Comments To The July 9, 2020: SEC Staff Roundtable on Emerging Markets

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In the 1990s, the SEC issued Regulation S, which obviated the need for SEC registration for offerings on foreign exchanges where there are no efforts to sell to U.S. investors. The SEC later clarified Regulation S with stated exemptions that made it possible for securities traded in foreign markets to sell on U.S. exchanges after a prescribed time.

At that time, the SEC could not have anticipated the emergence of equities originating from a country which bans transparency by law, which does not prescribe to any particular form of generally accepted accounting principles, which restricts the use of generally accepted auditing standards, and which refuses to allow companies to comply with SEC rules.

These actions started the move to internationalize U.S. based stock exchanges and SEC rules and regulations, but not all parts of the world wanted to embrace transparency. Some actors worked to exploit weaknesses, to the detriment of investors.

In 1997, when the Final Release ”Offshore Offers and Sales (Regulation S)” was issued, the SEC commentary noted:

> "The Commission agrees that absent a showing of abuse, imposing significant new restrictions on the offshore offering practices of foreign companies is not warranted. However, the Commission will monitor practices in this area, and will revisit the issue if abuses occur."

In the twenty-three years since the SEC regulation, modification, abuses, and risks have intensified due to a combination of circumstances. At the center of the SEC's actions were Felicia H. Kung, Chief, Office of Rule-making at the SEC. In her 2002 "The Rationalization of Regulatory Internationalization," Kung noted two primary issues regarding internationalization:

> "...it contravenes the principle of national treatment, wherein foreign issuers are accorded treatment similar to that provided to domestic issuers. While there may be some deviation in the regulatory scheme that is applied to foreign as opposed to domestic issuers in some jurisdictions, as a general matter regulators try not to put their domestic issuers at a competitive disadvantage vis-a-vis foreign issuers. With mutual recognition, a foreign issuer may be able to access the capital markets using the less stringent requirements of its home jurisdiction, to the disadvantage of the domestic issuers in that market."
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> "...a system of mutual recognition that is applied globally without the contemporaneous institution of high-quality disclosure standards that are accepted worldwide would encourage regulatory arbitrage and a 'race to the bottom’ in the quality of regulation. Corporations would choose as the primary regulator the jurisdiction with the least demanding regulations by incorporating in that jurisdiction. They could then make offerings in other countries without complying with the stricter disclosure requirements

> of the jurisdictions in which the offerings are being made. Investors in the markets in which the offerings are made would be harmed by the reduced disclosure, and domestic corporations in that jurisdiction would suffer a competitive disadvantage compared to foreign issuers. To rectify the discrepancy between the requirements applicable to domestic and foreign issuers, regulators might well feel pressure to reduce disclosure standards to the level of the least regulatory jurisdiction."

Each U.S. company seeking capital on U.S. based exchanges complies with all domestic securities laws. Their compliance costs millions of dollars individually to review all generally accepted accounting principles, install and maintain sufficient internal accounting controls, hire independent auditors, support independent audits according to generally accepted auditing standards, and report all financial activities according to SEC rules. On the other hand, foreign companies do not have to comply with such rigorous standards if their domestic regulators do not impose the same U.S. standards. While almost all countries have comparable transparency standards, the People's Republic of China (PRC) stands out as the exception, with a marked lack of transparency standards and a proven track record of financial deception and manipulation.

Many of the PRC's companies on U.S. based exchanges are state-owned enterprises (SOEs) in which either instrumentalities of the PRC or high-ranking officials of the Chinese Communist Party (CCP) hold significant ownership. It is common and often required that the CCP play a role in management and board oversight, even actively running the companies. In fact, the August 2015 reshuffle of senior management at China's three mobile telecommunications companies (all of which are U.S. listed) was planned and carried out by the CCP Organization Department. Since the China Securities Regulatory Commission (CSRC) is an agency of the PRC's State Council and is therefore controlled by the CCP, the conflicts are apparent and appropriate governance does not exist.

The PRC does not require adopting any particular form of generally accepted accounting principles (GAAP). Until relatively recently, Chinese Generally Accepted Accounting Principles (CAS) were based on a socialist economic model. Although the PRC's CAS has evolved somewhat, there are still differences even within PRC regions.

Without consistent accounting principles in the PRC, companies can manipulate the revenue recognition, expense accounting, and bottom-line results to fit the circumstance and the objective.

PRC laws are structured to broadly classify company information as "state secrets," which severely limits the independent auditor's auditing procedures and enables obfuscation of State subsidies, illegal payments, and forced labor.

Financial reporting from PRC companies routinely notes departures from U.S. GAAP or IAS. In many cases, financial statement footnotes in audit reports indicate the inability to calculate the departures' economic impact.

There is a lack of independence of many analysts/economists working for investment banks in greater China. The SEC promulgated Regulation A.C. in 2003 which requires certification that analyst opinions and recommendations are independent. The Regulation was drafted to ensure that the equity research division of banks would not be influenced by their investment banking divisions. In the case of the PRC a conflict of interest exists because of the CCP control of companies and the fact that many analysts, even at Western banks in China, are CCP members.

