U.S. Securities and Exchange Commission
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Washington, D.C. 20549

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File Number S7-03-21
Holding Foreign Companies Accountable Act Disclosure — Interim Final Rule
Response to Request for Comments

This letter responds to the Commission's request for public comment on its interim final rule regarding submission and disclosure requirements in Sections 2 and 3 of the Holding Foreign Companies Accountable Act. The comments in this letter are based on recommendations found in a Note that I wrote on the Holding Foreign Companies Accountable Act for my Advanced Federal Securities Regulation course at the Georgetown University Law Center. The views and opinions expressed in this letter and the Note are my own and should not be affiliated with Georgetown University Law Center or any other organization with which I have been affiliated during my time at the Georgetown University Law Center.

Below you will find an executive summary detailing three key recommendations found within my Note. I hope you find them helpful in your endeavors to interpret and implement the Holding Foreign Companies Accountable Act in a pragmatic and meaningful way.

Thank you for considering these comments.

Respectfully submitted,

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Encl.: Kelly, "From Congress to the SEC: Interpreting and Implementing the Holding Foreign Companies Accountable Act in a Meaningful and Pragmatic Manner"

<u>Executive Summary</u>

Comment 1: Determination of Commission-Identified Foreign Issuers

The Commission has requested comment on what process it should use to identify registrants as Commission-Identified Foreign Issuers. The Commission should consider the following factors when crafting its process to identify such issuers: (1) current deficiencies in disclosure requirements for foreign private issuers ("FPIs"); (2) existing, heightened disclosure requirements for registrants that offer securities via American Depositary Receipts ("ADRs"); and (3) special risks for registrants that use a VIE structure.

1. *Current Deficiencies in Disclosure Requirements for FPIs:* The Commission should consider whether the current regulatory regime for FPIs is still viable, given that 79 percent of registrants possibly covered by the Holding Foreign Companies Accountable Act ("HFCA Act") disclosed listing only on a U.S. national exchange. The Commission should consider distinguishing companies that list exclusively on a U.S. exchange from those who have a secondary listing overseas or a primary listing on a Chinese domestic exchange.
2. *Existing, Heightened Disclosure Requirements for ADR Participants:* The Commission should research whether companies that list on U.S. exchanges via a U.S. depositary bank and through ADRs have mitigated any disclosure risks, as U.S. investors currently do not distinguish between companies that use ADRs and those that do not—and U.S. auditors charge Chinese ADRs 79 percent more relative to other emerging ADRs.

3. *Special Risks for Registrants that Utilize the VIE Structure:* The Commission should consider whether risks are heightened for companies that use a VIE structure, given that this structure could block meaningful disclosure of financial and political information of the underlying companies. Providing guidance on relaxed disclosures for companies that do not use VIE structure could incentivize future registrants to reconsider the VIE structure's viability.

Comment 2: Determination of "Owned or Controlled" by a Foreign Governmental Entity

The Commission has requested comment on the terms "owned or controlled" in Section 2 of the HFCA Act. The Commission should consider the following suggestions when determining whether a registrant is owned or controlled by a foreign governmental entity: (1) mere presence of an internal Party organization in a corporate charter does not equate outright control by the Chinese Communist Party (the "CCP"); and (2) narrowly tailored restrictions that use objective, quantitative, and open-source data will better assist U.S. investors in evaluating those companies and transactions that pose the biggest risk.

1. *Mere Presence of an Internal Party Organization in a Corporate Charter Does Not Equate Outright Control by the CCP:* Ties between Chinese companies and the CCP are often difficult to trace. With recent amendments to Chinese law that require an internal Party organization in corporate charters, the HFCA Act could theoretically apply to all China-Based Issuers. Such a broad interpretation would complicate U.S. investors' ability to distinguish between "high-" and "low-" risk companies.
2. *Objective, Quantitative, and Open-Source Data Are Most Helpful:* U.S. investors need to understand the relationship between China-Based Issuers and the CCP.

