

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

October 21, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: October 26, 2021, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets Hearing entitled, “Taking Stock of ‘China, Inc.’: Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets”

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Taking Stock of ‘China, Inc.’: Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets” on Tuesday, October 26, 2021, at 10:00 am in room 2128 of the Rayburn House Office Building and on the Cisco Webex platform. There will be one panel with the following witnesses:

- Karen Sutter, Specialist in Asian Trade and Finance, Congressional Research Service
- Samantha Ross, Founder, AssuranceMark, The Investors’ Consortium for Assurance
- Claire Chu, Senior Analyst, RWR Advisory Group
- Eric Lorber, Senior Director of the Center on Economic and Financial Power, Foundation for Defense of Democracies

Overview

In recent years, growing engagement between U.S. investors and China-based companies, which have sought to raise capital by issuing registered and unregistered securities in the U.S., has produced a number of risks to investor protection, the American economy, and national security. Among the risks to U.S. investors include: lack of corporate transparency and reliable financial information, increased corporate fraud, lack of legal recourse for U.S. investors, and other legal barriers that prevent U.S. securities regulators from conducting effective oversight of foreign issuers, and more recently, an increase in regulatory activity by Chinese authorities targeting China-based companies.

Background on Investment Vehicles Used By China-based Companies

Listed and Public Markets

The issuance of equity and debt securities, both registered and unregistered, by China-based foreign companies in U.S. markets has increased significantly over the past two decades. According to data from Ernest & Young, 50 percent of foreign initial public offerings (IPOs) completed in the U.S. during the first half of 2021 were by companies based in China.¹ These offerings represented nearly 15 percent of total IPO proceeds raised in the U.S. during that period.² The IPO of online Chinese retail marketplace Alibaba (listed on September 18, 2014) on the New York Stock Exchange, which generated proceeds of nearly \$22 billion, remains the second largest IPO in U.S. history.³ As of October 2, 2020,

¹ See *Ernst & Young Global Limited, doing business as “EY”, Q2 2021 IPO Report*, at 12, (Jul. 15, 2021).

² *Id.*

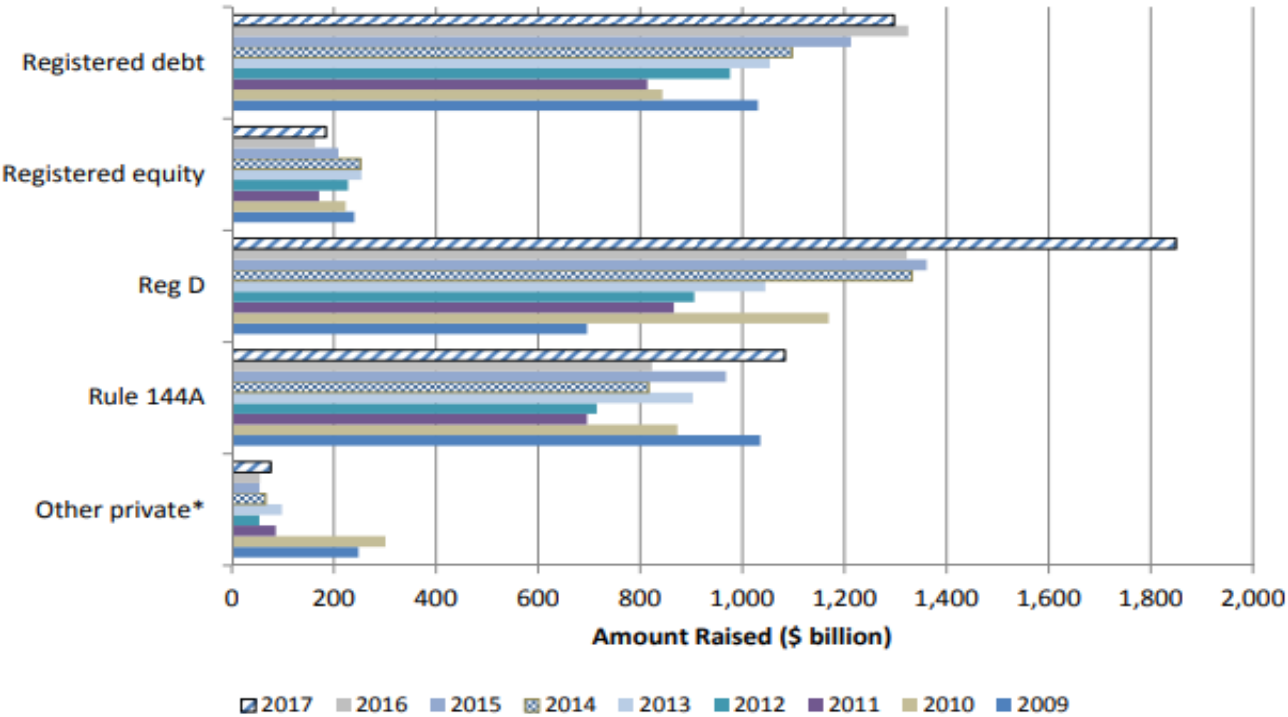
³ Renaissance Capital, *All Time Largest U.S. IPOs*, (Jun. 2021).

