

Via Hand Delivery

June 18, 2019

The Honorable Carolyn B. Maloney
Chair
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Bill Huizenga
Ranking Member
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Re: June 19, 2019, Hearing entitled “Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators”¹

Dear Madam Chair and Ranking Member Huizenga:

I am writing on behalf of the Council of Institutional Investors (CII) to express our appreciation for holding the above referenced hearing and to provide you with our views on two of the legislative proposals that are expected to be discussed at the hearing. We would respectfully request that this letter be made a part of the hearing record.

CII is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately \$4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than \$35 trillion in assets under management.²

¹ Hearings, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators (June 19, 2019), <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403833>.

² For more information about the Council of Institutional Investors (“CII”), including its board and members, please visit CII’s website at <http://www.cii.org>.

The Public Company Accounting Oversight Board (PCAOB or Board)

*CII generally supports the Discussion Drafts: the Holding Foreign Companies Accountable Act of 2019;*³ *and the PCAOB Enforcement Transparency Act of 2019.*⁴

Investors—who include approximately half of American families⁵—rely on honest and accurate financial statements in determining whether to invest in public corporations and how to allocate their capital.⁶ By mid-2002, following bankruptcies of Enron and WorldCom, the investing public’s confidence had been badly shaken by massive corporate scandals involving these and other prominent companies with household names.⁷

With the disclosure of wrongs by senior corporate executives and widespread auditing failures involving some members of the accounting profession, investors no longer trusted the information coming from issuers.⁸ The widespread failure by auditors to detect serious management fraud, which shocked American financial markets, occurred largely because no one was watching the watchers.⁹

The scandals demonstrated the inadequacy of accounting industry self-regulation.¹⁰ The crisis focused attention on the need for fundamental reform.¹¹ The intense effort of investors, shareowners, other stakeholders, regulators, and legislators culminated in the passage of the Sarbanes-Oxley Act of 2002 (SOX).¹²

The centerpiece of SOX was the creation of the PCAOB—the serious, industry-independent, accountable regulator that the accounting industry had long needed and always lacked.¹³ Among its many responsibilities, the PCAOB must inspect both U.S. and non-U.S. auditors auditing U.S. public companies.¹⁴ However, in practice, the positions of certain foreign authorities have prevented or significantly impaired the PCAOB’s ability to inspect non-U.S. audit firms.¹⁵

³ H.R. ____, the Holding Foreign Companies Accountable Act of 2019, 116th Cong. (2019) (DISCUSSION DRAFT), <https://financialservices.house.gov/uploadedfiles/bills-116pih-forcoacc.pdf>.

⁴ H.R. ____, the PCAOB Enforcement Transparency Act of 2019, 116th Cong. (2019) (DISCUSSION DRAFT), <https://financialservices.house.gov/uploadedfiles/bills-116pih-pcaobenf.pdf>.

⁵ See, e.g., Lewis Jacobson, What Percentage of Americans Own Stock?, PolitiFact California (Sept. 18, 2018), <https://www.politifact.com/california/statements/2018/sep/18/ro-khanna/what-percentage-americans-own-stocks/>.

⁶ Brief of Council of Institutional Investors et al. at 5, *Free Enterprise Fund v. PCAOB*, 571 U.S. 477 (2010) (No. 08-861),

https://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_861_ResponseAmCu12InvestmentGrps.authcheckdam.pdf.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at 5-6.

¹⁰ *Id.* at 6.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ See, e.g., Memorandum from FSC Majority Staff to Members, Committee on Financial Services 2 (June 14, 2019), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-20190619-sd002_-_memo.pdf.

¹⁵ *Id.*

Specifically, while many countries have cooperative agreements or simply cooperate with the PCAOB, the Chinese government prevents the PCAOB from inspecting auditors in China and, to the extent their audit clients have operations in China, Hong Kong. In addition, the PCAOB is prevented from inspecting the U.S.-related audit work and practices of PCAOB-registered firms in Belgium.¹⁶

The PCAOB also has the authority and responsibility to bring disciplinary action against auditing firms for noncompliance with SOX, or Securities and Exchange Commission (SEC or Commission), and PCAOB rules.¹⁷ In those disciplinary actions, the PCAOB may impose a range of sanctions on an auditor, including a censure, monetary penalties, revocation of a firm's registration, and a bar on an individual's association with registered accounting firms.¹⁸ However, SOX requires the PCAOB to keep its investigations and disciplinary proceedings confidential at least until the case is appealed to the Commission, the SEC elects on its own to review the Board's final decision, or the opportunity for SEC review has passed.¹⁹

CII believes that, despite the aforementioned limitations, the PCAOB has played and continues to play a vital role in protecting the investing public.²⁰ As we recently reiterated in a comment letter to the PCAOB, “we strongly endorse the PCAOB’s mission, vision, and values [and believe they] are generally consistent with our membership approved policies.”²¹

Holding Foreign Companies Accountable Act of 2019 (Accountable Act)

The provisions of the Accountable Act would require the SEC to prohibit U.S. public companies from trading on an exchange or an alternative trading system if: (1) the firm is inspected annually and it retains a foreign public accounting firm that the PCAOB is unable to inspect for three consecutive years;²² or (2) the firm is inspected once every three years and it retains a foreign public accounting firm that the PCAOB is unable to inspect for six consecutive years.²³

The provisions of the Accountable Act would also provide that the Commission end the trading prohibition once the company certifies that it has retained a public accounting firm that the PCAOB is able to inspect.²⁴ The Accountable Act would also require an issuer to disclose

¹⁶ PCAOB, Issuers that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections (updated Sept. 10, 2018),

<https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>.

