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Legal Sidebar

U.S. Regulation of Chinese Stocks: Legal Background and Regulatory Options

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Tensions between the United States and China have again moved to center stage. In recent weeks, the Trump Administration has ordered China to close its Houston consulate over allegations of economic espionage, imposed sanctions on Hong Kong officials accused of undermining the region's autonomy, and issued executive orders that may effectively ban the use of two Chinese apps—TikTok and WeChat—in the United States. While commentators once noted the interdependence that characterized the U.S.-China relationship, these developments and similar disputes now generate debate over whether the two powers are on the verge of an economic "decoupling."

The regulation of U.S. investment in Chinese securities is another fissure in the bilateral relationship that has attracted special attention from Congress, the Trump Administration, and the Securities and Exchange Commission (SEC). In April, SEC officials released a statement warning investors of the risks of emerging-market stocks after two U.S.-listed Chinese firms announced that their employees had fraudulently inflated past sales figures. A month later, the Senate unanimously approved legislation that would prohibit trading in the securities of companies whose auditors deny U.S. regulators access to their work papers—a category that most prominently includes Chinese firms. And in July, the President's Working Group on Financial Markets (PWG) issued a report endorsing several proposals to strengthen protections for American investors in Chinese securities.

Stricter regulation of Chinese stocks could have important implications for U.S. investors. Chinese companies listed on U.S. exchanges boasted a combined market capitalization of $1.2 trillion at the end of 2019. American investors have also taken on more exposure to firms listed on Chinese exchanges—perhaps unwittingly—as major index providers have increased the weight of such companies in their emerging-market indexes over the past year.

This Legal Sidebar discusses the current regulatory framework governing U.S. investment in Chinese stocks, alleged inadequacies in that framework, and several proposals to strengthen the relevant laws and regulations.

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Legal Background

To protect investors and facilitate capital formation, federal law imposes a range of requirements on companies that issue securities, accounting firms that audit their financial statements, funds that invest in securities, firms that advise others about securities, and securities markets. This section of the Sidebar reviews each set of regulations in turn.

Federal law requires certain companies that issue securities to abide by several disclosure requirements. The Securities Exchange Act of 1934 (the Exchange Act) and associated regulations require reporting companies—in brief, companies that are listed on a national securities exchange, exceed certain size thresholds, or that offer securities to the public—to periodically disclose audited financial statements to investors. SEC regulations also require reporting companies to disclose *qualitative* risks associated with their securities. Item 105 of SEC Regulation S-K requires reporting companies to annually disclose their most significant "risk factors." And Item 303 of Regulation S-K requires a reporting company's management to describe any "known trends or uncertainties" that it reasonably expects to materially impact the company's revenues.

The Sarbanes-Oxley Act of 2002 (SOX) supplemented these requirements with an additional layer of regulations on accounting firms that audit reporting companies' financial statements. SOX created the Public Company Accounting Oversight Board (PCAOB) to regulate these firms, subject to the SEC's oversight. The Act empowered the PCAOB to establish standards for regulated auditors, inspect regulated auditors for compliance with those standards, and impose sanctions on firms that violate its rules. Foreign auditors are generally subject to the same SOX requirements as domestic firms. Like U.S. auditors, foreign accountants that audit reporting companies must register with the PCAOB and provide the Board with audit work papers upon request.

The regulatory perimeter also encompasses certain funds that invest in securities and firms that advise others about securities. The Investment Company Act of 1940 and associated regulations require certain investment companies like mutual funds and exchange-traded funds to disclose their principal investment strategies and risks to investors. The Supreme Court has also interpreted the Investment Advisers Act of 1940 as imposing fiduciary duties on persons who advise others about securities. The SEC has explained that these obligations include a duty of care that requires investment advisers to offer advice that is suitable based on their clients' objectives.

