UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE CHAIRMAN

May 4, 2020

The Honorable Rick Scott
United States Senate
716 Hart Senate Office Building
Washington, DC 20510

Dear Senator Scott:

Thank you for your recent letters requesting information regarding the impact that certain laws and practices in China may have on the U.S. capital markets and investors. Specifically, your January 23, 2020 letter inquired about the potential impact of China's recently enacted cryptography laws on companies and investors, and your February 28, 2020 letter requested information about U.S.-listed Chinese companies and the risks they may pose generally to U.S. markets and investors.

U.S. Investors Should Better Understand the Risks of Investing in Emerging Markets—Including China

Over the past decade, U.S. investors, and the U.S. capital markets more generally, have become more exposed to companies with significant operations in emerging markets, including China—the largest emerging market and the world's second largest economy. I share many of your concerns as investments in emerging markets, including China, entail significant disclosure, financial reporting and other risks for U.S. investors. Significantly, while the U.S. securities laws and regulations applicable to emerging market companies listed on U.S. exchanges are the same as (or comparable to) the laws and regulations applicable to U.S. public companies, the practical effects are substantially different based on the inability of U.S. regulators to inspect for compliance and enforce these rules and regulations. For example, in the event of fraud or other misconduct by an emerging market company listed on a U.S. exchange, remedies, including compensation to harmed investors, often are limited and in many cases, are effectively nonexistent. This is a fundamental issue in emerging market investing that I believe investors, particularly our Main Street investors, should better understand. To put it bluntly, and noting that in some emerging market jurisdictions the issue is not as acute, laws without meaningful inspection and enforcement capabilities are little more than words.

Fundamental Components of U.S. Capital Markets—Robust Disclosure and Accountability for That Disclosure—Often Are More Limited in Emerging Markets

Investors and companies have long embraced and benefited from our public capital markets regulatory system where companies must provide disclosure of material information and take responsibility for that information, and, in turn, investors allocate investment capital where they believe best. This dynamic drives good outcomes, individually and collectively. If

investors do not have access to reliable information reasonably necessary to make informed investment decisions, they are at risk and capital may be allocated poorly.

The SEC's ability to ensure that investors and other market participants have access to high-quality, reliable disclosure and financial reporting, including by providing meaningful, principled oversight and enforcement, is substantially limited in emerging markets, including China. In these markets oversight and enforcement is significantly dependent on the actions of local authorities—which, in turn, are constrained by an array of national policy considerations in those countries, including resource constraints and the primacy of local law and practice. As a result, there is substantially greater risk that disclosures will be incomplete or misleading and, in the event of investor harm, substantially less access to recourse, in comparison to U.S. domestic companies. I also note that the ability of U.S. authorities to bring actions against non-U.S. persons, including company directors and officers, in emerging markets is often limited. In my experience, when this individual accountability is lacking, investor risk increases significantly.

At the risk of being repetitive, I am going to make this point from a different perspective and, hopefully, dispel a too-common misunderstanding. This misunderstanding is that U.S.-listed companies that are based in emerging markets, including China, are subject to substantially different and materially less rigorous laws than U.S. companies, including under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). In fact, applicable U.S. law and regulation is largely the same for domestic and foreign U.S.-listed companies. For example, with some flexibility around timing and in respect of non-U.S. governance structures, U.S.-listed foreign companies are largely subject to the same legal responsibility for disclosure and related controls and procedures, including those required by Sarbanes-Oxley.[1] The asymmetry is not in applicable law and regulation; rather the asymmetry is in the practicalities of inspection and enforcement. But that asymmetry is fundamental—without the ability to inspect for compliance and enforce laws and regulations, the effectiveness of those laws and regulations (or any new laws and regulations) is severely constrained.

The SEC and PCAOB Have Taken a Number of Emerging Markets-Focused Investor Protection Actions

For the past several years, the SEC has been actively monitoring the risks to U.S. investors posed by investments in U.S.-listed companies based in, or with significant operations in, emerging markets, including China. Recognizing the difficulties we face with inspection and enforcement, along with our fellow regulators, we have taken a number of steps to address issues that arise from these investments.

April 2020 Joint Statement. In order to bring greater attention to these risks, two weeks ago the Chairman of the Public Company Accounting Oversight Board (PCAOB), Bill Duhnke, the SEC's Chief Accountant, the Directors of the SEC's Divisions of Corporation Finance and Investment Management and I issued a joint statement where we encouraged investors, funds, financial professionals and index providers to consider carefully the issues, risks and

[1] See Appendix A for a summary comparison of the application of certain principal provisions of Sarbanes-Oxley to U.S. issuers and foreign private issuers.

uncertainties associated with investing in emerging markets, including China.[2] We also noted the responsibilities of companies based in, or with significant operations in, these emerging markets to: (1) prepare and provide high-quality, reliable financial information and other disclosures, including through considerations of the circumstances and environment in which these companies operate; and (2) provide materially accurate and complete risk disclosure, including with regard to the limited rights and remedies of U.S. authorities and investors. We further noted that issuers should discuss these matters with their independent auditors and (where applicable) audit committees, who play vital roles through their review and oversight of financial reporting.

