

**President's Working Group on Financial Markets:
Report on Protecting United States Investors from
Significant Risks from Chinese Companies**

July 24, 2020



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

July 24, 2020

The Honorable Donald J. Trump
The White House
Washington, DC

Dear Mr. President:

On June 4, 2020, you issued a Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies (the Memorandum). The Memorandum tasked the President's Working Group on Financial Markets (the PWG) with examining certain risks to investors in U.S. financial markets posed by the Chinese government's failure to allow audit firms that are registered with the Public Company Accounting Oversight Board (PCAOB) to comply with U.S. securities laws and investor protection requirements, and directed the PWG to submit a report that includes recommendations to further protect investors in Chinese companies listed in the United States in response to the PCAOB's lack of access to the work of such companies' auditors, taking into account the impact on investors and ensuring the continued fair and orderly operation of U.S. financial markets.

The members of the PWG examined the risks to investors in U.S. financial markets posed by the failure to allow access, and developed the recommendations detailed in this report with the goal of increasing consumer protection, while taking into account the impact on investors and ensuring the continued fair and orderly operation of U.S. financial markets.

The PWG convened to review the recommendations in detail, and unanimously recommends that the Securities and Exchange Commission take the steps outlined in the attached report.

The PWG believes that the implementation of these recommendations would help ensure that companies listing on U.S. exchanges from Non-Cooperating Jurisdictions (NCJs) such as China meet U.S. investor protection objectives expected of all U.S.-listed companies.

Specifically, the PWG recommends enhancing listing standards to require, as a condition to initial and continued exchange listing in the United States, PCAOB access to work papers of the principal audit firm for the audit of a listed company. For companies that are unable to satisfy that standard as a result of governmental restrictions on access to audit work papers and practices in NCJs, this standard may be satisfied by providing a co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the audit firm. To reduce market disruption, the recommended new listing standards would provide for a transition period until January 1, 2022 for currently listed companies from NCJs to come into compliance. The PWG also recommends

enhanced issuer disclosures, enhanced fund disclosures, greater due diligence of indexes and index providers, and the issuance of guidance with respect to fiduciary obligations for investment advisors considering investments in NCJs.

Sincerely,

A handwritten signature in black ink, appearing to read "Steven T. Mnuchin". The signature is fluid and cursive, with a prominent initial "S" and a long, sweeping underline.

Steven T. Mnuchin
Secretary of the Treasury
Chairman, President's Working Group on Financial Markets

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EXECUTIVE SUMMARY

Audit Inspection and the PCAOB. The Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley” or the “Act”) was enacted to strengthen corporate governance standards. The Act created the Public Company Accounting Oversight Board (“PCAOB”) to oversee the accounting profession¹ by establishing auditing standards for public accounting firms and inspecting registered accounting firms to assess their compliance with those standards and undertaking investigations and enforcement actions for failure to comply with those standards.² In addition to other requirements, any accounting firm, whether in the United States or abroad, that prepares or issues an audit opinion with respect to any issuer of securities in the United States is required to produce the underlying audit work papers related to that audit work at the request of the PCAOB or the Securities and Exchange Commission (“SEC”).³

Certain jurisdictions, however, do not currently provide the PCAOB with the ability to inspect public accounting firms, including sufficient access to conduct inspections and investigations of audits of public companies, or otherwise do not cooperate with U.S. regulators (“Non-Cooperating Jurisdictions,” or “NCJs”). The PCAOB has been unable to fulfill its statutory mandate under Sarbanes-Oxley to inspect audit firms in NCJs, including those in China, potentially exposing investors in U.S. capital markets to significant risks. The PCAOB has been unable to fulfill this mandate meaningfully with respect to audit firms based in China for more than a decade.⁴

Recent Legislation. There are legislative proposals in Congress that are designed to address the PCAOB’s lack of access to audit work papers and other information needed to complete audit firm inspections. Most recently, S. 945, the Holding Foreign Companies Accountable (“HFCA”) Act would require the SEC to prohibit the trading of the securities of listed companies, subject to certain transition periods, that retain an auditor whose reports cannot be inspected or investigated completely, as well as prohibit trading of such securities on an over-the-counter (“OTC”) market.⁵ The Senate passed the HFCA Act, which was introduced by U.S. Senators John Kennedy (R-La.) and Chris Van Hollen (D-Md.), by unanimous consent on May 20, 2020.⁶

¹ 15 U.S.C. § 7201 et seq.

² 15 U.S.C. § 7214.

³ 15 U.S.C. § 7216(b).

⁴ See **Appendix A**, PCAOB, *PCAOB Letter to President’s Working Group on Financial Markets* (July 10, 2020) (“PCAOB Letter”).

⁵ See Senate, *S.945 – Holding Foreign Companies Accountable Act* (May 22, 2020), available at <https://www.congress.gov/bill/116th-congress/senate-bill/945> (Last visited on July 16, 2020).

⁶ See John Kennedy United States Senator for Louisiana, *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> (Last visited on July 22, 2020). In addition, the U.S. House of

President's Working Group on Financial Markets. Seeking to address these issues, the President on June 4, 2020 issued a Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies (the "Memorandum").⁷ The Memorandum tasks the President's Working Group on Financial Markets ("PWG") with examining certain risks to investors in U.S. financial markets posed by the Chinese government's failure to allow audit firms that are registered with the PCAOB to comply with U.S. securities laws and investor protection requirements. The Memorandum directs the PWG to submit to the President a report that includes recommendations to further protect investors in Chinese companies listed in the United States in response to the PCAOB's lack of access to the work of such companies' auditors, taking into account the impact on investors and ensuring the continued fair and orderly operation of U.S. financial markets.

In preparing this report, the PWG, which is chaired by the Secretary of the Treasury, and includes the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the Commodity Futures Trading Commission, also sought the views of the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

The PWG's recommendations are informed by the HFCA Act.

Recommendations. The recommendations of the PWG in this report include:

- (1) **Enhanced Listing Standards for Access to Audit Work Papers.** Enhancing the listing standards of U.S. exchanges to require as a condition to initial and continued exchange listing:
 - (a) PCAOB access to work papers of the principal audit firm for the audit of the listed company; or
 - (b) Companies that are unable to satisfy the 1(a) standard as a result of governmental restrictions on access to audit work papers and practices in NCJs may satisfy this standard by providing a co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the co-audit firm.

To reduce market disruption, the new listing standards could provide for a transition period until January 1, 2022 for currently listed companies from NCJs to come into compliance. The new listing standards would apply immediately to new company listings once the necessary rulemakings and/or standard-setting are effective.

Representatives recently included provisions, which are substantially similar to the HFCA Act, in the National Defense Authorization Act.

⁷ See The White House, *Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies* (June 4, 2020), available at <https://www.whitehouse.gov/presidential-actions/memorandum-protecting-united-states-investors-significant-risks-chinese-companies/> (Last visited on July 9, 2020).

- (2) **Enhanced Issuer Disclosures.** Requiring enhanced and prominent issuer disclosures of the risks of investing in NCJs, including issuing interpretive guidance to clarify these disclosure requirements to increase investor awareness, and more general awareness of the risks of investing in such companies.
- (3) **Enhanced Fund Disclosures.** Reviewing the risk disclosures of registered funds that have exposures to issuers from NCJs to enhance the disclosures by these funds, including issuing interpretive guidance to clarify the disclosure requirements to increase investor awareness of the risks of investing in such funds.
- (4) **Greater Due Diligence of Indexes and Index Providers.** Encouraging or requiring registered funds that track indexes to perform greater due diligence on an index and its index provider, prior to the selection of the index to implement a particular investment strategy or objective.
- (5) **Guidance for Investment Advisers.** Issuing guidance to investment advisers with respect to fiduciary obligations when considering investments in NCJs, including China.

It is the PWG's recommendation to take steps to implement all five options, for the reasons detailed further below.

RELEVANT U.S. AUTHORITIES AND PUBLIC POLICY OBJECTIVES

U.S. securities rules and regulations aim to achieve integrity, transparency and accountability with a strong foundation for innovation, growth and competitiveness. Truly competitive capital markets must inspire investor confidence that the operating environment is fair both in perception and fact.⁸ Because publicly held companies in the United States are subject to clear and rigorously enforced disclosure and corporate governance regulations that help to prevent fraud and mismanagement, shareholders are more confident that their value will be protected, enabling companies to raise funding more easily. To this end, the ability of U.S. authorities to examine for compliance, investigate and bring enforcement actions to hold issuers and gatekeepers accountable is a key aspect of U.S. securities law.⁹ Such inspection and enforcement efforts are even more critical when the integrity of, and confidence in, U.S. markets is negatively impacted by other jurisdictions' inconsistent enforcement of their own laws and regulations. Capital markets rely on trust, which

⁸ Refer to **Appendix B Market Context** for information and context on the U.S. and Chinese capital markets.

⁹ See SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman and SEC Division of Investment Management Director Dalia Blass, *Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited* (Apr. 21, 2020), available at <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting> (Last visited on July 23, 2020).

is based on financial information presumed to be accurate and to reflect economic reality.¹⁰ Clear accounting and auditing standards, disclosure requirements designed to elicit material information and investor protection laws are important to ensure that investors have reliable information on which to base their decisions.

In particular, the SEC's mandate includes protecting investors while maintaining fair, orderly and efficient markets and facilitating capital formation. Ensuring that investors and other market participants have access to high-quality, reliable disclosures, including financial reporting, is at the core of the SEC's mission. To achieve this, the federal securities laws and the SEC require public companies to disclose meaningful financial and other information to investors, which investors can use to make better informed investment and voting decisions. The SEC administers and enforces requirements for public companies, funds and broker-dealers to provide audited financial statements to investors. Complete, accurate financial statements and high-quality audits are important to protect U.S. investors and to maintain the efficiency of the U.S. markets. A commitment to high-quality disclosure standards—including meaningful, principled oversight and enforcement—has long been a focus of U.S. policymakers.

A. Relevant Authorities and the PCAOB's Access to Audit Work Papers

Sarbanes-Oxley requires that PCAOB-registered accounting firms, which prepare or issue audit opinions for U.S.-listed issuers, submit to PCAOB inspection and produce audit work papers. The PCAOB has been thwarted, however, in its ability to enforce compliance with those requirements by PCAOB-registered accounting firms in China, which audit U.S.-listed Chinese issuers.

1. *Legal Framework for PCAOB-Registered Accounting Firms Regarding Work Paper Inspections*

Sarbanes-Oxley strengthened prevailing U.S. corporate governance standards and created the PCAOB to oversee the accounting profession.¹¹ Subject to approval and oversight by the SEC, the PCAOB establishes auditing standards for public accounting firms and inspects registered accounting firms to assess their compliance with the PCAOB's standards.¹² Sarbanes-

¹⁰ See U.S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession* (October 6, 2008) at D:2, available at <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf> (Last visited on July 10, 2020).

