THE HOLDING FOREIGN COMPANIES ACCOUNTABLE (HFCA) ACT: A CRITIQUE

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The Holding Foreign Companies Accountable (HFCA) Act: A Critique

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Abstract

The 2020 Holding Foreign Companies Accountable (HFCA) Act will force China-based firms to delist from U.S. exchanges if China fails to permit audit inspections during a two-year period. The Act also requires such firms, as soon as China blocks such inspections, to disclose ties to the Chinese party-state. We first explain why the delisting provisions, while well-intentioned, may well harm U.S. investors. We then turn to the disclosure provisions, explaining that they appear to be motivated by a desire to name-shame Chinese firms rather than to protect investors. While China-based firms do pose unique risks to U.S. investors, the Act fails to mitigate—and may well exacerbate—these risks.

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I. Introduction

On December 18, 2020, then-President Donald Trump signed into law the Holding Foreign Companies Accountable Act (the HFCA Act, or the Act). The Act, as amended, subjects China-based U.S.-listed firms to delisting if the Public Company Accounting Oversight Board (PCAOB) cannot inspect their auditors for two years, an inspection that is required every three years for other U.S.-listed firms by The Sarbanes-Oxley Act of 2002 (SOX). The HFCA Act also requires China-based U.S.-listed firms to submit documentation and make certain disclosures related to their ties to the Chinese government and the Chinese Communist Party (together, the party-state). On December 2, 2021, the Securities and Exchange Commission (SEC) finalized amendments to various rules implementing the Act.

China, unlike other countries, has until recently refused to allow local audit firms to share audit materials with foreign regulators such as the PCAOB. The main purported purpose of the HFCA Act is to ensure that all U.S.-listed firms have PCAOB-inspected auditors, as required by SOX. Either China allows PCAOB inspections of local auditors, or China-based firms would be forced to delist.

In August 2022, under the specter of the HFCA Act, the PCAOB and China’s market regulators reached an agreement to give the PCAOB complete access to the audit materials of registered public accounting firms in China and Hong Kong that audit China-

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3 For purposes of this paper, the term “China” refers to the mainland (neidi) jurisdiction of the PRC’s Central People’s Government, thus excluding Hong Kong. See 中华人民共和国出境入境管理法 (Exit and Entry Administration Law of the People’s Republic of China) (promulgated by the Standing Comm. Nat’l People’s Cong., June 30, 2012, effective July 13, 2013) 2012 STANDING COMM. NAT’L PEOPLE’S CONG. GAZ. 433.


5 See infra Part II.B.2.
based U.S.-listed firms. According to PCAOB reports, the agreement gave the PCAOB sole discretion to select the audit firms it inspected, allowed for the full investigation of complete audit work papers, and permitted the PCAOB direct access to interview and take testimony from all associated personnel. In September, the PCAOB began conducting inspections pursuant to the agreement. On December 15, 2022, the PCAOB announced that the investigations were successful, and that it had secured complete access to inspect the audit materials of registered public accounting firms headquartered in Mainland China and Hong Kong. With this announcement, the countdown for a trading prohibition under the HFCA Act was, at least temporarily, paused.

Overall, we assess the expected effect of the HFCA Act on U.S. investors as negative. As we will explain, there is a substantial likelihood that China will at some point refuse to fulfill these commitments, at least with respect to certain firms, including for the reasons China has resisted PCAOB inspections in the past. If this refusal occurs, delisting will ensue and U.S. investors will be harmed. If China continues to allow PCAOB inspections, these investors will see only modest benefits. Meanwhile, the required submissions and disclosures about each firm’s relations with the party-state offer little in the way of investor protection, as they are likely to generate information that is either irrelevant or misleading. This part of the Act appears to be an attempt by Congress to use securities laws to make a political statement under the guise of investor protection.

Relatedly, and outside the scope of the HFCA Act, in July 2021 the SEC indicated that it would require enhanced risk-disclosures from China-based companies that have a variable interest entity (VIE) structure when seeking an IPO on a U.S.

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7 Id.


11 See infra Part III.B.2.a.
exchange. Unlike the Act, the SEC’s added disclosures do not address potential ties to the Chinese government, but rather require additional transparency concerning the organizational structure of foreign issuers that are connected to a China-domiciled operating company through contractual arrangements. The SEC will also require additional disclosure of the potential risks for U.S. investors from their exposure to China-based operating companies, including risks involved in exposure to the shifting regulatory environment in China.

Although our paper focuses on the U.S. regulation of China-based firms trading in the United States, it is worth noting that the Chinese party-state has also begun enhancing its own control and regulatory oversight of such firms. In particular, it revitalized and tightened the legal framework concerning data sharing with foreign parties and regulators; enhanced administrative oversight of China-based U.S.-listed firms; and enhanced international credibility and influence.


13 Risks related to regulatory changes in China were evident in the share decrease of two China-based U.S.-listed online education platforms, TAL Education and New Oriental Education and Technology, whose shares plunged (70.8% and 54.2%, respectively) following a July 2021 policy shift in China that narrowed the operating scope of domestic online education services in China. Similar share price declines happened across the industry, impacting the value of online education service companies’ shares listed in Hong Kong and Mainland China as well. See Wang Baiwen (王伯文), Jiao Pei “Shuangjian” Xinzheng Luodi Xindongfang Diefu Po Jilu (教培“双减”新政落地新东方跌幅纪录) [Double Reduction Policy Causes Record Decline for New Oriental], CAIXIN (July 23, 2021, 5:02 PM), https://www.caixin.com/2021-07-23/10174497.html.

14 ZHONGGONG ZHongyang BANGONGTING, GUOWUYUAN BANGONGTING (中共中央办公厅, 国务院办公厅) [The CCP Central Committee and the State Council], GUANYU YIFA CONGYAN DAJI ZHENGQUAN WEIFA HUODONG DE YIJIAN (关于依法从严打击证券违法活动的意见) [Opinions on Cracking Down on Illegal Activity in Securities Strictly and in Accordance with Law] (July 6, 2021), http://www.gov.cn/zhengce/2021-07/06/content_5622763.htm (discussing, in Part 5, the topic of “Further Strengthening Cross-border Cooperation in Law Enforcement and Administration of Justice,” id. pt. 5); GUOWUYUAN BANGONGTING (国务院办公厅) [The General Office of the State Council], GUANYU JINYIBU GUIFAN CAIWU SHENJII ZHIHUI CUJIN ZHUICE KUAIJISHI HANGYE JIANKANG FAZHAN DE YIJIAN (关于进一步规范财务审计秩序促进注册会计师行业健康发展的意见) [Opinions on Further Regulating the Order of Financial Auditing and Promoting the Healthy Development of the Certified Public Accountant Industry] (2021) [hereafter, Opinions on Further Regulating Financial Auditing and the Certified Public Accountant Industry], http://www.gov.cn/zhengce/content/2021-08/23/content_5632714.htm (tightening supervision over the accounting industry, including the establishment of greater coordination mechanisms that would guaranty that the industry “carry out cross-border accounting audit supervision cooperation in accordance with laws and regulations and safeguard the national economic information security and the legitimate rights and interests of enterprises and enhance international credibility and influence,” id. art. 6)

15 See ZHONGHUA RENMIN GONGHEGUO DANGAN FA (中华人民共和国档案法) [Amendment to the Archives Law] (revised by the Stan. Comm. of the Thirteenth Nat’l People’s Cong., Jun. 20, 2020, effective Jan 1, 2021) arts. 22, 25; ZHONGHUA RENMIN GONGHEGUO SHIJU ANQUAN FA (中华人民共和国数据安全法) [Data Security Law of the People’s Republic of China], (promulgated by the STANDING COMM. OF THE THIRTEENTH NAT’L PEOPLE’S CONG., JUN. 10,
firms including via cybersecurity reviews and data-protection inspections;\textsuperscript{16} tightened enforcement in the Chinese cybersecurity market, including with respect to auditors and other intermediary gatekeepers;\textsuperscript{17} and established a review and approval system for future offshore listings of Chinese companies and their affiliates.\textsuperscript{18}

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\textsuperscript{16} See, e.g., Shuju Chujing Anquan Pinggu Banfa (数据出境安全评估办法) [Measures for the Security Assessment of Outbound Data Transfer] (issued by the Cyberspace Admin. of China, Jul. 7, 2022, effective Sep. 1, 2022). These rules are expected to have an impact on data-rich technology firms and their U.S. listings such as Alibaba and TikTok. The earliest example of such regulatory tightening involved China-based U.S.-listed Didi Chuxing, a ride-sharing company, whose Chinese operating company was scrutinized for data security violations just days after the firm’s New York IPO, causing the stock price to sharply decrease. See China Investigates Didi over Cybersecurity Days After Its Huge IPO, REUTERS (July 2, 2021, 12:17 PM), https://www.reuters.com/technology/china-cyberspace-administration-launches-security-investigation-into-didi-2021-07-02/ (noting that the announcement by China’s cyberspace agency that it would investigate Didi caused the company’s stock price to fall by more than 10%). This was followed by the investigations of two other China-based U.S.-listed companies, Full Truck Alliance Co. Ltd. (a digital freight platform) and Kanzhun Ltd. (an online recruitment service provider). See China Shows Full Truck Alliance, Kanzhun Who’s Boss, SEEKING ALPHA (July 6, 2021, 2:00 AM), https://seekingalpha.com/article/4437952-china-shows-full-truck-alliance-kanzhun-whos-boss (reporting that both companies committed to fully cooperate with the investigation and to conduct comprehensive investigations into their operations for potential cybersecurity risks); Raffaele Huang & Liza Lin, China Eases Regulatory Restraints on Two Tech Platforms, WALL ST. J. (June 29, 2022, 9:51 AM), https://www.wsj.com/articles/china-eases-regulatory-restraints-on-two-tech-platforms-11656510696?mod=Searchresults_pos1&page=1 (noting that the companies saw their stock prices “plunge” following the announcement of the investigation). While, domestically within China, these developments are portrayed with Chinese consumers in mind, national security concerns driven by U.S.-China competition is a significant motivator. See China Ups Security Review for Online Platforms Seeking Overseas IPOs, Xinhua (Jan. 5, 2022, 12:03 AM), http://www.xinhuanet.com/english/20220105/ea983c934f92479fa1b6f2fc543db770/c.html (“Regulators will assess whether the public listing of a company may lead to key information infrastructure, core data, important data or a large amount of personal information being affected, controlled or maliciously used by foreign governments, according to the new rule.”).

