US/CHINA: Prospects for a deal to avoid de-listing of Chinese companies

- Beijing has made a significant concession to Washington by revising rules that prevented US regulators from inspecting audit papers on US-listed Chinese companies.
- But even the revised rules may not satisfy Washington's requirement for unfettered access, since Chinese authorities must still grant permission on a case-by-case basis for Chinese companies to cooperate.
- Even if the practical issues are resolved, the Biden administration may face political resistance to any deal, as some in Washington view the audit issue as a proxy for broader concerns about US investment in Chinese companies.

China's securities regulator published draft rules on 2 April that open a path towards resolving the longstanding dispute with Washington that could force the de-listing of around 270 US-listed Chinese companies in 2024. The new regulations would enable regulators to inspect the working papers of Chinese auditors, while adding measures to ensure that those records don't contain secrets that an adversarial government could exploit.

Regarding US inspections of Chinese auditors, the China Securities Regulatory Commission's (CSRC) proposed regulations remove a previous requirement that "on-site inspections shall be conducted mainly by China's regulatory agencies." This requirement has prevented regulators from the US Public Companies Accounting Oversight Board (PCAOB) from inspecting the Chinese auditors that serve US-listed Chinese companies. As previously discussed, the Holding Foreign Companies Accountable Act (HFCAA), a US law enacted in late 2020, requires de-listing of Chinese companies unless PCAOB inspectors gains full access to Chinese auditors and their working papers.

CSRC's draft regulations also instruct Chinese auditors to "reduce unnecessary entrance of state secrets and sensitive information into working papers." This requirement addresses Beijing's concerns that granting PCAOB unfettered access to audit papers would expose state secrets to a hostile foreign government (this note has examples of the kind of intrusive information requests that Beijing fears).

Some legal experts had believed that enabling PCAOB inspections would require China's legislature to amend the Securities Law and/or the National Security Law, which both contain provisions that – at least on some interpretations – forbid Chinese auditors from making certain disclosures to foreign regulators. But CSRC's new draft regulations draw legal authority from the Securities Law and amend previous rules issued in 2009, suggesting that new legislation is unnecessary. The public comment period lasts until 17 April, but the key elements are unlikely to change.

Too little, too late?

But it remains unclear if the amended rules will satisfy Washington. Even the new regulations require Chinese companies and their auditors to obtain CSRC permission before cooperating with foreign regulators. This case-by-case approach is a problem because the PCAOB is interpreting HFCAA to require a "jurisdiction-wide determination" about access to audit records. SEC Chairman Gary Gensler said on 30 March that if even one Chinese company refuses PCAOB access, the agency would be forced to declare that China is wholly non-compliant.

Given this constraint, one possibility is that certain Chinese companies deemed sensitive will de-list voluntarily, leaving PCAOB with unfettered access to those remaining on US exchanges. But this category of sensitive companies would likely cover many of the largest US-listed companies, including internet platforms and state-owned enterprises.

Political headwinds

Recent developments improve the outlook for a deal, but a final resolution remains far from certain. If Washington and Beijing are willing to handle the audit papers dispute as a technical issue, an agreement to prevent de-listings and resume initial public offerings should be achievable. The SEC and CSRC may be more inclined to take a pragmatic approach than the State Department and Chinese foreign ministry. Still, we have previously warned that broader antagonism in US-China relations presents political obstacles to such an agreement. Any sign that Beijing is actively supporting Russia's war effort in Ukraine would mobilize opposition to a deal to avoid de-listings.

In recent weeks, both Chinese and US regulators have commented on the progress of bilateral negotiations, but Beijing's statements appear more positive. China's top economic policymaker, Liu He, said in mid-March that the two sides had achieved "active progress." Gensler was more cautious, however, saying on 30 March that Beijing faces a "hard set of choices" and that the HFCAA leaves him with minimal discretion to accept anything short of full compliance.

With Beijing clearly seeking a deal, political resistance in Washington remains as the key variable. Rhetoric from some US legislators and commentators suggests they oppose US investment in Chinese companies based on considerations of national security, great power competition, and human rights. This faction may view the audit issue as an expedient method to force US-China financial de-coupling, and mere compliance with US audit inspection requirements will not necessarily satisfy these more fundamental concerns.

If the SEC and PCAOB strike a deal or appear on the verge of doing so, the Biden administration will likely face criticism. The criticism will be especially intense if the agreement contains any whiff of special treatment. In fact, the PCOAB has previously shown a degree of flexibility towards other foreign regulators. In a rule adopted in September to implement the HFCAA, the PCAOB commented that it has regularly "worked with its international counterparts where necessary or appropriate, based on norms of international comity, to develop arrangements and working practices … in a manner responsive to the potential conflicts of law that non-U.S. firms might confront."

But "comity" is scarce in US-China relations, so critics in Washington will have less tolerance for any compromise with Beijing. Gensler's tough rhetoric may be partially intended to preempt criticism that the SEC is offering special treatment. Furthermore, a deal to resolve the audit papers dispute may be accompanied by parallel actions designed to insulate the Biden administration from criticism. The most likely such action would be adding new names to the US Treasury's Chinese Military-Industrial Complex Companies list, which bans US investors from buying securities issued by designated companies.

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