¹¹ 15 U.S.C. § 7201 et seq. The PCAOB registers accounting firms that prepare audit reports on U.S. public companies; writes and administers rules governing auditing standards; conducts inspections of registered accounting firms in relation to audits of U.S. public companies; and conducts investigations, bringing disciplinary proceedings and imposing sanctions for violations related to the preparation of audit reports on the financial statements of U.S. public companies.

¹² 15 U.S.C. § 7214.

Oxley also empowers the PCAOB to impose sanctions on registered public accounting firms and their associated persons for compliance failures, decisions that may be appealed to the SEC.¹³

Foreign accounting firms that prepare or issue an audit report for a U.S.-listed foreign issuer are subject to the requirements of Sarbanes-Oxley. Foreign accounting firms that “prepare or issue, or . . . participate in the preparation or issuance of, any audit report with respect to any issuer” must register with the PCAOB.¹⁴ The PCAOB, in turn, may obtain “audit work papers” from a “registered public accounting firm . . . wherever domiciled” and make these audit work papers available to the SEC.”¹⁵ Any foreign accounting firm that “issues an audit report, performs audit work, or conducts interim reviews,” regardless of the materiality of such services or whether a U.S. accounting firm relies on such service, “shall produce the audit work papers” upon the SEC’s or PCAOB’s request¹⁶ and is subject to the jurisdiction of a U.S. court for purposes of enforcing such request.¹⁷ A willful refusal to comply, in whole or in part, with any request made by the SEC or PCAOB for audit work papers is deemed a violation of Sarbanes-Oxley.¹⁸

2. *The PCAOB’s Lack of Access to Audit Work Papers in Certain Jurisdictions*

U.S. securities laws and regulations applicable to foreign companies listed on U.S. exchanges are generally the same as or comparable to the laws and regulations applicable to U.S. public companies, and the PCAOB requires registered audit firms to provide documents relating to their work so that the quality of their audits can be inspected.¹⁹ Certain jurisdictions, however, currently do not provide the PCAOB with sufficient access to inspect audit work papers and practices. For example, Chinese law prohibits audit firms operating in China and Hong Kong from releasing documentation of Chinese issuers that Chinese authorities deem sensitive to share without explicit government permission. This has long been the position taken by Chinese authorities, although it has been made more explicit with Article 177 of the PRC Securities Law, which came into effect in March 2020:

¹³ 15 U.S.C. § 7215.

¹⁴ 15 U.S.C. § 7212(a). *See also* PCAOB, *Bylaws and Rules, Rule 2100* (2020), available at <http://pcaobus.org/Rules/PCAOBRules/Documents/All.pdf> [hereinafter PCAOB Rule X] (requiring that a public accounting firm that either (a) prepares or issues an audit report with respect to any issuer, broker or dealer, or (b) plays a substantial role in the preparation of an audit report with respect to such persons, be registered with the PCAOB).

¹⁵ 15 U.S.C. § 7215(b)(2)(B).

¹⁶ 15 U.S.C. § 7216(b) (emphasis added).

¹⁷ 15 U.S.C. § 7216(b).

¹⁸ *Id.* § 7216(e).

¹⁹ *See* PCAOB Website, *China-Related Access Challenges*, available at <https://pcaobus.org/International/Pages/China-Related-Access-Challenges.aspx> (Last visited July 9, 2020).

Overseas securities regulatory agencies shall not directly conduct investigation and evidence collection activities within the territory of the People's Republic of China. Without the approval of the securities regulatory authority of the State Council and the relevant competent department of the State Council, no entity or individual may provide documents and materials related to securities business activities to overseas [regulators].

This issue has had a significant impact on the ability of PCAOB and the SEC to access underlying audit work papers of Chinese-based issuers listed on U.S. exchanges. In the 18-month period ended May 31, 2020, 17 PCAOB-registered firms in mainland China and Hong Kong signed audit reports for 195 public companies with a combined global market capitalization (U.S. and non-U.S. exchanges) of approximately \$1.7 trillion.²⁰ The 10 largest of these companies have a combined market capitalization of approximately \$1.3 trillion. The PCAOB has been unable to fulfill its statutory mandates under Sarbanes-Oxley to conduct inspections and investigations of audits of public companies for over a decade, potentially exposing investors in U.S. capital markets to significant risks.²¹ As a result, the PCAOB remains concerned about its inability to inspect registered public accounting firms, including access to underlying work papers with respect to audit work and practices in China.²²

The SEC and PCAOB have engaged in a wide range of activities in an attempt to increase market awareness of the risks associated with these limitations, and to attempt to enforce compliance with the U.S. federal securities laws.²³ The PCAOB and SEC have on various occasions reminded investors of the significant risks related to investments in China due to the inability of the PCAOB to inspect audit work and practices of PCAOB-registered accounting firms in China (and in Hong Kong, to the extent their audit clients have operations in China) with respect to their audit work of U.S. reporting companies.²⁴ In addition, over the last decade, the SEC's enforcement staff has investigated and litigated in the federal courts and in administrative proceedings dozens of possible violations of the federal securities laws related to China-based issuers, registrants and persons. Although these efforts are critical to preserving and enhancing market integrity, transparency, integrity and investor protection, both the SEC and the PCAOB have confronted structural and legal obstacles to enforcing U.S. law and regulations.²⁵

²⁰ See PCAOB Website, *China-Related Access Challenges*, available at <https://pcaobus.org/International/Pages/China-Related-Access-Challenges.aspx> (Last visited on July 9, 2020).

²¹ See, **Appendix A**, *PCAOB Letter*, p. 3.

²² *Id.*

²³ Refer to **Appendix C**, *Relevant SEC and PCAOB activities related to market awareness and enforcement*.

²⁴ See Chairman William Duhnke, *Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited* (April 21, 2020), available at <https://pcaobus.org/News/Speech/Pages/emerging-market-investments-entail-significant-disclosure-financial-reporting-other-risks-remedies-are-limited.aspx> (Last visited July 9, 2020).

²⁵ Refer to **Appendix C**, *Part II "SEC and PCAOB Enforcement"* for additional information.

The PCAOB also faces some obstacles to inspect the audit work of firms in two EU member states, Belgium and France, but has publicly stated it expects “to conclude soon bilateral cooperative arrangements that will permit the PCAOB to commence inspections in Belgium and resume inspections in France.”²⁶

POTENTIAL POLICY OPTIONS AND CONSIDERATIONS

Despite the efforts described above, the PCAOB remains unable to inspect the audit work and practices of PCAOB-registered auditing firms in certain jurisdictions with respect to their work as the principal auditors of U.S.-listed companies. The PCAOB’s inability to conduct these audit inspections in NCJs poses significant risks to U.S. investors.

In response to the Memorandum, the PWG considered a series of potential policy options and considerations to further protect investors in companies listed in the United States and to ensure the continued fair and orderly operation of U.S. financial markets, while taking into account potential impacts. The PWG recommends the following:

- (1) **Enhanced Listing Standards for Access to Audit Work Papers.** Enhancing the listing standards of U.S. exchanges to require as a condition to initial and continued exchange listing:
 - (a) PCAOB access to audit work papers of the principal audit firm for the audit of the listed company; or
 - (b) Companies that are unable to satisfy the 1(a) standard as a result of governmental restrictions on access to audit work papers and practices in NCJs may satisfy this standard by providing a co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the co-audit firm.

To reduce market disruption, the new listing standards could provide for a transition period until January 1, 2022 for currently listed companies from NCJs to come into compliance. The new listing standards would apply immediately to new company listings once the necessary rulemakings and/or standard-setting are effective.

- (2) **Enhanced Issuer Disclosures.** Requiring enhanced and prominent issuer disclosures of the risks of investing in NCJs, including issuing interpretive guidance

²⁶ To facilitate inspection of non-U.S. registered public accounting firms, the PCAOB has over the years entered into formal cooperative arrangements with various foreign audit regulators designed to minimize administrative burdens and potential legal or other conflicts that non-U.S. registered public accounting firms may face in their home countries. See PCAOB, *Public Companies that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections* (as of June 1, 2020) <https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx> (Last visited on July 9, 2020).

to clarify these disclosure requirements to increase investor awareness, and more general awareness of the risks of investing in such companies.

- (3) **Enhanced Fund Disclosures.** Reviewing the risk disclosures of registered funds that have exposures to issuers from NCJs to enhance the disclosures by these funds, including issuing interpretive guidance to clarify the disclosure requirements to increase investor awareness of the risks of investing in such funds.
- (4) **Greater Due Diligence of Indexes and Index Providers.** Encouraging or requiring registered funds that track indexes to perform greater due diligence on an index and its index provider, prior to the selection of the index to implement a particular investment strategy or objective.
- (5) **Guidance for Investment Advisers.** Issuing guidance to investment advisers with respect to fiduciary obligations when considering investments in NCJs, including China.

It is the PWG’s recommendation to take steps to implement all five options for the reasons detailed below.

A. Enhanced Listing Standards for Access to Audit Work Papers

The PWG recommends that the SEC work to enhance U.S. exchanges’ listing standards in a tailored, phased-in manner in order to address certain issues highlighted by this report and maintain the fair and orderly functioning of U.S. markets.

1. *Enhanced Listing Standards*

The PWG recommends enhanced listing standards to require, as a condition to initial and continued exchange listing in the United States, PCAOB access to audit work papers of the principal audit firm for the audit of the listed company. Companies that are unable to satisfy this standard as a result of governmental restrictions on access to audit work papers and practices in NCJs may satisfy this standard by providing a co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the co-audit firm. These enhanced listing requirements would increase investor protections while seeking to continue to maintain fair and orderly operation of U.S. markets.

The SEC has oversight authority over securities exchanges in the United States, including those that list securities for trading, such as Nasdaq and the New York Stock Exchange (“NYSE”).²⁷ The SEC reviews and, as appropriate, approves or disapproves new exchange rules and changes to existing exchange rules proposed by the exchanges. The Securities Exchange Act of 1934

²⁷ 15 U.S.C. §§ 78f & 78s; 17 C.F.R. § 240.19b. See SEC Website, *Self-Regulatory Organization Rulemaking*, (June 26, 2020), available at <https://www.sec.gov/rules/sro.shtml> (providing list of National Securities Exchanges) (Last visited on July 9, 2020).

(“Exchange Act”) prescribes a process and the standards that the SEC must follow when reviewing proposed changes to the rules of the listing exchanges.

Following informal discussions with the SEC, the listing exchanges could voluntarily file proposals with the SEC under Section 19(b) of the Exchange Act to amend their initial and continued listing standards to add specific listing requirements for certain companies that are based in or have a significant portion of their audit services conducted by firms in NCJs.²⁸ For example, listing exchanges could impose specific requirements on listed companies based in NCJs that, by January 1, 2022, have not retained a principal auditor that is subject to PCAOB inspection. The new listing standards would apply immediately to new company listings once the necessary rulemakings and/or standard-setting are effective.

