SEC TAKES FURTHER AIM AT DISCLOSURE BY CHINA-BASED COMPANIES, BUT WHO IS DRIVING WHERE THESE COMPANIES ULTIMATELY ARE LISTED?

One should not be faulted for likening the latest salvos in the skirmishes between the United States and China over US listings by companies based, or that have the majority of their operations, in China ("China-based companies") to Kabuki Theatre. Until recently, the driving force behind the crackdown on China-based companies has been the United States – with a combination of tougher SEC disclosure standards and a legislatively mandated three-year process that is set to trigger US trading prohibitions and, therefore, delistings at the end of the three years. But China now, surprisingly, is doing its part, and if it wants to, it could effectively shut down those US listings. The question is, why the dance, why the theatre?

Background

Earlier this week, the Staff of the SEC's Division of Corporation Finance published a sample comment letter, in which the Staff indicated that more prominent, specific and tailored disclosure about the risks of investing in China-based companies, and in particular about the use of variable interest entity ("VIE") structures by technology companies, educational companies and companies in certain other sectors, is warranted. The Staff announcement makes reference to the issuance in November 2020 of CF Disclosure Guidance: Topic No. 10 (Disclosure Considerations for China-Based Issuers) ("CF-10") as well as SEC Chair Gensler's July 2021 Statement on Investor Protection Related to Recent Developments in China, in which he referred to recent Chinese government guidance and restrictions on capital raising offshore by China-based companies. The sample comment letter covers a variety of Staff comments that have been issued recently on individual filings; this letter, while presented as a sample and not disclosure guidance, nonetheless puts the relevant issuer community on notice. Where time often is of the essence, there is little benefit for issuers to "buy" the comments (*i.e.*, wait for the SEC Staff to issue the inevitable comments and delay the process).

All of the foregoing is occurring in the context of a longstanding, and seemingly intractable, dispute between US and Chinese regulators over the ability of the Public Company Accounting Oversight Board ("PCAOB") to inspect audit work and practices of PCAOB-registered public accounting firms in China and to inspect work papers for audits of the financial statements of China-based companies listing in the United States undertaken by PCAOB-registered public accounting firms in Hong Kong. China has resisted, presumably based on national security concerns. This dispute ultimately culminated in passage by the US Congress at the end of 2020 of the Holding Foreign Companies Accountable Act ("HFCAA") and related SEC rulemaking (see final rule: Holding Foreign Companies Accountable Act Disclosure, promulgated this month). The likely outcome of the current dispute and US action (baring a turnaround by one set of regulators) will be the delisting of China-based companies from US exchanges in three years by reason of trading prohibitions to be imposed by the SEC under the provisions of the HFCAA.

In July, Chinese regulators declared VIEs in the private (*i.e*, for profit) education sector to be off-limits to foreign investors, and for separate reasons compelled Didi Global, only months after its IPO, to announce in early December that it would delist from the NYSE and move its listing to Hong Kong.

Sample Comment Letter

The sample comment letter in effect calls for enhanced disclosure of risks that have been present (and known) for years when investing in publicly traded securities of China-based companies, as well as new risks (largely known, and certainly foreseeable) triggered by enactment of the HFCAA. The most prominent of the longstanding risks is the VIE structure, whereby offshore listed vehicles (organized outside of China, often in the Cayman Islands) enter into a series of contractual relationships, directly or indirectly, with an operating company in China engaged in a range of businesses.

The offshore listed vehicle has no direct equity ownership over the operations in China, but under applicable accounting rules for VIEs is able, as the nominal beneficiary, to consolidate the results of the operating company in its consolidated financial statements. As these structures have been a direct consequence of prohibitions on direct foreign ownership of China-based operations (as noted by the SEC, these structures allow China-based companies to circumvent foreign investment restrictions), there has always been the risk that these structures could be disallowed, and/or the contractual arrangements would be deemed unenforceable, in China. The underlying facts and the attendant risks typically have been disclosed in offering documents and annual reports of China-based companies. Similarly, the escalating concerns over PCAOB access have for some time (and well before passage of the HFCAA) been reflected in offering documents and annual reports.

The sample comment letter, builds on CF-10 (which had a section of VIEs), and adds a few new twists, which suggest that the SEC believes investors are not paying sufficient attention to well-known risks.

- The prospectus cover page should include prominent disclosure of VIE risks; general China risk (including potential action by Chinese regulators in response to VIE structure, data security and/or antitrust concerns, and the potential impact of the HFCAA); defined terms distinguishing between the listing vehicle and the VIE entities (reversing the SEC plain English use of "we," "us" and "our" to cover the entire enterprise); and how cash moves through the enterprise (including dividends and settlement of amounts owed under the VIE contractual arrangements). These items will be addresses elsewhere in a prospectus as well.
- In the prospectus summary, issuers in effect are directed to spell out how the VIE structure works, and the associated risks, including the uncertainties regarding the status of the rights of the offshore listed vehicle with respect to the contractual arrangements with its VIE, its founders and its owners and the challenges it might encounter were it to seek to enforce the arrangements, due to legal uncertainties and jurisdictional limits. Issuers are to refrain from conflating the offshore structure with the VIE (onshore) structure and implying that investors or the offshore structure has any equity ownership in, direct foreign investment in, or control of, the onshore structure. In sum, issuers are not to imply that the VIE contractual arrangements are the equivalent of ownership or control of the onshore structure. If true (which is the case), issuers are to disclose that VIE arrangements have not been tested in court.

  Issuers are to address all regulatory permissions and approvals to operate the business onshore and offer securities offshore, and to disclose whether any parts of the enterprise are covered by permission requirements of the China Securities Regulatory Commission, the Cyberspace Administration of China or any other governmental agency required to approve the onshore operations; whether all permissions or approvals have been obtained; and whether any have been denied. Issuers are to describe the consequences of not receiving or maintaining these permissions and approvals; of incorrectly concluding they are not required or of permissions and approvals becoming obligatory as a result of changes in law, regulation or interpretation.

Issuers are also to address in detail how cash moves through the enterprise and provide on a schedule disaggregated financial information for the operations.

Finally, the summary should address the potential trading prohibition under the HFCAA.

- Issuers are to revise their risk factors to, in effect, address the issues that inform the tightened disclosure requirements.

The SEC Staff notes that China-based companies that do not use VIE structures nonetheless should consider whether disclosure within the spirit of the sample comments, if not the letter, is warranted.

While the risks of investing in China-based companies, for a range of reasons, including but not limited to the VIE structures, have been clear to all who wished to see them, there are new dynamics at play that increase the likelihood that identified risks (largely hypothetical to date) will come to fruition. Those new dynamics are driven at this point by China, and, in a sense, the enhanced disclosure requirements should be seen not so much from the perspective of the SEC mandating clearer or more detailed disclosure about longstanding risks, but rather a recognition that China, as it re-evaluates its models of economic growth, is prepared to play a greater role in deciding who can invest in its economy, and through what channels. Therein lies the ultimate risk.

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