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Breakthrough in US/China Auditing Dispute

Realindex Team

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A 20-year dispute between US and Chinese regulators regarding the auditing of Chinese-domiciled but US-listed securities could soon be resolved. There was a high risk prior to this breakthrough that over 200 Chinese securities with a market cap of $1.6 trillion would be delisted from US exchanges in early 2024 under the Holding Foreign Companies Accountable Act (HFCAA). Affected securities include Chinese tech giants Alibaba, Tencent, JD.com, NetEase and Baidu.com. Chinese authorities previously restricted the ability of overseas regulators to supervise Chinese auditors due to confidentiality laws and national security grounds. The Public Company Accounting Oversight Board (PCAOB) has recently signed a Statement of Protocol with the China Securities Regulatory Commission (CSRC) and the Ministry of Finance of the People's Republic of China governing inspections and investigations of audit firms based in China and Hong Kong. This agreement establishes a specific, accountable framework to make possible complete inspections and investigations by the PCAOB of audit firms based in China and Hong Kong, as required under US law. This allows the PCAOB to see all audit documentation without redaction even if Chinese authorities deem it sensitive. Prior to this agreement, there have been announcements of voluntary American Depository Security (ADS) delisting's including five of China's largest state-owned companies – PetroChina, China Petroleum & Chemical, China Life Insurance, Aluminium Corp of China and Sinopec Shanghai Petrochemical. There has also been an increase in Chinese securities with US listings obtaining a secondary listing in Hong Kong (HK) or converting their secondary HK listing to a primary dual listing structure. The ongoing regulatory uncertainty has undermined investor confidence in Chinese American Depository Securities (ADS). While this new agreement is an important step forward, it should be noted that the agreement itself does not satisfy the HFCAA. Compliance with the agreement is ultimately what matters and US regulators will be monitoring compliance. The news of an agreement has provided some relief to investors and is an important step forward in resolving this dispute after significant uncertainly.

Background

Public Company Accounting Oversight Board (PCAOB)

Under US federal securities laws, the financial statements of public companies must be audited by a registered public accounting firm. In turn, the PCAOB is charged with regularly inspecting and investigating these auditors. This was implemented in response to the Enron and WorldCom accounting scandals in the early 2000's under the US Sarbanes Oxley Act.

The PCAOB is a non-profit corporation established by the US Congress to oversee the audits of public companies in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

Until August 2022 every jurisdiction in the world that has companies listed in the US, except for mainland China and Hong Kong, agreed to allow the PCAOB access to the working papers of the auditors of their companies. This requirement had conflicted with a long-standing directive from China's authorities to its companies that restricted the ability of overseas regulators to supervise Chinese auditors due to confidentiality laws and national security grounds. This has now changed with the reaching of the agreement between the PCAOB and CSRC but was previously a sticking point between the two countries.

Holding Foreign Companies Accountable Act (HFCAA)

In 2020 the Nasdaq-listed Luckin Coffee, China's home-grown Starbucks lookalike, collapsed and massive accounting frauds were revealed. In response the US Congress with bipartisan support passed the Holding Foreign Companies Accountable Act (HFCAA) on 18/12/2020. It requires the US Securities & Exchange Commission (SEC) to "identify public companies that have retained a registered public accounting firm to issue an audit report where the firm has a branch or office that:

(1) is located in a foreign jurisdiction, and
(2) the Public Company Accounting Oversight Board ("PCAOB") has determined that it is unable to inspect or investigate completely because of a position taken by an authority in the foreign jurisdiction." [1]

In 2021, the PCAOB made determinations that the positions taken by Chinese authorities prevented the PCAOB from inspecting and investigating in mainland China and Hong Kong completely. In December 2021, the SEC mandated that Chinese companies listed on U.S. stock exchanges must disclose whether they are owned or controlled by a government entity, and provide evidence of their auditing inspections. The SEC in 2022 started publishing a list of companies that could face removal. As of 31/08/2022 there were 162 companies conclusively identified and 1 companies provisionally identified and published on the SEC website[2]. Under the act companies on this list will be banned from trading and delisted from US exchanges if the PCAOB is not able to audit specified reports for three consecutive years.[3]

The HFCAA could result in 261 Chinese companies with a total market cap of USD$1.6t[4] being delisted from US exchanges. As of 31st July 2022, there are 25 securities with a 0.33% weight in the MSCI ACWI index and 2.87% weight in the MSCI EM index that has a primary listing in the US that have been identified by the HFCAA.

