



Ontario
Securities
Commission

Commission des
valeurs mobilières
de l'Ontario

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**IN THE MATTER OF THE *SECURITIES ACT*,
R.S.O. 1990, c. S.5, AS AMENDED**

- AND -

**IN THE MATTER OF
ZUNGUI HAIXI CORPORATION, YANDA CAI and FENGYI CAI**

**STATEMENT OF ALLEGATIONS
OF STAFF OF THE ONTARIO SECURITIES COMMISSION**

Staff of the Ontario Securities Commission (“Staff”) make the following allegations:

I. OVERVIEW

1. Zungui Haixi Corporation (“Zungui”) completed an initial public offering (“IPO”) in Canada on December 21, 2009 and raised total gross proceeds of \$39.8 million.¹ Zungui’s common shares are listed on the TSX Venture Exchange (the “TSX-V”) and it is a reporting issuer in all Canadian provinces.
2. Zungui’s IPO was carried out in connection with the acquisition of Mengshida Shoes Co., Ltd. (“Mengshida”), a Wholly Foreign Owned Enterprise located in the People’s Republic of China (the “PRC”). Zungui conducts substantially all its business and operations through Mengshida and Mengshida’s management and all its operations are located in the PRC.
3. Yanda Cai is the Chief Executive Officer of Zungui and along with the Chairman of Zungui, Fengyi Cai, controls the day-to-day operations of Mengshida.

¹ At the closing on December 21, 2009, 11,500,000 common shares were sold for gross proceeds of \$37,375,000. On January 12, 2010, Zungui announced that the underwriters had exercised their over-allotment option and an additional 795,500 common shares had been issued for \$2,468,375, bringing the total gross proceeds to \$39,843,375.

4. On August 22, 2011, Zungui issued a press release announcing that Ernst & Young LLP (“EY”), Zungui’s auditor, had suspended procedures with respect to the audit of Zungui’s financial statements for the year ended June 30, 2011 pending further action from Zungui. Following the press release, the market price of Zungui shares dropped by over 75% representing approximately a \$70 million loss in market capitalization in a single day of trading.
5. As noted below, EY suspended its audit procedures due to concerns related to (i) inconsistencies in bank documents; (ii) issues with the bank confirmation process; and (iii) incorrect VAT invoices supporting purchases from certain of Zungui’s suppliers. In light of these issues, EY also raised concerns with respect to Zungui’s previously issued financial statements and recommended an independent investigation.
6. These issues were raised with Yanda Cai and Fengyi Cai by Zungui’s independent directors and a unanimous resolution was passed by Zungui’s Board of Directors to create a Special Committee to investigate the issues raised by EY (the “Special Committee”).
7. Despite voting in favour of the resolution to appoint the Special Committee, Yanda Cai and Fengyi Cai failed to cooperate with the Special Committee in addressing EY’s concerns and obstructed an independent investigation into those concerns by the Special Committee and KPMG Forensic. This resulted in the resignations of Zungui’s independent directors, Chief Financial Officer and auditor (EY) leaving Zungui with no directors or senior officers located in Canada, no independent directors, no audit committee, no Chief Financial Officer and no auditor. Further, on October 28, 2011, Zungui failed to file audited annual financial statements as required by Ontario securities law.
8. Yanda Cai’s and Fengyi Cai’s conduct was abusive to investors and the capital markets and/or contrary to the public interest.

9. Zungui's common shares are currently suspended from trading on the TSX-V and all Zungui securities are currently subject to a temporary cease trade order made by the Ontario Securities Commission (the "Commission").
10. The specific allegations against Zungui, Yanda Cai and Fengyi Cai are as follows:
 - Zungui has failed to maintain an audit committee, as required by Ontario securities law, since September 22, 2011, contrary to section 2.1 of National Instrument 52-110 *Audit Committees* and contrary to the public interest;
 - Zungui failed to file audited annual financial statements on or before the 120th day after the end of its most recently completed financial year, contrary to paragraph 4.2(b)(i) of National Instrument 51-102 *Continuous Disclosure Obligations* and contrary to the public interest;
 - Yanda Cai and Fengyi Cai being directors and/or officers of Zungui authorized, permitted or acquiesced in the commission of the violations by Zungui, set out above, contrary to section 129.2 of the *Securities Act*, R.S.O. 1990, c. S.5 (the "Act") and contrary to the public interest;
 - Yanda Cai engaged in conduct contrary to the public interest by imposing limitations on the scope of the audit procedures of Zungui's auditor EY during its audit of Zungui's financial statements for the year ended June 30, 2011;
 - Yanda Cai and Fengyi Cai engaged in conduct contrary to public interest by (i) failing to cooperate with Zungui's audit committee and special committee in addressing EY's concerns and obstructing an independent investigation of those concerns by the Special Committee and KPMG Forensic; and (ii) failing to respond to Staff inquiries and to produce documents relevant to the business of Zungui requested by Staff; and
 - Zungui engaged in conduct contrary to the public interest by failing to produce documents requested by Staff.

