination. This appeal followed.

SmartHeat's appeal is meritless: The factual bases for the delisting are undisputed. SmartHeat's only substantive contention is that the decision to delist it was an abuse of discretion—a very difficult burden to carry—and the delisting decision falls well within NASDAQ's discretion under Rule 5101. For the reasons set forth below, the Commission should dismiss SmartHeat's application for review and affirm the delisting decision of the NASDAQ Listing and Hearing Review Council (the "Listing Council").

II. QUESTIONS PRESENTED

SmartHeat has appealed the Listing Council's delisting determination. Under 15 U.S.C. § 78s(f), the questions for consideration are (1) whether the stated bases for the Listing Council's

determination exist in fact; (2) whether the Listing Council properly applied its own rules; and (3) whether the determination is consistent with the purposes of the Securities Exchange Act of 1934 ("Exchange Act"). SmartHeat agrees that these are the issues for review by the Commission. *See* SmartHeat Br. 6.

III. SUMMARY OF FACTS

A. SmartHeat, Inc.

SmartHeat is a holding company. Its foreign subsidiaries design, manufacture, and sell heat exchangers and heat pumps for commercial and residential developments. All of the subsidiaries are Chinese companies that operate exclusively in China, with the exception of one German subsidiary. NASDAQ-000003.[1] SmartHeat became public through a reverse merger with a Nevada shell corporation and was listed on NASDAQ in January 2009. *Id.*; *see also* SmartHeat Br. 1. Before May 30, 2012, SmartHeat was run by James Jun Wang, who was simultaneously President, CEO, and Chairman of the Board of Directors. NASDAQ-000003.

B. Concerns Raised by the Management Turnover and Subsequent Investigation

On May 15, 2012, the company disclosed that the chair of its Audit Committee, Arnold Staloff, had resigned for unexplained reasons. Fifteen days later, on May 30, 2012, SmartHeat issued a press release and submitted a Form 8-K disclosure announcing a number of additional major developments. All of its executive officers had resigned: James Jun Wang, the President, CEO, and Chairman of the Board; Zhijuan Guo, the Chief Financial Officer; Wen Sha, the Vice President of Marketing; and Xudong Wang, the Vice President of Strategy. NASDAQ-000003. The release also revealed that the company had engaged a restructuring consultant and had

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[1] Citations are to the record compiled and submitted by NASDAQ pursuant to Rule 420 of the S.E.C. Rules of Practice.

selected a new President and Director, Oliver Bialowons. Additionally, the release announced that SmartHeat had entered into a $1 million revolving credit agreement to "fund ordinary course operating expenses" with an entity whose principals included the now-former CEO Mr. Jun Wang. NASDAQ-000004. Based on this release, the Staff immediately halted trading in SmartHeat's common stock and submitted requests for additional information from the company. *Id.* SmartHeat has conceded that, given the magnitude of the May 30 announcement, SmartHeat itself should have requested a voluntary suspension of trading. NASDAQ-000047.

1. Liquidity Crisis

SmartHeat's Form 10-Q filed May 15, 2012 disclosed a severe liquidity problem: SmartHeat had only $27,469 in cash in its accounts. SmartHeat further revealed that, without the $1 million line of credit, it would be unable to pay its bills. NASDAQ-000004; NASDAQ-000092. As recently as January 2011, in contrast, SmartHeat held over $33 million in cash, and it had raised more than $100 million from its public offerings in the United States from 2009 through 2010. Most of that cash, however, was transferred to SmartHeat's Chinese subsidiaries. NASDAQ-000006.

The Staff observed a $2.8 million transfer from the holding company to one of the Chinese subsidiaries made on May 29, 2012—just *one day* before SmartHeat's management shake-up was announced. The substance of this transaction was never fully explained, but a Chinese subsidiary—Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. ("Taiyu"), which was founded by James Jun Wang, *see* SmartHeat, Inc. Form 10-K, at 33 (Mar. 15, 2011)—received an incentive payment from the Chinese government to invest in a foreign company; the Chinese subsidiary "invested" in a SmartHeat German subsidiary (GWP); the German subsidiary transferred the money to SmartHeat; and SmartHeat immediately transferred the funds in a round-trip back to Taiyu—to account for Chinese registered capital requirements,

according to SmartHeat. NASDAQ-000101-02. None of these funds were kept by SmartHeat to help avert its liquidity crisis.

2. Line of Credit

SmartHeat established a line of credit with a British Virgin Islands company called NorthTech Holdings, Inc. ("NorthTech"), which is a special purpose entity created solely to lend money to SmartHeat. NASDAQ-000094. NorthTech's principals are the former executives of SmartHeat, with James Jun Wang as the primary financier. Mr. Jun Wang is also currently running SmartHeat's Chinese subsidiaries. NASDAQ-000094. The terms of the agreement were finalized in July 2012. NASDAQ-000105. SmartHeat stated that it considered alternatives; however, "[n]one of these approaches yielded a specific financing proposal," and SmartHeat asserted that the terms of the agreement were better than it could get from the market. NASDAQ-000093. As of July 10, 2012, SmartHeat had not retained an independent third party to value its assets in association with the credit facility even though the agreement committed 35% of the company's assets as collateral, nor had any independent third party opined on the fairness of the deal. NASDAQ-000096.

The terms of the agreement changed from its announcement in May until its finalization in July 2012. The final agreement establishes a $2 million revolving credit line with a 4% origination fee. The interest rate is set at 1.25% per month. The original term is for nine months; SmartHeat may renew the agreement for an additional four nine-month periods for a 4% renewal fee payable for each renewal. The loan is prepayable only with a 10% prepayment fee for any drawn amount. NorthTech takes as collateral a pledge of 35% of equity interests in SmartHeat's subsidiaries and a lien on all bank accounts and other SmartHeat assets. NASDAQ-000106. As disclosed in the agreement, NorthTech maintains complete discretion over this high-interest, high-fee agreement, including whether to make any loans at all and in what amount.