As noted above, for companies from NCJs, the recommendation allows for co-audit arrangements, which address the audit concerns of the PCAOB and SEC.

In particular, if a company that is based in an NCJ²⁹ cannot meet the new standard, it would be required to engage an affiliated U.S.-member registered public accounting firm (“U.S. Firm”) to serve as the principal auditor of the listed company’s annual financial statements through a co-audit arrangement with the audit firm in an NCJ (“NCJ Firm”). Under PCAOB Standards, the principal auditor is permitted to use the work and reports of other independent audit firms that have audited the financial statements of one or more subsidiaries, divisions, branches, components or investments included in the consolidated financial statements.³⁰ Rulemaking or standard-setting by the PCAOB, SEC or both would be needed to require the U.S. Firm to supervise the work of the NCJ Firm, such that the NCJ Firm’s work is performed under the U.S. Firm’s guidance and control. The U.S. Firm would be required to include in its work papers documentation of audit evidence sufficient to support the audit conclusions.

Under this recommendation, because the U.S. Firm would be the principal auditor and would be required to maintain the work papers in the U.S., the PCAOB would have the ability to inspect the audit work and practices of the U.S. Firm, including the U.S. Firm’s quality controls with respect to its work on listed companies based in an NCJ.³¹ Importantly, this recommendation would require the government of an NCJ to permit the U.S. Firm to perform the work and retain the

²⁸ In May 2020, The Nasdaq Stock Market LLC (“Nasdaq”) voluntarily filed three rule proposals with the SEC that, according to Nasdaq, are intended to strengthen its listing standards for issuers that principally administer their businesses from China or other Restrictive Marketsrestrictive markets that limit regulatory information sharing. Refer to **Appendix D**, *Overview of Nasdaq’s Recent Voluntary Rule Proposals*.

²⁹ As a general matter, listed companies engage auditors in their home jurisdiction; therefore, a NCJ-based company would engage a NCJ audit firm as the principal auditor whereas, for example, a U.S. company would engage a U.S. audit firm as the principal auditor. Therefore, this recommendation would affect companies based in NCJs.

³⁰ See PCAOB Auditing Standard (AS) 1205: *Part of the Audit Performed by Other Independent Auditors*, available at <https://pcaobus.org/Standards/Auditing/Pages/AS1205.aspx> (Last visited on July 13, 2020).

³¹ Additionally, rulemaking may be needed to allow the U.S. Firm to leverage the work of an NCJ Firm with respect to reading, inspecting and evaluating documents that will be in the local language(s), and to assist in performing inquiries of registrant personnel who may have limited English-speaking capabilities.

relevant work papers outside of the NCJ. The PCAOB’s inspection process would follow its typical process.

To reduce market disruption, the new listing standards could provide for a transition period until January 1, 2022 for currently listed companies from NCJs to come into compliance. After this transition period, if currently listed companies are unable to meet the enhanced listing standard (or co-audit requirement), then they would become subject to the exchange rules and processes described below that could lead to possible de-listing if not cured. For new listings, however, there would be no transition period. The listing standards would apply immediately to new listings once the necessary rulemakings and/or standard-setting are effective.

In addition to the listing exchanges voluntarily filing its proposals to amend its listing standards, the SEC could also, on its own, pursue a rulemaking to amend directly the exchanges’ listing standards pursuant to Sections 23(a) and 6(b)(5) of the Exchange Act. The SEC has certain authority to impose new exchange rules or amend or delete existing exchange rules—for example, when the SEC deems such action “necessary or appropriate” to “insure the fair administration” of the exchange; the agency can also informally encourage an exchange to propose a modification or enhancement of its listing standards.³²

2. *Delisting and Trading Suspensions*

Securities exchanges are legally obligated to monitor for and enforce compliance with their own rules and standards, including listing standards. In general, if an issuer violates, or fails to comply with, an exchange’s given listing standards, the exchange must initiate a series of procedures under its rules that may result in the delisting of the issuer, if the violations are not cured, or impose trading suspensions.³³ Therefore, enhanced listing standards could also ensure that securities of companies based in an NCJ that do not meet those standards cannot list on U.S. exchanges.

The SEC and the Financial Industry Regulatory Authority (“FINRA”) have authority to suspend trading in a given security. Specifically, the SEC has the authority, under Section 12(k) of the Exchange Act, to suspend trading in a security for 10 business days. Under FINRA Rule 6440, FINRA may halt trading in an OTC, or non-exchange traded, equity security for certain

³² 15 U.S.C. § 78s(c).

³³ Generally speaking, exchange listed companies that are out of compliance with continued listing standards are notified by the exchange and given a period to regain compliance (*e.g.*, deficiency notice, opportunity to cure violations within a given time frame, trading halt and appeals to the exchange and/or the SEC). *See, e.g.*, Nasdaq, *Continued Listing Guide*, (June 2020), available at <https://listingcenter.nasdaq.com/assets/continuedguide.pdf> (Last visited on July 9, 2020). The Exchange Rules provides that such compliance periods can be as long as one year to eighteen months, though the period can be longer due to various appeals processes. *See, e.g.*, NYSE Listed Company Manual Rules 802.02 and 802.03 and Nasdaq Rules 5810 and 5815(c)(1).

Companies notified that they are out of compliance must also make a public announcement by filing a Form 8-K, where required by SEC rules, or by issuing a press release so that the public and investors have notice that the company is not in compliance with continued listing standards. If the company is not compliant at the end of the compliance period, a delisting notice is issued, which can be appealed to the exchange. During the appeals process, the company’s securities will generally continue to trade on the exchange with some exceptions, such as where a regulatory trading halt has been imposed by the exchange. *See, e.g.*, NYSE Listed Company Manual Rule 804 and Nasdaq Rule 5815 (a)(1).

“extraordinary” events, but not indefinitely. Recent legislative proposals (e.g., HFCA Act) also would authorize and require the SEC to prohibit the trading of listed companies who use an auditor that cannot be inspected, subject to certain time-periods to comply before the prohibition takes effect.

3. *Policy Considerations Regarding Enhanced Listing Standards*

Enhancing U.S. listing standards would not, of course, prohibit these issuers from listing their securities on exchanges outside the United States, including Hong Kong, Shanghai or London. U.S. investors could purchase such securities on foreign exchanges, and these purchases may be subject to fewer investor protections than in the United States. For example, panelists from the SEC’s Roundtable on Emerging Markets in July 2020 expressed concern that China-based issuers would move their listings to foreign exchanges where there would be even fewer transparency and investor protections.

There may be other unintended consequences with policy options that ultimately result in de-listing from U.S. exchanges. Re-listing of issuers’ securities on non-U.S. exchanges could involve “going-private” or other transactions at discounted valuations at the expense of existing U.S. shareholders. In these transactions, the issuer, its control persons or other affiliates acquire all of the company’s remaining public equity. Oftentimes, the insiders initiating the transaction have the requisite voting power to approve the proposed transaction with little or no minority shareholder support. Due to differences in corporate law in the United States and the Cayman Islands or British Virgin Islands, the jurisdictions in which many issuers from NCJs are generally incorporated, and difficulties associated with obtaining and enforcing extraterritorial judgments, U.S. investors have limited recourse if they oppose the transaction or disagree on valuation. Some of these issuers from NCJs subsequently could reoffer and list their securities in their home country at significantly higher valuations than those ascribed to the firm at the time of the going-private transaction, resulting in a financial windfall to insiders.³⁴

B. *Enhanced Issuer Disclosures*

The PWG recommends that, as a specific listing standard, a more specific disclosure requirement or both, requiring enhanced and prominent issuer disclosures of the risks of investing in issuers from NCJs. These actions could include rulemaking and/or issuing interpretive guidance to clarify the disclosure requirements to increase investor awareness, and more general awareness of the risks of investing in such companies.

1. *Enhanced Issuer Disclosures*

³⁴ See Professor Jesse Fried, *The Risky Business of Investing in Chinese Tech Firms*, Harvard Law School Forum on Corporate Governance (February 2019) available at <https://corpgov.law.harvard.edu/2019/02/04/the-risky-business-of-investing-in-chinese-tech-firms/> (Last visited on July 9, 2020); See Akiko Fujita, *The Ultimate Insult: How U.S. Listed Chinese Companies are Gaming American Investors*, Yahoo Finance (March 2019) available at <https://finance.yahoo.com/news/how-u-s-listed-chinese-companies-are-squeezing-out-minority-investors-172606715.html> (Last visited on July 9, 2020).

Companies registered with the SEC, including issuers from NCJs, are subject to disclosure and financial statement requirements under the federal securities laws and SEC rules that are designed to provide investors with material information to use in making investment and voting decisions. In particular, companies are required to provide information about the most significant risks of an investment in the company's securities, material government regulations and information about beneficial owners of the company's securities, among other requirements.

Although these types of disclosures are currently required by the SEC's existing principles-based disclosure requirements, a more specific listing standard or disclosure requirement could further highlight for investors the risks of investing in an issuer from an NCJ. With respect to issuers from NCJs, the areas of disclosures generally include the company's variable interest entity ("VIE") structure,³⁵ risks related to a lack of enforcement mechanisms and PCAOB inspection limitations, and the NCJ's regulatory environment, which in general provides governmental authorities with significant discretion that can be used to influence how such issuers conduct their business operations.

2. *Policy Considerations Regarding Enhanced Issuer Disclosures*

This policy approach would provide additional investor protections through enhanced and more prominent disclosures.

C. *Enhanced Risk Disclosures and Due Diligence by Registered Investment Funds*

The PWG recommends that the SEC seek enhanced risk disclosures and due diligence on the part of registered investment funds and their managers, as well as an enhanced fiduciary focus by investment advisers when considering investments in emerging markets. The enhanced risk disclosure could focus on issues unique to emerging markets, including PCAOB enforcement limitations with respect to issuers based in China and other NCJs. The enhanced due diligence of index providers could result in index providers more carefully considering the implications of different regulatory, accounting, auditing and financial recordkeeping standards when considering issuers to include in an index. The enhanced fiduciary focus of investment advisers should result

³⁵ A VIE is an entity in which an investor holds a controlling interest based on contractual arrangements rather than on owning the majority of voting rights. See FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities — an interpretation of ARB No. 51* (revised Dec. 2003), available at <https://fasb.org/summary/finsum46r.shtml> (Last visited on July 23, 2020). The VIE structure is a business structure that is used in certain business sectors in China that have prohibitions or restrictions on foreign investment. See Council of Institutional Investors, *Buyer Beware: Chinese Companies and the VIE Structure* (December 2017), p. 4, available at https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf (Last visited on July 20, 2020). VIEs operate using contractual arrangements rather than direct ownership, leaving U.S. investors without the rights to residual profits or control over the company's management that they would otherwise enjoy through equity ownership. See *id.* at 2.

in additional investigation into the risks and regulatory implications of investments in China and other NCJs.