\textsuperscript{17} Guanyu Yifa Cong Yan Daji Zhengquan Weifa Huodong de Yijian (关于依法从严打击证券违法活动的意见) [Opinions on Strictly Cracking Down on Illegal Securities Activities in Accordance with the Law] (issued by the General Office of the Central Committee of the Chinese Communist Party and the General Office of the State Council, Jul. 6, 2021) [hereinafter Opinions on Strictly Cracking Down on Illegal Securities Activities]. Articles 15 through 17 discuss the accountability of intermediaries (e.g., audit firms), while articles 19 through 21 highlight improving cross border cooperation. See id.

\textsuperscript{18} Wangluo Anquan Shenchu Banya (2021) (网络安全审查办法 (2021)) [Cyber Security Review Measures (2021)], issued by Decree No.8 of the Cyberspace Administration of China, effective Feb 15, 2022, see art. 7 (introducing requirements that firms with at least one million users undergo a cyber security review prior to listing offshore); China Unveils Sweeping Rules for Offshore Listings in Wake of Didi, STRAITS TIMES, Dec. 28, 2021,
The remainder of the paper is structured as follows. Part II provides a backdrop to the HFCA Act. Part III discusses the delisting provisions of the Act and their likely effects. Part IV discusses the disclosure provisions of the Act and their futility. Part V concludes.

II. Backdrop to the HFCA Act

This Part describes the types of China-based firms listed in the United States (Section A) and discusses the prior decade’s wave of reverse-merger frauds and the audit controversy (Section B) that led to the HFCA Act.

A. Chinese Firms in the United States

Although China has robust and growing capital markets, many China-based firms are listed outside China, including in the United States. As of January 2023, several hundred Chinese companies with a total market capitalization of approximately $1.03 trillion were listed on U.S. exchanges. China-based U.S.-listed firms generally fall into one of three categories:

https://www.straitstimes.com/business/companies-markets/china-slaps-new-curbs-on-offshore-listings-by-companies-from-restricted-sectors (noting how companies in industries noted in the foreign investment negative list now must seek a waiver before proceeding for share sales even while using a Variable Interest Entity (VIE) structure, which previously enabled them to bypass foreign investment limitations without regulatory oversight);
Jingnei Qiye Jingwai Faxing Zhengquan he Shangshi Guanli Shixing Banfa (境内企业境外发行证券和上市管理试行办法) [Trial Measures for the Administration of Overseas Issuance and Listing of Securities by Domestic Enterprise] (released in Notice 43. of China Sec. Reg. Comm’n, Feb. 17, 2023, effective March 31, 2023) (enhancing oversight and control on off-shore issuances, including through the use of a VIE structure, by e.g. limiting the companies that may be permitted to issue shares off-shore by their industry; by the criminal record of their controllers; and by the standing legal disputes against them).


20 See U.S.-CHINA ECON. & SEC. REV. COMM’N, CHINESE COMPANIES LISTED ON MAJOR U.S. STOCK EXCHANGES (Jan. 9, 2023) [hereinafter, U.S.-China Review Comm’n Report]. This was a decline relative to the end of 2020, when the USCC released its first list of China-based U.S.-listed firms, in which the total market capitalization of China-based U.S.-listed companies reached $2.2 trillion (with 217 companies), but a rise from September 2022, when the total market capitalization was $775.6 billion (with 262 companies). Cf. Id with U.S.-CHINA ECON. & SEC. REV. COMM’N, CHINESE COMPANIES LISTED ON MAJOR U.S. STOCK EXCHANGES (Oct. 2, 2020), https://china.usc.edu/sites/default/files/article/attachments/uscc-2020-Chinese_Companies_on_US_Stock_Exchange_10-2020.pdf.
State-owned enterprises (SOEs): The Chinese State-Owned Asset Supervision and Administration Commission (SASAC) controls many of China’s industrial and commercial enterprises through complex holding groups and ownership networks.²¹ It controls, for example, 70% of China’s Fortune Global 500 firms.²² We call SASAC-controlled firms “SOEs”, even though such firms are not wholly owned and might not even be majority owned by SASAC.

A number of overseas-listed companies are nestled within SASAC-controlled groups. When the HFCA Act was enacted, there were thirteen such companies listed in the United States; all have since been delisted. No Chinese SOEs currently trade on major U.S. exchanges.²³ As we explain in Part III, when listed in the United States these firms disclosed to U.S. regulators (and investors) their ownership structures, including ties to SASAC. Because they are domiciled in China (or Hong Kong), they are subject to the company law of the People’s Republic of China (PRC) or Hong Kong and, when listed in the United States, were considered foreign issuers under U.S. securities law.


²² Out of the total 145 Chinese firms on the Fortune Global 500 list, close to 70% are formally owned by the Chinese government (47 firms are owned by the central government, 39 are owned by the local level of SASAC, and 12 are owned by state-owned financial institutions. See Guozi Baogao Dujia Jiedu 2022 Niandu Caifu Shijie 500 Qiang Shangbang Guoqi Mingdan (《国资报告》独家解读2022年度《财富》世界500强上榜国企名单), ZHONGGUODUIWAI CHENGBAOGONGCHENG SHANGHUI (中国对外承包工程商会) [CHINA INT’L CONTRACTORS ASS’N] (Aug. 4, 2022), https://www.chinac.org/cica/info/22080418022511.

Their “onshore” (in China) subsidiaries and affiliates are subject to PRC domestic laws, including PRC company law.  

*Reverse-merger firms:* Hundreds of private-sector firms have entered U.S. stock exchanges through reverse mergers and thereby became domiciled in a U.S. state, typically Nevada or Delaware. Because they are domiciled in the United States, these firms are considered domestic issuers under U.S. securities law. Their onshore China-based subsidiaries and affiliates are subject to PRC laws. They tend to be small and, as we explain in Section II.B, have been unusually fraud prone.

*Technology firms:* Over 100 private-sector firms, mostly technology based, have conducted an IPO on a U.S. exchange. Alibaba is the most prominent. The total market capitalization of these firms exceeded $1 trillion in 2021. They are typically domiciled in a tax haven like the Cayman Islands or the British Virgin Islands, and are thus considered foreign private issuers under U.S. securities law. Their China-based subsidiaries and affiliates (which contain the bulk of their operating assets) are subject to PRC company law.

### B. Reverse-Merger Frauds and the Audit Controversy

Over the last decade, it has become clear that law-breaking Chinese insiders were beyond the reach of U.S. regulators and investors. It also became clear that the Chinese government has had little interest in enabling PCAOB inspections of local auditors that are required by U.S. securities law.

#### 1. The Reverse-Merger Frauds

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24 PRC corporations are subject to the Company Law of the People’s Republic of China. **ZHONGHUA RENMIN GONGHEGUO GONGSI FA** (中华人民共和国公司法) [Company Law of the People’s Republic of China] (promulgated by the STANDING COMM. NAT’L PEOPLE’S CONG., Dec. 26, 2018, effective Dec. 26, 2018) 2018 STANDING COMM. NAT’L PEOPLE’S CONG. GAZ. 790 [hereinafter PRC Company Law]. To the extent these entities are not structured as corporations, but rather some other kind of business entity, they would be subject to a different kind of PRC enterprise organization law. We use “company law” here to mean enterprise organization law more generally.

25 See Fried & Kamar, *Law-Proof Insiders*, supra note 19, at 234-36; infra Part II.B.

26 See infra Part II.B.


Since 2000, hundreds of China-based private firms entered U.S. public markets through a reverse merger—a process in which a public U.S. shell company acquired a private Chinese operating company. The reverse merger, unlike an IPO, enabled the Chinese company to access U.S. capital markets without the SEC first scrutinizing its disclosures. The result typically was a U.S.-listed U.S-domiciled firm with one or more China-based subsidiaries. Following the reverse merger, the public company would usually issue additional shares and send the proceeds to China-based subsidiaries, where they became available to the firm’s China-based insiders.

