The Difficulties Facing Chinese Companies Listed in the United States and How to Achieve a Hong Kong Listing

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Against the backdrop of ongoing tensions between the U.S. and China, as well as the financial irregularities following Luckin Coffee's high-profile NASDAQ listing,[1] U.S. regulators have renewed their focus on Chinese companies listed on U.S. securities exchanges. On 21 April 2020, the Chairmen of the U.S. Securities and Exchange Commission (the **SEC**) and the Public Company Accounting Oversight Board (the **PCAOB**) issued a joint statement highlighting the PCAOB's inability to inspect audit work papers in China and the substantial difficulties faced by U.S. authorities in bringing and enforcing actions against non-U.S. companies and non-U.S. persons.[2] This was followed by the passage of the Holding Foreign Companies Accountable Act (the **HFCAA**) by unanimous consent of the U.S. Senate on 20 May 2020, which if passed by the U.S. House of Representatives and signed into law by the U.S. President, could conflict with securities and state secrecy laws and regulations in China and result in Chinese companies being prohibited from listing and trading their securities on any U.S. securities exchanges.[3]

As a result, U.S.-listed Chinese companies are now looking at alternative listing venues, including the Hong Kong Stock Exchange (the **HKEX** or the **Exchange**). This publication highlights the difficult issues facing Chinese companies currently listed in the United States and the mechanics and process for a listing on the HKEX.

Overview of the HFCAA

The HFCAA would amend the Sarbanes-Oxley Act of 2002 (**SOX**) by requiring certain issuers to disclose to the SEC information regarding foreign jurisdictions that prevent the PCAOB from performing inspections under SOX. More specifically, the HFCAA would require the SEC to identify all reporting issuers who are audited by registered accounting firms with a branch or office in a foreign jurisdiction and where the PCAOB is unable to inspect or investigate such accounting firms completely, including their audit work and working papers, due to a position taken by an authority in such foreign jurisdiction. Such reporting issuers would be required to establish and confirm to the SEC that they are not owned or controlled by a governmental entity in the relevant foreign jurisdiction.

In addition, if the PCAOB is unable to inspect the auditors of such reporting issuers for three consecutive years, the SEC will be required to prohibit the trading of such issuers' securities on any national securities exchange or over-the-

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[1] Nasdaq Press Release - Luckin Coffee Receives Delisting Notice from Nasdaq and Plans to Request Hearing

[2] Joint Statement of SEC and PCAOB - Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks

[3] US Senate S. 945 - HFCAA

counter markets in the United States (the **Initial Prohibition**). The SEC would be allowed to lift the Initial Prohibition if the issuer certifies to the SEC's satisfaction that the issuer has retained an auditor that the PCAOB has inspected. However, if the PCAOB later determines that it is unable to inspect such issuer's auditor in a year subsequent to the end of the Initial Prohibition, the SEC would then be required to impose a subsequent prohibition on trading of the issuer's securities for a period of at least five years (the **Subsequent Prohibition**). The SEC will be allowed to lift the Subsequent Prohibition after the five-year period if the issuer certifies to the SEC's satisfaction that it will retain an auditor that the PCAOB is able to inspect.

The HFCAA would also require reporting issuers to make additional disclosures for a non-inspection year, including with respect to the percentage of its shares owned by governmental entities in its jurisdiction of incorporation, whether governmental entities in the applicable foreign jurisdiction have a controlling financial interest in it, and, if applicable, the names of any Communist Party of China officials who are its directors or directors of its operating entity.

Implications for Chinese Issuers

If enacted, the HFCAA could cause a serious compliance dilemma for Chinese issuers listed on U.S. securities exchanges. Under SOX, U.S.-listed companies are required to be audited by firms that are inspected by the PCAOB. However, Chinese laws governing the protection of state secrets and national security have been invoked to limit foreign access to China-based business books and records and audit work papers. This ongoing conflict escalated in December of 2012 when the SEC initiated administrative proceedings against the China affiliates of each of the "Big Four" accounting firms and another large U.S. accounting firm for refusing to produce audit work papers and other documents related to China-based companies under investigation by the SEC for potential accounting fraud against U.S. investors.[4]

In an attempt to resolve the issue, the PCAOB entered into a memorandum of understanding (the **MOU**) with the China Securities Regulatory Commission (**CSRC**) and the Ministry of Finance on 7 May 2013, which established a cooperative framework for the production and exchange of audit documents relevant to investigations in both countries' respective jurisdictions.[5] However, under the MOU, access to audit papers can still be withheld based on "grounds of public interest or essential national interest", and the PCAOB has continued to raise concerns that Chinese cooperation has not been sufficient for the PCAOB to obtain timely access to relevant documents and testimony necessary for the PCAOB to carry out enforcement matters.[6]

