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

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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.

TABLE OF CONTENTS

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Introduction

On December 18, 2020, then-President Donald Trump signed into law the Holding Foreign Companies Accountable Act (the HFCA Act, or the Act).[1] 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).[2] 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).[3] On December 2, 2021, the Securities and Exchange Commission (SEC) finalized amendments to various rules implementing the Act.[4]

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[1] Pub. L. No. 116–222, 134 Stat. 1063 (2020). The Act was amended to accelerate the period towards potential trading prohibition from three years to two years. *See* Consolidated Appropriations Act of 2023, Pub. L. No. 117–328 (2022).

[2] Pub. L. No. 107–204, 116 Stat. 745 (July 30, 2002), *codified at* 15 U.S.C. § 7201 (2002).

[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* Zhonghua Renmin Gongheguo Chujing Rujing Guanli Fa (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.

[4] Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Amendments to Finalize Rules Relating to the Holding Foreign Companies Accountable Act (Dec. 2, 2021), https://www.sec.gov/news/press-release/2021-250.

China, unlike other countries, has until recently refused to allow local audit firms to share audit materials with foreign regulators such as the PCAOB.[5] 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.[6]

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-based U.S.-listed firms.[7] 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.[8] In September of that year, the PCAOB began conducting inspections pursuant to the agreement.[9] 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.[10] With this announcement, the countdown for a trading prohibition under the HFCA Act was, at least temporarily, paused.[11]

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.[12] 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

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[5] *See infra* Part I.B.2.

[6] *See supra* note 2.

[7] *See PCAOB Signs Agreement with Chinese Authorities, Taking First Step Toward Complete Access for PCAOB to Select, Inspect and Investigate in China*, Pub. Co. Acct. Oversight Bd. (Aug. 26, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-signs-agreement-with-chinese-authorities-taking-first-step-toward-complete-access-for-pcaob-to-select-inspect-and-investigate-in-china.

[8] *See id.*

[9] Xie Yu & Julie Zhu, *U.S. Audit Inspections of Chinese Companies in Hong Kong Ends - Sources*, Reuters (Nov. 4, 2022, 1:31 PM), https://www.reuters.com/business/us-audit-inspection-chinese-companies-hong-kong-ends-sources-2022-11-04/.

[10] *See PCAOB Secures Complete Access to Inspect, Investigate Chinese Firms for First Time in History,* Pub. Co. Acct. Oversight Bd. (Dec. 15, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-secures-complete-access-to-inspect-investigate-chinese-firms-for-first-time-in-history.

[11] *See* Yaroslav Alekseyev et al., *China Provides Complete Access to PCAOB to Inspect Audit Firms for First Time*, Linklaters (Dec. 20, 2022), https://www.linklaters.com/en-us/knowledge/publications/alerts-newsletters-and-guides/2022/december/20/looming-us-delisting-of-chinese-companies-averted-at--least-for-now.

[12] *See infra* Part II.B.2.a.

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 International Public Offering (IPO) on a U.S. exchange.[13] 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.[14]

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.[15]

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[13] Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n, Statement on Investor Protection Related to Recent Developments in China (July 30, 2021), https://www.sec.gov/news/public-statement/gensler-2021-07-30.

[14] 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 (王佰文), Jiao Pei "Shuangjian" Xinzheng Luodi Xindongfang Diefu Po Jilu (教培"双减"新政落地新东方跌幅破纪录) [Double Reduction Policy Causes Record Decline for New Oriental], Caixin (July 23, 2021, 5:02 PM), https://www.caixin.com/2021-07-23/101744497.html.

[15] Zhonggong Zhongyang Bangongting, Guowuyuan Bangongting (中共中央办公厅, 国务院办公厅) [The General Office of the CCP Central Committee and the General Office of 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 Shenji Zhixu Cujin Zhuce 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).

In particular, it revitalized and tightened the legal framework concerning data sharing with foreign parties and regulators;[16] enhanced administrative oversight of China-based U.S.-listed firms including via cybersecurity reviews and data-protection inspections;[17] tightened enforcement in the Chinese capital market, including with respect to auditors and other intermediary

[16] *See* Zhonghua Renmin Gongheguo Dangan Fa (中华人民共和国档案法) [Amendment to the Archives Law] (revised by the Standing Comm. of the Thirteenth Nat'l People's Cong., June 20, 2020, effective Jan. 1, 2021) arts. 22, 25; Zhonghua Renmin Gongheguo Shuju 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., June 10, 2021, effective Sep. 1, 2021) arts. 36, 48; Zhonghua Renmin Gongheguo Geren Xinxi Baohu Fa (中华人民共和国个人信息保护法) [Personal Information Protection Law of the People's Republic of China] (promulgated by the Standing Comm. of the Thirteenth Nat'l People's Cong., Aug. 20, 2021, effective Nov. 1, 2021), (including a Chapter III on "Rules on Cross border Provisions of Personal Information"); Guanyu Jiaqiang Jingnei Qiye Jingwai Faxing Zhengquan he Shangshi Xiangguan Baomi he Dang'an Guanli Gongzuo de Guiding (关于加强境内企业境外发行证券和上市相关保密和档案管理工作的规定) [Regulations on Strengthening the Confidentiality and Archives Management Related to the Overseas Issuance and Listing of Securities by Domestic Enterprises] (released in Notice 44 of China Sec. Reg. Comm'n, Feb. 24, 2023, effective Mar. 31, 2023).

[17] *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, July 7, 2022, effective Sep. 1, 2022).

These rules are expected to have an impact on data-rich technology firms, such as TikTok, and the U.S. listings of such firms (e.g., Alibaba). The earliest example of such regulatory tightening involved China-based U.S.-listed Didi Chuxing (嘀嘀打车), 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 and leading to the company's voluntary delisting from NASDAQ. *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 are 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.").

gatekeepers;[18] and established a review and approval system for future offshore listings of Chinese companies and their affiliates.[19]

The remainder of the paper is structured as follows. Part I provides a backdrop to the HFCA Act. Part II discusses the delisting provisions of the Act and their likely effects. Part III discusses the disclosure provisions of the Act and their futility. Part IV concludes.

I. 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.[20] As of January 2023, several hundred Chinese companies with a total market

[18] 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, July 6, 2021) [hereinafter Opinions on Strictly Cracking Down on Illegal Securities Activities]. Articles 15–17 discuss the accountability of intermediaries (e.g., audit firms), while articles 19–21 highlight improving cross-border cooperation. *See id.*

[19] Wangluo Anquan Shencha Banfa (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), 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 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 offshore issuances, including the use of a VIE structure, by e.g. limiting the companies that may be permitted to issue shares offshore by their industry; by the criminal record of their controllers; and by the standing legal disputes against them).

[20] *See* Jesse M. Fried & Ehud Kamar, *China and the Rise of Law-Proof Insiders*, 48 J. Corp. L. 215 (2023) [hereinafter Fried & Kamar, *Law-Proof Insiders*] (explaining why many China-based firms list in the United States); Tamar Groswald Ozery, *Illiberal Governance and the Rise of China's Public Firms: An Oxymoron or China's Greatest Triumph*?, 42 U. Pa. J. Int'l L. 921, 927–37 (2021) [hereinafter Groswald Ozery, *Illiberal Governance*] (reviewing China's growing integration with global capital markets).

capitalization of approximately $1.03 trillion were listed on U.S. exchanges.[21] China-based U.S.-listed firms generally fall into one of three categories:

State-owned enterprises (*SOE*s): 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.[22] It controls, for example, 70% of China's Fortune Global 500 firms.[23] 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.[24] No Chinese SOEs currently trade on major U.S. exchanges.[25] As we explain in

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[21] *See Chinese Companies Listed on Major U.S. Stock Exchanges*, U.S.-China Econ. and Sec. Rev. Comm'n (Jan. 9, 2023) [hereinafter U.S.-China Review Comm'n Report], https://www.uscc.gov/sites/default/files/2023-01/Chinese_Companies_Listed_on_US_Stock_Exchanges_01_2023.pdf. 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 *Chinese Companies Listed on Major U.S. Stock Exchanges*, U.S.-China Econ. & Sec. Rev. Comm'n, (Oct. 2, 2020), https://china.usc.edu/sites/default/files/article/attachments/uscc-2020-Chinese_Companies_on_US_Stock_Exchanges_10-2020.pdf. By the time this article went to print, the trend reversed again and the market capitalization of China-based U.S.-listed companies declined to $848 billion, see *Chinese Companies Listed on Major U.S. Stock Exchanges*, U.S.-China Econ. & Sec. Rev. Comm'n, (Jan. 8, 2024), https://www.uscc.gov/sites/default/files/2024-01/Chinese_Companies_Listed_on_US_Stock_Exchanges_01_2024.pdf.