From 2010 to 2012, many of these reverse-merger firms were exposed as frauds. In 2011 and 2012, more than 50 China-based firms were delisted or were forced to stop trading due to fraud and other violations of U.S. securities law. The reverse-merger fraud wave negatively impacted the share prices of all Chinese reverse-merger firms, including ones that might not have been fraudulent.

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32 See Fried & Kamar, Law-Proof Insiders, supra note 19, at 234.

33 Thus, the structure is similar to China-based technology firms that conduct their IPO in the United States, such as Alibaba, see Fried & Kamar, Alibaba, supra note 29, except that the parent company is legally domiciled in the United States rather than in (say) the Cayman Islands.

34 See Fried & Kamar, Law-Proof Insiders, supra note 19.


market capitalization of all China-based reverse-merger firms fell by 75%.\textsuperscript{38} The collapse in share prices provided an opportunity even for firms not involved in fraud to be taken private on the cheap.\textsuperscript{39} The fraud wave and cheap freeze-outs that followed resulted billions of dollars of losses for U.S. investors.\textsuperscript{40}

As one of us and Ehud Kamar have explained, China-based insiders are essentially law-proof from the perspective of U.S. investors and regulators: the location in China of the insiders and their assets, and the firm and its assets, makes insiders legally unreachable.\textsuperscript{41} The aftermath of the reverse-merger frauds made this law-proofness perfectly clear. The U.S. legal system was powerless in dealing with China-based firms, even though these firms were subject both to U.S. securities law and to U.S. state corporate law. Neither U.S. investors nor the U.S. authorities had any recourse.\textsuperscript{42} The fraudsters could not be extradited, and their assets could not be seized; recoveries were minimal; and wrongdoers kept most of their ill-gotten gains.\textsuperscript{43}

2. The Audit Controversy

As part of its investigations into Chinese reverse-merger firms, the SEC sought audit working papers from these firms’ auditors,\textsuperscript{44} including from China-based affiliates

\textsuperscript{38} See Paul Gillis, Accounting Matters (Guest Series), \textit{The Three Terrors of Investors in Chinese Stocks}, FORENSIC ASIA (July 25, 2013), \url{https://www.chinaaccountingblog.com/weblog/2013_07_25_three_terrors.pdf}.

\textsuperscript{39} See Darrough et al., supra note 36, at 1009.


\textsuperscript{41} See Fried & Kamar, \textit{Law-Proof Insiders}, supra note 19, at 226-34.

\textsuperscript{42} See Gillis, supra note 39, at 7.


\textsuperscript{44} Audit working papers can provide information about complex corporate transactions that is often unavailable in firm records. See David M. Stuart & Charles F. Wright, \textit{The Sarbanes-Oxley Act: Advocating the SEC’s Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations}, 2002 COLUM. BUS. L. REV. 749, 751-52 (2002).
of the Big Four accounting firms. Under SOX, the firms were obliged to comply. But the China-based audit firms refused, claiming that compliance could violate China’s State Secrets Law and the Archives Law, and would potentially result in the dissolution of their firms and the imprisonment of their management. An SEC administrative judge ruled that the firms violated U.S. law by refusing to comply. Eventually, the SEC obtained the working papers after the China Securities Regulatory Commission (CSRC) allowed the papers to be shared. In 2015, the audit firms agreed to pay fines of $500,000 each for failing to produce the documents before proceedings had been brought. These were token fines, amounting to less than an average partner’s salary. The SEC could have barred public companies from relying on these audit firms but, as China’s state-owned media reportedly trumpeted, they were “too big to ban.”

Although the SEC prevailed in this battle, for the last decade or so U.S. regulators have generally been unable to inspect audit working papers of China-based firms, leading to ongoing violations of U.S. securities law, which mandates such inspections. Under SOX, the PCAOB-registered audit firms conducting audits for these


49 See id. Because the audit firms are based in China, they are subject to regulation by the CSRC. See Qingxiu Bu, The Chinese Reverse Merger Companies (RMCS) Reassessed: Promising But Challenging?, 12 J. INT’L BUS. & L. 17, 30 (2013).


52 See id.
firms must be regularly inspected by the PCAOB. Any such registered audit firm is deemed to have consented to produce its audit working papers for PCAOB inspection and to be subject to the jurisdiction of the United States for enforcement of requests for production of documents. These inspections are to ensure adherence to U.S. auditing standards.

Thus, while the PCAOB has reached agreements with other foreign jurisdictions on inspection protocols for local firms that play a role in auditing U.S.-listed firms, for over a decade it had generally been unable to conduct inspections in China. The PCAOB, therefore, was unable to systematically inspect China-based accounting

53 According to PCAOB reports, during the 13-month period ending September 31, 2021, 15 PCAOB-registered audit firms in China and Hong Kong signed off to audit reports of 191 public companies with a combined global market capitalization of approximately $1.9 trillion. China-Related Access Challenges, PUB. CO. ACCT. OVERSIGHT BD., https://pcaobus.org/oversight/international/china-related-access-challenges.


55 See id § 7216(b)(1).


57 See Robin Hui Huang, The U.S.-China Audit Oversight Dispute: Causes, Solutions, and Implications for Hong Kong, 54 INT’L LAW. 151, 158-63 (2021).

58 See id. at 167; Gillis, Three Terrors, supra note 39, at 6. In May 2013, the PCAOB and the CSRC signed a memorandum of understanding on enforcement cooperation, aimed at “establish[ing] a cooperative framework between the parties for the production and exchange of audit documents relevant to investigations in both countries . . . and provid[ing] a mechanism for the parties to request and receive from each other assistance in obtaining documents and information in furtherance of their investigative duties.” See Memorandum of Understanding on Enforcement Cooperation between the Public Company Accounting Oversight Board of the United States and the China Securities Regulatory Commission and the Ministry of Finance of China (May 7, 2013) http://upload.news.esnai.com/2013/0617/1371444412766.pdf. However, the PCAOB noted that after signing the memorandum of understanding, “Chinese cooperation ha[d] not been sufficient for the PCAOB to obtain timely access to relevant documents and testimony necessary for the PCAOB to carry out enforcement matters.” Press Release, Pub. Co. Acct. Oversight Bd., PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators (May 24, 2013). The memorandum of understanding did not carry meaningful force, as it provided for assistance and cooperation only when “consistent with the domestic laws of the respective States.” Id.
firms which audit hundreds of public companies. As a result, U.S.-listed China-based firms have operated with less regulatory oversight than other firms, exposing U.S. investors to a greater risk of fraud.

Until 2020, the SEC and PCAOB struggled un成功进行ly to advance inspections of China-based auditors, with little support from Congress. But rising tensions between the United States and China created political space for such support. In December 2020, the U.S. Congress passed, and then-President Trump signed, the HFCA Act.

The Act introduces two sets of rules: one around audit inspections and delisting and a second around disclosure of ties to the Chinese party-state (Part IV). We address them in Parts III and IV, respectively.

III. The HFCA Act’s Delisting Rules

Section A describes the HFCA Act’s delisting rules. Section B explains why they may well harm U.S. investors.

A. The Rules

The Act requires the SEC to identify U.S. reporting issuers whose audit reports have been issued by a registered public accounting firm with an office or a branch in a foreign jurisdiction and which the PCAOB is unable to inspect or investigate completely due to a position taken by an authority in such foreign jurisdiction (“SEC-Identified Issuer”). If the issuer is so identified for two consecutive years, the Act directs the SEC to prohibit trading in the issuer’s securities. While this part of the Act was not explicitly


63 The Act originally contained a three-year time horizon. See id. § 2(i)(3)(A) (“If the Commission determines that a covered issuer has 3 consecutive non-inspection years, the Commission shall prohibit the securities of the covered issuer from being traded—’(i) on a national securities exchange; or ‘(ii) through any other method that is within the jurisdiction of the Commission to regulate, including through the method of trading that is commonly referred to
aimed at China, China is the only foreign jurisdiction to which it applied; the PCAOB had worked out cooperation arrangements with all other relevant jurisdictions.\textsuperscript{64}

\textbf{B. The Effects}

The looming deadline of the HFCA Act spurred the parties to action. In August 2022, the PCAOB and Chinese regulators reached an agreement to allow PCAOB access to inspect Chinese auditing materials.\textsuperscript{65} The agreement was not made public but U.S. regulators reported that it promised to give the PCAOB complete discretion and unprecedented access to carry out inspections of registered public accounting firms in China and Hong Kong.\textsuperscript{66} Inspections began in September 2022,\textsuperscript{67} and in December 2022 the PCAOB announced that the inspections were a success and that “for the first time in history, [the PCAOB is] able to perform full and thorough inspections and investigations” in China.\textsuperscript{68}

As we will explain, there is a substantial likelihood that, even if China continues to fulfill these commitments in the short run, it will begin refusing to fulfill them after time passes. If this refusal occurs, delisting will ensue, and U.S. investors will be harmed. If

\textsuperscript{64} On April 20, 2021, four months after the Act entered into force, a cooperation agreement was signed between the PCAOB and the Belgian Audit Regulator. At that date, Mainland China and Hong Kong remained the only jurisdictions where the PCAOB reported as systematically not being able to conduct inspections of audit work. See \textit{PCAOB Cooperative Arrangements with Non-U.S. Regulators}, PUB. CO. ACCT. OVERSIGHT BD., \url{https://pcaobus.org/oversight/international/regulatorycooperation}.


