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U.S.-Listed Chinese Companies: Regulatory Scrutiny & Strategic Options

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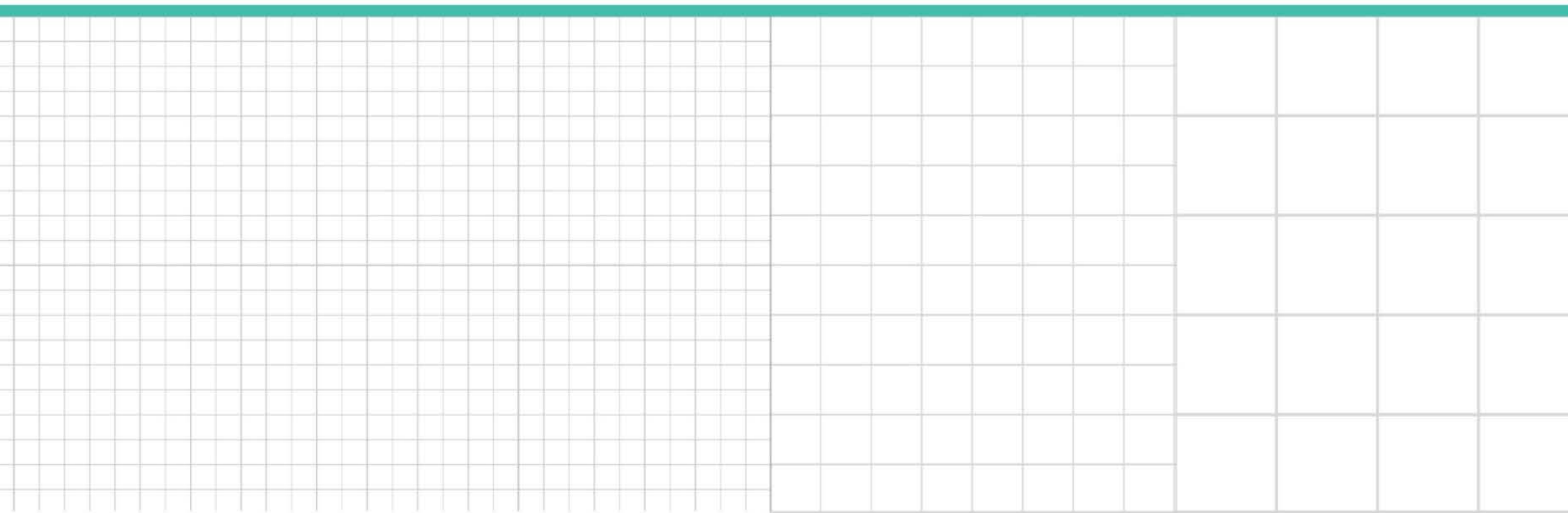

U.S.-Listed Chinese Companies: Regulatory Scrutiny & Strategic Options

Contributed by Liza Mark and Han Liang, Haynes and Boone

China has become the largest emerging market economy and the second largest economy in the world. As a result, many Chinese companies have elected to access the U.S. capital markets for their financing needs. As of June 2020, there are over 200 China-based issuers listed on U.S. exchanges with a collective market capitalization of over $1.15 trillion. With the rising geopolitical tensions between China and the U.S., long standing regulatory concerns, and the recent fraud scandals surrounding these "China Inc." companies, U.S. regulators are increasing their focus on U.S.-listed Chinese companies.

Long-Standing Regulatory Concerns

On the regulatory side, there have been long standing concerns regarding China-based issuers. China-based audit firms—including the Chinese branches of the "Big Four" accounting firms—have long been unable to comply with the U.S. Public Company Accounting Oversight Board (PCAOB) inspections required under the Sarbanes-Oxley Act of 2002 (SOX Act), arguing that the production of audit papers would violate Chinese law due to the potential disclosure of state secrets in the audit materials.

In 2012, the Chinese branches of several audit firms were barred by the U.S. Securities and Exchange Commission from auditing companies listed on U.S. exchanges for six months for refusing to produce work papers. The matter was settled after the China Securities Regulatory Commission provided copies of the audit firms' work papers to the SEC.