In the event of delisting, the SEC advised that any "investors holding these securities will have severely limited opportunities to sell the securities, potentially affecting the value of the securities

[1] Definition of HFCAA - https://www.sec.gov/hfcaa
[2] List of Issuers identified under the HFCAA - https://www.sec.gov/hfcaa
[3] HFCAA - https://www.congress.gov/bill/116th-congress/senate-bill/945/text
[4] Chinese companies listed on the New York Stock Exchange, NASDAQ, and NYSE American - https://www.uscc.gov/research/chinese-companies-listed-major-us-stock-exchanges

significantly."[5] Therefore it is prudent that investors sell out or convert to an alternative line prior to the 3 year delisting date. There is also a bill currently under consideration in Washington that would accelerate the timeline by a year – forcing any Chinese company trading in the US to be banned when it files its next annual report, which usually happens in April. Some of the targeted Chinese companies have recently started to seek alternative listings in Hong Kong and have made announcements to delist from US exchanges.

Agreement between Regulators

Negotiations between regulators to solve the impasse have been ongoing for over 10 years with significant uncertainty that an agreement would be reached before companies were to be delisted. Tensions had been escalating but there was a breakthrough on 26th August 2022 when the PCAOB signed[6] a Statement of Protocol with the CSRC and the Ministry of Finance of the People's Republic of China (PRC) governing inspections and investigations of audit firms based in China and Hong Kong. This agreement establishes a specific, accountable framework for complete inspections and investigations by the PCAOB of audit firms based in China and Hong Kong, as required under US law. This agreement allows the PCAOB to see all audit documentation without redaction even if Chinese authorities deem it sensitive.

This agreement is an important first step, but it should be noted that the agreement itself does not satisfy the HFCAA. "Compliance with the agreement is ultimately what matters. If the PCAOB continues to be prohibited from conducting complete inspections and investigations of PCAOB-registered public accounting firms in China and Hong Kong, roughly 200 China-based companies will face trading prohibitions and likely delisting in the US"[7].

The statement[8] by the CSRC however, emphasized the principle for bilateral cooperation is "equal", and the U.S. side will have to obtain documents through the Chinese regulator, and have to involve and let the China side coordinate the interview and testimony taking. There could still be tension with complying with China's stringent data security rules but they "remain committed to working with the U.S. regulators to proactively advance the cooperation in a professional and pragmatic manner to achieve positive results with joint efforts."

As a result of this historic agreement, the PCAOB will reassess its determinations that Chinese & Hong Kong companies are not compliant with the HFCAA by the end of 2022.

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[5] SEC Investor Alert – HFCAA Companies - https://www.sec.gov/oiea/investor-alerts-and-bulletins/trading-prohibitions-foreign-companies-under-hfcaa-investor

[6] PCAOB Agreement 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

[7] SEC Q&A – SOP Agreement - https://www.sec.gov/files/china-sop-qa_0.pdf

[8] CSRC – Q&A on agreement CSRC Officials Answered Reporter Questions regarding China-U.S. Audit Oversight Cooperation Agreement_CSRC

Listings in Hong Kong

Chinese companies initially flocked to US markets because of the vast and stable pools of capital and broader investor bases available in markets that are more efficient, and provide more efficient and timely access, than their own more-intrusively regulated and relatively shallow home markets.