Disclosures on the number of government sales contracts that are defense or non-defense related, as well as management executives' attendance of CCP-member exclusive events, are more likely to help U.S. investors assess risk.

Comment 3: Other Considerations for Implementing the HFCA Act

The Commission should consider how the HFCA Act will affect other actors within a financial ecosystem and how its implementation of the HFCA Act can be informed by peer regulators overseas to promote uniformity within the global capital markets.

1. *Impact of HFCA Act on Financial Ecosystems:* The Commission should provide guidance on how other stakeholders can help facilitate transparent and accurate disclosures. Within the U.S. financial ecosystem, the Commission should consider increased due-diligence obligations on asset managers and institutional investors and increased monitoring by investment funds over indices that contain China-Based Issuers. The Commission should also consider identifying and understanding the relationships between different actors within China's financial ecosystem.
2. *Influence from Peer Regulators Overseas:* The Commission should analyze how peer regulators overseas have worked with Chinese regulators, such as the London-Shanghai Stock Connect program, and consider whether similar programs would lend toward a uniform, international enforcement of China-Based Issuers. The Commission should consider requiring China-Based Issuers to conduct a primary listing in China and then have a secondary listing in the U.S. through ADR program that would make the ADR fully fungible with the Chinese domestic A-shares.

From Congress to the SEC: Interpreting and Implementing the Holding Foreign Companies Accountable Act in a Meaningful and Pragmatic Manner

Introduction

China's position in the global economy grows more dominant every day as it balances increased foreign investment with a desire to maintain control of its domestic markets.[1] Over the past decade, U.S. investor exposure to companies based in or with the majority of their operations in China ("China-Based Issuers") has increased with certain risks.[2] While these risks are nothing new, tensions escalated during the Trump Administration with the Luckin Coffee accounting scandal and amendments to China's Securities Law that expressly prohibit sharing audit information to overseas regulatory agencies like the Public Company Accounting Oversight Board (the "PCAOB").[3] The U.S. responded with the Holding Foreign Companies Accountable Act (the "HFCA Act"), a mandate to the Securities and Exchange Commission (the "Commission") to prohibit the trading of securities of listed companies that retain an auditor whose reports cannot be inspected or investigated completely by the PCAOB.[4]

Enforcement of the HFCA Act could cause the delisting more than 194 China-Based Issuers should their auditors continue to deny PCAOB inspection for the next three years.[5] At the time of submission of this Note, such a delisting would eliminate a total market capitalization of $1.84 trillion on U.S. stock exchanges.[6] Large institutional investors would be forced to take their investments overseas, retail investors would be left with limited legal recourse to recover on the worthless value of their shares, and the position of the U.S. in the world economy would be weakened as China, the UK, Japan, and others entice those stranded China-Based Issuers to their respective exchanges.[7]

This Note suggests best practices for the Commission to interpret and implement the mandates of the HFCA Act and also identifies areas of concern within the HFCA Act that the Commission should highlight for congressional consideration. Part One presents a primer on the risks that China-Based Issuers pose to U.S. investors. Part Two evaluates the likelihood that the HFCA Act will resolve those risks for U.S. investors. Finally, Part Three responds to the Commission's request for comment on Sections 2 and 3 of the HFCA Act and provides other considerations for future implementation. This Note acknowledges that political forces complicate the ability of regulators to create and enforce rules and that diplomatic cooperation on the highest level of government from both the U.S. and China will be required to establish change.

I. What are the risks that China-Based Issuers pose to U.S. investors?

Three of the world's five largest companies are Chinese.[8] China has more Fortune 500 companies than the U.S., with nearly 75% of them being state-owned enterprises ("SOEs").[9] Given China's rise in the global economy, more U.S. investors are investing in China-Based Issuers. Alphabet's Google and Walmart are big stakeholders in JD.com, a B2C Chinese online retailer; investment management companies Blackrock and Vanguard are among Alibaba and Baidu's top shareholders; about 240 China-Based Issuers trade on U.S. exchanges; and an estimated $400 billion of long-term inflows will go to China's stock market over the next decade via index inclusions.[10] U.S. retail investors bought roughly $211 billion in individual stocks last year, which is about as much volume as mutual funds and hedge funds combined.[11] Increased exposure to China-Based Issuers thus poses many risks to U.S. investors, namely (1) an unmet need for high-quality and reliable financial reporting, (2) vague company organizational structures, and (3) challenges navigating the Chinese regulatory environment.

