U.S.- CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

Hearing on "Corporate Accountability, Access to Credit, and Access to Markets in China's Financial System—
The Rules and Their Ramifications for U.S. Investors"

Opening Statement of Commissioner Carte Goodwin
March 07, 2013
Washington, DC

Welcome to the second hearing of the U.S.-China Commission's 2013 Annual Report cycle. This hearing will examine the state of China's markets and the impact of the Chinese government's policies on the United States. Today, we will compare rules and regulations governing U.S. and Chinese financial markets. We will examine the restrictions to credit faced by ordinary citizens in China and the implications for the Chinese economy. We will also review the barriers faced by U.S. financial firms seeking to do business in China. We have assembled an exceptionally knowledgeable set of witnesses to address different aspects of this topic, and I'd like to thank them for their participation in this hearing.

China's 12th Five-Year-Plan emphasizes boosting domestic consumption and Chinese investment abroad as the country seeks to lessen its dependence on exports and chart a successful course for sustained economic development. Achieving these goals requires that Chinese families and private sector Chinese businesses have sufficient access to capital markets. Official sources of credit in China are largely inaccessible to Chinese individuals and small-and-medium-sized enterprises, as they exist mainly to service the country's large state-owned enterprises. Unofficial sources of credit are filling in some of the gaps, but China's shadow banking system remains under-regulated and risky. U.S. financial services firms see an opportunity to help shepherd China's development of a more robust financial market. Yet firms seeking to participate in China's financial services sector face market access barriers and other operational difficulties.

Chinese entrepreneurs face difficulty at home obtaining credit, thereby limiting China's ability to diversify its economy, one of the chief goals in the Five Year Plan. Some of these smaller companies are seeking capital in the United States. Other Chinese companies have entered U.S. capital markets in recent years as part of a government plan to encourage investment abroad and to create "national champions" from among China's state-owned businesses. The larger Chinese companies have mainly listed on U.S. exchanges via initial public offerings and have accounted for the greatest share of Chinese companies' market capitalization. But those few giant companies are greatly outnumbered by the hundreds of smaller Chinese firms that have entered the U.S. markets via reverse mergers.

The reverse merger is a means of listing on U.S. exchanges by merging with already registered U.S. companies that have undergone bankruptcy or are greatly reduced in size. Such reverse mergers have historically drawn much less regulatory scrutiny by the Securities and Exchange Commission than initial public offerings. The SEC tightened registration requirements for reverse merger companies in late 2011, as it became clear that they were particularly susceptible to fraud and accounting irregularities. An ABC News investigation that aired in January 2013 found that since 2010, more than 70 Chinese companies have been removed from or left the NASDAQ and New York Stock Exchange after reports of alleged fraud and financial irregularities. Most of these are companies that entered U.S. capital markets via reverse mergers.

The Big Four accounting firms (PricewaterhouseCoopers; KPMG; Deloitte Touche Tohmatsu; and Ernst & Young) audit approximately 88% of all U.S.-listed Chinese companies.[i] During recent probes, the SEC has sought audit work papers from the accounting firms, a common step during fraud investigations. To date, the firms have refused to produce these documents, arguing that doing so would put them in violation of Chinese state secret laws. During the SEC's investigation of Deloitte Touche Tohmatsu's auditing of China-based Longtop Financial Technologies, for instance, Deloitte said Chinese regulators had warned them that turning over working papers to the SEC could lead to life imprisonment for the partners involved and to the firm being banned from China.[ii]

In China, sharing accounting information with foreign regulators and removing audit papers from the country violates Chinese state secrets laws, and Chinese authorities do not permit non-Chinese regulators to conduct investigations in China.[iii] But in the U.S., withholding foreign public accounting paperwork of U.S.-traded companies violates both the Securities Exchange Act and the Sarbanes-Oxley Act, which require foreign audit firms to produce documents concerning U.S.-listed clients at the SEC's request.[iv]

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress empowered the Public Company Accounting Oversight Board to negotiate agreements for reciprocal inspections with audit regulators outside the U.S., as well as the confidential exchange of information with other regulators. Such cooperation between the PCAOB and foreign auditing oversight bodies is aimed at encouraging jurisdictions to better harmonize auditing standards and requirements. That way, U.S. regulators can avoid legal conflicts such as the one that exists among the SEC and the CSRC and Ministry of Finance.[v] The PCAOB now has cooperation agreements with 16 nations. After the 2010 Strategic and Economic Dialogue, the United States and China announced their intent to negotiate such an agreement on the sharing of confidential information for regulatory purposes.[vi] However, the PCAOB has yet to achieve that goal with China, despite ongoing negotiations.

The PCAOB contends that Chinese government disclosure limitations create a gap in investor protection. The lack of an information sharing agreement with China not only limits U.S. regulators' ability to ensure proper conduct at the Big Four accounting firms, it also limits their ability to ensure proper conduct at the Chinese-domiciled accounting firms that audit U.S.-listed Chinese companies and the Chinese operations of U.S. companies.
Unfortunately, these issues are not limited to U.S.-listed Chinese companies, but also extend to U.S. companies' operations in China. For example, on January 18, Caterpillar disclosed

"deliberate, multi-year, coordinated accounting misconduct" at a unit of its recently acquired ERA Mining Machinery. Caterpillar said it would write off most of the $654 million it had paid to acquire ERA only months earlier. Caterpillar has disclosed $450 million in inventory "discrepancies," inflated profits and improperly recorded costs and revenue at the Siwei unit. The Caterpillar experience and the growing catalog of deception and abuse involving smaller U.S. affiliates' operations within China indicate that U.S. firms face unique accounting and governance challenges there.

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[i] Paul Gillis, "Who Audits China?" China Accounting Blog, November 22, 2011.
[ii] Megan Mcardle, "Accounting War," The Daily Beast, December 13, 2012.
[iii] Michelle FlorCruz, *Standoff Between US, Chinese Over Audits of Chinese Firms Could Mean Delisting From US Exchanges for Many Chinese Companies*, International Business Times, December 4, 2012
[iv] Kathy Chu, Michael Rapaport and Ben Dummett, *SEC Probe Puts China Listings in Doubt, The Wall Street Journal*, December 4, 2012
[v] Cynthia Fornelli, "Financial Reporting and Confidence in Trading Markets," Center for Professional Education, Inc. 2011 SEC Conference, June 21, 2011.
[vi] Cynthia Fornelli, "Financial Reporting and Confidence in Trading Markets," Center for Professional Education, Inc. 2011 SEC Conference, June 21, 2011.