As a result of the HFCAA, there has been a trend by Chinese companies with a primary listing in the US to setup a secondary listing in Hong Kong in order to avoid the auditing requirements of the US. The Hong Kong Stock Exchange (HKEX) announced new rules in November 2021 to streamline the listing regime for overseas issuers by relaxing its requirements for secondary listings. They allowed companies with special shareholding structures such as weighted voting rights (WVR) and variable interest entities (VIE) to apply for dual primary listings for the first time. Alibaba was one of the first large companies to get a secondary listing in Hong Kong in November 2019. In July 2022 it announced[9] that it would seek primary listing on the HKEX and hence become a dual primary listed in both New York and Hong Kong. This change would allow it to "broaden its investor base, facilitate incremental liquidity, and in particular expand access to China - and other Asia-based investors" [10]. Alibaba's proposed primary listing in Hong Kong would facilitate stock purchases by mainland Chinese via a Stock Connect program which is not currently available to secondary listing.

There are a 2 main options for companies seeking a secondary listing on the HKEX with advantages and dis-advantages as outlined below.

Under **dual primary listing** status, an issuer makes a primary listing on one or more overseas exchanges at the same time, i.e. it lists different types of shares on different stock exchanges. Dual primary listings face more stringent regulation, and the HKEX imposes the exact same listing requirements on them as companies that IPO in Hong Kong, which results in a complex and more costly listing process. But companies with dual primary listings in Hong Kong can be included in the mainland-Hong Kong Stock Connect list, thereby gaining access to capital inflows from A-share investors and expanding their shareholder base.[11]

In the case of a **secondary listing**, a company lists a portion of its outstanding shares on another stock exchange where it is not registered, i.e., the company lists the same type of shares on both exchanges. Secondary listings are less difficult and have more exemptions. If a company has a secondary listing in Hong Kong, the company is primarily subject to the regulations and regulatory authorities of the jurisdiction in which it has its primary listing. In this case companies that have a secondary listing in HK would still be subject to the regulatory requirements of the US.

Beijing has also made some contingency plans. In July, it launched a "stock connect" scheme with the Swiss exchange. This will allow companies listed in Shanghai or Shenzhen to apply for a secondary listing in Switzerland. Improving links with European capital markets is necessary because Hong Kong is too small to be a real alternative to New York for Chinese companies.

Chinese authorities have also sought to increase their influence over big tech companies after PRC President Xi Jinping's reorientation of China's economy away from private enterprise and towards a

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[9] Alibaba announcement to become a dual primary listing in Hong Kong https://www1.hkexnews.hk/listedco/listconews/sehk/2022/0726/2022072600077.pdf

[10] Alibaba announcement to become a dual primary listing in Hong Kong https://www1.hkexnews.hk/listedco/listconews/sehk/2022/0726/2022072600077.pdf

[11] HKEX – Secondary Listings - https://www.hkex.com.hk/Listing/Rules-and-Guidance/Listing-of-Overseas-Companies/Company-Information-Sheets?sc_lang=en

more socialist model. Chinese regulators released new rules in December 2021 that require all Chinese companies seeking initial public offerings or additional share sales abroad to register with the securities regulator. The requirements only apply to new shares and won't affect the foreign ownership of companies already listed overseas (e.g. Alibaba). Any firm whose listing could pose a national security threat won't be allowed to proceed. Those in industries banned from foreign investment need to seek a waiver before listing. Companies holding data on at least 1 million people seeking "foreign" listings must also undergo cyber-security and national security reviews. Many of China's technology firms have near-monopolies in their fields and vast pools of user data, and the Chinese Communist Party appears intent on making sure sensitive data can't be accessed by foreign regulators.

The Chinese ride hailing company Didi went ahead with their US IPO in June 2021, prior to the new rules being implemented but having been warned by Chinese officials to put the IPO on hold whilst data practices were reviewed. Within days of the IPO, China's cyber-security regulator told app stores to remove the company's app, citing serious violations on the collection and usage of personal information. Didi's share price fell as much as 25% on the first trading day after that announcement. On December 2, Didi announced that it would file for a delisting of its American depositary shares from the New York Stock Exchange and start work on a Hong Kong share sale. No timeframe has been announced but the market cap of Didi has plummeted from US$40.8B on 1 Nov 2021 to US$12.1 billion by 31 March 2022 highlighting to risks to investors of such a move.

