Testimony before the U.S.-China Economic and Security Review Commission

"U.S. China Relations in 2021: Emerging Risks"

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Introduction

My name is Shas Das and it is an honor to be presenting before this commission on the important topic of current U.S.-China relations. Before joining the private sector, I spent five years at the PCAOB in its international affairs department and more than 20 years in total working for the U.S. financial regulators. Among other responsibilities at the PCAOB, I served as the organization's chief negotiator with the Chinese regulators on cross-border cooperation and inspections of PCAOB-registered audit firms based in China. In this capacity, I worked closely with the SEC and U.S. Treasury Department. I should note at the outset that the views expressed here are solely my views and do not necessarily reflect the views of my colleagues or law firm.

This panel will touch on several issues. But I'd like to start with a 30,000-foot view of U.S.-China relations, which bears heavily on each topic. To that end, I will discuss *why* China is acting the way it is, sometimes in a manner that seems contrary to its own economic interests.

Many people in the U.S. tend to believe that people in other countries largely share our values. After all, we have successfully exported many aspects of our culture, including our innovative spirit and entrepreneurial drive.

While many have indeed embraced the pursuit of wealth, countries such as China, with a rich and varied history, do not fit so easily into the capitalist mold. It is through this lens that we are able to not only view more clearly the actions China has already taken, but gain a better understanding of why they have acted that way, and how they are likely to act in the future. In mid-August, for example, President Xi Jinping commented that Beijing will increasingly promote social equality, using the new catchphrase "common prosperity", in an attempt to portray China as a socialist country.[1] Despite this statement, China most definitely remains a communist country where property and economic resources are either owned or controlled by the state.

[1] Chong Koh Ping, *Chinese Stocks Slide as Beijing's Crackdown Shows No Sign of Abating*, Wall Street Journal, August 20, 2021

To skip ahead a bit, it is my belief that China has for the past several years viewed U.S. capital markets as a relatively easy source of funds. In light of the increased scrutiny of Chinese companies listed on U.S. exchanges, the most likely course of events is for China to retrench, forcing their companies to list on Shenzhen's ChiNext, Shanghai's STAR Market, in Hong Kong, or other non-U.S. exchanges.

Said differently, while China certainly cares about economic power, it also cares about issues such as pride, security, and most importantly control. They appear willing to sacrifice the monetary gains that accrue from U.S. listings if doing so will, in their view, better protect other values consistent with its authoritarian society.

Thus, any future negotiations regarding U.S. inspections of its companies' audits are likely to be unsuccessful without major compromises on both sides.

China's changing regulatory approach

China is quite clearly taking a more aggressive regulatory stance of late, with one agency in particular playing a very prominent role.

The most recent example is the actions taken against ride-hailing company Didi, with the Chinese government announcing an investigation into the company's data security practices, and then mandating the Didi app be removed from app stores, just days after the company raised $4.4 billion in a U.S. IPO. This has been followed by a new regulation that requires all companies with data on more than one million users—so effectively all internet companies—to seek formal approval from the Cyberspace Administration of China ("CAC") before pursuing a foreign listing.

The CAC has been around since 2011, but has only recently come to wield such outsized influence. It is governed by the Central Cyberspace Affairs Commission chaired by President Xi, and its recent prominence gives a sense of how seriously Xi is now taking data security (or perhaps more accurately, data control).

Other regulators include the State Administration of Market Regulation—basically the antitrust unit—as well as financial and trade regulators such as the China Securities Regulatory Commission, Ministry of Finance, and the Ministry of Commerce, which quashed Qualcomm's proposed merger with NXP Semiconductors in 2018.

Again, it is not so important *who* the regulators are, as what matters to them. And the recent elevation of the CAC sends a clear message that, for China, data security trumps financial gains. Or at least that is the message they want to send.

The reality, however, may be quite different. I generally believe this is all political/pretextual, rather than a genuine concern over data protection. With the prospect of delistings now on the horizon, the Chinese Communist Party ("CCP") has stepped up its scrutiny of Chinese companies listed in the U.S., largely in reaction to the actions of the U.S. government, including but not limited to the moratorium on new IPOs until such companies beef up their risk disclosures and separately the issuance of the Chinese Military-Industrial Complex list ("CMIC"). The CCP wants to control the narrative and be able to argue that they brought these companies back home on its terms, rather than because they were threatened with delisting by U.S. regulators.

Future of the VIE structure and potential economic consequences

Briefly, for those who do not know the history, the VIE structure was used early on by the Chinese internet companies Sina and Sohu, both of which listed on Nasdaq in 2000.[2] (It was also famously abused by Enron, which led to the establishment of new rules for the structure.) VIE stands for Variable Interest Entity, and is the primary method that Chinese companies use to get around rules that forbid foreign ownership of Chinese companies.

