

Legal Update

SEC Division of Corporation Finance Publishes Disclosure Considerations for China-based Issuers

The US Securities and Exchange Commission (SEC) Division of Corporation Finance published CF Disclosure Topic No. 10 (the disclosure topic) on November 23, 2020.¹ The disclosure topic provides guidance to China-based Issuers: companies based in or with the majority of their operations in the People's Republic of China (China). The guidance is the latest step by US regulators to strengthen investor protection with respect to China-based Issuers, particularly with regards to the unique legal and regulatory risks such companies present. The guidance follows the recommendations of the President's Working Group on Financial Markets, and shows that US regulators remain focused on China-based Issuers that do not comply with US investor protection laws.

The disclosure topic notes that US investor exposure to China-based Issuers has increased over the past decade, and explains the staff's concern that "[a]lthough China-based Issuers that access the U.S. public capital markets generally have the same disclosure obligations and legal responsibilities as other non-U.S. issuers, the Commission's ability to promote and enforce high-quality disclosure standards for China-based Issuers may be materially limited."

The disclosure topic details the specific risks associated with China-based Issuers. In particular, the staff explains that China-based Issuers may not provide investors with high-quality, reliable disclosure and financial reporting due to the current restrictions China has placed on the Public Company Accounting Oversight Board's (PCAOB) ability to inspect or investigate PCAOB-registered public accounting firms in connection with their audits of China-based Issuers.² Another risk relates to China's restrictions on US regulators' ability to oversee China-based Issuers participating in the US capital markets. Specifically, China has often denied US regulators' access to certain information about China-based Issuers, limiting US regulators' ability to investigate or pursue potential violations. China's lack of cooperation makes it difficult for US regulators to bring or enforce actions against China-based Issuers and their directors and officers, potentially leaving harmed US investors without any remedy. The disclosure topic also outlines the risks inherent in investing in Chinese variable interest entities (VIE), an organizational structure relying on contractual arrangements that in the case of many China-based Issuers may be used to circumvent Chinese restrictions on foreign ownership, which include limited control over the operating company due to the contractual nature of the relationship (as opposed to direct equity ownership) and the potential for the

Chinese government to determine that the organizational structure violates Chinese law. Lastly, the disclosure topic details the regulatory risks given the uncertainty created by the evolving laws and regulations in China.

The disclosure topic goes on to explain to investors the differences in shareholder rights and recourse, governance, and reporting associated with China-based Issuers in comparison to US issuers.

Finally, the disclosure topic provides comprehensive and specific guidance to China-based Issuers subject to US reporting requirements in the form of questions to consider when drafting disclosure. The guidance is provided in the form of detailed questions related to the risks and considerations the staff elaborated on throughout the disclosure topic. For example, among the questions that the guidance suggests China-based Issuers evaluate are the following:

- 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?

Practical Considerations

Companies that fall under the disclosure topic's categorization of "China-based Issuers" should read the disclosure guidance carefully and aim to address all applicable questions in SEC filings going forward. Expect the SEC staff to use the guidance as a roadmap for comments to issue when reviewing filings made by China-based Issuers.

The SEC staff's Emerging Markets Roundtable³ in July was closely followed by recommendations to the SEC made by the President's Working Group on Financial Markets.⁴ In August 2020, Chairman Clayton and several SEC senior officials across the agency published a statement that they intend to take action.⁵ While the guidance provided by the disclosure topic addresses the goal of improving disclosure regarding the risks of investing in China-based Issuers, several division directors and office chiefs outside of the Division of Corporation Finance signed onto the August statement, stating their intention to "level[] the playing field for all companies listed on U.S. exchanges." Relatedly, bills have been passed in both chambers of Congress that, if enacted into law, could result in the delisting of companies from US stock exchanges if those companies use an auditor that the PCAOB is not able to inspect.⁶ There may be more to come from the SEC staff or the Commission itself on this front.

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Endnotes

¹ See SEC Division of Corporation Finance, *Disclosure Guidance: Topic No. 10: Disclosure Considerations for China-Based Issuers* (Nov. 23, 2020), available at <https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers>.

² This is not the first time that SEC officials have alerted investors to this risk. See, e.g., SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman, and SEC Division of Investment Management Director Dalia Blass, *Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited* (Apr. 21, 2020), available at <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting>. Additionally, on November 24, 2020, Chairman Clayton, Chairman Duhnke, and SEC Chief Accountant Teotia released a joint statement summarizing recent discussions they had with the four largest U.S. audit firms on audit quality in emerging markets. The statement reports on seemingly productive discussions, but does not indicate resolution of any of the issues related to the PCAOB's inability to inspect the audit work and practices of PCAOB-registered audit firms in China. See SEC Chairman Jay Clayton, SEC Chief Accountant Sagar Teotia, and PCAOB Chairman William D. Duhnke III, *Statement on Third Meeting with Audit Firm Representatives Regarding Audit Quality in Emerging Markets and Recent Developments* (Nov. 24, 2020), available at <https://www.sec.gov/news/public-statement/statement-audit-quality-emerging-markets>.

³ See SEC's "Emerging Markets Roundtable" webpage, available at <https://www.sec.gov/page/emerging-markets-roundtable>.

⁴ See President's Working Group on Financial Markets, *Report on Protecting United States Investors from Significant Risks from Chinese Companies* (Jul. 24, 2020), available at <https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf>.

⁵ SEC Chairman Jay Clayton, SEC Division of Corporation Finance Director William Hinman, SEC Division of Investment Management Director Dalia Blass, SEC Division of Trading and Markets Director Brett Redfearn, SEC Office of International Affairs Director Raquel Fox, SEC Chief Accountant Sagar Teotia, *Statement on SEC Response to the Report of the President's Working Group on Financial Markets* (Aug. 10, 2020), available at <https://www.sec.gov/news/public-statement/statement-presidents-working-group-financial-markets>.

⁶ See Holding Foreign Companies Accountable Act, S. 945, 116th Cong. (2020) and National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, 116th Cong. (2020).



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