Credit and Security Agreement By and Between SmartHeat, Inc. and NorthTech Holdings, Inc., SmartHeat, Inc. Form 8-K Ex. 10.12, Section 2.8 (July 27, 2012).

3. Management Turnover

As announced in the May 30, 2012 release, SmartHeat's entire executive team resigned. The company hired Nimbus Restructuring Manager LLC ("Nimbus"), headed by William McGrath, to provide restructuring services and had paid Nimbus $390,000 in fees as of July 10, 2012. NASDAQ-000092. Mr. McGrath introduced SmartHeat's Board to Oliver Bialowons, and the company named him President and CEO. NASDAQ-000097. Subsequently, the company chose Michael Wilhelm, a former associate of Mr. Bialowons, as its CFO. Neither individual is employed by the company, but instead they are engaged through services contracts between SmartHeat and business entities of which they are sole members. SmartHeat states that this arrangement was reached to facilitate payment and to allow Messrs. Bialowons and Wilhelm to accept other consultancies during their service to SmartHeat. NASDAQ-000102-03.

Of the four executives who resigned from SmartHeat on May 30, three of them—including James Jun Wang—continue to manage SmartHeat's Chinese subsidiaries.[2] When asked why "the Company chose to allow James Jun Wang, Wen Sha and Xudong Wang to retain their positions in the Company's subsidiaries," SmartHeat responded that "[e]ach of the Company's subsidiaries is responsible for hiring its own personnel. The Company does not have [the] right, nor does the Board believ[e] that it would serve the best interests of the Company's stockholders[,] to interfere with the management of its subsidiaries." NASDAQ-000085.

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[2] The company's Website continues to list its former management team as executives of SmartHeat, Inc. *See* SmartHeat, *Our People*, www.smartheatinc.com/web/people.asp (last visited Dec. 18, 2013).

Based on SmartHeat's submission to NASDAQ, as of June 12, 2012, SmartHeat had not discussed any of the matters revealed in the May 30, 2012 release with its independent auditor. NASDAQ-000090.

4. The Company's Structure

The Staff also looked into problems revealed in SmartHeat's corporate structure, as millions of dollars had been sent to the subsidiaries without any plan for repatriating the funds to SmartHeat, even to pay the expenses surrounding its obligations as a public company. *See* NASDAQ-000091 (listing hundreds of thousands of dollars in expected compliance costs). The company submitted that there were only two ways for a holding company to get funds from Chinese subsidiaries: either through dividend payments from subsidiary profits or from management and service agreements that establish regular payments. The Chinese subsidiaries were operating at a loss, and SmartHeat admitted that, while it was typical for reverse merger companies to have management and services agreements in place, it had never made any such arrangements. NASDAQ-000007. In addition, the company explained that the holding company could not control its Chinese subsidiaries, as it "[did] not have [the] right" to make operational or management decisions about them. NASDAQ-000085. Consequently, SmartHeat could not compel the subsidiaries to return funds to SmartHeat.

5. Other Concerns

The Staff also looked into SmartHeat's associations with Benjamin Wey, who had sponsored the reverse merger that initially brought SmartHeat to the U.S. securities market. Mr. Wey was under investigation by government authorities for potential financial misconduct, and the Staff was concerned about SmartHeat's relationship with Mr. Wey and his affiliated organizations. NASDAQ-000008-9. SmartHeat acknowledges that its own Board was

"concerned" about these federal investigations. SmartHeat Br. 1. As noted below, however, these concerns ultimately were not a basis for the delisting.

C. Delisting Determination and SmartHeat's Appeals

On August 23, 2012, the Staff issued its "Staff Delisting Determination" based on the May 30 release and subsequent investigation. The Staff cited and discussed four primary concerns raised by the May 30 release: "Liquidity Concerns," "Line of Credit," "Management Turnover," and "Company Structure." NASDAQ-000003-11.

NASDAQ's Rule 5800 series governs review of delisting determinations. As approved by the Commission, NASDAQ rules establish a multi-tiered review process comprised of independent adjudicators. A company challenging a delisting determination may first appeal to the NASDAQ Hearing Panel (the "Hearing Panel"), with right to a hearing and the opportunity to present evidence to challenge the Staff's determinations. NASDAQ Listing Rule 5815. The Hearing Panel is to be composed of "at least two persons who are not employees or otherwise affiliated with Nasdaq or its affiliates." NASDAQ Listing Rule 5805(d). If unsatisfied with the Hearing Panel review, another appeal may be made to the Listing Council, another independent body, which must include non-Industry and Public members. *See* NASDAQ Listing Rule 5820; NASDAQ Bylaws, Article V. Both reviewing bodies, pursuant to the Rule 5100 series, "may subject the Company to additional or more stringent criteria . . . based on any event, condition, or circumstance" that makes continued listing "inadvisable or unwarranted" in the body's opinion. NASDAQ Listing Rules 5815(c)(4) and 5820(d)(3). The NASDAQ Board of Directors may, at its own discretion, determine to review a Listing Council decision. NASDAQ Listing Rule 5825.

SmartHeat appealed the Staff's delisting determination to the Hearing Panel and submitted its supporting memorandum on September 20, 2012. NASDAQ-000035. In

addressing the liquidity and line of credit issues, SmartHeat argued that it faced a short-term liquidity issue that had been resolved; it acknowledged, however, that "[t]he Company did not manage its cash resources adequately in the past which resulted in a misallocation of cash and cash being 'trapped' in the China subsidiaries." NASDAQ-000052. SmartHeat stated that the "line of credit [wa]s the only source of cash available to the Company" because it "lacked time and cash resources to support an immediate and urgent search for credit or capital." NASDAQ-000051. SmartHeat also explained that it "was not in a position to make full and fair disclosure to an outsider concerning pending investigations (because the government agencies conducting the investigations requested that the Company not make disclosures of the investigations)." NASDAQ-000052. These government agencies evidently included the SEC, the FBI, and the U.S. Attorney's office—not NASDAQ—and they were conducting investigations into SmartHeat because of its association with Benjamin Wey. *See* NASDAQ-000071; SmartHeat Br. 16 (discussing investigations by "the SEC and US Attorney").