there are a total of 248 China-based firms listed on U.S. stock exchanges, representing a combined market capitalization of \$2.2 trillion⁴—but it is unclear how much of this \$2.2 trillion is held by U.S. investors.

Exempt and Non-Public Markets

Foreign issuers aiming to raise capital from U.S. investors also have access to the “exempt offerings” regime, which—unlike publicly listed and SEC-registered securities—allows for issuers to sell their securities without registering with the SEC or providing regular and detailed disclosures. More than two-thirds of capital raised through the securities markets in the United States is conducted through these exempt offerings⁵ (Figure 1). In 2019 alone, over \$2.7 trillion was raised through exempt offerings in the U.S.⁶ Foreign issuers “accounted for approximately 22% of the total amount reported sold during 2017.”⁷ Regulation D and Rule 144A are the most frequently used exemption to issue and sell unregistered securities. Data on unregistered offerings by China-based or China-related issuers (e.g., issuers that are based outside China but raise capital for firms based in China) is limited, but some of these companies currently do raise capital through exempt offerings. Should currently U.S.-listed China-based companies be de-listed or “go dark,” they may migrate to the exempt offerings space.

Figure 1. Aggregate capital raised in 2009-2017 by offering method (\$billions)



* Other private includes Regulation S offerings, Section 4(a)(2) offerings, Regulation Crowdfunding offerings, and Regulation A offerings.

⁴ See US-China Economic and Security Review Commission, *Chinese Companies Listed on Major U.S. Stock Exchanges*, (May 13, 2021).
⁵ See SEC, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings*, 2009-2017 (Aug. 2018).
⁶ See SEC, *Final Rule: Facilitating Capital Formation...* (Nov. 2020) p.129.
⁷ See fn.5, *ibid*, p.2.

Variable Interest Entity

China's government generally prohibits China-based companies from accepting investments that would result in foreign ownership of the firm.⁸ Since 2000, many China-based companies have circumvented this restriction to raise equity capital in the U.S. through the use of a variable interest entity (VIE) structure.⁹ Although not officially authorized or regulated by the Chinese government, this VIE structure is employed to avoid foreign ownership of any company in a restricted industry, and instead provides foreign investors with an economic interest in the company through contractual agreements.¹⁰ In a simple VIE structure, two new legal entities are formed to join the existing China-based operating company. One entity is an offshore shell company, typically formed in the Cayman Islands or another similar jurisdiction. This shell company is the entity which is listed on an U.S. exchange. The other new entity is a company established in China which is wholly owned by the offshore shell company. Contractual agreements are established between the offshore shell company and the existing China-based operating company in a way that simulates equity ownership by the new company without technically qualifying as such.¹¹ Whatever value that is generated in the new China-based company through these agreements is then tangentially reflected in the share price of the offshore shell company whose shares are held by U.S. investors. The offshore shell company is often given the same name as the original China-based operating company which creates the misleading impression that they are the same firm. Approximately two-thirds of China-based companies listed on U.S. exchanges are structured as VIEs.¹²

