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

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

January 26, 2017

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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 Chinese investment in the U.S. Before joining private practice almost a year ago, I spent five years at the PCAOB in its international affairs department and more than 20 years working for 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 herein are my views and do not necessarily reflect the views of my colleagues or firm.

Chinese listings in the U.S. and risks posed

Before addressing the current landscape and some possible recommendations for the Commission's consideration, I think it's worth recounting some of the history of Chinese listings in the U.S. When Chinese companies began to first list in the United States, they generally came in three waves between 1990 and 2010.[1] The first listings occurred in the 1990s after privatization and at the direction of Chinese regulators, who recognized that the largest and most prestigious Chinese companies would benefit from the capital and governance standards that an embryonic domestic market in China could not offer.[2] The hope was that listing in Hong Kong or New York would enable Chinese companies to transition from government controlled entities into fully functional corporations that had boards, and imposed U.S.-style corporate governance standards. With its robust governance standards, New York was a highly sought after listing destination.

The second wave of listings included more state-owned enterprises, as well as an increasing number of private companies, many from China's growing technology sector, including Baidu. These companies viewed the U.S. capital markets as offering the best environment for their needs, given their concentration of analysts and experience with technology listings. Combined, these first two waves comprised around 100 companies with an average market capitalization of $24 billion as of 2013, representing 48 percent of the total value of Chinese companies listed in New York.

The third wave of listings was larger by number—around 500 companies—though the companies themselves were much smaller, with an average market cap of less than $5 billion. Unable to compete

[1] How they fell: The collapse of Chinese cross-border listings, December 2013, McKinsey & Company, December 2013.

[2] Today, the Shanghai and Shenzhen stock exchanges are the world's third- and fifth-largest stock exchanges, respectively, based on domestic market capitalization. Both were established in 1990 as part the Chinese government's effort to move toward a market-based economy. Only domestic Chinese firms are listed on these exchanges. Foreign ownership of Chinese equities is relatively small and strictly regulated.

for capital in the domestic stock markets with the larger private and state-owned enterprises, many of them sought to list instead in New York where they found ready access to U.S. capital markets and investors who had developed a considerable appetite for U.S.-listed Chinese companies and the China growth story.

The New York Stock Exchange maintained the prestige and brand that had attracted the first wave of listings, with a ready infrastructure in place to support these IPOs. Most major U.S. law firms and investment banks had a presence in China, as did a group of smaller advisory firms specializing in reverse-merger listings, where an unlisted company acquires a shell that is already listed and registered with the U.S. SEC, bypassing the more rigorous scrutiny of a standard IPO. These tended to be much smaller in size: as the crisis hit, companies listed by reverse merger had an average market capitalization of only $68 million and represented less than 1 percent of total market capitalization of all New York–listed Chinese companies.

By early 2011, a series of scandals had developed around companies from the latest wave of listings. Many involved fraud with features that presented particular problems for investors. Many involved misrepresentations in financial reporting that would have been missed by a standard audit. Many involved falsification of the underlying documents on which audits relied, particularly commercial banks' transaction records. This could be detected by a forensic audit or due diligence, which are typically only conducted by exception. Many of the scandals involved companies that had listed by reverse merger. By June 2011, the SEC had issued an investor bulletin discussing the risks of reverse mergers[3] and about two dozen companies had been hit with SEC fraud or financial reporting charges. Some of the investigations stalled because the companies' audit papers are located in China – beyond the SEC's reach.

