

An Offshore Perspective on the Impact of New US-PRC Laws on China VC

Where Things Are

PRC Summary

The current regulatory regime for overseas issuances of listed securities was promulgated in 1994, revised in 2019 and supplemented by various rules by the People's Republic of China ("PRC") Government, the China Securities Regulatory Commission ("CSRC"), Cyberspace Administration of China ("CAC"), National Development and Reform Commission ("NDRC") and Ministry of Commerce ("MOFCOM"), respectively, in 2021 and 2022, which, on the whole, are still in draft form – CAC issued on 7 July 2022 supervisory measures for security assessment of cross-border transfers with respect to the export of relevant data (including relating to national security) and personal information. The overseas issuances of listed securities, relating to, and matters of, national security, state secrets, data security, confidentiality, personal information of more than one million users, cybersecurity and prohibited business approval (negative list), are the chief concerns of the PRC authorities which the various proposed laws and regulations seek to address.

Although independent in nature, many of the laws and regulations relate to what the US authorities are also doing, in particular, the CSRC's Provisions on Strengthening Confidentiality and Archives Administration of Overseas Securities Offering and Listing by Domestic Companies, issued on 2 April 2022, which seeks to implement a confidentiality system for relevant participants (e.g. auditors, the companies themselves) and minimises

unnecessary confidential and sensitive information (including state secrets) from being disclosed in audit working papers.

US Summary

At the time of writing, around 261 Chinese companies are listed on US exchanges. In December 2021, the Public Company Accounting Oversight Board ("PCAOB") determined that all registered audit firms headquartered in mainland China or Hong Kong were not accessible to the PCAOB. In the past year, the PCAOB reported that approximately 223 audit reports issued by or relying on referred work from PCAOB-registered firms in jurisdictions where authorities deny access to conduct inspections; and 166 were from mainland China and 57 from Hong Kong.

More than 135 companies that relied on auditors headquartered in mainland China and Hong Kong have been deemed (conclusively) to be 'non-compliant' by the PCAOB, for their FY 2021 annual report filings. Under the Holding Foreign Companies Accountable Act ("HFCAA"), companies identified by the US Securities and Exchange Commission ("SEC") in 2022 are on track to being subject to a securities trading ban and probable delisting from US exchanges by 2024 (their third consecutive year of identification), unless in the meantime they either retain an auditor the PCAOB is able to inspect or the PCAOB changes its determinations regarding its access to audit firms in mainland China and Hong Kong.

The US Congress is currently considering legislation to expedite the process under the Accelerating the Holding Foreign Companies Accountable Act which would accelerate the imposition of the SEC's trading ban on identified issuers from three consecutive years of identification to two years, and the US House of Representatives has also indicated its approval for this policy as part of the America Competes Act and the Bipartisan Innovation Act. If enacted, that would mean trading bans would take effect in 2023.

Recent press coverage has indicated that the PCAOB and Chinese regulators (CSRC / MOFCOM) as well as the SEC appear to be *actively* negotiating an agreement on PCAOB access to audit firms based in mainland China and Hong Kong. However, the SEC Director, YJ Fischer, recently commented¹ that time is running out and that even if an agreement is signed among the PCAOB and the Chinese authorities, it would only be a first step. Assuming an agreement is reached, PCAOB inspections will have to be completed this year before the PCAOB determines whether audit firms based in mainland China and Hong Kong are accessible to it.

Impact on Offshore Listings

The current and prospective impact of the new US-PRC laws and regulations on Cayman structured China VC companies mean that issuers must now consider different strategies:

- Companies switching to a US-based auditor / US-based audit firms conducting the China-based company audits by using their China-based affiliate to conduct a portion of the audit and rely on that work to issue an audit report;
- Delisting, take private and or dual listings – in particular, Hong Kong Stock Exchange ("HKSE") Primary listing; and
- PRC listings - CDRs on Shanghai Stock Exchange Science and Tech Board

("STAR Market") and the Shenzhen Stock Exchange.

VIE Structures

Current regulations in mainland China limit or prohibit foreign investment in Chinese companies operating in certain industries. For example, there are restrictions on foreign ownership in certain internet-related businesses and telecommunications companies and prohibitions on ownership of educational institutions. To navigate through the relevant restrictions, many China-based issuers form non-Chinese holding companies that enter into contractual arrangements, through its wholly foreign-owned enterprise (WFOE), intended to represent direct ownership with its Chinese operating company. Through these contractual arrangements, the China-based issuer is generally able to consolidate the Chinese operating company, commonly referred to as a variable interest entity ("VIE"), in its financial statements, although whether the China-based issuer maintains legal control of the Chinese operating company is a matter of Chinese law. Under the VIE structure, the Chinese operating company, which the China-based issuer cannot hold an equity interest in, typically holds licences and other assets that the China-based issuer is unable to hold directly.