Other companies have shelved or delayed their US IPO plans, including healthcare firm LinkDoc Technology, bike-sharing company Hello Inc and audio-sharing platform Ximalaya Inc. RoboSense, a Chinese developer of sensor technologies used in self-driving cars, decided to list in Hong Kong instead, following others including Lalamove and Xiaohongshu. Chinese headquartered companies with sensitive data that have not yet listed may instead favour listing in Hong Kong rather than the US to avoid the regulatory scrutiny of the PCAOB.

Index Implications:

The move to company's having dual listings has implications for index providers. Index vendors will only include 1 listing (typically the most liquid) per security in the index but have a preference for a local line vs a foreign line. As more companies have moved to dual listings, we are seeing changes in the primary line for these stocks. One of the first of these was Alibaba which in May 2021 MSCI announced[12] that their indexes would instead start tracking the Hong Kong listing (9988 HK) of Alibaba rather than the US listed ADR line (BABA US) due to sufficient liquidity. Table 1 outlines the stocks that MSCI has changed from US to Hong Kong listings in the recent rebalances. Realindex expects to see further index line switches as liquidity improves in secondary listed Hong Kong securities.

Securities that go the next step and actually delist from the exchanges: NYSE Euronext (New York), NASDAQ, New York AMEX or Singapore, will be deleted from the MSCI Overseas China Index. However there is no change to the securities membership of underlying MSCI GIMI regional or country indexes (e.g. MSCI China) as a result of the listing change.

[12] MSCI - Alibaba line change announcement - https://app2.msci.com/webapp/index_ann/DocGet?pub_key=lGpRksdt3Ng%3D&lang=en&format=html

Other index vendors such as FTSE Russell have also followed suit and converted China N shares (US Listed) to China P Chips (Hong Kong Listed) across at their respective indexes during scheduled quarterly rebalances. FTSE converted Alibaba in March 2021[13].

Table 1: MSCI Index Changes:

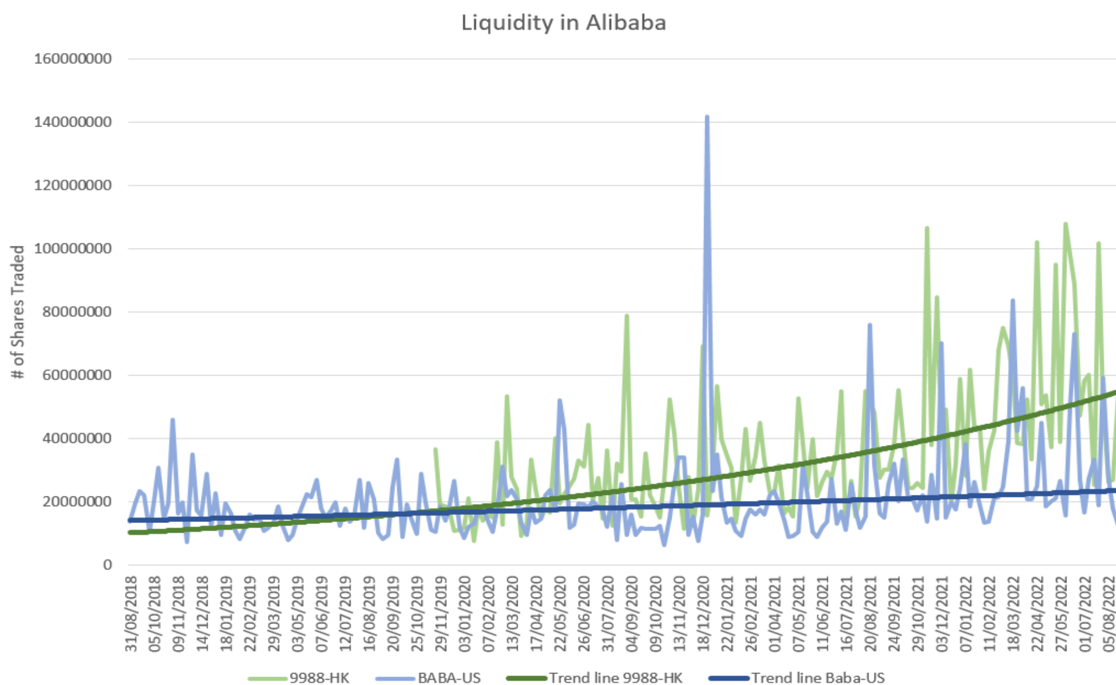
Date of Change	Company Name	US Listing	HK Listing
May 2021	Alibaba Group	BABA US	9988 HK
Nov 2021	JD.com	JD US	9618 HK
Nov 2021	NetEase	NTES US	9999 HK
May 2022	New Oriental Education	EDU US	9901 HK
May 2022	GDS Holdings	GDS US	9698 HK
May 2022	Baidu Inc	BIDU US	9888 HK
May 2022	Bilibili Inc	BILI US	9626 HK

