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BLOG

Division of Corporation Finance Issues New Guidance on Disclosures for China-Based Issuers

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On November 23, 2020, the Division of Corporation Finance (the Division) of the U.S. Securities and Exchange Commission (the SEC) released new disclosure guidance[1] on the Division's views regarding disclosures for companies based in, or with the majority of their operations located in, China. The disclosure guidance is in response to one of the recommendations of the President's Working Group on Financial Markets (the PWG) to the SEC to issue guidance to issuers from non-cooperating jurisdictions (NCJs), including China, to include enhanced and prominent issuer disclosures of the risks of investing in issuers from NCJs, including on issues such as corporate structure, the risks related to a lack of enforcement mechanisms in the NCJ's regulatory environment, and non-compliance with Public Company Accounting Oversight Board (PCAOB) inspection requirements.

The Division noted that while China-based issuers accessing U.S. capital markets typically have the same disclosure obligations and responsibilities as other non-U.S. issuers, the SEC's "ability to promote and enforce high-quality disclosure standards for China-based [issuers] may be materially limited." With the heightened risk of incomplete or inaccurate disclosures that could lead to greater investor harm, the Division highlighted disclosure considerations that China-based issuers should consider as they fulfill their obligations under U.S. federal securities laws:

Risks Associated with China-Based Issuers

TOPIC	DESCRIPTION

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Risks Related to High-Quality and Reliable Financial Reporting	Currently, PCAOB is restricted from inspecting the audit work and practices of PCAOB-registered public accounting firms in China and Hong Kong. While the Sarbanes-Oxley Act of 2002 requires the PCAOB to inspect registered accounting firms to access compliance with auditing standards, investigate, and bring enforcement actions for non-compliance, China has not provided the PCAOB access to inspect or investigate these firms with respect to China-based issuers. In response, the U.S. House of Representatives and U.S. Senate have passed bills that could result in the delisting of companies that use an auditor that the PCAOB is not permitted to inspect. Moreover, the PWG has recommended that U.S. stock exchanges require PCAOB access to working papers of the principal audit firm as a condition to initial and continued listing. These efforts may have an adverse impact on the trading prices of securities or terminate the trading of securities of China-based issuers.
Risks Related to Access to Information and Regulatory Oversight	China has restricted U.S. regulator access to information, as well as investigations of, or the pursuit of remedies against, China-based issuers, under state secrecy and national security laws. Under Article 177 of the PRC Securities Law, no overseas securities regulator is permitted to directly conduct investigations or perform evidence-collecting activities within the PRC, and no entity or individual in China is permitted to provide documentation or information relating to securities business activities to an overseas regulator without governmental approval. U.S. authorities have faced significant challenges in bringing and enforcing actions against China-based issuers, as well as against their officers and directors. As a result, investors in China-based issuers may not benefit from a transparent regulatory environment.

TOPIC	DESCRIPTION
Risks Related to a Company's Organizational Structure	Current regulations in China limit or prohibit foreign investment in Chinese companies operating in certain industries (e.g., telecommunications, educational institutions, etc.). To circumvent these restrictions, many China-based issuers form non-Chinese holding companies that are intended to mimic direct ownership of the companies and that enter contractual arrangements with Chinese operating companies. Through these arrangements, China-based issuers can consolidate the Chinese operating company (or variable interest entity (VIE)) into its financial statements even though its legal control of the operating company is a question of Chinese law. These structures can pose risks to U.S. investors that are not present in other organizational structures, because (1) exerting control through contractual obligations may be less effective than direct equity ownership; (2) the Chinese government could determine that these structures do not comply with applicable Chinese laws and regulations, including restrictions on foreign ownership; and (3) a China-based issuer's control over a VIE may be jeopardized if a natural person who holds equity interest in the VIE breaches the terms of the agreements, is subject to legal proceedings, or if physical instruments (i.e., chops and seals) are used without the China-based issuer's authorizations to enter into contractual obligations in China.
Risks Related to the Regulatory Environment	The Chinese legal system is substantially different from the American legal system, which may raise risks concerning the intent, effect, and enforcement of its laws, rules, and regulations, including those that restrict the inflow and outflow of foreign capital or provide the Chinese governmental with significant authority to exert influence on a China-based issuer's ability to conduct business or raise capital. This lack of certainty may result in the inconsistent and unpredictable interpretation and enforcement of laws, rules, and regulations, which may change quickly.