[22] *See* Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 Stan. L. Rev. 697 (2013) (describing Chinese SOEs and their relationship with the state).

[23] 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) [State-Owned Assets Report on State-Owned Enterprises on the 2022 Fortune Global 500], Zhongguo Duiwai Chengbao Gongcheng Shanghui (中国对外承包工程商会) [China Int'l Contractors Ass'n] (Aug. 4, 2022), https://www.chinca.org/cica/info/22080418022511.

[24] *See* Michelle Chan, *Last Two Chinese State-Owned Companies to Delist from NYSE*, Wall St. J. (Jan. 13, 2023, 5:08 PM), https://www.wsj.com/livecoverage/stock-market-news-today-01-13-2023/card/last-two-chinese-state-owned-companies-to-delist-from-nyse-cDo3iXPQLYSzbcubsqAO.

[25] Four companies that are ultimately controlled by SASAC (China Telecom, China Mobile, China Unicom Hong Kong, and CNOOC Limited) were delisted by the NYSE in compliance with Executive Orders designating them as "Communist Chinese Military Companies" and banning investment activity in their securities. *See* Exec. Order No. 13959, 3 C.F.R. 475 (2021); Exec. Order No. 14032, 3 C.F.R. 586 (2022) (replacing Executive Order No. 13959); *Chinese Military Companies Sanctions*, U.S. Dep't Treasury, https://home.treasury.gov/policy-issues/financial-sanctions/sanctions-programs-and-country-information/chinese-military-companies-sanctions. One company (Guangshen Railway) had voluntarily delisted earlier and continues to trade over the counter. *See* Xu Wei, *China's Guangshen Railway to Delist from NYSE, Citing Sluggish Trading*, YiCai Glob. (Sept. 1, 2020), https://www.yicaiglobal.com/news/china-guangshen-railway-to-delist-from-nyse-citing-sluggish-trading-. Thus, at the end of 2021, only eight such companies remained. Five of the remaining eight undertook a coordinated delisting

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. Their "onshore" (in China) subsidiaries and affiliates are subject to PRC domestic laws, including PRC company law.[26]

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.[27] 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 I.B, have been unusually prone to fraud.[28]

Technology firms: Over 100 private-sector firms, mostly technology based, have conducted an IPO on a U.S. exchange.[29] Alibaba is the most prominent.[30] The total market capitalization of these firms exceeded $1 trillion in 2021.[31] 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.[32] Their China-based subsidiaries and affiliates (which contain the bulk of their operating assets) are subject to PRC company law.[33]

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on August 12, 2022 (Aluminum Corporation of China Limited, China Life Insurance Company, China Petroleum and Chemical Corporation (SINOPEC), PetroChina International Limited, and SINOPEC Shanghai Petrochemical Company, Ltd.), while the sixth had delisted earlier in July (Huaneng Power International). *See* U.S.-China Review Comm'n Report, *supra* note 21, at 4. The last two remaining SOEs, China Eastern Airlines and China Southern Airlines, voluntarily delisted in February 2023. *See* Chan, *supra* note 24.

[26] 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.

[27] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 234–36; *infra* Part I.B.

[28] *See infra* Part I.B.

[29] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 222.

[30] *See* Jesse M. Fried & Ehud Kamar, *Alibaba*: *A Case Study of Synthetic Control*, 11 Harv. Bus. L. Rev. 280 (2021).

[31] *See Chinese Companies Listed on Major U.S. Stock Exchanges*, U.S.-China Econ. & Sec. Rev. Comm'n (May 2021), https://www.uscc.gov/sites/default/files/2021-05/Chinese_Companies_on_US_Stock_Exchanges_5-2021.pdf.

[32] For a definition of "foreign private issuer," see 17 C.F.R. § 240.3b-4.

[33] For an example of this structure, see Alibaba Group Holding, Registration Statement Under the Securities Act of 1933 (Form F-1) (May 6, 2014).

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

Since 2000, hundreds of China-based private firms entered U.S. public markets through a reverse merger[34]—a process in which a public U.S. shell company acquired a private Chinese operating company.[35] The reverse merger, unlike an IPO, enabled the Chinese company to access U.S. capital markets without the SEC first scrutinizing its disclosures.[36] The result typically was a U.S.-listed, U.S-domiciled firm with one or more China-based subsidiaries.[37] 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.[38]

From 2010 to 2012, many of these reverse-merger firms were exposed as frauds.[39] 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.[40] The reverse-merger fraud wave negatively impacted the share prices of all Chinese reverse-merger firms, including ones that might not have been fraudulent.[41] The aggregate market capitalization of all China-based

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[34] A PCAOB research note found that 159 Chinese companies accessed U.S. capital markets via reverse merger between 2007 and 2010 alone. *See* PUB. CO. ACCT. OVERSIGHT BD., ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION: JANUARY 2007 THROUGH MARCH 31, 2010, at 3 (2011), https://pcaobus.org//research/documents/chinese_reverse_merger_research_note.pdf.

[35] *See* U.S. SEC. & EXCH. COMM'N, INVESTOR BULLETIN: REVERSE MERGERS 1 (June 2011), http://www.sec.gov/investor/alerts/reversemergers.pdf. The shareholders of the private firm exchange their shares for a large majority of the shell company's shares, and the shell company survives the merger. *See* Fried & Kamar, *Law-Proof Insiders, supra* note 20, at 234 n.116.

[36] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 234.

[37] Thus, the structure is similar to those of China-based technology firms that conduct their IPO in the United States, such as Alibaba, except that the parent company is legally domiciled in the United States rather than in (say) the Cayman Islands. *See* Fried & Kamar, *supra* note 30.

[38] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20.

[39] *See* Masako N. Darrough et al., *The Spillover Effect of Fraud Allegations Against Chinese Reverse Mergers*, 37 CONTEMP. ACCT. RES. 982 (2020).

[40] *See* Yimiao Chen et al., *GAAP Difference or Accounting Fraud? Evidence from Chinese Reverse Mergers Delisted from U.S. Markets*, 7 J. FORENSIC & INVESTIGATIVE ACCT. 122 (2015), http://web.nacva.com/JFIA/Issues/JFIA-2015-1_5.pdf.

[41] *See* Lewis Ferguson, Remarks at the California State University 11th Annual SEC Financial Reporting Conference, Investor Protection through Audit Oversight (Sept. 21, 2012), https://pcaobus.org/News/Speech/Pages/09212012_FergusonCalState.aspx. *Cf.* Charles M.C. Lee, et al., *Shell Games: The Long-Term Performance of Chinese Reverse-Merger Firms,* 90

reverse-merger firms fell by 75%.[42] The collapse in share prices provided an opportunity even for firms not involved in fraud to be taken private on the cheap.[43] The fraud wave and cheap freeze-outs that followed resulted in billions of dollars of losses for U.S. investors.[44]

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.[45] 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.[46] 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.[47]

2. The Audit Controversy

As part of its investigations into Chinese reverse-merger firms, the SEC sought audit working papers from these firms' auditors,[48] including from

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ACCT. REV. 1547, 1547–89 (2015) (comparing the long-term performance of reverse merger listed firms and finding that, contrary to common criticisms, they outperform their peers).

[42] *See* Paul Gillis, *The Three Terrors of Investors in Chinese Stocks*, FORENSIC ASIA (July 25, 2013), https://web.archive.org/web/20230328061944/https://www.chinaaccountingblog.com/weblog/2013_07_25_three_terrors.pdf.

[43] *See* Darrough et al., *supra* note 39, at 1009.

[44] *See* Ramsey Sharara, *The Reverse Merger Fraud—How Chinese Corporations Fooled American Investors*, THE BULL & BEAR (Oct. 6, 2020), https://bullandbearmcgill.com/the-reverse-merger-fraud-how-chinese-corporations-fooled-american-investors/#:~:text=In%20the%20late%202000s%2C%20hundreds,billion%20between%202009%20and%202012 (noting losses of over USD 500 billion between 2009 and 2012); Xianjie He et al., *U.S. Listing of Chinese Firms: Bonding vs. Adverse Selection* 13–15 (Chinese Univ. of H.K., Sch. Of. Acct., Working Paper No. 2012, 2012), https://accountancy.smu.edu.sg/sites/default/files/accountancy/pdf/Papers/tjwong2012_paper.pdf; Ferguson, *supra* note 41.