The Chinese reverse merger fraud crisis resulted in more than 100 U.S. listed Chinese companies that were either delisted or halted from trading in 2011 and 2012 based on claims of fraud and other violations of U.S. securities laws, including the failure to file timely financial reports. A number of others were the target of short sellers and changed auditors more than once in some cases. These companies took advantage of a legal regime in the U.S. so they could merge with American shell companies. By doing so, they eluded much of the SEC oversight that comes from selling shares on U.S. markets for the first time accompanied by an IPO subject to SEC registration requirements.[4]

In a speech given by PCAOB Board member Lew Ferguson in 2012, he noted that "[b]illions of dollars of market capitalization of such companies have been lost in U.S. securities markets and it is fair to say that all of these smaller China-based companies listed on U.S. securities exchanges have suffered serious losses of both market value and investor confidence as a result of the problems of other companies." [5] U.S. shareholders face major risks from the complexity and purpose of the VIE structure. For example, the legal contracts that serve as the basis of the structure are enforceable only in China, where rule of

[3] See Investor Bulletin: Reverse Mergers, U.S. Securities and Exchange Commission, June 9, 2011, https://www.sec.gov/news/press/2011/2011-123.htm

[4] While the public shell company is required to report the reverse merger in a Form 8-K filing with the SEC, there are no registration requirements under the Securities Act of 1933 as there would be for an IPO.

[5] Investor Protection through Audit Oversight, Sept. 21, 2002, https://pcaobus.org/News/Speech/Pages/09212012_FergusonCalState.aspx

law remains elusive. Though listing VIEs on U.S. exchanges is legal in the U.S., they can be considered illegal in China. Internet giants Alibaba, Baidu, and Tencent all listed via the VIE structure.

In response to this crisis, in 2011, the SEC required the major stock exchanges in the U.S. to impose rules making it harder for companies going public to use reverse mergers to qualify for listings on their exchanges. Among those new standards that were implemented by the SEC was a requirement that reverse merger companies, before applying for a listing on the NASDAQ, NYSE, or AMEX, complete a one year "seasoning period" by trading on an over the counter market or another U.S. or foreign exchange and maintain a minimum, requisite share price for a sustained period for at least 30-60 days prior to listing.[6]

In total today, as of January 2017, there are approximately 136 China-based companies listed on the NASDAQ, NYSE, and AMEX exchanges. Out of the 136 companies, 91 are in the form of American Depositary Receipts,[7] with the remaining in the form of ordinary shares and listed through reverse merger transactions.

Role the SEC plays in regulating Chinese companies listed on U.S. stock exchanges

The SEC requires companies to include risk disclosures in their filings of Chinese companies seeking to list in the U.S. that either their primary auditor or an auditor of a substantial portion of their financial statements has not been inspected by the PCAOB. That said, the SEC does not evaluate or otherwise opine on a company's quality through an IPO review. The operational risk of a company does not necessarily move in lock step with static indicators like financial data.

As noted in a speech that SEC Chair White gave last fall before the International Bar Association, she stressed the importance of cross-border regulatory cooperation.[8] She noted that the SEC has over seventy five formal cooperative arrangements with foreign regulators and law enforcement agencies and is a signatory to the IOSCO Multilateral Memorandum of Understanding on enforcement cooperation, to which there are now over 100 signatories. All of these arrangements facilitate sharing critical enforcement and supervisory information. And the SEC and other countries make extensive use of them – most recently entering into an agreement providing for enforcement cooperation with the Hong Kong securities regulator last week.[9]

While the SEC and DOJ are increasingly working with their foreign counterparts in such areas as FCPA enforcement to accounting fraud, U.S. regulators and law enforcement agencies must contend with

[6] SEC approves New Rules to Toughen Listing Standards for Reverse Merger Companies, November 9, 2011 https://www.**sec**.gov/news/press/2011/2011-235.htm

[7] ADRs are securities that trade in the United States but represent a specified number of shares in a foreign corporation. ADRs are bought and sold on American markets just like regular stocks and are issued/sponsored in the U.S. by a bank or brokerage

[8] Securities Regulation in the Interconnected, Global Marketplace, September 21, 2016, International Bar Association.