\textsuperscript{66} See \textit{id}.


China continues to allow PCAOB inspections, there is only a modest upside for these investors.

We first consider the effects that China fulfilling its commitment to allow PCAOB inspections will have on U.S. investors. We then examine the effects if, as we fear is likely, China at some point, or with respect to certain firms, refuses to fully cooperate.

1. A Modest Upside to Robust PCAOB Inspections

U.S. investors may well benefit from the Act’s success in inducing China to allow robust PCAOB inspections. Periodic PCAOB inspections will improve audit quality, and better audit quality is likely to lead to higher-quality financial statements.

But these benefits are limited. Even if PCAOB inspections were to substantially improve the audit quality of China-based firms,\(^69\) such inspections will not protect U.S. investors against fraud. It is not the duty of auditors to detect fraud,\(^70\) and there are many situations where they will fail to do so.\(^71\) Even if PCAOB inspections would lead to auditors detecting fraud, insiders could still expropriate investors. The day after the auditors leave, the insiders can loot the company’s assets. The main problem is enforcement and the lack of recourse for injured investors. As was noted earlier, the reverse-merger frauds made abundantly clear that U.S. investors and regulators have little recourse against China-base insiders given their inability to extradite these insiders, seize China-based assets, or gather information needed to enforce corporate and securities laws in judicial proceedings.\(^72\)

The Act also created a paradox, as one of us has explained elsewhere.\(^73\) The Act’s disclosure rules, discussed in Part IV, assume that China’s party-state influence over China-based firms is a risk about which U.S. investors should be informed. But the

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\(^69\) See, e.g., Philip T. Lamoreau, *Does PCAOB Inspection Access Improve Audit Quality? An Examination of Foreign Firms Listed in the United States*, 61 J. ACCT. & ECON. 313 (2016) (finding that auditors subject to PCAOB inspection access provide higher quality audits).

\(^70\) See W. Steve Albrecht & Jeffrey L. Hoopes, *Real Examples of Why Financial Statement Audits Cannot Detect All Fraud: Insights from an Expert Witness in Major Fraud Cases* 2 (March 11, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019354 ("[I]t is widely understand in the academic and professional auditing literature that it is not the auditor’s duty to guarantee that the financial statements are accurately represented.").

\(^71\) Id. (reporting that auditors cannot be expected to detect fraud when (1) the large number of accounting records requires the auditors to engage in sampling; (2) fraudsters use people outside the organization to help conceal the frauds; (3) people do not reveal what they know to the auditor; and (4) the fraudsters and those with knowledge of their behavior engage in forgery and lying).


\(^73\) Groswald Ozery, *Illiberal Governance*, supra note 19, at 994.
specter of delisting can only strengthen the power of the Chinese party-state vis-à-vis these firms. In particular, to comply with U.S. audit inspections, China-based U.S.-listed firms or their auditors must engage with Chinese authorities to get permission to release information to the PCAOB; otherwise, these firms and their auditors will be in violation of PRC law. The HFCA Act thus makes China-based U.S.-listed firms even more dependent on the goodwill and strategic intentions of China’s party-state.

2. A Large Downside if China Reneges

Although we hope China will continue to allow robust PCAOB inspections, we are skeptical that such inspections will continue indefinitely. If we are right, the effects of the HFCA Act on investors will be negative.

(a) Reasons China Might Renege

China might end up blocking future PCAOB inspections for a number of reasons. The first is domestic regulatory competition and bureaucratic paralysis. The limitations on information sharing with foreigners (“secrecy rules”) are administered and enforced by overlapping bureaucracies, many of which have no incentive to provide permission. China’s securities regulator, the CSRC, is assigned to implement the August 2022 cooperation agreement with the SEC. But the CSRC faces strong regulatory competition, including with the very powerful Cyberspace Administration of China (CAC), whose relative political-economic sway within the Chinese party-state system has increased with geopolitical tensions, and which likely has the ability to torpedo PCAOB inspections.

Second, there are costs to providing PCAOB inspection access: bowing to U.S. pressure might come to be seen as humiliating and infringing upon PRC regulatory sovereignty—a value held dear in China. Additionally, institutions as well as

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74 Particularly as China’s information sharing laws, as well as their supervision and enforcement, have tightened following the Act, see supra notes 15-19.

75 See Huang, supra note 58, at 183-85.


individuals might not want U.S. regulators probing domestic transactions that could involve shady payments among powerful business figures and officials.  

Third, China might at some point actually prefer to see China-based firms delisted. Beijing is unhappy that its largest and most meaningful private tech firms—such as Alibaba and Baidu—trade in the United States and not in China. The Chinese government has made efforts to make its domestic markets attractive to listing tech and science companies, including its 2019 creation of the STAR Market (the Technology and Innovation Board of the Shanghai Exchange), and a newly established Beijing stock exchange for innovation-driven SMEs.

China is actively seeking to lure its major entrepreneurial tech companies with overseas listings to its domestic market. It particularly wants its crown jewels, such as Alibaba, back. Bringing such firms home would enable local retail investors to participate in their future growth, boost the prestige of Chinese exchanges, and align well with China’s long-term plan of technology-driven economic growth. But so far, there have been no takers.

The HFCA Act may provide China with a gift, by giving China the de facto power to force these tech firms to leave the United States while blaming the United States. By simply refusing to allow future PCAOB audit inspections, China can trigger trading bans that would lead to delistings. If the firms then list in China, the Act will have helped China achieve what its own inducements so far could not.

(b) Effects if China Reneges

If China reneges, China-based U.S.-listed firms will stop trading in the United States. If a firm has listed elsewhere where U.S. investors can trade (such as Hong

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78 See Jesse Fried, Delisting Chinese Companies Plays Straight into Their Hands, FIN. TIMES (June 1, 2020) [hereinafter Fried, Delisting], https://www.ft.com/content/7bb80406-a0c6-11ea-ba68-3d5500196c30.

79 See id.


82 Groswald Ozery, Illiberal Governance, supra note 19, at 944.
Kong), the firm can (but might not) give U.S. investors shares tradable in that venue. Otherwise, the firm will go private, perhaps eventually relisting in a different market (probably Mainland China or Hong Kong). Either way, U.S. investors are harmed, especially in the go-private scenario.\(^83\)

1. **U.S. Investors Given Other Shares**

A number of China-based U.S.-listed firms are also listed in Hong Kong and Mainland China, or could become listed there before a trading ban goes into effect.\(^84\) If the HFCA Act leads to a trade ban on such a firm, it can give its U.S. shareholders shares tradable in Hong Kong. Firms that are likely to offer non-U.S. traded shares are the SOEs (which already trade in HK and/or in China and cannot go private), as well as the large private technology firms that appear too big for a go-private transaction (e.g., Alibaba).

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84 Alibaba, JD.com, and NetEase Inc., and Baidu are among the firms with primary listings in the United States and secondary listings in Hong Kong. See Joanne Chiu, *Hong Kong Wins More Listings of U.S.-Traded Chinese Firms*, WALL ST. J. (Sept. 10, 2020), https://www.wsj.com/articles/hong-kong-wins-more-listings-of-u-s-traded-chinese-firms-11599717480; Jing Yang & Xie Yu, *Hong Kong ‘Homecoming Listings’ Are All the Rage, but New York Is Still the Life of the Party*, WALL ST. J. (Mar. 26, 2021), https://www.wsj.com/articles/hong-kong-homecoming-listings-are-all-the-rage-but-new-york-is-still-the-life-of-the-party-11616751710. Companies that currently trade in the US or the UK are eligible for a secondary listing in Hong Kong if they have at least HK$10 billion (USD $1.29 billion) in market capitalization and HK$1 billion (USD $129 million) in revenue; there appear to be more than 25 companies that could satisfy these requirements but are not yet listed in Hong Kong. See Iris Ouyang, *Pinduoduo, NIO are Among 27 US-Traded Stocks Eligible to List in Hong Kong, Goldman Says*, S. CHINA MORNING POST (Dec. 7, 2021, 7:30 AM), https://www.scmp.com/business/banking-finance/article/3158685/pinduoduo-nio-among-27-adrs-which-could-be-eligible. As of September 2022, there appear to be more than 215 Chinese companies listed in the United States that would not qualify for secondary listings in Hong Kong based on insufficient market capitalization alone; 56 of these firms are classified as operating in the “technology” sector. Some companies, such as Yum China Holdings (which runs KFC and Pizza Hut in Mainland China), Baozun Inc., Bilibili Inc., converted their secondary Hong Kong listing into a primary listing status. See U.S.-China Review Comm’n Report, supra note 20, p. 4-5.
But there are various costs to holding and trading shares in a foreign market, including possibly the cost of switching brokers and the loss of any protection provided by U.S. securities laws (besides PCAOB auditor inspection). These will be borne by U.S. investors who continue to own shares. As for those U.S. investors who dump their U.S.-traded shares (perhaps to be purchased by foreign investors who can more easily hold shares in other markets), they are likely to exit at temporarily depressed prices. Either way, U.S. investors lose.

