

Via Email

June 25, 2020

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number SR-NASDAQ-2020-027 & File Number SR-NASDAQ-2020-026

Dear Madam Secretary:

I am writing in response to The Nasdaq Stock Market LLC (Nasdaq) *Notice of Filing of Proposed Rule Change To Apply Additional Initial Listing Criteria for Companies Primarily Operating in Restrictive Markets*,¹ and *Notice of Filing of Proposed Rule Change To Adopt a New Requirement Related to the Qualification of Management for Companies From Restrictive Markets*² (collectively, the Proposed Rules).

The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of U.S. public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately \$4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than 15 million participants – true “Main Street” investors through their pension funds. Our associate members include non-U.S. asset owners with about \$4 trillion in assets, and a range of asset managers with more than \$35 trillion in assets under management.³

As the leading voice for effective corporate governance and strong shareholder rights, CII believes that accurate and reliable audited financial statements are critical to investors in making informed decisions, and vital to the overall well-being of our capital markets.⁴ Consistent with

¹ Notice of Filing of Proposed Rule Change To Apply Additional Initial Listing Criteria for Companies Primarily Operating in Restrictive Markets, Exchange Act Release No. 89,027, 85 Fed. Reg. 35,962 (proposed June 8, 2020), <https://www.federalregister.gov/documents/2020/06/12/2020-12685/self-regulatory-organizations-the-nasdaq-stock-market-llc-notice-of-filing-of-proposed-rule-change>.

² Notice of Filing of Proposed Rule Change To Adopt a New Requirement Related to the Qualification of Management for Companies From Restrictive Markets, Exchange Act Release No. 89,028, 85 Fed. Reg. 35,967 (proposed June 8, 2020), <https://www.federalregister.gov/documents/2020/06/12/2020-12686/self-regulatory-organizations-the-nasdaq-stock-market-llc-notice-of-filing-of-proposed-rule-change>.

³ For more information about the Council of Institutional Investors (“CII”), including its board and members, please visit CII’s website at <http://www.cii.org>.

⁴ CII, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (updated Mar. 1, 2017), http://www.cii.org/policies_other_issues#indep_acct_audit_standards.

our membership approved policies, we have long been troubled by the lack of cooperation of China's regulators with United States (U.S.) Securities and Exchange Commission (SEC or Commission) and Public Company Accounting Oversight Board (PCAOB or Board) requirements for companies listed on U.S. exchanges, including efforts to promote high quality audits of financial reports of Chinese companies that are listed on U.S. exchanges.⁵ In recent years those concerns have grown as the number of Chinese companies listed has increased significantly,⁶ and with many of those companies adopting variable interest entity and dual class stock structures,⁷ both of which include risks are not fully understood by many market participants.⁸

Since April the level of our concern has increased further as the result of several significant events including (1) on April 2 Nasdaq-listed Chinese coffeehouse chain Luckin Coffee Inc. (Luckin), whose PCAOB registered auditor has never been subject to a Board inspection,⁹ disclosed that it had fabricated as much as \$310 million in sales from the second quarter of 2019;¹⁰ and (2) on April 21, in what has been described as an "unprecedented public

⁵ See, e.g., Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Office of the Secretary, PCAOB 6 (Sept. 6, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/September%206.%202018%20PCAOB%20Strategic%20Plan.pdf ("We are particularly concerned about PCAOB-registered firms located in China for at least four reasons: (1) since 2010 the PCAOB has actively sought without success inspections of China-based audit firms and the mainland affiliates of the Big Four accountancies - Deloitte, KPMG, PricewaterhouseCoopers and EY; (2) many of the China-based audit firms do significant work on audits of major U.S. companies doing business in China; (3) the recent surge in the number of Chinese companies listed on U.S. stock exchanges; and (4) most of the Chinese companies listed on U.S. stock exchanges in recent years have a variable interest entity structure that is highly complex and might include risks that some investors and auditors may not fully understand or appreciate.").

⁶ See, e.g., Press Releases, Senate passes Kennedy and Van Hollen's bill to kick deceitful Chinese companies off U.S. exchanges (May 20, 2020), <https://www.kennedy.senate.gov/public/2020/5/senate-passes-kennedy-and-van-hollen-s-bill-to-kick-deceitful-chinese-companies-off-u-s-exchanges> ("In the last 10 years, the number of Chinese companies listed on U.S. stock exchanges has increased significantly, as those firms take advantage of the capital available in America.").