In addition, new provisions under Article 177 of the Securities Law of the People's Republic of China came into effect on 1 March 2020, which provide that no entity or individual in China may provide documents and/or materials relating to securities business activities overseas without the approval of CSRC and various regulatory authorities under the China State Council.[7] These new provisions, together with existing state secrecy laws and regulations in China that prohibit the sharing of sensitive information with foreign parties, put Chinese companies listed on U.S. securities exchanges in the precarious position of trying to comply with conflicting laws in the U.S., which require disclosure of certain

[4] SEC News Digest Issue 2012-230 - SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents

[5] PCAOB Press Release - PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators

[6] PCAOB Statement - China-Related Access Challenges

[7] CSRC - Securities Law of the People's Republic of China

information, and laws in China, which prohibit such disclosure. As a result, U.S.-listed Chinese companies may have a renewed interest in terminating their U.S. listings and reporting obligations and seeking a listing in another jurisdiction.

Delisting and Reregistration from the U.S. – Going Dark or Going Private

Chinese companies listed on a U.S. securities exchange may terminate their reporting obligations in the U.S. and delist from a U.S. securities exchange by either "going dark" or "going private". The primary difference between these two routes, which are described below, is that a company that "goes dark" will continue trading after the date of deregistration, whereas a company that "goes private" will no longer trade after deregistration.

Going Dark. U.S.-listed companies are entitled to voluntarily delist their securities and deregister under the U.S. Securities Exchange Act of 1934 (the **Exchange Act**), provided they satisfy certain conditions. Foreign private issuers that are also listed outside the U.S. are generally eligible to proceed with a streamlined delisting and deregistration process under Rule 12h-6 of the Exchange Act, provided that:

- the issuer must have been a reporting company under the Exchange Act for at least one year, have filed or submitted all Exchange Act reports required for this period and have filed at least one annual report;
- the issuer must not have made a registered offering in the U.S. for the past 12 months (with limited exceptions);
- the issuer must have maintained a non-U.S. listing, which is its primary trading market, that constituted at least 55% of its trading in a recent 12-month period;
- (i) the average daily trading volume (**ADTV**) of the issuer's shares in the U.S. during a recent 12-month period must not be greater than 5% of the ADTV of the issuer's shares on a worldwide basis and/or (ii) the issuer has fewer than 300 holders who are U.S. residents or fewer than 300 holders worldwide, on a date falling within 120 days of filing the requisite notice to the SEC; and
- there is a further 12-month waiting period if the issuer did not meet the 5% ADTV test when delisted.

Going Private. Companies that are not eligible to "go dark" can still pursue a privatization process that involves cashing-out all or a substantial portion of their public shareholder's so that they become eligible to delist and deregister their shares under the Exchange Act. Depending on company-specific factors, including the participation of controlling shareholders and affiliates, going-private transactions are often structured as one-step mergers or as tender offers followed by a back-end or short-form merger. Reverse stock splits can also be used to reduce the number of public shareholders in order to render the company eligible to delist and deregister under the Exchange Act. Going private transactions may involve negotiations with a special committee of the target company's board, the issuance of fairness opinions, extensive public disclosures under Rule 13e-3 of the Exchange Act and a shareholder vote. Additional factors to consider in going private transactions include the timing and substance of the necessary disclosures, as well as the likelihood of litigation relating to the disclosure. Going private transactions tend to be more time consuming and costly than going dark transactions.

Listing in Hong Kong

Given the benefits of "going dark" under Rule 12h-6 of the Exchange Act as compared to other methods to terminate reporting obligations in the U.S., U.S.-listed Chinese companies are now actively exploring alternative listing venues prior to proceeding with the delisting and deregistration process in the U.S., preferably in another international financial centre that offers comparable ability to raise international capital, such as the HKEX. So far, Alibaba Group, JD.com and NetEase have all completed a secondary listing in Hong Kong, together with very large new equity issues to Hong Kong retail and institutional investors. In connection with this, we set out below a summary of the requirements for pursuing a dual-primary or secondary listing on the HKEX.

PRC-based issuers that are already listed in the United States *(e.g.*, on the New York Stock Exchange (**NYSE**) or NASDAQ), have the option of pursuing either a dual-primary listing under Chapters 18 or 18A or a secondary listing under the concessionary route under Chapter 19C. In particular, Chapter 19C has attracted significant attention in recent months, as a number of high-profile PRC tech companies (including Alibaba Group, JD.com and NetEase) have completed or are in the process of completing a Hong Kong listing under Chapter 19C. The traditional secondary listing route is not available to PRC-based issuers, as the HKEX and the Securities and Futures Commission require an issuer pursuing a traditional secondary listing to have a "centre of gravity"[8] outside of Greater China.