2. Go Private

While the SOEs and largest non-state China-based firms could give U.S. investors shares tradable overseas, the reverse merger firms and smaller private technology firms will choose (or be forced) to go private in transactions that will enrich firm insiders at American investors’ expense.

Over the last decade, controlling shareholders of dozens of China-based U.S.-traded firms have arranged low-ball “take private” transactions. The goal is to delist U.S. shares at a depressed buyout price and then relist in China or Hong Kong at a much loftier valuation. The poster child for this maneuver is Qihoo 360, an internet security firm. Founders squeezed out U.S. shareholders in mid-2016 at a valuation of $9.3 billion. In February 2018, they relisted Qihoo on the Shanghai Stock Exchange at a valuation exceeding $60 billion, a 550% return. Qihoo’s chairman personally made $12 billion, more than the entire company was claimed to be worth 18 months earlier.

Investors in U.S.-listed Chinese companies are much more vulnerable to an unfair take-private than investors in publicly traded American firms. The least of their problems is that financial statements are not reliable, mostly because insiders cannot be legally reached if they deliberately misinform U.S. investors. Another problem is that, unlike most U.S. companies that incorporate in Delaware, most private Chinese


86 See Chong Koh Ping, Looming Delisting Jolts Chinese Telecom Stocks, WALL ST. J. (Jan. 4, 2021) (noting that the share prices for the three telecom companies forced to delist have declined between 16% to 23% since Executive Order No. 13959 banned investment activity in “Communist Chinese Military Companies,” and that the Hong Kong-listed shares in all three dipped sharply in the first trading session since the NYSE delisting was announced, before reversing course later in the day).


88 See id.
technology firms incorporate in the Cayman Islands, a jurisdiction that affords investors much less protection than Delaware. Yet another problem is that when American investors are hurt, the same state-secrecy laws make it difficult for shareholders and regulators to collect litigation-critical information. But the biggest problem is that neither U.S. nor Cayman court judgments can be enforced in China, where insiders and assets are based, even if U.S. investors can show that they have been illegally expropriated.

While American investors are currently very vulnerable to cheap take-privates, the HFCA Act’s trading ban could make things even worse for them. Consider a Chinese controller who plans a cheap take-private but is willing to bide her time if that enables an even lower price. If China reneges on cooperation in future PCAOB inspections, the SEC will eventually announce a trading ban for the controller’s firm, causing a rout in the stock as investors dump shares before the ban takes effect. The controller can then use a take-private to cash out investors at a rock-bottom price, all while blaming the delisting on the SEC. The HFCA Act will have handed the controller a gift on a silver platter: a means to conduct a take-private on even more confiscatory terms.

IV. The HFCA Act’s Documentation and Disclosure Rules

The HFCA Act requires China-based firms that are SEC-Identified Issuers to disclose ownership ties to Chinese governmental entities and certain relationships with the Chinese Communist Party (CCP). Section A describes the rules. Section B explains that the very design of these rules makes it clear that Congress did not believe the disclosed information is material to investors. Section C explains that the rules can shed no light on the extent of the party-state’s connections with SOEs and reverse-merger firms. Section D explains that the rules can generate new information about technology firms’ ties to the

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89 See generally William J. Moon, Delaware’s Global Competitiveness, 106 IOWA L. REV. 1683 (2021) (identifying 243 “Chinese corporations” listed in the U.S., among which 62.1% were domiciled in the Cayman Islands).

90 See, e.g., William J. Moon, Delaware’s New Competition, 114 NW. U. L. REV. 1403, 1444-49 (2020) (pointing to Cayman Islands’ procedural hurdles to pursuing derivative lawsuits); Fried & Kamar, Law-Proof Insiders, supra note 19, at 242-46 (pointing to substantive and procedural differences between Cayman Islands and Delaware corporate law that make the Cayman Islands less shareholder friendly).

91 See Fried & Kamar, Law-Proof Insiders, supra note 19, at 230-34.

92 See id. at 228-30.

Chinese party-state, but that the information is unlikely to be useful to investors, and in fact is more likely to mislead them.

A. The Rules

The Act’s rules require SEC-Identified Issuers to provide documentation and disclosure of ties to Chinese governmental entities and the CCP. (Recall that an SEC-Identified Issuer is a firm whose auditor cannot be inspected by the PCAOB due to a position taken by an authority in such foreign jurisdiction; thus, for now, no firm is an SEC-Identified Issuer.)

1. Ties to Chinese Governmental Entities

The Act has two documentation/disclosure requirements relating to an SEC-Identified Issuer’s ties to Chinese governmental entities.

First, Section 2 of the Act requires a covered issuer to submit to the SEC “documentation that establishes that it is not owned or controlled by a governmental entity in the foreign jurisdiction” of the registered public accounting firm that the PCAOB is unable to inspect or investigate completely (meaning China or Hong Kong). The subsequent implementation rules by the SEC allowed for flexibility, giving identified issuers discretion to determine how best to satisfy this requirement in each specific case.

Second, Section 3 requires an SEC-Identified Issuer that is a foreign issuer to disclose in its annual report:

1) The percentage of the shares of the issuer owned by governmental entities in the foreign jurisdiction in which the issuer is incorporated or otherwise organized; and
2) Whether governmental entities in the foreign jurisdiction where the issuer’s financial reporting is audited have a controlling financial interest in the issuer.

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95 Neither the HFCA Act nor the SEC Final Rules Amendments specify the types of documentation that should be submitted to establish the lack of state ownership and/or control. In its Interim Final Rules, the SEC noted that it “recognize[s] that available documentation could vary depending upon the organizational structure and other factors specific to the registrant.” Holding Foreign Companies Accountable Act Disclosure, Release No. 34-91364, 86 Fed. Reg. 17528, 17531 (proposed Apr. 5, 2021) (to be codified at 17 C.F.R. pts. 249, 274) [hereinafter SEC Interim Final Rules]. The Final Rules Amendments finalized this approach without modification. See SEC Final Rules Amendments, supra note 93.

96 The term “foreign issuer” refers to any issuer which is a foreign government, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country. 17 C.F.R. § 240.3b-4 (“Exchange Act Rule 3b-4”).

According to the SEC, the use of the terms “owned or controlled” in Section 2 of the Act, as well as the use of the terms “owned” and “controlling financial interest” in Section 3 of the Act, are intended to reference a person’s or governmental entity’s ability to “control” the registrant as that term is used in the Exchange Act and the Exchange Act rules.98 The Exchange Act defines “control” as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”99

2. Ties to the CCP

In addition to the disclosure rules relating to ties to governmental entities, Section 3 requires SEC-Identified Issuers that are foreign issuers to disclose in their annual reports certain ties to the CCP. This information includes:

1) The name of each official of the CCP who is a member of the board of directors of either the issuer or the operating entity with respect to the issuer; and

2) Whether the articles of incorporation of the issuer (or equivalent organizing document) contains any charter of the CCP, including the text of any such charter.100

The SEC Final Rules Amendments implementing the Act applied Section 3 disclosure requirements also with respect to the operating entities of SEC-Identified Issuers that are foreign issuers.101 Thus, such an issuer that uses a VIE structure, or any structure that results in additional foreign entities being consolidated in the financial statements of the registrant, must now provide required Section 3 disclosures (i.e., with respect to both government ownership and CCP ties) not only for itself and but also for any consolidated operating entities.

B. The Rules Make Clear Congress’ Belief That the Required Information is Not Actually Material to Investors

If Congress actually believed that the information required by Sections 2 and 3 of the HFCA Act was material to investors, it would have required disclosure of this information before a firm’s shares are first sold to the public (at the IPO stage) and for as long as the firm remains publicly traded. Such disclosure might thus protect all investors considering buying shares in the firm.

However, the HFCA Act fails to provide such disclosure to all potential buyers. First, the disclosure requirements apply only to firms’ annual reports, not to their IPO

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98 SEC Final Rules Amendments, supra note 93, at 70029.


101 SEC Final Rules Amendments, supra note 93, at 15.
registration statements.\textsuperscript{102} This means that U.S. investors will have already purchased shares in a company before they see the information. Between the time that the HFCA Act was enacted and December 2022 (when the PCAOB determined that it had sufficient access to China-based auditors), dozens of China-based firms conducted an IPO in the US;\textsuperscript{103} none of them was required to disclose this information in their IPO prospectuses.

Second, the Act’s disclosure requirements apply only to SEC-Identified Issuers. This means that the disclosure requirements are not imposed in any year where China permits PCAOB audit inspections. But if this information (about ties to the party-state) is truly considered material for investors, there is no reason to believe that it would be material only in years where the PCAOB cannot inspect auditors.

All of this suggests that the motivation behind the documentation and disclosure requirements in Section 2 and 3 of the HFCA were grounded on something else other than investors’ interests.

\section*{C. Rules Disclose No New Information on Chinese SOEs and Reverse Merger Firms}

The structure of the HFCA Act’s disclosure rules means that they cannot generate any new information about SOEs or reverse-merger firms.

