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ALERT MEMORANDUM

The SEC Roundtable on "Emerging Markets, including China"

July 19, 2020

The Securities and Exchange Commission held a roundtable on July 9, 2020 on investing in emerging markets. Participants with a very wide range of perspectives addressed three concentric circles of topics:

- At the core is the regulatory impasse between the United States and China over the ability of the Public Company Accounting Oversight Board (PCAOB) to conduct inspections and investigations of Chinese auditing firms.
- More broadly, many participants discussed whether there are specific risks involved in investing in Chinese businesses with equity securities trading on U.S. exchanges.
- At the most general level, the discussion addressed risks of "investing in emerging markets," a term that participants used in different ways.

This memorandum summarizes some themes from the discussion and identifies questions about possible future regulatory developments.[1]

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1 A webcast of the SEC Emerging Markets Virtual Roundtable is available in two parts, here and here. Jason Benitez and Shelbi Vaughn provided invaluable assistance in the preparation of this memorandum.

Context

The roundtable was the latest development in a campaign that has featured these earlier steps:

- June 4, 2020 – A presidential memorandum directs federal agencies to develop regulatory measures to protect U.S. investors from "risks from Chinese companies".[2]

- May 29, 2020 – Nasdaq proposes amendments to its listing rules for "Restrictive Market Companies" – defined to include a company operating or incorporated in a jurisdiction that restricts access by U.S. regulators.[3]

- May 20, 2020 – The Senate passes Senate Bill S. 945, the Holding Foreign Companies Accountable Act, sponsored by Sen. Kennedy of Louisiana.[4] S. 945 would impose specified consequences on a reporting company if the PCAOB is unable to inspect or investigate its auditor because of a position taken by an authority in the auditor's jurisdiction. The consequences could include delisting if the circumstances continue for three reporting years, and disclosure of (1) the percentage of the shares of the issuer owned by governmental entities, (2) whether any governmental entities have a controlling financial interest in the issuer, (3) the name of each official of the Chinese Communist Party who is a member of the board of directors and (4) whether the articles of incorporation of the issuer contains any charter of the Chinese Communist Party.

- April 21, 2020 – A public statement by senior officials of the SEC and the PCAOB calls attention to "disclosure, financial reporting and other risks" of emerging markets investments.[5]

- December 7, 2018 – A public statement by senior officials of the SEC and the PCAOB calls attention specifically to information access challenges with respect to U.S.-listed companies with operations in China.[6]

The background to all this activity includes the growth in U.S. listings of equity of China-centered businesses over the past two decades. Today more than 200 U.S.-listed companies are either Chinese-incorporated or doing business principally in China. In 2019 there were 25 IPOs of U.S.-listed Chinese companies, accounting for over 18% of all U.S.-listed IPOs that year.[7] The issuers in question range widely, including big state-controlled entities, some of the world's largest tech firms, as well as startups and other smaller businesses. In many cases, the U.S.-listed company is incorporated outside China – usually in the Cayman Islands – and is listed only in the United States, but in recent months some of these businesses are seeking a second listing outside the United States.[8]

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2 Presidential Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies (June 4, 2020), available here.

3 Proposed Amendments to Nasdaq Rule 5005(a)(37), SR-NASDAQ-2020-027 (May 29, 2020).

4 The Holding Foreign Companies Accountable Act, S.945, 116th Cong. (2020), available here.

5 SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman, SEC Division of Investment Management Director Dalia Blass, Public Statement on Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited (April 21, 2020), available here.

6 SEC Chairman Jay Clayton, SEC Chief Accountant Wes Bricker and PCAOB Chairman William D. Duhnke III, Public Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally— Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China (Dec. 7, 2018), available here.

7 *See* data compiled by University of Florida Professor Jay Ritter, available here.

8 *See* Scott Murdoch and Julie Zhu, *Chinese Companies Take Record 50% of Global Equity Raising in First Half of 2020*, REUTERS (June 28,

Crucially, the background also includes the now long-standing impasse between the PCAOB and the Chinese financial regulatory authorities. A U.S.-listed foreign private issuer is required to file an annual report on Form 20-F containing financial statements audited by an audit firm registered with the PCAOB, and audit firms that are so registered are subject to inspection and enforcement by the PCAOB. This regime was established by the Sarbanes-Oxley Act of 2002, and from the beginning the PCAOB and the Chinese authorities have been unable to agree on how the PCAOB can exercise its mandate in China and Hong Kong. Absent such an agreement, Chinese law prohibits auditors from cooperating with the PCAOB, most recently pursuant to Article 177 of China's Securities Law, which took effect earlier this year.

Observations from the Roundtable

The PCAOB's China problem

Some recent rhetoric from the SEC and the PCAOB has suggested that the problem of how the PCAOB can pursue its mandate in China is part of a larger problem with "emerging markets," but PCAOB Chair Bill Duhnke was explicit at the Roundtable that China (including Hong Kong) is the only major problem. There are at present obstacles to inspections in France and Belgium, but he reported that in both cases the problems will be resolved shortly.

It is hard to see why the PCAOB would suggest the problem is more general. The Chinese impasse should not obscure the fact that the PCAOB was given a very ambitious mandate – to extend its regulatory mission internationally – and has been remarkably successful. As Chair Duhnke summarized, through arduous negotiation the PCAOB has built up the ability to inspect auditors and enforce its standards in 51 countries. Moreover, the U.S. regime for auditor oversight has been influential around the world, stimulating the development of comparable regimes elsewhere. China is the exception that proves the rule.

