

Taking Stock of 'China, Inc.': Examining Risks to Investors and the
U.S. Posed by Foreign Issuers in U.S. Markets

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Chair Sherman, Ranking Member Huizenga, and Members of the Subcommittee:
I am pleased to appear before you today to discuss risks to investors and the U.S. posed by foreign issuers in U.S. markets. In particular, I will address the significant risks investors face from Chinese companies that benefit from access to U.S. markets but do not comply with the important investor protections provided under U.S. law.

In continuing to block routine inspections of the financial audits of Mainland China and Hong Kong-based companies that sell securities in the United States, the People's Republic of China (PRC) is an outlier among nations. All other jurisdictions where issuers of U.S. securities are domiciled allow such inspections, and in many cases the local audit regulator cooperates in them. Allowing Chinese companies to continue to evade audit inspections not only weakens protections for investors in those companies, but it also harms U.S. markets more broadly. The actions this Subcommittee, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have taken to protect U.S. investors and markets through the Holding Foreign Companies Accountable Act are appropriate. The U.S. must remain vigilant to ensure that China-based companies and individuals do not access capital in the U.S. if they refuse to comply with our laws and standards.

My testimony is informed by my experience over a period of 18 years serving as staff in the Division of Enforcement at the SEC, where I gained first-hand knowledge of fraudulent accounting practices by foreign private issuers, and at the PCAOB. As Chief of Staff to the PCAOB's first Chair, the late William J. McDonough, I helped design audit oversight rules and initiatives that laid a framework to protect investors in foreign companies that issue securities in U.S. markets. Those measures, which remain in force today, provide demonstrable benefits to investors and our markets, as I'll explain in detail in a moment. Since leaving public service, I've continued to serve investors through education and initiatives to promote high quality audits of corporate disclosure.

I want to commend the Subcommittee for its longstanding, bipartisan support for protecting both U.S. investors and U.S. capital markets. Our markets are a national treasure that make it possible for savers and entrepreneurs to realize their dreams. They are a fundamental mechanism for U.S. economic growth. And they have proven to be an enormously successful form of soft power, by affording equal protections to foreign investors in our markets and equal access to foreign companies who commit to our high standards for investor protection. Twenty years ago, the financial reporting scandals relating to Enron, Adelphia, WorldCom, and other U.S. and non-U.S. companies rocked investor trust in our markets and threatened to put these benefits in jeopardy. As these problems were emerging, the House Financial Services Committee and the Senate Banking Committee acted swiftly and decisively in a bipartisan way to restore public confidence in U.S. markets with the Sarbanes-Oxley Act of 2002. The law passed by votes of 423-3 in the House of Representatives, and 99-0 in the Senate.

Title I of the Sarbanes-Oxley Act established the PCAOB to oversee the auditors of U.S. issuers that have registered securities with, or file reports with, the SEC in order to access

the U.S. capital markets.¹ The Act explicitly provides that the PCAOB's authority applies to any foreign public accounting firm that has registered with the PCAOB "in the same manner and to the same extent as" it applies to U.S.-based public accounting firms.²

As of September 2021, 840 non-U.S. accounting firms from more than 80 jurisdictions have registered with the PCAOB in order to be able to prepare or participate in the preparation of audit reports that attest to financial statements submitted to the SEC.³ This includes 36 firms based in Mainland China and 28 firms based in Hong Kong.⁴

One of the most important powers of the PCAOB is to conduct inspections of public accounting firms that prepare or participate in the preparation of audit reports for U.S. issuers.⁵ Initially, there were many foreign jurisdictions that objected to the PCAOB's powers to inspect firms that were based in their jurisdictions, even though the firms issued or participated in the preparation of audit reports on the financial statements of U.S. issuers. Some of the reasons given at the time were that the PCAOB's authority conflicted with local blocking statutes or local secrecy laws, such as those in France and Switzerland. Other countries objected based on a concern that PCAOB inspections could infringe on cultural and legal prohibitions, including important privacy protections in some jurisdictions, such as Germany, against collecting certain information on individuals.

These were formidable objections, but from the beginning, the PCAOB pursued a strategy to engage with its counterparts to raise awareness of the significant risks that investors in both the U.S. and the local jurisdiction faced; impart deeper understanding of the PCAOB's inspection process; develop cooperative approaches to partner with local regulators to mitigate their concerns; and, where necessary, identify legal and other impediments in the local jurisdictions that could be removed with local legislative or other action.