Accounting and Audit Oversight

With the passage of the Sarbanes-Oxley Act (Sarbanes-Oxley) of 2002, Congress created the Public Company Accounting Oversight Board (PCAOB), mandating it to conduct independent, external oversight of the auditors of U.S. public companies, in part, by requiring those audit firms to register with the PCAOB. For the past decade the PCAOB has struggled to conduct effective oversight of PCAOB-registered audit firms that are based in mainland China and Hong Kong and serve as the primary auditor for U.S. exchange-listed companies.¹³ Currently, China's government blocks the PCAOB's inspection of US-related audit work and the practices of PCAOB-registered firms in mainland China and Hong Kong, citing national security and state secrecy policies.¹⁴ China is an outlier in this regard. The PCAOB currently maintains cooperative agreements with 23 foreign regulatory authorities, recently securing agreements with Belgium and France on April 7, 2021,¹⁵ and has conducted inspections of audit firms in over 50 foreign jurisdictions.¹⁶

The potential risks associated with this issue were highlighted in April 2020 when the NASDAQ-listed China-based retailer, Luckin Coffee, admitted to having filed financial reports that fabricated over \$300 million in sales revenue.¹⁷ News of this fraud resulted in an almost immediate 80 percent decline in the price of Luckin shares in the U.S., which erased nearly \$5 billion in its market value.¹⁸ The company, which was subsequently delisted from the NASDAQ, has agreed to pay a \$180 million penalty to the

⁸ See China Briefing, [China Releases 2020 Negative List for Market Access](#), (Dec. 23, 2020).

⁹ See Inventus Law, [China Variable Interest Entity Structure 2020](#), (Feb. 24, 2020).

¹⁰ *Id.*

¹¹ See Council of Institutional Investors, [Buyer Beware: Chinese Companies and the VIE Structure](#), (Dec. 2017).

¹² *Id.*

¹³ See Reuters, [Top U.S. market's audit watchdog gives gloomy forecast for quality bookkeeping at U.S.-listed Chinese firms](#), (Jul. 9, 2020).

¹⁴ See PCAOB, [China-Related Access Challenges](#), (Sept. 2021).

¹⁵ See PCAOB's agreement with the Belgian Audit Oversight College, available at [cooperative-agreement-belgium-2021.pdf](#), and agreement with France's Haut Conseil du Commissariat aux Comptes, available at [EN SOP H3C PCAOB 4.7.2021 public.pdf](#).

¹⁶ See PCAOB, [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).

¹⁷ See CNBC, [Shares of China's Luckin Coffee plummet 80% after investigation finds COO fabricated sales](#), (Apr. 2, 2020).

¹⁸ *Id.*

Securities and Exchange Commission (SEC) to settle charges of fraud,¹⁹ and on February 5, 2021, filed for bankruptcy.²⁰

In December of 2020, Congress passed the Holding Foreign Companies Accountable Act, which requires that any U.S. exchange-listed foreign company be delisted if, for three consecutive years following the date of enactment, the PCAOB is unable to inspect the primary auditor of that company.²¹ In 2020, in an effort to address related investor protection concerns associated with the U.S. listing of China-based companies, the President's Working Group on Financial Markets published a report that itemized five policy recommendations.²² These recommendations include proposals to enhance listing standards, issuer disclosures, fund disclosures, due diligence of indices and index providers, and guidance for investment advisors.