As for the China problem itself, several participants in the Roundtable referred to the Kennedy bill with apparent approval, as SEC Chair Jay Clayton has reportedly also done,[9] while others questioned it. But there was no detailed discussion of how the bill would work in practice or what impact it would have if it became law. The topic might be better addressed by regulatory action, which would permit a carefully drawn tactical approach and would also benefit from notice and comment, while legislation may be crudely drawn and poorly thought out. But there were no specific suggestions for what steps the SEC itself might take to attach regulatory consequences when the principal auditor is not subject to inspection,[10] or otherwise to develop regulatory pressure on Chinese issuers or financial regulators. It is possible the SEC is considering such measures, but if so there was no indication of it at the Roundtable.

One of the panels did focus on the ways in which issuers and auditors deal with internal controls for Chinese businesses. The discussion acknowledged that this question is important to multinationals with business in China, even if China is not their principal market and their principal auditors are not located in China, and that Chinese audit firms contribute substantial work to the audits of these issuers.[11] On

2020); Joanne Chiu, *Chinese Tech Firms Get Trading Boost From Hong Kong Listings*, THE WALL STREET JOURNAL (July 8, 2020).

9 *See* Benjamin Bain and David Westin, *SEC Chief Backs Bill to Delist China Firms Barring Audit Reviews*, BLOOMBERG (June 2, 2020); Dave Michaels and Akane Otani, *U.S. Moves to Audit Chinese Firms. Market Frets Over What Comes Next*, THE WALL STREET JOURNAL (May 26, 2020).

10 The lone exception was a proposal submitted the same day in writing by Carson Block, the founder of Muddy Waters, an investment boutique that was central in publicizing the alleged accounting problems at Luckin Coffee and other U.S-registered issuers. It proposes that U.S. member firms for auditors of China-based issuers bear financial liability for audit failures of U.S. listed clients. The proposal is available here.

11 The principal auditor is required to identify in a PCAOB filing on Form AP any other firm that contributed more than 5% of total audit hours. The PCAOB website provides extensive information based on these filings, including a list of more than

the question whether the attendant risks are adequately disclosed, there was some discussion of possible improvements, but several participants observed that the risks are widely known.

Emerging Markets Generally

The April 21 statement by senior U.S. regulators was styled as a statement about emerging markets in general. It discussed China as if it were only an example, but it did not identify any other countries. In introducing the Roundtable, Chair Clayton similarly described its topic as "risks for investors in emerging markets, including China."

The Roundtable discussion did not carefully spell out the scope of that broader concern, for example as to (1) what countries may be implicated, (2) whether the focus is the jurisdiction where the issuer is incorporated or the countries where it does business, or (3) whether the concern is limited to equity securities listed on U.S. exchanges. Of course, U.S. investors have significant exposure to companies that are not listed in the United States, so the risks are not limited to companies that trade on U.S. exchanges and are consequently subject to SEC reporting requirements.

These more general concerns were little discussed at the Roundtable, where most of the participants spoke about China most of the time. There was no indication that the SEC is considering particular measures aimed at a broader class of investments. However, several interesting themes emerged concerning the broader question of SEC regulation of cross-border investment.

- *Corporate governance*. There was some discussion of differences in corporate governance standards between U.S. and non-U.S. issuers, and of the SEC disclosure requirements on this topic. Panelists did not suggest changes in SEC rules or the governance standards of the securities exchanges. Of course, the federal securities laws are not the primary basis for corporate governance practices, which are driven mainly by state law (for U.S. companies) and foreign law (for non-U.S. companies).

- *Index inclusion*. Several participants referred to the importance of index investing and the decisions made by index providers. The SEC's traditional approach to disclosure rests on the assumption that corporate disclosures influence the decisions of investors, but the rise of index investing casts doubt on this model. Instead it invites a focus on how index providers decide what securities to include, which was the subject of an interesting discussion in the Roundtable, and on how investment managers decide what index to use as a benchmark.[12]

- *FPI reporting regime*. Mr. Hinman asked whether some features of the SEC's reporting regime for foreign private issuers should be modified. That regime provides a variety of disclosure accommodations and regulatory exemptions, and he raised the example of the exemption from Regulation FD. Some features of the regime were historically based on the expectation that a foreign private issuer with a U.S. listing also has a "primary" listing in its home jurisdiction. This is not, however, always the case, as some foreign issuers, including most of the Chinese IPOs of recent years, are listed only in the U.S. Mr. Hinman seemed to echo a concern, which SEC officials have occasionally raised in the past, that aspects of the FPI regime might be inappropriate for a company in that circumstance.

What to Expect

The Roundtable did not identify any imminent regulatory action on the topics it addressed, but agencies including the SEC will presumably need

600 issuers that name a Chinese audit firm, available here.

12 In May 2020, a retirement fund for federal workers – the Federal Retirement Thrift Investment Board – deferred implementing a decision to transition a specific fund, with about $50 billion in assets, to an index that includes Chinese stocks. The decision was widely reportedly to have been made at the direction of the White House.

to develop specific proposals in response to the June 4 Presidential memorandum. A focused next step on the PCAOB's China problem should be expected.

Ideally, whatever is proposed will not lose sight of the successes of the SEC's foreign private issuer regime and the SEC's leading role among regulators worldwide. For the past 40 years, the SEC has established high standards for reporting companies and invited foreign companies to meet those standards. Its standards have also helped to stimulate far-reaching improvements in regulatory practices around the world. The interests of investors would be poorly served by undermining those achievements.

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