The concessionary secondary listing regime under Chapter 19C differentiates between PRC-based issuers that were listed on or before 15 December 2017 (**Grandfathered Greater China Issuers**) and those that were listed after 15 December 2017 (**Non-Grandfathered Greater China Issuers**). On the basis that Grandfathered Greater China Issuers were listed prior to the publication of the Exchange's proposals for a concessionary secondary listing route (and therefore the risk of regulatory arbitrage is limited), a wider range of waivers are available to them to facilitate their listing in Hong Kong.

If after a PRC-based issuer has completed a secondary listing in Hong Kong, the bulk of trading in its shares moves to Hong Kong on a permanent basis, which means that at least 55% of the total worldwide trading volume, by dollar value, of those shares (including the volume of trading in repository receipts issued on those shares) over such issuer's most recent financial year, take place on the Exchange's market, then such issuer will be treated by the HKEX as having a dual-primary listing in Hong Kong.

A brief overview of the relevant listing requirements are set out in the Appendix hereto.

[8] The HKEX would take into account factors including, but not limited to, the issuer's history, location of its central management and control, its main business operations and assets, etc.

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Appendix

	Dual-primary Listing (Chapters 18/18A)	Concessionary secondary listing for established innovative companies (Chapter 19C)
Eligibility requirements	➢ Satisfies one the financial eligibility requirements below*: ○ Profit test – profit of HK$20 million in the most recent year, and aggregate of not less than HK$30 million in the two preceding years; or ○ Market capitalisation/revenue/cash flow test – market capitalisation of HK$2 billion, revenue of HK$500 million in the most recent year and aggregate cash flow of HK$100 million in the three preceding years; or ○ Market capitalisation/revenue test – market capitalisation of HK$4 billion and revenue of HK$500 million in the most recent year ➢ trading record of not less than three years** ➢ management continuity for at least the three preceding years and ownership continuity and control for at least the most recent year** ➢ an adequate and open market for its securities ➢ sufficient management presence in Hong Kong * Chapter 18A pre-revenue biotech companies could meet the requirement for R&D and clinical trials instead ** Chapter 18A pre-revenue biotech companies are required to have its current line of business in operation for at least two years under substantially the same management. There is no strict ownership continuity requirement although HKEX would take this into assessment	➢ Satisfies the general listing eligibility requirements – see requirement for dual-primary listing ➢ "Innovative company" normally possessing more than one of the following characteristics: ○ success attributable to the application of new technologies, innovations; and/or new business model, which also differentiates it from existing players; ○ R&D being a significant contributor of its expected value and constitutes a major activity and expense; ○ success attributable to its unique features or intellectual property; and/or ○ an outsized market capitalisation / intangible asset value relative to its tangible asset value ➢ Primary listed on a Qualifying Exchange (which includes NYSE and NASDAQ) and have a track record of good regulatory compliance of at least 2 years ➢ Market capitalisation of at least HK$40 billion or at least HK$10 billion if its revenue was at least HK1 billion in the most recent audited financial year
Shareholder protection standards	➢ Demonstrates a level of shareholder protection at least equivalent to those in Hong Kong, with particular focus on certain key shareholder protection standards: ○ a super majority vote of shareholders required for: ▪ change to constitutional documents; ▪ variation of rights; or ▪ voluntary winding-up ○ individual shareholders to approve increase in shareholder's liability	➢ Grandfathered Greater China Issuer would not be required to modify their constitutional documents to comply with Appendices 3 and 13 of the Listing Rules ○ Instead they must comply with the key shareholder protection matters set out in 19C which mirror the key shareholder protection standards for dual primary listings from acceptable jurisdictions ○ HKEX would not necessarily require amendments to constitutional documents to demonstrate compliance with the standards in Chapter 19C

	Dual-primary Listing (Chapters 18/18A)	Concessionary secondary listing for established innovative companies (Chapter 19C)
	○ appointment and removal of auditors to be approved by shareholders or other body independent of the board of directors ○ issuer must hold general meeting each year and give reasonable notice of such meetings ○ members must have right to speak and vote at general meetings ○ members must be able to requisition a general meeting (threshold must not be higher than 10% of voting rights on a one vote one share basis) ○ make necessary arrangements with HKSCC to ensure members' right to attend, speak and vote at general meetings ➢ Approach varies based on the jurisdiction of incorporation: ○ Companies incorporated in the Cayman Islands (most PRC-based issuers will fall into this category), Bermuda or the PRC would be required to modify their constitutional documents to be in compliance with Appendices 3 and 13 of the Listing Rules (these are generally equivalent to the requirements under Hong Kong law and are more extensive than the key shareholder protection standards set out above) ○ Companies incorporated in California, Delaware and Nevada (being acceptable jurisdictions) may adopt arrangements in country guides – typically would need to modify constitutional documents to address any shortfall in standards ○ Companies incorporated in a jurisdiction not previously approved by HKEX would have to produce a jurisdiction comparison to show how it would meet the required standards	➢ Non-Grandfathered Greater China Issuer must modify its constitutional documents to comply with Appendices 3 and 13 of the Listing Rules (or, if it is not incorporated in a "recognized jurisdiction" such as Cayman Islands, it would be required to vary its constitutional documents to comply with the shareholder protection standards set out in Chapter 19C)

