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Dr. Paul L. Gillis
Professor of Practice
Guanghua School of Management, Peking University, Beijing, China

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Co-chairpersons Bartholomew and Cleveland, 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 over 21 years.

China's Capital Markets

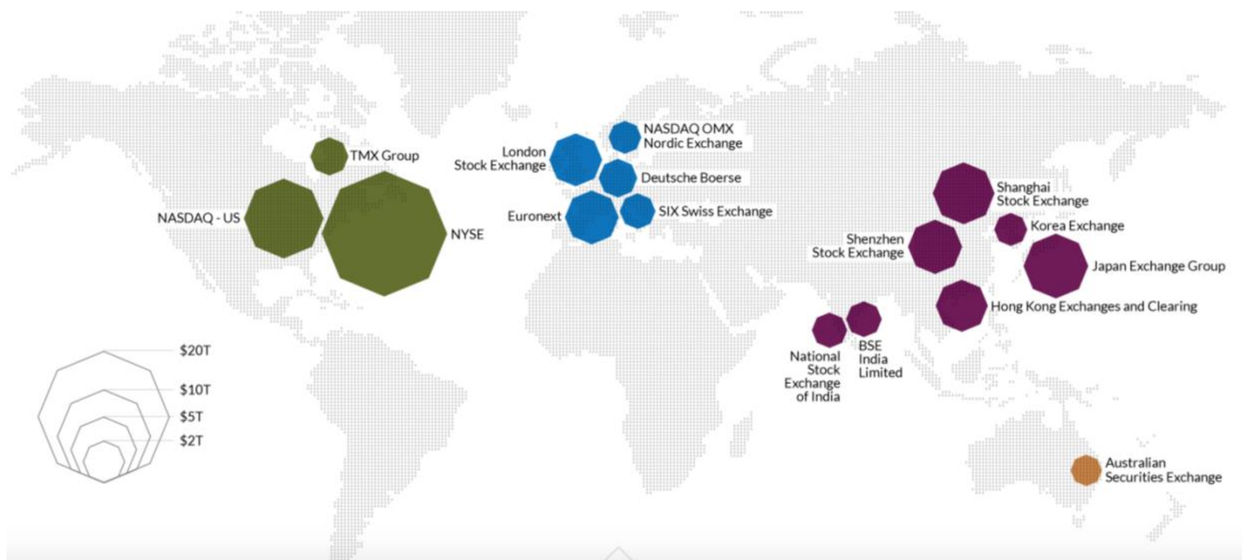
China is a socialist market economy. Ideologically, China is argued to be in the primary stage of socialism, and at that early stage certain capitalistic techniques must be deployed. China's capital markets are perhaps the most powerful of capitalistic techniques. While the Chinese conception of a socialist 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 1,460 and 2,141 companies respectively, while the NYSE lists 2,800 and NASDAQ lists 3,426 companies[2]. China has also opened a "third board" – the National Equities Exchange and Quotation (NEEQ), which has listed over 10,500 smaller companies which trade over the counter to accredited investors. A new technology bourse has been proposed for Shanghai.

While China and Hong Kong's stock markets remain smaller than leading US exchanges, they have grown to be among the world's largest markets.



Source: http://money.visualcapitalist.com/all-of-the-worlds-stock-exchanges-by-size/

Foreign investment through China's stock exchanges

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.

For a time, some 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. China's stock markets are dominated by individual investors and encouraging foreign investment brings more sophisticated investors to the market. 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.

Morgan Stanley Capital International (MSCI)[3] publishes an index used to measure equity market performance in global emerging markets. The index is important because many institutional investors measure their performance against the index, so they often own the same shares as

are included in the index in order to perform similarly to the index. On May 31, 2018 MCSI included 226 large cap A shares in its emerging markets index at a weighting of 5% (half on May 31, 2018, the other half in August). The inclusion was forecast to lead to approximately $22 billion of capital inflows into these stocks. The initial inclusion of A shares boosted China's proportion of the index by .8% to 31.3%. Full inclusion of A shares would result in China's weighting rising to 40% of the emerging markets index.