A. Risk related to high-quality and reliable financial reporting

High-quality disclosure reduces information asymmetries between investors and issuers.[12] Such disclosure is mandated under the Sarbanes-Oxley Act, which authorizes the PCAOB to inspect registered accounting firms to assess their compliance with auditing standards.[13] When the PCAOB targets an area for inspection, audit firms react—a powerful tool for generating improvements to financial disclosure.[14] The PCAOB's inability to inspect an auditor thus signals a lack of transparency surrounding the reliability of the financial information, leading to potentially suboptimal investment decisions by investors.[15]

A 2020 report found that China has not provided the PCAOB meaningful access to inspect registered public accounting firms regarding audits of China-Based Issuers since 2007.[16] The China Securities Regulatory Commission (the "CSRC") recently confirmed its goal to secure the compliance of audit firms and safeguard the fairness and transparency of its capital markets,[17] but March 2020 amendments to China's Securities Law are contradictory by expressly prohibiting the disclosure of state secrets overseas and blocking overseas regulators from accessing relevant audit documents in China.[18] The Commission and PCAOB noted this contradiction in a rare but important joint statement that warned U.S. investors of risks associated with China-Based Issuers.[19] Specifically, the joint statement highlighted the insufficiency of boilerplate disclosure statements that would otherwise be acceptable for vetted, domestic companies and advocated for industry- and jurisdiction-specific disclosures.[20]

U.S. investors have already suffered the impact of insufficient disclosure and poor-quality financial reporting from China-Based Issuers, most recently in the Luckin Coffee accounting scandal. Just one year after the Luckin Coffee startup raised $651 million through its first-time Nasdaq sale, the company was delisted and fined $180 million for allegedly fabricating more than $300 million in sales by inflating firm's expenses by more than $190 million, creating a fake operations database, and altering accounting and bank records to reflect the false sales.[21] Luckin Coffee is unlikely to be the last bad actor, with similar investigations allegedly underway for major video streaming service iQiyi and after-school tutoring company GSX Techedu.[22]

B. Risk related to the organizational structure of companies

Corporate governance experts are troubled by the growing prevalence of companies whose ownership structures limit or remove shareholder voting rights, arguing that discrepancies between control and economic ownership reduce accountability to the economic owners of the business, entrench management, and skew incentives.[23] In the U.S., this problem has largely weighed on the tech industry, with companies like Facebook and Lyft introducing dual-class share structures in their IPOs.[24]

In the U.S.-China context, this problem manifests in the use of variable interest entity ("VIE") structures to bypass Chinese regulatory restrictions for foreign ownership of companies in hot sectors like telecommunications and online education.[25] To balance Chinese regulators' need for control with their desire to increase foreign investment, VIEs are headquartered in a new country (e.g., the Cayman Islands) but owned by Chinese citizens.[26] The VIEs hold private shares of a China-Based Issuer's underlying company and then sell stakes to foreign investors via IPOs, granting foreign exposure to the company's growth without any direct voting rights.[27]

Notable examples of China-Based Issuers who use the VIE structure include Alibaba and Baidu.[28] In 2017, 62% of China-Based Issuers listed on U.S. exchanges used VIEs and more than 80% IPO'd within the past three years.[29]

Most China-Based Issuers perceive a VIE stake to be a direct stake in the company.[30] For example, large tech company SINA allowed its shareholders to vote on a U.S. hedge fund's shareholder proposal given its 4% ownership stake in the company's VIE.[31] However, the VIE structure poses many risks to U.S. investors—most notably, China-Based Issuers who organize under a VIE structure and Chinese regulators could unilaterally invalidate the VIE with little to no legal recourse for foreign investors.[32] For example, Jack Ma unilaterally transferred 100% ownership of Alipay to a company controlled solely by himself despite Yahoo's 43% ownership stake in Alibaba's VIE.[33] Ultimately, Ma paid a paltry $6 billion to outraged Yahoo shareholders for the Alipay business, which was recently valued at $300 billion.[34]