\subsection*{1. SOEs}

Although by now all SOEs have delisted, for completeness (and because SOEs may consider listing in the United States in the future) we will discuss how the HFCA Act’s disclosure rules apply to SOEs. An SOE obviously cannot submit the documentation required by Section 2—that it is not owned or controlled by the Chinese government—\textit{because it is} owned or controlled by the Chinese government. The SEC helpfully clarified that such documentation submission requirement does not apply to issuers that \textit{are} owned or controlled by a foreign governmental entity.\textsuperscript{104}

But SOEs are foreign issuers, so they must provide Section 3 disclosures. As SOEs are both domiciled and audited in China, they must report the percentage of shares owned by government entities in China, and whether government entities have a controlling

\textsuperscript{102} The SEC clarified that they will not amend the disclosure requirements for registration statements. See \textit{id.} at 70029-31.

\textsuperscript{103} See, \textit{e.g.}, \textsc{Kroll Corp. Fin., China Transactions Insights (2022)}, \url{https://www.kroll.com/-/media/kroll/pdfs/publications/m-and-a/china-transactions-insights-winter-2022.pdf} (noting that there were 53 Chinese IPOs in the U.S. market in 2021 alone).

\textsuperscript{104} SEC Interim Final Rules, \textit{supra} note 96, at 17531. This did not exempt those issuers that are SEC-identified \textit{foreign} issuers from complying with the disclosure requirements under Section 3 of the Act. \textit{id.}
financial interest. However, Section 3 does not provide US investors with new information, as this information is already disclosed pursuant to existing rules.\textsuperscript{105}

Section 3 also requires SOEs to disclose CCP officials on the board of directors of the issuer or “the operating entity with respect to the issuer.” But SOEs generally disclose directors’ party affiliation and background in the firm’s annual reports.\textsuperscript{106} If this information is not already disclosed, its disclosure will not reveal that Chinese authorities have hidden control over the firm. Investors already know that SOEs are controlled by China’s party-state. As applied to SOEs, this disclosure rule is completely pointless.

Additionally, as foreign issuers, Section 3 requires that SOEs also report whether their organizing documents contain any charter of the CCP and the text of such charter. This provision is pointless as well. As one of us elaborated elsewhere,\textsuperscript{107} an SOE is required by Chinese law to set up a Party committee within the SOE as well as to amend its articles of association accordingly, detailing the roles of such committee in the firm.\textsuperscript{108} This requirement applies to all SOEs, including those listed on foreign exchanges.\textsuperscript{109} Thus, to

\textsuperscript{105} See, e.g., China Petroleum & Chem. Corp., Annual Report (Form 20-F) F-81 (Apr. 20, 2021) (“The directors consider the parent and ultimate holding company of the Group as of December 31, 2020 is [sic] Sinopec Group Company, a state-owned enterprise established in the PRC. This entity does not produce financial statements available for public use.”); China Life Ins. Co., Ltd., Annual Report (Form 20-F) 98 (Apr. 29, 2021) (listing China Life Insurance (Group) Company as a 92.8% shareholder); id. at 118 (“As of the date of this annual report, CLIC [China Life Insurance Company], a wholly state-owned enterprise, is our only controlling shareholder.”); China S. Airlines Co., Ltd., Annual Report (Form 20-F) F-11 (Apr. 28, 2021) (“The Company’s majority interest is owned by China Southern Air Holding Company Limited (“CSAH”), a state-owned enterprise incorporated in the PRC.”).

\textsuperscript{106} See, e.g., China Life Ins. Co., Ltd., Annual Report (Form 20-F) 126-32 (Apr. 24, 2019) (noting that one of the company’s directors is “a delegate to the 19th National Congress of the Communist Party of China”); PetroChina Co. Ltd., Annual Report (From 20-F) 76-84 (Apr. 29, 2019) (detailing the company’s directors’ experiences as members of various CCP committees and leadership groups related to the petroleum industry).


\textsuperscript{109} Groswald Ozery, Illiberal Governance, supra note 19, at 978-79.
comply with Chinese law, SOEs have amended their articles of association, a change that had to be disclosed to the SEC and to U.S. investors even before the HFCA Act.

2. Reverse Merger Firms

Because reverse merger firms are not foreign issuers, Section 3 disclosure rules (including those related to CCP officers on the board of directors) do not apply. Reverse merger firms, not being controlled by Chinese governmental entities, must submit documentation to that effect under Section 2. But this will provide no new information to


111 For the rate of articles of association amendments in SOEs that are listed in China, see Lauren Yu-Hsin Lin & Curtis J. Milhaupt, Party Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance, 50 J. LEGAL S. TUD. 187, 203-04 (2021). Note that the data concerns those SOEs that list in the mainland; companies that list in Hong Kong are only included if that firm lists in the mainland as well. See id. at 202.

112 SEC Form 6-K requires a foreign private issuer to report any material information that is required to be made public according to the law of the jurisdiction of its domicile, incorporation, or organization. See Prac. L. Corp. & Sec., Preparing Form 6-K, THOMSON REUTERS PRACTICAL LAW, https://us.practicallaw.thomsonreuters.com/4-385-2537. The domestic laws of both the PRC and Cayman Islands require disclosing amendments to the company’s articles of association. For relevant PRC law, see PRC Company Law, supra note 24, art 37(10); Shangshi Gongsi Zhangcheng Zhiyin (上市公司章程指引) [Guidelines for the Articles of Associations of Listed Companies], revised by ANNOUNC. NO. 2 CHINA SEC. REG. COMM., Jan. 5, 2022, arts. 190 & 192; Shangshi Gongsi Xinxi Pilu Guanli Banfa (上市公司信息披露管理办法) [Measures for the Administration of Information Disclosure by Listed Companies], revised by ORDER NO. 182, CHINA SEC. REG. COMM., Mar. 18, 2021, effective May 1, 2021, arts. 22(6) & 23. For relevant Cayman law, see CONTINUING REQUIREMENTS OF THE COMPANIES ACT OF THE CAYMAN ISLANDS, CONVERS 10 (Jan. 2022), https://www.conyers.com/wp-content/uploads/2022/01/Continuing_Requirements_of_Companies-CAY.pdf. Therefore, a change in the articles of incorporation would trigger a 6-K filing for either China-domiciled SOEs or Cayman-domiciled technology companies. For examples of such disclosures, see PetroChina Co. Ltd., Report of Foreign Issuer (Form 6-K) Exhibit 99.2 (Oct. 26, 2017), https://www.sec.gov/Archives/edgar/data/1108329/000119312517320342/d481389dex992.htm; China Life Ins. Co. Ltd., Report of Foreign Issuer (Form 6-K) Exhibit 99.1 (Dec. 20, 2018), https://www.sec.gov/Archives/edgar/data/1268896/000119312519242593/d798845dex991.htm (disclosing proposed amendments that were later approved at the company’s annual general meeting on May 30, 2019). Even if PRC or Cayman law did not require such disclosure, it would still be required by Form 20-F, the annual reporting form for foreign private issuers. See Prac. L. Corp. & Sec., Annual Report on Form 20-F, THOMSEN REUTERS PRACTICAL LAW, https://us.practicallaw.thomsonreuters.com/9-387-4914 (noting that a description of the company’s memorandum and articles of association should be included in the 20-F, and should only be incorporated via reference to previous statements if the information has not changed).
investors, who never would have had any reason to believe that reverse merger firms were formally controlled by the Chinese authorities.\textsuperscript{113}

D. Why Disclosure Rules Will Not Shed Useful Light on Technology Firms

We have just explained why the HFCA Act’s disclosure rules provide no new information about SOEs and reverse merger firms. We now examine their impact on technology firms. We argue that the disclosure rules can generate new information about technology firms; however, this information may well be of little use to U.S. investors.

1. The Light Shed on Technology Firms

Technology firms are not “owned” or “controlled” by government entities in China (where the auditors are located) according to the SEC’s interpretation of the terms.\textsuperscript{114} Thus, they will submit documentation to that effect under Section 2.

Because the technology firms are foreign issuers, they are subject to Section 3. They will thus report under Section 3(b)(3) that the Chinese government does not have a controlling financial interest.\textsuperscript{115} A firm must also report the percentage of shares owned by the government of the jurisdiction in which the firm is domiciled under Section 3(b)(2).\textsuperscript{116} As technology firms are domiciled outside China (typically in the Cayman Islands) and the governments of these jurisdictions do not own shares in the companies, the percentage reported will be “0.”

Each must also disclose whether its organizational documents contain any charter of the CCP and the text of such charter.\textsuperscript{117} The technology firm itself (as opposed to its onshore affiliates) is unlikely to have any “charter of the CCP” in its organizing documents. Consider, for example, Alibaba: reportedly it has over 200 CCP cells throughout its subsidiaries and affiliates but not in the publicly traded Cayman-domiciled holding company (at least not one that can be observed from the firm’s publicly available

\textsuperscript{113} As we explain in more detail in Section IV.D, the Chinese authorities have various informal means of controlling China-based firms, regardless of formal control arrangements, and these informal mechanisms need not be disclosed under the Act (nor could they easily be required).

\textsuperscript{114} Supra notes 97-100.

\textsuperscript{115} See Holding Foreign Companies Accountable Act § 3(b)(3), 15 U.S.C. § 7214a(b)(3) (2020) [requiring disclosure of whether governmental entities in the “applicable foreign jurisdiction with respect to . . . [the firm’s] registered public accounting firm have a controlling financial interest with respect to the issuer”).