II. THE RESPONDENTS

11. Zungui was incorporated under the *Business Corporations Act*, R.S.O. 1990 c. B-16 on August 11, 2009. Its registered office is in Toronto, Ontario. Zungui became a “reporting issuer” within the meaning of the Act when a receipt was issued for its IPO prospectus of that date. Its shares traded on the TSX Venture Exchange under the symbol ZUN.
12. Yanda Cai is a resident of the PRC. Yanda Cai is a director and the Chief Executive Officer of Zungui.
13. Fengyi Cai is a resident of the PRC and also maintains a residence in Hong Kong. Fengyi Cai is a director and the Chairman of Zungui. According to Zungui’s management information circular dated November 2, 2010, Fengyi Cai beneficially owns or exercises control or direction over 56.8% of the outstanding common shares of Zungui.
14. Yanda Cai and Fengyi Cai are directors and officers of Mengshida and control its day-to-day operations.

III. BACKGROUND

Zungui

15. Zungui is a holding company and conducts substantially all of its business through Mengshida which generates substantially all of Zungui’s revenue.
16. Mengshida was founded on January 14, 1992 and its business involves the manufacture and sale of athletic footwear, apparel and accessories as well as casual footwear, to the local Chinese market.
17. According to the historical financial statements filed with the Commission, cash has consistently represented a substantial portion of Zungui’s assets.

18. The audited consolidated financial statements for the year ended June 30, 2010 show that Zungui had \$85.9 million of cash representing approximately 65% of Zungui's assets. The balance in one Mengshida bank account represented over 90% of the Zungui cash balance as at June 30, 2010.
19. Based on the most recently filed consolidated financial statements for the interim period ended March 31, 2011, Zungui had \$65.3 million of cash representing approximately 52% of Zungui's assets.
20. According to the same March 31, 2011 consolidated financial statements, Zungui had \$33.3 million in accounts receivable and, together, cash and accounts receivable accounted for 79% of Zungui's assets. The Zungui accounts receivable consist primarily of Mengshida accounts receivable.
21. Mengshida's bank accounts are held at bank branches located in the PRC. Access to Mengshida's bank accounts is controlled by the person in possession of Mengshida's chop (a form of corporate seal). During the material time, Mengshida's chop has been under the control and direction of Yanda Cai.

Suspension of Audit Procedures by Zungui's Auditor

22. On August 22, 2011, Zungui issued a press release (the "August 22 Press Release") announcing that EY had suspended procedures with respect to the audit of Zungui's financial statements for the year ended June 30, 2011 pending further action from Zungui. The press release noted that EY's suspension of audit procedures will remain in place until Zungui clarifies and substantiates its position with respect to issues pertaining to the current and prior year which EY identified in the course of its audit work, and that EY recommended that the issues identified be addressed by an independent investigation.
23. On August 22, 2011, pending the issuance of the August 22 Press Release, trading of Zungui shares was halted on the TSX-V. Following the issuance of the August 22 Press Release, trading resumed and the market price of the Zungui shares dropped by over 75%

to \$0.34 per share from the last closing price of \$1.47 per share. The halt was reinstated prior to the market open on August 23, 2011.

24. On September 16, 2011, Zungui issued a further press release which provided, among other things, that:

- the concerns raised by EY related to (i) inconsistencies in bank documents; (ii) the inability to obtain bank confirmations in a manner acceptable to the auditors; and (iii) incorrect VAT invoices supporting purchases from certain of Zungui's suppliers;
- Zungui's Board of Directors appointed a committee of independent directors (the "Special Committee") to conduct an independent investigation into the issues raised by EY;
- the Special Committee was given full authority and broad powers in connection with the investigation and related matters;
- the Special Committee had retained professional advisors in Canada and China to advise and assist the Special Committee in the independent investigation; and
- the Special Committee had sought the cooperation and assistance of Yanda Cai but added that "[i]t is not clear whether such cooperation or the funding necessary for the Special Committee to undertake its investigation will be forthcoming".

25. The Special Committee was comprised of the same independent directors that comprised Zungui's Audit Committee (the "Audit Committee").

26. On September 23, 2011, Zungui issued a further press release, dated September 22, 2011, announcing that:

In spite of numerous requests for cooperation, there has been no positive response from [Yanda] Cai. The requests for cooperation (which the Board

unanimously supported when it resolved to appoint the Special Committee) have included two directors travelling to Hong Kong to meet with Mr. Cai, as well as other email and oral communications. These efforts have not led to the access required to conduct a meaningful investigation or the transfer of funds to Canada to allow the Special Committee to pursue its mandate, nor has there been any indication that such cooperation or funding will be forthcoming. As a consequence, the Special Committee has concluded that it is prevented from fulfilling its mandate and each of the four independent directors (Michael Manley, Patrick Ryan, Margaret Cornish and Elliott Wahle), as well as the Chief Financial Officer, Shelly Gobin, have resigned.