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. By listing companies overseas China was able to import foreign corporate governance processes that might have proved difficult to directly impose on local 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 practices. There are presently 12 large SOEs that trade 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.

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 the publicly held shares of 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. Yet, China has not withdrawn the existing listings of SOEs in the US.

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[4].

The first meaningful wave of US listings of Chinese companies came during the dotcom boom and bubble of 1995-2001. Most of 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, discussed further below.

At present, there are 167 Chinese companies listed on major US stock exchanges[5]

Listings of Chinese Companies on U.S. exchanges (February 2019)

NASDAQ	124
NYSE	38
AMEX	5
Total	167

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 $431 billion. By contrast, the market capitalization of the entire ChiNext is $692 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	743
SME Shenzhen	926
Main Board Shenzhen	473
Shanghai	1,505
Total	3,647

Source: Exchange websites

IPOs of private Chinese companies in the U.S. have slowed in recent years. Many companies are unicorns, pre-IPO companies valued at over $1 billion that have deferred their IPOs to a later stage than was done in the past. There are presently more unicorns in China (181) than in the United States (138). Six of the ten largest unicorns globally are in China.

There have also been more attractive valuations available on Chinese exchanges, particularly for smaller companies, although the Chinese market tends to be highly volatile. The listing process for Chinese exchanges is opaque, foreigners are restricted in participating in Chinese IPOs, and the popular control structures and VIEs have not been permitted. Consequentially, I 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.

Private companies began to list in the U.S. in significant numbers beginning with the IPOs of Sina.com and Sohu.com in 2000. Alibaba became the largest IPO in history when it listed in New York in 2014. There are several reasons why this is the case.

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) have not allowed these structures (however, competition from the U.S. has led both China and Hong Kong to liberalize their rules. 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.

The process of doing an IPO in the U.S. involves companies first selecting advisors – typically led by a U.S. investment bank as underwriter, although Chinese investment banks have entered this space. Auditors and several sets of law firms (local and US counsel, as well as separate counsel for the underwriter. The company faces a decision of whether to list in the U.S. or Hong

Kong. The decision may be guided by investment bankers, who usually obtain a higher fee through a U.S. listing.

Chinese buying shares of overseas listed companies

Many of China's most successful companies are not listed in China and only trade on international exchanges, primarily in the United States and Hong Kong. This has created a significant issue because China severely restricts the ability of its nationals to obtain foreign currency. Consequentially, most Chinese are unable to purchase shares of China's most successful companies. Rather than relax exchange controls, China has created a way for Chinese investors to buy stock in overseas listed Chinese companies.

The primary method at present are the Connects between the Shanghai and Shenzhen exchanges and the Hong Kong Stock Exchange. Under the Connects, Chinese nationals can buy Hong Kong stocks paying in local currency and receiving local currency upon sale. Similarly, foreigners can buy Chinese stocks in Hong Kong using Hong Kong dollars and receiving Hong Kong dollars upon sale.

There is currently discussion about extending the Connects to London and Singapore. It is theoretically possible to extend the Connects to U.S. exchanges, but to do so would require significant regulatory changes in the U.S.

In November 2018, Chinese president Xi Jinping announced plans to open a technology-oriented bourse in Shanghai to create more alternatives for Chinese companies to raise capital. Proposed rules for this bourse indicate significant regulatory changes in an attempt to encourage companies to list at home. The new bourse proposes to follow the U.S. approach to IPOs, adopting a disclosure-based system similar to the SEC and allowing companies rather than regulators to decide on the timing of an IPO.

Perhaps more significant for the new bourse is to allow offshore companies (most US listings of Chinese companies are incorporated in the Cayman Islands) and to follow the US in allowing loss making companies and those using control structures and VIEs to list. This would be done through China Depositary Receipts (CDRs) which would allow a company like Alibaba to list shares in China that would be denominated in local currency. There was a push to have Xiaomi use the CDR structure for its listing in Hong Kong in 2018, but there ended up being too many unanswered questions at the time of its offering. I expect most of the major U.S. listed Chinese companies to come under considerable pressure to issue CDRs. The CDR mechanism may be the way for some U.S. listed Chinese companies to move their listing to China. If they are able to sell sufficient shares to Chinese, they can buy back shares from U.S. investors. Because the value of these companies is often very high, this is not a process that will likely play out in the short term.