As explained below, the PWG has three recommendations to implement these policy options. The SEC could seek enhanced investment company risk disclosure, due diligence of index providers and fiduciary focus of investment advisers by (1) encouraging registered investment companies to enhance risk disclosure regarding investing in emerging markets, including China and other NCJs; (2) encouraging or requiring registered funds to conduct due diligence of index providers; and/or (3) encouraging investment advisers to focus on their duties of loyalty and care when considering emerging market investments, including in China and other NCJs.

1. Encouraging Enhanced Risk Disclosures by Registered Investment Companies

The PWG recommends that the SEC issue interpretive guidance to clarify investment companies' disclosure obligations regarding investments in emerging markets, including with respect to PCAOB inspection and enforcement limitations of issuers based in China or other NCJs. The staff of the SEC's Division of Investment Management reviews disclosures in registered investment company (e.g., fund) filings. The staff focuses on disclosures of topics most important to investors, such as investment strategy and risk disclosures. All registered funds are required by law to disclose their principal investment strategies and risks.³⁶

Over the past several decades, the portfolios of U.S. investors have become increasingly exposed to companies that are based in emerging markets, including China, or that otherwise have significant operations in emerging markets. A significant amount of this exposure comes through registered funds investing in these markets.³⁷ The SEC staff carefully reviews risk disclosures made by these funds to ensure that they adequately describe principal risks, such as those that can result from differences in local regulatory, accounting, auditing and financial recordkeeping standards.³⁸ They also review filings for disclosure of risks relating to the fact that funds are increasingly exposed to emerging market companies by tracking an index that is comprised of these companies.

³⁶ See Item 4 of Form N-1A. With respect to the matters raised in Section C, as a matter of practice, SEC staff typically consults with CFTC staff regarding disclosure requirements of registered investment companies that have advisers also registered with the CFTC as commodity pool operators.

³⁷ See SEC Division of Economic and Risk Analysis, *U.S. Investors' Exposure to Domestic Chinese Issuers* (July 6, 2020), available at https://www.sec.gov/files/US-Investors-Exposure-to-Domestic-Chinese-Issuers_2020.07.06.pdf (Last visited on July 9, 2020).

³⁸ See, e.g., SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman and SEC Division of Investment Management Director Dalia Blass, *Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited* (Apr. 21, 2020), available at <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting> (Last visited on July 9, 2020).

SEC staff will continue to focus on reviewing the risk disclosures of registered funds that have exposure to emerging markets for adequacy. As part of the SEC's efforts to enhance disclosures by these funds, the Commission or the staff could issue additional interpretive guidance to clarify requirements about disclosure of relevant risks, including PCAOB inspection and enforcement limitations with respect to issuers based in NCJs.³⁹ In addition, such guidance could promote enhanced disclosure regarding limitations on a fund adviser's ability to oversee an index provider's due diligence process over index data prior to its use in index computation, construction and/or rebalancing. The disclosure could further acknowledge that the rights and remedies associated with investments in a fund that tracks an index comprised of foreign securities, particularly emerging market securities, may be different from those of a fund that tracks an index of domestic securities.

Policy Considerations Regarding Enhanced Investment Company Risk Disclosures

Funds and their outside counsel regularly review their disclosures in light of evolving SEC guidance. Thus, issuing interpretive guidance on enhancing relevant risk disclosure could encourage enhanced disclosure by funds regarding investments in emerging markets, including China. It also would provide retail investors with clear notice of relevant risks. Nonbinding guidance, however, may influence but not fully alter behavior or reduce investments by funds in China and other NCJs, though it would be a concrete statement of the SEC's views regarding appropriate risk disclosure.

2. Encouragement of or Requirement to Conduct Due Diligence of Indexes and Index Providers by Registered Funds

The PWG recommends that the SEC consider taking steps to encourage or require SEC-registered mutual funds and ETFs that track indexes to perform greater due diligence on an index and its index provider prior to the selection of the index to implement a particular investment strategy or objective. This enhanced due diligence should take into account the index provider's process for index construction, including with respect to index rebalances. In particular, due diligence should address whether the process takes into account any potential errors in index data, index computation and/or index construction if the information from issuers based in NCJs, including China, is unreliable or outdated or if less information about such companies is publicly available due to differences in regulatory, accounting, auditing and financial recordkeeping standards. It should also take into account the potential effects of such differences on the fund's performance.

Encouraging funds that intend to utilize indexes to conduct more robust due diligence could result in index providers considering these differences in standards more carefully, and possibly altering how they construct indexes. The SEC could also encourage or require index funds to provide disclosure regarding their due diligence in their registration statements, reports to shareholders or other disclosure documents. Depending on the scope of the requirements for enhanced due diligence, this option could be implemented through Commission or staff guidance, which could be issued relatively quickly but would be non-binding, or Commission rulemaking, which could be more prescriptive but would take more time.

³⁹ *Id.*

Policy Considerations Regarding Enhanced Due Diligence of Indexes and Index Providers

Unlike other jurisdictions (e.g., the EU and the UK), the SEC and other federal regulators do not have authority to directly regulate the activities of the index providers that are responsible for, among other things, selecting, updating and rebalancing indexes. In the absence of such regulatory authority, this option may indirectly encourage index providers to consider factors such as transparency and quality of financial information more carefully in index construction. Further, it would not limit investor choice, and it would not be perceived as a limitation on the ability of foreign issuers to access the U.S. capital markets. The degree of impact will depend on incentives for registered funds to conduct additional due diligence, incentives for index providers to change indices based on that due diligence and incentives for issuers to be included on indexes.

3. Guidance on Investment Adviser Fiduciary Obligations

In addition to the enhanced risk disclosures and due diligence of index and index providers, the PWG recommends that the SEC consider issuing guidance to investment advisers with respect to fiduciary obligations when considering investments in NCJs, including China.

Investment advisers have a fiduciary duty to their clients under the Investment Advisers Act of 1940 (“Advisers Act”), including a duty of loyalty and a duty of care. The duty of care includes a duty to provide investment advice that is in the best interest of the client. In order to provide such advice, an adviser must have a reasonable belief that the advice is in the client’s best interest based on the client’s objectives. For example, an adviser should consider whether investments are recommended only to those clients who understand the risks and provide informed consent, and should conduct a reasonable investigation into the investment sufficient not to base its advice on materially inaccurate or incomplete information. With respect to investments in China and other NCJs, an investment adviser should consider differences in local regulatory, accounting, auditing and financial recordkeeping standards and the effects of those differences on the ability to accurately select investments that meet the client’s investment objectives and goals.

Accordingly, investment advisers that are recommending investments in these jurisdictions may want to consider, as part of their reasonable investigation, whether there are limitations on the quality or availability of financial information with respect to these investments, as well as possible limitations on investors’ legal remedies in such jurisdictions.

Policy Considerations Regarding Investment Adviser Fiduciary Obligations

The regulatory framework under the Advisers Act is largely principles-based. Thus, additional guidance on investment advisers’ fiduciary obligations with respect to investments in China and other NCJs may influence advisers’ behavior, but it would not prescribe precisely how each adviser would be expected to incorporate the considerations discussed into its process for conducting a reasonable investigation of the investments that it recommends for its clients. Similar to the policy considerations with respect to due diligence of indexes and index providers, therefore, this option would not limit investor choice, and it would not be perceived as a limitation on the ability of foreign issuers to access the U.S. capital markets.

CONCLUSION

The United States is a premier jurisdiction in the world for raising capital. Investor trust in U.S. capital markets reflects a combination of, among other things, a strong investor protection framework, robust disclosure requirements, clear and effective regulation, fair enforcement, a free market system and confidence in the financial information provided by companies listed on U.S. exchanges. The U.S. government and financial regulators should not compromise on these core principles. The recommendations outlined in the PWG report are designed to address risks to investors posed by NCJs' failure to uphold transparency and accountability, including NCJs' refusal to permit companies to comply with U.S. laws. The recommendations would protect investors by ensuring a level playing field for all companies listed on U. S. exchanges.

Appendix A – PCAOB LETTER, DATED JULY 10, 2020

July 10, 2020

President's Working Group on Financial Markets

Secretary Steven T. Mnuchin
U.S. Department of the Treasury

Chairman Jay Clayton
U.S. Securities and Exchange Commission

Chairman Jerome H. Powell
Board of Governors of the Federal
Reserve System

Chairman Heath P. Tarbert
U.S. Commodity Futures Trading
Commission

Dear Working Group Members:

At the request of Chairman Clayton, I am providing the President's Working Group on Financial Markets with this overview of the PCAOB's past and current efforts to appropriately conduct inspections of audit work performed in China with respect to public companies.

I. Background

The Public Company Accounting Oversight Board ("PCAOB") was created by the Sarbanes-Oxley Act ("SOX") to oversee the audits of public companies and SEC-registered brokers and dealers in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.¹ We accomplish that mission by registering and inspecting audit firms, setting auditing standards, and enforcing compliance with auditing standards and related provisions of the federal securities laws.²

International cooperation lies at the heart of our ability to fulfill our statutory mandate with respect to audit services performed by non-U.S. audit firms. Under SOX, PCAOB oversight extends to non-U.S. audit firms that audit or play a substantial role in

¹ 15 U.S.C. § 7211.

² 15 U.S.C. §§ 7212–7216.

the audit of public companies and brokers and dealers.³ In exercising our oversight authority outside of the U.S., we benefit greatly from cross-border cooperation. To facilitate that cooperation, we often enter into formal cooperative arrangements with foreign audit regulators.

To date, the PCAOB has performed inspections of one or more registered firms in more than 50 non-U.S. jurisdictions. We have worked closely with our international counterparts in many of these jurisdictions on joint inspections as well as enforcement matters, and we have built constructive, collaborative relationships that facilitate meaningful cooperation. We have entered into formal cooperative arrangements that facilitate our access in 24 jurisdictions.⁴

In entering into formal cooperative arrangements, we often have been asked to accommodate the specific legal requirements of individual jurisdictions. Without fail, we have done so when the accommodation can be made consistent with our statutory mandate. In each such case, however, the accommodations have not infringed on certain access-related principles that are fundamental to accomplishing our statutory mandate. These principles are:

- (1) The ability to conduct inspections and investigations consistent with our mandate;
- (2) The ability to select the audit work and potential violations to be examined; and
- (3) Access to firm personnel, audit workpapers, and other information or documents deemed relevant by our teams.

³ See, e.g., 15 U.S.C. §§ 7214(a)(1), 7215(b)(1), and 7216(a)(1).

⁴ Not every jurisdiction requires us to enter into a formal cooperative arrangement to exercise our oversight authority. For those that do, our formal cooperative arrangements generally minimize the administrative burdens and potential legal or other conflicts that non-U.S. PCAOB-registered firms may face in their home countries. In many cases, cooperation under these agreements includes the PCAOB regularly carrying out inspections jointly with the home-country regulators and obtaining access to documents and witnesses for enforcement purposes.