¹⁷ Memorandum from FSC Majority Staff to Members, op. cit. at 1-2.

¹⁸ See *id.* at 2; PCAOB, Enforcement, Enforcement Actions, <https://pcaobus.org/Enforcement/Pages/default.aspx> (last visited June 18, 2019).

¹⁹ Memorandum from FSC Majority Staff to Members, op. cit. at 2.

²⁰ *Id.*

²¹ Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Office of the Secretary, PCAOB 1 (Sept. 6, 2018),

https://www.cii.org/files/issues_and_advocacy/correspondence/2018/September%206,%202018%20PCAOB%20Strategic%20Plan.pdf (includes discussion of CII membership approved policies relevant to the Public Company Accounting Oversight Board).

²² See H.R. ____, the Holding Foreign Companies Accountable Act of 2019, § 2(a)(i)(2)(A)(i).

²³ *Id.* § 2(a)(i)(2)(A)(ii).

²⁴ *Id.* § 2(a)(i)(2)(B).

whether it is state-owned or government-controlled.²⁵ The Accountable Act would have particular implications for Chinese companies, given opposition of the Chinese government to PCAOB inspections.²⁶

In September 2018 we submitted a comment letter to the PCAOB in response to the PCAOB Draft Strategic Plan 2018-2022 (September Letter).²⁷ The September Letter identified the following issues regarding U.S. Chinese listed companies:

[W]e are concerned that the PCAOB has identified more than 130 issuers that are audit clients of PCAOB-registered firms located in China where the PCAOB is denied access to conduct inspections in violation of the Sarbanes-Oxley Act of 2002. We are particularly concerned about PCAOB-registered firms located in China for at least four reasons: (1) since 2010 the PCAOB has actively sought without success inspections of China-based audit firms and the mainland affiliates of the Big Four . . . - Deloitte, KPMG, PricewaterhouseCoopers and EY; (2) many of the China-based audit firms do significant work on audits of major U.S. companies doing business in China; (3) the recent surge in the number of Chinese companies listed on U.S. stock exchanges; and (4) most of the Chinese companies listed on U.S. stock exchanges in recent years have a variable interest entity structure that is highly complex and might include risks that some investors and auditors may not fully understand or appreciate.²⁸

Three months following the submission of the September Letter to the PCAOB, SEC Chairman Jay Clayton, SEC Chief Accountant Wes Bricker, and PCAOB Chairman William D. Duhnke III issued a joint statement describing the size, scope, and significance of some of the investor protection and oversight issues resulting from U.S. Chinese listed companies (Joint Statement).²⁹ The Joint Statement confirmed many of the concerns we had raised and included the following relevant information:

[S]ignificant current issues relate[] to the ability of the PCAOB to inspect the audit work and practices of PCAOB-registered auditing firms in China (including Hong Kong-based audit firms, to the extent their audit clients have operations in mainland China) with respect to their audit work of U.S.-listed companies with operations in China . . .

²⁵ *Id.* § 2(a)(i)(1).

²⁶ CII has some particular concerns on certain China issuers, for example see Buyer Beware: Chinese Companies and the VIE Structure 16 (Dec. 2017), https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf (discussing risks of China VIEs, and describing five potential actions the Securities and Exchange Commission “should consider”).

²⁷ Letter from Jeffrey P. Mahoney.

²⁸ *Id.* at 6.

²⁹ SEC Chairman Jay Clayton, SEC Chief Accountant Wes Bricker, PCAOB Chairman William D. Duhnke III, Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China (Dec. 7, 2018), <https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other>.

While the analysis of the quality of financial reporting is principally an issuer-specific exercise, on a collective basis, the size and scope of the current issue is meaningful. For example, consider the following data points:

- There are 224 U.S.-listed companies (with \$1.8 trillion in combined market capitalization) where the PCAOB faces obstacles in inspecting the principal auditor's work.
- There are another 207 U.S.-listed companies where the PCAOB can inspect some—although not all—of the auditor's work.

....

[B]oth the SEC and the PCAOB currently face significant challenges in overseeing the financial reporting for U.S.-listed companies whose operations are based in China—a market where U.S. investors' interest has increased and is significant.

....

The PCAOB is currently restricted from inspecting audit work and practices of PCAOB-registered firms in China (including Hong Kong, to the extent their audit clients have operations in China). . . . Where the PCAOB is not able to conduct inspections of audits of foreign-based companies listed in the U.S., investors in these companies do not receive the tangible, quality-enhancing benefits that can result from PCAOB inspections.