[45] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 226–34; Robin Hui Huang and Weixia Gu, *China's Recognition and Enforcement of Foreign Securities Judgments against Overseas-listed Chinese Companies*, 26 J. INT'L ECON. L. 577 (2023) (discussing the challenges of enforcing cross-border foreign securities law judgments against Chinese companies that are listed overseas).

[46] *See* Gillis, *supra* note 42, at 7.

[47] *See, e.g.*, *In re* Puda Coal, Inc., No. 6476–CS, 2014 WL 2469666 (Del. Ch. June 2, 2014) (ordering a default judgment against defendants for failure to appear after being duly served); Siping Fang v. Eighth Jud. Dist. Ct. of Nev., 425 P.3d 716 (Nev. 2018); *United States Court Issues Arrest Warrant for Wealthy China Businessman Siping Fang*, CISION P.R. NEWSWIRE (Apr. 26, 2019, 3:34 PM), https://www.prnewswire.com/news-releases/united-states-court-issues-arrest-warrant-for-wealthy-china-businessman-siping-fang-300839231.html.

[48] Audit working papers can provide information about complex corporate transactions that is often unavailable in firm records. *See* David M. Stuart & Charles F. Wright, *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).

China-based affiliates of the Big Four accounting firms.[49] Under SOX, the firms were obliged to comply.[50] But the China-based audit firms refused, claiming that compliance could violate China's State Secrets Law and the Archives Law,[51] 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.[52] Eventually, the SEC obtained the working papers after the China Securities Regulatory Commission (CSRC) allowed the papers to be shared.[53] In 2015, the audit firms agreed to pay fines of $500,000 each for failing to produce the documents before proceedings had been brought.[54] These were token fines, amounting to less than an average partner's salary.[55] 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."[56]

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.[57] Under SOX, the PCAOB-registered audit firms conducting audits for these firms[58] must be regularly inspected by the PCAOB.[59] 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

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[49] *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents (Feb. 6, 2015), https://www.sec.gov/news/pressrelease/2015-25.html.

[50] *See* 15 U.S.C. § 7216(b).

[51] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 238; David Moncure, *The Conflict Between United States Discovery Rules and the Laws of China: The Risks Have Become Realities*, 16 Sedona Conf. J. 283, 296–97 (2015).

[52] *See* U.S. Sec. & Exch. Comm'n, *supra* note 49.

[53] *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).

[54] *See* Michael Rapoport, *SEC, Big Four Accounting Firms in China Settle Dispute*, Wall St. J. (Feb. 6, 2015, 7:03 PM), https://www.wsj.com/articles/sec-big-four-accounting-firms-in-china-settle-dispute-1423237083. This was the first SEC enforcement action under Section 106I of SOX. Xiao Luo, *Accessing Foreign Audit Work Papers and the Conflicting Non-U.S. Laws Defense: A Recent Case Study*, 18 N.Y.U. J. Legis. & Pub. Pol'y 185, 202 (2014).

[55] *See The SEC Caves on China*, Wall St. J. (Feb. 26, 2015, 11:12 AM), https://www.wsj.com/articles/the-sec-caves-on-china-1424967173.

[56] *See id.*

[57] *See* Robin Hui Huang, *The U.S.-China Audit Oversight Dispute: Causes, Solutions, and Implications for Hong Kong*, 54 Int'l Law. 151, 174–79 (2021).

[58] 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. *See PCAOB Makes HFCAA Determinations Regarding Mainland China and Hong Kong*, Pub. Co. Acct. Oversight Bd., (Dec. 16, 2021), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-makes-hfcaa-determinations-regarding-mainland-china-and-hong-kong.

[59] *See* 15 U.S.C. § 7214.

enforcement of requests for production of documents.[60] These inspections are to ensure adherence to U.S. auditing standards.[61]

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,[62] for over a decade it had generally been unable to conduct inspections in China.[63] The PCAOB, therefore, was unable to systematically inspect China-based accounting firms,[64] which audit hundreds of public companies.[65] 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.[66]

Until 2020, the SEC and PCAOB struggled unsuccessfully 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.[67]

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[60] *See id.* § 7216(b)(1).

[61] *See* Paul Gillis, *Destroyers and the PCAOB*, China Acct. Blog (Nov. 6, 2015), https://www.chinaaccountingblog.com/weblog/destroyers-and-the-pcaob.html; *Basics of Inspections*, Pub. Co. Acct. Oversight Bd., https://pcaobus.org/Inspections/Pages/InspectedFirms.aspx.

[62] *See* Huang, *supra* note 57, at 158–63.

[63] *See id.* at 163–67; Gillis, *supra* note 42, 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), https://web.archive.org/web/20230426180354/https://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), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-enters-into-enforcement-cooperation-agreement-with-chinese-regulators_430. 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.*

[64] *See Chinese Investment in the United States: Impacts and Issues for Policymakers: Hearing Before the U.S.-China Econ. & Sec. Rev. Comm'n*, 115th Cong., 9 (2017) (statement of Paul Gillis, Professor of Practice, Guanghua School of Management, Peking University), https://www.uscc.gov/sites/default/files/Gillis_USCC%20Hearing%20Testimony012617.pdf; Reuters Staff, *Timeline: U.S., HK Regulators Struggle to Get China Audit Papers*, Reuters (Dec. 20, 2017), https://www.reuters.com/article/china-audit-timeline/timeline-u-s-hk-regulators-struggle-to-get-china-audit-papers-idUSKBN1EE0HT.

[65] *See Data about Our China-Related Access Challenges*, Pub. Co. Acct. Oversight Bd., https://pcaobus.org/International/Pages/data-about-our-china-related-access-challenges.aspx.

[66] *See Chinese Investment in the United States: Impacts and Issues for Policymakers: Hearing Before the U.S.-China Econ. & Sec. Rev. Comm'n*, 115th Cong., 167–68 (2017) (statement of Shaswat Das, Senior Att'y, Hunton & Williams LLP), https://www.uscc.gov/sites/default/files/transcripts/Chinese%20Investment%20in%20the%20United%20States%20Transcript.pdf.

[67] Pub. L. No. 116–222, 134 Stat. 1063 (2020).

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. We address them in Parts II and III, respectively.

II. 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 three consecutive years, the Act directs the SEC to prohibit trading in the issuer's securities.[68] While this part of the Act was not explicitly 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.[69]

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

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[68] 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 as the 'over-the-counter' trading of securities."). However, an omnibus government spending bill passed in December 2022 included a provision that shortened this window to two years. *See* Consolidated Appropriations Act of 2023, Pub. L. No. 117–328, 136 Stat. 4459 (2022). Because of the PCAOB's recent announcement that it had secured access to these audit materials, see *infra* Part II.B, the new, shorter window will only become relevant if the PCAOB determines in the future that it is again unable to inspect these firms. *See* Soyoung Ho, *Congress Passes Bill to Fund Government, Turns up Pressure on Chinese Auditors*, Thomson Reuters (Jan. 4, 2023), https://tax.thomsonreuters.com/news/congress-passes-bill-to-fund-government-turns-up-pressure-on-chinese-auditors//.

[69] 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 PCAOB Cooperative Arrangements with Non-U.S. Regulators*, Pub. Co. Acct. Oversight Bd., https://pcaobus.org/oversight/international/regulatorycooperation.

to allow PCAOB access to inspect Chinese auditing materials.[70] 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.[71] Inspections began in September 2022,[72] 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.[73]

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 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,[74] such inspections will not protect U.S. investors against fraud. It is not the duty of auditors to

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[70] *See PCAOB Signs Agreement with Chinese Authorities, Taking First Step Toward Complete Access for PCAOB to Select, Inspect and Investigate in China*, Pub. Co. Acct. Oversight Bd. (Aug. 26, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-signs-agreement-with-chinese-authorities-taking-first-step-toward-complete-access-for-pcaob-to-select-inspect-and-investigate-in-china.

[71] *See id.*

[72] Michelle Chan, *Audits of Chinese Companies Start to Face U.S. Inspections*, Wall St. J. (Sept. 22, 2022, 3:45 PM), https://www.wsj.com/articles/audits-of-chinese-companies-start-to-face-u-s-inspections-11663875097?mod=Searchresults_pos1&page=1.

[73] *See PCAOB Secures Complete Access to Inspect, Investigate Chinese Firms for First Time in History*, Pub. Co. Acct. Oversight Bd. (Dec. 15, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-secures-complete-access-to-inspect-investigate-chinese-firms-for-first-time-in-history.