[9] SEC Establishes Supervisory Cooperation Arrangement with Hong Kong SFC, available at https://www.sec.gov/news/pressrelease/2017-26.html

foreign privacy and data protection laws that complicate cross-border data transfers.[10] Various country laws, including blocking statutes, privacy, bank secrecy, and state secrecy laws are designed to advance important national objective but may create barriers to cross-border flows of information between regulators and foreign domiciled registrants.

Status of the Public Company Accounting Oversight Board's negotiations with its Chinese counterparts

Having served as the PCAOB's chief negotiator at the staff level with the Chinese regulators, I know first-hand the challenges the PCAOB faces with respect to the ongoing impasse between the PCAOB and the Chinese regulators on an agreement that would facilitate PCAOB inspections of audit firms based in China. The Ministry of Finance, China Securities and Regulatory Commission, and China Institute of Certified Public Accountants all have oversight responsibilities over the accounting profession. They conduct inspections of audit firms by examining firms' quality control procedures as well as inspect the engagement audit work papers. Administrative penalties are the most common sanctions in China.

While I led the PCAOB negotiations for a number of years, which resulted in an agreement on enforcement cooperation in 2013, negotiations on an agreement providing for cross-border inspections stalled at the end of 2015 due to a dispute regarding the issuer audits that would be inspected by the PCAOB. We sought to inspect Alibaba and Baidu but the Chinese securities regulator and Ministry of Finance indicated that approvals from other relevant ministries needed to be obtained before the PCAOB could gain access to the audit work papers of those companies; at the time, the Chinese authorities were amenable to the PCAOB inspecting issuer audits that posed less concern or in other words were deemed to be less sensitive from a national security or technological standpoint. This past year, and after almost a decade of negotiations, the PCAOB has been largely silent on the progress of its discussions with the Chinese regulators, only commenting that they continue to work on reaching an agreement. One report suggested that PCAOB inspectors obtained access to audit work papers of Baidu during the summer of 2016 but that it's review was hampered by the lack of access to firm personnel and extensive redactions such that the PCAOB could not conduct a meaningful inspection.[11] Last year, two PCAOB-registered firms based in Hong Kong had their registrations revoked for violations of PCAOB audit standards and failure to cooperate with PCAOB investigations.[12]

This gap in the PCAOB's inspection program exposes not only U.S. investors to uncertainty regarding the quality of the audits being performed in China, but also U.S. companies with growing subsidiary and joint venture activity in China. Until the PCAOB satisfactorily resolves the Chinese inspection issue, U.S. investors and companies face uncertainty regarding the quality of the audits being conducted on the financial statements of Chinese issuers listed on U.S. exchanges. The PCAOB should redouble its efforts to reach an agreement with the relevant Chinese authorities on cross-border inspections. Recently, the

[10] As the SEC broadens international enforcement focus, compliance efforts must adapt, January 18, 2017, Compliance Week.

[11] Pilot Inspection Begins for EY's Chinese Affiliate, Thompson Reuters, August 4, 2016.

[12] PCAOB Sanctions Hong Kong Audit Firm and Three Individuals For Failing to Cooperate with Board Investigation, available at https://pcaobus.org/News/Releases/Pages/PKF-Hong-Kong-enforcement-1-13-16.aspx; PCAOB Sanctions Hong Kong Audit Firm, its New York Affiliate, and Four Individuals, available at https://pcaobus.org/News/Releases/Pages/PCAOB-sanctions-hong-kong-audit-firm-new-york-affiliate-four-individuals.aspx.

