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Co-chairpersons Cleveland and Wessel, and members of the Commission, I thank you for the opportunity to appear before you today. My name is Paul Gillis and I am a professor at Peking University in Beijing. I am an American who was formerly a partner with PricewaterhouseCoopers and have lived in China for nearly 20 years.

China's Capital Markets

China is a socialist market economy. Ideologically, China is argued to be in the primary stage of socialism, and at that early stage certain capitalistic techniques must be deployed. China's capital markets are perhaps the most powerful of capitalistic techniques. While the Chinese conception of a socialist market economy is based on the primacy of a large, state-owned sector, the private sector now accounts for three-fifths of China's GDP and four-fifths of its workforce.

China's stock markets closed after the 1949 revolution and were not reopened until 1990. Initially, the reopened markets were used primarily to corporatize and raise capital for state owned enterprises.

At first, China's own stock exchanges were not friendly to privately held enterprises, with private companies raising only 8% of the capital that was raised on Chinese stock exchanges in 2000. Chinese stock markets opened more widely to private investment with the opening of an SME board in Shenzhen in 2005 and more significantly with the opening of ChiNext, China's version of NASDAQ in 2009. By 2009, private companies raised 67% of the capital raised on Chinese stock exchanges[1].

China's stock markets have grown significantly as its economy expanded. At present the Shanghai and Shenzhen stock exchanges list 1,161 and 1,847 companies respectively, while the NYSE lists 1,839 and NASDAQ lists 2,439 companies[2]. China has also opened a "third board" – the National Equities Exchange and Quotation (NEEQ), which has listed over 10,000 smaller companies which trade over the counter.

Foreigners are generally not permitted to purchase shares of Chinese companies through China's stock exchanges. Until China removes foreign exchange restrictions it is unlikely that these restrictions can be removed. China has tried several approaches to allowing foreigners to trade stocks listed on Chinese exchanges.

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[1] Source: CCER

[2] Source: Stock exchanges

For a time, several Chinese companies issued B shares, which were denominated in dollars and available only to foreign investors through the Shanghai Stock Exchange. B shares tended to trade at a significant discount to the A shares sold to Chinese. There are approximately 200 Chinese companies that have issued B shares. Chinese citizens are now permitted to purchase B shares but they have largely fallen out of favor.

Since 2003 China has had a scheme under which foreign institutional investors are permitted to trade in Chinese securities. The Qualified Foreign Investor program (QFII) was established in 2003 and was replaced by the RMB Qualified Foreign Investor Program (RQFII) in 2011. The program establishes quotas for each institutional investor.

The Shanghai-Hong Kong stock connect opened in 2014 to allow foreign investors to purchase shares of Chinese companies listed on the Shanghai Stock Exchange and to allow Chinese citizens to purchase shares listed on the Hong Kong Stock Exchange. The connect was extended to the Shenzhen Stock Exchange in 2016. Other "connects" have been suggested for London and Singapore. The connects represent an opening up of China's markets without relaxing currency controls.

The primary means for foreigners to purchase shares of Chinese companies has been to purchase shares on foreign exchanges. Starting in 1992 China allowed certain State owned enterprises (SOEs) to sell shares in Hong Kong as "H" shares. There are presently 241 H shares traded in Hong Kong. There are also 153 red chips listed in Hong Kong. Red Chips are offshore companies that are incorporated internationally but hold primarily mainland assets. In addition to Hong Kong, Chinese companies have listed on most of the world's stock exchanges, although Shanghai, Shenzhen, Hong Kong and the United States remain the primary destinations.

US listing of Chinese companies

China has made extensive use of U.S. capital markets in its process of opening up. That is mainly because China's own stock markets were inadequate to meet the needs of China's companies. The first Chinese company to list in the U.S. was Brilliance China Automotive Holdings which listed on the New York Stock Exchange on October 8, 1992 and was delisted in 2007.

There were three groups of Chinese companies that chose to list in the United States.