On the issue of management turnover, SmartHeat argued that the turnover was long-discussed and that the resulting management team is an improvement in terms of competence and familiarity with U.S. securities laws. NASDAQ-000057. In terms of the Staff's concerns about the corporate structure, SmartHeat argued that the company's structure is mandated by Chinese law and that many other listed companies have the same structural challenges. NASDAQ-000059-60.

A hearing was held October 11, 2012, at which Oliver Bialowons, Michael Wilhelm, and William McGrath represented SmartHeat. NASDAQ-000122. The Hearing Panel was made up of two independent professionals: A partner with the accounting firm Grant Thornton LLP and an attorney and Chartered Financial Analyst who is a principal at a FINRA member. NASDAQ-

000123. At the hearing, Mr. McGrath claimed that SmartHeat's governance problems were resolved because it could now change the management of its subsidiaries; "it never was [possible] before," he stated, "because you had the Chinese management guy, you know, the fox watching the henhouse. There was no one standing up for investors." NASDAQ-000137. Mr. Bialowons admitted disappointment with the former managers of SmartHeat but explained that "you wish sometimes to get rid of people who put this company into that situation, but you are simply, at least for a while, dependent on some of the people because they have the knowledge, they know how to do the daily operations. And, therefore, I only can tell you from what I have learned within the last 23 years, it's a process which takes time . . . to come back to what I call a normally run company." NASDAQ-000169-70.

The Hearing Panel issued its decision on November 7, 2012, affirming the Staff's delisting determination. NASDAQ-000197-203. The decision invoked the same public interest concerns raised by the Staff, including "the liquidity crisis, management turnover, and line of credit from former officers." NASDAQ-000198. While it discussed SmartHeat's affiliation with Benjamin Wey, the Hearing Panel did not base its decision on Mr. Wey, noting that "several factors compel delisting in the Panel's view." NASDAQ-000201. The Hearing Panel concluded that "the extreme fragility of the Company's financial situation and its admitted inability to raise or access funds in the near term, put in doubt the Company's viability." NASDAQ-000201. The Hearing Panel also cited the line of credit with former officers and the lack of any cogent restructuring plan to cure the corporate-structure concerns as bases for affirming the delisting, stating that SmartHeat's new management team "will be depending upon managers of the subsidiaries who hold the purse strings but are not attuned to the regulatory requirements of a listed Company, and who are not contractually bound to the parent." NASDAQ-000202. As a

result of the Panel's decision, the company's shares were suspended from trading on NASDAQ on November 9, 2012 and eligible to resume trading in the over-the-counter market. NASDAQ-000202.

SmartHeat subsequently appealed that decision to the Listing Council, which affirmed the delisting on February 25, 2013. In a "lengthy opinion," SmartHeat Br. 5, the Listing Council found that "it was appropriate to deny continued listing" because SmartHeat (1) "allowed a $33 million cash balance to decrease to approximately $25,000 over the course of 14 months without a means to adequately fund the Company's operations; (2) chose to rely on funding from employees of its Chinese subsidiaries to avoid insolvency, with no apparent consideration of other sources; (3) experienced significant management turnover; [and] (4) has a lack of contractual arrangements with its Chinese subsidiaries that allow for the transfer of funds from China to the U.S. for business expenses." NASDAQ-000288. The Listing Council (like the Hearing Panel) did not rely on the possible relationship with Mr. Wey as a basis for delisting; to the contrary, it emphasized that it "does not view the relationship with th[e] affiliates of Mr. Wey as a determining factor in finding that the Company should be delisted." *Id.* at n.17.

On August 5, 2013, NASDAQ informed SmartHeat that the NASDAQ Board of Directors declined to review the Listing Council's decision, thus making the Listing Council's decision the final decision of NASDAQ. NASDAQ-000291. This appeal followed.

IV. STANDARD OF REVIEW

Rule 5101 empowers NASDAQ to "suspend or delist particular securities based on any event, condition, or circumstance that exists or occurs that makes initial or continued listing of the securities on NASDAQ inadvisable or unwarranted in the opinion of NASDAQ, even though the securities meet all enumerated criteria for initial or continued listing on NASDAQ."

NASDAQ Listing Rule 5101. SmartHeat's appeal from its delisting under Rule 5101 requires the Commission to determine whether "the specific grounds on which [the delisting] is based exist in fact," whether "such [delisting] is in accordance with the rules of the self-regulatory organization," and whether "such rules are, and were applied in a manner, consistent with the purposes" of the Exchange Act. 15 U.S.C. § 78s(f).

In reviewing the Listing Council's delisting determination, the Commission is "not at liberty to substitute [its] discretion for that of [the Listing Council]" and applies a deferential abuse of discretion standard of review. *In re Tassaway, Inc.*, Exchange Act Release No. 34-11291, 1975 WL 160383, at *2 (S.E.C. March 13, 1975); *see also In re Cleantech Innovations, Inc.*, Exchange Act Release No. 69968, 2013 WL 3477086, at *6 (S.E.C. July 11, 2013) ("NASDAQ has broad discretion in determining whether to permit a security's initial or continued listing on the Exchange, and we are not free to substitute our discretion for NASDAQ's.").