Foreign Regulatory Activity and Ownership

In recent months, China's regulators have taken significant steps to enforce existing and establish new regulatory requirements for China-based companies operating in a range of industries. Many of these actions have affected large companies in the technology sector and have focused specifically on consumer data security and protection as well as anti-monopoly efforts.²³ There is growing concern regarding the collateral impact this activity may have on U.S. investors in China-based firms that have issued securities or listed for trading in the U.S. On June 30, 2021, China-based ride hailing company Didi Global Inc. completed its U.S. IPO having raised \$4.4 billion in total proceeds, the second largest U.S. IPO in the first half of this year.²⁴ Two days later, on July 2, China's Cyberspace Administration announced that it had launched a cybersecurity review of the company and on July 4, the Chinese government mandated that the Didi mobile app be removed from app stores, causing a sharp decline of Didi's share prices—which, as of this writing, is down 40 percent from its IPO price.²⁵

Similarly, on July 23, 2021, the Chinese government announced a finalized set of new broad regulations which effectively ban many services by private tutoring companies and prohibit those firms from raising capital or going public.²⁶ In particular, these Education Sector Implementation Rules appear to go beyond existing prohibitions on foreign ownership of China-based education companies and explicitly ban use of the VIE structure by firms in this industry.²⁷ Immediately following the announcement of these new regulations, U.S.-listed China-based private tutoring companies, including TAL Education Group, New Oriental, and Gaotu Techedu, each experienced a more than 60 percent drop in share prices.²⁸ To date, share prices in all of these companies have not recovered from that decline.

In instances such as these, many investors have sought to recover financial losses by suing the issuers for not adequately disclosing risks faced by the firm.²⁹ Didi currently faces multiple shareholder lawsuits for allegedly failing to disclose that the company was encouraged to delay its IPO by Chinese

¹⁹ See SEC, [Luckin Coffee Agrees to Pay \\$180 Million Penalty to Settle Accounting Fraud Charges](#), (Dec. 16, 2020).

²⁰ See Forbes, [Luckin Coffee Files For Bankruptcy Seven Months After Nasdaq Delisting](#), (Feb. 5, 2021).

²¹ Public Law No: 116-222.

²² See President's Working Group on Financial Markets, [Report on Protecting United States Investors from Significant Risks from Chinese Companies](#), (Jul. 24, 2020).

²³ See CNBC, [China's regulatory crackdown has wiped billions off tech stocks — here are the risks ahead](#), (Aug. 30, 2021). Didi's IPO price was \$14.14, and it closed at \$8.56 on Tuesday, Oct 19, 2021.

²⁴ See Reuters, [China's Didi raises \\$4.4 bln in upsized U.S. IPO](#), (Jun. 30, 2021).

²⁵ See Bloomberg News, [Didi Dives as China Unveils New Cyber Probe After Mega IPO](#), (July 3, 2021).

²⁶ See Bloomberg News, [China Bans For-Profit School Tutoring in Sweeping Overhaul](#), (Jul. 25, 2021).

²⁷ See Akin Gump LLP, [New Mainland China Implementation Rules for the Law for Promoting Private Education – Implications for Investments into VIE Structures?](#), (Jun. 22, 2021).

²⁸ See Financial Times, [Global investors try to claw back their capital from China tutoring groups](#), (Aug. 5, 2021).

²⁹ See OpenPR, [Investigation announced for Investors in shares of Gaotu Techedu Inc.](#), (Sep. 13, 2021).

authorities.³⁰ However, due to the VIE structure through which shareholders maintain no real ownership of the China-based operating company, according to November 2020 guidance issued by the SEC's Division of Corporation Finance "even if an investor obtains a judgment in a U.S. court, the investor may be unable to enforce such judgment, particularly in the case of a China-based issuer, where the related assets or persons are typically located outside of the United States and in jurisdictions that may not recognize or enforce U.S. judgments." A clear demonstration of the limited control afforded to U.S. investors in companies that rely on a VIE structure was the lucrative 2011 spinoff of Alipay by Alibaba, which was able to take place without Yahoo Inc, then a 43 percent owner of Alibaba, being consulted.³¹