Today, U.S. investors continue to invest heavily in VIEs. Critics argue that U.S. investors do so unwittingly in part because VIEs are often listed on passive index funds that preclude investors from being fully aware of the constituent securities.[35] Chinese regulators have relaxed restrictions on VIEs to bring back innovative tech companies with dual-class structures by allowing such companies to set up weighted voting rights share structures when registering a new company on the Shenzhen Stock Exchange.[36] But it is unclear if these relaxed rules will be enough to incentivize such companies to return home.[37]

C. Risk related to the regulatory environment

Government ownership can pose both risks (e.g., inefficiencies and expropriation) and benefits (e.g., easier access to financing) for investors.[38] Such risks may be amplified when the regulatory environment is weak or riddled with heightened political risk.[39] These risks play out in the U.S.-China context in many ways, including differing views on corporate governance.

The type of corporate governance celebrated in the U.S. is economic governance—that is, an economic concern to maximize shareholder profits over environmental, social, and governance considerations, and there is no place for government intervention in otherwise private transactions between corporations and stakeholders.[40] In contrast, China embraces administrative governance, in which the government "at all levels acts as a guardian of the public and arbitrator in organizing enterprise and social interests" so that companies fulfill their corporate social responsibilities.[41] Administrative governance has been closely tied to the Chinese Community Party (the "CCP") since the late 1970s and very likely will continue to be the norm in China as long as the CCP remains the leading political party in China.[42]

Administrative governance certainly has its advantages. When wielded for the public good, administrative governance checks a corporation's economic mandate with an equal mandate to be responsible to the people and environment.[43] For example, the CSRC responded instantly to the June 2015 stock market plunge by banning sale of shares from shareholders holding more than 5% of a corporation's capital.[44] However, administrative governance also leads to conflicts of interest when government gets involved in the decision-making of companies on a management level, where government preference could pressure companies to forego short-term profitable investment opportunities for the long-term public interest.[45]

The CCP has made recent efforts to ensure greater oversight over China's commercial sector by requiring companies to codify a role for the CCP to participate in management decisions ("internal Party organizations") in their corporate charters.[46] In measuring the impact of these amendments, consider that SOEs are required to comply with the new rule and that

SOEs account for more than half of the bank loans offered in China and about 90% of corporate bonds.[47] While private sector companies are not required to comply, a survey of China's top 500 private enterprises shows that 94.2% of such enterprises participated in various national development schemes during 2019.[48] While mere presence of an internal Party organization in a company's corporate charter does not necessarily represent outright control by the CCP, the move suggests at a minimum *potential* encroachment of politics on corporate decision-making.[49] For example, China's Belt-Road Initiative is building regional trade connectivity between China and countries in Asia, Africa, Europe, South America, and the Pacific, and the initiative has largely been brought about by Chinese SOEs.[50]

II. Is the HFCA Act likely to resolve the risks that China-Based Issuers pose to U.S. investors?

The HFCA Act passed by Congress with bipartisan support on December 18, 2020.[51] The law requires companies publicly listed on stock exchanges in the United States to declare they are not owned or controlled by any foreign government.[52] It is a mandate to the Commission to prohibit the trading of securities of listed companies that retain an auditor whose reports cannot be inspected or investigated completely by the PCAOB.[53] There are a few aspects of the HFCA Act that are novel. First, delisted companies normally reserve the ability to move their shares to the OTC market; however, the HFCA Act removes this option for violators, effectively eliminating any outlet for the shares to trade in the U.S.[54] Second, no prior legal requirement in the U.S. exists for companies to disclose political party affiliations of management and oversight, nor has there ever been any requirement to systematically disclose the identity and ownership stake of any person or group of persons who directly or indirectly acquire or have beneficial ownership of less than five percent of a class of a securities.[55] And third, no prior legal requirement in the U.S. exists for companies to identify the political or textual origins of any portion of a registrant's articles of incorporation.[56]