The SEC also has ultimate regulatory authority over national securities exchanges and broker-dealers that operate in over-the-counter (OTC) securities markets. The Commission exercises this authority by supervising "self-regulatory organizations" (SROs) that have front-line responsibility to develop certain rules and enforce them against their members. National securities exchanges like the New York Stock Exchange and NASDAQ are themselves SROs, while the Financial Industry Regulatory Authority regulates broker-dealers that operate in OTC markets. The Exchange Act gives the SEC final authority over SRO rules. Under Section 19 of the Act, SROs must submit proposed rules and proposed rule changes to the SEC for approval. The Commission can also *directly* add to or amend an SRO's rules through notice-and-comment rulemaking.

The Risks of Investing in Chinese Stocks

The case for investing in Chinese stocks as part of a diversified portfolio is fairly straightforward. China has sustained high levels of economic growth over the past forty years and is now the world's largest economy based on purchasing power parity. Unsurprisingly, China is also home to some of the world's largest and fastest-growing companies. And Chinese equities may offer diversification benefits when added to a basket of developed-market securities.

But Chinese stocks also carry significant risks. While foreign companies that issue securities in the United States are generally subject to the same or comparable regulations as their American counterparts, the practical efficacy of these regulations can be substantially different when it comes to firms in developing markets. U.S. regulators have explained that they are often significantly constrained in their ability to oversee and obtain legal recourse against such companies, raising concerns about fraud and other forms of misconduct.

Chinese companies traded in U.S. markets are particularly prominent examples of this general problem. China has long refused to allow its accounting firms to share their audit papers with overseas regulators like the PCAOB, even though SOX requires foreign auditors to provide such papers upon request. As a result, the PCAOB has been unable to fulfill its statutory mandate to monitor firms that audit Chinese companies traded in U.S. markets. While the PCAOB has maintained dialogue with Chinese regulators to obtain access to audit work papers, the Board has said that the relevant Chinese access proposals have been insufficient for it to fulfill its statutory responsibilities.

The risks associated with Chinese stocks are not limited to these gaps in regulatory oversight. Many U.S.-listed Chinese firms employ an ownership structure that some commentators have described as both legally dubious and unsafe for investors. Under this structure—the "variable interest entity" (VIE)—U.S. investors do not purchase direct ownership interests in Chinese firms. Instead, they receive interests in U.S.-listed shell companies, which then enter into contractual arrangements entitling them to the profits of operating Chinese companies.

Some analysts have argued that the status of VIEs under Chinese law remains uncertain. These commentators contend that the purpose of the VIE structure—to circumvent Chinese legal restrictions on foreign investment in certain industries—exposes U.S. investors to the risk that Chinese authorities will ultimately condemn such arrangements. Besides these legal uncertainties, some commentators have argued that VIEs present U.S. investors with other risks related to owner expropriation, taxation, and corporate governance.

There is also active debate over the ethics of investing in certain Chinese companies. Several commentators have argued that some Chinese firms included in major stock indexes are complicit in human-rights violations, including abuses related to China's treatment of its Muslim Uighur population. Others have raised concerns that U.S. investors are harming national security by subsidizing firms that work closely with the Chinese military.

Reform Proposals

Policymakers have developed several proposals to address the issues discussed above. Most significantly, the Senate has passed legislation that would, after a three-year transition period, impose trading prohibitions on companies whose auditors deny the PCAOB access to their work papers. Other commentators have proposed more limited measures involving disclosure requirements, the fiduciary duties of investment advisers, and the regulation of index providers. This section of the Sidebar reviews each category of proposal in turn.

Trading Prohibitions

Overview

The Senate has unanimously approved legislation—S. 945, the Holding Foreign Companies Accountable Act—that would direct the SEC to prohibit trading in the securities of companies whose auditors deny the PCAOB access to their work papers for three consecutive years. The bill's prohibition would apply to

trading on national securities exchanges and OTC markets within the SEC's jurisdiction. A companion House bill (H.R. 7000) is also pending before the Financial Services Committee.