In 2013, the PCAOB negotiated a memorandum of understanding with CSRC allowing the PCAOB to obtain audit work papers of China-based audit firms, with several exceptions where Chinese government approval was needed. However, both the SEC and PCAOB have noted that "progress has been slow and satisfactory resolution remains uncertain." Since then, the PCAOB has long complained about the lack of Chinese cooperation for it to obtain timely access to relevant documents and information necessary for it to carry out its oversight function.

On April 21, 2020, the SEC and PCAOB jointly issued a statement warning investors about investing in "emerging market" companies given the absence of PCAOB inspections. In this statement, the SEC and PCAOB chairs both expressed serious concerns regarding the SEC and the PCAOB's inability to promote and enforce disclosure standards for U.S.-listed companies operating in emerging markets, particularly China. They warned financial professionals and investment funds to consider the risks posed by issuers in emerging markets when constructing funds, making investments and providing investment recommendations, and make appropriate disclosures to investors.

Recent Regulatory Changes

Within a span of a couple of months in 2020, the White House, the U.S. Senate and the Nasdaq Stock Market, have all announced initiatives focusing on legal and regulatory changes targeting China-based issuers. A sharp escalation of tensions between the U.S. and China caused by the Covid-19 pandemic also contributes to these rapid regulatory actions.

Nasdaq's Three Proposals

On May 18, 2020, Nasdaq submitted three proposals to the SEC to adopt additional listing criteria applicable to companies that primarily operate in countries where there are secrecy laws, blocking statutes, national security laws or other laws or regulations restricting access to information by regulators of U.S.-listed companies (Restrictive Markets).

The first proposal is to adopt a new requirement related to the qualification of management. Nasdaq is proposing a new listing standard which would require Restrictive Market companies listing on Nasdaq to have one member of senior management or a director that has experience at a U.S.-listed public company or familiarity with the U.S. public company regulatory framework or, alternatively, a third-party advisor to provide the company with guidance on an ongoing basis. Companies that fail to meet this new requirement would need to disclose that information and would have a 180-day compliance period to regain compliance. The proposed rule changes would be applied prospectively to Restrictive Markets companies newly listed on Nasdaq but not to companies that were already listed.

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The second proposal is to apply additional initial listing criteria as to the offering size and liquidity requirements. This proposal would require companies listing via an IPO on Nasdaq to have a certain minimum offering size or public float percentage if they are primarily operating in a Restrictive Market.

Specifically, the proposed rule would require the company to offer a minimum amount of securities in a firm commitment offering in the U.S. to public holders that: will result in gross proceeds to the company of at least $25 million, or will represent at least 25% of the company's post-offering Market Value of Listed Securities, whichever is lower. Nasdaq would also impose similar requirements on business combinations with companies primarily operating in Restrictive Markets.

The third proposal is to apply additional criteria to a listing applicant or a listed company based on the qualifications of the company's auditor. This proposal would codify Nasdaq's discretionary authority to apply additional listing criteria if a company is primarily operating in a Restrictive Market, as well as in situations where a company's auditor does not demonstrate sufficient PCAOB inspection history, quality controls, resources, geographic reach and experience to adequately perform the company's audit.

Once identified, to ensure suitability for listing, Nasdaq would apply additional and more stringent criteria to these companies, such as requiring higher equity, assets, earnings or liquidity measures, that any offering be underwritten on a firm commitment basis (which typically involves more due diligence), or that companies impose lock-up restrictions on officers and directors.

The Holding Foreign Companies Accountable Act

On May 20, 2020, the U.S. Senate passed S. 945, the Holding Foreign Companies Accountable Act which will amend the SOX Act to require certain issuers to disclose to the SEC information regarding foreign jurisdictions that prevent the PCAOB from performing inspections.

A core component of the bill requires certain issuers to certify that they are not owned or controlled by a foreign government. If an issuer fails to do so, or if the PCAOB is unable to inspect the issuer's public accounting firm for three consecutive years, the issuer's securities are banned from trading on a U.S. national exchange or through other methods in the U.S.