While many have praised the HFCA Act as a good first measure to protecting U.S. investors, they have not been without criticism. The HFCA Act's notable flaws are that it: (1) posits China-Based Issuers in a lose-lose situation in which satisfaction of U.S. law necessarily would result in a violation of Chinese law; (2) will result in unintended but severe consequences to U.S. investors; and (3) does not incentivize China to reform its approach within the global capital markets.

A. Caught Between a Rock and a Hard Place

China-Based Issuers that fall under the HFCA Act's scope will find themselves in a lose-lose situation. Compliance with the HFCA Act would require the auditors of China-Based Issuers to disclose audit information to the PCAOB that Chinese state secrecy, archival, and securities laws expressly prohibit.[57] Thus, satisfying U.S. securities laws would necessarily violate Chinese securities laws, and vice versa.

China-Based Issuers who operate in the private sector, such as Alibaba, face additional scrutiny from the CCP.[58] For example, Ant Group's anticipated $34 billion IPO was halted by the CCP in November 2020 for "setting private enterprise's interests above those of the Chinese state and challenging financial regulators."[59] [60] Since then, the company has been subjected to a record $2.8 billion fine, possible reclassification to fall under Chinese banking laws as a financial holding company, and the possible exit of Jack Ma from the company are all on the table.[61]

More than 100 U.S.-listed Chinese companies (including Baidu and Pinduoduo) and Chinese electric-vehicle stocks (like Nio and Xpeng) do not have a secondary listing outside of the U.S.[62] When confronted with such a lose-lose situation, China-Based Issuers may very well choose to voluntarily delist and find a home elsewhere, or at least hedge by listing secondary shares closer to home.[63] Of course, going private is a costly transaction that would expose any company to litigation risk, but such risk is significantly mitigated by the VIE structure and the weak regulatory enforcement power that U.S. regulators have over these companies.

B. Unintended Consequences to U.S. Investors

Delisting China-Based Issuers may bring short-term, immediate political clout to the U.S. at the long-term risk of failing to protect U.S. investors.[64] A rigid implementation of the HFCA Act could damage the reputation of the U.S. free capital markets system and disproportionately affect available recourse for U.S. retail investors as compared to institutional investors.

Politicizing the capital markets could put into question the fundamental principle that arguably distinguishes the U.S. capital markets from Chinese markets: free, accessible markets based on efficiency rather than politics.[65] Notably, the HFCA Act was passed at a time when Chinese regulators are reportedly at an all-time high for getting tougher on securities fraud and noncompliance with rules and regulations.[66]

Even more problematically, the Act will likely disproportionately affect retail investors over institutional investors. While institutional investors can likely navigate the burdens of investing overseas, retail investors cannot do so as easily and would suffer great cost with limited recourse if China-Based Issuers go private or delist. For example, a tender offer to buy back shares would likely undervalue a company significantly because many of the China-Based Issuers employ a dual-class share system that would render futile any foreign resistance to a lowball go-private offer.[67] Because investors must pursue independent legal action to recover their money from a delisting (and U.S. regulators are unable to enforce U.S. securities laws over China-Based Issuers that employ a VIE structure), U.S. retail investors could be left with worthless shares and limited to no legal recourse.[68]

C. Delisting Won't Encourage Reform in China

Even if U.S. investment restrictions posed a serious threat to the viability of China-Based Issuers, China would likely provide capital to those lucrative and innovative tech companies to incentivize those companies to return home.[69] China's desire to reel in these companies is best evidenced through its establishment of the STAR Market, a simplified system under the Shanghai Stock Exchange that strips layers of red tape for tech companies and startups to access the domestic capital markets.[70] The STAR Market provides for relaxed rules and regulations, such as lowered wait time for registration approval, removal of limits on pricing of IPOs, and elimination of caps on first-day trading gains.[71] Since its creation in 2018 through March 2021, the STAR Market has brought in over 240 firms with a combined market capitalization of $486 billion and has anticipated bringing in 150 to 180 more companies by the end of 2021.[72]