\textsuperscript{116} Id. § 3(b)(2), 15 U.S.C. § 7214a(b)(2).

\textsuperscript{117} Id. § 3(b)(5), 15 U.S.C. § 7214a(b)(5).
In any event, when technology firms go public in the US, they already disclose to the SEC and investors their articles of association, enabling investors to see whether there is “any charter of the CCP” included there. And any subsequent change in the charter must be disclosed to the SEC and investors. Thus, existing laws already require firms to reveal this information.

But the HFCA Act disclosure requirements might still yield new information about technology firms. First, Section 3 also requires disclosure of the names of CCP officers on the board of directors of the issuer or of the “operating company” with respect to the issuer, and the SEC’s Final Rules Amendments apply Section 3’s rules to any affiliate, including on-shore operating subsidiaries and affiliates that are China-domiciled. Such information is not currently disclosed, and an investor might believe that the presence of many CCP officers on a board of an affiliated firm could indicate that China’s party-state has significant influence.

Second, the SEC’s Final Rules Amendments disclosure rules around government ownership apply to any affiliate of a technology firm, including China-based affiliates. To the extent Chinese state entities have a minority interest in a firm, the Chinese government is afforded “boosted” rights, regardless of the percentage of equity it holds. These rights include certain powers relating to the nomination and removal of directors and supervisors, board-like rights relating to assessing managerial performance and standards for remuneration, and veto rights over certain transactions. In addition, directors, supervisors, and senior managers in such firms owe a form of fiduciary duty not

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120 See supra note 113.

121 SEC Final Rules Amendments, supra note 93.

122 Id. at 15. Note that the Final Rules Amendments are unclear as to whether the “relevant jurisdiction” is the “foreign jurisdiction in which the issuer is incorporated”, per the HFCA Act Section 3(b)(2), i.e. the Cayman Islands for most technology firms, or the foreign jurisdiction in which the operating company is incorporated, i.e. China. Here we assume the latter.

123 Groswald Ozery, USCC Testimony, supra note 111, at 7-8.

only to the invested enterprise but also specifically to the state, and the firm itself also owes a type of fiduciary responsibility to the state investor. All of this gives the state leverage over the operating companies in which it invests (regardless of the extent of the ownership interest), and by extension over the affiliated U.S.-listed issuer.

However, as we explain below, there are many other ways in which the party-state can exert influence over non-SOE firms such as technology firms (Section 2), and it is not at all clear whether this influence is harmful or beneficial to foreign investors (Section 3).

2. Failure to Reveal Extent of Chinese Authorities’ Control

While the Act’s disclosure rules might expose CCP “officers” on the boards of technology firms and their affiliates, and government ownership percentage of PRC-domiciled affiliates, they fail to capture the full extent of China’s party-state control over a technology firm. The party-state can exert control over any firm through (a) PRC company law (and other domestic law) as applied to subsidiaries and affiliates of the issuer; (b) CCP officers, members, and committees sprinkled throughout the issuer and its subsidiaries; and (c) general “fear governance.”

a. State Influence via PRC Company Law

Even when the Chinese government does not have an equity interest in PRC-domiciled subsidiaries of technology firms, it can influence those subsidiaries through

125 See id. arts. 17, 26, 71.

126 The SEC Final Rules Amendments also require any affiliate of a technology firm to disclose the existence of a CCP charter, or the role of the CCP in the articles of association. See SEC Final Rules Amendments, supra note 93. However, there is no reason for a privately-owned operating entity, even one domiciled in China, to include a CCP charter or indicate the role of the CCP within the firm in its articles of association. Chinese law currently does not mandate that non-SOE firms reflect the existence and the roles of the CCP in the firm (i.e., through a Party Committee) in their organizing documents. Unlike SOEs, which are required by Chinese law to incorporate the functions of a CCP Committee into their articles of associations, private Chinese firms are currently not subject to the same requirement. See Groswald Ozery, USCC Testimony, supra note 111, at 11-13. Thus, while it is more likely that such information would be found in the governance documents of China-domiciled affiliates than in the U.S.-listed technology firm itself, it is almost certain that such information will not be found in any organizational documents of either the firm or its affiliates. That said, some privately held Chinese firms might voluntarily amend their articles of association to reflect the presence of a party committee. Some examples exist with respect to non-SOE public firms listed in China. See Lin & Milhaupt, supra note 112, at 204 tbl.3 (finding that only close to 6% of privately owned listed enterprises in China (143 firms) have amended their articles to reflect the roles of the CCP, while not being required to do so).

127 Of course, the capacities of the party-state are not without limits. In this paper, we take no position as to whether and when the party-state chooses to exercise its levers of control or influence over firms, and for what purpose. For a discussion in the institutional and political economy factors that impact the party-state’s use of its levers over firms, see Groswald Ozery, USCC Testimony, supra note 111, at 3-5.
application of PRC domestic law. In particular, PRC Company Law mandates social responsibility obligation on all companies. In particular, PRC Company Law mandates social responsibility obligation on all companies. Indeed, Chinese firms are pressured to contribute to national goals even in firms with no state ownership. A survey of China’s top 500 private enterprises (the biggest enterprises by annual operating income) shows that 94.2% of such enterprises participated in various national development schemes during 2019.

b. Undisclosed ties to CCP

For SEC Identified Issuers that are foreign issuers, such as technology firms, the Act (and SEC regulations) seeks to ascertain potential CCP influence by requiring firms to disclose the presence of “CCP officials” on the board of directors of the issuer or any affiliates. But that does not capture how the CCP, through its members or officials, exerts influence within a firm.

1. Board-Level Ties

The CCP has over 90 million members, individuals typically selected when they are young adults based on academic achievement, community service, reputation, and the results of an ideological examination. Because of the CCP’s selection process, and the

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128 PRC Company Law, supra note 24, art. 5 (“When conducting business operations, a company shall comply with . . . social morality . . . [and] accept the supervision of the government and general public and bear social responsibilities.”).


tightening of linkages encouraged between the Party and the private sector, particularly entrepreneurs,\(^\text{132}\) there is likely to be substantial and increasing overlap between board directors and CCP members.\(^\text{133}\)

But the Act does not clarify what constitutes an “official” of the CCP for purposes of the Act, and neither do the SEC Final Rules Amendments.\(^\text{134}\) One interpretation might be a public employee who receives a salary from the CCP to perform her official party functions (a “cadre”, ganbu 干部).\(^\text{135}\) Thus, by using the term “official” instead of “member,” the Act may allow firms to not report those directors who are members of the CCP but not cadres. The Act also does not require firms to disclose non-CCP directors who may well be under the influence of the CCP because of their connections to organizations under the CCP’s patronage, such as the Communist Youth League, the All-China Federation of Industry and Commerce, or other chambers of commerce.

2. Party Committees Inside Firms

Within PRC-domiciled firms, including on-shore subsidiaries and affiliates of U.S. issuers, the CCP operates not only through the board but also through a Party organization (for simplicity, “Party committee”) whenever there are at least three CCP


\(^{134}\) SEC Final Rules Amendments, supra note 93, at 70031. The SEC indicated that it found it unnecessary to clarify the term “CCP Official” and additional disclosure requirements about the various control paths of the Chinese party-state were held “outside the scope of this rulemaking”. Id.

\(^{135}\) On the complexity of China’s public employment system and the challenges to define, assess, and distinguish between different levels of public personnel in the party-state system, see Yuen Yuen Ang, COUNTING CADRES: A COMPARATIVE VIEW OF THE SIZE OF CHINA’S PUBLIC EMPLOYMENT, 211 CHINA Q. 676 (2012).
members.\textsuperscript{136} Such committees are widespread.\textsuperscript{137} These members may or may not be directors of the firm, and they may receive all of their compensation from the firm (and hence are not paid CCP “officials”).

This Party committee gives the CCP the capacity to advance its interests within the firm. While until recently the CCP did not deploy this capacity outside several important SOEs, it has begun to establish its presence across firms more systematically, including in non-state firms.\textsuperscript{138} As noted, this capacity can exist regardless of the provisions in the firm’s organizing documents, particularly in non-SOE firms.\textsuperscript{139}

c. Fear Governance

The Chinese party-state may exert considerable influence on Chinese firms in various informal ways that are not confined to conventional corporate governance institutions (i.e. stockholder rights, board seats, fiduciary duties) or even to CCP committees inside

\textsuperscript{136} Zhongguo Gongchandang Zhangcheng (中国共产党章程) [The Charter of The Communist Party of China] (as amended and promulgated by the Nat’l Cong. Of the Communist Party of China, Oct. 24, 2017); PRC Company Law, supra note 24, art. 19 (“The Chinese Communist Party may, according to the Constitution of the Chinese Communist Party, establish its organizations in companies to carry out activities of the Chinese Communist Party. The company shall provide necessary conditions to facilitate the activities of the Party.”).


\textsuperscript{139} See supra Section IV.D.1.
firms. These informal ways include ideological messaging and party-line education to inform managers what is expected of them, monitoring to ensure compliance, and the use of carrots and sticks to reward and punish individuals in light of what is expected of them. We call these informal approaches “fear governance” even though both carrots and sticks are used, to distinguish this influence from more formal corporate governance institutions.