As an example, since many of the objecting jurisdictions were members of the European Union, one of the first acts of the PCAOB's first chair, Bill McDonough, was to embark on a deep engagement with the European Commissioner and Director General for Internal Markets. In May 2004, I was pleased to testify before the full Committee on the constructive working relationship the PCAOB established with the European Commission

¹ Under Section 2(a)(7) of the Sarbanes-Oxley Act, the term "issuer" includes public companies that have either registered, or are in the process of registering, a class of securities with the SEC or are otherwise subject to Commission reporting requirements.

² Sarbanes-Oxley Act, Section 106(a)(1).

³ PCAOB Release No. 2021-004, *Rule Governing Board Determinations Under the Holding Foreign Companies Accountable Act* (Sept. 22, 2021).

⁴ These figures are derived from an interactive map maintained by the PCAOB showing jurisdictions where the PCAOB has access to inspect and jurisdictions where it is denied access. PCAOB Website, *International* available at <https://pcaobus.org/oversight/international> (accessed Oct. 23, 2021).

⁵ Sarbanes-Oxley Act, Section 101(c).

to further our mutual objectives to restore confidence in our respective capital markets.⁶ The EC's Director General for Internal Markets also testified at that hearing, attesting to our mutual interests in promoting audit quality through cooperation in regulatory oversight. That relationship proved to be the foundation for European member states, over a period of years, to work through and address impediments to the PCAOB conducting required inspections.

While these negotiations were ongoing around the world, the PCAOB began inspecting non-U.S. registered firms in 2005, where it could gain access. Over time, the PCAOB increased the number of non-U.S. firms it inspected, as it resolved impediments and reached formal cooperative agreements with foreign audit regulators. These arrangements both minimized administrative burdens and provided mechanisms to resolve potential legal or other conflicts that non-U.S. firms might face in the foreign jurisdiction in question.

Generally speaking, the PCAOB carries out its non-U.S. inspections in two ways:

- First, in some cases, the PCAOB conducts the inspections on its own, with the knowledge and acquiescence of local authorities.
- Second, other cases, the PCAOB conducts the inspections jointly with the home country regulator.

Although the PCAOB was able to work out cooperative arrangements with some of the objecting jurisdictions early on, the pace of such arrangements increased significantly after the financial crisis, which I believe instilled a sense of heightened urgency amongst some jurisdictions to resolve even the thorniest of legal impediments. As I mentioned already, some jurisdictions had to amend their laws before they were able to cooperate in PCAOB inspections, which took considerable time. Ireland and Belgium are two examples. In many cases, local authorities went to great lengths to remove these impediments.

At present, the PCAOB has conducted inspections of one or more firms in more than 50 non-U.S. jurisdictions,⁷ and it maintains cooperative arrangements with 25 foreign audit regulators. These arrangements enable the PCAOB to inspect audits of U.S. issuers in all jurisdictions where PCAOB-registered public accounting firms are domiciled, with two exceptions, Mainland China and Hong Kong. As the sole authority that blocks cooperation with PCAOB inspections of audits of U.S. issuers, the PRC is the outlier.

⁶ Testimony Concerning the Regulatory Dialogue Between the Public Company Accounting Oversight Board and the European Commission (May 13, 2004), available at <http://archives-financialservices.house.gov/media/pdf/051304sr.pdf>.

⁷ PCAOB Website, *Non-U.S. Jurisdictions Where the PCAOB Has Conducted Oversight* (as of June 30, 2021), available at <https://pcaobus.org/oversight/international/international/pcaob-inspections-of-registered-non-u-s--firms> (accessed Oct. 20, 2021).

The PCAOB reports that, in the 13-month period ended June 30, 2021, 15 PCAOB-registered firms in mainland China and Hong Kong signed audit reports for 194 public companies with a combined global market capitalization (U.S. and non-U.S. exchanges) of approximately \$2.4 trillion.⁸ The ten largest of these companies had a combined market capitalization of approximately \$1.6 trillion.⁹

Unfortunately, our markets are being tested by a string of frauds by China-based companies that obtained capital from our markets but failed to comply with our investor protection rules. Last year, Luckin Coffee announced that its chief operating officer had fabricated billions of yuan in sales for 2019, after obtaining more than half a billion dollars by selling American Depository Receipts (ADRs) in an IPO in May of that year.¹⁰ On the heels of the Luckin Coffee revelations, another China-based company – TAL Education Group – revealed that it had inflated sales by forging contracts.¹¹ TAL is a tutoring business that listed ADRs on the New York Stock Exchange in 2010 and whose success turned its founder into one of China’s richest people.¹² In September 2020, another China-based, U.S.-listed education company – Gaotu Edutech Inc. – announced that it too was under investigation by the SEC for possible accounting improprieties.¹³ These are just a few of the more prominent, recent announcements related to China-based, U.S.-listed companies.

