Prague Security Studies Institute

August 10, 2020

Response to the Report of the President's Working Group (PWG) on Financial Markets Addressing China-Related Risks Posed to U.S Investors in America's Capital Markets

The Presidential Working Group (PWG) on Financial Markets was mandated by President Donald Trump on June 4, 2020 to report on the risks posed to U.S investors by the presence of Chinese companies in the U.S. capital markets. The working group members include the Secretary of the Treasury (Steve Mnuchin), the Chairman of the Board of Governors of the Federal Reserve System (Jay Powell), the Chairman of the Securities and Exchange Commission (Jay Clayton), and the Chairman of the Commodity Futures Trading Commission (Heath Tarbert). The PWG is chaired by the Secretary of Treasury.

This report is dated July 24, 2020 and was released late last week, with five recommendations designed – in the view of the PWG – to protect U.S investors from risks posed by Chinese enterprises in America's capital markets. While framed as addressing NCJs (Non-Cooperating Jurisdictions), this was merely a euphemism for China, so as not to irritate Beijing.

Significant discussions and actions have been taken by the White House and the Congress in this rapidly emerging new front in the U.S.-China struggle, which enjoys strong bipartisan support. What follows is a PSSI summary of these recommendations, with accompanying commentaries.

1. Enhanced Listing Standards for Access to Audit Work Papers

This recommendation aims to increase the PCAOB access to the auditing papers of the "principal audit firm for the audit of the listed company." Those companies which do not allow access to work papers may satisfy the requirement by providing a "co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers."

The co-audit requires a company based in a non-cooperating jurisdiction (NCJ), such as China, to engage a U.S accounting firm to serve as the principal auditor of the financial statements, and keep the financial statements in the U.S. All work done by the NCJ audit firm would be supervised by the U.S firm.

As noted in the recommendations, "Sarbanes- Oxley also empowers the PCAOB to impose sanctions on registered public accounting firms and their associated persons for compliance failures, decisions that may be appealed to the SEC." There is no further mention of sanctions or penalties in the document.

The PWG recommendation is shaped by the March 2020 PRC Securities law, which states explicitly, in Article 177,

> "Overseas securities regulatory agencies shall not directly conduct investigation and evidence collection activities within the territory of the People's Republic of China. Without the approval of the securities regulatory authority of the State Council and the relevant competent department of the State Council, no entity or individual may provide documents and materials related to securities business activities to overseas [regulators]."

Ultimately, the PCAOB and SEC are currently unable to access the auditing papers of any Chinese entities. This recommendation seeks to put in place a "work-around" mechanism (being described as a "co-audit") that is being characterized as compliance enforcement, but that is taking place without any ability to examine directly the financial information of the targeted companies. Furthermore, these new standards "provide for a transition period until January 1, 2022," at which time non-compliance with the work-around would carry implications.

PSSI Commentary

This is a clear case of the PWG seeking to accommodate the requirements of the Chinese Communist Party (CCP) over the interests of unwitting and largely unprotected American retail investors. The proposed "co-audit" arrangement as a "solution" to the PCAOB audit problem and Beijing's overall non-compliance with U.S. securities laws is fundamentally problematic. It is nothing more than an invented, preferential work-around that is not made available to American companies in the U.S. capital markets. Moreover, the lack of access also creates the unverifiable possibility of Chinese companies generating "two sets of books," one for Chinese auditing firms to share with its government and a second ginned up to be used by an American auditing firm reviewing the same PRC enterprise to share with the PCAOB.

The simple fact is that the CCP *will not permit the PCAOB to audit any Chinese companies, particularly its auditing firms.* This refusal should be viewed as unacceptable to the Trump White House, as it constitutes the continuation of preferential treatment being accorded to Chinese companies over their American corporate counterparts and the resulting obvious endangerment of American investors. It should be the case – given the special circumstances in the U.S.-China relationship – that any Chinese company traded in the U.S. capital markets (including those in index funds) be audited directly by the PCAOB or be delisted and deregistered from U.S. exchanges.

Moreover, providing Chinese companies with almost 18 months to comply with U.S. securities laws – *after having refused to do so for some 20 or more years* – merely extends the amount of time that U.S. authorities are permitting the enabling and funding of their respective abuses in certain cases, such as those of U.S.-sanctioned and other Chinese corporate "bad actors." The deadline for compliance should be not later than January 1, 2021.

2. Enhanced Issuer Disclosures

The PWG calls for enhanced disclosures for issuers from non-cooperating jurisdictions (NCJs) -- again, read: China -- and offers guidance for providing increased investor awareness of the elevated risks of investing in these companies. It adds that although these types of disclosures are currently required by the SEC, “a more specific listing standard or disclosure requirement could further highlight for investors the risks of investing in an issuer from an NCJ.”

PSSI Commentary

This is a rather weak, understated PWG acknowledgement of the "black box" nature of investing in Chinese companies that offer a level of disclosure that would be wholly inadequate were it to come from most any other jurisdiction.

Prague Security Studies Institute

3. Enhanced Fund Disclosures

The PWG suggested reviewing the existing disclosures of registered funds to enhance them, and issued guidance to clarify the disclosure requirements to increase investor "awareness."

PSSI Commentary

When reviewing a recommendation like this one, it is easy to see how some 150 million or more American investors have ended up in the present tragic conundrum, whereby Chinese corporate "bad actors" are being integrated into their investment portfolios amidst shabby investor protection procedures.

4. Due Diligence of Indexes and Index Providers

"Encouraging or requiring" registered funds that track indexes to increase due diligence prior to the index selection. It adds that this includes encouraging funds to focus this due diligence on restructuring how due diligence is constructed, including taking into account "any potential errors in index data, index computation and/or index construction if the information from issuers based in NCJs, including China, is unreliable or outdated or if less information about such companies is publicly available due to differences in regulatory, accounting, auditing and financial recordkeeping standards."

PSSI Commentary

U.S. index providers and their Exchange-Traded Funds sponsors are the principal architects of China's multi-trillion-dollar undisciplined access to the U.S. capital markets. The existing way in which U.S. index providers choose "A shares"– whereby hundreds of unregulated and unvetted Chinese companies listed in Shenzhen and Shanghai are added to U.S. indexes and then onward into the investment portfolios of scores of millions of unwitting American investors – should be eliminated forthwith and "Regulation S" discontinued. The current system is harmful to our national security, the financial well-being of American investors and our fundamental human rights values.

5. Guidance for Investment Advisers

The PWG recommends providing “guidance to investment advisors with respect to fiduciary obligations” when considering investments in China. This entails reminding investment advisors of their duty to their clients, “including a duty of loyalty and a duty of care,” including advice in the best interest of their clients. This is largely a “principles-based” recommendation, and would not limit investor-choice, but simply provide guidance.

PSSI Commentary

By now, it is abundantly clear that what drives most fund managers and "fiduciaries" on Wall Street – at least with respect to China – are the prospect of large fees. These often require looking the other way on investor protection, national security and human rights. It is telling that this mini lecture the PWG provides for fiduciaries is viewed as adequate to persuade these firms to return to the straight and narrow and offer more responsible "guidance." They surely must realize that mere platitudes are likely to change little with regard to the status quo. Robust new SEC rules and tough enforcement measures have a much better chance of success, only exceeded by Presidential Executive Orders and veto-proof bipartisan legislation.