⁷ See, e.g., CII, Dual-Class Snapshot: Statistics (as of June 16, 2020) (on file with CII) (In 2019, 9.9% of initial public offerings (IPOs) were foreign private issuers (FPIs) from China (21 out of 212), of these 21 Chinese FPIs, 14 (66.67%) have a dual class structure and 17 (77.2%) have a Variable Interest Entity (VIE) structure, and thus far 16.7% of IPOs in 2020 have been Chinese FPIs (9 out of 54), of these 9 Chinese FPIs, 3 (33.3%) have a dual class structure and 6 (66.7%) have a VIE structure.).

⁸ See Letter from Ash Williams, Chair, CII, et al. to John Zecca, Senior Vice President, General Counsel, North America and Chief Regulatory Officer, NASDAQ Stock Market 3-4 (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NASDAQ%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf ("over time and on average, the valuation of these [dual class stock structure] firms tends to decline, as the "wedge" between ownership and control widens, the agency costs of insider control and lack of shareholder accountability increase, founder's entrepreneurial skills and insights that initially propelled a company become dated, and opportunities and risks change in ways not foreseeable by investors at IPO.); CII Research Analyst Brandon Whitehill, Buyer Beware: Chinese Companies and the VIE Structure 2 (Dec. 2017), https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf ("VIEs are fraught with complexity and risk for investors, including vulnerability to Chinese government pressures and management conflicts of interest").

⁹ See PCAOB, Registration, Annual and Special Reporting, Firm Summary, Ernst & Young Hua Ming LLP (1408) (last visited June 17, 2020), <https://pcaobus.org/firms/1408> (Registration date: 07/08/2004).

¹⁰ See Quentin Webb & Joanne Chiu, *Ernst & Young Says It First Found Accounting Issues at Luckin*, Wall St. J., Apr. 3, 2020, available at <https://www.chinabevnews.com/2020/04/ernst-young-says-it-first-found.html>; Jeanny Yu

statement,”¹¹ SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, and SEC senior staff warned investors that disclosures by SEC-registered companies from China may be incomplete and misleading.¹² The Clayton/Duhnke statement referenced a March 1 revision to the Peoples Republic of China Securities Law that provides that “without the approval of its securities regulator and various components of the Chinese government, no entity or individual in China may provide documents and information relating to securities business activities of overseas regulators.”¹³

We agree with Chairman Clayton that the “status quo has come to be unacceptable”¹⁴ As we described our June 18th letter in response to Nasdaq’s related *Notice of Filing of Proposed Rule Change To Amend IM–5101–1 (Use of Discretionary Authority) To Deny Listing or Continued Listing or To Apply Additional and More Stringent Criteria to an Applicant or Listed Company Based on Considerations Related to the Company’s Auditor or When a Company’s Business Is Principally Administered in a Jurisdiction That Is a Restrictive Market* (June 2 Proposed Rule),¹⁵ we believe Nasdaq can most effectively respond to investor concerns about the audits of financial reports of Chinese companies that are listed on Nasdaq by revising the June 2 Proposed Rule in the following manner:

et al., Luckin Coffee Scandal Deals New Blow to Corporate China, Bloomberg (Apr. 3, 2020), available at <https://www.msn.com/en-in/money/news/luckin-coffee-scandal-deals-new-blow-to-corporate-china/ar-BB129nkW>; Bob Pisani, Trader Talk, Luckin Coffee is a painful reminder of ‘the extreme fraud risk’ of some China-based companies, CNBC (Apr. 3, 2020, 7:12 AM EDT), <https://www.cnbc.com/2020/04/03/luckin-coffee-debacle-is-a-painful-reminder-of-fraud-risk.html>.

¹¹ Michael D. Mann & Arthur Levitt Jr., *Opinion/Commentary, The SEC’s China Evasion*, Wall St. J., May 6, 2020, available at https://www.realclearenergy.org/2020/05/08/the_secs_china_evasion_491148.html.

¹² See SEC Chairman Jay Clayton et al., Public Statement, Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited (Apr. 21, 2020), <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting> (“in . . . China, there is substantially greater risk that disclosures will be incomplete or misleading and, in the event of investor harm, substantially less access to recourse, in comparison to U.S. domestic companies”).