December 2019 Guidance Regarding Intellectual Property-Related Risks. In December 2019, the SEC's Division of Corporation Finance issued disclosure guidance on technology and intellectual property-related risks that may result when companies conduct business operations in foreign jurisdictions generally, including China.[3] The staff guidance encourages companies with international operations to assess the risks related to the potential theft or compromise of their technology, data, or intellectual property and how these risks may impact their business, including their financial condition and results of operations. The staff guidance also provides a non-exhaustive list of questions for companies to consider in evaluating and thinking critically about these risks with respect to both current operations and future business plans, which in turn should assist companies in crafting disclosure about these risks, as required under the federal securities laws. The staff will devote additional resources to reviewing these disclosures.

Financial Reporting Risks. In addition to the intellectual property-related risks, one of the most significant risks posed by investments in companies with significant operations in China is that the quality of financial information and standards vary greatly, and the PCAOB remains unable to inspect audit work and practices of PCAOB-registered firms in China (including Hong Kong, to the extent their audit clients have operations in China). As emphasized in the joint statement issued last month, I have been and remain concerned that the inability of the PCAOB to inspect the audits of certain foreign-based companies listed in the U.S., as well as certain foreign operations of U.S. companies, could adversely affect U.S. investors. For example, the reduction in oversight can raise company-specific risks and reduce the certainty provided by U.S. law and oversight, and U.S. investors in these companies may not receive the benefits that can result from PCAOB inspections. Investors should understand the potential impacts of the PCAOB's lack of access when investing in companies whose auditor is based in China. Even when the auditor signing the audit report is not based in China, if the company has operations in China, investors should consider whether significant portions of the audit may have been performed by firms in China, and the potential impact of the PCAOB's inability to access such audit work papers. Investors can access information about the PCAOB's lack of access on the PCAOB's website.

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[2] *See* Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited (Apr. 21, 2020), *available at* https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting.

[3] *See* Intellectual Property and Technology Risks Associated with International Business Operations (Dec. 19, 2019), *available at* https://www.sec.gov/corpfin/risks-technology-intellectual-property-international-business-operations.

February 2020 Joint Statement Regarding China's Denial of Access to PCAOB. In February 2020, PCAOB Chairman Duhnke, the SEC's Chief Accountant, the SEC's Director of the Division of Corporation Finance and I released a joint statement outlining the current challenges facing U.S. regulators to obtain information related to U.S.-listed companies with significant operations in China and how they may adversely affect investors in the U.S. markets and the interests they own in these companies.[4]

Increased SEC and PCAOB Oversight of International Auditing Firms Regarding their Work in China—2019 and 2020. Along with PCAOB Chairman Duhnke and members of the SEC staff, I met with senior representatives of the four largest U.S. audit firms in November 2019 and February 2020 to discuss audit quality across their global networks and certain of the challenges faced in auditing public companies with operations in emerging markets, including China.[5] Most recently, in March 2020, we continued these meetings with two additional audit firms. In these meetings, we have made it clear that with the PCAOB restricted in its inspection efforts in China, we expect U.S. audit firms to bring appropriate increased attention and resources and have the appropriate internal and cross-network quality controls in place. These meetings addressed various issues, including acceptance and retention policies, independent internal and cross-network review processes, training, benchmarking and the anticipated and potential effects of COVID-19.

In addition to these meetings and statements, there is a broader, continuing dialogue with U.S. audit firms and network representatives regarding the importance of effective and consistent oversight of member firms globally, including those operating in China and other emerging markets. The PCAOB has been in negotiations with foreign audit regulators in certain countries, including China, that currently prevent or constraint the PCAOB from carrying out its inspection process with respect to the audits of companies by audit firms based in those countries. Even while these negotiations are ongoing, a refusal to cooperate by an audit firm—either in an inspection or an investigation—could subject the firm to SEC or PCAOB sanctions and remedial measures. Having the ability to impose sanctions and remedial measures may enhance the ability to make further progress with respect to such negotiations, but the imposition of such measures needs to be balanced with their potential impact on investors and the broader capital markets.

Additional Considerations and Potential Steps

Depending on various facts and circumstances, including company-specific considerations, if significant barriers to effective inspections and regulatory oversight continue to exist in certain jurisdictions, remedial actions that involve or affect U.S.-listed companies with significant operations in those jurisdictions may be necessary or appropriate. There is a spectrum of potential actions. In the past, remedial measures have included, as examples,

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[4] *See* Statement on Continued Dialogue with Audit Firm Representatives on Audit Quality in China and Other Emerging Markets; Coronavirus — Reporting Considerations and Potential Relief (Feb. 19, 2020), *available at* https://www.sec.gov/news/public-statement/statement-audit-quality-china-2020-02-19.