V. ARGUMENT

In determining to delist SmartHeat, NASDAQ invoked its broad discretionary authority under Rule 5101. In its appeal, SmartHeat refers disparagingly to NASDAQ's "*supposedly* discretionary authority under Rule 5101." SmartHeat Br. 6 (emphasis added). When first addressing the issue, however, SmartHeat conceded that NASDAQ possesses "*broad discretionary authority*" under Rule 5101. NASDAQ-000041 (emphasis added). That NASDAQ possesses broad discretion in delisting companies under Rule 5101 is made obvious by the Rule's Commission-approved text, which empowers NASDAQ to "suspend or delist particular securities based on *any event, condition, or circumstance that exists or occurs* that makes initial or continued listing of the securities on NASDAQ inadvisable or unwarranted *in*

the opinion of NASDAQ," even if "the securities meet all enumerated criteria for initial or continued listing on NASDAQ." NASDAQ Listing Rule 5101 (emphases added); *see also Fog Cutter Capital Group Inc. v. S.E.C.*, 474 F.3d 822, 825-26 (D.C. Cir. 2007) (NASDAQ has "broad discretion to determine whether the public interest requires delisting securities").

SmartHeat claims that NASDAQ abused its discretion under Rule 5101, but this is not a close case: Every basis for the Listing Council's delisting decision exists in fact and indeed is undisputed; the Listing Council properly invoked and followed Rule 5101 in evaluating these grounds for delisting; and delisting was fully appropriate and consistent with the purposes of the Exchange Act to protect the investing public.

A. The Bases For The Listing Council's Delisting Determination Exist In Fact.

SmartHeat claims that it was delisted based on a "finding that the restructuring of [the] Company violated NASDAQ Rule 5101." SmartHeat Br. 1. In fact, the Listing Council cited four bases for its delisting decision: SmartHeat (1) "allowed a $33 million cash balance to decrease to approximately $25,000 over the course of 14 months without a means to adequately fund the Company's operations; (2) chose to rely on funding from employees of its Chinese subsidiaries to avoid insolvency, with no apparent consideration of other sources; (3) experienced significant management turnover; [and] (4) has a lack of contractual arrangements with its Chinese subsidiaries that allow for the transfer of funds from China to the U.S. for business expenses." NASDAQ-000288. These four bases exist in fact and are amply supported by the record. Indeed, while SmartHeat attempts to dismiss these grounds as "supposed facts," SmartHeat Br. 6, they are undisputed. In addition, while SmartHeat attempts to inject a fifth issue—its alleged affiliation with Benjamin Wey—the Listing Council made clear that its delisting determination was not based in any respect on Mr. Wey.

1. SmartHeat Admittedly Experienced A Severe Liquidity Crisis.

SmartHeat's Form 10-Q filed on May 15, 2012—the same day it announced that the chair of its Audit Committee had resigned without explanation—showed that it held only $27,469 in cash in its accounts. NASDAQ-000004; *see also* SmartHeat, Inc. Form 10-Q, at 8 (May 15, 2012). Based on documents submitted to the Staff during the course of the Staff's investigation, SmartHeat revealed that, just over one year before this, SmartHeat held over $33 million in cash in its accounts. NASDAQ-000005.

SmartHeat was in the midst of a severe liquidity crisis, and it admitted that, without the credit facility, it would not have been able to pay its bills. SmartHeat's May 30 press release acknowledged that it had "immediate cash needs" necessitating its credit facility agreement with SmartHeat's former executives. In addition, SmartHeat stated in that release that it was hiring a restructuring adviser "to assist SmartHeat's Board to address its financial and liquidity issues" reflected in its Form 10-Q for the quarter ending March 31, 2012. SmartHeat, Inc. Form 8-K Ex. 99.1 (May 30, 2012). In its first response to the delisting decision, SmartHeat acknowledged that it had "identified a short-term liquidity issue," although it argued that the issue had been resolved—just as SmartHeat argues here. NASDAQ-000050; SmartHeat Br. 14. SmartHeat has never disputed, however, that it faced a liquidity crisis at least in May 2012.

The cause of this cash-drain from the holding company is also not in dispute. In response to requests for additional information from the Staff, SmartHeat acknowledged two multi-million dollar transfers occurring over this fourteen-month period—from the parent holding company to a Chinese subsidiary. In January 2011, SmartHeat transferred $25 million to Taiyu. NASDAQ-000094. On May 29, 2012, in the midst of its acknowledged "short-term liquidity issue," SmartHeat transferred $2.8 million to Taiyu to complete an odd, round-trip transaction. NASDAQ-000101-02. As SmartHeat itself acknowledged, "[t]he Company did not manage its

cash resources adequately in the past which resulted in a misallocation of cash and cash being 'trapped' in the China subsidiaries." NASDAQ-000052.

Although the liquidity crisis is conceded by SmartHeat and is further confirmed by its public statements and Commission filings, SmartHeat maintains that the crisis was short-term and has been resolved. In practically the same breath, however, it points to longer-term macroeconomic factors that caused a bad business cycle for the company. SmartHeat Br. 14-15. None of these factors justifies the liquidity crisis; they are the normal types of macroeconomic factors that every company must contend with; and listed companies should in any event be able to keep more than $25,000 in cash available to meet their ongoing obligations—a basic test of responsible management that SmartHeat undeniably failed.

SmartHeat also contends that it was not slow to react to this liquidity crisis. But NASDAQ has never stated that this liquidity crisis "arose quickly," as SmartHeat has suggested. SmartHeat Br. 16. Fourteen months can hardly be considered a rapid onset and would have been ample time to pursue financing alternatives other than the insider-controlled credit facility put into place.

Thus, this basis for the delisting decision undeniably exists in fact. Given the severity of the liquidity crisis and the management imprudence in handling it, the Listing Council had ample reason to conclude that the events and circumstances surrounding the company demonstrated that continued listing was unwarranted.