[74] *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).

detect fraud,[75] and there are many situations where they will fail to do so.[76] 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-based 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.[77]

The Act also created a paradox, as one of us has explained elsewhere.[78] The Act's disclosure rules, discussed in Part III, assume that China's party-state influence over China-based firms is a risk about which U.S. investors should be informed. But the 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.[79] 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")

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[75] *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 (Mar. 11, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019354 ("[I]t is widely understood in the academic and professional auditing literature that it is not the auditor's duty to guarantee that the financial statements are accurately represented.")

[76] *See 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).

[77] *See generally* Fried & Kamar, *Law-Proof Insiders, supra* note 20.

[78] Groswald Ozery, *Illiberal Governance*, *supra* note 20, at 994.

[79] This is particularly the case as China's information sharing laws, as well as their supervision and enforcement, have tightened at the backdrop of the Act. *See supra* notes 16–20.

are administered and enforced by overlapping bureaucracies, many of which have no incentive to provide permission.[80] China's securities regulator, the CSRC, is assigned to implement the August 2022 cooperation agreement with the PCAOB. But the CSRC faces strong regulatory competition, including with the very powerful Cyberspace Administration of China (CAC), which has the mandate to oversee and approve the transfer of data outside the country. CAC is no ordinary regulatory agency. It is a hybrid party-state institution, situated under the Central Committee of the Chinese Communist Party,[81] and thus high-up in the party-state's institutional hierarchy. The relative political-economic sway that the CAC enjoys within the Chinese party-state system has increased with geopolitical tensions, and the agency likely has the ability to torpedo PCAOB inspections. This is particularly relevant in cases where high-volume or sensitive private information needs to be shared, or when the data to be shared involves a critical information infrastructure operator.[82]

This category of firms may seem narrow, as it seems limited to online platforms or website operators in industries where network products and services are offered or data processing activities are performed. However, the actual boundaries of this category are vague, leaving much discretion to government officials in different departments across industries.[83] These officials are likely to err on the side of caution and include a firm in the category as a critical information operator, thus subjecting the firm to potential CAC inspection, to minimize the risk of transgressing the fearsome CAC. Indeed, many data-rich China-based firms (including notably Alibaba, Pinduoduo, NetEase, Baidu, BeiGene, Yum China, Tencent Music) disclose in their annual reports, as a future risk factor, that they may be subject to a CAC review. The vagueness

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[80] *See* Huang, *supra* note 57, at 183–85. The joint issuance of the Cybersecurity Review Measures is reflective of the number of cooks in the kitchen. The Measures establish cybersecurity reviews in firms for the assessment of risk factors, including those that might emanate from certain cross-border IPOs, listings, and export of data. They were issued jointly by a large number of government agencies, including the Cyberspace Administration of China, the CSRC, China's National Development and Reform Commission (NDRC), the Ministry of Industry and Information Technology (MIIT), the Ministry of Public Security (MPS), the Ministry of National Security, the Ministry of Finance, the Ministry of Commerce, the People's Bank of China, the State Administration of Market Regulation (SAMR), the National Radio and Television Administration, the National Administration of State Secrets Protection, and the State Cryptography Administration, Decree No. 8, Nov. 16, 2021 (effective Feb. 15, 2022), https://www.gov.cn/zhengce/zhengceku/2022-01/04/content_5666430.htm.

[81] Jamie P. Horsley, *Behind the Façade of China's Cyber Super-Regulator,* DigiChina (Aug. 8, 2022), https://digichina.stanford.edu/work/behind-the-facade-of-chinas-cyber-super-regulator/.

[82] Cujin He Guifan Shuju Kua Jing Liudong Guiding (促进和规范数据跨境流动规定) [Provisions on Promoting and Regulating Cross-Border Data Flow], https://web.archive.org/web/20240829165718/www.cac.gov.cn/2024-03/22/c_1712776611775634.htm.

[83] Critical information infrastructure operator is a blurry category formulated on the basis of China's Cybersecurity Law and various subsequent regulations including the Regulations on the Security and Protection of Critical Information Infrastructure, which delegates identification tasks to relevant departments and agencies across market industries. *See*, Order No. 745 of the State Council, Oct. 17, 2021, (effective Sept. 1, 2021), https://www.gov.cn/zhengce/content/2021-08/17/content_5631671.htm?mc_cid=da5881cf31&mc_eid=a268621911.

of the category and the multiple lower-level agencies involved thus can be expected to expand the CAC's de facto authority in this space, and its dominance over the CSRC. This further jeopardizes a consistent implementation of the CSRC's agreement with the PCAOB.

Second, there are political 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, particularly in the current geopolitical climate.[84] Additionally, institutions as well as individuals might not want U.S. regulators probing domestic transactions that could involve shady payments among powerful business figures and officials.[85]

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.[86] 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 Science and Technology Innovation Board of the Shanghai Stock Exchange),[87] and a newly established Beijing stock exchange for innovation-driven SMEs.[88]

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

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[84] China's reluctance to acknowledge infringements on its regulatory rights is reflected in differing characterizations of the PCAOB inspection agreement in the U.S. and Chinese government descriptions of the agreement. *Compare PCAOB Secures Complete Access to Inspect, Investigate Chinese Firms for First Time in History,* Pub. Co. Acct. Oversight Bd. (Dec. 15, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-secures-complete-access-to-inspect-investigate-chinese-firms-for-first-time-in-history (highlighting the PCAOB's sole discretion in selecting the firms and works inspected), *with CSRC Officials Answered Reporter Question regarding Progress in China-U.S. Audit Oversight Cooperation,* CSRC News (Dec. 15, 2022), http://www.csrc.gov.cn/csrc_en/c102030/c6913420/content.shtml (highlighting the role of the Chinese regulator in facilitating these inspections, including its involvement in the interviews and testimony collection process).

[85] *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.

[86] *See id.*

[87] Daniel Ren, *Shanghai Stock Exchange to Debut Nasdaq-Style Market for Tech Stocks on July 22, Three Weeks Ahead of Schedule*, S. China Morning Post (July 5, 2019, 9:15 PM), https://www.scmp.com/business/companies/article/3017476/shanghai-stock-exchange-debut-nasdaq-style-market-tech-stocks.

[88] The Beijing exchange was announced in September 2021 and opened shortly thereafter. *See Beijing Bourse Introduces Govt Bond Issuance, Benchmark Index on First Anniversary*, Reuters (Sept. 2, 2022, 8:24 AM), https://www.reuters.com/article/china-markets-beijing-stock-exchange/update-2-beijing-bourse-introduces-govt-bond-issuance-benchmark-index-on-first-anniversary-idUKL1N3090LD.

the United States. By simply refusing to allow future PCAOB audit inspections, China can trigger trading bans that would lead to delistings.[89] 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 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.[90]

i. 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.[91] If the HFCA Act leads to a trade ban on such a firm, it can give

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[89] Groswald Ozery, *Illiberal Governance*, *supra* note 20, at 994.

[90] Over the past several years, many Chinese firms went private or obtained secondary listings in Hong Kong. *See* Joanne Chiu & Frances Yoon, *Ahead of U.S. Audit Bill, Chinese Companies Are Finding Their Way Home,* WALL ST. J. (Dec. 3, 2020, 7:18 AM), https://www.wsj.com/articles/ahead-of-u-s-audit-bill-chinese-companies-are-finding-their-way-home-11606997906; Peter Elstrom, *China's Sina Agrees to Go Private in Sweetened $2.6 Billion Deal*, BLOOMBERG (Sept. 28, 2020, 5:58 AM), https://www.bloomberg.com/news/articles/2020-09-28/china-s-sina-agrees-to-go-private-in-deal-valued-at-2-6-billion; *China's 58.com to go Private in $8.7 Billion Deal*, REUTERS (June 15, 2020,10:50 AM), https://www.reuters.com/article/us-58-com-m-a-warburg-pincus/chinas-58-com-to-go-private-in-8-7-billion-deal-idUSKBN23M1X5; Yvonne Lau, *JD Logistics Soars in Hong Kong Debut, Extending the Empire of 'China's Amazon'*, FORTUNE (May 28, 2021), https://fortune.com/2021/05/28/jd-logistics-ipo-share-hong-kong-listing/; Rebecca Isjwara, et al., *US-Listed Chinese Companies' Homecoming to Buoy Mainland, Hong Kong Exchanges*, S&P GLOB. (Sept. 19, 2022), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-listed-chinese-companies-homecoming-to-buoy-mainland-hong-kong-exchanges-72039466 ("[A]t least nine U.S.-listed Chinese companies, such as internet service provider Baidu Inc. and video-sharing mobile app Kuaishou Technology, have listed in Hong Kong ever since the [SEC] expressed concerns about allowing Chinese companies to remain listed if they fail to meet U.S. auditing standards. . . . [F]ive other Chinese state-owned companies, including China Life Insurance Co. Ltd. and oil giant China Petroleum & Chemical Corp., have said they planned to de-list from the U.S.").