For its part, the Trump Administration appears to be broadly supportive of such measures. In a recent report, the PWG endorsed a similar proposal that would allow Chinese companies to comply with the relevant requirements by submitting to a co-audit from a firm that provides the PCAOB with sufficient access to its work papers.

Considerations for Congress

The debate over trading prohibitions for Chinese securities hinges largely on disagreement over the likely Chinese response to such actions. Supporters of trading prohibitions contend that the attractiveness of U.S. capital markets will cause Chinese authorities to accede to U.S. demands for greater transparency rather than lose valuable market access. But other commentators are skeptical that China will capitulate in the face of trading bans, meaning Chinese companies will ultimately be kicked out of U.S. markets if S. 945 becomes law.

Skeptics of trading bans contend that eliminating Chinese firms from U.S. markets may harm U.S. investors. For example, Harvard Law Professor Jesse Fried has argued that Chinese companies would respond to trading bans with confiscatory "take-private" transactions in which they de-list their U.S. shares at low buyout prices and then re-list on foreign exchanges at much higher valuations. To mitigate this risk, Fried argues that any prohibitions should apply only prospectively to Chinese firms that are not currently traded in U.S. markets.

Other commentators have identified broader problems with trading bans. According to several observers, barring Chinese firms from U.S. markets would not seriously impede their ability to raise capital. These analysts contend that Chinese companies that are banned from U.S. markets could still raise money by listing on foreign exchanges. Moreover, U.S. investors could still purchase Chinese securities on those foreign exchanges, which are often subject to less rigorous oversight. In that case, Chinese firms would retain access to U.S. capital, while American investors would potentially enjoy fewer protections than they have in U.S. markets.

Enhanced Disclosure Requirements

Overview

Policymakers have also proposed more limited steps to reform the regulation of Chinese stocks. The PWG has endorsed enhanced disclosure requirements for Chinese companies that issue securities and funds that invest in Chinese securities. These measures would build upon the existing disclosure regime. As discussed, Items 105 and 303 of SEC Regulation S-K already require reporting companies to disclose certain qualitative risks associated with their securities. The Investment Company Act and related regulations likewise require certain mutual funds and exchange-traded funds to disclose their risks to investors.

These regulations reflect what the SEC has called a "principles-based" approach to disclosure. Under this approach, a company's management must exercise judgment in evaluating whether a given piece of information is sufficiently significant to meet the general standard articulated in the regulations. The SEC has distinguished such "principles-based" regulations from "prescriptive" disclosure requirements that employ bright-line tests triggering reporting obligations.

Enhanced disclosure rules for Chinese firms or funds that invest in Chinese firms could include prescriptive requirements involving specific risk factors. For example, such rules could require Chinese companies and funds that invest in them to disclose the PCAOB's inability to supervise Chinese auditors

and the precise risks associated with VIE structures. New disclosure requirements could also extend to some of the ethical concerns discussed above, like the use of forced labor or involvement with the Chinese military.

Short of adopting new prescriptive requirements, Congress could direct the SEC to issue guidance clarifying the application of existing principles-based disclosure obligations to Chinese securities. The Commission has issued similar guidance on its own initiative for emerging issues ranging from climate change to COVID-19.

Considerations for Congress

Advocates of enhanced disclosure measures cite the need to provide investors with clear notice of the financial risks associated with Chinese stocks. This is a familiar justification for securities disclosure requirements, which aim to facilitate accurate stock prices and the efficient allocation of capital. But new qualitative disclosures regarding the financial risks of Chinese firms may only marginally improve the pricing of their stocks. Many sophisticated investors are likely already aware of the financial risks associated with Chinese securities. And several studies have concluded that retail investors often do not read securities disclosure documents. The efficacy of new qualitative disclosures focused on financial risk may therefore be fairly limited.