Put simply, the VIE is 100% owned by a Chinese individual, or in some cases such as Alibaba entities owned by Chinese individuals, usually but not always the founder and chairman. The shares sold to U.S. investors are part of a Wholly Foreign-Owned Enterprise ("WFOE") – which is the wholly-owned Chinese subsidiary of the offshore, shell company that is generally incorporated in the Cayman Islands or other offshore jurisdictions. In most cases, the VIE owns effectively all of the business through a set of contractual agreements, with the WFOE acting as a sort of "tracking stock" that fluctuates along with the underlying company's business, but which has *no claim on any significant business assets*. Presently, VIE arrangements transfer control to the WFOE, and indirectly to the offshore parent, which remains in the hands of Chinese nationals. The equity ownership of these companies is held by China-based shareholders; while the VIE shell companies have contractual rights, the enforcement of those rights is highly questionable.

Indeed, many prospectuses of these companies are replete with warnings about the lack of shareholder rights. Picking almost at random from the prospectus of electric-vehicle maker NIO, shareholders are warned they have "no general rights under Cayman Islands law to inspect corporate records or to obtain copies of lists of shareholders," that "it may be difficult or impossible for you to bring an action against us or against these individuals in the United

[2] Gillem Tulloch, "Variable Interest Entities in China," GMT Research, March 13, 2019.

States," and that "it will be . . . difficult for US shareholders to originate actions against us in the PRC in accordance with PRC laws."[3]

It is also worth noting that, while Chinese regulators have never objected to the VIE structure to any effect, they have also never blessed it. It is therefore *possible*—however unlikely it may seem—they could one day simply invalidate VIEs, leaving U.S. investors holding an empty bag. This scenario is difficult to imagine, given that such a step *would affect all foreign investors*, not just those located in the U.S., effectively cutting off Chinese company access to the global financial markets. Rather, it is far more likely that the Chinese government will tighten the rules for its companies listed overseas, including requiring companies that have personal data of users above a certain threshold to apply for a cybersecurity review to purportedly safeguard national security.

Convertability of ADRs and U.S.-listed Chinese companies that could "go private" or "go dark"

The future of the VIE structure leads directly to the question of how companies are removed from U.S. exchanges. As mentioned, while the VIE has been a useful construct for Chinese companies over the past two decades, much of the value from China's point of view has been the ability to evade measures such as U.S. audits of Chinese firms. Now that this is being threatened, the VIE structure holds far less appeal for China in the current environment.

As you may know, I dealt with this very issue during my time at PCAOB, when China showed little interest in complying with U.S. inspections, notwithstanding an agreement that was struck providing cooperation on cross-border investigations. But with the Holding Foreign Companies Accountable Act—and significantly, President Trump's Executive Order, as amended by President Biden, prohibiting U.S. persons from buying or selling certain, identified publicly traded stocks that finance the Chinese defense sector—the U.S. finally appears ready to stand its ground.

Arguably more important, from a U.S. investor perspective, is *how* such delistings happen. As noted, one of the "features" of the VIE structure is that WFOE owners actually have little to no say in what happens.

For example, in July 2016, the founders of the Chinese internet security firm Qihoo 360 bought out U.S. shareholders at $77 a share, valuing the firm at $9.3 billion.[4] While only 21% of minority shareholders voted in favor of the deal, Qihoo's Chairman and President together controlled 61% of voting power. In fact, confidential fundraising materials for the

[3] NIO ADS prospectus, sec. gov, 2018.
[4] Jesse Fried, *The Risky Business of Investing in Chinese Tech Firms*, Harvard Law School Forum on Corporate Governance, February 4, 2019.

privatization—at the time of the deal —projected a 500% return by 2019, but even this proved conservative: the company relisted in February 2018 at a valuation of more than $60 billion. Qihoo's chairman personally made $12 billion upon relisting, more than the total value of the buyout he authored 18 months earlier.

Even this is not a worst-case scenario. While it remains the most likely way these delistings play out, it is not inconceivable that the Chinese owners of the company could pay U.S. investors *nothing*. As mentioned, the WFOE structure provides few rights or protections for U.S. investors. And the willingness of Chinese owners to pay is likely contingent on what they expect to get out of it.

In the case of Qihoo, the founder and corporate insiders, were clearly expecting to relist on a U.S. exchange relatively quickly, and so did not want to entirely burn their bridges. But if China is really turning inward and away from U.S. capital markets, we have to ask the question: What obligations do they have to pay U.S. investors anything at all? This is particularly true given the U.S. legislation requiring PCAOB inspections or face delistings, which could provide a ready-made scapegoat for Chinese regulators.

However, there are some ADRs of Chinese listings in the U.S., depending on the details of the ADR contracts, that would enable investors, such as U.S.-based global fund managers, to convert those shares into corresponding securities listed on other overseas exchanges, such as Hong Kong.[5] U.S.-listed firms including Alibaba, JD.com, NetEase, Yum China, and New Oriental have already listed in Hong Kong; to date, the vast majority of U.S.-listed Chinese companies do not qualify for secondary listings on the Hong Kong exchange, and as such U.S. investors in those companies would not be able to take advantage of this conversion or transfer process. Despite the lack of PCAOB inspections, U.S. investors that buy securities of Chinese companies on overseas exchanges may likely be investing in securities that are subject to weaker investor protections, including corporate governance standards.