PCAOB issued staff guidance regarding the obligations of audit firms located outside of mainland China that audit China-based issuers listed on U.S. exchanges. Effectively, this guidance instructs PCAOB-registered audit firms to disregard – arguably violate – Chinese law governing foreign regulatory access to audit work papers, ignoring long-standing principles of international comity.[13] It will be interesting to see whether this staff guidance is enforced by the PCAOB and how the PCAOB will address such conflict of law concerns. To date, this particular issue has not been litigated in a U.S. federal court.[14]

In addition to sovereignty concerns, one obstacle, though not insurmountable, confronting U.S. regulators is the issue of state secrets. State secrecy laws in China are well known for their vague

[13] See Staff Questions and Answers – Audits of Mainland China Issuers by Registered Firms Outside of Mainland China. The Q&A responds to the circular entitled *Notice of the Ministry of Finance on* Issuing the *Interim Provisions on Auditing Operations Conducted by Accounting Firms Concerning the Overseas Listing of Domestic Chinese Companies* (see attached) issued by China's Ministry of Finance (the "MOF Rule"), which applies to audits of U.S. listed Chinese companies by overseas accounting firms. The MOF Rule includes provisions related to the conduct of auditors based outside of mainland China that perform audit work in mainland China. In particular, Article 12 of the Interim Provisions stipulates that where the listing of a mainland company becomes the subject of legal action or other matter and an overseas judicial or regulatory authority requires access to the audit working papers relating to that company, or where an overseas regulatory authority requires access to the audit working papers for a mainland company, access should be sought in accordance with the relevant supervision agreement entered into between the regulatory authorities of Mainland China and the relevant overseas jurisdiction. Notwithstanding and in spite of this regulation/directive, and in the absence of such a supervision agreement, the PCAOB Q&A provides that registered auditors must make working papers accessible to the PCAOB upon demand in accordance with Section 106 of the Sarbanes-Oxley Act. Violation of the pertinent provisions of the Sarbanes-Oxley Act may result in the deregistration of the audit firm; it could also result in the ban from auditing the financial statements of any companies with China operations, either directly or indirectly through subsidiaries, that are listed or plan to list in the U.S., effectively cutting off Chinese companies, e.g., Alibaba, from the U.S. capital markets. In addition to smaller audit firms in the U.S. and elsewhere (outside of mainland China), this guidance potentially affects all Fortune 500 U.S. public companies that have operations in China.

[14] The principles of international comity have been historically applied by U.S. courts whenever it has been determined that there if a conflict between enforcing an obligation under U.S. law to produce evidence or other documentation from a foreign jurisdiction when such obligation conflicts with the laws of that jurisdiction. For example, the U.S. Second Circuit Court of Appeals, In re Vitamin C Litigation, 13-4791-cv (2nd Cir., September 20, 2016) vacated a $147 million judgment and injunctive relief by the federal district court, ruling that Chinese vitamin C sellers were not liable for violating US antitrust law because they were compelled by the Chinese government to set prices and reduce quantities for the vitamin. The Chinese government filed a formal statement, indicating that Chinese law required the companies, Hebei Welcome Pharmaceutical and North China Pharmaceutical Group, to set prices and lower quantities of vitamin C sold abroad. The court ruled that, because the companies "could not simultaneously comply with Chinese law and U.S. antitrust laws, the principles of international comity required the district court to abstain from exercising jurisdiction in this case." The court further ruled that the lower court should have abstained from exercising jurisdiction on comity grounds because "there is a true conflict between U.S. law and Chinese law in this case" and articulated the following position with regard to the degree of deference that should be afforded to a foreign nation's interpretation of its own laws: "[w]e reaffirm the principle that when a foreign government, acting through counsel or otherwise, directly participates in U.S. court proceedings by providing a sworn evidentiary proffer regarding the construction and effect of its laws and regulations, which is reasonable under the circumstances presented, a U.S. court is bound to defer to those statements." The court noted that a contrary ruling "disregards and unravels the tradition of according respect to a foreign government's explication of its own laws, the same respect and treatment that we would expect our government to receive in comparable matters before a foreign court." The court also noted that "[t]he official statements of the Ministry should be credited and accorded deference."

language and lack of clarification; state secrets broadly can be defined as encompassing those matters involving state security and national interests. Although the relevant statute goes on to provide a list of major state secret matters, which includes "activities related to foreign countries" and "national economic and social development," there is a catch-all provision that authorizes agencies administering the protection of state secrets to identify matters not listed in the statute as state secrets. Under the implementing regulation, the State Secrecy Bureau is responsible for designing national policy on protection of state secrets, while central government agencies may separately or jointly with the State Secrecy Bureau identify matters that are "within their respective administrative areas" as state secrets.