SEC Statement

Based on recent annual report filings, approximately 184 Chinese companies listed on US exchanges use a VIE structure. On 30 July 2021, the SEC published a statement with respect to investor protection *vis-à-vis* VIE structures, stressing the importance of ensuring complete and accurate disclosure in the registration statement filed by China-based operating companies, particularly those structured as variable interest entities. The SEC's concerns relate to the fact that investors may not be aware that they simply own shares in a Cayman Islands company but not in the underlying China operating company. The SEC

¹ www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422

will require more disclosure on the VIE structure and its relationship to, in particular, the Cayman Islands (which most VIE structures are) US-listed company including the VIE ownership structure, consolidated accounts, whether the company has been denied the right to list in the US by PRC authorities, and specifically that company accounts may be inspected which could result in a delisting.

Impact on Series Financings Transactions and Listings

The market remains fluid however:

- We are still seeing a reasonable flow of Series financings / pre-IPO deals going to market which for some may, in any event, be the only viable exit available to them and *jittery* investors;
- In terms of overall environment for VC (early, midterm, pre-IPO) and M&A transactions in China, it is challenging, and is likely to remain that way in the short-term; and
- When the dust settles, we would hope to see investors start to adjust and target more 'encouraged' sectors (e.g. hardware, cloud, AI, robotics, advanced manufacturing, semi-conductors, health care)

Listing options - we would expect that:

- Listings of Cayman Islands and British Virgin Islands ("BVI") companies in the US would continue although under a changing and evolving landscape – we are still seeing clients bringing prospective listings to market both on NYSE and NASDAQ including primary listings and special purpose acquisition companies (SPACs); and
- Consideration may be given to:

- (a) HKSE listings as a potential alternative listing venue – PRC companies have benefitted from the new HKSE weighted voting rights ("WVR") regime – Maples Group acted for, among others, Xiaomi Corporation which was the first company to list on the HKSE with a WVR structure since the HKSE revised its listing rules to permit such listings;
- (b) Dual listings on the HKSE - Maples Group represented, among others, JD.com², Baidu, Inc and Alibaba Group Holding Limited³ on each of their dual/secondary listing on the HKSE; and
- (c) PRC domestic listings including of Chinese Depositary Receipts ("CDRs") – Maples Group represented Ninebot Limited on the first ever initial public offering of CDRs on the STAR Market⁴.

Conclusion

As the leading firm acting for around 260 offshore companies listed in the US, and the market leader (with an overall market share of approximately 45% in 2022 to date) for HKSE listings, we believe Maples Group is well placed to assist our clients as we navigate through what is clearly a fluid and evolving space.

We have not seen that the various PRC and US legislation, and the ongoing shifting sands that is the legislative landscape in this space, presents insurmountable obstacles for issuers wishing to go to market, as we continue to see an interest in listings in the US and Hong Kong (including dual listings) as issuers adjust to what is clearly *the new world order* for Chinese companies wanting to list in the US and Hong Kong.

We do note that given the flexibility, certainty and light touch regulatory approach adopted in the Cayman Islands and the BVI, that as a consequence of changes to rules made by

² <https://maples.com/en/news/2020/7/maples-group-supports-jdcom-and-netease-on-the-largest-hong-kong-dual-listings-of-2020>

³ <https://maples.com/en/news/2019/11/maples-advises-alibaba-on-largest-hong-kong-ipo>

⁴ <https://maples.com/en/news/2020/10/maples-group-supports-e-scooter-producer-ninebot>

overseas regulators, we do not see that impacting the regulatory landscape in the Cayman Islands and the BVI, but we do see both continuing to be, as they always have been, best placed to respond to any challenges that may lie ahead.

If you would like further information please liaise with your usual Maples Group contact or:

Hong Kong

Everton Robertson

+852 3690 7424

everton.robertson@maples.com

August 2022

© MAPLES GROUP

This article is intended to provide only general information for the clients and professional contacts of the Maples Group. It does not purport to be comprehensive or to render legal advice.