1) *Large State-Owned Enterprises (SOEs)*

In preparation for China entering the World Trade Organization in 2001, several large SOEs did initial public offerings in the United States both to raise capital for modernization as well as to import foreign corporate governance. There are presently 12 large SOEs that trades so-called N shares on the New York Stock Exchange (NYSE). The companies include several whose IPO made a list of the largest IPOs in history and several are among the largest companies in the world. Most of these companies are cross-listed in Hong Kong and Shanghai. The last NYSE IPO of a major SOE was the December 17, 2003 IPO of China Life. Since 2003, China's SOEs have listed in Hong Kong instead of the U.S.

One reason the large SOEs listed in the United States was that the Hong Kong Stock Exchange was not sufficiently developed to provide liquidity for these companies. After 2003, most SOEs

listed either on mainland exchanges or in Hong Kong, which had developed sufficiently to handle large companies

Another reason why large SOEs stopped listing in New York may be because of the difficulties faced by China Life following its IPO. Shortly after the IPO there was an SEC investigation and class action law suit concerning potential accounting irregularities. Some have argued that the difficulties faced by China Life soured Chinese bureaucrats on US listings.

2) *Private company IPOs*

The United States became the primary destination for IPOs of privately held Chinese companies. Although the private sector has had increasing significance to China's economy, it found access to credit and capital in China to be difficult. 98% of China's 40+ million small and medium sized enterprises could not obtain bank loans in China in 2006[1].

The first meaningful wave of US listings of Chinese companies came during the dotcom boom and bubble of 1995-2001. The first listings were internet companies that were essentially clones of US internet pioneers. These companies chose to list in the U.S. for several reasons.

At present, there are 135 Chinese companies listed on major US stock exchanges[3]

Listings of Chinese Companies on U.S. exchanges (January 2017)

Exchange	Listings
NASDAQ	90
NYSE	42
AMEX	3
Total	135

While far more companies have listed on Chinese stock exchanges the largest and best known companies have tended to list in the US. Alibaba is listed on the New York Stock Exchange and has a market capitalization of $242 billion. By contrast, the market capitalization of the entire ChiNext is $744 billion, evidencing that the Chinese stock markets may not yet be sufficiently large to handle some of China's largest private companies.

Listings on major Chinese stock exchanges

Exchange	Companies listed
Shenzhen ChiNext	578
SME Shenzhen	825
Main Board Shenzhen	478
Shanghai	1,194
Total	3,075

IPOs of private Chinese companies in the U.S. have slowed in recent years. The primary reason for the slowdown is the more attractive valuations available on Chinese exchanges. However, the listing process for Chinese exchanges is opaque, foreigners are restricted in participating in Chinese IPOs, and the popular control structures and VIEs are not permitted. Consequentially, I

[3] Source: Nasdaq.com

expect we will continue to see some private Chinese companies continuing to use the U.S. for IPOs, but I expect these numbers to further decline as China's stock markets develop.

3) R*everse mergers*

A reverse merger is a merger of a larger company into a smaller company, with the shareholders of the larger company controlling the merged entity. Because of relaxed U.S. regulatory requirements for reverse mergers, the technique became a popular way to "backdoor" list private Chinese companies. Over 500 Chinese companies are said to have sought US listings through reverse mergers. Most planned to raise additional capital following the reverse merger and then to seek a listing on NASDAQ or the NYSE.

Most reverse mergers involved the merger of a private Chinese company into a shell company that was already registered with the SEC. Many of these shell companies had gone bankrupt but the SEC registered shell company remained alive. The transactions were typically promoted by small U.S. investment banking firms many of which have fallen into regulatory difficulty with the SEC.

The primary advantage of a reverse merger is that it was a cheap and fast way to list a company in the U.S. Unlike an IPO, there was no SEC review prior to the transaction and auditors, investment bankers and securities lawyers were often uninvolved.

Unsurprisingly, the lack of regulation and oversight led many of these reverse mergers to collapse under fraud allegations. Both the NYSE and NASDAQ implemented rules in 2011 to require 'seasoning periods" for reverse mergers, and these rules removed the advantage of reverse mergers and they have substantially disappeared from the market.

Some reverse merger companies were successful at obtaining a listing on a major exchange. Others are traded, if at all, on over-the counter markets such as OTCBB and the Pink Sheets. Many have gone dark, where they stop communicating with shareholders and stop filing with the SEC. The failure to file ultimately leads the SEC to revoke the company's registration and the shareholder's investment is typically lost.