2. SmartHeat Negotiated A Line of Credit With Former Company Insiders To Satisfy Its Cash Needs.

As disclosed in its May 30, 2012 release, SmartHeat entered into a revolving credit agreement with NorthTech, which had as its main principal James Jun Wang, the former head of SmartHeat. NASDAQ-000094. When originally announced in May 2012, this agreement was

for a $1 million line of credit, but it was negotiated over time to provide for a $2 million credit line with various terms the company has claimed are beneficial and better than it could have received in the market. NASDAQ-0000105-6; *see also* SmartHeat Br. 17. The fundamentals of the deal and the fact that it is funded by the same insiders who put the company in its precarious position are not in dispute.

Though SmartHeat has argued that the line of credit is a sign of strength and was negotiated on fair terms, SmartHeat has admitted that the transaction was never subjected to any fairness review by an independent third party—even though SmartHeat stated that it had intended to seek such review. NASDAQ-000096. SmartHeat promised as collateral for this agreement all of its tangible and intangible assets, plus a 35% equity stake in the subsidiaries; yet it has never assigned a specific value to its U.S. assets, nor has the company ever attempted to value the subsidiaries, which hold multiple millions of dollars of cash as well as registered capital. NASDAQ-000095-96.[3] Moreover, the agreement pays NorthTech a number of fees, yet requires nothing from NorthTech: It grants NorthTech the complete discretion whether to make any advances at all and in what amount. *See* SmartHeat, Inc. Form 8-K Ex. 10.12, Section 2.8 (July 27, 2012). This high-interest line of credit is thus potentially illusory, and outside of SmartHeat's control.

How this credit agreement came about is also highly questionable, as the Listing Council concluded that there were no serious attempts to pursue alternative financing options. SmartHeat

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[3] SmartHeat stated that Taiyu—just one of its Chinese subsidiaries—held RMB 263.45 million in registered capital in 2012, which amounts to more than $30 million based on the nearly 8:1 exchange rate during that time. NASDAQ-000105. SmartHeat's Form 10-Q for the first quarter of 2012 also showed that its Chinese subsidiaries held more than $14 million in cash. SmartHeat, Inc. Form 10-Q, at 8 (May 15, 2012).

admitted that it did not consider other alternatives because "[t]he immediate and obvious option was to ask for support from insiders because there was neither time nor cash to look elsewhere for alternatives." NASDAQ-000051. Despite the fourteen-month period it took to draw-down SmartHeat's cash resources, SmartHeat waited until the situation was so urgent and immediate that it could not consider other options.[4]

Nothing about the line of credit or these facts is in dispute. Again, SmartHeat concedes the relevant facts, and they are confirmed by their public filings with the Commission. The Listing Council could reasonably conclude that the line of credit contributed to the troubling events and circumstances surrounding the company, which demonstrated that continued listing was unwarranted.

3. SmartHeat's Executive Officers And The Chair Of Its Audit Committee Abruptly Resigned.

The facts underlying the Listing Council's concern with significant management turnover are also not in dispute. On May 15, 2012, the chair of SmartHeat's Audit Committee, Arnold Staloff, resigned without explanation—on the same day the company revealed that it had just $27,469 in cash. On May 30, the company disclosed that *all* of its executive officers—including its President, CEO, and Chairman of the Board, as well as its CFO—were resigning. NASDAQ-000003. SmartHeat engaged as its new President and CEO Oliver Bialowons, who, later with CFO Michael Wilhelm, became the sole executive officers of SmartHeat. NASDAQ-000007.

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[4] In its submissions before the Staff's delisting determination, SmartHeat contended that it had no time to seek alternatives, *see* NASDAQ-000051; following the delisting, SmartHeat claims to have contacted 700 potential lenders for more optimal terms but states that it received no viable proposals that did not "put the company at risk," NASDAQ-000134.

SmartHeat's response to the concern about management changes is that it was part of "a Board driven management reorganization and realignment" plan and—surprisingly—that it was "not meaningful turnover." SmartHeat Br. 11. But SmartHeat points to no public disclosures of any such plans for realignment and reorganization, or of any succession plan, and yet still claims that its management changes should be seen as "commonplace," "not meaningful turnover," "an indicator of good governance," and a "Best Practice." SmartHeat Br. 4, 11, 13. This massive, disruptive change is far from being a "Best Practice" of corporate governance; indeed, the Commission Staff has pointed to the importance of proper succession planning. *See* Staff Legal Bulletin No. 14E, *available at* www.sec.gov/interps/legal/cfslb14e.htm (Oct. 27, 2009) ("[r]ecent events have underscored the importance" of a succession plan). SmartHeat admitted that, because of this factor alone it should have requested a voluntary halt to trading upon its May 30, 2012 announcement. NASDAQ-000047. An unannounced, unplanned resignation of a company's entire executive management is far from a best practice, and it shows a company unqualified for listing by NASDAQ.

Indeed, Mr. McGrath, SmartHeat's restructuring advisor, characterized the situation with the former CEO, Mr. Jun Wang, as being "the fox watching the henhouse. There was no one standing up for investors." NASDAQ-000137. SmartHeat believes NASDAQ should make nothing of this turnover because the new management team has supposedly solved the management concerns. To the contrary, however, the management team that so grossly mismanaged the holding company's assets still retains control over the Chinese subsidiaries, which are the *actual* revenue-generating parts of the business. Recognizing the untenable management dynamic in which the "fox watching the henhouse" is the principal with complete discretionary control over the liquidity that (at times) keeps the holding company afloat,

Mr. Bialowons suggested at the October 11, 2012 hearing that SmartHeat planned at some point in the future to control and otherwise replace the management of the subsidiaries. NASDAQ-000169-70. But on June 12, 2012, he had stated that "[e]ach of the Company's subsidiaries is responsible for hiring its own personnel. The Company does not have [the] right, nor does the Board believe, that it would serve the best interests of the Company's stockholders[,] to interfere with the management of its subsidiaries." NASDAQ-000085.