We have, either directly or together with other regulators, established arrangements that implement these principles in every jurisdiction where PCAOB-registered audit firms operate, with one exception: China, and by extension, Hong Kong.^{5,6}

II. China's Long-Standing Refusal to Cooperate with PCAOB Oversight

China's refusal to cooperate meaningfully with the PCAOB is not new. It dates back to 2007 when Chinese and Hong Kong audit firms first invoked Chinese restrictions to refuse us access to conduct inspections of audit work performed in China. Since that initial refusal in 2007, the PCAOB has engaged in numerous attempts to obtain access to conduct inspections and enforcement activities in China on terms consistent with the remainder of the world. For example, the PCAOB has: (1) directly negotiated potential access with the Chinese Ministry of Finance ("MOF") and China Securities Regulatory Commission ("CSRC"), both of which have jurisdiction over audit firms in China; (2) held recurring discussions at the Treasury-led U.S.-China Strategic and Economic Dialogue; (3) conducted a "confidence-building exercise" with the CSRC; (4) entered into a Memorandum of Understanding with the MOF and CSRC related to enforcement activities; and (5) attempted to conduct a pilot inspection of one China-based firm.⁷ Notwithstanding these time-consuming and costly efforts, the Chinese side has never agreed to provide access consistent with our core principles.

⁵ Although this letter focuses primarily on access issues related to our oversight of audit firms located in mainland China, Chinese authorities also impose restrictions on foreign regulators' access to audit work performed by Hong Kong auditors with respect to mainland China-based public companies. Because the largest PCAOB-registered audit firms in Hong Kong perform significant audit work on mainland China-based public companies, the positions taken by Chinese authorities described herein prevent the PCAOB from conducting oversight of Hong Kong firms.

⁶ Our concerns over access in Belgium and France are distinct from our concerns related to China. We have developed strong, productive relationships with the audit regulators in those countries and anticipate that, once our agreements are finalized, we will have no concerns with conducting our oversight activities there. The sole impediment to finalizing our new agreement with Belgium and renewing our prior agreement with France is receiving final approval from relevant data protection authorities on cooperation practices under the European Union's recent General Data Protection Regulation.

⁷ To the extent it would be helpful, we would be pleased to provide a more detailed summary of our efforts to obtain access in China since 2007.

III. China's Most Recent Proposal Does Not Accord with our Core Principles for Access

Since 2018, when the U.S. Securities and Exchange Commission appointed a new governing Board at the PCAOB, we have maintained regular correspondence and dialogue with the CSRC regarding our access concerns. Through that dialogue, we have reiterated to the Chinese side the need to reach an agreement on access that is consistent with our three core principles (as articulated above). Despite claiming that they have presented a model of cooperation that aligns with these principles, the CSRC's latest proposal, attached as Exhibit A hereto, is materially deficient in myriad ways.

First, the Chinese proposal implies critical limitations on the PCAOB's ability to select the specific engagements it will inspect. Although the letter accompanying the proposal states that "the Chinese authorities have no intention to impose restrictions on [the] PCAOB's selection of engagements" and that the PCAOB "can choose engagements for inspection freely," the accompanying proposal in fact imposes limitations. The proposal specifically states that "the engagements to be inspected and the scope of the inspection *shall be determined by both sides.*"⁸ That language is consistent with the position maintained by the Chinese side over the past decade. For example, while negotiating access in October 2015, the CSRC and MOF stated they must have veto power over PCAOB engagement selection. They noted in particular that state-owned enterprises ("SOEs") and subsequently, Baidu and Alibaba, two of the largest China-based public companies (as measured by market capitalization) were off-limits for inspection. While the CSRC's position subsequently softened with respect to non-SOEs, their position on SOEs was reiterated to us in December 2017 and September 2019 when CSRC Vice Chair Fang stated bluntly that the Chinese side is not prepared to facilitate PCAOB inspections of the audits of SOEs.

Second, the latest proposal implies limitations on the PCAOB's ability to define the scope of our inspections. More specifically, it requires that the CSRC and PCAOB "reach consensus on . . . engagements, scope and key areas for inspection, procedures to be performed" That language suggests that, contrary to international norms for cooperation, the Chinese side plans to seek to limit the scope of and approach taken in our inspections. We note that, based on prior conversations with the Chinese side, the CSRC has consistently insisted that key inspection parameters required the review and

⁸ None of our formal cooperative agreements contain a requirement that we reach consensus on engagement selection.

approval of the multiple Chinese authorities and that the CSRC could not alone approve these.

Third, the most recent proposal leaves unaddressed the unacceptable limitations on PCAOB access to audit workpapers and related information we deem relevant for inspections or investigations. In 2017, the PCAOB attempted a pilot inspection of an audit of a significant China-based public company. In connection with that pilot, the CSRC refused us direct access to a series of relevant workpapers and redacted numerous other workpapers. Although the company was not a SOE, the Chinese side refused full access to the relevant workpapers on the basis of national security or state secret concerns. The CSRC ultimately acknowledged that the redactions applied to information that, *prima facie*, did not present national security or state secrets concerns, yet they refused to reconsider the redactions. As a result, our inspectors were unable to examine relevant documents and information necessary to conclude the inspection. Based on that experience and in the interest of reaching a cooperative arrangement that comports with our principles, we have previously requested that the Chinese side propose a timely and effective mechanism to address redactions that impair our ability to examine necessary information. The latest proposal omits such a mechanism.⁹

Fourth, the Chinese side historically has refused to commit to a recurring cycle of inspections that would enable us to meet our SOX-mandated triennial inspection schedule for firms that issue audit reports. They have consistently maintained that it would be burdensome for CSRC resources, require approvals from various Chinese authorities, and involve multi-agency review of engagement files. Their most recent proposal leaves this unaddressed.

Fifth, the latest proposal ignores our longstanding concerns related to enforcement access. In early 2011 through 2012, numerous mainland China-based public companies were delisted or suspended from trading in U.S. markets for various reasons, including financial reporting allegations and insolvency. The PCAOB's Division of Enforcement and Investigations launched a number of investigations into potential auditing issues surrounding those public companies. After years of negotiating for access, in May 2013, the PCAOB, CSRC, and MOF executed an enforcement-related Memorandum of Understanding ("MOU"). Unfortunately, since

⁹ In every jurisdiction other than China, our experience is that redactions are extremely rare, narrowly tailored to specific statutory provisions (*e.g.*, the protection of personally identifiable information), and applied in a transparent manner. This stands in stark contrast to our experience during the pilot inspection in China.

signing the MOU in 2013, Chinese cooperation has not been sufficient for the PCAOB to obtain access to relevant documents and testimony. In many cases, the Chinese side has produced no documents at all. In the limited instances where they have produced some documents, the productions have been so untimely and incomplete as to stifle meaningful progress on the investigations. We have not received any documents since 2015. Chinese authorities have also never allowed us to take testimony from a single witness located in mainland China. Given these challenges, the MOU is not effective in promoting enforcement cooperation, a point we have reiterated both formally and informally to the Chinese side.¹⁰ The most recent proposal ignores this issue altogether.

IV. Conclusion

We cannot—and will not—compromise on our core principles for obtaining access in China and Hong Kong. To do so would create an unlevel playing field for audit firms in China and Hong Kong and would potentially jeopardize our formal cooperative agreements with other jurisdictions, which have taken us more than a decade to put in place.

We appreciate the opportunity to provide this information and would welcome an opportunity to provide any additional information on the subject matter. Feel free to reach out to me at (202) 591-4126 or (202) 718-6924 if you would like to discuss these issues further.

Sincerely,



William D. Duhnke III
Chairman
Public Company Accounting Oversight Board

Enclosure: Exhibit A – April 3, 2020 CSRC correspondence

¹⁰ After signing the enforcement MOU, the CSRC newly asserted that the MOU does not address cooperation as to Hong Kong firms that perform audit work in mainland China and that a further protocol must be executed for the PCAOB to take testimony.

Exhibit A

NON-PUBLIC AND CONFIDENTIAL

Liza McAndrew Moberg
Director
Office of International Affairs
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006-2803
U.S.A

(Via e-mail)

April 3, 2020

RE: CSRC Proposal of Joint Inspection

Dear Liza

During this difficult time when the COV-19 outbreak became a global pandemic, we hope you and your family and colleagues are doing well and stay very safe. With thankful reference to your letter on 20 December 2019, I'm writing to follow up on our discussion about the proposal of joint inspection on audit firms. CSRC have attached great importance to audit oversight. I believe both sides share the common objectives in securing compliance of audit firms and safeguarding fairness and transparency of capital markets. By cooperating with mutual respects in a professional and forward-looking manner, I believe, we can definitely resolve the remaining differences and work out a mutually satisfactory solution.

As Vice Chair FANG Xinghai expressed during the meeting with you in Washington D.C. last September, the Chinese side agrees to the three core principles identified by PCAOB. In order to address the core principles, CSRC together with the Ministry of Finance of China have made further revisions to our proposal, whilst studying and drawing references to the protocols PCAOB have entered into with other audit supervisors in Europe. With this letter, I would like to convey to you some major considerations of our new proposal.

Principle 1: PCAOB has ability to conduct inspections and investigations.

With regards to inspection, the starting point of our proposal on joint inspection is to solve this issue. We suggest and hope PCAOB can start discussion with us on the proposal soon so that both sides can reach an agreement at a sooner date. Based on this and upon the signing of our cooperation protocol, we can start the normal course of regular inspections on related audit firms.

With regards to enforcement cooperation, both sides had very good cooperation

under the enforcement MoU signed in 2013. Our disagreement now is about onward sharing of non-public information PCAOB obtained from the Chinese side under an enforcement request. If PCAOB can adopt the same solution that we found during the pilot inspection program in 2017, which set up clear procedures about information sharing to SEC, both sides can carry on enforcement cooperation readily. We hope PCAOB can respond to our proposal on this matter soon so as to resolve the issue at an earlier date.

Principle 2: PCAOB has ability to select the audit work and potential violation to be examined.

For inspections, the Chinese authorities have no intention to impose restrictions on PCAOB's selection of engagements. We are willing to and have made it clear in our new proposal that the requesting party can choose engagements for inspection freely. Same as that in the protocols signed between PCAOB and H3C in France (H3C), AOB in Germany (AOB), etc., that the Parties shall endeavor to reach a consensus on a work plan for inspection as well as the audit engagements and scope to be reviewed, we also envisaged such a practice in our proposal. This should not constitute impediments or restrictions to PCAOB's ability to freely select engagements. In fact, such prior communication on work plans is essential for efficiently utilizing resources of both sides and satisfying the regulatory needs for both sides.