27. EY resigned as Zungui's auditor effective September 23, 2011.

V. ALLEGATIONS

Conduct Contrary to the Public Interest by Zungui, Yanda Cai and Fengyi Cai

- **Failing to Cooperate with Zungui's Auditor, Audit Committee and Special Committee and Obstructing an Independent Investigation into Concerns Raised by Zungui's Auditor**

28. Prior to commencing procedures with respect to Zungui's 2011 year end audit, EY informed Zungui's management that it would be implementing changes to its bank confirmation process.
29. However, in July and August 2011, when members of EY's audit team attempted to conduct the bank confirmations on the Mengshida accounts they were not permitted to confirm the accounts as requested. At that time, members of the EY audit team contacted Yanda Cai and he failed to provide the authorization necessary for EY to conduct their bank confirmation process.
30. As noted above, in addition to concerns with the bank confirmation process and the reliability of the bank confirmations received, during the course of their audit, EY identified issues with respect to invalid VAT invoices supporting purchases from

suppliers and the authenticity of bank advices and bank statements reviewed during the audit. EY raised these concerns with the Audit Committee.

31. Zungui's independent directors, including members of the Audit Committee and Special Committee (once constituted), repeatedly sought the cooperation of Yanda Cai and Fengyi Cai in addressing EY's concerns. This included requesting that EY be permitted to perform the bank confirmations in the manner requested and that KPMG Forensic be permitted to conduct an independent investigation into the issues raised by EY.
32. As noted above, despite repeated attempts, Yanda Cai and Fengyi Cai failed to cooperate and provide the requested permissions and failed to respond to the valid concerns raised by EY, the Audit Committee and the Special Committee.
33. Further, through his actions Yanda Cai prevented independent verification of Zungui's largest asset: the cash balance in the Mengshida accounts.
34. Zungui's independent directors, including the members of the Audit Committee and Special Committee and Zungui's Chief Financial Officer resigned on September 22, 2011 and EY resigned as Zungui's auditor on September 23, 2011.
35. The conduct of Yanda Cai and Fengyi Cai described above was abusive to investors in Zungui securities and the capital markets and/or contrary to the public interest.

- **Failure to Cooperate with Commission Staff**

36. Prior to the resignation of Zungui's Chief Financial Officer and independent directors, Staff requested the production of documents and records from Zungui.
37. Many of the documents and records relevant to Zungui's business are located in China and the cooperation of Yanda Cai and/or Fengyi Cai is necessary to facilitate production of the documents.

38. Members of the Special Committee sought the cooperation of Yanda Cai to facilitate production of the documents. This cooperation was not provided.
39. Staff also requested, through counsel for the Special Committee, to speak with Yanda Cai and/or Fengyi Cai and this request was communicated to Yanda Cai.
40. Staff reiterated the request that Yanda Cai and Fengyi Cai contact Staff and assist in the production of documents by letters to Yanda Cai and Fengyi Cai dated October 18, 2011.
41. To date, Staff has not received any communication, directly or indirectly, from Yanda Cai or Fengyi Cai and none of Zungui, Yanda Cai or Fengyi Cai has facilitated production of the documents or records requested by Staff.

Breaches of Ontario Securities Law by Zungui

- **Failure to File Audited Financial Statements**

42. As a venture issuer, Zungui is required to file audited annual financial statements on or before the 120th day after the end of its most recently completed financial year pursuant to paragraph 4.2(b)(i) of National Instrument 51-102 *Continuous Disclosure Obligations*.
43. Zungui's audited financial statements for the year ended June 30, 2011 were due on October 28, 2011.
44. Zungui failed to file the audited financial statements on that date and is in default of its filing obligations contrary to Ontario securities law.

- **Failure to Maintain an Audit Committee**

45. Zungui is a “reporting issuer” as that term is defined in Ontario securities law and is required to have an audit committee that complies with National Instrument 52-110 *Audit Committees* (“NI 52-110”).

46. As noted above, the independent directors that comprised Zungui's audit committee resigned on September 22, 2011 and, since that time, Zungui has not appointed an audit committee in compliance with NI 52-110 contrary to Ontario securities law.

V. STAFF'S INVESTIGATION IS ONGOING

47. The conduct of Zungui, Yanda Cai and Fengyi Cai (the "Respondents") outlined above has been, and continues to be, abusive to investors and the capital markets and/or contrary to the public interest. At this time, Staff request that the Commission make certain orders in the public interest to, among other things, prohibit the Respondents' participation in Ontario's capital markets.
48. However, Staff's investigation in relation to Zungui (the "Investigation") is ongoing and Staff may bring further allegations and/or seek further orders in respect of the Respondents and/or other parties as a result of the Investigation.

VI. CONDUCT CONTRARY TO ONTARIO SECURITIES LAW AND THE PUBLIC INTEREST

49. Based on the foregoing, Zungui, Yanda Cai and Fengyi Cai breached Ontario securities law and/or acted in a manner that is contrary to the public interest.
50. Such further and other allegations as Staff may advise and the Commission may permit.

DATED at Toronto, November 7, 2011.