While it may be technically possible for the CDR approach to allow U.S. multinationals to sell shares in China, I do not see this as likely in the near term. CDRs will be used primarily to provide a secondary listing for overseas listed Chinese companies.

Foreigners acquiring Chinese shares

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.

Problems with U.S. listed Chinese Companies

Some analysts have argued that U.S. listed companies are valued lower than their American peers, while the fundamentals of the Chinese market suggest these companies should be valued higher because of greater market potential. The reason for the lower valuation appears rooted in several risk factors that are present with these securities.

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 over 200 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 selling activities against U.S. listed Chinese companies have declined since 2011, likely because of two reasons. Short selling is challenging in a rising market, and the low hanging fruit of easily identified frauds has been picked. Since 2011, more short sellers appear to have focused on Hong Kong listed Chinese companies, where low levels of regulatory oversight may have created ideal conditions for 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.

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 intend to 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)[6]. 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 proposed legislation in 2015 that would make clear that VIE arrangements were not acceptable yet provide 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). The legislation was not enacted, and recently reintroduced legislation does not include this provision.

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”[7]. 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 38 Chinese CPA firms and 32 Hong Kong CPA firms[8] (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[9]. 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.

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[10]. 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.

On December 7, 2018 the SEC and the PCAOB issued a rare joint statement bemoaning the fact that the PCAOB is banned from inspecting Chinese accounting firms.[11] Negotiations with China to allow PCAOB inspectors to inspect the audit work of Chinese firms (mostly Chinese affiliates of the Big Four) have been underway for over a decade, and are ongoing, but little progress has been made. China objects to the inspections as an impingement on its national sovereignty, and as a risk that national secrets might be disclosed.

The PCAOB has so far been unwilling to take unilateral action by deregistering Chinese auditors it cannot inspect. This alternative has been called the nuclear option, since it would effectively revoke the listing of Chinese companies in the US, with potentially adverse impact on the Big Four, investors, and the US stock exchanges.

On December 10, 2018 Representative K. Michael Conaway (R-Texas) introduced HR 7234[12], Holding Foreign Companies Accountable Act, which proposed to amend the Sarbanes-Oxley Act of 2002 to require issuers audited by uninspected accounting firms to disclose this fact to the SEC annually. This disclosure would not change the current situation, since the inspection issues are already reported by these companies as a risk factor. The bill, however, requires the delisting from national stock exchanges for companies that disclose their auditor is not inspected for three consecutive years. Effectively, the legislation would start a three-year transition period for negotiations with China to bear fruit, or for the companies involved to work out how to move their listings from New York to Hong Kong, Shanghai, or Shenzhen.

One of the concerns about the nuclear option was that it might have an adverse effect on US companies with significant operations in China. A Wall Street Journal article[13] on July 21, 2018 reported a number of US multinationals where China based auditors perform a significant amount of work for their U.S. affiliate who audits those companies. Under PCAOB rules, only auditors who perform a substantial role in the audit are required to register[14]. “Substantial role” is generally defined as a situation where the foreign auditor audits at least 20% of assets or revenue or has fees or hours of at least 20% of the total fee or hours. I believe such situations are rare, applying only to a handful of companies where substantially all operations are in China (such as Yum China Holdings, Inc. (YUMC – NYSE). The SEC/PCAOB statement claims that 207 multinational companies have reported that Chinese (or Belgium, which also bans inspections) auditors have done more than 5% of the audit work that is reported on by other auditors. But the actual threshold for material participation is much higher than 5%.

HR 7234 appears to have avoided this issue by only banning those companies who use the Chinese affiliate of the Big Four (or another Chinese CPA firm) to issue their audit report, but not those whose Chinese affiliate performs a substantial role in the audit. This would appear to limit the issue to Chinese auditors, which will reduce the impact on American investors and American multinationals with significant Chinese operations.

