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Report on Protecting United States Investors From Significant Risks From Chinese Companies:

An Update to Delisting of Chinese Companies from US Exchanges

US – August 24, 2020

Summary

On August 6, 2020, the President's Working Group on Financial Markets (PWG) released its "Report on Protecting United States Investors from Significant Risks from Chinese Companies" (Report) pursuant to a directive from President Trump issued on June 4, 2020. The Report is the latest development in the US government's efforts to level the playing field among issuers listed on US exchanges, an initiative spurred by the US Senate's May 20, 2020, unanimous passage of S. 945 Holding Foreign Companies Accountable Act (Act).

The Securities and Exchange Commission (SEC), which oversees the Public Company Accounting Oversight Board (PCAOB), mandates that in order to list on US exchanges, companies must provide access to these documents to the PCAOB. Presently, the PWG is tasked with examining certain risks to investors in US financial markets, resulting from the inability of the PCAOB to access the audit work papers of US-listed companies whose operations are based in China (Chinese Companies). As analyzed in our prior publication, "Delisting From Exchanges," Chinese law currently prohibits Chinese Companies from sharing materials relating to securities business activities overseas.

Both the Report and the Act (together, the Measures) still must go through the required procedures to take effect. The Measures should continue to move forward in the US, but in the interim, certain actions have been proactively taken that could significantly alter the landscape of capital markets, including revisions to exchange listing requirements in mainland China and Hong Kong, going private transactions and secondary listings on alternative exchanges.

A Solution for the Chinese Companies Caught Between Conflicting Laws?

The Report offers five recommendations that would have to go through the rulemaking process if adopted by the SEC. The core recommendation outlines the mechanisms through which the SEC may delist or suspend issuers for non-compliance with certain existing requirements for initial and continued listing on US exchanges.

More importantly, the Report offers a workaround for the Chinese Companies faced with the underlying challenge of conflicting laws: the SEC requirement that any listed company provide access to primary auditor work papers to the PCAOB and Chinese law prohibiting the Chinese Companies from sharing such information.

The Report offers companies stuck in that awkward position the option to seek a "co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the co-audit firm." In essence, the primary auditor of the Chinese Company will provide to "an affiliated US-member registered public accounting firm" access to the primary auditor's work papers of its audit of the Chinese Company. The US accounting firm will then submit its audit-of-the-audit to the PCAOB and, seemingly, also shoulder accountability for the primary audit, as well as its own. Whether this workaround would be an effective resolution should the SEC implement such a rule remains to be seen.

Finally, the Report also addresses the audit visibility gap through the remaining four recommendations. Those recommendations focus on enhanced risk disclosure and diligence, not only by the issuers (i.e., Chinese Companies), but now also on the part of investment funds, the funds' managers and investment advisers.

Due Diligence on Index Providers and Its Potential Impact on US Investment Into Chinese Companies

Notably, one recommendation is to encourage or require registered funds to conduct due diligence on index providers. This could be seen as an attempt to encourage foreign indexes to tighten their own internal regulations, which carries the potential for consequential impact on Chinese companies more broadly.

Reading between the lines, a fund or ETF lacking sufficient visibility into the companies listed on an index may face consequences for continuing to offer products that include those indexes, at least some of which contain Chinese Companies. The Report confirms as much in its guidance regarding the type of diligence enhancements the SEC should require:

> "Due diligence should address whether the process [employed by funds and ETFs] takes into account any potential errors in index data, index computation and/or index construction if the information from issuers based in NCJs, including China, is unreliable or outdated or if less information about such companies is publicly available due to differences in regulatory, accounting, auditing and financial recordkeeping standards."

If the SEC implements this recommendation and attaches consequences for non-compliance by mutual funds and ETFs, this indirect approach could impact investment by US investors into Chinese Companies.

Secondary Listings in Hong Kong

A perfect storm appears to have positioned Hong Kong as a solution to the uncertainty surrounding the present situation. The spark igniting the secondary listing trend can be attributed to the November 2019 secondary listing in Hong Kong by Alibaba, which netted the company nearly US$13 billion in additional capital. Alibaba's successful secondary listing has mainstreamed a growing trend of secondary listings by massive Chinese Companies in the technology sector. For example, in June, both JD.com and NetEase completed secondary Hong Kong listings that raised US$4 billion and US$2.8 billion respectively. Notably, the Chinese financial technology company founded by Jack Ma, Ant Group Co., announced in July that it plans concurrent primary and secondary listings in Hong Kong and Shanghai. As per *The Wall Street Journal*, the company was last valued at US$150 billion.

Note that Hong Kong recently instituted landmark revisions to the Hang Seng Index, an index traditionally dominated by financial services companies. Those revisions loosened the requirements for inclusion on the Hang Seng, and it was announced this month that Chinese Company giants Alibaba, Xiaomi and WuXi Biologics will now all be included in the index.

The Rise in Chinese Companies Going Private

Alternatively, an increasing number of Chinese Companies have engaged in going private transactions. This uptick will likely continue to gain momentum, creating lucrative opportunities for those supporting the transactions, yet increasing risk for US investors in the Companies.

In 2020 alone, examples of Chinese Companies entering into definitive agreements that will result in going private, include 58.com Inc., Bitauto Holding Ltd., Cellular Biomedicine Group, Inc., China XD Plastics Co. Ltd. and Jumei International Holding Limited. Additionally, offers to enter into such buyout agreements have increased, most notably tech giant Tencent Holdings Ltd.'s offer to buy out the other investors in Sogou Inc. and the recent offer from New Wave MMXV Limited to take Sina Corporation private.

However, transactions taking Chinese Companies private remain controversial and are perceived to have harmed US investors in the past. In a typical going-private transaction, the parties seeking to buy out the other shareholders want to pay the lowest price per share to buy them out. Oftentimes, the Chinese Company's share price at the time of the buyout offer or agreement is lower than the Company's IPO share price. Not only does this cause early investors to suffer losses, but the inability of the PCAOB to access audit working papers of the Chinese Companies results in a roadblock to shareholders seeking to challenge the buyout valuation, either through appraisal rights or otherwise.

Conclusion

As of today, the US continues to serve as the primary listing location for each of the aforementioned Chinese Companies with recent secondary listings. Further, the US remains the paramount listing location due to the integrity and consistency furthered by regulations aimed at protecting investors in its markets. However, the secondary listing trend signals other companies considering secondary listings and even primary listings in Asia Pacific markets and exchanges. Critically, absent interim efforts to assure the Chinese Companies that a workable solution is within reach, decisions to list on non-US exchanges may soon transition from headlining news to regular occurrences. The same can be said about the trend of Chinese Companies going private. In addition to the ongoing and devastating global pandemic, the first half of 2020 has ushered in historic shifts and uncertainties, which will continue to shape a new landscape in capital markets. Regardless of one's stake, the current situation and the interwoven layers of complexity require close attention, evaluation and action. We continue to carefully monitor the situation.

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