These facts set the perfect environment for financial fraud on a broad scale, particularly when companies seek to please the CCP's shareholders, management, and regulators. The recent $300 million revenue fraud in the financial reporting of Luckin Coffee is a prime example. In addition, during the exact same time, revenue fraud was also reported at TAL Education Group and iQiyi. In all cases, American shareholders lost a significant amount of assets due to the deception.

Despite these known risks, broadly followed stock market indices, such as MSCI and FTSE, materially include PRC stocks alternatively listed in China (A shares), Hong Kong (H Shares) or Depository Receipts listed in the U.S. -- in their stock market indices, most prominently in their emerging market indices. The place of listing is irrelevant as the problematic PRC accounting and governance regulations apply. Since the introduction, the index weighting has increased substantially. These index makers know of the lack of independent audits and inconsistent financial principles and attempt to minimize their risk by noting a waiver of liability language, which clearly describes the lack of complete accounting. A majority of pension funds use the MSCI index in particular as their investment guide. Ironically, the MSCI index is also used by the Pension Benefit Guarantee Corporation (PBGC) to manage the $133 billion in pension insurance reserves.

In situations of fraud, such as Luckin Coffee and others, if the audited financials of a PRC company do not meet U.S. accounting and audit standards, then parties liable under the Securities Act for the correctness of a Registration Statement should not be able to rely upon the "expert due diligence defense" of Section 11 of the Securities Act. Removing that reliance would preclude board members and underwriters from the claim that they relied on the expert opinion of Lukin's auditors, which is flawed in the complexities and limitations of the PRC's purposeful and willful manipulation of transparency.

In a letter about including the MSCI Index Fund into the federal employees' retirement fund (TSP) Director of the NEC Larry Kudlow and National Security Advisor Robert O'Brian write:

> "The financial impact of this risk is significant: scandals involving Chinese companies in recent years have cost investors billions of dollars. In addition, the Chinese Government currently prevents companies with Chinese operations listed on U.S. exchanges from complying with applicable U.S. securities law, leaving investors without the benefit of important protections. According to the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB), Chinese authorities have impeded the PCAOB's ability to oversee PCAOB-registered audit firms in mainland China and Hong Kong who serve mainland Chinese companies.”
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> “This has prevented the PCAOB from conducting inspections of those firms' audits of Chinese companies in violation of U.S. law. Recently, a Chinese law came into effect that prevents the PCAOB from directly conducting its oversight function inside Chinese territory. This is part of the significant legal and practical obstacles to the SEC and PCAOB obtaining information needed for investigations or enforcement actions.”
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> “The Chinese Government's intentional thwarting of U.S. investor protections should raise serious concerns about the reliability of financial information from Chinese companies and demonstrate the significant risks to investors, especially retail investors such as TSP beneficiaries, of investing in the companies listed on the Chinese exchanges that would be represented in the new index."

As a result, Labor Secretary Eugene Scalia sent a letter to the Thrift Savings Plan's governing board saying "at the direction of President Trump, the Board is to immediately halt all steps"

toward switching to a broader international stock market index, one that includes China, in one of its investment funds.

Prior to the decision, the TSP fund had already come under intense scrutiny from members of Congress on both sides of the aisle, who have argued the move would expose the retirement assets of federal employees and military members to severe and undisclosed risks with Chinese companies.

After bills were introduced in Congress to stop the change, the TSP board had consultants perform two studies, with both arriving at the same conclusion. They found that the 401(k)s of all 10 of the largest publicly traded U.S. companies, all 10 of the top federal contractors, all 20 of the largest state pension plans and all six of the largest target-date mutual-fund providers invest in emerging markets including China.

The compelling need to eliminate Regulation S springs from the fact that a majority of pension funds use the MSCI index as their investment guide. Ironically, the MSCI index is also used by the Pension Benefit Guarantee Corporation (PBGC) to manage the $133 billion in pension insurance reserves.

PRC stocks directly affect the pension assets of Americans and civil servants in particular. According to the United States Census Bureau, there were 3,992 public pension systems in the country as of 2013. Of these, 231 were state-level programs, while the remaining 3,761 were local. As of 2013, membership in the country's various pension systems totaled 20 million. If a catastrophic meltdown occurred in PRC stocks in the fraud-prone and deceptive environment, the retirement assets of a majority of civil servants would be lost.

The words of the SEC Chief, Office of Rule making, are ominous and predicted the future. At present, the preferential treatment afforded foreign companies causes an unlevel playing field for capital transactions with an extreme bias against U.S. companies. As a nation, The SEC is at a crossroads as the predictions have come true. The time has come to act upon the abuses, to protect and defend the quality of U.S. security laws and the reputation of the U.S. capital markets.

Throughout the world, financial transparency is a virtue. In the People's Republic of China, transparency is a threat to national security. As such, actions and laws pass to prevent sufficient disclosure.

We now need to answer one question as a nation and act appropriately: Can we continue to afford to put American shareholders at risk, to put American companies at a disadvantage, and to allow our preeminence as the gold standard for financial markets to be weakened by allowing exceptions to America's securities regulations?

It is incumbent upon the SEC to make the proper decision on behalf of American investors.