[91] 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, 4:58 AM), 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, 5:41 AM), 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

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 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).

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).[92] 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.[93] Either way, U.S. investors lose.

ii. 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.[94] 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

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., and Bilibili Inc., converted their secondary Hong Kong listing into a primary listing status. *See* U.S.-China Review Comm'n Report, *supra* note 21, at 4–5.

[92] *See* Chong Koh Ping & Alexander Osipovich, *NYSE to Delist Chinese Telecom Carriers After Rejecting Appeals*, Wall St. J. (May 7, 2021, 6:35 PM), https://www.wsj.com/articles/nyse-to-delist-chinese-telecoms-carriers-after-rejecting-appeals-11620394719?page=1 (reporting that U.S. investors who didn't sell their shares in delisted Chinese companies cannot trade them because their brokerages don't support international brokerage accounts).

[93] *See* Chong Koh Ping, *Looming Delisting Jolts Chinese Telecom Stocks*, Wall St. J. (Jan. 4, 2021, 9:53 PM), https://www.wsj.com/articles/chinese-telecom-stocks-fall-as-u-s-delisting-looms-11609734838 (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).

[94] *See* Jesse M. Fried & Matthew Schoenfeld, *Will China Cheat American Investors?*, Wall St. J. (Dec. 13, 2018, 6:45 PM), https://www.wsj.com/articles/will-china-cheat-american-investors-11544744711.

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.[95]

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 technology firms incorporate in the Cayman Islands,[96] a jurisdiction that affords investors much less protection than Delaware.[97] 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.[98] But the biggest problem is that neither U.S. nor Cayman court judgments can be enforced in China, where insiders and assets are based,[99] 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 transaction 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.

III. 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

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[95] *See id.*

[96] *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).

[97] *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).

[98] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 230–34.

[99] *See id.* at 228–30.

relationships with the Chinese Communist Party (CCP).[100] 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 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).[101] 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.[102]

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[100] On December 2, 2021, the SEC issued its Final Rules Amendment (effective January 10, 2022), amending Rule 405 (regulation S-T) and Forms 20-F, 40-F, 10-K of the Exchange Act, as well as Form N-CSR of the Investment Company Act, to implement the disclosure and submission requirements of the HFCA Act. *See* Holding Foreign Companies Accountable Act Disclosure, Release No. 34-93701, 86 Fed. Reg. 70027 (Dec. 9, 2021) (to be codified at 17 C.F.R. pts. 200, 232, 249) [hereinafter SEC Final Rules Amendments].

[101] Holding Foreign Companies Accountable Act § 2(i)(2)(B), 15 U.S.C. § 7214(i)(2)(B).

[102] 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 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 100.

Second, Section 3 requires an SEC-Identified Issuer that is a foreign issuer[103] 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.[104]

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.[105] 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."[106]

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.[107]

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.[108] Thus, such an issuer that uses a VIE structure, or any structure that results in additional foreign entities being

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[103] 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").

[104] Holding Foreign Companies Accountable Act § 3(b)(2)-(3), 15 U.S.C. § 7214a(b)(2)-(3).

[105] SEC Final Rules Amendments, *supra* note 100, at 70029.

[106] "Control" includes the terms "controlling," "controlled by," and "under common control with." *See* Securities Exchange Act of 1934, 17 C.F.R. § 240.12b-2.

[107] Holding Foreign Companies Accountable Act § 3(b)(4)–(5), 15 U.S.C. § 7214a(b)(4)–(5).

[108] SEC Final Rules Amendments, *supra* note 100, at 70031.

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, 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 registration statements.[109] 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;[110] none of them were 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 Sections 2 and 3 of the HFCA were grounded on something else other than investors' interests.

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.

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[109] The SEC clarified that they will not amend the disclosure requirements for registration statements. *See id.* at 70029–31.

[110] *See, e.g.*, Kroll Corp. Fin., China Transactions Insights (2022), 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).

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—*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 *are* owned or controlled by a foreign governmental entity.[111]

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 financial interest. However, Section 3 does not provide U.S. investors with new information, as this information is already disclosed pursuant to existing rules.[112]

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."[113] But SOEs generally disclose directors' party affiliation and background in the firm's annual reports.[114] 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

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[111] SEC Interim Final Rules, *supra* note 102, at 17531. This did not exempt those issuers that are SEC-identified *foreign* issuers from complying with the disclosure requirements under Section 3 of the Act. *Id.*

[112] *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.").

[113] Holding Foreign Companies Accountable Act § 3(b)(4).

[114] *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).

elsewhere,[115] 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 committees in the firm.[116] This requirement applies to all SOEs, including those listed on foreign exchanges.[117] Thus, to comply with Chinese law,[118] SOEs have amended their articles of association,[119] a change that had to be disclosed to the SEC and to U.S. investors even before the HFCA Act.[120]

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[115] Tamar Groswald Ozery, *The Politicization of Corporate Governance—A Viable Alternative?*, 70 Am. J. Compar. L. 43, 60–68 (2022) [hereinafter Groswald Ozery, *Politicization of Corporate Governance*] (detailing changes under Chinese law and the corporate governance roles of such Party committees).

[116] *See* Zhonggong Zhongyang, Guowuyuan guanyu Shenhua Guoyou Qiye Gaige de Zhidao Yijian, (中共中央、国务院关于深化国有企业改革的指导意见) [CPC Central Committee and State Council Opinions on Deepening the Guidance of State-Owned Enterprise Reform] art. 7(24) (Aug. 24, 2015); Guanyu Zhashi Tuidong Guoyou Qiye Dangjian Gongzuo Yaoqiu Xieru Gongsi Zhangcheng de Tongzhi (关于扎实推动国有企业党建工作要求写入公司章程的通知) [Notice Regarding the Promotion of the Requirements of Incorporation of Party Building Work into the Articles of Associations of State-owned Enterprises] (promulgated by Org. Dep't CCP & Party Comm. SASAC, Mar. 15, 2017).

[117] Groswald Ozery, *Illiberal Governance*, *supra* note 20, at 978–79.

[118] *See U.S. Investment in China's Capital Markets and Military-Industrial Complex: Hearing Before the U.S.-China Econ. & Sec. Rev. Comm'n*, 117th Cong., 11 (2021) (statement of Tamar Groswald Ozery, Fellow, Harvard L. Sch. Prog. on Corp. Governance) [hereinafter Groswald Ozery, USCC Testimony], https://www.uscc.gov/sites/default/files/2021-03/Tamar_Groswald_Ozery_Testimony.pdf.

[119] 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 Stud. 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. See also Zhuang John, Liu, and Angela Huyue, Zhang, *Ownership and Political Control: Evidence from Charter Amendments*, 60 Int'l Rev. L. & Econ. 105853 (2019).

[120] 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 26, 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 Announcement No. 2 China Sec. Reg. Comm'n, 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'n, 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, Conyers 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, 3019). 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.

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 investors, who never would have had any reason to believe that reverse merger firms were *formally* controlled by the Chinese authorities.[121]

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.[122] 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.[123] 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).[124] Since technology firms are domiciled outside China (typically in the Cayman Islands) and the

& Sec., *Annual Report on Form 20-F*, Thomson Reuters Prac. L., 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).

[121] As we explain in more detail in Section III.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).

[122] *Supra* notes 100–05.

[123] *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").

[124] *Id.* § 3(b)(2), 15 U.S.C. § 7214a(b)(2).

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.[125] 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 organization documents.[126] In any event, when technology firms go public in the US, they already disclose to the SEC and investors their articles of association,[127] 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.[128] 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.[129] Such information was not disclosed prior to the Act, 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, unlike the HFCA Act, the SEC's Final Rules Amendments did apply the disclosure rules about government ownership to any affiliate of a technology firm, including China-based affiliates.[130] Such information had not been disclosed before, and the SEC's Final Rules Amendments, therefore, provides new information. Information that we believe is of little use to investors.

To the extent Chinese state entities have a minority interest in an on-shore firm, the Chinese government is afforded "boosted" rights, regardless of the

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[125] *Id.* § 3(b)(5), 15 U.S.C. § 7214a(b)(5).

