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What Happens If Chinese Firms Are Kicked Out Of The U.S. Stock Market

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An important battle is developing between U.S. financial regulators and their Chinese counterparts. At stake are hundreds of Chinese public companies with over one trillion dollars worth of shares trading in the U.S. that are threatened with "delisting" from U.S. stock markets. That is, they may be kicked off the New York Stock Exchange and NASDAQ. The headlines have it that the Chinese companies have cheated, somehow. Colluding with Beijing, and helped by the inadvertence of U.S. regulators, they have evaded and avoided compliance with regulations that apply to all American public companies, to almost all foreign companies except the Chinese, and which should apply to the Chinese firms trading on exchanges here. And to say that they "should apply" is not to state a goal or an aspiration; it is a straight reading of settled U.S. law. The rhetoric is fierce – there are "rogues" and "frauds" and "no level playing field," and "billions in losses for American investors," and of course lots of "China this and China that" - as here, from a joint press release last year by two leading U.S. Senators (Rep & Dem):

"'The current failure of China to comply with our laws and play by the same rules as everyone else puts American investors and the credibility of our markets at risk…' the senators write. 'The fact that China stands alone in its noncompliance is yet another example of how it fails to play by the same rules as other countries. China's failure to comply with our disclosure laws has already impacted investor confidence and the integrity of our financial markets.'"

A complication in this story involves the changing situation in Hong Kong — for now still the world's third largest financial market – but under threat from Beijing's new security laws. In the back and forth debate between the Cassandras

predicting Hong Kong's impending loss of its status as a premier financial center, and the purveyors of Hong Kong Happy Talk who see only a brighter future for the city under the CCP, one emerging theme is the idea that "delisting" Chinese companies in the U.S. will drive them all to "secondary listing" in Hong Kong – with gobs of money falling out of the South China skies. Even those who should know better are caught up in the merry outcry:

"Delisting…would be a victory for Hong Kong, post-National Security Law. The market, increasingly Chinese-dominated, would welcome the additional hundreds of billions of dollars in market capitalization that U.S.-listed Chinese companies could bring."

This is fantasy. The consequences of a mass delisting of Chinese companies here – if it comes to that – will cost these firms, and China, and Hong Kong, dearly. But to understand why, and what this really means, we need to step back and ask basic questions:

What is "delisting"?

For that matter – What is "listing"?

What are "cross-listing" and "secondary listing"?

Why do companies do cross-listings in the first place? Why would a company based in Shenzhen go half way around the world to offer its shares to investors in New York?

What are the real consequences of delisting?

The Background

On May 20, the Senate approved the (awkwardly-named) Holding Foreign Companies Accountable Act. It seeks to close a long-standing loophole in the the system of financial regulation, which has allowed hundreds of companies to operate for decades in open defiance of U.S. law. The overwhelming majority of these "rogue" companies are Chinese firms that have "listed" or "cross-listed" their shares in New York. The Senate's vote was unanimous – rare in the current climate – which can be interpreted as both a political bow-shot aimed at Beijing, and as an enough-is-enough message to a particular set of Washington

bureaucrats.

The bureaucracy in question is the Public Company Accounting Oversight Board (PCAOB, or, as it is expressed verbally, “Peekaboo”). The PCAOB was created by the Sarbanes-Oxley Act of 2002, and given the mission of regulating the auditing methods and standards for companies whose shares trade publicly on American stock exchanges, including foreign companies listed here.

[All publicly traded companies must produce audited financial statements annually. An audit is a thorough review of the company’s financial information, as well as the underlying business documentation supporting that information, and – importantly – the company’s processes and safeguards to prevent errors or fraud. The auditor – an independent accounting firm – issues a formal “opinion” and vouches for the quality of the company’s information and control processes. This opinion is included in the company’s filings with regulators (e.g., the SEC) – and the auditor accepts legal liability for the accuracy of the audit (at least up to a point). Until Sarbanes-Oxley, the auditing industry was self-regulating, but after the Enron scandal (among others), lawmakers felt that formal government oversight of auditing standards and methods was in order.]

PCAOB has been reasonably successful in its 18 years of existence in reaching agreements with foreign financial regulators. This has extended its oversight to cover the audits for hundreds of foreign companies that have chosen to list their shares in New York (in addition to their home markets). China is the hold-out. The new Act would expand the powers of PCAOB to enable it to fix this situation. Non-compliant companies could be forced off the exchange.