¹³ *Id.* at n.20; see Presidential Memorandum, Memorandum on Protecting United States Investors from Significant Risks for Chinese Companies, Foreign Policy (June 4, 2020), <https://www.whitehouse.gov/presidential-actions/memorandum-protecting-united-states-investors-significant-risks-chinese-companies/> (“Recently, the Chinese government enacted a statute that expressly prevents audit firms from providing this information without the prior consent of Chinese financial regulators [and] [p]reventing the PCAOB from complying with its statutory mandate means that investors cannot have confidence in the financial reports of audited companies and creates significant risks to investors in the securities listed on United States stock exchanges.”); see also Morgan Stanley, Execution Services Sales, Trading Unicorns Part 2: China ADRs & HK Secondary Listing Key Debates 10 (June 10, 2020) (on file with CII) (commenting on the lack of “visibility to inspect audits of overseas listed Chinese companies as their audit papers are not allowed to be shared with overseas regulators without regulatory approval”).

¹⁴ Capital Markets and Emergency Lending in the COVID-19 Era: Hearing Before H. Comm. on Fin. Servs. Inv’t Prot., Entrepreneurship, & Capital Mkts. Subcomm., 116th Cong. (2020) (testimony of Jay Clayton, Chairman, U.S. Securities and Exchange Commission at 9), <https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-claytonj-20200625.pdf>.

¹⁵ Notice of Filing of Proposed Rule Change To Amend IM–5101–1 (Use of Discretionary Authority) To Deny Listing or Continued Listing or To Apply Additional and More Stringent Criteria to an Applicant or Listed Company Based on Considerations Related to the Company’s Auditor or When a Company’s Business Is Principally Administered in a Jurisdiction That Is a Restrictive Market, Exchange Act Release No. 88,987, 85 Fed. Reg. 34,774 (proposed June 2, 2020), <https://www.federalregister.gov/documents/2020/06/08/2020-12271/self-regulatory-organizations-the-nasdaq-stock-market-llc-notice-of-filing-of-proposed-rule-change>.

- The proposed IM-5101-1(b)(1) and IM-5101-1(c) would be replaced by new rules that would require that listing applicants and listed companies from a Restrictive Market, including companies listed prior to the effectiveness of the new rules, be prohibited from having an auditor or an accounting firm engaged to assist with their company audit that is located in a jurisdiction that limits the PCAOB's ability to inspect the auditor (New Auditor Inspection Rules).
- Generally consistent with the [June 2] Proposed Rule, a Nasdaq staff determination to deny the initial or continued listing of a company for lack of compliance with the New Auditor Inspection Rules would result in the issuance "of a denial or delisting letter to the company that will inform the company of the factual basis for Nasdaq's determination and its right for review of the decision pursuant to the Rule 5800 Series."
- Nasdaq Rule 5810 would be amended to provide Nasdaq Hearings Panel the discretion to grant a listed company an exception from the New Auditor Inspection Rules for a period not to exceed 540 days from the date of the delisting letter.¹⁶

Proposed Rules

CII generally supports the Proposed Rules *as a supplement to, but not as a replacement of our proposed New Auditor Inspection Rules*. We offer the following specific comments in response to each of the following items discussed in the Proposed Rules:

Minimum offering size or public float percentage for an initial public offering (IPO)¹⁷

We generally support "[a]s proposed, Rule 5210(l)(i) [that] would require a company that is listing its Primary Equity Security on Nasdaq in connection with its IPO, and that principally administers its business in a Restrictive Market, to offer a minimum amount of securities in a Firm Commitment Offering in the U.S. to Public Holders that: (i) Will result in gross proceeds to the company of at least \$25 million; or (ii) will represent at least 25% of the company's post-offering Market Value of Listed Securities, whichever is lower"¹⁸ (IPO Proposal).