The reverse merger problem was caused by weak regulation but has been largely cured through regulatory action by the stock exchanges.

Why do Chinese companies list in the United States?

The size and liquidity of U.S. markets initially attracted the large SOE listings as well as early private companies. In the past 20 years both China and Hong Kong stock exchanges have grown significantly and this is no longer a compelling reason.

The U.S. permits owners to use control structures that keep voting power in the hands of founders. Most markets (including China and Hong Kong) do not allow these structures. Ever since Steve Jobs was forced from Apple by its board, technology entrepreneurs have often used two classes of stock to keep control in the hands of founders. Chinese companies have tended to follow this practice, giving voting shares to founders and non-voting shares to investors. The

Hong Kong Stock Exchange rejected a request from Jack Ma to modify its rules to allow a control structure for Alibaba, and consequently lost the listing to the New York Stock Exchange.

Overseas listings may provide opportunities for Chinese owners to obtain access to foreign currency. Concerns over capital flight have led to a crackdown on practices designed to circumvent China's currency controls.

Accounting Fraud

Starting in 2009, activist short sellers began to target overseas listed Chinese companies. Short sellers borrow and sell shares in target companies, publish negative research, and then hope to repurchase and return borrowed shares at lower prices. There have been 199 short campaigns against overseas listed Chinese companies since 2009, with activity peaking in 2011 with 65 campaigns returning 36.24% to the short sellers.

Short sellers found a target rich environment among U.S. listed Chinese companies. While some of the companies were clearly fraudsters preying on investors, others appear to have been unprepared for the challenges of reporting as a public company.

Short selling campaigns against Chinese companies

Year	Number of campaigns China & Hong Kong HQ	Campaign Returns (%)
2009	4	21.11
2010	19	80.52
2011	65	36.24
2012	19	-51.94
2013	12	-59.45
2014	28	14.71
2015	30	15.3
2016	22	13.09
Totals	**199**	

Source: Activist Insight

Privatization

High levels of fraud among U.S. listed Chinese companies led to a significant decline in market values for these companies, with many trading below the price of the initial public offering. At the same time, values of shares traded on the Chinese stock exchanges rose to extremely high values.

Over 50 U.S. listed Chinese companies have announced or completed plans to delist from U.S. stock exchanges by repurchasing outstanding shares. These companies then restructure and relist on Chinese stock exchanges, often through a reverse merger transaction. Only a few transactions have been completed all the way through relisting. A good example is Focus Media, which delisted from NASDAQ in 2013 at a value of $3.7 billion and then relisted in Shenzhen in 2015 at a value of $7.2 billion.

Curiously, before U.S. listed companies can relist in China, Chinese regulators require that the company eliminate three of the issues that have led to many problems for U.S. shareholders - offshore holding companies, variable interest entity structures, and control structures that keep insiders in control. These features are all permitted in the U.S. but not in China.

U.S. shareholders in companies facing a privatization offer are often disadvantaged. Although companies typically obtain fairness opinions on the transactions, shareholders are often concerned that the privatization offers are underpriced. Most U.S. listed Chinese companies are listed in Cayman Islands and there is significantly less investor protection available in Cayman Islands compared to typical U.S. state laws. There have been concerns that some companies may be adjusting earnings downward to justify lower going-private prices.

Variable Interest Entities

Somewhat unique to China is the extensive use of a corporate structure known as the variable interest entity (VIE)[2]. A VIE is an arrangement where a company is controlled through contracts instead of through ownership. Contracts are an inferior form of ownership compared to direct ownership of shares.

VIE structures take advantage of U.S. accounting rules that were designed to stop the abuses of Enron by requiring companies to put off balance sheet debt back on the balance sheet. Chinese companies have cleverly used these rules in a new way – to put assets that are not actually owned by the company on the balance sheet.

China restricts foreign investment in many sectors, including the internet sector that is the most popular among U.S. listed Chinese companies. The VIE structure provides a work around for these restrictions. Activities that cannot be owned by foreigners are put in a domestic company that is owned by a Chinese individual, typically the CEO of the company. This company is then put under the contractual control of the offshore public company. This allows the company to tell its story in two ways: to domestic regulators it claims to be locally owned and not subject to foreign investment restrictions, while foreign investors are led to believe that they own the entire business.