Chinese firms are audited by Chinese auditors. Chinese regulators have prohibited Chinese auditors from sharing their work with PCAOB. This impasse has existed for many years now, and all the while, Chinese firms have enthusiastically IPO-ed or cross-listed in New York, inveigled, coddled, and coached by American investment banks and stock exchanges, a lucrative trade for both sides. The bureaucracy (PCAOB) has dithered, issued press releases, and acceded to the prevailing currents of foreign policy. Until recently, the overarching directive with respect to China seems to have been “Work with them.” Freer trade would surely promote political liberalization, and if winking for now at a few “technical” irregularities could assist towards that end, it must be a small price to pay. So, the bureaucrats might omit to enforce the law. (Was it a considered policy, or a more generalized ineffectiveness? The PCAOB has had its troubles.

Last year the House passed a whistleblower law aimed at the agency. Already one prominent case – alleging internal strife, staffing deficits, and enforcement failures – is pending.)

But those questions may be set aside for the moment. The PCAOB in all its blandness – accounting standards, audit procedures, “oversight” – is back on the front pages, and in the middle of a geopolitical storm. So, what does the “delisting” threat amount to?

First, What Is “Listing”?

In simplest terms, “listing” means that the company has complied with the relevant rules and regulations, and its shares are therefore authorized to trade on a public exchange. There are two sets of these rules: those of the exchange, and those of the regulator.

The regulator – in the U.S. it is the Securities & Exchange Commission (SEC) – has the stronger say. The SEC’s main concern is the quality, accuracy, and completeness of the financial information the company makes available to the public. The principle is that investors should always have access to an accurate and reasonably up-to-date picture of the company’s performance. The quality of a company’s financial reporting is confirmed partly by the SEC’s own review, but the regulators rely substantially on the independent audit. That is where the PCAOB comes in. It is the subsidiary of the SEC responsible for keeping an eye on the auditing process.

The exchange’s rules for “listing” are… well, they really aren’t that important here. Exchanges (like NYSE) specify that a listing company has to be big enough, and generally respectable enough, so as not to embarrass the other members of the club. But respectability is a malleable concept. The fact that the listings of these Chinese firms are noncompliant has not deterred NYSE and Nasdaq from competing for the business. If the regulator is not sufficiently concerned to require compliance, why should the exchange operator trouble over it?

Delisting

If a company fails to meet the requirements of either the exchange or the regulator, and cannot cure the problem quickly, it can be booted out of the club. (Listed firms may also delist voluntarily, if they go private, for example.)

Delisting doesn't mean that the company's shares can't trade. They just can't trade on the exchange, with the attendant safeguards and assurances.There are several lower circles in the market eco-system, where investors can still buy and sell shares of "less qualified" companies. Regarding these "over-the-counter" markets — such as the OTC Bulletin Board, and even lower, the "Pink Sheets" (we'll skip the story of that odd name for now) – they operate with fewer rules (almost no rules in the case of the Pink market), and certainly without the prestige that a proper "listing" conveys. But there are lots of small fish in those shallows – about 10,000 OTC companies today (compared to 3600 "listed" companies on NYSE and Nasdaq). There are 152 Chinese companies on the American OTC markets (compared to 138 listed Chinese firms on NYSE and NASDAQ). Delisting is not fatal, but it is not advantageous. It is definitely a come down for a previously listed company, in terms of reputation and other considerations described below.

Cross-Listing

Cross-listing is when a firm lists its shares to trade on both its domestic exchange and an exchange in another country. (There are several types of cross-listing, or functionally similar foreign listing models. The differences are not important here.)

To cross-list, a company must comply with the listing requirements of both exchanges, and both national regulators. So, a Chinese firm that lists on NASDAQ, say, has to provide audited financial statements as required by the SEC. And in principle, they are subject to the PCAOB oversight of their audit. But

for more than a decade, the PCAOB and the SEC have moaned and groaned, ineffectually, about the campaign of resistance by the Chinese to prevent the PCAOB from reviewing their audits. And so the un-audited Chinese listings have multiplied, growing to 3.3% of the total U.S. stock market.