We agree with Nasdaq that the IPO Proposal addresses "a risk that substantial participation by foreign investors in an offering, combined with insiders retaining significant ownership, does not promote sufficient investor base and trading interest to support trading in the secondary market [and] [t]he risk to U.S. investors is compounded when a company is located in a Restrictive Market due to barriers on access to information and limitations on the ability of U.S. regulators to conduct investigations or bring or enforce actions against the company and non-U.S. persons, which create concerns about the accuracy of disclosures, accountability and access to information."¹⁹ We also agree that these risks may be mitigated, at least in part, "by the company

¹⁶ Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Secretary, Securities and Exchange Commission 6-7 (June 18, 2020) (footnotes omitted), [https://www.cii.org/files/issues_and_advocacy/correspondence/2020/June%2018,%202020%20Nasdaq%20letter%20\(final!\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2020/June%2018,%202020%20Nasdaq%20letter%20(final!).pdf)[https://www.cii.org/files/issues_and_advocacy/correspondence/2020/June%2018,%202020%20Nasdaq%20letter%20\(final!\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2020/June%2018,%202020%20Nasdaq%20letter%20(final!).pdf).

¹⁷ See 85 Fed. Reg. at 35,963-64.

¹⁸ *Id.* at 35,963 (footnotes omitted).

¹⁹ *Id.*

conducting a Firm Commitment Offering of at least \$25 million or 25% of the company's post-offering Market Value of Listed Securities, whichever is lower[, because] Firm Commitment Offerings typically involve a book building process that helps to generate an investor base and trading interest that promotes sufficient depth and liquidity to help support fair and orderly trading on the Exchange [and] [s]uch offerings . . . typically involve more due diligence by the broker-dealer than would be done in connection with a best-efforts offering, which helps to ensure that third parties subject to U.S. regulatory oversight are conducting significant due diligence on the company, its registration statement and its financial statements."²⁰

Minimum market value of publicly held shares for a business combination²¹

We generally support the "proposed Rule 5210(l)(ii) [that] would require the listed company to have a minimum Market Value of Unrestricted Publicly Held Shares following the business combination equal to the lesser of: (i) \$25 million; or (ii) 25% of the post-business combination entity's Market Value of Listed Securities"(BC Proposal).²²

We agree with Nasdaq that the BC Proposal "presents similar risks to U.S. investors" as the IPO Proposal.²³ We also agree that "requiring the post-business combination entity to have a minimum Market Value of Unrestricted Publicly Held Shares of at least \$25 million or 25% of its Market Value of Listed Securities, whichever is lower, would help to provide an additional assurance that there are sufficient freely tradable shares and investor interest to support fair and orderly trading on the Exchange when the target company principally administers its business in a Restrictive Market [and] . . . that this will help mitigate the unique risks that Restrictive Market Companies present to U.S. investors due to barriers on access to information and limitations on the ability of U.S. regulators to conduct investigations or bring or enforce actions against the company and non-U.S. persons, which create concerns about the accuracy of disclosures, accountability and access to information."²⁴

Direct listings of restrictive market companies²⁵

We generally *do not* support the proposal "to adopt Rule 5210(l)(iii) to provide that a Restrictive Market Company would be permitted to list on the Nasdaq Global Select Market or Nasdaq Global Market in connection with a Direct Listing (as defined in IM- 5315-1), provided that the company meets all applicable listing requirements for the Nasdaq Global Select Market and the additional requirements of IM-5315-1, or the applicable listing requirements for the Nasdaq Global Market and the additional requirements of IM-5405-1" (DL Proposal).²⁶

²⁰ *Id.*

²¹ *Id.* at 35,964.

²² *Id.*

²³ *See id.* ("Nasdaq believes that a business combination, as described in Rule 5110(a) or IM-5101-2, involving a Restrictive Market Company presents similar risks to U.S. investors as IPOs of Restrictive Market Companies.").

²⁴ *Id.*

²⁵ *See id.* at 35,964-65.

²⁶ *Id.* at 35,964.

We currently oppose any proposals like the DL Proposal that would expand the use of direct listings. As we explained in our January 16 letter to the SEC in response to the New York Stock Exchange LLC proposal to modify their Listed Company Manual provisions relating to direct listings:

The SEC should take real and substantial steps, on an urgent basis, to explore establishing a system of traceable shares before approving a direct listing regime. In our view, the SEC has put the cart before the horse in seeking to change the shareholder proposal regime and to impose onerous regulation on proxy advice for institutional investors before correcting so-called “proxy plumbing” problems, which relate importantly to how shares are held.