For our suggestion of taking a risk-based approach in selecting engagements, we think this is consistent with the SEC and PCAOB's supervisory philosophy and of mutual interests to regulators of both sides for safeguarding audit compliance .

We hope this arrangement for audit selections should already meet the second principle. If PCAOB still has concerns or doubts on this point, we would be happy to discuss with you in order to relieve these concerns or doubts.

Principle 3: PCAOB has access to firm personnel, audit working papers, and other information or documents deemed relevant.

With regards to access to firm personnel, we propose that the requesting party can interview firm personnel, with staff from the requested party being present. This would eliminate the inconveniences of interviewing via video conference, which was employed during the pilot inspections program in 2017.

With regards to access to audit working papers, we modified our proposal which now allows the firms to transfer audit working papers directly to PCAOB with prior approval of the Chinese regulators. We believe this approach will be even better than most of your current practices. As for "other information or documents" mentioned in the third principle, we would need PCAOB to define precisely or make clarifications. We believe both sides should be able to define this term clearly in our future discussion.

By properly addressing the three core principles, we hope the above elaborations are of help to PCAOB to fully understand our proposal and eliminate your remaining concerns. If it is still deemed to have remaining restrictions on PCAOB access, we would very much like to hear your specific views and underlying considerations, so as to narrow down our disagreements and allow for targeted discussions in order to resolve misalignment and reach an early agreement. For this purpose, CSRC would like to visit US or invite you and your colleagues to China for face-to-face discussions about the proposal. Given the restrictions on global travels due to the COV-19 pandemic, we would suggest that we have an audio or video conference calls as alternative. We welcome open and candid discussions with PCAOB in any form that deemed convenient for you.

With this, I look forward to hearing from you soon.

Yours sincerely



Bing SHEN

Director General

Department of International Affairs

China Securities Regulatory Commission

Enclosure: Updated Proposal of Conducting Joint Inspection with PCAOB

Proposal of Conducting Joint Inspection with PCAOB

1. Purpose

In order to protect investors, promote public trust in the audit process of accounting firms and to fulfill each other's own regulatory responsibilities, both sides agree to enhance cooperation and to conduct joint inspection on related accounting firms and their audit engagements. Both sides agree to formulate plans and procedures for conducting joint inspection through consultation so as to provide guidance on the implementation of joint inspection and establish an effective cooperation mechanism for audit supervision on a long term basis. Joint inspection is also intended to assist both parties in determining the degree to which one party may rely in the future on the other party's oversight activity with regard to audit firms that fall within the regulatory jurisdiction of all parties.

2. Guiding Principle

- 1) mutual respect for each other's sovereignty, laws and regulations; no damage shall be posed on national security or national interests;
- 2) mutual benefit, equality and reciprocity;
- 3) cooperation in the utmost possibility to fulfill regulatory mandates required by the laws of both sides, that may include but not limited to: joint inspection over the audit firms that fall within the regulatory jurisdiction of both sides, selection of audit work and files for inspection, access to working papers and related documents that are deemed relevant for inspection.
- 4) to refer to international practice in the utmost possibility while in compliance with the laws of both sides.

3. Specific Arrangements for joint inspection

- 1) **annual plan for joint inspection:** both sides shall have annual communications with each other and reach consensus on the conduction of joint inspection. The requested party shall make best efforts within its capability to meet the requests of the requesting party .

- 2) **selection of engagements for inspection:** the requesting party may choose engagements for inspection freely. Before an inspection is carried out jointly, the engagements to be inspected and the scope of the inspection shall be determined by both sides via mutual consultation, trying to meet the regulatory needs from both sides. The selection of engagements for inspection shall be based on risk assessment.
- 3) **specific plan for joint inspection:** before conducting a joint inspection, both sides shall communicate with each other and reach consensus on the specific working plan, that may include but not limited to: engagements, scope and key areas for inspection, procedures to be performed, work allocation between inspection staff of each party and sharing of costs.
- 4) **Division of responsibilities:** with regards to the organization and coordination, the requested party is responsible for the overall coordination and arrangements, as well as communications between the inspection team and the firm. With regards to the implementation of specific inspection, the requesting party may lead the relevant inspection work. (i) for inspection of audit engagements, both parties can conduct inspection jointly on one engagement or separately on different engagements; (ii) for inspection of quality control system, both parties can conduct inspection jointly on same issues or on different issues; (iii) for personnel interviews, before conducting the interview the requesting party shall send its plan and questionnaire to the requested party, and the latter would arrange the interview accordingly. During the interview, the requesting party is responsible for asking questions, with staff from the requested party being present. The requesting party can raise follow-up questions within the scope of the questionnaire, and for questions out of the scope of the questionnaire the requesting party shall send them to the requested party to arrange for another interview.
- 5) **transfer of files including audit working papers:** audit working papers and other documents can be transferred from the auditor to the requesting party with the approval of the requested party.
- 6) **transfer of the inspection materials to the other side's jurisdiction:** the requesting party shall identify the list of copies of documents that may be

transferred to its own jurisdiction in the principle of necessity and inform the requested party. The copies may be transferred to the requesting party's jurisdiction with the approval from the requested party. The requested party shall provide necessary assistance to facilitate such transfer of materials.

- 7) **use of inspection materials and situations where legal proceedings are involved:** PCAOB may share materials obtained during inspection with the US SEC and other entities identified in section 105 (b) (5) (B) of the Sarbanes-Oxley Act. If the US SEC intends to use related inspection materials for conducting a civil proceeding or assisting in a criminal prosecution, it shall submit a request for assistance under the IOSCO Multilateral Memorandum of Understanding ("MMoU") to the CSRC. Both sides shall obtain prior written consent from the other party if they plan to transfer certain inspection materials to other third party.
- 8) **joint inspection report:** both sides shall consult each other before the inspection conclusion is reached and inspection report is released. During field work, both parties shall consult each other about their findings and conclusion. Before publicly announcing any sanctions imposed to related entity of individual, the party shall give advance notice to the other party.
- 9) **situations where requests may be denied:** inspection requests of one party may be denied under some specific circumstances. This may include but not limited to : acceding to the request would contravene a party's laws and regulations; pose harm on one's public interests or public order; competent authorities of one party already initiated investigation or imposed sanctions on related firms.

4. **Timeline for the joint inspection**

The working teams from both sides can soon start negotiation on the cooperation protocol and try to reach consensus on working levels in the first half of 2020, finish internal approval procedures and officially sign the cooperation protocol in the third quarter of 2020 and to start a joint inspection on an audit firm that fall within the regulatory jurisdiction of both sides in the fourth quarter of 2020, after which the joint inspection may gradually become regular.

Appendix B – MARKET CONTEXT

The U.S. capital markets are the largest, deepest and most vibrant in the world and of critical importance in supporting U.S. economic growth.⁴⁰ The United States successfully derives a greater portion of business financing from its capital markets (rather than the banking system) than most other advanced economies.⁴¹ U.S. capital markets provide invaluable capital resources to entrepreneurs and owners of businesses, whether they are large or small, public or private, domestic or foreign. The NYSE and Nasdaq are the largest stock exchanges in the world, representing a total combined market capitalization of over \$36 trillion as of end-June 2020.⁴²

Over the past decade, there has been rising demand by U.S. investors for investment opportunities in companies with significant operations in emerging markets, particularly China, due to their high growth potential. As a result, U.S. capital markets, and therefore U.S. investors, generally have become more exposed to such companies.

I. U.S. Markets Provide Attractive Opportunities for a Broad and Diverse Investor Base

U.S. equity markets provide investment opportunities to a broad range of investors, from large institutions to individuals saving for retirement. Access to a diversified investor base is an important reason that businesses worldwide choose to raise capital in the U.S. market, where a wide range of investors enable business innovation and expansion. These include a diverse banking system with over \$20 trillion in assets,⁴³ a large number of institutional investors and investment firms, as well as a broad swath of retail investors who invest directly or through intermediaries.

With the objective of maximizing valuation, the primary considerations for listing decisions—regardless of where an issuer is based—are generally: (1) the depth and liquidity of a given market; (2) the presence of the rule of law and the ability to move capital freely; (3) the quality of an exchange’s institutional investors and their understanding of a company’s business; (4) the likelihood of attracting research coverage; (5) visibility to customers and suppliers; (6) the degree to which similar companies (e.g. same sector, market competitors) trade on the market; and (7) the prestige or reputation of the exchange.

⁴⁰ See U.S. Department of Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets* (October 2017), available at <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf> (Last visited on July 9, 2020).

⁴¹ *Id.*

⁴² See World of Exchanges, *Statistics*, available at <https://www.world-exchanges.org/our-work/statistics> (Last visited on July 23, 2020).

⁴³ See Federal Reserve Bank of St. Louis, *Economic Data, All Commercial Banks*, available at <https://fred.stlouisfed.org/series/TLAACBW027SBOG> (Last visited on July 9, 2020).

II. Chinese Authorities Encourage Mainland Issuers to Access Capital Markets in Hong Kong or Mainland Exchanges

At the same time, China actively encourages mainland issuers to list on Hong Kong or mainland exchanges rather than on foreign exchanges.⁴⁴ Recently, China's market regulator, the China Securities Regulatory Commission ("CSRC"), publicly noted that China will firmly support Hong Kong's development as an international financial center with various policies.⁴⁵ The CSRC also noted that Hong Kong may be a main destination for secondary listings for Chinese issuers, as Hong Kong has more comprehensive secondary listing rules and close linkage with mainland markets.⁴⁶ The prospect of potential U.S. delistings, as well as a 2018 loosening of Hong Kong's listing rules may have helped spur recent share offerings in Hong Kong.⁴⁷

A. Hong Kong Exchanges and Clearing Limited ("HKEX")

Some analysts estimate that HKEX⁴⁸ may have sufficient liquidity to support secondary listings of eligible Chinese issuers.⁴⁹ In April 2018, HKEX finalized significant changes to its rules for secondary listings on its exchange by overseas issuers and Hong Kong incorporated issuers

⁴⁴ See Engen Tham, Scott Murdoch, *Chinese Companies put U.S. Listing Plans on Ice as Tensions Mount*, Reuters.com (June 9, 2020), available at <https://www.reuters.com/article/us-china-usa-ipo/chinese-companies-put-u-s-listing-plans-on-ice-as-tensions-mount-idUSKBN23H01U> (Last visited on July 23, 2020).; See Chad Bray, *Hong Kong Top Destination for Chinese IPOs, but new Shanghai Tech Board Poses Threat*, South China Morning Post (June 14, 2019), available at <https://www.scmp.com/business/companies/article/3014404/hong-kong-top-destination-chinese-ipos-new-shanghai-tech-board> (last visited on July 23, 2020).

⁴⁵ See Reuters, *China Regulator Confident of HK's Future as Global Financial Hub* (June 22, 2020), available at <https://www.reuters.com/article/china-regulator-hongkong/china-regulator-confident-of-hks-future-as-global-financial-hub-idUSL4N2DZ0YW> (Last visited on July 9, 2020).

