

SEC Reporting & Compliance Alert

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SEC Staff Issues Guidance Regarding Unique Challenges and Disclosure Considerations for China-Based Issuers

On November 23, 2020, the Division of Corporation Finance of the U.S. Securities and Exchange Commission (SEC) issued *CF Disclosure Guidance: Topic No. 10* regarding disclosure considerations for companies based in or with the majority of their operations in China (China-based issuers).¹ The guidance focuses on China-based issuer disclosures in comparison to U.S.-based domestic issuers in shareholder recourse, while also addressing other questions that China-based issuers should consider when assessing their disclosure obligations under U.S. federal securities laws. Below is a summary of the guidance.

Unique Challenges Faced by China-Based Issuers and U.S. Regulators

The guidance acknowledges some of the potential obstacles that China-based issuers and U.S. regulators may face as a result of China's evolving regulatory environment and organizational structures and corporate governance practices common among China-based issuers. Some of the commonly identified challenges faced by China-based issuers as disclosed in their SEC filings include:

- **Evolving Laws and Regulations.** The guidance notes that China-based issuers may face risks related to evolving laws and regulations, which could affect their ability to obtain or maintain permits or licenses required to conduct business in China.
- **Variable Interest Entities.** The guidance notes that regulations in China prohibit or restrict foreign investment in Chinese companies operating in certain restricted industries. As a result, to comply with these regulations, some China-based issuers have formed non-Chinese holding companies that enter into contractual arrangements with Chinese operating companies. Pursuant to these contractual arrangements, the China-based issuer exerts control over, and is the primary beneficiary of, the Chinese operating company. This arrangement is commonly referred to as a variable interest entity (VIE) organizational structure. The guidance provides that exerting control through contractual arrangements may be less effective than direct equity ownership, and a company may incur substantial costs to enforce the terms of the contractual arrangements.

¹ The guidance follows [recent reports](#) that in December 2020 the SEC is likely to issue for public comment a proposal that will substantially implement [recommendations](#) of the President's Working Group on Financial Markets focusing on the soundness of China-based issuers' financial statements and related disclosures.

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Likewise, from the perspective of U.S. regulators, some of the identified challenges include:

- **Restrictions on the Public Company Accounting Oversight Board (PCAOB).** The guidance acknowledges that China has not provided the PCAOB with access to inspect or investigate China-based issuer audits conducted by PCAOB-registered public accounting firms in China.

- **Chinese State Secrecy and National Security Laws.** The guidance notes that under Article 177 of the People's Republic of China Securities Law, overseas securities regulators are prohibited from directly conducting investigations or engaging in evidence collection activities within China. Moreover, Article 177 also prohibits any entity or individual in China from providing documents and information relating to securities business activities to overseas regulators without Chinese government approval. Therefore, the SEC faces substantial challenges in bringing and enforcing actions against China-based issuers.

- **Shareholder Rights and Recourse.** The guidance acknowledges that, even if an investor obtains a judgment in a U.S. court against a China-based issuer (or its directors or officers) for securities law violations, it may be impractical for the investor to enforce the judgment if the China-based issuer's assets are located outside of the U.S. and the issuer does not cooperate in paying the penalties.

Disclosure Considerations for China-Based Issuers

Given some differences in the regulatory and corporate governance landscape for China-based issuers, the guidance emphasizes the importance of high-quality, reliable disclosure, including regarding financial reporting. To this end, the guidance encourages China-based issuers to fully disclose material risks related to their operations in China, and provides a list of questions China-based issuers should give careful consideration to when assessing their disclosure obligations under U.S. federal securities laws:

- **PCAOB Limitations.** Does the China-based issuer provide clear and prominent disclosure of PCAOB inspection limitations and lack of enforcement mechanisms, as well as the risks regarding the quality of the financial statements? For example, does the China-based issuer disclose the possibility that legislative or

other regulatory action in the U.S. may result in listing standards or other requirements that, if the company cannot meet, may result in delisting?²

- **VIE Organizational Structure.** Does the China-based issuer use VIEs in its organizational structure? If so, does the China-based issuer include sufficient disclosure about the related party transactions in the VIE structure and caution investors about the risks associated with such a structure being employed in China, including that the VIE structure may be disregarded by Chinese tax authorities resulting in increased tax liabilities?

- **China's Regulatory Environment.** Does the China-based issuer disclose risks related to the regulatory environment in China, including risks related to uncertain interpretation and enforcement of evolving laws and regulations? For example, does the China-based issuer disclose that intellectual property rights and protections may be insufficient for companies with material intellectual property in China?

- **Differing Shareholder Rights.** Does the China-based issuer provide risk disclosure about differing shareholder rights and remedies in the company's country of organization and/or based on where a company's operations are located? For example, does the China-based issuer disclose the difficulties in effecting service of legal process, enforcing judgments obtained in U.S. courts, and bringing claims against the company or its directors and officers?

- **Foreign Private Issuer.** If the China-based issuer is a foreign private issuer, does it describe corporate governance differences pursuant to Item 16G of Form 20-F, or differences in reporting requirements between U.S. domestic issuers and foreign private issuers, such as the frequency of financial reporting, the exemption from filing quarterly reports and proxy solicitation materials, and the exemption from Regulation FD?

² As part of a continued regulatory focus in the U.S. on access to audit information, the U.S. Senate unanimously passed a bill ([S. 945, Holding Foreign Companies Accountable Act](#)) that, if enacted into law, may prohibit the securities of a company from being listed on any U.S. securities exchange or traded "over-the-counter" if the company's auditor has not been subject to PCAOB inspection for three consecutive years. The U.S. House of Representatives is expected to vote on this same bill in December 2020. Some China-based issuers have publicly acknowledged that they may preemptively switch to non-U.S. exchanges if the proposed legislation becomes law. The impact of the legislation, if passed, and the consequences to U.S. investors owning securities of China-based issuers listed or traded in the U.S., remains to be seen.