This proposed legislation would first require the SEC to identify issuers on U.S. securities exchanges that:

- issue audit reports prepared by registered public accounting firms with offices located in foreign jurisdictions
- fail to allow PCAOB to conduct an audit of the reports prepared by the accounting firm because of a position taken by an authority within the foreign jurisdiction

Once identified, the issuer:

- would be required to submit documentation to the SEC establishing that they are not owned or controlled by a foreign government in the foreign jurisdiction in which the public accounting firm has an office
- must allow the PCAOB to conduct an audit of its reports

If an identified issuer fails to allow the PCAOB to conduct such an audit for three consecutive years starting from the year in which the SEC identified it, the SEC would need to prohibit the trading of that issuer's securities on any U.S. securities exchanges or trading through any method that the SEC regulates, including over-the-counter trading. The SEC would end such prohibition if the issuer then certifies to the SEC that it has retained a registered public accounting firm that the PCAOB has inspected to the satisfaction of the SEC. However, if the issuer then fails to allow PCAOB to conduct an audit for any year after the certification, the SEC is required to ban the issuer again for at least five years.

In addition, for any year in which the foreign issuer fails to allow PCAOB to conduct an audit of the reports, the issuer would need to disclose in its reports the percentage of its shares owned by governmental entities in the jurisdiction where it is incorporated, whether governmental entities in the accounting firm's jurisdiction have a controlling financial interest and other specified information.

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Presidential Memorandum

On June 4, 2020, the White House issued a presidential memorandum calling for "firm, orderly action to end the Chinese practice of flouting American transparency requirements without negatively affecting American investors and financial markets."

In this memorandum, the U.S. president directs the Working Group on Financial Markets, which includes the chairman of the SEC, to discuss the associated risks "to American investors and financial markets posed by the Chinese government's failure to uphold its international commitments to transparency and accountability and its refusal to permit companies to comply with United States law" and submit to the president a report, within 60 days of the memorandum, recommending actions for the executive branch, the SEC, and the PCAOB, or any other federal agency to take to address the investor protection issues identified by the working group.

Options for the U.S.-listed Chinese Companies

Facing the tightening regulatory scrutiny, there are several options for U.S.-listed Chinese companies:

Stay in the U.S.

Chinese companies may try their best to comply with U.S. laws and regulations to ensure accurate and timely disclosure, thus maintaining their listing status on the U.S. stock exchanges. However, certain prohibitions under Chinese laws might make strict compliance challenging.

First, there are prohibitions under Chinese securities laws:

- The "Provisions of the China Securities Regulatory Commission, the State Secrecy Bureau and the State Archives Administration on Strengthening Confidentiality and Archives Administration Relating to Overseas Issuance and Listing of Securities ([2009] No. 29)" promulgated on Oct. 29, 2009, provides that during "the process of overseas issuance and listing of securities, archives such as the manuscripts of working papers formed within the territory of China by securities firms and securities service institutions that provide relevant securities services shall be stored within the territory of China."
- Article 177 of the newly amended Securities Law of the People's Republic of China (effective on March 1, 2020), provides that, without the approval of the securities regulatory authority under the State Council, no entity or individual in China may provide documents or materials relating to securities business activities overseas.

Second, since many of the China-based issuers are state-owned enterprises in energy, transportation, communications, and pharmaceutical industries, the work papers of their audit reports may involve sensitive information and handing those over may trip state secrets laws.

- Chinese authorities take a broad view of what information is deemed to be "state secrets." The Law of the People's Republic of China on Guarding State Secrets, as amended on April 29, 2010, defines "state secrets" as "matters that have a vital bearing on State security and national interests." It identifies seven categories of state secrets—mostly involving national defense, foreign affairs, energy resources, science, technology, and infrastructure, with a catch-all provision covering "other matters that are classified as state secrets by the national State Secrets Bureau." Such vague definition leaves Chinese authorities broad discretion over what information constitutes "state secrets."
- Article 25 of the State Secrets Law provides that "[a]n organ or organization shall strengthen the management of state secret carriers, and no organization or individual may conduct the following acts: … (4) [m]ailing or consigning state secret carriers out of China; and (5) [c]arrying or transmitting state secret carriers out of China without approval by the relevant authority."
- Article 21, Section (7) of the Implementing Regulations of the Law of the People's Republic of China on Guarding State Secrets provides that "[w]here carriers of state secrets are to be taken out of the organs or entities to which they belong, the confidentiality provisions of the State shall be complied with and reliable confidentiality measures shall be taken; and, where carriers of state secrets are to be taken abroad,

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procedures for approval and carriage shall be gone through in accordance with the confidentiality provisions of the State."

