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REPORT
The Future of Chinese Listings in the United States

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The Future of Chinese Listings in the United States

As of October 2020, 217 Chinese companies were listed on US exchanges with a $2.2 trillion market capitalization. For over a decade, a US listing by a Chinese company was viewed in the Mainland as the gold standard, a status symbol of corporate success. This was always the case even as the last decade was a tumultuous one for Chinese firms and US investors that reeled from a series of high-profile scandals but reached unparalleled heights in 2014 with the then-largest IPO in history - the listing of Alibaba.

In a somewhat ironic occurrence, the flow and quality of Chinese listings in the United States have improved over the past four years as the rhetoric towards every facet of the US-China relationship deteriorated. Although some high-quality companies have chosen to go public despite the tone, ever-present concerns of short-sellers relating to reporting, non-disclosure, and accounting differences came back to the fore via the scandal relating to Luckin Coffee. This shone a light on a glaring regulatory gap between US and Chinese companies listing on the same exchanges and forced investors and regulators alike to ask the obvious question.

Is it fair or appropriate that Chinese companies have different reporting and disclosure standards from American companies when listing on US exchanges?

Putting it in those terms, it seems like the future is bleak. As will be discussed, US and Chinese regulators have been trying for years to bridge the divide that would allow US regulators access to Chinese audit firms in the event of an action against a Chinese company. The broadness and vagueness of the National Security regulations makes this highly unlikely.

While the financial services sector has generally avoided the brunt of US-China tensions, recent developments have threatened to open a new front in the conflict between the two countries. Congress's Holding Foreign Companies Accountable Act and a report from the President's Working Group on Financial Markets highlight risks that Chinese companies pose to US investors. All this could lead to the delisting of Chinese companies on US exchanges as early as 2022.

Alison Schonberg, a business advisory services manager at the US-China Business Council, hosted a panel discussing the status of Chinese listings in the US amidst larger US-China tensions. Featuring:

Claudius Modesti — Partner at Akin Gump

Liza Mark — Administrative Partner of Haynes and Boone's Shanghai office

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Background: Chinese Corporate Listings in the US

Liza Mark: a brief background on Chinese companies listing in the US. Some key points:

- Today, 217 Chinese companies are listed on US major stock exchanges representing about $2.2 trillion in market cap.
- The US market's prestige and deep capital pool made it a gold standard for Chinese companies in the past two decades.
- Listings of Chinese companies have ebbed and flowed in the last ten years; despite several smaller scandals involving de-listings and trading suspensions, more and more Chinese companies held IPOs between 2017 to 2019.

For years, the differences in accounting practices, reporting procedures, and non-disclosures made Chinese companies the target of short-sellers. This all came to a head with the Luckin Coffee scandal.

Luckin Coffee

Luckin Coffee is China's answer to Starbucks. The Chinese company was very successful — at least on face value — and came to the US for an IPO in May of 2019.

The scandal started in January 2020 when Muddy Waters, an American investment research firm, issued a short-seller report, challenging Luckin Coffee's reported revenue for their IPO prospectus. Luckin ended up doing an internal investigation and admitted to its issues, and their market value dropped by 94% before they were delisted in May.

Recently they were fined 9 million dollars by the Chinese government, but given how high profile the company was and how much vetting was supposedly done, the scandal sounded a warning bell for a lot of the regulators that were looking at the US market. Luckin Coffee's case certainly played into many fears of cooked books among Chinese companies.

US Regulations and the PCAOB

Claudius Modesti: For context, the PCAOB or Public Company Accounting Oversight Board was created under the Sarbanes-Oxley Act in the early 2000s. The PCAOB was required to inspect audit firms and their reports, and at the time, the focus was largely domestic in the aftermath of US-based frauds such as WorldCom, Enron, Adelphia. That was until Congress decided to expand its jurisdiction to include the audits of foreign-based companies listed in the US.

While audit firms elsewhere eventually complied, the PCAOB ran into trouble with China-based ones. The PCAOB had been negotiating for some time for access to China-based audit firms for inspection, as some of the frauds that happened in 2008 to 2010 involved Chinese companies — most of which were not household names.

Around the same time, PCAOB began publishing lists of publicly traded companies whose auditors were not complying with the PCAOB. Moreover, the Securities and Exchange Commission (SEC) brought enforcement proceedings against the Chinese affiliates of the "Big Four" accounting firms for not providing documents that the SEC wanted for its investigations. That was eventually settled when the SEC's Chinese counterpart agreed to assist the SEC.