Investors have lost significant sums when VIE arrangements have failed. There have been instances where the VIE shareholder simply absconds with the VIE. Attempts to enforce the contractual arrangements have generally failed since China's Supreme Court and arbitrators have held that the VIE contracts are not enforceable under Chinese law because they attempt an illegal work around the foreign investment restrictions.

Chinese regulators are aware of the use of variable interest entities, and last year proposed legislation that would make clear that VIE arrangements were not acceptable, yet providing an exception for those VIE arrangements where a Chinese national was effectively in control of the company (such as through use of control structures that give Chinese founders control of voting). Regulations issued in October did not contain these provisions, but do require the disclosure of controlling interests.

The extensive use of VIEs by U.S. listed Chinese companies is a major source of risk for investors. The SEC has done a good job requiring companies to significantly expand disclosures. "While companies already disclose those material risks in technical compliance with relevant SEC rules, the disclosure is often lengthy, difficult to understand, and effectively buried under pages of dense, boilerplate language"[3]. While disclosures identify the risks, it is unclear whether investors fully understand them. Analysts say that U.S. listed Chinese stocks usually trade at a discount when compared to peer companies in the U.S. That discount is likely because of the risks of the VIE structure and the higher incidence of accounting fraud among U.S. listed Chinese companies. Reforms that reduced these risks should lead to higher valuations in these stocks, benefiting American investors.

PCAOB Inspections

The Public Company Accounting Oversight Board (PCAOB) was established by the Sarbanes Oxley act. The PCAOB has three primary functions. 1) The PCAOB sets the rules for auditing U.S. listed companies, a task formerly done by the American Institute of CPAs; 2) The PCAOB inspects accounting firms that audit U.S. listed companies to determine whether they are complying with the rules; and 3) The PCAOB investigates and disciplines auditors who do not follow the rules. Arguably the most important function of the PCAOB is inspections.

Every accounting firm registered with the PCAOB is to be inspected at least every three years (annually for those firms auditing over 100 issuers). There are currently 43 Chinese CPA firms and 36 Hong Kong CPA firms [4] (including affiliates of global CPA firms) that have registered with the PCAOB. When the PCAOB attempted to inspect Chinese and Hong Kong CPA firms that had registered with the PCAOB, they were blocked by Chinese regulators who argued that these inspections would impinge on China's national sovereignty and risk disclosure of state secrets.

Negotiations between Chinese regulators and the PCAOB have continued for over ten years. In 2013 the PCAOB reached agreement with Chinese regulators with respect to cooperation on investigative activities of the PCAOB. No agreement has been reached with respect to the more important inspections. Recent negotiations on a potential pilot program for inspections appear to have stalled over disputes over which companies can be inspected.

The PCAOB has reached agreements with 22 countries and territories that establish a protocol for PCAOB activities in those countries and territories. China has insisted that the PCAOB follow the lead of the European Union, which granted regulatory equivalency to China with respect to audit regulation. Regulatory equivalency allows European regulators to rely on the work of Chinese regulators as if it were their own. The PCAOB has not accepted the concept of regulatory equivalency, insisting instead on at least joint inspections. There is valid concern that foreign regulators may not have the expertise or interest in reviewing the audits of U.S. listed companies.

Inspections are the primary protection for investors from shoddy audits. Research indicates that investors are unable to distinguish between good Chinese firms and bad Chinese firms based on traditional signals of firm quality including a firm's stock returns, earnings performance, accounting quality, and external monitoring mechanisms such as auditor and underwriter quality[5]. Certainly, the information about auditor quality that would be available from PCAOB inspections would help investors to identify risk and to differentiate between good and bad Chinese firms.

Recently the PCAOB found serious problems with audits done by Deloitte affiliates in Brazil and Mexico that led to significant fines on the firms. Without inspections of firms auditing U.S. listed Chinese companies, it is not possible for investors to assess the quality of audits.

Research suggests it is in China's interest to allow PCAOB inspections. Professor Shroff of MIT examined the clients of non-U.S. auditors that were inspected by the PCAOB and found that audit quality on all of their clients improved, not just those listed in the U.S. and subject to PCAOB and SEC jurisdiction [6]. In other words, there is a spillover effect. PCAOB inspections improve all audits done by a firm in a country, not just U.S. audits that are subject to PCAOB inspection.