⁴⁶ *Id.*

⁴⁷ According to FactSet data, the Hong Kong Exchanges and Clearing Limited (HKEX) now accounts for nearly a fifth of the shares changing hands by value in Alibaba Group Holding, Ltd. after the e-commerce company's Hong Kong listing in November 2019, and since NetEase Inc. and JD.com Inc. made their debuts in Hong Kong in June 2020, their Hong Kong shares have accounted for about 33% and 21%, respectively, of total turnover by value. See Wall Street Journal, *Chinese Tech Firms Get Trading Boost from Hong Kong Listings* (July 8, 2020), available at <https://www.wsj.com/articles/chinese-tech-firms-get-trading-boost-from-hong-kong-listings-11594200602?mod=searchresults&page=1&pos=7> (Last visited on July 9, 2020).

⁴⁸ HKEX is a Hong Kong-based holding company that operates exchanges, including the Stock Exchange of Hong Kong Limited (SEHK) (equity market) and Hong Kong Futures Exchange Limited (HKFE) (derivatives market). See HKEX website, *History of HKEX and its Market*, available at https://www.hkexgroup.com/About-HKEX/Company-Information/About-HKEX/History-of-HKEX-and-its-Market?sc_lang=en (Last visited on July 8, 2020).

⁴⁹ See Liu, Wendy, et.al, *Possible US Financial Restrictions on China III: US-listed Chinese companies returning to Hong Kong*, UBS China Equity Strategy (June 8, 2020).

primarily listed on a qualifying exchange.⁵⁰ These changes were part of a broader effort to expand its listing regime to attract and facilitate listings by companies from “emerging and innovative sectors.”⁵¹ An issuer must have its primary listing on the NYSE, Nasdaq or “premium listing” segment of the London Stock Exchange’s Main Market and satisfy a minimum required expected market capitalization on HKEX.⁵² The new rules also allow the listing of companies with weighted voting rights structures, which tend to be favored by technology firms that Hong Kong wants to attract.

B. Shanghai, Shenzhen and London Exchanges

China has also developed mechanisms to encourage Chinese-based companies to list in Shanghai, Shenzhen and London. Mainland Chinese exchanges in Shanghai and Shenzhen have a combined market capitalization of \$7.5 trillion, about 1.5 times that of HKEX, but they lack meaningful direct participation by global institutional investors (foreign investors hold only about 3.5% of total shares traded)⁵³ and are disadvantaged by China’s capital controls and reputational issues linked to rule of law and accounting standards. Nonetheless, Chinese authorities are pursuing reforms to increase the viability of domestic exchanges as alternatives to other global exchanges such as expanding options for equity structure. They also offer less restrictive financial requirements for listing (e.g., market capitalization minimums).

Currently, six China-based companies are listed on the London Stock Exchange,⁵⁴ in part due to restrictions against the weighted voting rights structure that Chinese issuers tend to employ for overseas listings.⁵⁵ However, the London and Shanghai stock exchanges recently launched a “connect” that facilitates Chinese companies adding a secondary listing of Global Depository

⁵⁰ See Securities Exchange of Hong Kong, *Consultation Conclusions: A Listing Regime For Companies From Emerging and Innovative Sectors* (April 2018), available at [https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/February-2018-Emerging-and-Innovative-Sectors/Conclusions-\(April-2018\)/cp201802cc.pdf](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/February-2018-Emerging-and-Innovative-Sectors/Conclusions-(April-2018)/cp201802cc.pdf) [hereinafter HKEX, Consultation Conclusions] (Last visited on July 23, 2020).

⁵¹ *Id.*. Note that the announced changes regarding overseas listings accompanied other rule changes that allowed pre-revenue Biotech Companies to list even if they did not satisfy the Financial Eligibility Test for listing on the HKEX. These changes are also detailed in the Consultation Conclusions and Consultation Paper.

⁵² *Id.*, paras. 253–54.

⁵³ See Cheng, Evelyn. *U.S. Pressure Could Accelerate Growth for Markets in Greater China*, CNBC (June 11, 2020), available at <https://www.cnbc.com/2020/06/11/us-pressure-could-accelerate-growth-for-markets-in-greater-china.html> (Last visited on July 9, 2020).

⁵⁴ See London Stock Exchange, *Issuer List* (as of June 30, 2020), available at <https://www.londonstockexchange.com/reports?tab=issuers> (Last visited on July 15, 2020).

⁵⁵ See Financial Conduct Authority, *Premium Listing Principles 3 and 4*, *FCA Handbook, LR 7.2.IAR*, available at <https://www.handbook.fca.org.uk/handbook/LR/7/2.html> (Last visited on July 15, 2020).

Receipts in London. Only two Chinese companies currently list through the connect,⁵⁶ but Chinese authorities are reportedly urging their domestic companies to consider this option over U.S. listings in response to potential U.S. policy restrictions.⁵⁷ In early 2020, China also temporarily suspended the connect reportedly due to political tensions.⁵⁸

⁵⁶ See Bloomberg, *Shanghai-London Stock Link Could Finally Revive After Year Halt* (June 3, 2020), available at <https://www.bloomberg.com/news/articles/2020-06-03/shanghai-london-link-to-revive-after-year-long-gap-ecm-watch> (Last visited on July 15, 2020).

⁵⁷ See Ramnarayan, Abhinav, et. al., *China Urges Its Firms To List in London in Renewed Global Push: Sources*, Reuters, (May 28, 2020), available at <https://www.reuters.com/article/us-britain-listings-china/china-urges-its-firms-to-list-in-london-in-renewed-global-push-sources-idUSKBN22U1M4> (Last visited on July 15, 2020).

⁵⁸ See Zu, Julie, et. al., *China halts British stock link over political tensions*, Reuters (Jan. 2, 2020), available at, <https://www.reuters.com/article/us-china-britain-ipos-exclusive/exclusive-china-halts-british-stock-link-over-political-tensions-sources-idUSKBN1Z108L> (Last visited on July 23, 2020).

Appendix C – RELEVANT SEC AND PCAOB ACTIVITIES RELATING TO MARKET AWARENESS AND ENFORCEMENT

Remediating concerns about the inability of the PCAOB to conduct inspections and obtain audit work papers of China-based auditors has long been a U.S. priority, and the SEC and PCAOB have engaged in a wide range of activities in an attempt to increase market awareness of the risks associated with these limitations, and to attempt to enforce compliance with the U.S. federal securities laws.

I. Activities to Increase Market Awareness

The SEC and the PCAOB have taken a number of investor protection actions to bring greater attention to the issues, risks and uncertainties of investing in emerging markets, including China.⁵⁹ For example, the SEC promotes informed investment decision-making through education initiatives aimed at providing the investing public with a better understanding of the capital markets and the opportunities and risks associated with the array of investment choices presented to them. There are several potential ways to increase investor and market participant awareness of the risks and other issues associated with investments in China, many of which are already underway.

A. Investor Roundtables

The SEC hosted a Roundtable on Emerging Markets⁶⁰ on July 9, 2020 to solicit views of market participants, audit professionals, other regulators and industry experts on how the SEC can continue to raise investor awareness of the risks of investing in emerging markets, including China, and explore potential additional steps that can be taken to mitigate them.⁶¹ Panelists generally agreed that there are risks of investing in emerging markets, specifically China, for reasons that include a lack of PCAOB inspection rights, difficulty in accessing audit work papers and documents and different corporate governance standards.⁶² Panelists acknowledged that emerging markets have an important role to play in diversifying U.S. investors' portfolios, and expressed a range of views about the impacts of efforts to mitigate risks to investors, including concern that China-based issuers would move their listings to foreign exchanges where there would be even

⁵⁹ See SEC Chairman Jay Clayton, *Letter to the Honorable Rick Scott*, (May 4, 2020), available at <https://www.rickscott.senate.gov/sites/default/files/2020-05/Scott%20-%20Jan%20and%20Feb%20ltrs%20-Response%5b2%5d.pdf> (Last visited on July 13, 2020).

⁶⁰ See SEC, *SEC Staff Host July 9 Roundtable on Emerging Markets* (May 19, 2020), available at <https://www.sec.gov/news/press-release/2020-116> (Last visited on July 9, 2020).

⁶¹ See SEC, *July 9, 2020: Staff Roundtable on Emerging Markets*, available at <https://www.sec.gov/page/emerging-markets-roundtable> (Last visited on July 9, 2020).

⁶² See SEC Webcasts, *Emerging Markets Virtual Roundtable*, (July 9, 2020), available at <https://www.sec.gov/news/webcasts.htm> (Last visited July 13, 2020).

less transparency and investor protections.⁶³ While most of the panelists believed that investors had adequate disclosures about the risks of investing in China-based issuers, many panelists believed enhanced disclosures could be beneficial. The SEC also received comment letters from the public expressing a range of views about the subject matter of the roundtable.⁶⁴

B. Investor Education Platforms

The SEC's investor education platform covers a wide variety of subjects and uses multiple communication channels, including social and digital communication. The SEC's Office of Investor Education and Advocacy ("OIEA") spearheads these efforts with support from the SEC's other Divisions and Offices. In particular, the SEC's OIEA has a "Before You Invest, Investor.gov" public service campaign focused on empowering retail (non-professional) investors through information and education⁶⁵ and helping individuals protect themselves from various types of investment fraud.⁶⁶ In order to focus on the risks of emerging markets, the SEC has a dedicated spotlight page on its website, which highlights the risks for investors in emerging markets, including China.⁶⁷ Similarly, the PCAOB has extensive information on its website about its China-related access challenges.⁶⁸ The PCAOB also has a webpage dedicated to providing information to investors.⁶⁹

C. Investor Alerts and Investor Bulletins

The SEC provides a variety of services and tools to address problems faced by investors. It issues Investor Alerts focused on recent investment frauds and scams, and Investor Bulletins focused on topical issues, including the risks of investing in foreign securities.⁷⁰ The PCAOB staff has published information about its China-related access challenges and the audits of Chinese issuers

⁶³ *Id.*

⁶⁴ See SEC, *Comments on Chairman's Statement on Statement Announcing SEC Staff Roundtable on Emerging Markets*, available at <https://www.sec.gov/comments/emerging-markets/cll9.htm> (Last visited on July 24, 2020).

⁶⁵ See SEC, *Investor.gov*, available at <https://www.investor.gov/> (Last visited on July 23, 2020).

⁶⁶ See SEC, *Public Service Campaign, Investor.gov* available at <https://www.investor.gov/public-service-campaign> (Last visited on July 23, 2020).

⁶⁷ See SEC, *July 9, 2020: Staff Roundtable on Emerging Markets*, available at <https://www.sec.gov/page/emerging-markets-roundtable> (Last visited on July 9, 2020).