I agree with something Carson Block—a short-seller with significant Chinese experience—recently said: "If Chinese companies largely get out of the US before the mandate to delist kicks in, then it kind of looks to Xi's domestic audience, like Chinese companies left the U.S. out of strength, as opposed to being thrown out."[6]

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[5] The Economist, Buttonwood, "*How the delisting of Chinese firms on American exchanges might play out",* August 14, 2021.

[6] Akiko Fujita, *Why China is Cracking Down on certain publicly-traded companies, according to Carson Block*, Yahoo Finance, August 7, 2021.

As mentioned, it seems likely that President Xi would want to be seen as proactively "calling companies home" rather than having them kicked off exchanges by U.S. regulators. But that narrative is for Chinese citizens. We can easily imagine a parallel narrative for U.S. investors where the Chinese government blames, in its view, "overzealous" U.S. politicians and regulators.

Hong Kong's role in China's enforcement and regulatory approach

Finally, Hong Kong plays a large role in any U.S. delisting of Chinese stocks. Indeed, certain Chinese companies such as Alibaba already trade on the Hong Kong market, and for institutional investors it is a relatively simple matter to buy there as opposed to the U.S.

That said, while the Hong Kong market is indeed more liquid and "legit" than for example ChiNEXT, it is no Nasdaq. The U.S. dollar volume of daily trading in Hong Kong is somewhere around $25 billion, as opposed to about $200 billion on Nasdaq. Moreover, the Hong Kong market remains effectively off limits to many U.S. investors, either through lack of brokerage options to trade there, or simple unwillingness to venture outside the U.S. due to concerns relating to transparency and regulatory oversight.

Said differently, the Hong Kong market is a relatively poor substitute for U.S. markets. While many Chinese companies could and indeed do list there, a mass migration of listings to Hong Kong would limit access to some U.S. investors and, by extension, fresh capital from new offerings.

Recommendations

The U.S. is in a difficult spot here. Millions of U.S. investors now hold positions in what they believe to be claims on Chinese corporate assets, but which are in reality nothing more than shell corporations. Delisting these companies will almost certainly result in large losses for many U.S. investors, if not a total wipeout of their capital.

That said, ignoring the problem is likely the worst option. As you know, I fought hard to reach an agreement whereby China-based audit firms registered with the PCAOB would comply with U.S. inspections during my time at the PCAOB.

When I appeared before this commission four years ago, I made several recommendations about how we could potentially work with the Chinese government to resolve this issue. Obviously, during the intervening period, a lot has changed. China seems content to continue to tap U.S. capital markets for funds so long as we play by their rules, in many cases providing worthless paper in exchange for dollars, and not allowing their companies' auditors to submit to PCAOB inspections required of all other companies traded on U.S. exchanges.

In addition to modernizing and enhancing certain financial disclosure requirements in Regulation S-K,[7] in my earlier testimony, I argued for greater disclosure of the risks presented to U.S. investors. In this vein, I support Chairman Gensler's focus on more robust disclosures relating to investing in Chinese companies, especially the VIE structure, both with respect to new Chinese IPOs as well as filings by companies with significant China-based operations.[8] While the cornerstone of the U.S. federal securities law is disclosure, this alone, of course, is not a panacea when it comes to this matter – as has been well-established.

Ultimately, this matter has now boiled down to one issue: China refuses to allow its companies to comply with U.S. inspections of their audits, and the prospect of this changing seems bleak despite some recent reporting that China's State Council is ready to increase its efforts on cross-border audit cooperation during the latter part of this year.[9] The U.S., therefore, has a decision to make. We can either allow China to continue to play by its own set of rules, or stand our ground and insist on inspections as a condition of continued U.S. listings. That decision appears to have been made.

While this is no reason to disengage with the Chinese regulators on this issue, and further attempts to resolve this impasse through negotiation should continue, U.S. regulators should, as mandated, implement the Holding Foreign Companies Accountable Act with all deliberate speed. Without this leverage, or the prospect of delistings, any negotiations certainly will not be fruitful; after all, listing on the U.S. markets still holds weight and prestige given that it remains the largest, deepest, and most liquid marketplace in the world.

Thank you for the opportunity to appear before you here today, along with this distinguished group of panelists.

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[7] SEC.gov | SEC Adopts Amendments to Modernize and Enhance Management's Discussion and Analysis and other Financial Disclosures

[8] Paul Kiernan, *SEC to Set New Disclosure Requirements for Chinese Company IPOs*, Wall Street Journal, July 30, 2021.

[9] Jonas O. Bergman, *China's Top Policy Makers Signal Plan to Fix US. Audit Impasse*, Bloomberg, August 23, 2021.