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The Backlash Against Chinese-Company Listings on U.S. Exchanges Has a Long History

By Georges Ugeux January 25, 2021

Comment

The reach of American law has recently entered familiar territory: listings of international companies on U.S. exchanges. Yet the listings of Chinese companies have in particular prompted a backlash. I want to shed some light on the situation – and outline U.S. government responses to Chinese listings – given my experience bringing Chinese companies to the New York Stock Exchange (NYSE) as its group executive vice president from 1996 to 2003.

The Listings Wave

During that period, listings of foreign companies improved their transparency and governance, thanks to the listing standards of the exchanges and Securities and Exchange Commission, and international investors responded positively. Today, 217 Chinese companies are listed on U.S. stock exchanges with a combined market capitalization of $2.2 trillion.

The PCAOB and Chinese Accounting Firms

Following the Enron scandal in the early 2000s, the U.S. created the Public Company Accounting Oversight Board (PCAOB). The PCAOB is in charge of inspecting registered public accounting firms to assess compliance with the Sarbanes-Oxley Act and SEC and exchange rules and looking at accountants' audits involving U.S. public companies and broker-dealers.

Chinese authorities, not surprisingly, are rejecting the PCAOB's "jurisdiction" to inspect Chinese audit firms, including Hong Kong-based audit firms, if their audit clients have operations in mainland China. Bloomberg reports that China's accounting firms, including affiliates of Deloitte, Ernst & Young, PwC, and KPMG, argue that Chinese law prohibits them from sharing audit work papers with the PCAOB on the grounds that the documents may contain state secrets.[1] This refusal apparently stems from the Chinese government's concerns about what the inspectors might see.[2] Attempts to convince the Chinese regulators to accept a form of audit oversight in connection with the PCAOB's inspections failed.

The Back-Door Listings

The U.S. exchanges, for commercial reasons, have accepted the listing of Chinese companies through non-Chinese (often Caribbean) companies. These companies have not gone through SEC registration as Chinese companies but only as holding companies located somewhere else. This practice avoided the registration of the Chinese company with the SEC. A series of those back-door listings led to frauds and bankruptcies, and several backdoor Chinese companies were delisted from the U.S. Many others voluntarily delisted from the U.S. exchanges, often in favor of Hong Kong.

The Chinese Securities Regulatory Commission (CSRC) met the suggestion that it should pay attention to those situations with the response that its board (the Chinese Government) did not consider those foreign domiciled entities to be under Chinese jurisdiction. Eventually a new CSRC rule required that companies' assets should be placed inside a listed entity and required to have posted more than 20 million yuan (HK $23.8 million) of net profit in total in the previous two years.

Eventually the SEC changed the regulation and made back door listings ineffective.[3]

The Holding Foreign Companies Accountable Act

As the latest development on Chinese listings in the U.S., in December 2020, former President Donald Trump signed the Holding Foreign Companies Accountable Act (HFCA).[4] The act prohibits foreign companies' securities from being listed or traded on U.S. securities markets if, first, the PCAOB cannot inspect the company's foreign accountants because those accountants are located in a foreign jurisdiction that prohibits PCAOB inspection and, second, that inability to inspect lasts for three consecutive years.[5]

This regulation also requires certain issuers of securities to establish that they are not owned or controlled by a foreign government. Specifically, an issuer must make this certification if the PCAOB is unable to audit specified reports because the issuer has retained a foreign public accounting firm not subject to inspection by the board.

Foreign issuers of securities that use such a firm to prepare an audit report must disclose for each non-inspection year:

- the percentage of shares owned by governmental entities where the issuer is incorporated,
- whether these governmental entities have a controlling financial interest,
- information related to any board members who are officials of the Chinese Communist Party,
- whether the articles of incorporation of the issuer contain any charter of the Chinese Communist Party.

While the rule was not specifically targeted at Chinese companies, the last point leaves little to the imagination of the lawmakers.

The SEC Questions the Quality of China-Based Issuers

The SEC is thinking along similar lines. On November 23, 2020, its corporate finance division issued a "staff paper" (different from a commission position) on the particular case of Chinese companies:

We recognize that some of the risks and differences discussed below pertain to issuers operating in emerging markets or foreign private issuers more generally. However, we include these risks and differences because the limitations on U.S. regulatory oversight of China-based Issuers can magnify these risks and differences. Additionally, some of the risks and differences may amplify other risks and differences, increasing the significance of their disclosure for China-based Issuers. Thus, China-based Issuers should consider the cumulative effects of these risks and differences as they consider their disclosure obligations under the federal securities laws.[6]

Outgoing SEC Chairman Jay Clayton has backed the law, stating that the HFCAA would address critical investor protection issues. The SEC will now start the rulemaking to implement the act.

The U.S. Treasury, SEC, and the FCPA

In addition to the issues raised under the securities law, the application of the Foreign Corrupt Practices Act (FCPA) to U.S. listed companies has been a high priority for the SEC. The FCPA prohibits companies issuing stock in the U.S. from bribing foreign officials in exchange for government contracts and other business.[7] In 2010, the SEC's enforcement division created a special unit to enhance its enforcement of the FCPA.

Since the FCPA applied retroactively, many international companies listed before its enactment became subject to intense scrutiny by the U.S. Treasury. The Office of Foreign Assets Control ("OFAC") of the Department of the Treasury administers and enforces economic and trade sanctions, based on U.S. foreign policy and national security goals, against foreign countries, terrorists, international narcotics traffickers, and any other entity engaged in activities related to the proliferation of weapons of mass destruction or other threats to the national security, foreign policy, or economy of the United States.[8]

The most recent cases include the $1.1 billion fine against Goldman Sachs for violating the FCPA in connection with the 1Malaysia Development Berhad (1MDB) bribery scheme.