However, reporting requirements are also viewed as a tool for shaping corporate conduct. Requirements that companies disclose certain distasteful business practices—like the use of forced labor—may incentivize companies to avoid those practices. These types of disclosure requirements may therefore have more bite than new qualitative requirements focused on financial risk.

Fiduciary Duties of Investment Advisers

Overview

The PWG has also recommended that the SEC consider issuing guidance on investment advisers' fiduciary obligations when recommending Chinese stocks to clients. As discussed, investment advisers have a duty of care that requires them to offer advice that is in their clients' best interest based on their clients' objectives. SEC guidance could clarify that investment advisers have a duty to fully disclose the risks associated with Chinese securities when recommending them to clients. Congress could also strengthen the existing regulatory framework—which is largely principles-based—with more prescriptive requirements compelling investment advisers to provide their clients with specific information about the dangers and ethical concerns associated with Chinese stocks.

Considerations for Congress

The case for enhanced regulation of investment advisers largely draws on some of the considerations discussed above. More robust disclosures can protect investors and facilitate more accurate pricing of securities. Requiring investment advisers to fully inform their clients of the risks associated with Chinese stocks could therefore further these core goals of securities regulation. But altering investment-adviser regulation would remain a limited step toward addressing the regulatory gaps involving Chinese stocks. As the PWG has noted, such tweaks may not ultimately limit investor choice or the ability of Chinese firms to access U.S. capital.

Index-Provider Regulation

Overview

The shift from active management to passive investing is among the most pronounced trends in equity markets over the past twenty years. Rather than invest in funds run by stock pickers, many savers now invest in vehicles that aim to replicate the performance of a broad index of securities like the S&P 500 or the MSCI All-Country World Index. This shift has dramatically increased the power of companies like MSCI, FTSE Russell, and S&P Dow Jones Indices that develop and license the most popular indexes. However, unlike certain foreign regulators, the SEC lacks jurisdiction over these index providers, who are free to develop their own criteria for index construction. In exercising this freedom, index providers have included Chinese firms in several popular benchmarks. For example, Chinese companies represent over 40 percent of MSCI's Emerging Markets Index and over 12 percent of its All-Country World ex USA Index as of the publication of this Sidebar.

Bringing index providers under the umbrella of federal securities regulation may be a way to address some of the issues with Chinese firms discussed above. This type of regulation could be either direct or indirect. The PWG has endorsed an indirect approach, recommending that the SEC consider requiring *registered investment companies* to "perform greater due diligence on an index and its index provider" before selecting it to implement an investment strategy. Congress could also consider more direct regulation of index providers. For example, Congress could prohibit registered investment companies from tracking indexes that have not been approved by the SEC. Alternatively, Congress could impose an SRO regulatory structure on index providers and require them to obtain SEC approval for their index-construction methodologies.

Considerations for Congress

Regulating index providers would tackle one of the main concerns that animates the policy discourse surrounding Chinese stocks. Many commentators have focused their criticism of the existing regulatory framework on the fact that U.S. investors may be *unwittingly* purchasing Chinese securities because of the decisions of major index providers. Subjecting these firms' methodologies to closer scrutiny may be a straightforward way to address such worries.

Direct index-provider regulation may also offer the SEC a more nuanced means of confronting the risks and ethical dilemmas associated with Chinese stocks. This type of approach could allow the SEC to target the business practices of specific companies rather than eliminating large swathes of Chinese firms from U.S. markets. For example, if the Commission—potentially with the assistance of other federal agencies—were to determine that some Chinese firms have links to the Chinese military, it could prohibit registered investment companies from tracking indexes that include those firms. This type of regime may offer regulators a more discriminating method of addressing problematic practices than categorical trading bans.

However, direct index-provider regulation would also be uncharted territory. The framework outlined above may prove overly complicated for the SEC to administer with its existing resources. And inserting the Commission into the details of index construction may come uncomfortably close to the type of "merit regulation" that the federal securities laws have traditionally avoided.

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