The CSRC followed through in 2009 when it issued an agency rule jointly with the State Secrecy Bureau – commonly referred to as Notice 29.[15] The rule creates two obligations for accounting firms with respect to transfer of audit work papers. First, audit work papers that "involve any state secrets" cannot be transmitted outside China without the approval of "relevant in-charge authorities." Second, accounting firms must report "any matter involving state secrets" to "in-charge authorities . . . for approval" when "overseas securities regulatory authorities . . . propose to conduct offsite inspection." The rule concludes by reminding accounting firms of the liabilities, including criminal ones, they may incur if they violate the rule. However, Notice 29 expressly contemplates that, with the approval of the competent authorities, information that is not legitimately a state secret can be disclosed to foreign regulators.

Effectiveness of the tools and resources available to U.S. law enforcement and other relevant agencies for addressing fraud by Chinese companies listed in the United States

I believe that the current laws available to U.S. law enforcement and regulators are sufficient. Before 2002 and the passage of the Sarbanes-Oxley Act, the SEC did not have meaningful enforcement tools. Section 106 of the Sarbanes-Oxley Act increased the authority of the SEC and the PCAOB to compel the production to them of audit work papers of foreign private accounting firms by making such firms subject to the jurisdiction of U.S. courts for purposes of enforcement, requiring U.S. registered public accounting firms to secure the agreement of any foreign accounting firm upon which it relies in its audit to produce the work papers of that firm. The Act permits a foreign public accounting firm to produce work papers through alternate means, such as through foreign securities regulators.

The most formidable legal obstacle is conflicting non-U.S. laws. A foreign jurisdiction may restrict or even prohibit the transfer of certain audit work papers out of the jurisdiction with various civil or criminal liabilities that will attach if an accounting firm violates the restriction or prohibition. Foreign accounting firms can contest an SEC subpoena or document request, that complying with the request or subpoena will force them to violate a foreign law.

Over the years, the SEC has signed enforcement Memoranda of Understanding ("MOUs") with more than 75 foreign counterparts and through these MOUs the SEC sends out over 600 requests annually for assistance to foreign regulators. Though empirical evidence of the MOUs' effectiveness is lacking, the fact that the SEC continues to promote such MOUs and that such requests typically are not denied serves as testimony to their success. Indeed, on its website, the SEC has listed notable enforcement cases that are the fruits of assistance provided by foreign regulators. One of the underpinnings of such MOUs is the SEC's respect for foreign sovereignty. In virtually all enforcement MOUs, including the

[15] Provisions on Strengthening Confidentiality and Archives Administration in Overseas Issuance and Listing of Securities (promulgated by the China Sec. Regulatory Commission, State Secrecy Bureau, and State Archives Admin., Oct. 20, 2009) (China) (hereinafter Notice or Circular 29).

multi-lateral IOSCO MOU signed by most signatories, there is a clause that permits a foreign regulator to deny an assistance request if it would require the foreign regulator to “act in a manner that would violate the laws of the [foreign country]” or if accommodating the request would be contrary to the foreign country’s “public interest” or “national security.” PCAOB agreements with foreign audit regulators contain similar language.

Recommendations

For such listings to work there needs to be a regulatory framework that provides transparency and protects investors, a professional-services environment that provides effective quality control for listings, and an investor base with the knowledge and capabilities to understand the businesses properly. If regulators and investors are serious about avoiding similar crises in the future—involving companies from China or elsewhere—there are several lessons to learn.