	Dual-primary Listing (Chapters 18/18A)	Concessionary secondary listing for established innovative companies (Chapter 19C)
Weighted voting rights (WVR)	➢ Eligible and suitable for listing with a WVR structure (i.e., innovation, high growth, contribution and role of WVR holder and external validation) ➢ Market capitalisation of at least HK$40 billion or at least HK$10 billion if its revenue was at least HK1 billion in the most recent audited financial year ➢ Restrictions ○ WVR voting power not more than 10 times that of non-WVR shares ○ WVR beneficiaries own at least 10% underlying economic interest at the time of listing ○ Non-WVR holders must hold at least 10% of votes and must have ability to convene general meeting on a one-share-one-vote basis ○ No post-listing alteration of the terms of WVR shares to increase voting power ○ No transfer of WVR shares	➢ A Grandfathered Greater China Issuer would be able to keep its existing WVR structure and would not need to adopt WVR safeguards under Chapter 8A ➢ A Non-Grandfathered Greater China Issuer would have to comply with the eligibility requirements and safeguards applicable to a primary listing
Applicable waivers	➢ Generally required to comply with Listing Rules in full, but common waivers available: ○ submission of electronic copies of announcements or notices ○ qualifications of Company Secretary or accountants ○ management presence in Hong Kong ○ dealing by connected persons during listing process ○ restriction on existing shareholders' purchase and subscription of shares ○ post-listing lock-up of controlling shareholder ○ restriction on further issues of shares within six months of listing	➢ Extensive waivers, including waiving the need to comply with the rules on notifiable transactions (Chapter 14) and connected transactions (Chapter 14A)
Confidential filings	➢ Listed on a recognised overseas exchange (including NYSE and NASDAQ OMX) for not less than 5 years ➢ Significantly large market capitalisation of not less than US$400 million	➢ Automatically entitled

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Contractual arrangements	➢ VIE structures are allowed on a case-by-case basis: ○ must be narrowly tailored to the listing applicant ○ fulfil any additional eligibility standards by other relevant regulators ○ ensure the contractual arrangements include the required power of attorney, dispute resolution clauses and rights to deal with its assets ○ legal opinion on compliance with laws and regulations ○ additional disclosures	➢ A Grandfathered Greater China Issuer would be able to keep its existing VIE structure in place, subject to providing a legal opinion on the VIE's compliance with laws and regulations and certain disclosure requirements ➢ A Non-Grandfathered Greater China Issuer would have to comply with existing requirements applicable to a primary listing
Accounting and auditing related requirements	➢ Comply with auditing and financial reporting standards comparable to that required in Hong Kong (including the US Public Company Accounting Oversight Board auditing standards and the US GAAP)	➢ Similar requirements
Practical and operational matters	➢ Whether conflict arises between the laws and regulations of the home jurisdiction and those of Hong Kong ➢ Eligibility of its securities for deposit, clearance and settlement under the relevant rules in Hong Kong ➢ Arrangements to facilitate cross-border clearing and settlement	➢ Similar considerations
Stock Connect Inclusion	➢ Primary listed companies are eligible to be included in the Southbound Stock Connect provided they meet the relevant criteria, including, inter alia, market value and turnover requirements for the relevant Hang Seng indices ➢ From 28 October 2019, WVR companies are eligible to be included in the Southbound Stock Connect, as long as they meet the following criteria: ○ a constituent of the Hang Seng Composite Large-Cap Index or Hang Seng Composite Mid-Cap Index; and ○ listed in Hong Kong for at least six months plus twenty trading days; and	➢ Eligible to be included in the Hang Seng Composite Index since 2018, but inclusion in the Stock Connect is still under discussion

	Dual-primary Listing (Chapters 18/18A)	Concessionary secondary listing for established innovative companies (Chapter 19C)
	○ meets the daily market capitalisation and trading volume threshold; and ○ must not have been publicly accused or sanctioned by HKEX	
Applicability of the Hong Kong Takeovers Code (the Code)	➢ Applies from date of listing	➢ For a PRC-based issuer: ○ The Code does not apply at listing ○ The Code will apply if the bulk of trading in the shares moves to Hong Kong on a permanent basis and the company is treated as having a dual primary listing in Hong Kong
Migration of the bulk of trading to Hong Kong	➢ No implication	➢ Status becomes dual-primary listing ➢ The original waivers would fall away after a one-year grace period (waivers normally granted for dual-primary listing would then be in place) ➢ Grandfathered Greater China Issuers could keep existing WVR structure even if its listing status becomes dual-primary listing