[5] *See* Press Release, SEC Chairman Clayton, PCAOB Chairman Duhnke, and Members of SEC Staff Meet With Auditing Firm Representatives to Discuss Audit Quality in Emerging Economies and Markets (Nov. 4, 2019), *available at* https://www.sec.gov/news/press-release/2019-228.

requiring affected companies to make additional disclosures, placing additional restrictions on new securities issuances and the adoption of more prescriptive, accountability-oriented listing standards. Some have suggested additional measures, including requiring the delisting of U.S.-listed companies who are audited by firms that the PCAOB is not sufficiently able to inspect or investigate, as well as the deregistration of audit firms themselves.

We should expect that remedial actions that go beyond improved disclosure and access requirements could have collateral consequences for various market participants. For example, in the event of forced delistings of companies and deregistrations of auditors, potentially affected participants include U.S. investors in emerging markets companies and U.S. companies (and their investors) who maintain significant operations in China and utilize auditing firms that the PCAOB currently cannot inspect for portions of their audits. In addition, foreign issuers may instead issue and list securities on foreign markets that provide less protection for investors. U.S. investors may retain exposure to these markets through emerging market funds and other global investment strategies. The effects of these various considerations need to be carefully evaluated in the context of the SEC's long-standing commitments to investor protection, fair, orderly and efficient markets and capital formation.

To conclude, I will return to the fundamental point that the ability to inspect for and enforce our laws and regulations is of paramount importance to U.S. investors and our capital markets more generally. Investors should understand that our ability to inspect and enforce our regulations in emerging markets, including China, is limited. To further promote engagement and help inform our consideration of these issues, we are doing two things. First, the SEC staff is providing an email box to receive additional input; I encourage all interested parties to communicate through the following address: emergingmarkets@sec.gov. The staff anticipates making submissions public.[6] Second, further to our discussions, I will soon be announcing a public roundtable to explore views from investors, other market participants, regulators and industry experts on potential additional steps we can take in this area.

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Thank you again for your letters, and I look forward to continue working with you on these issues to ensure transparency and confidence in our markets. Please do not hesitate to contact me at (202) 551-2100, or have a member of your staff contact Holli Heiles Pandol, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010 if you have any questions or comments.

Sincerely,

Jay Clayton
Chairman

[6] Submissions received will be posted without change; personal identifying information in the submission will not be redacted or edited, so interested parties should submit only information that they wish to make available publicly.

Appendix A

With the exception of a few accommodations noted in the table below, the principal provisions of Sarbanes-Oxley apply equally to foreign private issuers (FPIs) as they apply to U.S. domestic issuers.

- Sarbanes Oxley does not apply to: (1) voluntary filers, (2) Rule 12g3-2(b) exempt companies,[7] and (3) Schedule B issuers.[8]

Principal SOX Requirements	U.S. Issuer	FPI
Audit committee	Yes	Yes, with some accommodations[9]
Audit committee financial expert	Yes	Yes
Prohibited loans to executives	Yes	Yes
Code of ethics	Yes	Yes
Use of non-GAAP (Reg. G)	Yes	Some exceptions[10]
Off-balance sheet arrangements	Yes	Yes
SOX 404 attestation	Yes	Yes
Disclosure controls and procedures	Yes	Yes
302 certifications	Yes, quarterly	Yes, annually
906 certifications	Yes, quarterly	Yes, annually

[7] Rule 12g3-2(b) exempts a FPI from Section 12(g) registration if, among other requirements, the issuer furnishes to the Commission on an ongoing basis information it has made public or is required to make public under the laws of its jurisdiction of incorporation, organization or domicile, pursuant to its non-U.S. stock exchange filing requirements, or that it has distributed or is required to distribute to its security holders. The Rule 12g3-2(b) exemption enables a foreign private issuer to have its equity securities traded on a limited basis in the over-the-counter market in the US while avoiding registration under Exchange Act Section 12(g). Typically a FPI obtains the Rule 12g3-2(b) exemption in order to have established an unlisted, sponsored or unsponsored depositary facility for its American Depositary Receipts (ADRs).

[8] Schedule B is a registration framework used by foreign governments and their political subdivisions to conduct offerings of securities in the international capital markets that target the U.S. investor base.

[9] To account for conflicts with local laws, there are two primary accommodations for FPI: (1) an expanded definition of permitted members of an audit committee; and (2) alternative structures established under foreign law that provide an exemption from the audit committee's oversight and independence requirements.

[10] Exempt if: (1) the securities of the issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the U.S.; (2) the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP; and (3) the disclosure is made by or on behalf of the issuer outside the U.S., or is included in a written communication that is released by or on behalf of the issuer outside the U.S.