It would seem that a trillion dollars of unregulated capital is a bit too much. The recent actions by the Senate and the White House are bringing this to a head. It was the focus of the Wall Street Journal's lead editorial today (August 11).

Why Does Cross-Listing Matter?

And so we arrive at the key question: Why do Chinese companies cross-list in the first place?

Simplistically, one might assume that cross listing is done to attract American investors. But this is not a sufficient answer. Most of these companies also list in Hong Kong, or could do so, a market that is already open to American investors.

It is also true that New York listings generate favorable publicity and interest — increased media attention, better analyst coverage, better liquidity (roughly, tradability). All true enough, but incidental.

The real advantage of cross listing is increased enterprise value. Which entails an equally important consequence: lower cost of capital, for both debt and equity.

The penalty for delisting, therefore, will be a reduction in real value, and higher financing costs.

The Effect of Cross-Listing on Market Value

The relationship between cross-listing and a firm's market value has been studied, and the results are clear. An early study found a huge valuation boost for firms in 40 countries that cross-listed in the U.S.

This study predates the development of China's stock markets, but it does include cross-listed Hong Kong companies. Note that in both the Hong Kong and the combined data for all countries, the "penalty" for dropping down from the full "listed" status to the OTC status is a 20-30% reduction in value.

Cross-listing premium for Hong Kong Companies

The markets themselves are alert to this "cross-listing premium," and prices move on the mere announcement of such a plan. Another study looked at the one-day jump in price from the announcement of a cross-listing, as a function of the "destination market." The value increase is strongest for cross-listing in the U.S.

The role of the PCAOB – and the significance of its being blocked – is also understood by the investors. A third study analyzed market reactions in China to three specific announcements by the PCAOB in 2009-2010. In the first two announcements, the PCAOB indicated that it was experiencing delays in obtaining cooperation, but assessed somewhat hopefully: "Discussions are continuing with the relevant authorities in those jurisdictions in an effort to resolve their objections to PCAOB inspections." In the third announcement, they were more forthright about the obstruction: "The PCAOB is denied access to conduct inspections."

The study looked at the short-term price movements in the Chinese markets, which were quite large, and quite negative.

A loss of nearly 8% in a few days is in any case impressive. The fact that it was driven by a couple of press releases from a rather feckless bureaucracy half way around the world shows how tuned in to the cross-listing opportunity, or the lack of it, the Chinese markets are. The threat of losing the cross-listing premium, the rationale for the whole undertaking, was felt even then, though it will have taken ten more years for the other shoe to drop.

Why Does Cross-Listing Increase Market Value?

The answer? The academic literature calls it “bonding” – which means that companies abroad, especially those based in countries with weak standards of financial reporting and regulation, seek to demonstrate their quality by voluntarily stepping up to the more stringent standards in the U.S. market.

“Strong legal standards today attract, rather than repel, issuers who are cross-listing….migrating firms are opting into stronger, more mandatory legal standards.”

The practice of auditing – an expensive, arduous, and sometimes irksome exercise for any company – developed in the UK and the US well before there was any legal requirement whatsoever to provide audited statements. In other words, unlike most of normative finance, auditing began as a voluntary initiative of the capitalist enterprise to further its own interests, rather than a regulatory requirement imposed by the state. The role of strong laws and strong financial regulation in creating value is well-attested, and the superior quality of financial superintendence here is a cornerstone of American dominance in the global financial system.

Cross-listing by Chinese (and other foreign firms) is a powerful manifestation of this fact. These firms are seeking to add value by voluntarily raising the bar, above the rather sorry practices that prevail in China today. PCAOB-compliance adds value. That is why they came to New York in the first place. Running away from it, or being chased out, sends the opposite signal. Journalists may expatiate on the purported benefits to the Hong Kong market (and China as a whole) as all these prospectively delisted companies may come rushing home — indeed it is being branded by the Hong Kong Happy Talk set as the great “homecoming.” It won’t turn out that way. I think the Chinese companies know this too. If delisting does occur, it will hurt them and their shareholders, and the numbers cited above suggest that the hurt will be rather severe. And we should not ignore the even harsher possibility that Hong Kong may itself be peering over the downslope of its long career as a global financial center. It’s no fun if the “homecoming” means living in the basement.