HR 7234 was not enacted before the end of the 115th Congress and has yet to be reintroduced. Senator Marco Rubio has indicated an interest in introducing legislation concerning China and specifically this issue[15].

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[16]. 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.

Inadequate disclosure

Most U.S. listed Chinese companies are classified as foreign private issuers (FPIs) by the SEC. FPIs are companies that meet specific rules limiting the extent of U.S. management and shareholding. FPI's are subject to lower disclosure rules, likely because the SEC wished to encourage foreign companies to list on U.S. exchanges and most FPIs have historically been subject to regulation by a home country exchange. None of the U.S. listed Chinese companies (other than some state-controlled entities) are subject to regulation by Chinese exchanges.

One of the best rules that the SEC ever put in place was Regulation Fair Disclosure, or Reg FD, which was promulgated in 2000. Reg FD mandates that public companies must disclose material information to all investors at the same time.

Prior to Reg FD, companies would often disclose market-moving information to certain investors before others, allowing them to profit by placing trades before the information became widely known. Reg FD does not apply to FPIs, and I believe this leads to pervasive insider trading in the shares of U.S. listed Chinese companies.

FPIs are also exempted from certain other corporate governance practices that most listed companies must observe. FPIs are not required to file quarterly reports on Form 10Q together with auditor reviews. Most FPIs voluntarily disclose quarterly information, but it is not reviewed by auditors.

FPIs are not required to hold annual shareholder meetings unless required by local law where they are incorporated. The Cayman Islands, where most U.S. listed Chinese companies are incorporated, does not require annual meetings. Many still hold annual meetings, although Baidu has not held a meeting in over a decade.

Corporate governance: the race to the bottom

One of the attractions of listing in the U.S. is that the U.S. tolerates certain corporate governance practices that few other countries permit. First was the reverse merger process that has largely been shut down by exchange regulation. Second is lower disclosure and corporate governance practices for FPIs. Third is the use of control structures that allow the founders to retain voting control. Fourth is allowing loss making companies to list. Finally, is the acceptance of VIEs.

Hong Kong has modified its listing rules to permit the use of control structures and to allow loss making companies to list. These modifications were made despite considerable opposition because of fear that Hong Kong would miss out on future Chinese listings to the U.S. if it did not relax its rules. Hong Kong lost the Alibaba listing to New York when Hong Kong regulators refused to allow it to use a control structure. Hong Kong already permits the use of VIEs although it requires significantly less disclosure about them. US generally accepted accounting principles require vastly more disclosure about VIEs than does International Financial Reporting Standards that are used in Hong Kong.

While China does not allow the listing of loss-making companies, those with VIEs, those incorporated outside China, or those with control structures, it has indicated that it will allow these companies to list CDRs on Chinese exchanges.

U.S operations of U.S. listed Chinese companies

Few of the U.S. listed Chinese companies have significant U.S. based operations. That is because most are fairly early stage companies and have focused on the China market. As growth in the China market slows, some companies like Alibaba have begun to focus on developing international markets, but many, like bike sharing company OFO, have failed in efforts to do so.

Many U.S. listed Chinese companies have significant cash reserves and have been acquiring technology in the U.S. Acquisitions of U.S. companies have slowed significantly likely because of the combined impact of enhanced CFIUS oversight and China's crackdown on foreign exchange practices. Some U.S. listed Chinese companies are making early stage investments in U.S. based startups, such as TuSimple, a San Diego startup founded by Chinese nationals that is developing self-driving trucks in the U.S. and China. Sina has recently led a series D funding round that raised $95 million and made the company a unicorn[17].

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 three 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 market participants.

The final option would be to adopt legislation similar to HR 7234. This option is preferable to deregistering the firms, since it appears to avoid unintentionally hurting U.S. MNCs. It is also likely to lead to the U.S. listings move to Hong Kong, unless American negotiators can use the proposed legislation as leverage in obtaining inspection rights.

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.

Finally, I recommend that the SEC modify the disclosure rules to limit the lower disclosure and corporate governance practices allowed for FPIs to those FPIs that are actually listed in their home countries and are subject to alternative disclosure and governance practices.

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