SEC Regulation

The SEC has brought several actions related to Chinese stocks listed in the U.S., including suits against gatekeepers like investment bankers. The SEC's Cross-Border Working Group targets companies with substantial foreign operations that are publicly traded in the U.S. Since its inception, the Working Group has been behind the SEC's filing of fraud cases against more than 65 foreign issuers or executives and deregistration of the securities of more than 50 companies[7]. The biggest case brought by the SEC was against the Chinese member firms of the Big Four accounting firms and BDO. The case charged the firms will failing to comply with a Sarbanes Oxley provision that requires the firms to provide working papers to the SEC. The firms argued that to do so would violate Chinese laws related to state secrets. An administrative trial judge banned the firms from practice for six months. That judgment was later settled with a fine of $500,000 per firm.

The SEC has had a formal information sharing agreement with China since 1994. Both China and the United States have signed the International Organization of Securities Commissions' (IOSCO) Multilateral Memorandum of Understanding Concerning Consultation and Exchange of Information. It is not clear how well these agreements are functioning to allow the SEC access

to people and documents inside China. The testimony at the Big Four administrative trial judge proceeding documented a sorry tale of China promising but not delivering documents to the SEC. SEC criminal prosecutions have been successful only against individuals present in the United States. I am unaware of any situation where China has commenced criminal prosecution for crimes committed related to overseas listed Chinese companies, even where the alleged crime is clearly a crime under China's statutes. China's securities regulators have indicated that Public Security officials have exercised their prosecutorial discretion to not focus on those crimes.

The regulation of the U.S. securities market is heavily based on disclosure of risks by issuers. The SEC has done a commendable job improving risk disclosures on U.S. listed Chinese companies, particularly the risks associated with variable interest entities. The risk disclosures have become so extensive and so boilerplate in nature that many investors overlook them. That said, analysts argue there is awareness of the risks in these stocks, evidenced by the lower values these stocks obtain in the market compared to U.S. based peers.

Recommendations

In my opinion, the major problem with respect to U.S. listed Chinese companies is the inability of the PCAOB to conduct inspections of China based accounting firms. This has resulted in a situation where there is a double standard in regulation. All auditors of companies listed in the U.S. must be inspected, except for auditors of Chinese companies (and companies of a few other minor countries), which are not inspected. While this fact is routinely disclosed in the issuer's filings, the double standard makes a mockery of U.S. regulation.

In my view, there are two alternatives to eliminate the double standards. First, Sarbanes Oxley could be amended to remove the requirement that the PCAOB inspect foreign accounting firms. Instead, the PCAOB could follow the lead of the European Union and negotiate regulatory equivalency under which the PCAOB would accept the work of Chinese regulators as their own. I do not think this is the best option, since I think it is unlikely that Chinese regulators will rigorously examine overseas listed companies nor do they have the necessary expertise in U.S. accounting and auditing rules.

The second option is to terminate the registration with the PCAOB of any auditors that the PCAOB is unable to inspect. The U.S. should require companies that seek to list in the U.S. to agree to follow all U.S. laws. If China determines that a company has state secrets that cannot be disclosed, a company with such secrets should not be permitted to list in the U.S.

Termination of accounting firm registrations would lead to the delisting of shares of companies audited by the deregistered firms, since financial statements audited by a PCAOB registered accounting firm are a requirement for continued listing. Delisted companies are likely to seek to relist in China or Hong Kong, although they may be required to restructure to eliminate control structures and/or variable interest entity arrangements that may not be permitted in the other jurisdiction. The PCAOB has so far been unwilling to go this far, likely due to opposition from capital markets.

Another problem with U.S. regulation is the overlapping jurisdiction of financial regulators. There is little secret that there is considerable tension between the SEC and the PCAOB. I believe this both confuses Chinese regulators as well as creating opportunities for Chinese bureaucrats to play one regulator off the other. I think Congress should consider abolishing the PCAOB, transferring the inspection and enforcement activities to the SEC and sending standard setting back to the American Institute of CPAs.

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