

December 1, 2020

Securities and Exchange Commission Issues Disclosure Guidance for China-Based Issuers

On November 23, 2020, the Division of Corporation Finance (the “Division”) of the U.S. Securities and Exchange Commission (“SEC”) issued guidance (the “Guidance”) that (i) highlights certain risks (and their implications to U.S. investors) associated with investments in China-based Issuers¹ and (ii) summarizes the Division’s views on the enhanced disclosures that China-based Issuers should make regarding such risks. The Guidance follows the passage of the Holding Foreign Companies Accountable Act (the “Senate Bill”) by the U.S. Senate in May 2020 and, more recently, the July 2020 recommendations from the President’s Working Group on Financial Markets, both of which are intended to facilitate increased U.S. regulatory scrutiny of China-based Issuers.

Attorneys
[Victoria Lloyd](#)
[Thomas Danielski](#)
[Irene Lau](#)
[Alyce Chen](#)

Highlighted risks identified in the Guidance consist of the following:

- **Risks related to high-quality and reliable financial reporting.** The current restrictions within the PRC on the Public Company Accounting Oversight Board’s (“PCAOB”) ability to conduct inspections in mainland China and Hong Kong in relation to the audit work and practices of PCAOB-registered accounting firms are identified as presenting significant questions on the reliability of the financial reporting of China-based Issuers. The Senate Bill, if enacted as law,² could result in the suspension in trading of China-based Issuers relying on audited financial statements prepared by audit firms for which the PCAOB cannot inspect underlying audit work papers. Risk is identified in relation to potential adversity to the trading prices and liquidity of China-based Issuers, or even the delisting of China-based Issuers.
- **Risks related to access to information and regulatory oversight.** Pursuant to Art 177 of the Securities Law of the PRC, which took effect in March 2020, securities regulators outside of the PRC are not permitted to directly conduct investigations (including gathering evidence) within China, and no entity or individual within China is permitted to provide business- and/or securities-related documents and/or information to non-PRC regulatory authorities without the prior approval of the PRC government. Additionally, non-PRC regulatory authorities, including the SEC, are identified as facing substantial challenges in instituting and enforcing actions against China-based Issuers. Risk is identified within the Guidance as presenting limited recourse by investors against defaulting China-based Issuers.
- **Risks related to variable interest entity (VIE) structures.** Due to foreign ownership restrictions and/or limitations in certain industries deemed sensitive by the PRC government (e.g., telecommunications, internet content providers and education services), VIE structures have become widely adopted by China-based Issuers operating in such sensitive industries. Due to the absence of direct equity ownership in the affiliates of the China-based Issuers that utilize VIE structures, risk is identified within the Guidance as presenting challenges to investors seeking recourse against such China-based Issuers if the PRC government determines that VIE structures circumvent applicable law, or if the persons or entities holding equity interests in the local operating companies of such VIE structures breach their obligations to the China-based Issuers and/or enter into other commercial arrangements without the approval of their affiliated China-based Issuer.

¹ The Guidance defines “China-based Issuers” as companies based or having the majority of their operations in the People’s Republic of China.

² The Bill remains subject to consideration and approval by the U.S. House of Representatives and therefore has not been adopted into law.

- **Risks related to the regulatory environment.** The Guidance notes that the PRC legal system is substantially different from the U.S. legal system. Risk is identified within the Guidance that uncertainties and inconsistencies exist with respect to the interpretation, effect, and enforcement of China's laws, rules and regulations, as well as the swiftness with which regulations can change within China.

The Guidance also alerts investors of the differences between U.S. domiciled issuers versus non-U.S. domiciled issuers, particularly in relation to potentially decreased statutory shareholder protection, governance standards and disclosure obligations of foreign private issuers.

The Guidance provides a list of items to guide China-based Issuers on enhanced risk factor disclosures. Although the Guidance does not carry the legal force of a rule, regulation or statement of the SEC, companies are expected to follow these recommendations to stay abreast of the regulatory development. The recommendations are as follows:

- To consider if an issuer has provided clear and prominent disclosure of the inspection limitations faced by PCAOB and the lack of enforcement mechanisms against, as well as the risks relating to, the quality of the financial statements of China-based Issuers.
- If an issuer has adopted VIE in its organizational structure, to consider if it has cautioned investors about the risks associated with the VIE structure employed in China.
- To consider if an issuer has disclosed risks relating to the regulatory environment in China, including risks related to its legal system, which may have inconsistent and unpredictable interpretation and enforcement of laws and regulations.
- To consider if an issuer has included risk disclosures about differing shareholder rights and corporate governance protections in the issuer's place of incorporation as compared to those applicable to a U.S. domestic issuer.

If you have any questions about the content of this Alert, please contact Ropes & Gray.