[126] *See* Chen Qingqing, *Concerns over Alibaba Founder's Party Membership Reflect Lack of Knowledge of CPC Grassroots Functions: Experts*, People's Daily Online (Nov. 28, 2018, 8:27 PM), https://web.archive.org/web/20230131080317/http://en.people.cn/n3/2018/1128/c90000-9522707.html. There is no mention of such party branches, committees, or cells in the articles of association and annual reports of Alibaba Group Holding Limited, the Cayman Island U.S.-issuer. *See* Alibaba Grp. Holding Ltd, Annual Report (Form 20-F) (July 26, 2022).

[127] *See* 15 U.S.C. § 78l(b)(2) (requiring disclosure of the articles of incorporation for publicly traded securities).

[128] *See supra* note 120.

[129] SEC Final Rules Amendments, *supra* note 100, at 70040.

[130] *Id.* 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 Holding Foreign Companies Accountable 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.

percentage of equity it holds.[131] 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.[132] In addition, directors, supervisors, and senior managers in such firms owe a form of fiduciary duty not 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.[133]

In addition to the general boosted rights above which are afforded to the Chinese government in any state-invested China-domiciled firm, and therefore also in China-based affiliates of the technology firms, the Chinese government developed another way to extend its control rights specifically in technology firms that operate in data-rich internet and media spaces.

In recent years, several major media tech companies have accepted investments from designated government investment funds through a special arrangement that in return assigns a relevant government agency with a "golden share" (*Jingu*, 金股), also known as "special management shares" (*teshu guanligu*, 特殊管理股).[134] Under such arrangement, the state's investment, representing less than 1% of the company's equity, gives the government agency the right to appoint at least one director to the board or to veto certain corporate decisions.[135] Among the firms that have adopted, or are in the process of adopting such mechanism are two of Alibaba's subsidiary companies; subsidiaries of the online video sharing platform Bilibili and of the digital freight platform Full Truck Alliance.[136] All three, Alibaba, Bilibili, and Full Truck Alliance, are U.S.-listed technology firms incorporated in the Cayman Islands.

These investment arrangements give the Chinese party-state leverage over the operating companies in which it invests, regardless of the extent of

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[131] For the nature and legal source of such boosted rights see, Groswald Ozery, USCC Testimony, *supra* note 118, at 7–8.

[132] *See* Zhonghua Renming Gonghe Guo Qiye Gouyou Zichan Fa (中华人民共和国企业国有资产法) [Law of the People's Republic of China on the State-Owned Assets of Enterprises] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009) [hereinafter SOE Assets Law]; *see also id.* arts. 22(3), 23, 27, 51, 53.

[133] *See id.* arts. 17, 26, 71.

[134] Following China's 2013 State Council Pilot Program for Preferred Shares, one of us identified the possible coming development of a Golden Share mechanism in China, see Tamar Groswald Ozery, *Minority Public Shareholders in China's Concentrated Capital Markets-A New Paradigm,* 1 Colum. J. Asian L. 30, 48–49 (2016).

[135] *See Authorities are Tightening Their Grip in the Private Sector*, The Economist (Nov. 18, 2021), https://www.economist.com/business/chinas-communist-authorities-reinvent-state-capitalism/21806311.

The investment trend of state investment funds taking less than 5 percent in private, primarily tech, companies has been in practice since at least 2015. The golden share mechanism is more commonly used since 2021 and seems to be an extension of such practice, granting decision making participation rights specifically tailored to online media platforms and data rich companies.

[136] *China Moves to Take 'Golden Shares' in Alibaba and Tencent Units*, Fin. Times (Jan. 12, 2023), https://www.ft.com/content/65e60815-c5a0-4c4a-bcec-4af0f76462de.

its ownership interest, and by extension over their affiliated U.S.-listed issuer. Disclosure of the percentage of shares owned by the government in China-based affiliates of a technology firm (Section 3(b)(2), together with the SEC's Final Rules Amendments), therefore, might yield new information.[137] But the opacity of the arrangements whose bases lie outside the transparent and easily accessible corporate law framework, makes understanding their nature based on U.S.-laws ownership and control tests alone, impossible, and highlight that such disclosures are of little use.

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

2. Failure to Reveal the 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 potential China's party-state control over a technology firm.[138] The party-state can exert control over any firm through (a) PRC Company Law, or 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."

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[137] 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 100. 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 118, 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 119, at 34 (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).

[138] 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 118, at 3–5.

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 application of PRC domestic law. In particular, PRC Company Law mandates a social responsibility obligation on all companies.[139] Indeed, Chinese firms are pressured to contribute to national goals even in firms with no state ownership.[140] 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.[141]

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.

i. Board-Level Ties

The CCP has over ninety million members, individuals typically selected when they are young adults based on academic achievement, community

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[139] PRC Company Law, *supra* note 26, 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.").

[140] For example, in the recent Covid-19 context, firms were mobilized to shift production lines to combat the spread of Covid-19. Finbarr Bermingham & Su-Lin Tan, *Coronavirus: China Ramps up Mask Production, and Reminds World it is Manufacturing King*, InkStone News (Mar. 12, 2020), https://www.inkstonenews.com/business/coronavirus-china-ramps-mask-production-and-reminds-world-it-manufacturing-king/article/3074900. Private firms are similarly mobilized in pursuit of Xi Jinping's poverty alleviation campaign. *See*, Yang Xuemin, *How Do Companies Help Alleviate Poverty in China?*, CGTN (Sep. 13, 2020, 5:24 PM), https://news.cgtn.com/news/2020-09-13/How-do-companies-help-alleviate-poverty-in-China--TKAtK-zLUJ2/index.html.

[141] Zhonghua Quanguo Gongshangye Lianhe Hui (中华全国工商业联合) [All-China Federation of Industry and Commerce] 2020 Zhongguo Minying Qiye 500 Qiang Fabu Baogao (2020中国民营企业500强发布报告) [China Top 500 Enterprises 2020 Survey and Analysis Report] (2020), https://web.archive.org/web/20220506015518/http://www.acfic.org.cn/zzjg_327/nsjg/jjb/jjbgzhdzt/2020my5bq/2020my5bq_bgbd/202009/W020200910356331413523.pdf. Alibaba's enlistment to China's poverty alleviation and rural vitalization, two of President Xi's recent national priority campaigns, is one example. *See* Xubei Luo, *E-Commerce for Poverty Alleviation in Rural China: From Grassroots Development to Public-Private Partnerships*, World Bank Blogs (Mar. 19, 2019), https://blogs.worldbank.org/eastasiapacific/e-commerce-poverty-alleviation-rural-china-grassroots-development-public-private-partnerships.

service, reputation, and the results of an ideological examination.[142] Because of the CCP's selection process, and the tightening of linkages encouraged between the Party and the private sector, particularly entrepreneurs,[143] there is likely to be substantial and increasing overlap between board directors and CCP members.[144]

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.[145] 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).[146] 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.

ii. 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

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[142] *See* R.W. McMorrow, *Membership in the Communist Party of China: Who is Being Admitted and How?*, JSTOR Daily (Dec. 19, 2015), https://daily.jstor.org/communist-party-of-china/; Neil Thomas, *Members Only: Recruitment Trends in the Chinese Communist Party*, MacroPolo (July 15, 2020) (noting that "[t]he CCP has a rigorous selection process for applicants, who must pass a battery of tests, interviews, investigations, votes, and probation over a 2-3 year period before becoming full members," and that the admittance process under Xi Jinping has become more rigorous, admitting fewer new members each year as an emphasis on "quality" increases).

[143] *See, e.g.*, Zhonggong Zhongyang Bangongting (中共中央办) [The Central Committee of the CCP], Guanyu Jiaqiang Xin Shidai Minying Jingji Tongzhan Gongzuo de Yijian (关于加强新时代民营经济统战工作的意见) [The Opinions on Strengthening the United Front Work of the Private Economy in a New Era] Sec. III(7) (Sep. 15, 2020), http://www.gov.cn/zhengce/2020-09/15/content_5543685.htm ("Give full play to the exemplary role of Party members among private entrepreneurs."); Zhonggong Zhongyang, Guowuyuan (中共中央, 国务院) [The Central Committee of the CCP and the State Council], Guanyu Yingzao Qiyejia Jiankang Chengzhang Huanjing Hongyang Youxiu Qiyejia Jingshen Geng Hao Fahui Qiyejia Zuoyong de Yijian (关于营造企业家健康成长环境弘扬优秀企业家精神更好发挥企业家作用的意见) [Opinions of the CPC Central Committee and the State Council on Creating a Sound Entrepreneur Growth Environment, Advocating Excellent Entrepreneurship and Better Using Entrepreneurs' Role] (Sept. 8, 2017), http://www.gov.cn/zhengce/2017- 09/25/content_5227473.htm.