SmartHeat argues that it has improved management, but the experience and intentions of the new management team are not at issue. The corporate structure remains unchanged, and nothing has occurred to show that the Listing Council's conclusion was so off the mark as to be an abuse of discretion. The facts underlying the Listing Council's decision did exist and remain at SmartHeat: The executives are not able to exert the control necessary to protect the interests of SmartHeat's stockholders.[5] There is no dispute as to these underlying facts surrounding the management-turnover basis for the delisting decision. The Listing Council could reasonably conclude that the concerns over the management turnover, as part of the events and circumstances surrounding the company, supported delisting.

4. SmartHeat's Corporate Structure Has Caused Cash To Become "Trapped" In Its Foreign Subsidiaries With No Way To Repatriate The Funds.

SmartHeat's corporate structure is similarly not in dispute. SmartHeat is a holding company that, as relevant here, owns a number of Chinese subsidiaries and one German

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[5] SmartHeat's claim that its new management team should be considered by the Commission as a factor militating against delisting is also hard to square with its announcement, on February 25, 2013, that Michael Wilhelm had resigned as the company's CFO. *See* SmartHeat Form 8-K (Feb. 25, 2013). The Commission "look[s] to the facts as they were at the time of the Exchange's determination," but "subsequent developments" can be considered insofar as they show futility in a delisted company's arguments. *In re BBI, Inc.*, Exchange Act Release No. 11686, 1975 WL 160559, at *3 (S.E.C. Sept. 26, 1975).

subsidiary. According to SmartHeat, there are only two ways for a U.S. holding company to receive funds from its Chinese subsidiaries: either through dividends from profits, or from management or services contracts with the holding company that bring in regular payments. NASDAQ-000007. Evidently, there are no profits, and SmartHeat conceded that it—unlike other similarly structured companies—has no management or services contracts with its subsidiaries. Indeed, one of the primary causes of the company's liquidity crisis was that the management had misallocated its cash, sending it to the Chinese subsidiaries and thereby causing the cash to be "trapped" by the corporate structure that would not allow repatriation of the funds. NASDAQ-000052. Nothing about this corporate structure has changed in any way, and the company still does not contend that it has any management agreements with SmartHeat's subsidiaries to ensure cash-flow from their operations. *See* SmartHeat's Br. 15-16.

These aspects of the structure, as well as the fact that there were not any management services agreements or other contractual arrangements to transfer money from the Chinese subsidiaries to SmartHeat, are undisputed. But SmartHeat argues that, because hundreds of listed companies share the same corporate structure as SmartHeat and that it is required by Chinese law, it is not a valid basis for delisting. SmartHeat Br. 10. While SmartHeat may not be the only U.S. holding company with Chinese subsidiaries listed for trading on U.S. stock exchanges, SmartHeat has conceded that these similar companies typically establish in the reverse-merger process—at the very least—regular payment agreements between the parent and subsidiaries to insure cash-flow up the corporate chain to the parent company. *See* NASDAQ-000076. SmartHeat has not had, and does not claim to have, any such arrangements. *See* NASDAQ-000144.

Additionally, SmartHeat has never contended that any of these other similarly structured companies faced the same overwhelming "confluence of events" as SmartHeat. SmartHeat Br. 17. Whether required by Chinese law and whether fully disclosed to the public, the corporate structure becomes problematic when management chooses to drive holding-company cash into the subsidiaries without any regard for getting funds back to the stockholders, when the company faces an extreme liquidity crisis, when there is significant management turnover, and when the company's liquidity lifeline continues to be controlled by a former executive who runs the Chinese subsidiaries.

SmartHeat argues that the limitations imposed by its corporate structure "are matters of common knowledge to lawyers and investment professionals and are not unique to the Company." SmartHeat Br. 10. The significant omission from this list is the investing public, which NASDAQ is charged with protecting. These events and conditions, while uncontested, are extraordinary, and the Listing Council could reasonably conclude, within its broad discretion, that they demonstrated that continued listing was unwarranted.[6]

* * *

In the end, SmartHeat's entire appeal comes down to one big "yes, but" response: *yes*, the facts supporting the Listing Council's decisions are all true; *but*, the company has tried to do something in response to these concerns. As shown above, the company's response has been

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[6] SmartHeat's argument about disclosure also misstates the law: Disclosure alone cannot exempt a company from NASDAQ's discretionary authority to regulate its stock exchange. Various "events, conditions, or circumstances" warrant action under Rule 5101, and nowhere does the rule state that such "events, conditions, or circumstances" must be unknown or undisclosed. Indeed, such an argument has been rejected by the D.C. Circuit in reviewing the Commission's *Fog Cutter* decision. *See* 474 F.3d at 826 ("disclosure of [the delisted company's] arrangements . . . did not change the nature of those arrangements").

both belated and inadequate. In any event, SmartHeat never questions in a serious way NASDAQ's use of its own discretion to make its delisting determination. Facing a heavy burden of proving an "abuse of discretion" in reaching these conclusions, SmartHeat would need to articulate how it would be *unreasonable* for the Listing Council to have concluded what it did. Yet SmartHeat does not even attempt to make such a showing beyond its unsupportable *ipse dixit* assertion that the issues identified by the Listing Council were "not serious." SmartHeat Br. 18. Therefore, SmartHeat fails to provide any reason why the Listing Council did not properly apply Rule 5101.