Regulators outside of the U.S., such as the U.K., Hong Kong, and Japan, are trying to make the hop easier with their own relaxed rules and regulations.[73] For example, the 2019 London-Shanghai Stock Connect program ("Stock Connect") allows Chinese companies to raise capital from overseas investors by using an instrument that is fully fungible with their domestic

A-shares.[74] While political tensions escalated between London and Beijing over the anti-government protests in Hong Kong, the CSRC recently affirmed that the program was operating as usual and cited the program as "an important initiative in China's financial opening [and] instrumental in expanding cross-border investing and funding channels bilaterally."[75] While the program seems promising, it is still too soon to gauge the success of any of these measures yet.

III. What are best practices for the Commission to interpret and implement the HFCA Act, and what other factors should the Commission consider?

The HFCA Act is a congressional mandate to the Commission; and, as such, the Commission is obligated to enact rules and regulations to uphold it. As the Commission noted in its March 24, 2021 interim final rule, there are areas within the HFCA Act that the Commission has discretion to interpret prior to implementation.[76] For example, the Commission requests public comment on the following: (1) how to determine whether a China-Based Issuer should fall under the scope of the HFCA Act (a "Commission-Identified Foreign Issuer"); (2) how to determine whether a potential Commission-Identified Foreign Issuer is owned or controlled by a foreign governmental entity; and (3) other considerations that the Commission should keep in mind when implementing the HFCA Act.

A. Determination of "Commission-Identified Foreign Issuer"

A Commission-Identified Foreign Issuer is defined as an issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country that has retained a registered public accounting firm to issue an audit report where that registered public account firm has a branch or office that: (a) is located in a foreign jurisdiction and (b) the PCAOB has determined that it is unable to inspect or investigate completely because of a position taken by an authority in the foreign jurisdiction.[77] Excluded from this definition are registrants that are owned or controlled by a foreign governmental entity.[78] In determining whether a registrant should be classified as a Commission-Identified Foreign Issuer, the Commission should consider the following factors: (1) current deficiencies in disclosure requirements for foreign private issuers ("FPIs"); (2) existing, heightened disclosure requirements for registrants that offer securities via American Depositary Receipts ("ADRs"); and (3) special risks for registrants that use a VIE structure.

i. Current Deficiencies in Disclosure Requirements for FPIs

In its interim final rule, the Commission found that approximately 79% of registrants potentially under the HFCA Act's scope disclosed listing only on a U.S. national exchange and no other exchanges.[79] The Commission should consider whether the current regulatory regime for FPIs is still viable because the regime was created largely to prevent duplicative disclosure burdens for companies whose U.S. listing was secondary to a primary listing that was already subject to stringent regulatory oversight.[80] Without such oversight, managers of U.S.-only listed FPIs have great discretion to provide fewer 6-Ks despite substantially greater investor interest in these disclosures.[81] The Commission should consider distinguishing companies that list exclusively on a U.S. exchange from those who have a secondary listing overseas or a primary listing on a Chinese domestic exchange.

ii. Existing, Heightened Disclosure Requirements for ADR Participants

China-Based Issuers that list on U.S. stock exchanges via an ADR program are subject to higher levels of scrutiny than China-Based Issuers that directly list on U.S. exchanges because a depositary bank facilitates the sale of the ADRs.[82] However, U.S. investors are generally unable to distinguish between China-Based Issuers that are vetted through a depositary bank and those that directly list, which in turn makes auditors perceive Chinese engagements as risky and charge 79% more for such Chinese ADRs relative to other emerging ADRs.[83] The Commission should consider whether any risks to U.S. investors are mitigated by partnership with a U.S. depositary bank.

iii. Special Risks for Registrants that Use the VIE Structure

The HFCA Act does not account for different treatment if a China-Based Issuer were to organize exclusively under Chinese law instead of separating the U.S. investor-facing facet of the company from the underlying Chinese company.[84] If the HFCA Act were strictly interpreted without any such distinction, registrants who use a VIE structure could merely reveal disclosures stemming from the VIEs instead of the information of the underlying companies, effectively circumventing meaningful disclosure on the financial information and political breakdown of the company.[85] The Commission should consider providing guidance on relaxed disclosures for companies that do not use VIE structure could incentivize future registrants to reconsider the VIE structure's viability.