[144] *See generally* Bruce Dickinson, Wealth into Power: The Communist Party's Embrace of China's Private Sector (2008) (terming this "crony-communism").

[145] SEC Final Rules Amendments, *supra* note 100, 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.*

[146] 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, 680 (2012).

there are at least three CCP members.[147] Such committees are widespread.[148] 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").

The Party committee has several designated corporate governance roles including corporate oversight and disciplinary functions, overseeing legal compliance, and participating in the firm's decision-making process in certain circumstances. The Party committee, therefore, gives the CCP the capacity to advance its interests within the firm.[149] While historically, throughout China's opening-up reforms, the CCP did not deploy this capacity outside several important SOEs, in recent years it has begun to establish its presence across firms more systematically, including in non-state firms.[150]

As noted, this capacity can exist regardless of the provisions in the firm's organizing documents, particularly in non-SOE firms.[151]

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[147] 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), https://perma.cc/GKD4-6DBS; PRC Company Law, *supra* note 26, 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.").

[148] China's official surveys show that over 92% of China's top 500 private enterprises (or, more accurately, civil enterprises or "people-run" enterprises (*minying qiye*)) have a Party organization. Zhonghua Quanguo Gongshangye Lianhehui (中华全国工商业联合会) [All-China Federation of Industry and Commerce], Woguo Minying Qiye Dangzuzhi Jianshe Xianzhuang Fenxi Baogao (我国民营企业党组织建设现状分析报告) [An Analysis Report about the Status of Building Party Organizations in Civilian-Run Enterprises] (May 23, 2019), https://archive.ph/H4mys; Zhonghua Remin Gongheguo Zhongyang Renmin Zhengfu (中华人民共和国中央人民政府) [The State Council of the People's Republic of China], Quanguo Gongshanglian Fabu 2020 Zhongguo Minying Qiye 500 Qiangd Diaoyan Fenxi Baogao (全国工商联发布《2020中国民营企业500强调研分析报告》) [All-China Federation of Industry and Commerce Research & Analysis Report: 2020 Top-500 Chinese Civilian-run Enterprises] (Sept. 10, 2020), https://archive.ph/UhzCq.

[149] On the corporate governance roles of the corporate Party committee and other political governance levers that the CCP holds over firms, see Tamar Groswald Ozery, Law and Political Economy in China: The Role of Law in Corporate Governance and Market Growth 96, 205–26 (2023).

[150] *See* Groswald Ozery, *Politicization of Corporate Governance*, *supra* note 115, at 54–66 (reviewing the legal origin of the Party capacity in firms and its recent expansion); Jake Laband, *Fact Sheet: Communist Party Groups in Foreign Companies in China*, China Bus. Rev. (May 31, 2018), https://www.chinabusinessreview.com/fact-sheet-communist-party-groups-in-foreign-companies-in-china/ (discussing China's plans to put CCP organizations in foreign-owned firms operating in China as well); *Weihe Minying Hulianwang Qiye Chengli Dang Zuzhi yi Cheng Jingpen zhi Shi* (为何民营互联网企业成立党组织已呈井喷之势) [Why is the Establishment of Party Committees by Private Internet Companies Surging?], Sina News (Mar. 26, 2018), https://web.archive.org/web/20230131083045/https://news.sina.cn/gn/2018-03-26/detail-ifysrnnk1362359.d.html (noting the rising trend of establishing Party cells and employing party members in private data platform companies); Lin & Milhaupt, *supra* note 119.

[151] *See* Lin & Milhaupt, s*upra* note 119, at Section III.D.1.

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 firms.[152] These informal ways include ideological messaging and party-line education to inform managers what is expected of them, monitoring to ensure compliance,[153] and the use of carrots and sticks to reward and punish individuals in light of Party expectations and priorities.[154] 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.[155]

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.[156] Sometimes, these crackdowns are initiated through

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[152] *See* Groswald Ozery, *supra* note 115 (explaining how the CCP deploys various corporate governance capacities that substitute for the functions of conventional corporate governance institutions, both inside and outside firms).

[153] A promising yet still forming tool to induce compliance is the corporate social credit system (*qiye shehui xinyong tixi*, 企业社会信用体系) which aims to evaluate and score the "creditworthiness" of Chinese businesses. The idea has been a subject for experimentation in various localities for more than a decade and has not been authorized at the national level as of yet. Nonetheless, the system has the potential to become one of the primary, systematic and data-driven tools for imposing fear governance on firms and their insiders. For an analysis of the implementation of the system in Zhejiang Province and potential implications for firms, *see* Lin, Lauren Yu-Hsin, and Curtis J. Milhaupt, *China's Corporate Social Credit System: The Dawn of Surveillance State Capitalism?*, 256 China Q. 835 (2021).

[154] Groswald Ozery, *Illiberal Governance*, *supra* note 20, at 967–91 (discussing the use of carrots and sticks in Chinese firms, such as political managerial incentives, to skew incentives and modify managerial behavior).

[155] For the potential broad market effects of China's politicized corporate governance mechanisms, see Groswald Ozery, *supra* note 115, at 88-92.

[156] *See, e.g.*, George Calhoun, *The Sad End of Jack Ma Inc.*, Forbes (June 7, 2020), https://www.forbes.com/sites/georgecalhoun/2021/06/07/the-sad-end-of-jack-ma-inc/?sh=6de4e994123a; *but see* https://www.thewirechina.com/2021/03/14/chinas-regulatory-war-on-ant/ (positioning the recent crackdown on Jack Ma's payment group—Ant Group, an Alibaba affiliate—as a regulatory catch-up); Kerry A. Dolan, *Why Being A Billionaire In China Comes With The Risk of Disappearance, Arrest or Worse*, Forbes (Oct. 26, 2016), https://www.forbes.com/sites/kerryadolan/2016/10/26/why-being-a-billionaire-in-china-comes-with-the-risk-of-disappearance-arrest-or-worse/?sh=1a6b87571bfb (recounting the troubles of Hua Bangsong, Guo Guangchang, Zhou Chengjian, and Xu Ming); James Palmer, *Who Is Guo Wengui, the Chinese Émigré with Links to Steve Bannon?*, Foreign Pol'y (Aug. 26, 2020), https://foreignpolicy.com/2020/08/26/guo-wengui-chinese-billionaire-emigre-links-steve-bannon/.

the CCP's anti-corruption processes carried outside the formal legal system.[157] 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.);[158] Wu Xiaohui, the politically connected and 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;[159] and Xiao Jianhua, a billionaire financier who operated a secretive network of financial businesses and engaged with the top echelon of the CCP,[160] and then was allegedly kidnaped and had his financial conglomerate Tomorrow Group dismantled and the group's businesses taken over by various authorities.[161]

More recently, fear governance has been used to pressure managers to align with the shifting national development priorities of the Party-state:[162] 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.[163] Similarly, in what appears to be an effort to stay in the Chinese Government's good

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[157] On the use of the CCP's anti-corruption apparatus as an alternative corporate governance mechanism and its recent legalization see Groswald Ozery, *supra* note 115, at 68–78.

[158] 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), https://www.scmp.com/business/companies/article/3022905/missing-oil-tycoon-ye-jianmings-firm-faces-delisting-china-18.

[159] Michael Forsythe & Jonathan Ansfield, *A Chinese Mystery: Who Owns a Firm on a Global Shopping Spree?*, N.Y. Times (Sept. 1, 2016), https://www.nytimes.com/2016/09/02/business/dealbook/anbang-global-shopping-spree-china-mystery-ownership.html.

[160] Michael Forsythe & Paul Mozur, *A Video, a Wheelchair, a Suitcase: Mystery of Vanished Tycoon Deepens*, N.Y. Times (Feb. 10, 2017), https://www.nytimes.com/2017/02/10/world/asia/xiao-jianhua-hong-kong-disappearance.html.

[161] David Barboza, *China Seizes Tycoon's Assets*, Wire China (July 17, 2020), https://www.thewirechina.com/2020/07/17/china-seizes-tycoons-assets/; *see also* Alexandra Stevenson, *Chinese Canadian Billionaire Sentenced to 13 Years for Financial Crimes*, N.Y. Times (Aug. 19, 2020), https://www.nytimes.com/2022/08/19/business/chinese-canadian-billionaire-xiao-jianhua-sentenced.html (reporting that Xiao Jianhua was sentenced to 13 years in prison and his company fines $8 billion).