SEC jurisdiction on FCPA became one of the big reasons why the pipeline of foreign listings dried up.

The Presidential Executive Order on Chinese "Military Companies"

Former President Trump issued on November 24, 2020, after the election of President Joe Biden, an executive order aimed at 31 companies considered to be part of the Chinese military. [9] The order prohibits U.S. persons from purchasing or investing in publicly traded securities of companies identified by the U.S. government as "Communist Chinese military companies." The term "Communist Chinese military company" includes any company that the U.S. Department of Defense ("DOD") has identified pursuant to Section 1237 of the National Defense Authorization Act. As of January 22, 2021, the U.S. government has identified 44 PRC companies as Communist Chinese Military Companies, including the three principal Chinese telecom companies.

Like many executive orders, this one is a knee jerk reaction that ignores the legality of the decision or its impact. In a stock exchange filing, China Telecom said it estimated the executive order might affect the price of its shares, and American depository shares.[10]

The NYSE Between a Rock and a Hard Place

The executive order was followed almost immediately by an announcement that the NYSE had begun to delist China's three largest state-run telecom groups in compliance with the order.[11] It is surprising in view of the fact that such considerations are not part of the listing standards of the NYSE.[12]

The timing of the action just a few days before the end of the Trump administration has raised questions. In the words of Columbia Law School Professor John Coffee, "I am surprised that the NYSE did not just wait Trump out and ask Biden to rescind the Trump executive order".[13]

Delisting is a procedure that is regulated by each exchange. The adequacy of audited accounts is not part of the jurisdiction of the NYSE but part of the filing with the SEC. It would be normal for an exchange to delist a company if the SEC objected to its auditing standards or accounts. None of this happened. By delisting these companies anyhow, the NYSE has threatened the value of their shares and put U.S. shareholders at risk in contradiction to the NYSE's own delisting rules, which imply a delay to request comments?[14]

Is that the reason the NYSE reversed its decision to delist two days later?[15]

The three Chinese telecommunications companies that were delisted from the NYSE have asked the exchange to once again reconsider its decision.[16]

Time for a Pause to Answer Fundamental Questions

These approaches to Chinese listings have created considerable confusion among investors and foreign companies. It might be useful to address the following issues:

1. A listing on United States exchanges is a seal of approval that derives from the rigorous listing process: Audit failures are unacceptable. Such a listing has positive influence on the governance of those companies. The listing of state-owned enterprises (SOEs) from China has resulted in some progress on governance (including independent directors and reporting and disclosure standards) and improved the functioning of SOEs to the benefit of all capital markets.
2. The fact that the SEC's corporate finance staff analyzed the failures of some Chinese companies should be commended. Should we assume that they concluded their analysis proved that these deficiencies were unique to Chinese companies? Or did they for some reasons single out China?
3. Have all avenues been explored to resolve the objections to Chinese listings? Is there an alternative to forcing China to accept PCAOB inspection of auditing firms? Imposing an additional registered audit firm report would have avoided accusations of extraterritoriality but ensured that the benefit of a U.S. listing comes with further scrutiny for companies whose local audit standards are considered insufficient.
4. Should such prohibitions apply to funds, and especially ETFs, that follow market indices? Why did index provider MSCI immediately announce its intention to delete three Chinese communications companies from its global indices?
5. At a time of conflict in Hong Kong, did the parties involve realize that they were effectively leaving Chinese companies with the one option of listing in Hong Kong and submitting to the governance standards of Beijing?
6. Should regulators and exchanges consider the implication of their decisions for listed companies and investors? Should they be accountable for rumors that the authorities are now targeting Alibaba and Tencent, which were not covered by the Trump administration's executive order on Chinese military companies?[17]

International listings should not be part of a domestic or international feud. The actions describe above raise questions about whether politics play too much of a role in U.S. capital markets. Several former chairmen of the SEC have expressed their concerns about this trend, given that foreign listings are so important to the stature and reputation of U.S. stock exchanges.

ENDNOTES

[1] https://www.bloomberg.com/news/articles/2020-08-06/u-s-moves-to-tighten-disclosure-requirements-for-china-listings?sref=TqbeXaQO

[2] https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other

[3] https://www.sec.gov/rules/sro/nyse/2017/34-81856.pdf

[4] https://www.congress.gov/bill/116th-congress/senate-bill/945

[5] https://www.mayerbrown.com/en/perspectives-events/publications/2020/12/congress-passes-the-holding-foreign-companies-accountable-act

[6] https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers

[7] https://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml

[8] https://home.treasury.gov/policy-issues/office-of-foreign-assets-control-sanctions-programs-and-information

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[10] https://www.reuters.com/article/usa-china-securities/trump-bans-u-s-investments-in-companies-linked-to-chinese-military-idUSKBN27T1MD

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[12] https://www.nyse.com/publicdocs/nyse/markets/nyse-american/MKT_Continued_Listing_Standards.pdf

[13] https://www.ft.com/content/b9d40c2f-bf2e-47e9-98ce-801fe22b24f0

[14] https://www.nyse.com/regulation/delistings

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[17] https://www.wsj.com/articles/u-s-considers-adding-alibaba-tencent-to-china-stock-ban-11609961075

This post comes to us from Georges Ugeux, who is the chairman and CEO of Galileo Global Advisors and teaches international finance at Columbia Law School. He is scheduled to speak on February 4, 2021, at a panel organized by the Hong Yen Chang Center for Chinese Legal Studies at Columbia. See here for details.