August 7, 2020

Update for Chinese SEC Reporting Companies: President's Working Group Issues Mandated Report on Listings

On August 6, 2020, the U.S. Treasury Secretary, on behalf of the President's Working Group on Financial Markets ("PWG"), released a report (the "Report") (available here) in response to President Trump's Memorandum on Chinese companies listed in the United States, issued on June 4.[1] The PWG was tasked by the President with examining the risks to U.S. investors posed by the continued constraints imposed by the Chinese government on access by the Public Company Accounting Oversight Board (the "PCAOB") to audit work papers of auditors of Chinese companies listed in the United States. While the Report notes that certain jurisdictions do not currently provide the PCAOB with the ability to inspect public accounting firms, including sufficient access to conduct inspections and investigations of audits of public companies, or otherwise do not cooperate with U.S. regulators (what it refers to as "Non-Cooperating Jurisdictions," or "NCJs"), the focus is very much on China.

The Recommendations

The PWG recommends that the Securities and Exchange Commission ("SEC") take the following steps.

Enhanced Listing Standards for Access to Audit Work Papers

The Report calls for enhancing the listing standards of U.S. stock exchanges to require as a condition to initial and continued exchange listing either:

- PCAOB access to work papers of the principal audit firm for the audit of the listed company; or
- for companies that are unable to satisfy the standard as a result of governmental restrictions on access to audit work papers and practices in NCJs, the provisions of a "co-audit" from an audit firm with

[1] Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies (available here) (see our June 8 alert available here). We also previously reported (see our May 26 alert available here) on various actions taken in May by the U.S. Senate and by Nasdaq to address the longstanding issue of access by U.S. regulators to information relating to Chinese companies listed in the United States and, in particular, access by the PCAOB to work papers relating to the audits of the financial statements of such companies and its ability to conduct on-site inspections of auditors.

comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the co-audit firm.

To reduce market disruption, the new listing standards could provide for a transition period until January 1, 2022 for currently listed companies from NCJs to come into compliance. The new listing standards would apply immediately to new listings once the necessary rulemakings and/or standard-setting actions are effective. The Report notes that the exchanges could voluntarily file proposals to amend their initial and continued listing standards, or the SEC could on its own pursue rulemaking to amend those listing standards.

It is unclear how the co-audit process would work in practice. The Report suggests that an affiliated U.S. member firm would serve as the principal auditor through a co-audit arrangement with the local audit firm. The Report notes that currently an NCJ-based listed company generally would engage an NCJ audit firm as the principal auditor and, under PCAOB standards, a principal auditor is permitted to use the work and reports of other independent audit firms that have audited the financial statements of subsidiaries, divisions, branches, components or investments included in the listed company's consolidated financial statements. The Report notes that additional rulemaking or standard setting may be needed to require the U.S. firm to supervise the work of the local firm, such that the latter's work is performed under the U.S. firm's guidance and control. Additionally, rulemaking also may be needed to allow the U.S. firm to leverage the work of a local firm with respect to reading, inspecting and evaluating documents in local language(s), and to assist in performing inquiries of company personnel. There remains, as the Report notes, the issue of whether NCJ governments would permit a U.S. firm to perform the work and retain the relevant work papers outside the NSJ.

The Report does note two policy considerations in respect of the recommended enhanced listing standards. First, forced delistings of Chinese companies would not preclude these companies from relisting in jurisdictions outside the United States, and forcing U.S. investors to invest in securities regulated locally may well mean that these investors will enjoy fewer protections than they have today under existing SEC disclosure requirements. Second, the Report notes that adoption of enhanced listing standards may result in Chinese companies being taken private, depriving public investors of their ability to maintain their investments. Also, though not noted in the Report, the enhanced listing standards would not impact the ability of Chinese issuers to access the U.S. equity and debt markets on a private placement basis (namely under Rule 144A), which is at odds with the SEC's longstanding efforts to attract non-U.S. issuers to the U.S. *public* markets.

Enhanced Issuer Disclosures

The Report recommends requiring enhanced and prominent issuer disclosures of the risks of investing in companies located in NCJs, including either rulemaking or interpretive guidance to clarify these disclosure requirements to increase investor awareness, and more general awareness of the risks of investing in such companies. As there are a range of principles-based disclosure requirements currently applicable to all SEC reporting companies, presumably the Report is focused on more specific line-item requirements. This recommendation also is at odds with SEC disclosure trends, which have moved in recent years to a more principles-based regime.

Enhanced Fund Disclosures and Due Diligence

The Report recommends that the SEC review the risk disclosures of registered funds that have exposures to issuers from NCJs to enhance the disclosures by these funds, including issuing interpretive guidance to clarify the disclosure requirements to increase investor awareness of the risks of investing in such funds. The Report also recommends that the SEC seek enhanced due diligence by these funds and their managers, as well as enhanced fiduciary focus by investment advisers, when considering investments in emerging markets.

Greater Due Diligence of Indexes and Index Providers

The Report recommends SEC action to encourage or require registered mutual funds and ETFs that track indexes to perform greater due diligence on an index and its index provider, prior to the selection of the index to implement a particular investment strategy or objective.

Guidance for Investment Advisers

Finally, the Report recommends that the SEC issue guidance to investment advisers with respect to fiduciary obligations when considering investments in NCJs, including China.

Next Steps

The Report needs to be viewed in the context of the broader geopolitical tensions between the United States and China and moves by the Trump Administration in recent days and weeks on matters ranging from technology to trade. The issues that underlie the Report, legislative moves in Congress and the recently publicized views of the SEC on emerging market risks can only be resolved at a political level. In the meantime, the recommendations in the Report call for rulemaking and standard setting, which can be a lengthy process. The recommendations simply may accelerate a process that sees migrations of listings to exchanges outside the United States, which ultimately, from the standpoint of protection of U.S. investors, could be counterproductive.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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