An individual’s extreme (or rapid) economic success attracts the attention of the party-state. The person may become entangled with anti-corruption investigations, regulatory scrutiny, and at times selective enforcement. In recent years, several well-connected privately held conglomerates and their managing or founding tycoons have been allowed to rise and accumulate extreme wealth and power only to fall abruptly on various accusations of corruption, embezzlement, and corporate fraud following the shifting development priorities of the party-state. Sometimes, these crackdowns are initiated through the CCP’s anti-corruption processes carried outside the formal legal system. Thereafter, the individuals may or may not be subjected to legal enforcement as well, and their conglomerates pushed to the brink through mandated restructuring and asset seizures by government authorities.

Examples of such cases include Ye Jianming, one of China’s most powerful private tycoons, who was detained on corruption accusations and disappeared in the process of his investigation (Ye’s Fortune 500 conglomerate—CEFC China Energy and its listed Shanghai subsidiary—fell along with him); Wu Xiaohui, the politically connected and

140 Groswald Ozery, The Politicization of Corporate Governance, supra note 107 (explaining how the CCP deploys various corporate governance capacities that substitute for the functions of conventional corporate governance institutions, both inside and outside firms).

141 Groswald Ozery, Illiberal Governance, supra note 19, at 967-91

142 For the potential broad market effects of China’s politicized corporate governance mechanisms see Groswald Ozery, The Politicization of Corporate Governance, supra note 107, at 63.


144 On the use of the CCP’s anti-corruption apparatus as an alternative corporate governance mechanism and its recent legalization see Groswald Ozery, The Politicization of Corporate Governance, supra note 107, at 33-46.

145 Xie Yu, Missing Oil Tycoon Ye Jianming’s Firm Faces Delisting in China, 18 Months After He Was Detained by Chinese Authorities, S. CHINA MORNING POST (Aug. 15, 2019, 2:29 PM),
powerful chairman of Anbang Insurance Group, who was sentenced to 18 years in prison for fraud and embezzlement and saw the assets of Anbang seized by the state;\textsuperscript{146} and Xiao Jianhua, a billionaire financier who operated a secretive network of financial businesses and engaged with the top echelon of the CCP\textsuperscript{147} and then was allegedly kidnapped and had his financial conglomerate Tomorrow Group dismantled and the group’s businesses taken over by various authorities.\textsuperscript{148}

More recently, fear governance has been used to pressure managers to align with the shifting national development priorities of the Party-state\textsuperscript{149}: Billionaire Hui Ka Yan, founder of deeply indebted Evergrande Group, injected over $1.1 billion of his personal funds to support the firm’s operations—he was reportedly pressured by the government to do so.\textsuperscript{150} Similarly, in what appears to be an effort to stay in the Chinese Government’s good graces during a time of increased scrutiny in the tech sector, Alibaba and Tencent recently pledged more than $15 billion each to support President Xi’s heavily promoted “common prosperity” campaign.\textsuperscript{151}


\textsuperscript{149}See Laura He, \textit{China’s Biggest Private Companies are in Chaos. It’s All Part of Beijing’s Plan}, CNN Business (Aug. 4, 2021, 1:17 AM), \texttt{https://www.cnn.com/2021/08/04/tech/china-crackdown-tech-education-mic-intl-hnk/index.html} (opining that the fear of crackdowns in China’s tech, education, and startup industries has been used to scare companies into aligning with the government’s priorities).

\textsuperscript{150}See Yue Wang, \textit{Hui Ka Yuan Uses $1 Billion of Personal Fortune to Help Embattled Evergrande}, \textit{Forbes} (Nov. 22, 2021, 9:52 AM), \texttt{https://www.forbes.com/sites/ywang/2021/11/22/hui-ka-yan-uses-1-billion-of-personal-fortune-to-help-embattled-evergrande/} ("The billionaire is believed to be under government pressure to make good on Evergrande’s financial obligations and avoid being held personally culpable.").

3. State/CCP Control Could Help Investors

In addition to failing to reveal the extent of party-state control and influence over firms, the Act appears to assume that such influence is inherently harmful (even if not harmful enough to require disclosure when the firm is not an SEC-Identified Issuer). That assumption may well be erroneous. While so far China has turned a blind eye to massive expropriation of U.S. investors by Chinese residents, it may wish to prevent expropriation in the future (as recent regulatory tightening may suggest), especially at a highly visible firm or where there is an impact on China’s domestic market. If so, a firm’s connections to the Chinese party-state might reduce the risk of misappropriation; it may also ease regulatory bottlenecks (such as licensing) and open new growth opportunities, thereby benefiting, not harming, investors.

Indeed, the CCP is deeply committed to, and politically invested in, China’s growth narrative. One sign of such commitment is its increasingly direct role in corporate monitoring, especially via CCP committees embedded inside firms. Such presence can

152 See Fried & Kamar, Law-Proof Insiders, supra note 19, at 4.

153 For example, the recent amendment of the PRC Securities Law includes a provision that expands the reach of the law and thus the CSRC’s oversight and enforcement authorities extrajurisdictionally. See Zhonghua Renmin Gongheguo Zhengchuan Fa [中华人民共和国证券法] (Securities Law of the People’s Republic of China) (promulgated by Standing Comm. of the 9th Nat’l People’s Cong., Dec. 29, 1998, rev’d Oct. 27, 2005, amended Dec. 28, 2019 (effective, March 1, 2020)), art. 2 states:

“Where the issuance and transaction of securities outside the territory of the People’s Republic China have disrupted the market order within the territory of the People’s Republic of China and damaged the legitimate rights and interests of investors within the territory, such activities shall be handled and investigated for legal responsibility in accordance with the relevant provisions of this Law.”

Additionally, administrative regulations were issued to tighten oversight and improve the quality of auditors and other intermediary gatekeepers, see Opinions on Further Regulating Financial Auditing and the Certified Public Accountant Industry, supra note 15, art. 6 (purporting to “carry out cross-border accounting audit supervision cooperation in accordance with laws and regulations and safeguard the national economic information security and the legitimate rights and interests of enterprises and enhance international credibility and influence”). See also Opinions on Strictly Cracking Down on Illegal Securities Activities, supra notes 18, pt. 5 (which highlight measures for “Further Strengthening Cross-border Cooperation in Law Enforcement and Administration of Justice”). As well as the Measures for the Administration of Overseas Issuance and Listing of Securities by Domestic Enterprise, supra notes 18 (which purports to enhance regulatory oversight over firms’ issuances off-shore, including specifically with respect to the use of questionable registration structures such as VIEs).

154 See Groswald Ozery, Illiberal Governance, supra note 19, at 967-91 (explaining how the Chinese party-state uses both carrots and sticks to induce Chinese firms and their insiders to act according to its growth priorities, thus signaling its commitment to growth and potentially providing protection to investors, including foreign investors in foreign-listed China-based firms).

improve monitoring of managers and corporate discipline. Some studies have shown positive capital market reaction to enhanced CCP oversight in China-domiciled listed firms; potential factors include increases in accountability of corporate insiders for wrongdoing as well as deterrence against corruption and corporate malfeasance. Such contributions improve overall market regularity in the Chinese market, with potential implications for investors’ confidence.¹⁵⁶

V. Conclusion

The HFCA Act purports to better protect U.S. investors, but there is a substantial likelihood it will end up harming them. The Act has forced China, at least for now, to permit PCAOB inspections of China-based auditors of U.S.-listed firms. These inspections may marginally improve the quality of these firms’ audits. But these audits are not designed, and unlikely, to catch or deter fraud. Moreover, Beijing is unlikely to permit PCAOB inspections indefinitely, especially if they threaten sensitive party-state interests. If such inspections are halted, a tsunami of delistings and cheap take-privates will follow, hurting investors in China-based firms. The U.S. government will then be blamed for the financial carnage.

The HFCA Act’s disclosure rules, which are supposedly designed to warn investors of the extent of the Chinese party-state’s influence over U.S.-listed firms, make little sense except as a naming-and-shaming exercise. The party-state can pressure any firm to do its bidding; formalistic indications of ownership and control simply cannot capture the complexities of China’s political economy and the resulting levers of control over firms, including China-based U.S.-issuers. The fact that HFCA Act’s disclosure rules do not apply at the IPO and are waived in any year where the PCAOB can inspect China-based auditors make clear that U.S. policymakers do not themselves believe this information is material to investors.

The core problem with China-based U.S.-listed firms is that China-based insiders are law-proof. As long as this remains the case, there is no appealing policy option for protecting investors in China-based firms trading here. What can be done? Congress should pressure China to cooperate on enforcement and design solutions to treat fraud and expropriation cases when such are revealed. Congress should consider barring future listings from countries that impede PCAOB inspections or otherwise frustrate the pursuit of cross-border wrongdoers. Had this step been taken years ago, we would not be stuck between a rock and a hard place today. Such a forward-looking bar would come too late to help investors in already-listed China-based firms, but it would at least limit the amount of future expropriation.

¹⁵⁶ For a discussion of related studies, see Groswald Ozery, *Illiberal Governance*, *supra* note 19, at 63-71.