5. The Listing Council Did Not Base Its Delisting Decision On Any Facts Related to Benjamin Wey.

SmartHeat devotes substantial time to Benjamin Wey in an attempt to suggest that the Listing Council based its decision on unsupported facts. The Staff had concerns about SmartHeat's association with Benjamin Wey and its relationships with his affiliated auditing and law firms; the Listing Council, however, was *explicit* in stating that Benjamin Wey and any affiliation with SmartHeat was not a factor in its decision. NASDAQ-000288. Any factual disputes surrounding Mr. Wey are therefore immaterial to the decision under review.[7]

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[7] SmartHeat also attempts to use the Commission's decision in *Cleantech* to establish that, "absent some independent violation by the company of NASDAQ's rules," a past affiliation with Benjamin Wey is insufficient to justify delisting of a company. SmartHeat Br. 8. There are two fatal problems with this argument. *First*, *Cleantech* stands for no such proposition. The case was decided entirely based on the Commission's conclusion that the factual bases for the Listing Council's decision to delist were not adequately supported by the record before it. *See Cleantech*, 2013 WL 3477086, at *6 ("But in this proceeding, the record does not show that the specific grounds on which NASDAQ based its delisting decision exist in fact, and the considerable discretion afforded to NASDAQ therefore does not permit its delisting decision."). *Second*, *Cleantech* does not limit NASDAQ's discretion under Rule 5101; instead, it speaks to the factual support necessary to sustain a delisting determination. In this case, the facts supporting that determination are undisputed.

B. The Listing Council's Delisting Decision Properly Applied Rule 5101.

With no real disputes about the underlying facts, SmartHeat's appeal attacks the Listing Council's application of Rule 5101 and questions its discretionary judgments about the undisputed facts. These arguments are without merit.

1. The Listing Council Properly Applied Its Discretion Under Rule 5101.

SmartHeat claims that "there is no allegation that the Company engaged in conduct that is illegal, improper, fraudulent, self-dealing, careless or unfair to stockholders." SmartHeat Br. 6. Yet SmartHeat took the capital raised from its public offerings and pushed it down into its Chinese subsidiaries without any plan or ability to repatriate the funds to stockholders. In January 2011, SmartHeat had more than $33 million in cash on hand; by August 2012, it had just $25,000 in cash. Over the course of this period, SmartHeat engaged in at least two multi-million dollar transactions sending money to a Chinese subsidiary without any plan or ability to repatriate funds, and one of these transactions seemed to be a circular scheme to wrangle investment-incentive payments out of the Chinese government.

Without seeking any serious alternatives to resolve its liquidity crisis, SmartHeat entered into a revolving credit agreement with its former executives that vested complete discretion in the former executives whether to extend funds to SmartHeat, creating a substantial power imbalance and wedge between the stockholder-owners of SmartHeat and actual control. In just one month, without warning, the chair of its Audit Committee resigned, and its entire executive management team resigned shortly thereafter, while maintaining control of the Chinese subsidiaries. As SmartHeat's current chief legal and restructuring advisor explained, SmartHeat had "the fox watching the henhouse," and "no one [was] standing up for investors." NASDAQ-000137.

SmartHeat's behavior displays substantial evidence of corporate carelessness, at best. The transactions and arrangements among the subsidiaries, along with the insider-controlled line of credit, agreed to without any formal or independent fairness opinion or asset valuation, are suggestive of self-dealing and in any event support grave concerns about the corporate structure and operations. And the use of SmartHeat as a source to push funds down to subsidiaries—where the monies remain in China with no way for stockholders to retrieve value—would surely be unfair to stockholders. Indeed, SmartHeat showed a number of the "Examples of Fraud Risk Factors" that auditors have developed to identify potentially fraudulent behavior. There are at least eight red flags that SmartHeat was waving in May 2012:

- High turnover of senior management, counsel, or board members;
- Difficulty in determining the organization or individuals that have controlling interest in the entity;
- Domination of management by a single person or small group (in a non-owner-managed business) without compensating controls;
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist;
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions;
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm;
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent; and
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.

Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 99, AU § 316.85 (Am. Inst. of Certified Pub. Accountants 2002).

These red flags support the reasonableness of the delisting decision and the Listing Council's concerns about management. At the very least, SmartHeat's admitted carelessness in managing its cash flows, combined with the use of SmartHeat as a source to raise money from the U.S. markets in order to send capital to foreign subsidiaries without any plan or ability to receive funds back for the benefit of its stockholders, shows an unfairness to those stockholders. These red flags showed a company that was either totally unprepared for the demands of NASDAQ listing or was engaged in substantial malfeasance—either way, delisting was justified, and it was not an abuse of discretion for the Listing Council to so conclude.

In *Fog Cutter*, the Commission reviewed NASDAQ's delisting of a company based on its discretionary authority to apply "additional or more stringent standards [to] prevent fraud or manipulation, promote just and equitable principles of trade, and to protect investors and the public interest." *In re Fog Cutter Capital Group, Inc.*, Exchange Act Release No. 52993, 2005 WL 3500274, at *3 (S.E.C. Dec. 21, 2005), *petition for review denied*, 474 F.3d 822 (D.C. Cir. 2007). In that case, Fog Cutter's CEO had been imprisoned after pleading guilty to felonies related to a separate business operation. With full knowledge of the then-pending charges, Fog Cutter had negotiated an amended employment agreement that exempted the CEO from being removed for the pending charges and later made payments to him for the purpose of paying restitution from his conviction. The company also intended to keep the CEO onboard during his incarceration and to keep him on the Board of Directors. NASDAQ delisted the company based on these public interest concerns—not only the anomaly that an incarcerated felon would be running a listed company but also that the Board of Directors had shown either a lack of independence, a lack of judgment, or both, all of which "presented inappropriate non-market risk to public investors." *Id.* at *5.

Fog Cutter argued, as SmartHeat argues here, that the company's steps were all rational business decisions. The Commission, however, affirmed NASDAQ's determination based on NASDAQ's broad discretion, stating that the issue was "not the Board's business judgment but, rather, the public interest" implicated by continuing to list companies that do not "meet basic standards of corporate governance and financial soundness." *Fog Cutter*, 2005 WL 3500274, at *6; *see also Fog Cutter*, 474 F.3d at 825-26 (NASDAQ has "broad discretion to determine whether the public interest requires delisting securities"). Under *Fog Cutter*, the undisputed facts of SmartHeat's behavior put it within the scope of Rule 5101.