U.S. Regulatory Response

Since November of 2020, SEC guidance has directed all China-based issuers to prominently disclose unique risk factors such as whether the firm's auditor is subject to PCAOB oversight, whether the company relies on a VIE structure and associated legal risks, and the potential for heightened regulatory enforcement by Chinese authorities.³² In July 2021, following the sudden investigation of Didi by China's Cyberspace Administration, SEC Chair Gary Gensler announced that he has directed SEC staff to ensure that China-based firms that have filed for an IPO clearly and prominently make many of these types of disclosures before deeming the registration statements of these firms effective.³³ In his statement, Chair Gensler also indicated that has asked SEC staff to "engage in targeted additional reviews of filings for companies with significant China-based operations."³⁴

The Holding Foreign Companies Accountable Act further requires foreign issuers that rely on audit firms beyond the reach of the PCAOB to make annual disclosures specifically focused on clarifying the company's relationship to any foreign governments and to the Chinese government. Once the SEC has finalized its rulemaking, these companies will be required to disclose the percentage of shares owned by government entities in which the company is incorporated and whether these government entities have a controlling financial interest in the firm. Firms will also have to disclose information related to any board members who are officials of the Chinese Communist Party and whether the articles of incorporation of the issuer contain any charter of the Chinese Communist Party.

Systemic Risks and Evergrande

On September 23, Evergrande, one of China's largest property developers, failed to make a \$83.5 million payment to bondholders, signaling major financial stress within the company.³⁵ In recent years, Evergrande has made substantial investments in China's housing market and is now struggling to manage its \$300 billion debt burden, roughly equivalent to 2 percent of China's GDP.³⁶ According to some estimates, the company has already sold \$200 billion of apartments, 1.4 million units, which it has not completed construction.³⁷ The real estate market and related industries represent approximately 30 percent of China's annual GDP.³⁸ Given the size of Evergrande's balance sheet and relatively high-asset prices in the China's property market, many market participants remain concerned that a collapse of the company could produce a downturn real estate prices and cause a shock to the global financial system.³⁹

³⁰ See Fortune, [Didi's problems with Chinese regulators lead to two U.S. shareholder suits](#), (Jul. 8, 2021).

³¹ See Reuters, [Yahoo gets short end of stick in Alibaba deal](#), (Jul. 29, 2011).

³² See SEC Division of Corporation Finance, [Disclosure Considerations for China-Based Issuers](#), (Nov. 23, 2020).

³³ A requirement of the traditional IPO process is for staff within the Commission's Division of Corporation Finance to review and provide comments on the company's registration statement before it is declared effective.

³⁴ See SEC, [Statement on Investor Protection Related to Recent Developments in China](#), (Jul. 30, 2021).

³⁵ Barron's, [Evergrande Missed Payment Deadline on Global Bonds, According to Reports](#), (Sept. 24, 2021).

³⁶ Washington Post, [China's 'controlled demolition' plan for Evergrande marks the end of its housing boom](#), (Sept. 29, 2021).

³⁷ Wall Street Journal, [What Is China Evergrande, and Why Is Its Crisis Worrying Markets?](#), (Oct. 8, 2021).

³⁸ Bloomberg Opinion, [Why China's Evergrande Crisis Could Be Worse Than the U.S. Crash](#), (Sept. 25, 2021).

³⁹ *Id.*

Legislation

- **H.R. _____, Accelerating Holding Foreign Companies Accountable Act (Sherman).** This bill would shorten the time period in the Holding Foreign Companies Accountable Act from three years to two years for foreign companies to comply with PCAOB audits or face delisting from US exchanges.
- **H.R. 2072, Uyghur Forced Labor Disclosure Act (Waxton and Sherman).** This bill requires issuers of securities to publicly disclose their activities related to China's Xinjiang Uyghur Autonomous Region. Specifically, issuers must disclose the importation of manufactured goods and materials that originated or are sourced from that region, as well as details about the commercial activity, gross revenue and net profits, and future import plans regarding these goods and materials. Furthermore, issuers must disclose whether any of these goods or materials are from forced labor camps.