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SEC Again Highlights Risks Of Investing In Chinese Securities

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Last week the Securities and Exchange Commission's Division of Corporation Finance continued its push for greater clarity in financial disclosures provided by China-based securities issuers. In its *Disclosure Guidance: Topic No. 10*, CorpFin offered its "views regarding certain disclosure considerations for companies based in or with the majority of their operations in the People's Republic of China."

The guidance focuses on "potential risks associated with investments in China-based Issuers," and highlights the "related disclosure considerations that these issuers should consider as they seek to fulfill their disclosure obligations under the federal securities laws." As with other SEC guidance on the subject, the new guidance stems from the SEC's continuing concerns about its ability to impose its financial regulatory regime on China-based issuers and the increased risk of harm to U.S. investors that non-compliance entails.

Among the many risks associated with investments in China-based issuers, the Division of Corporation Finance's overarching concern has to do with the lack of transparency. According to the SEC's guidance, "[o]ne of the most

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significant risks to high-quality, reliable disclosure and financial reporting by China-based Issuers results from current restrictions on the Public Company Accounting Oversight Board's ('PCAOB') ability to inspect audit work and practices of PCAOB-registered public accounting firms in China and on the PCAOB's ability to inspect audit work with respect to China-based Issuer audits by PCAOB-registered public accounting firms in Hong Kong."

The lack of transparency is the result of China's refusal to provide the PCAOB access to inspect these accounting firms and their audits of China-based issuers. The guidance also notes that China has "restricted U.S. regulators' access to information and limited regulators' ability to investigate or pursue remedies with respect to China-based Issuers." This, in turn, deprives investors of "a regulatory environment that fosters effective enforcement of U.S. federal securities laws."

CorpFin's guidance also underscored the limited scope of investor recourse for wrongs committed by China-based issuers. "Legal claims, including federal 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. . . . Even if an investor obtains a judgment in a U.S. court, the investor may be unable to enforce such judgment, particularly in the case of a China-based Issuer, where the related assets or persons are typically located outside of the United States and in jurisdictions that may not recognize or enforce U.S. judgments."

Compounding this problem is the fact that China-based issuers may not even be properly organized under the laws of China. Instead, many nominally China-based issuers may be organized in non-Chinese jurisdictions with few shareholder protections, such as the Cayman Islands and British Virgin Islands. All of this serves to simultaneously increase opacity of ownership and dilute (or eliminate) investor protection.

Disclosure Considerations for China-Based Issuers

In an effort to mitigate some of the risks identified by the SEC Division of Corporation Finance, the guidance reminds China-based issuers of their obligation to "fully disclose material risks related to their operations in China," including providing affirmative answers to the following questions:

- 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 variable interest entities (or VIEs, entities established to circumvent Chinese laws prohibiting foreign ownership of certain Chinese companies) 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 or based

on where a company's operations are located?

The SEC's efforts to require greater transparency of public Chinese companies are, of course, laudable and necessary. The problem with the approach taken by the SEC so far is that it is based entirely on the cooperation of China-based issuers themselves. To date, there have been no real repercussions for non-compliance by those issuers. The SEC can initiate one-off enforcement actions once problems with a foreign issuer's public disclosures have been discovered, but it has so far been reluctant to impose industry-wide preventative measures on foreign companies that don't comply with the regulatory obligations applicable to domestic U.S. issuers.

As discussed in CorpFin's guidance, however, both houses of Congress have passed bills that could significantly change the U.S. approach. If enacted, the new rules could result in the delisting of companies that "use an auditor that the PCAOB is not able to inspect," effectively shutting non-compliant foreign issuers out of U.S. securities markets.

Similarly, the President's Working Group on Financial Markets has recommended "that U.S. exchanges require PCAOB access to work papers of the principal audit firm as a condition to initial and continued exchange listing." These efforts could, as the new guidance notes, have significant adverse impacts on the China-based issuers to whom they would apply. But it seems to us that that's the point – the half-measures employed by U.S. regulators so far don't seem to have gotten the job done.