As Paul Zarowin, professor of accounting at the Stern School of Business at New York University, put it:

The basic problem is that they don’t have the same auditing standards that we do here And compounding that problem is that the PCAOB [Public Company Accounting Oversight Board] which oversees the auditing firms, generally can’t get access to audit the Chinese auditing firms. So a lot of firms go public from China into Western capital markets that don’t meet the same disclosure and auditing standards that we would here.¹⁴

⁸ PCAOB Website at <https://pcaobus.org/oversight/international/china-related-access-challenges> (accessed Oct. 20, 2021).

⁹ Id.

¹⁰ Sofia Horta e Costa, *Two Accounting Scandals in China in One Week Burn Investors*, Bloomberg (Apr. 8, 2020).

¹¹ Venus Feng, *Chinese Tutoring Mogul Loses \$1.8 Billion After Revealing Fraud*, Bloomberg (April 8, 2020).

¹² Lynn Cowan, *TAL Education IPO Surges 50%*, Wall Street Journal (Oct. 21, 2010); Sofia Horta e Costa, *Two Accounting Scandals in China in One Week Burn Investors*, Bloomberg (Apr. 8, 2020).

¹³ Bloomberg News, *SEC Probes Chinese Education Firm Amid Tighter U.S. Scrutiny* (Sept. 2, 2020).

¹⁴ Therese Poletti, *Luckin Coffee Shows How Risky Chinese IPOs Can Be, But Investors Just Aren’t Listening*, Marketwatch (May 20, 2020) (noting that after the IPO, Luckin Coffee’s market capitalization topped \$4.4 billion after investors sent shares more than 40% higher in its first day of trading on the Nasdaq, making losses by investors who bought in after the IPO even greater than IPO-purchasers losses, when the fraud came to light).

By enacting the Holding Foreign Companies Accountable Act, and by holding hearings such as this one, Congress is playing a critical role in signaling that companies that seek access to capital from U.S. markets must adhere to our rules.

I also commend the SEC for the decisive approach it is taking to implement the Holding Foreign Companies Accountable Act, under which it is preparing to prohibit trading in about 270 China-related companies by early 2024.¹⁵ I also commend the PCAOB for its rulemaking, concluded last month. That rulemaking establishes a framework for the PCAOB to use to determine whether it is unable to complete an inspection or investigation because of a position taken by one or more authorities in that jurisdiction.¹⁶

The SEC has announced that it has paused new offerings from both Chinese operating companies who list directly and their shell-company affiliates.¹⁷ It has also signaled its readiness to accelerate the trading prohibitions to 2023, if Congress enacts the Accelerating Holding Foreign Companies Accountable Act. The SEC is also focused on the risks that investors face from the confusing and unusual corporate structures that many China-based companies seeking capital in the U.S. take. Chairman Gensler has directed the SEC staff to “ensure that these companies provide full, fair and transparent disclosure of their risks and corporate structures, among other factors, if they wish to offer securities in U.S. markets.”¹⁸ These are all important steps that will not only strengthen protection of investors in China-based companies, but also strengthen protection of our markets more broadly.

A great body of research documents the benefits that foreign private issuers obtain by issuing securities in the United States, which binds them to high quality disclosure and audit standards.¹⁹ Those benefits include a lower cost of capital than they would face in their home-country capital markets. The linchpin of these benefits is the binding commitment companies make to our standards, including high quality financial reporting requirements and a reliable third-party audit. Enforcement of this commitment – rather than relying on companies’ assertions of compliance – is what distinguishes U.S. listings and produces their capital market benefits.

PCAOB inspections are a critical component of our enforcement regime. Inspections examine whether third-party auditors are in fact holding companies to their commitments

¹⁵ SEC Chair Gary Gensler, *Chinese Firms Need to Open Their Books*, Wall Street Journal (Sept. 13, 2021) (“Gensler Op-ed”).

¹⁶ PCAOB Press Release, *PCAOB Adopts Rule to Create Framework for HFCAA Determinations* (Sept. 22, 2021). This rule must be approved by the SEC in order to go into effect.

¹⁷ Gensler Op-ed.

¹⁸ Id.