For the past five years then, the focus has been on Chinese companies. The PCAOB negotiated a Memorandum of Understanding in 2013 (which Claudius participated in) that allowed the US to access Chinese audit work papers and other relevant information. For a while, there weren't any enforcement cases and public pronouncement cases until the Securities and Exchange Commission (SEC) and PCAOB issued joint statements in the past two years that outlined their challenges in accessing information on China.

China's Problem with PCAOB

Claudius Modesti: On their end, China prefers that the PCAOB recognize their Chinese counterparts as the regulatory equivalent of US regulators. China is concerned about whether information turned over to US regulators would reveal state secrets and other sensitive information. Board members who are officials of the Chinese Communist Party would be disclosed, for instance, as well as articles of incorporations that include any charters of the Chinese Communist Party.

These issues still haven't been resolved. While negotiations may continue, they're surfacing in the broader context of tensions between the United States and China: it will be very challenging for one side or the other to compromise.

Liza Mark: There are three Chinese laws that inhibit auditing firms:

- Financial records of security firms and security service institutions must be stored within China and cannot be provided to overseas securities business activities.
- Most Chinese companies listing in the US at the early stages were large state-owned enterprises that were concerned some of their documents had state secrets. This, to some extent, has extended to private Chinese firms.
- Chinese archival laws — differing from most Western countries — require those records to be kept within China and cannot be carried or transported out of the country without authorization.

The critical problem is that there are two clashing sets of regulations under which these Chinese companies and the audit firms are trapped.

US response to China's opposition

Liza Mark: Following the Luckin Coffee scandal, the Senate passed the Holding Foreign Companies Accountable Act this past May, and the House of Representatives incorporated a very similar piece of legislation into its broader National Defense Authorization Act (NDAA). If it's enacted, the Sarbanes-Oxley Act will impose requirements on their lists of companies and the PCAOB's obligations in inspecting those audits.

If a company is listed in the US for three years and is issued an audit that cannot be inspected by the PCAOB, it is delisted. The company could try to get a compliant auditor and list again, but if that doesn't happen, then there's an automatic mandatory 5-year prohibition. Moreover, any year that went without an audit opinion from a PCAOB-inspected firm would also be subjected to heightened disclosure obligations.

They are certainly making it difficult for Chinese companies to list in the US by applying more pressure to make it possible for the PCAOB to carry out their inspection duties.

Claudius Modesti: The US picked something uncontroversial would show both domestically and globally that these Chinese companies — and the Chinese government — are not willing to comply.

The two versions of this legislation have different ideas of the threshold for which companies would be delisted. The House's version, which is more likely to be passed as part of the NDAA, would force companies to delist if more than one-third of its auditing work was done by an auditing firm that is not PCAOB-compliant.

The two chambers of Congress will put together a committee to finalize a version of the bill. This will probably happen after the election — sometime in December — but it is considered a "must-pass" bill.

In addition to legislation, both the SEC and President Trump have convened meetings to discuss Chinese company access to US markets and the consequences for American investors if these companies were to leave.

Simultaneously, the administration is putting pressure on US institutions that have vested interests in Chinese companies. Pension agencies for federal workers such as Federal Retirement Thrift Investment Board and US Railroad Retirement Board were warned that their investments in Chinese companies might be risky. US universities, too, were asked to consider divesting some of their endowments away from Chinese companies.

In short, the US is maintaining the narrative that these Chinese companies are not only risky but also that these institutions are supporting the Chinese government and military through investments.

Co-Audit as a solution

Claudius Modesti: There have been talks of a solution called a co-audit model, which has aroused some doubts as to its viability. With details on rulemaking and standards that are still under discussion, the idea is to have US-based audit firms lead the audit and use staff of the Chinese firm, leveraging local knowledge and skills. Since this is something new, at least in the

US, it will likely require the SEC to change listing standards. The problem remains the same: that US regulators have to gain access to these companies' documents, and if needed, bring these papers to the US.

Some doubt it would solve the tension between the US and Chinese requirements imposed on audit firms and their clients. But we are expecting something to happen between now and the end of the year in the form of a proposal on this from the SEC under the President's recommendations. Regardless of the election, there'll be much pressure to keep things moving forward. Simultaneously, the SEC will have to think very carefully about focusing on emerging market auditors without making US exchanges less desirable to companies.

