Chinese Issuers See Progress on US Audit Issue and HKEX Reforms, but US Policies Could Impact Tech Companies

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Key Points

- While progress has been made in resolving the long-standing issue of PCAOB's access to inspect audits of China-based issuers, regulatory initiatives in the U.S. introduce new complexities.
- Chinese authorities recently introduced a new regulatory framework for overseas listings of China-based issuers.
- HKEX has taken a number of initiatives to modernize the Hong Kong market, improve alignment with global standards, provide additional channels for capital-raising and improve liquidity.

The past year presented a complex landscape for China-based companies seeking to access global capital markets. Against a backdrop of challenging macroeconomic conditions and escalating geopolitical tensions, regulatory authorities in the U.S., mainland China and Hong Kong introduced initiatives for China-based issuers that provide opportunities for those able to navigate the regulatory process successfully.

US Regulatory Developments

Concerns over auditor inspections abate. The Holding Foreign Companies Accountable Act (HFCAA), together with the Consolidated Appropriations Act of 2023, requires the U.S. Securities and Exchange Commission (SEC) to prohibit China-based issuers' securities from being traded on a U.S. securities exchange or in the over-the-counter trading market in the U.S. if the Public Company Accounting Oversight Board (PCAOB) is unable to inspect or investigate the issuers' China-based auditors for two consecutive years.

In December 2022, the PCAOB issued a report that removed mainland China and Hong Kong from the list of jurisdictions that are not subject to complete inspection. As a result, many China-based issuers that were designated by the SEC, pursuant to the HFCAA, as "commission-identified issuers" in 2022 because their auditors were located in mainland China or Hong Kong were no longer identified as such in 2023. The PCAOB's inspection of the work of auditors in mainland China and Hong Kong is ongoing.

SEC initiatives focus on China-related disclosures. Following a July 2021 statement from SEC Chairman Gary Gensler requesting more prominent disclosures from Chinese companies, the SEC issued a sample comment letter to those companies. The letter requires certain disclosures in the companies' registration statements and periodic or current reports, emphasizing critical areas including risks relating to the use of variable interest entity (VIE) structures, risks associated with doing business in China, permissions and approvals from Chinese authorities and disclosures about the HFCAA.

In July 2023, the SEC issued another sample comment letter for China-specific disclosures focusing on three areas:

- Commission-identified issuers under the HFCAA.
- Risk of intervention or control by the Chinese government.
- Impact of the U.S. Uyghur Forced Labor Prevention Act.

Both comment letters underscore the SEC's consistent focus on more prominent and robust disclosure regarding China-related issues. Most China-based issuers are receiving, or are expected to receive, those SEC comments during their IPO process or on periodic reports.

Outbound technology investment review is forthcoming. The Biden administration issued an executive order on August 9, 2023, directing U.S. agencies to establish regulations that will prohibit, or require notification of, certain types of outbound investments by U.S. persons in entities in China (including Hong Kong and Macau) involved in three specific categories of advanced technologies and products: semiconductors and microelectronics, quantum information technologies and artificial intelligence.

The final rules are likely to become effective in 2024, and the scope of the review program will be narrowly targeted, at least at the outset, with the greatest impact most likely on U.S. private equity and venture capital investments in China. Some activities are expressly exempted from the review, such as investments in public companies, bank lending and underwriting activities.

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Certain biotech segments are also reportedly under consideration for potential restrictions for investments in China, and autonomous driving technologies appear to be facing varying levels of regulatory scrutiny. In October 2023, the U.S. Department of Commerce unveiled new regulations that further tighten a sweeping set of export controls on advanced chips and chipmaking equipment first introduced in October 2022.

U.S.-China political tension grows. In July 2023, the U.S. House Select Committee on the Chinese Communist Party sent letters to four U.S. venture capital firms expressing "serious concern" about investments in Chinese tech startups. Some observers interpreted these letters as a means of exerting pressure on the executive branch, given the limited results from legislative efforts to control outbound investments in certain Chinese industries. President Joe Biden's executive order of August 9, 2023, appears to align with the intentions of this House committee.