¹⁹ See, e.g., John C. Coffee, Jr., *Racing towards the top? The impact of cross-listings and stock market competition on international corporate governance*, 102 Columbia Law Review 1757–1831 (2002); Rene M. Stulz, *Globalization of equity markets and the cost of capital*, 12 J. Applied Corp. Fin., 12: 8–25 (1999); Craig Doidge, Andrew Karolyi, and Rene Stulz, *Why are foreign firms listed in the U.S. worth more?* 71 J. of Fin. Econ. 205–238 (2004).

to produce high quality and reliable financial reports. For example, empirical evidence suggests that capital markets find financial reporting more credible following introduction of PCAOB inspections in non-U.S. jurisdictions.²⁰ That is, investors put more faith in financial reporting when the PCAOB is able to inspect.

There is a basis for this trust: research has also found that auditors in jurisdictions where the PCAOB can inspect provide higher quality audits as measured by more going concern opinions, more reported material weaknesses, and less earnings management, relative to auditors in jurisdictions where the PCAOB cannot inspect.²¹ Inspection access is also associated with higher-quality analyst forecasts, which suggests that the PCAOB gaining access to inspect “reduces information risk for market participants.”²²

This higher level of trust translates to benefits for companies. Researchers have found that foreign SEC registrants with auditors from countries that allow PCAOB inspections enjoy a lower cost of capital, relative to foreign SEC registrants with auditors from countries that prohibit inspections.²³ With this evidence, it should be no surprise that most jurisdictions found ways to accommodate PCAOB inspections.

China-based companies’ free-riding on U.S. markets, without complying with U.S. audit regulations, increases fraud risks for investors in those companies. But that is not the only reason why it is important to stop the free-riding. It also harms our markets more broadly. The benefits I’ve described exist because participation in our markets means something; it is a signal of the quality and reliability of the financial information of the companies that list here. As we saw in the days of the Enron scandal, when any group of participants fails to comply with our standards, that sends a signal that weakens confidence in the whole market. Thus, for the benefits to continue to flow to compliant U.S. and non-U.S. companies, it must be clear that we enforce our standards across the board.

If China continues to block PCAOB inspections, then China-based issuers that are prohibited from U.S. public securities markets may attempt to access U.S. capital through private markets for exempt offerings that do not have reporting requirements. The theoretical foundation for such exemptions is that sophisticated private investors have superior access to information through their ownership stake. But this is not the case when it comes to China-based companies. To get around Chinese regulatory requirements,

²⁰ Brandon Gipper, Christian Leuz, and Mark Maffett, *Public Oversight and Reporting Credibility: Evidence from the PCAOB Inspection Regime*, The Review of Financial Studies (Dec. 26, 2019).

²¹ Phillip T. Lamoreaux, *Does the PCAOB Inspection Process Improve Audit Quality? An Examination of Foreign Firms Listed in the United States*, J. Acc. Res. (2016) (On the other hand, there is no observable difference between the two sets of auditors prior to the PCAOB inspection regime.).

²² Id.

²³ Phillip T. Lamoreaux, Landon M. Mauler, and Nathan J. Newton, *Audit Regulation and Cost of Equity Capital: Evidence from PCAOB’s International Inspection Regime*, Contemporary Acc. Res. (Winter 2020).

China-based private companies seeking capital outside of China adopt complex structures through contracts with shell companies in foreign jurisdictions, which break the chain of ownership. U.S. investors buying into such structures have no control over the China-based company's management or assets and no rights to information about them. The SEC is right to be concerned about these risks, whether the investor is accredited to make direct purchases in exempt private offerings or is indirectly exposed through shares in a mutual fund or other pooled investment vehicle that invests in private companies.²⁴

In conclusion, audit regulators around the world cooperate in PCAOB inspections of PCAOB-registered firms' audits of companies that offer securities in the U.S. The PRC is the only government that blocks them. This causes serious harm both to investors in such companies as well as our public capital markets more broadly. I commend the work you have done to put an end to these harms, as well as the work the SEC and PCAOB have done to implement the Holding Foreign Companies Accountable Act. Based on the heightened risks evident from a string of frauds that have already been revealed, it will also be important to ensure that China-based companies that are prohibited from trading on our public markets do not turn to other ways to access U.S. capital, and therefore I commend your continued vigilance as well as the SEC's work to ensure these companies provide full, fair and transparent disclosure of their risks and corporate structure.

²⁴ See, e.g., Andrew Ross Sorkin, *Main Street Portfolios Are Investing in Unicorns*, N.Y. Times (May 11, 2015).