[162] *See* Laura He, *China's Biggest Private Companies are in Chaos. It's All Part of Beijing's Plan*, CNN Bus. (Aug. 4, 2021, 1:17 AM), 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).

[163] *See* Yue Wang, *Hui Ka Yuan Uses $1 Billion of Personal Fortune to Help Embattled Evergrande*, Forbes (Nov. 22, 2021, 9:52 AM), https://www.forbes.com/sites/ywang/2021/11/22/hui-ka-yan-uses-1-billion-of-personal-fortune-to-help-embattled-evergrande/?sh=319a0c9162b2 ("The billionaire is believed to be under government pressure to make good on Evergrande's financial obligations and avoid being held personally culpable.").

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.[164]

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[165] it may wish to prevent expropriation in the future (as recent regulatory tightening may suggest),[166] 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.[167]

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[164] *See* Frances Yoon, *Alibaba Pledges $15.5 Billion as Chinese Companies Extol Beijing's 'Common-Prosperity' Push*, Wall St. J. (Sept. 3, 2021, 12:57 AM), https://www.wsj.com/articles/alibaba-pledges-15-5-billion-as-chinese-companies-extol-beijings-common-prosperity-push-11630587923; Keith Zhai & Stella Yifan Xie, *China's Communist Party Goes Back to Basics: Less for the Rich, More for the Poor*, Wall St. J. (Aug. 18, 2021, 11:06 PM), https://www.wsj.com/articles/chinas-xi-eyes-return-to-communist-party-roots-amid-private-sector-crackdown-11629289611?mod=article_inline.

[165] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 4.

[166] 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 extra jurisdictionally. Zhonghua Renmin Gongheguo Zhengquan Fa (中华人民共和国证券法) [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, 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* note 18, at 5 (highlighting measures for "Further Strengthening Cross-border Cooperation in Law Enforcement and Administration of Justice"); Measures for the Administration of Overseas Issuance and Listing of Securities by Domestic Enterprise, *supra* note 17 (purporting to enhance regulatory oversight over firms' issuances off-shore, including specifically with respect to the use of questionable registration structures such as VIEs).

[167] *See* Groswald Ozery, *Illiberal Governance*, *supra* note 20, 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

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.[168] Such presence can 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 increase 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.[169]

IV. Our Suggested Way Forward

As we discussed above, the disclosure rules of the HFCA Act are based on a parochial view of ownership and control which relies on the American corporate governance model and thus generates little useful information about how China-based firms are governed. The ties of China-based U.S.-listed firms to the Chinese party-state cannot be made clearer by requiring disclosures that focus on charter provisions, shareholders, and board members. These are perhaps the most important indicia of control and ownership for U.S.-domiciled firms, but they are only the outer, facially convergent, layer of an inherently divergent Chinese corporate governance system.[170] Indeed, as we explained, Congress itself did not seem to believe that the required information is material to investors. We therefore suggest doing away with the added disclosure rules, as they generate costs while not making investors better informed. Quite the contrary, the disclosure rules could actually mislead investors into underestimating, or overestimating, the risks of party-state influence in any given firm.

One might argue that the HFCA Act's disclosure rules should thus be "improved" so that they can provide useful information about China-based firms trading in the United States. But improving these disclosure rules would be impractical, costly, and simply futile. Even an "improved" fine-tuned disclosure regime would not capture the full idiosyncrasies of how the party-state governs Chinese firms and thus fail to inform investors about related financial risks. And even if improved disclosure rules could shed some further new light on party-state linkages, the information would be of limited use. Most

providing protection to investors, including foreign investors in foreign-listed China-based firms).

[168] *See* Groswald Ozery, *supra* note 115 (explaining how politicized corporate governance in China provides functional substitutes for traditional growth-supporting corporate governance mechanisms).

[169] For a discussion of related studies, see Groswald Ozery, *Illiberal Governance*, *supra* note 20, at 987–91.

[170] Groswald Ozery, *supra* note 149, Chapters 7–8.

investors are unlikely to be able to make useful calculations about the possibility that the party-state would indeed exert its power over any particular firm, and whether such influence would help or hurt investors. There is simply too much uncertainty inherent in the Chinese governance system itself and too much opacity around its working mechanisms. Translating party-state ties into grounded financial risk assessments is virtually impossible, except perhaps for asset management firms with a Chinese focus. Indeed, sophisticated U.S. investors appear to be aware of some of these risks and seem to discount the price or hedge against them accordingly.[171] Other investors are put on notice of "regulatory uncertainty" risks in firm's public disclosures.[172]

That said, it might be desirable to increase the disclosure obligations of China-based firms along other dimensions. Currently, almost all China-based firms trading in the United States are treated as foreign private issuers subject to much lighter disclosure obligations than domestic issuers—in terms of both the frequency and extent of disclosure.[173] If the U.S. government believes that U.S. investors need the frequency and extent of disclosure required of domestic issuers, it stands to reason that China-based firms listing in the United States (or, for that matter, firms from other countries) should not be allowed to provide less disclosure than is believed to be optimal.[174]

As we also explained, the delisting rule of the HFCA Act is more likely to harm than to help U.S. investors. If, as we fear is likely, China eventually prevents PCAOB inspections, the Act will harm U.S. investors by forcing value-destroying delistings. Controllers of China-based firms will engage in confiscatory take private transactions from which the U.S. legal system is unable to protect local investors. Instead of forcing currently-trading firms to delist if the PCAOB cannot inspect their auditor, efforts should be made to treat the main problem—that insiders of China-based firms are law-proof from the perspective of U.S. investors and regulators. We suggest that the U.S. government try to pressure China to cooperate around enforcement in fraud and expropriation cases. At the same time, Congress should consider barring *future* listings from countries that impede PCAOB inspections or otherwise

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[171] For example, mitigating informational inefficiencies and market opacity through other informational signals. *See* Groswald Ozery, *Illiberal Governance*, *supra* note 20, at 970 n.169 (pointing to foreign institutional investors' reliance on state investment and connections to the party-state as proxies for evaluating financial risks where information is lacking).

[172] For examples, see the Annual Report of Alibaba, Pinduoduo, Baidu and Yum China and their risk disclosures on regulatory uncertainty surrounding their China operations. Alibaba Grp. Holding Ltd, Annual Report (Form 20-F) 30–32 (July 21, 2023); PDD Holdings Inc., Annual Report (Form 20-F) 23–25, 27–29, 45–46 (April 26, 2023); NetEase Inc., Annual Report (Form 20-F) 7, 46–53 (April 27, 2023); Baidu Inc., Annual Report (Form 20-F) 17, 59–68 (March 22, 2023); Yum China Holdings Inc., Annual Report (Form 20-F) 41–44, 52–53 (March 1, 2023).

[173] *See* Fried & Kamar, *Law-Proof Insiders*, *supra* note 20, at 253–58 (discussing a pro-foreign bias in U.S. Securities Laws and discussing the option of leveling the playing field).

[174] Less disclosure could be permitted for issuers with a primary listing in a jurisdiction that requires and enforces a similar high standard of reporting.

frustrate the pursuit of cross-border wrongdoers. 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.

One could argue that a future ban of China-based firms is unnecessary, as investors can rely on the market to "price" enforcement risk. A market "true believer" would say that a firm will choose the optimal enforcement and disclosure regime to obtain the highest price when selling its shares and, if it fails to do so, investors will pay a lower price that will compensate them ex ante for the higher risk. On this view, barring future listings would create distortions and inefficiencies by interfering with a healthy market. But, for better or for worse, the U.S. securities regime does not embrace this view; domestic issuers are not permitted to calibrate the level of disclosure and enforcement, but rather forced to adopt a "one-size-fits-all" approach. We would have no problem allowing Chinese firms to be law-proof if domestic issuers could make similar choices (by, for example, waiving liability for breaching securities laws). The key point is that rules, and their enforcement, should be uniformly applied.

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;[175] 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 the HFCA Act's disclosure rules do not apply at the IPO and are waived in any year where the PCAOB can inspect China-based

[175] However, the party-state's calculus as to whether to exercise such power depends on the specific context. For a discussion of the political and economic costs which may reserve the party-state back from interfering at the individual firm level, see Groswald Ozery, USCC Testimony, *supra* note 118.

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.