Impact of New Chinese Filing Requirement on Offshore Listings

In February 2023, the China Securities Regulatory Commission (CSRC) issued new regulations mandating that companies based in China (even if they are incorporated offshore) that offer or list their securities in an overseas market must file with the CSRC within three business days of their listing application overseas. This requirement extends to IPOs and follow-on offerings in the U.S., Hong Kong and other overseas capital markets.

To date, more than 100 companies have filed with the CSRC. The review process experienced some initial delays but has accelerated since August 2023. The CSRC has cleared over 50 filings encompassing a diverse range of U.S. and Hong Kong IPO applicants, companies with and without offshore holding structures and, notably, companies that use a VIE structure — suggesting tacit recognition by Chinese regulators of this structure.

New Initiatives in Hong Kong

Hong Kong's SPAC market matures, sees its first de-SPAC transaction. At the beginning of 2022, The Stock Exchange of Hong Kong Limited (HKEX) introduced a regime permitting the listing of special purpose acquisition companies (SPACs). The market welcomed the initiative, with five SPAC listings on HKEX so far and a number of additional SPAC listing applications filed but not yet completed.

Under HKEX's rules, a SPAC must announce an acquisition or business combination (a de-SPAC transaction) within 24 months of listing and complete a de-SPAC transaction within 36 months of listing. Hong Kong's first de-SPAC transaction was announced in August 2023 by Aquila Acquisition Corporation, the first SPAC listed.

Aquila said it would combine with online steel market operator ZG Group. While that transaction has not yet closed, this "proof of concept" has prompted other companies to actively consider de-SPAC transactions as an option.

There are a number of complexities in structuring de-SPAC transactions under the Hong Kong rules, including the requirement for a simultaneous investment from institutional investors in the form of a "private investment in public equity" (PIPE) placement.

HKEX treats de-SPAC transactions as new listing applications and, as a result, the time and process required for a target to go public via a de-SPAC transaction are comparable to that for a traditional IPO. However, with challenging market conditions, the availability of this alternative channel for companies seeking fundraising and listing opportunities in Hong Kong is a welcome development.

IPO settlement time improves. After several years of planning, Hong Kong's "Faster Interface for New Issuance" (FINI) plan finally came into effect in November 2023. FINI is a new digital platform for IPO settlement, which has significantly shortened the time between pricing of an IPO and closing and commencement of trading, from five business days to two. Companies undertaking an IPO in Hong Kong will now see their IPO funds received and their shares listed and trading on HKEX on the second business day after pricing. Market participants, including underwriters and investors, will benefit from reduced market risk exposure because of the shorter settlement period.

The new system has also digitized extensive aspects of the IPO application, subscription and settlement process, with numerous documents now being accepted on the exchange's online system.

Treasury shares are permitted. In its latest initiative to improve capital management options and address liquidity issues, HKEX announced plans to permit listed companies to hold their own shares as treasury shares. Historically, HKEX has not permitted treasury shares, but with Hong Kong's increasing success at attracting "homecoming" listings of Greater China companies with dual listings in the U.S., where treasury shares are common, there has been pressure for Hong Kong to align with global market practice in this area.

Permitting treasury shares helps Hong Kong continue to remain an attractive listing destination for the region's leading new companies. HKEX plans to introduce rules governing the resale of treasury shares, which will enable companies to retain repurchased shares in treasury and to resell them into the market. Doing so will make it easier to sell shares in small quantities at market prices (as opposed to sales of large blocks of new shares, which generally take place at a discount).

Resales of treasury shares will be subject to the same rules as those applicable to issuances of new shares. HKEX is attempting to discourage companies from transacting in treasury shares with the aim of manipulating their share price or making a trading profit. As such, certain limitations will be applied to treasury share transactions, including a 30-day moratorium on resales after any repurchase and on repurchases after any resale, as well as a one-month blackout period on treasury share resales prior to any results announcement.

(See also "How Companies Are Adapting to Volatile Capital Markets and Planning Ahead.")