Source: MSCI / Realindex

Liquidity

The move to secondary listings has created a change in liquidity profile of some of the Chinese ADS's. If we look at Alibaba as an example in Chart 1, the ADR line still has sufficient liquidity and in fact this is still growing slightly over time. However, the growth in the liquidity of the local line is exponential and we expect to see this same pattern repeat with those companies that take up a secondary listing in HK.

Chart 1: Number of Shares Traded in BABA-US & 9988-HK



Source: FactSet / Realindex between 31/08/2018 to 26/08/2022

[13] FTSE Conversion of Alibaba https://research.ftserussell.com/products/index-notices/home/getnotice/?id=2599306

What next?

With the announced agreement there is now a way forward to resolve this dispute between regulators but until these audits are complete and the PCAOB reassesses its determination at the end of 2022 there still be some uncertainty for these ADR listings. We expect that Chinese companies will continue to look at ways to reduce their regulatory risk which may still involve the move to a secondary listing and then Primary listing in China. The move to a secondary listing in HK can be seen as the first step of the conversion from US listing back to China. Over the past 18 months we have seen a number of Chinese companies creating a secondary listing back in Hong Kong. As liquidity in this local line has increased, index providers have started to make these secondary listings the primary line for the index. Alibaba was one of the first instances of this. Originally listing in the US in September 2014, it created a secondary listing in November 2019 and since May 2021, this secondary listing is now the primary line for the MSCI indexes. It has since made an application for a dual primary listing in July 2022. Those listed in Table 1 above have all followed suit although at this stage only Bilibili has applied for Primary Dual listing (see table 2)

We suspect that once the dual listing is approved that these companies may announce a delisting from the US exchanges so as to avoid the regulatory issues although the urgency for this has dropped with the recent agreement. A secondary listing alone does not avoid the regulatory issues under the HFCAA. A listing in Hong Kong also creates the opportunity to be included in the mainland-Hong Kong Stock Connect list, thereby gaining access to capital inflows from A-share investors and expanding their shareholder base to the domestic Chinese market who are their main customers.

Table 2: HKEX Securities with Primary & Secondary Listings

Company Name	HK Stock Code	Listing Type	Alternative Exchange
Primary Dual Listing			
Zai Lab Limited	9688	Primary Dual	Nasdaq Global Select Market
Applied for Primary Dual Listing			
Alibaba Group Holding Limited	9988	Secondary	New York Stock Exchange
Bilibili Inc.	9626	Secondary	Nasdaq Global Select Market
Secondary Only			
Weibo Corporation	9898	Secondary	Nasdaq Global Select Market
NIO Inc.	9866	Secondary	New York Stock Exchange
Trip.com Group Limited	9961	Secondary	Nasdaq Global Select Market
Baidu, Inc.	9888	Secondary	Nasdaq Global Select Market
Autohome Inc.	2518	Secondary	New York Stock Exchange
New Oriental Education & Technology Group Inc.	9901	Secondary	New York Stock Exchange
GDS Holdings Limited	9698	Secondary	Nasdaq Global Market

ZTO Express	2057	Secondary	New York Stock Exchange
Baozun Inc.	9991	Secondary	Nasdaq Global Select Market
Huazhu Group Limited	1179	Secondary	Nasdaq Global Select Market
YUM CHINA HOLDINGS, INC.	9987	Secondary	Nasdaq Global Select Market
JD.com, Inc.	9618	Secondary	Nasdaq Global Select Market
NetEase, Inc.	9999	Secondary	Nasdaq Global Select Market

Source: as at 23/08/2022 https://www.hkex.com.hk/Listing/Rules-and-Guidance/Listing-of-Overseas-Companies/Company-Information-Sheets?sc_lang=en

What does it mean for investors?