Third, Chinese archive laws also impose certain restrictions. In China, any document that is deemed to have historical value to the state or the society, whether created by government action or by private action, is "archival" and must be preserved and protected for the public interest. Therefore, China has a unique body of laws that defines the scope of what is considered "archive" and establishes the requirements and procedures for use and retention of the archive.

As for the financial records:

- Article 6 of the Administrative Measures on Accounting Records (revised and adopted by the Ministry of Finance and the National Archives Bureau in 2015 (effective Jan. 1, 2016)) requires all the accounting records, including accounts books and financial accounting reports to be archived
- Article 18 of Archives Law of the People's Republic of China provides that "[s]tate-owned archives and the archives specified in Article l6 of this law (i.e., archives whose preservation is of value to the State and society) as well as duplicates of such archives shall not be carried or transported out of the country without authorization."

The above prohibitions are both far-reaching and unfortunately vague on the scope of the materials covered, which puts Chinese companies listed in the U.S. in a compliance dilemma.

Going Private

The recent heightened regulatory scrutiny might prompt and accelerate a new wave of "going private" transactions by Chinese companies listed in the U.S. For Chinese companies listed in the U.S., advantages of going private include:

- No longer subject to the SEC reporting obligations and the potential heightened regulatory scrutiny
- Realizing the full value of a company when the public market does not adequately value the company, especially under the current climate in the U.S. capital market
- Removal of the company's operations from public scrutiny (such as short seller firms) and minimization of the need to disclose sensitive information that competitors can utilize
- Company could consider to be re-listed on China A-Share or Hong Kong Exchange after privatization
- Enhancing the company's ability to pursue outside financing based on cash flow, revenue projections and cash balance rather than on a possibly undervalued stock price
- Allowing management to focus on long-term goals and objectives, rather than short-term management of market expectations

Obviously, there are certain disadvantages of going private, such as:

- Company will lose the prestige of an overseas listing in the U.S. market
- Limiting the company's access to capital markets, especially the overseas market to raise money
- Reducing liquidity for the remaining shareholders
- Limiting the company's ability to make acquisitions utilizing its stock as currency
- Reducing the attractiveness of stock-based incentive plans to employees

In addition, Chinese companies listed in the U.S. should also consider the high transaction costs involved in the process, as well as the potential litigation risk. There is a high likelihood that a going-private transaction will net a shareholder class action for claims of breach of fiduciary duties and disclosure obligations given the inherent conflicts of interests associated with these transactions.

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Moreover, both state laws and federal securities laws impose disclosure obligations that apply to going private transactions. Thus, the timing and substance of the necessary disclosure should be considered in advance to ensure that appropriate steps are taken to avoid premature disclosure and that materials are prepared with the understanding that they will later be disclosed publicly.

Secondary Listings on the Hong Kong Exchange

To diversify its risks of their U.S. listings, certain large U.S.-listed Chinese technology companies have recently taken advantage of HKEx's new secondary listing rules adopted in 2019. In November 2019, the Chinese e-commerce giant Alibaba raised more than $11 billion in its secondary offering in Hong Kong. In June 2020, China's mobile-gaming group NetEase's Inc., and e-commerce giant JD.com have both completed their secondary listings in Hong Kong, raising $2.7 billion and $3.88 billion, respectively. Chinese search engine Baidu.com also confirmed its plan for a secondary listing in Hong Kong.