The possibility of a Chinese backlash

Liza Marks: I don't think that's likely. These rules on transparent auditing processes have existed for more than ten years, and it's hard to make an exception for Chinese companies. However, one significant consequence is that other exchanges, notably Hong Kong, might benefit. Some key points:

- Companies would consider alternatives such as Hong Kong or China's Star board if the US market is no longer attractive. Chinese regulators, for instance, have opened the STAR board in Shanghai, and they're allowing the ChiNext in Shenzhen to go through a registration system rather than an approval system.
- Hong Kong has remained competitive in recent years for big IPOs, as the exchange revamped its listing standards in 2018 so that weighted voting rights structures are allowed. This is so that company founders can maintain control on the company side while still benefiting from a listing.
- Hong Kong has also focused more on businesses in greater China for secondary listings, increasing the minimum market capitalization to 40 billion Hong Kong dollars.
- Hong Kong is benefiting from tensions by allowing Chinese companies to do their IPO there or for them to do a dual primary listing in Hong Kong (this means that the company would have to comply with rules in both the US and Hong Kong). Yet it's an attractive option for some of China's most prominent companies: Alibaba, for instance, had raised 11 billion US dollars in its secondary offering in Hong Kong in November 2019.

To conclude, compared to 10 years ago, Hong Kong now has the capital depth for these companies. In the first eight months of this year, for instance, funds raised by 91 IPOs in Hong Kong increased by 74.7%. That's a huge bump. The China and Hong Kong markets are developing to the point where they can support the funding requirements for Chinese companies; certainly, we expect to see more fundraising migrating to the Asia market.

Discuss the SEC's rulemaking process if some iteration of the Holding Foreign Companies Accountable Act is included in Congress' National Defense Authorization Act. What would be the next steps?

Claudius Modesti: These requirements won't necessarily kick in immediately, and there'll be a bit of a lag. If it passes, I expect the SEC would probably put a pause on its other rulemaking. It depends on how that legislation ultimately gets implemented and if the SEC would have to compliment or require any gaps, and whether US exchanges would complement new rules with their standards.

Given the pre-election season and the broader political climate, we anticipate that a different administration would take on these issues just as fiercely, if not more so. Yet, if these companies manage not to get delisted for more than three years, there may be opportunities for workable compromises.

Liza Mark: Despite all the saber-rattling, a lot of US Capital has already gone into US-listed Chinese companies; in this case, I don't think the US market imagines a scenario where suddenly all the Chinese companies have delisted. That's really not good for US investors.

How may any of these rules eventually extend to fund managers that can invest in China from the United States?

Liza Mark: The direct answer is that at this point, it doesn't limit fund managers' access to Asia markets, but at some point, the more extensive capability of US capital being able to access higher growth markets could come into question. This is a gigantic chess game being played right now, and the Sarbanes-Oxley Act and PCAOB are only smaller parts of a much larger competition between China and the US.

On the other hand, alternatives such as Hong Kong, Singapore, and even the Chinese STAR market are available for Chinese companies' overseas listings. Despite these markets' flaws and shortcomings, they are growing and doing very well.

Ultimately, the question becomes: are you trying to protect the US market, or are you trying to protect US investors because they need the option of investing in high growth areas, of which China happens to be one?

Conclusion

Claudius and Liza eloquently discussed an issue that appears to have no positive solution. Their conversation, at its core, shone a light on a glaring regulatory gap between US and Chinese companies listing on the same exchanges and forced investors and regulators alike to ask the obvious question.

Is it fair that Chinese companies have different standards than American companies when listing on US exchanges?

Putting it in those terms, it seems like the future is bleak. As was discussed, the US and Chinese regulators have been trying for years to bridge the divide that would allow US regulators access to Chinese audit firms in actions against a Chinese company. The broadness and vagueness of the National Security regulations make this highly unlikely.

Why would US regulators, in an environment where companies like Bytedance and WeChat face restrictions for no valid stated reason outside of they are Chinese, accept Chinese companies on US exchanges where they blatantly have a disclosure advantage over US firms? I was not favoring action against Bytdance and WeChat as we were shown no evidence except for guilt by associations. Alibaba plays by different rules in the United States versus the like of Amazon. Given the US and Chinese regulators are unlikely to find common ground, it is difficult for me to see how this situation is likely to persist.

This would be the case under a Biden or Trump administration. While arbitrary action may end under a Biden presidency that will be much more rules-based and process-driven, forcing Chinese companies to adhere to the same standards all other companies seems like low hanging fruit and a necessary step to protect all investors. I would anticipate that the era of new Chinese listings in the United States has come to an end. While forced delisting would take time, it is entirely conceivable that no Chinese company has a US listing within five years.

Hong Kong is the ultimate beneficiary of this change. For all the turmoil facing Hong Kong in recent years, it could well take over the mantra of the preeminent location for high-profile Chinese corporate listings. While mainland exchanges will win their fair share of mandates, the Hong Kong Exchange is uniquely positioned to bridge the divide as a reliable access point for global investors and China's proximity. However, it could boil down to the following simplistic argument.

If you are a Chinese company, why would you risk listing in the United States if all the same investors can be reached in Hong Kong?

Putting it that way, the future for Chinese listings in the United States is dire indeed.

By Paul Krake

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