⁶⁸ See PCAOB Website, *China-Related Access Challenges*, available at <https://pcaobus.org/International/Pages/China-Related-Access-Challenges.aspx> (Last visited on July 9, 2020).

⁶⁹ See PCAOB Website, *Information for Investors*, available at <https://pcaobus.org/Pages/Investors.aspx> (Last visited on July 23, 2020).

⁷⁰ See SEC, *International Investing*, available at <https://www.sec.gov/reportspubs/investor-publications/investorpubsininvesthtm.html> (Last visited on July 23, 2020)

by registered public accounting firms outside of China.⁷¹ In addition to the public statements from the SEC and PCAOB's Chairmen, the SEC could issue Investor Alerts or Investor Bulletins about the risks associated with investments in emerging markets, including China.

D. *Speeches and Public Statements*

The SEC continues to engage the investing public and build ties with the industry to bring greater awareness and attention to the risks of emerging market investments. The SEC and PCAOB, and their staffs, have issued numerous public statements and delivered speeches on these issues.⁷² The SEC likely will continue these outreach programs at various levels of the agency.

II. SEC and PCAOB Enforcement

Companies registered with the SEC, including China-based issuers, are subject to disclosure and financial statement requirements under the federal securities laws and SEC rules that are designed to provide investors with material information to use in making investment and voting decisions. These disclosure issues have been highlighted in a number of public statements by the Chairman, Division Directors and Commission's Chief Accountant.⁷³

Over the last decade, the Commission's enforcement staff has investigated and litigated in the federal courts and in administrative proceedings dozens of possible violations of the federal securities laws related to China-based issuers, registrants and persons. Although these efforts are critical to preserving and enhancing market integrity, transparency, integrity and investor

⁷¹ See e.g., PCAOB, "Data about our China-Related Access Challenges" available at <https://pcaobus.org/International/Pages/data-about-our-china-related-access-challenges.aspx> (Last visited on July 23, 2020); See PCAOB, *Staff Questions and Answers – Audits of Mainland China Issuers by Registered Firms Outside of Mainland China* (Dec. 30, 2016), available at <https://pcaobus.org/Inspections/Documents/PCAOB%20Staff%20QA%20on%20MOF%20rule.pdf> (Last visited on July 23, 2020).

⁷² See SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman and SEC Division of Investment Management Director Dalia Blass, *Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited* (Apr. 21, 2020), available at <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting> (Last visited on July 23, 2020); See SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia and SEC Division of Corporation Finance Director Bill Hinman, *Statement on Continued Dialogue with Audit Firm Representatives on Audit Quality in China and Other Emerging Markets; Coronavirus — Reporting Considerations and Potential Relief* (Feb. 19, 2020) available at <https://www.sec.gov/news/public-statement/statement-audit-quality-china-2020-02-19> (Last visited on July 23, 2020); See SEC Chairman Jay Clayton, Former SEC Chief Accountant Wes Bricker, and PCAOB Chairman William D. Duhnke III, *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China* (Dec. 7, 2018) available at <https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other> (Last visited on July 23, 2020).

⁷³ *Id.*

protection, both the SEC and the PCAOB have confronted structural and legal obstacles to enforcing U.S. law and regulations.

A. SEC Enforcement

The SEC has been actively engaged in efforts to investigate China-based accounting fraud and disclosure violations for over a decade. Enforcement investigations and actions for potential violations of the U.S. federal securities laws are critical tools available to the SEC for advancing the goal of investor protection and seeking to ensure that U.S. issuers and foreign private issuers listed on U.S. exchanges with operations in China comply with U.S. law. But enforcement investigations and actions have been significantly hindered and delayed by an increasing number of structural and legal barriers put in place by China. These include China's extended review and withholding of materials based on the Chinese government's determination that the documentation constitutes "state secrets," which prevents the production of corporate documents, audit work papers and witness testimony; the passage of a law requiring all corporate and audit materials to remain and be maintained only in China for any China-based audit firm;⁷⁴ and the enactment of Article 177 of the PRC Securities Law.⁷⁵ More generally, the ability to bring enforcement actions is dependent on the facts and circumstances of a particular case.

To further the SEC's enforcement actions and to obtain access to the documents and witnesses necessary to bring enforcement actions, the SEC has focused on efforts to enhance its staff's ability to obtain records in China-based investigations, especially audit work papers from registered public accounting firms for audits conducted in China or of China-based issuers. For example, the SEC filed an enforcement action in 2011 against a large accounting firm for failing to produce documents responsive to an agency subpoena;⁷⁶ pursued and obtained a favorable administrative law judge ruling in 2014 in a proceeding against five China-based accounting firms for failing to produce audit work papers;⁷⁷ and in 2015, negotiated and established a framework for production

⁷⁴ See *Interim Provisions on Auditing Operations Conducted by Accounting Firms Concerning the Overseas Listing of Domestic Chinese Companies* (MoF Provisions). The MoF Provisions require that work papers from audits signed by an overseas accounting firm (principally in Hong Kong) but conducted by China-based audit firms be maintained in Mainland China.

⁷⁵ Article 177 of the 2020 Revised Chinese Securities Law provides, among other things, 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 to overseas regulators.

⁷⁶ See SEC Press Release, *SEC Files Subpoena Enforcement Action against Deloitte and Touche in Shanghai*, (Sept. 8, 2011), available at <https://www.sec.gov/news/press/2011/2011-180.htm> (Last visited on July 9, 2020).

⁷⁷ See SEC Press Release, *SEC Charges Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents*, (Dec. 3, 2012), available at <https://www.sec.gov/news/press-release/2012-2012-249.htm> (Last visited on July 9, 2020). The five firms were (1) Deloitte Touche Tohmatsu Certified Public Accountants Limited; (2) Ernst & Young Hua Ming LLP; (3) KPMG Huazhen (Special General Partnership); (4) PricewaterhouseCoopers Zhong Tian CPAs Limited Company; and (5) BDO China Dahua CPA Co., Ltd.

of audit work papers with the Chinese affiliates of the largest four accounting firms.⁷⁸

Since 2010, the SEC has brought approximately 60 China-based cases, including more than 40 fraud cases against more than 140 defendants. Over 21 of these 40 fraud cases focused on accounting (as opposed to market manipulation, insider trading, etc.).⁷⁹ All but two of these actions have been resolved by settlement or the entry of a default judgment.

B. PCAOB Enforcement

In early 2011 through 2012, numerous mainland China-based public companies were delisted or suspended from trading in U.S. markets for various reasons, including financial reporting allegations and insolvency.⁸⁰ The PCAOB's Division of Enforcement and Investigations launched a number of investigations into potential auditing issues surrounding those public companies.⁸¹ After years of negotiating for access, in May 2013, the PCAOB, CSRC and MOF executed an enforcement-related Memorandum of Understanding ("MOU").⁸² Unfortunately, since signing the MOU in 2013, Chinese cooperation has not been sufficient for the PCAOB to obtain access to relevant documents and testimony.⁸³ In many cases, the Chinese side has produced no documents at all. In the limited instances where they have produced some documents, the productions have been so untimely and incomplete as to stifle meaningful progress on the investigations. PCAOB has not received any documents since 2015 pursuant to the MOU.⁸⁴ Chinese authorities have also never allowed the PCAOB to take testimony from a single witness located in mainland China. Given these challenges, the MOU is not effective in promoting enforcement cooperation, a point the PCAOB has reiterated both formally and informally to the Chinese side.⁸⁵

⁷⁸ SEC Press Release, *SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents*, (Feb. 6, 2015), available at <https://www.sec.gov/news/pressrelease/2015-25.html>; see *infra* nn.11, 12, 26 (Last visited on July 9, 2020).

⁷⁹ In addition, there are more than a dozen additional matters involving non-scienter accounting.

⁸⁰ See **Appendix A**, *PCAOB Letter*, pp. 5-6.

⁸¹ *Id.*

⁸² See PCAOB Website, *China-Related Access Challenges*, available at <https://pcaobus.org/International/Pages/China-Related-Access-Challenges.aspx> (Last visited July 9, 2020).

⁸³ See **Appendix A**, *PCAOB Letter*, pp. 5-6.

⁸⁴ See **Appendix A**, *PCAOB Letter*, p. 6.

⁸⁵ *Id.*

Appendix D – OVERVIEW OF NASDAQ’S RECENT VOLUNTARY RULE PROPOSALS

In May 2020, Nasdaq Stock Market LLC (“Nasdaq”) filed three rule proposals with the SEC that, according to Nasdaq, are intended to strengthen its listing standards for issuers that principally administer their businesses from China or other markets that limit regulatory information sharing (“Restrictive Markets”). The first proposal would require companies in Restrictive Markets to have at least one member of senior management, a director or an outside consultant with general familiarity regarding the reporting requirements (e.g., GAAP) of a U.S.-listed public company.⁸⁶

The second proposal would apply additional initial listing criteria for companies in Restrictive Markets to ensure sufficient investor base and public float.⁸⁷ Under Nasdaq’s proposal, a company from a Restricted Market listing in connection with an initial public offering would be required to raise in a firm commitment offering the lesser of (1) \$25 million or (2) 25% of the company’s post-offering market value of listed securities. Nasdaq believes this proposal “will provide greater support for the company’s price, as determined through the offering, and will help assure that there will be sufficient liquidity, U.S. investor interest and distribution to support price discovery once a security is listed.”⁸⁸ Similar standards would apply to listed companies that engage in business combinations with companies from a Restricted Market. The proposal would also clarify that Nasdaq would permit a direct listing of an issuer from a Restricted Market on its top two tiers without any additional requirements.

Finally, the third proposal would allow Nasdaq to deny listing or continued listing or to impose additional listing standards in its discretion, including those requiring higher assets, earnings or liquidity, if Nasdaq has concerns relating to the audit of a potential or existing listed company (whether or not from a Restricted Market).⁸⁹ The proposal also would provide Nasdaq similar

⁸⁶ See SEC, *Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of Proposed Rule Change to Adopt a New Requirement Related to the Qualification of Management for Companies From Restrictive Markets*, File No. 34-89028, (June 8, 2020), available at <https://www.sec.gov/rules/sro/nasdaq/2020/34-89028.pdf> (Last visited on July 9, 2020).

⁸⁷ See SEC, *Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of Proposed Rule Change to Apply Additional Initial Listing Criteria for Companies Primarily Operating in Restrictive Markets*, (June 8, 2020), available at <https://www.sec.gov/rules/sro/nasdaq/2020/34-89027.pdf> (Last visited on July 9, 2020).

⁸⁸ *Id.* at 7.

⁸⁹ See SEC, *Self-Regulatory Organizations; The Nasdaq Stock Market LLC; 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, 2020), available at <https://www.sec.gov/rules/sro/nasdaq/2020/34-88987.pdf> (Last visited on July 9, 2020).

broad discretionary authority to impose additional listing requirements on issuers from a Restricted Market, regardless of whether there are audit concerns.