2. SmartHeat Knew What Issues Prompted Its Delisting And Had Every Opportunity To Litigate Those Issues.

SmartHeat further argues that the Listing Council "cited no objective criterion within its rules to support delisting." SmartHeat Br. 6-7. SmartHeat misses the point of Rule 5101, which is to empower NASDAQ to apply its subjective judgment—its broad discretion—to self-regulate its stock exchange. The rule specifically states that NASDAQ may delist a company based on "*any* event, condition, or circumstance" that makes continued listing inadvisable or unwarranted "*in the opinion of Nasdaq*." NASDAQ Listing Rule 5101 (emphases added). Nowhere does SmartHeat point to the source of some requirement that the Listing Council apply "objective criterion"—indeed, Rule 5101 explicitly permits the use of subjective judgment in delisting a company, even where "the securities meet all enumerated criteria for initial or continued listing on NASDAQ." *Id.*

But SmartHeat continues to argue that it was somehow wronged because it supposedly never had the opportunity to challenge NASDAQ's specific concerns. SmartHeat Br. 7. The Staff's delisting determination letter clearly identified the specific reasons for its decision. SmartHeat's original appeal of that determination addressed the exact issues addressed in its

present appeal: "Liquidity and Line of Credit," "Management Turnover," "The Company's Structure," and "Other Concerns (Ben Wey)." NASDAQ-000042. SmartHeat has no basis to argue that it was confused as to what NASDAQ rule was being applied and why it was being applied. SmartHeat was given a full opportunity to contest the Staff's determinations, which were consistently reviewed and affirmed at all stages of the review process.[8] NASDAQ applied Rule 5101 for the reasons advanced by the Staff and the four reasons, cited above, upon which the Listing Council affirmed the delisting determination.

C. Delisting Of SmartHeat Is Consistent With The Purposes of The Exchange Act.

The Exchange Act embraces a self-regulatory system in which private stock exchanges create rules to help elevate and enforce reasonable standards. NASDAQ is "entrusted with the authority to preserve and strengthen the quality of and public confidence in its market." *Sparta Surgical Corp. v. Nat. Ass'n of Securities Dealers, Inc.*, 159 F.3d 1209, 1214 (9th Cir. 1998) (quoting 59 Fed. Reg. 29834, 29843 (1994)). Indeed, listing of a security on NASDAQ's stock exchange "creates the public expectation that the company meets minimum financial criteria, as well as embrac[es] 'integrity and ethical business practices.'" *Id.* The Commission has recognized that upholding this standard requires subjectivity, and has reserved for NASDAQ the discretion to consider the facts and determine whether listing a particular security is warranted. *Tassaway*, 1975 WL 160383, at *2 ("To the extent that discretion enters into the matter—and it very often does—the discretion in question is [the Self-Regulatory Organization's], not ours."); *see also id.*, n.19 ("NASDAQ's rules . . . do not lend themselves to mechanical and inflexible

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[8] SmartHeat does not argue that there was any procedural violation of NASDAQ's delisting rules, such as failure to provide a hearing or follow the review process laid out in the Rule 5800 series.

administration. This is an area for pragmatic business judgments based on a kaleidoscopic variety of factors").

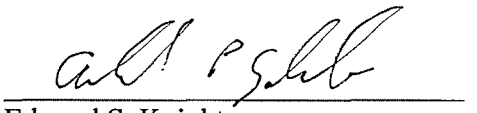
NASDAQ has not hesitated to use Rule 5101 to remove companies that did not meet high standards for corporate responsibility and to guard against any false projection to the public that a company meets these high standards. Regardless of the acknowledged effect on the present stockholders of SmartHeat, "primary emphasis must be placed on the interests of prospective future investors." *Tassaway, Inc.*, 1975 WL 160383, at *2. The clear focus of the Exchange Act and the Commission is on the prospective future investors who might be harmed by the continued listing of a company that no longer meets investors' expectations in listed companies, and on the integrity of the market as a whole. *See Fog Cutter*, 2005 WL 3500274, at *6 (affirming discretionary delisting because "[l]isting . . . creates expectations among investors that listed companies meet basic standards of corporate governance and financial soundness"); *Sparta*, 159 F.3d at 1214.

Throughout its brief, SmartHeat argues that it was being punished for taking the corrective actions it felt were warranted. SmartHeat Br. 10, 13, 15. But delisting is not a punishment; instead, it is a forward-looking action to protect prospective investors. In observing a company that faced a "confluence of factors" that called into question SmartHeat's stability and structure, the Listing Council found that the company should be delisted. That determination applies NASDAQ's rules in a way consistent with the purposes of the Exchange Act. *See Fog Cutter*, 474 F.3d at 826 (discretionary delisting based on public interest concerns is "obviously consistent with the Exchange Act").

VI. CONCLUSION

In delisting SmartHeat, the Listing Council acted on four factual bases that were and are completely undisputed. The Listing Council concluded that four "event[s], condition[s], or circumstance[s]" had occurred that warranted delisting. More is to be expected of public companies listed on a major stock exchange. SmartHeat has not articulated any reason for the Commission to conclude that the Listing Council was unreasonable in making its delisting determination under Rule 5101, nor otherwise engaged in an abuse of discretion. The Commission should dismiss SmartHeat's application for review.[9]

Respectfully submitted,



Dated: December 18, 2013

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[9] Because there is no dispute about the facts upon which the Listing Council based its decision and the straight-forward application of NASDAQ's broad discretion based upon those facts, NASDAQ believes the Commission would not benefit from oral argument in this case and thus opposes SmartHeat's motion for oral argument.