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BLOG

SEC Chair Directs Staff to Require Additional Disclosures and Engage in Targeted Reviews of Issuers Associated with China-based Operating Companies

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On July 30, 2021, SEC Chair Gary Gensler directed the SEC staff to seek certain disclosures and engage in targeted reviews of issuers associated with China-based operating companies in order to enhance the overall quality of disclosures in SEC registration statements and filings of these issuers. Chairman Gensler's statements follow recent restrictions and guidance issued by the Chinese government on China-based companies raising capital offshore and build on the SEC Division of Corporation Finance's previous guidance on disclosures for China-based companies discussed in previous Capital Markets & Securities Law Watch posts on July 30, 2021, and November 30, 2020.

Under Chinese regulations, Chinese companies in a number of sectors are not permitted to have foreign investors or to list directly on a stock exchange outside China. To raise capital offshore, Chinese operating companies often use a variable interest entity (VIE) structure in which an offshore shell company enters into service contracts with the operating company and issues shares to investors in the offshore market. While neither the shell company nor the investors have any equity ownership interest in the China-based operating company, for accounting purposes, the shell company is able to consolidate the operating company into its financial statements. Chairman Gensler stated his concern that "average investors may not realize that they hold stock in a shell company rather than a China-based operating company."

In view of the recent actions by the Chinese government and concern about the risks associated with the China-based VIE structure, Chairman Gensler directed the SEC staff to require clear and prominent disclosures in registration statements of issuers based in China or issuers associated with China-based operating companies with respect to the following:

- disclosure that investors in a shell company with a VIE structure are not buying shares of a China-based operating company but are instead buying shares of a shell company issuer that maintains service agreements with the associated VIE operating company. The business description of the issuer should clearly distinguish the description of the shell company's management services from the description of the China-based operating company;
- disclosure that the China-based operating company, the shell company issuer, and investors face uncertainty about future actions by the government of China that could significantly affect the operating company's financial performance and the enforceability of the contractual arrangements;

- inclusion of detailed financial information, including quantitative metrics, so that investors can understand the financial relationship between the VIE operating company and the shell company issuer;
- disclosure of whether the China-based operating company and the shell company issuer, when applicable, received or were denied permission from Chinese authorities to list on U.S. exchanges; the risks that such approval could be denied or rescinded; and a duty to disclose whether approval was rescinded[1]; and
- disclosure that the Holding Foreign Companies Accountable Act, which requires that the Public Company Accounting Oversight Board (PCAOB) be permitted to inspect the issuer's public-accounting firm within three years, may result in the delisting of the issuer in the future if the PCAOB is unable to inspect the audit firm.

In addition, Chairman Gensler asked the SEC staff to engage in targeted additional reviews of filings of companies with significant China-based operations.

Chairman Gensler indicated that he believes these changes will enhance the overall quality of disclosures of issuers associated with China-based operating companies, which "are crucial to informed investment decision-making and are at the heart of the SEC's mandate to protect investors in the U.S. capital markets."

Capital Markets & Securities Law Watch will continue to monitor developments in this area and will provide any updates.

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[1] This disclosure requirement is likely influenced by the recent Didi IPO, in which the issuer proceeded with the IPO before having fully addressed concerns raised by the Chinese government and subsequently became subject to significant Chinese regulatory review on its business.

3 Min Read

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