Differences in Shareholder Rights and Recourses, Governance, and Reporting Associated with China-Based Issuers

TOPIC	DESCRIPTION

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Limitations on Shareholder Rights & Recourse	Legal claims, including securities law claims, against China-based issuers or their officers, directors, and gatekeepers may be difficult or impossible for investors to pursue in U.S. courts. Enforcing a judgment against China-based issuers, whose related assets or persons are typically located outside the U.S. and in jurisdictions that do not recognize or enforce U.S. judgments, may also be difficult. The claims and remedies available in jurisdictions where a China-based issuer maintains assets may be significantly different than those available in the U.S. and may be difficult to pursue.
Corporate Law & Corporate Governance Differences	China-based issuers may be organized or incorporated in jurisdictions outside of both China and the U.S. (e.g., the Cayman Islands, British Virgin Islands, etc.), and the differences between the corporate law and governance rules and practices of these jurisdictions and U.S. jurisdictions may give rise to additional material risks and fewer shareholder protections. Some China-based issuers qualify as foreign private issuers (FPIs), which are exempt from certain corporate governance rules of U.S. stock exchanges that are applicable to U.S. domestic issuers, including (1) having a majority of independent directors; (2) having independent audit committee members, compensation committee members, and nominating committee members; (3) having independent board members meet in executive session; (4) holding annual meetings; and (5) obtaining shareholder approval for certain issuances of securities.
Reporting Differences	If a China-based issuer qualifies as an FPI, it will be exempt from certain reporting requirements under the U.S. federal securities laws applicable to U.S. domestic issuers, including (1) quarterly reports and certifications by the principal executive and financial officers; (2) current reports on Form 8-K that domestic issuers are required to file upon the occurrence of specified events; (3) the solicitation of proxies, consents, or authorizations under Section 14 of the Exchange Act; (4) rules that require insiders to comply with Section 16 of the Exchange Act; and (5) Regulation FD.

Disclosure Considerations for China-Based Issuers

The Division also noted that China-based issuers must fully disclose material risks related to their operations in China. The SEC guidance provides five categories of questions, with a series of more-detailed questions under each category, for China-based issuers to consider as they assess those risks and related disclosure obligations:

- Does the company provide clear and prominent disclosure of PCAOB inspection limitations and lack of enforcement mechanisms, as well as the risks relating to the quality of the financial statements?
- Does the company use VIEs in its organizational structure? If so, does the company include sufficient disclosure about the related party transactions in the VIE structure and caution investors about the risks associated with the

VIE structure employed in China?

- Does the company disclose risks relating to the regulatory environment in China, including risks related to a less-developed legal system, which may result in inconsistent and unpredictable interpretation and enforcement of laws and regulations?
- Does the company provide risk disclosure about differing shareholder rights and remedies in the company's country of organization and/or based on where a company's operations are located?
- If the company is an FPI, does it describe:
  - corporate governance differences pursuant to Item 16G of Form 20-F?
  - differences in reporting requirements between U.S. domestic issuers and foreign private issuers such as the frequency of financial reporting, the exemption from filing quarterly reports and proxy solicitation materials, and the exemption from Regulation FD?

Conclusion

The SEC's disclosure guidance is the latest step in a growing series of actions in recent months by the White House, Congress, and the SEC to tighten enforcement of U.S. federal securities laws with respect to China-based issuers, as reported in our blogs in Winston's Capital Markets & Securities Law Watch.

Recent news reports indicate that the SEC is preparing to implement another recommendation of the PWG by proposing rules to enhance the listing standards of U.S. stock exchanges to require, as a condition to initial and continued listing: (a) PCAOB access to work papers of the principal audit firm for the audit of the listed company, or (b) alternatively, providing a co-audit from an audit firm in a non-NCJ jurisdiction with comparable resources and experience where the PCAOB has sufficient access to audit work papers and practices to inspect the co-audit firm. Failure to comply with these listing standards could result in delisting of the China-based issuer starting in 2022, when the new rules are expected to be effective. Outgoing SEC Chairman Clayton had directed the SEC staff to prepare proposals in response to the PWG recommendations in August 2020, as soon as the PWG's recommendations were issued.

Winston's Capital Markets & Securities Law Watch will continue to monitor developments, including any proposed SEC rules, and bring updates to our readers.

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[1] The Division's guidance represents the views of the Division and its staff, and it is not a "rule, regulation or statement of the Securities and Exchange Commission." It has no legal force or effect; however, it should be taken as a view of the Division's policy and interpretation of currently effective rules and regulations.

7 Min Read

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