An equity market is more than just an exchange. Investors rely on a broad, interactive system of professional advisers, equity analysts, brokers, and regulators who perform quality control on the companies that list there. The dangers come when the system takes on issues that it is not prepared to evaluate. In the major global equity markets, investors take the high standards of this ecosystem for granted, when in fact relying on audited financials and company representations alone is insufficient in many markets.

The companies involved in this case happened to be Chinese, but the elements that led to fraud there are visible in many other emerging markets, as well as in some developed ones. The lack of quality control is especially concerning with regard to companies originally listed by reverse merger, since this route to market continues to be used. Indeed, on U.S. exchanges, there have been nearly as many reverse mergers per year involving non-Chinese companies after 2011 as in the preceding five years. Investors need to be aware of the shortcomings of reporting and find ways to fill the gaps, such as through analysts doing investigative diligence, academic research, or even the regulatory bodies themselves. The last research or advisory that the PCAOB or SEC for that matter published in this area was 2011; to my knowledge, the U.S. Office of Financial Research has yet to conduct a study regarding the risks posed by Chinese listings in the U.S.

Gaps in regulatory supervision must be closed. The SEC and PCAOB don’t face a problem just with Chinese audit firms but potentially with any audit firm outside its regulatory purview. And the SEC is not the only regulatory agency facing this problem, since every other major capital market could face the same experience, particularly given the growing competition among stock exchanges. The PCAOB in particular should redouble its efforts to reach an agreement with its foreign counterparts in China and offer more transparency regarding the prospects of doing so than they have shown in the last year. The PCAOB could consider partnering with the Chinese regulators in conducting its inspections so long as it can issue an independent inspection report (or joint report that reflects the views of both regulators). Some creativity is required here.

Cross-border listings play an increasingly important and valuable role for companies and investors in an ever changing global economy—and they promote the mobility of capital, competition between exchanges, and greater strategic flexibility for companies. As of 2015, U.S. investors held nearly $9.6

trillion in foreign securities and foreign holdings of U.S. securities were over $17.1 trillion.[16] The cornerstone of federal securities law is disclosure and the SEC can amend Regulation S-K[17] to require issuers to disclose the fact that foreign accounting firms performing audit work for the issuer may, under certain circumstances, be unable to comply with an SEC Section 106 request due to conflicting non-U.S. laws. Of course, the disclosure should be sufficiently detailed, and should include, but not be limited to, a description of the pertinent foreign laws at issue so that U.S. investors can appreciate the significance of the conflicts.

Companies and/or audit firms themselves may also address this issue through their own risk management procedures. Once an issuer is aware of an increased risk, like the lack of a PCAOB inspected audit firm, it may be prudent to implement compensating controls to the extent feasible. A company or audit firm that is aware that all or a portion of an audit is being conducted by a firm that has not been inspected should consider implementing additional procedures and/or controls over that portion of the financial statement or audit in order to address this increased risk.

Other recommendations.

- China implements "prudential oversight" over its markets rather than practicing "capital market oversight". This regulatory approach in China has been the fundamental problem causing instability within the Chinese capital markets. Regulators and governments will keep the listed companies afloat to ensure investor protection, so there is little incentive for investors to focus on listed companies' governance, transparency, and management performance. U.S. regulators should initiate further education of their counterparts on capital market oversight versus prudential oversight including the general principles of each oversight framework, differences, and intended results, and why each may not work if applied incorrectly.

- The National Development and Reform Commission is a powerful agency that is in charge of reforms throughout all the central and local government in China, including capital market reform, cross-border cooperation and economic reform. Finding and establishing a channel to the National Development and Reform Commission should be a high priority.

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

[16] *See Securities (c): Annual Cross-U.S. Border Portfolio Holdings*, Report of the Department of the Treasury, *available at* https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx#usclaims.

[17] Regulation S-K, 17 C.F.R. pt. 229 (2014) (covering the form and content of, and requirements for, non-financial statements information under the federal securities law).