The recent agreement is a breakthrough in negotiations and should provide some relief to investors concerned about delisting risk.

At present investors can still hold ADRs and there is still sufficient liquidity in these stocks. They could seek to move to a local line to avoid any risk associated with delisting and reduced liquidity in the future. If the share is fungible it can be converted across (for a fee) to the local line assuming the investor has a brokerage account set up in HK to received HKEX listed shares.

If the securities are not fungible, then the only alternative is to sell the US listing and to buy the Hong Kong listing on the market with the associated brokerage, exchange and tax costs. Investors that are ineligible to hold these local HK stocks will slowly lose the opportunity to gain exposure to these stocks if more of the ADRs delist.

Investors also face increased risk from Chinese stocks deciding to delist to avoid the regulatory action or if they refuse to comply with the new agreement. In the event of delisting investors will have limited opportunities to sell the securities, potentially affecting the value of the securities. Therefore it is prudent that investors sell out or convert to an alternative line prior to the 3-year delisting date. We have already seen this risk of delisting and valuation impacts occurring for a number of stocks. In early August 2022, five of China's largest state-owned companies: PetroChina, China Petroleum & Chemical, China Life Insurance, Aluminium Corp of China and Sinopec Shanghai Petrochemical, announced plans to delist their ADS shares from US stock exchanges resulting in significant price drops to the stock on the day of the announcement. The price impact was only temporary as they will maintain their primary Hong Kong & China exchange listings. US investors who cannot open a HK account will no longer be able to get exposure to these Chinese companies. It will be interesting to see if these companies go back on this announcement now that an agreement has been reached in late August 2022.

Chinese regulators have also provided some clarity to investor concern regarding the overseas listings of Chinese businesses on a variable interest entities ("VIE") structure. Under this structure, a Chinese company sets up an offshore entity for overseas listing purposes that allows foreign

investors to buy into the stock[14]. The arrangement was designed to help skirt Chinese rules restricting foreign investment in a number of sensitive industries such as media and telecommunications. Most offshore-listed Chinese tech firms, including Alibaba Group and JD.com, use this structure, as it gives them more flexibility to raise capital, while also bypassing the scrutiny and lengthy IPO vetting process that companies incorporated in China have to go through.

There has largely been no regulatory framework in China for listings of VIE-structured companies until December 24, 2021, when ("CSRC") released new draft rules[15]. These rules include VIE-structured companies in its proposed filing mechanism for offshore listings, removing uncertainty whether such companies would be banned from offshore listings entirely. The CSRC has also said that Chinese regulators respected the choices made by companies on listing locations and that the rules would not be retroactively applied - which means companies currently listed abroad will not be affected[16]. With this change, China has gone from turning a blind eye to VIE-structured overseas listings to tightening its regulation in this area.

Realindex

Realindex is continuing to closely monitor the situation. Similarly to index vendors, we have a preference to hold the most liquid listing of a security. If we do not already own the local line, which is the case in most instances, we will slowly sell down our ADR listing and move across to the HK listing at each rebalance. We do not have any restrictions on our ability to hold local HK listings.

[14] VIE Structure - https://www.reuters.com/markets/us/vie-structure-helping-chinese-firms-float-abroad-2021-12-29/

[15] CSRC – VIE structure The CSRC Solicits Public Opinions on Rules Regarding Overseas Listings_CSRC

[16] CSRC – Q&A on VIE Relevant Officials of the CSRC Answered Reporter Questions_CSRC

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