Critical shareholder litigation rights also depend in some cases, particularly Section 11 claims, on a better system to prove provenance of shares. SEC approval of the Proposed Rule before fixing our system of share ownership would follow the same disordered approach that the Commission has taken to fixing problems in proxy plumbing.²⁷

In addition, for direct listings on the Capital Market, we agree with Nasdaq “that Restrictive Market Companies present unique risks to U.S. investors due to barriers on access to information and limitations on the ability of U.S. regulators to conduct investigations or bring or enforce actions against the company and non-U.S. persons, which create concerns about the accuracy of disclosures, accountability and access to information [and] . . . precluding a Restrictive Market Company from listing through a Direct Listing on the Capital Market will help to ensure that the company has sufficient public float, investor base, and trading interest likely to generate depth and liquidity necessary to promote fair and orderly trading on the secondary market.”²⁸

Qualification of management for companies from restrictive markets²⁹

We generally support the proposals to: (1) “adopt a new listing standard in Rule 5210(c) to require that listing applicants from Restrictive Market countries have, and certify to Nasdaq that they will continue to have, a member of senior management or a director with relevant past employment experience at a U.S.- listed public company or other experience, training or background which results in the individual’s general familiarity with the regulatory and reporting requirements applicable to a U.S.-listed public company under Nasdaq rules and federal

²⁷ Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Secretary, Securities and Exchange Commission 2-3 (Jan. 16, 2020) (emphasis added), [https://www.cii.org/files/issues_and_advocacy/correspondence/2020/January%2016%202020%20NYSE%20direct%20listing%20\(final\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2020/January%2016%202020%20NYSE%20direct%20listing%20(final).pdf); see, e.g., Recommendation of the SEC Investor Advisory Committee (IAC), Relating to SEC Guidance and Rule Proposals on Proxy Advisors and Shareholder Proposals 2 (Jan. 24, 2020), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/sec-guidance-and-rule-proposals-on-proxy-advisors-and-shareholder-proposals.pdf> (“Despite inclusion in the SEC’s overall proxy system agenda, despite our previous recommendations, no formal guidance or rulemaking regarding proxy plumbing yet have been published by the SEC, and the SEC has not moved to finalize its good 2016 proposal on universal proxies.”).

²⁸ 85 Fed. Reg. at 35,965.

²⁹ *Id.* at 35,967-69.

securities laws;”³⁰(2) subject a company “to proposed Rule 5250(g) [that] . . . contain[s] the continuing obligations for a Restricted Market Company listed on Nasdaq to have at least one member of senior management or director who has relevant past employment experience at a U.S.-listed public company or other experience, training or background which results in the individual’s general familiarity with the regulatory and reporting requirements applicable to a U.S.-listed public company under Nasdaq rules and federal securities laws or, in the absence of such an individual, to retain on an ongoing basis an advisor or advisors, acceptable to Nasdaq, that will provide such guidance to the Company;”³¹and (3) change “Rule 5810 to allow a company from a Restrictive Market that is subject to, but does not maintain compliance with, this requirement to provide Nasdaq Staff with a plan to regain compliance.”³² (collectively, the QM Proposals).

We generally agree with Nasdaq that the QM Proposals “will better enable the company to satisfy the regulatory and reporting requirements applicable to a U.S.-listed public company under Nasdaq rules and federal securities laws, which will enhance investor protection and the public interest.”³³ Moreover, given the perceived benefits of the QM Proposals to investors, we would revise the QM Proposals so that they are applicable to *all* companies from Restrictive Market companies rather than, as proposed, just those companies “that apply to list on Nasdaq after the date of effectiveness” of the QM Proposals.³⁴ We note that Nasdaq does not provide any basis for its distinction and, suggests that the distinction may raise issues about whether the QM Proposals unfairly discriminate among companies.³⁵

We appreciate your consideration of our comments. Please let me know if you have any questions.

Sincerely,



Jeffrey P. Mahoney
General Counsel

³⁰ *Id.* at 35,967.

³¹ *Id.* at 35,968.

³² *Id.*

³³ *Id.*

³⁴ *Id.*; *see, e.g.*, Robert Schmidt et al., Markets, Wall Street Struggles to Avert Peril in Latest U.S.-China Flashpoint (June 17, 2020, updated 6:00 PM EDT) (on file with CII) (commenting that “[l]awmakers haven’t been receptive to suggestions [the reforms] . . . should only impact companies seeking new stock listings, which would insulate businesses already trading in the U.S.”).

³⁵ *See* 85 Fed. Reg. at 35,968 (stating “the Exchange believes that the proposal does not unfairly discriminate among companies”).