B. Determination of "Owned or Controlled" by a Foreign Governmental Entity

The HFCA Act applies to only those registrants that are not owned or controlled by a foreign governmental entity.[86] The Commission preliminarily defines the terms "owned or controlled" as intended to reference a person's or governmental entity's ability to "control" the registrant.[87] However, additional guidance on how to interpret these terms is necessary.[88] To determine whether a registrant is owned or controlled by a foreign governmental entity, the Commission should recognize that the ties between China-Based Issuers and the CCP are often difficult to trace, and virtually any China-Based Issuer with an internal Party organization charter could technically be said to have some relationship with the CCP.[89] A broad interpretation of the "owned or control" term could thus prevent transactions that pose relatively little risk to U.S. national security and make it even more difficult for the Commission to identify the truly bad actors.[90]

To allow U.S. investors to better assess risk associated with a China-Based Issuer's relationship with the CCP, the Commission should use objective, quantitative, open-source data to better understand the relationship between China-Based Issuers and the CCP.[91] For example, disclosures about the number of government sales contracts that are defense or non-defense related, for example, would be a better input for assessing the materiality of a potential security threat.[92] Additionally, signals that are observable in public records could be used to create a scoring or grading system of business practices that are questionable.[93] For example, instead of tracking the number of members affiliated with the CCP in any remote capacity, a requirement for registrants to disclose whether any members of their management participated in the People's Political Consultative Conference (an invite-only event designed to connect the Party with private business) might be more effective.[94] In sum, a more proactive, diagnostic approach should be taken to better understand how China-Based Issuers work and how to weigh their relationship with the CCP.[95]

C. Other Considerations

While the HFCA Act specifically targets China-Based Issuers and their respective auditors, these entities are not the only actors within a financial ecosystem. Likewise, the impact of the HFCA Act (and the likelihood of its enforceability) depends in part on how the HFCA Act conforms (or departs) from the laws and regulations of peer regulators overseas within the global financial markets. The Commission should consider how the HFCA Act will affect other actors within a financial ecosystem and how the Commission's interpretation and subsequent implementation of the HFCA Act can be informed by peer regulators overseas to promote uniformity within the global capital markets.

i. The Impact of the HFCA Act on the Financial Ecosystem as a Whole

As Nasdaq has emphasized to the Commission, "[n]o single stakeholder can effectively mitigate the unique risks presented by emerging market companies on its own. Each participant is part of a wider ecosystem and collectively we share the responsibility to protect investors as effectively as possible."[96] The Commission, the PCAOB, law firm counsel, underwriters, listing exchanges, financial advisors, investment advisors, fund managers, brokers, and the issuers themselves, among others, all contribute to the U.S. financial ecosystem. In interpreting and implementing the HFCA Act, the Commission should consider the role that actors other than the issuer and their respective auditors should play in helping U.S. investors better assess the risks of China-Based Issuers. For example, the Commission might consider increased due-diligence obligations on asset managers and institutional investors for investments that exceed certain thresholds.[97] Additionally, while the Commission has no statutory authority over index providers, it does require investment funds that track indices to disclose principal risks related to investments that could comprise the index and could require increased monitoring.[98] The Commission should identify factors that influenced the negotiations of index provider MSCI with Chinese regulators to include China-Based Issuers in its indices.[99] For example, one potential, contributing factor was that the index inclusion fell in-line with the CCP's state-capitalist logic because index inclusion would promote long-term, passive, foreign investors who would facilitate development of company reform and an increased global presence.[100]