For China based issuers, the advantages of a secondary listing on HKEx include:

- Back-up plan: company no longer completely reliant on U.S. markets for future capital needs
- Potentially higher valuation: listing closer to mainland China could expose the company to investors who better understand and appreciate Chinese businesses
- Additional trading liquidity: increased access to capital and the ability for its shares to trade for longer periods due to the differing time zones of the two exchanges
- Diversify its shareholder base during the U.S.-China trade war

Although, Hong Kong secondary listing seems to be an appealing option, the qualification requirements are quite high:

- Only companies involved in "innovation," with at least two years of listing status on the New York Stock Exchange, the Nasdaq or premium listing on the London Stock Exchange, are qualified for such a secondary listing
- In addition, they must be capitalized at no less than $10 billion Hong Kong dollars ($1.27 billion)
- Further, if their shareholding structures are based on weighted voting rights (WVR) (a commonly used structure among these overseas listed Chinese companies), and they are based anywhere in Greater China, they need to have at least HK$1 billion in revenue in the most recent financial year, if they are capitalized at less than HK$40 billion at the time of the secondary listing

It is also worth noting that, even if a U.S.-listed Chinese company successfully obtains a secondary listing on the HKEx, the company's primary regulator remains the SEC and the company is still subject to the full reporting obligations under the U.S. securities law, until the company's trading volume of its Hong Kong-listed shares exceeds 55% of the company's worldwide trading volume, then Hong Kong would become the company's primary market, and the Securities and Futures Commission in Hong Kong would become the primary regulator.

Primary Listing on China A-share Market

Another option for China-based issuers is to abandon the U.S. market and list on its home market, the China A-share market. To attract these overseas listed Chinese companies to "return home," China recently relaxes the so called "red-chip" IPO rules. Previously, red chips, or overseas listed Chinese companies, can only apply for an A-share listing if they have a market capitalization of at least 200 billion yuan. As from April 30, 2020, CSRC lowered that market capitalization requirement for "innovative companies" to 20 billion yuan, one-tenth of its previous requirement, in a move to attract more homegrown technology companies to the A-share market. Eligible candidates must have developed their own world-leading technologies and be able to demonstrate innovation and a strong position in their industries.

Even with these incentives, there is not significant interest by large overseas listed Chinese technology companies in seeking a primary listing on the Shanghai A-share market, given the historical disadvantages of that market, including the relatively small market capitalization, complicated listing procedures and high transaction costs involved in the process, and the long waiting time for governmental approval for listing.

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Potential Solutions

The above U.S. legal/regulatory changes, if adopted in their current form, would have a significant impact on many U.S.-listed Chinese companies, potentially resulting in a wave of de-listings from the U.S. exchanges. Luckily, some of the proposed legislation provides a three-year buffer period, which would give Chinese companies some time to decide how to react to the increased compliance requirements. Chinese companies listed in the U.S. should proactively consider their options based on the following factors, including its market cap, whether it is qualified for secondary listing on the HKEx, whether the company is associated with government entities or is a state-owned enterprise, the company's operation and financial condition, etc.

State Owned Enterprise

For Chinese state-owned enterprises listed in the U.S., given the proposed additional disclosure obligations imposed immediately on disclosure related to government ownership and control, they may want to seriously consider going private or seeking other listing status. In fact, many of the large state-owned enterprises listed in the U.S. already maintain dual-listing on the HKEx or China A Share, such as PetroChina, Sinopec, China Mobile, and China Unicom, resulting in a relatively small trading volume of their U.S.-listed shares. The proposed legislation may prompt these companies to continue decreasing their U.S.-listed shares' trading volume. If the company's U.S. trading volume decreases to 5% or below, or the number of its U.S. shareholders falls below 300, it will be exempted from the reporting obligations to the SEC.

Small Market Cap, Unqualified for HKEx Secondary Listing

Although Hong Kong secondary listing looks to be an appealing option, the qualification requirements are quite high. Currently, it is estimated that there are around 30 U.S.-listed Chinese companies that meet the requirements for a secondary listing on the HKEx. For companies with relatively smaller market capitalization and do not qualify for the HKEx secondary listing, their choices are limited. Well-established and financially sound companies may consider going private first and then seek to relist on the China A-Share or the HKEx. However, the timing of the privatization should be carefully thought out and planned given the grace period given under some of the proposed regulations, including the Holding Foreign Company Accountable Act.

Conclusion

Finally, it is important to consider these proposed legal and regulatory changes in the context of the strained U.S.-China relations. The geo-political situation (and the corresponding regulatory reaction) is changing very rapidly and this trend will likely intensify as the U.S. presidential election approaches. Chinese companies listed in the US should proactively consider their options and take preparatory action now to protect their long-term access to capital.

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