The Commission should also consider researching and analyzing China's financial ecosystem to identify the financial actors in China and how those actors work together. For example, understanding the relationship of the CSRC and the Chinese Institute of Certified Public Accountants (the "CICPA") with the CCP could help gauge which of the two regulators, if not both combined, would be best tasked to working with the Commission and PCAOB to implement improved audit practices. Going a step deeper, understanding the relationship between the CICPA with local accounting firms across China would also be instructive, as the CICPA appears to have significant influence over the ranking of the largest accounting firms in China and can thus influence what disclosures and monitoring practices these accounting firms need to report on an annual basis.[101]

ii. The Influence of Peer Regulators Overseas on the Efficacy of the HFCA Act

The Commission should consider where it can gain support from the international community in its implementation of the HFCA Act—perhaps by drawing from approaches taken by peer regulators in handling disclosure and transparency issues from China-Based Issuers. For example, the Commission might analyze what factors caused the CSRC to work with London in forming the Stock Connect program. Similar to index provider MSCI's negotiations with Chinese regulators, the Stock Connect program has complemented the CCP's state-capitalist objective of controlled, national development while attracting long-term foreign investors.[102] The Stock Connect program benefits London investors in part because the program requires eligible registrants to have a primary listing on a Chinese domestic exchange such that the shares are fully fungible (i.e., the shares listed via the Stock Connect program share a single price with the A-shares listed on the Chinese domestic exchange).[103]

Requiring registrants to have a primary listing on a Chinese domestic exchange makes clear the authority of Chinese regulators to monitor and oversee the business practices and financial disclosures of these companies. Likewise, tying the price of the shares listed in London with those listed in China aligns the objectives of London and China more closely, such that an increase or decrease in share price in London would result in the same increase or decrease to the share price in China, and vice versa. Perhaps the intertwining of share price could incentivize Chinese regulators to adopt, or at a minimum evaluate, some of London's corporate governance and disclosure practices.

The Commission should consider the viability of a similar program that would require China-Based Issuers to conduct a primary listing in China and then have a secondary listing in the U.S. through ADR program that would make the ADR fully fungible with the Chinese domestic A-shares. Requiring China-Based Issuers to have a primary listing on a Chinese domestic exchange would help resolve concerns on the viability of the current regulatory regime of FPIs, given that many China-Based Issuers list only on a U.S. domestic exchange. This requirement would also likely suit China's interest in bringing home lucrative and innovative tech companies, as has been indicated through the introduction of the STAR Market. Moreover, use of an ADR program could mitigate some risk surrounding China-Based Issuers, given that a U.S. depositary bank would be involved in the auditing process. The ADR program could also eliminate China-Based Issuers' use of the VIE structure if the ADR program was crafted such that the ADRs listed on the U.S. exchange represent the underlying A-shares of the China-Based Issuer and the Chinese Depositary Receipts listed on the Chinese exchange represent the underlying shares of the ADRs listed on the U.S. exchange. The U.S. depositary bank's role in the auditing process could be strengthened further if the Commission increases disclosure and monitoring obligations of depositary banks over ADR programs. Finally, tying the price of the U.S.-listed ADR with the price of the A-shares listed on the Chinese domestic exchange could align U.S. and Chinese interests more closely and make each country feel on equal footing.

Conclusion: Looking to the Future of HFCA Interpretation and Implementation

While politics and diplomacy very well may impede or complicate this already difficult issue, the Commission has a vital role in interpreting and implementing the HFCA Act as neutrally and equitably as possible to protect U.S. investors. Protecting U.S. investors means empowering U.S. investors with objective, quantitative, and open-source data that meaningfully allows investors to evaluate the unique risks of each China-Based Issuer. The Commission should recognize that helpful information may require the balancing of many fact-specific circumstances that do not fall neatly into "Yes" or "No" answers. Finally, though the HFCA Act specifically names Chinese companies within its language, the Commission should interpret and implement the HFCA Act as an opportunity to improve audit practices by the efforts of all actors within the financial ecosystem and covering issuers from all around the world.

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