. . . . [T]he PCAOB publishes on its website a list of companies whose auditors are located in jurisdictions where there are obstacles to PCAOB inspections. The current list includes 224 unique issuers, and they represent a significant portion of the capital markets, with a combined market capitalization exceeding \$1.8 trillion. Out of these 224 issuers, 213 have auditors based in mainland China or Hong Kong

....

While information barriers certainly continue to exist in multiple jurisdictions, we believe the resolution of these issues discussed above with China is of the most significance to investors. . . .

The inability to date to achieve this level of regulatory cooperation with Chinese authorities raises a number of investor protection and general oversight issues.

....

[T]he barriers to information access discussed above may adversely affect investors in the U.S. markets and the interests they own in companies that are China-based

or have significant operations in China, including because they reduce the certainty provided by U.S. law and oversight.

....

Finally, we note that . . . if significant information barriers persist, remedial actions involving U.S.-listed companies may be necessary or appropriate.³⁰

Since the issuance of the Joint Statement, we are unaware of any remedial actions that have been taken by the SEC or the PCAOB to address the investor protection and general oversight issues that have been identified. Moreover, in the absence of any action, those issues are only likely grow because the number of U.S. Chinese listed companies appears to be accelerating. CII tracked 33 foreign private issuers based in China that IPO'd on U.S. exchanges in 2018, and just last month a Nasdaq official commented:

“It seems like we will have over 40 IPOs from China, [which] are coming to the U.S. this year. So [2019] could be the strongest year ever”³¹

We acknowledge that there are a number of possible alternative actions the SEC,³² the PCAOB,³³ the stock exchanges,³⁴ or Congress³⁵ could potentially take to address, at least in part, the investor protection and general oversight issues that exist for U.S. Chinese listed companies. In our view, the provisions of the Accountability Act are not an unreasonable response, particularly in light of the apparent increasing size, scope, and significance of those issues.

³⁰ *Id.* (footnotes omitted).

³¹ Quian Chen, Deals & IPO, Nasdaq: The Pipeline for Chinese Companies Listing in the US ‘Is Stronger Than It Has Ever Been,’ CNBC (May 8, 2019), <https://www.cnbc.com/2019/05/08/nasdaq-chinese-companies-listing-in-us-pipeline-stronger-than-ever.html>.

³² See Buyer Beware: Chinese Companies and the VIE Structure at 16; Release, U.S. Securities and Exchange Commission, SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies (Nov. 9, 2011), <https://www.sec.gov/news/press/2011/2011-235.htm> (approving “new rules of the three major U.S. listing markets that toughen the standards that companies going public through a reverse merger must meet to become listed on those exchanges.”).

³³ See Letter from Jeffrey P. Mahoney at 6 (“respectfully request[ing] that the PCAOB consider examining whether some or all of the PCAOB-registered firms located in China (and perhaps other jurisdictions) should be deregistered because they are not subject to inspections in violation of the U.S. federal securities laws.”).

³⁴ See Letter from Senators Chris Van Hollen and John Kennedy to the Honorable Robert E. Lighthizer, United States Trade Representative, Office of the United States Trade Representative 2 (June 12, 2019), <https://www.vanhollen.senate.gov/imo/media/doc/itr%20to%20ustr%20re%20HFCA.pdf> (noting that in response to the “reverse merger crisis . . . the New York Stock Exchange and NASDAQ delisted over 50 Chinese companies between 2011 and 2012”); Francine McKenna, After China Fraud Boom, Nasdaq Steps Up Scrutiny of Shady Listings, MarketWatch (June 20, 2016), <https://www.marketwatch.com/story/after-china-fraud-boom-nasdaq-steps-up-scrutiny-of-shady-listings-2016-06-20> (describing a number of actions taken by the Nasdaq in response to the “Chinese reverse merger fraud crisis”).

³⁵ See S. 1731, the EQUITABLE Act, 116th Cong. (2019), <https://www.govtrack.us/congress/bills/116/s1731/text> (requiring an alternative listing prohibition and disclosures).

PCAOB Enforcement Transparency Act of 2019 (Transparency Act)

The provisions of the Transparency Act would amend SOX to make PCAOB enforcement hearings and all related notices, orders, motions, and sanctions open and available to the public unless otherwise ordered by the Board.³⁶

CII believes the lack of transparency surrounding PCAOB disciplinary proceedings could provide firms with an incentive to litigate cases in order to continue to shield conduct from the public.³⁷ For example, we understand that one accounting firm continued to issue no fewer than 29 additional audit reports on public companies without those companies knowing that it was subject to a PCAOB disciplinary proceeding.³⁸ The boards and shareholders of those companies may have been deprived of important information about the proceeding against the firm and the substance of any violations.

We note that CII's membership approved policies explicitly identify "fines levied by the Public Company Accounting Oversight Board" as a factor that an audit committee should consider when determining whether to change auditors.³⁹ Moreover, we believe that same factor should also be considered by shareowners when exercising their oversight of the committee and when their casting their proxy votes for the election of the chair and members of the committee and for ratification of the external auditor.

We also understand that PCAOB's currently required confidential proceedings run counter to the public enforcement proceedings of other regulators, including the SEC, the U.S. Department of Labor, the Federal Deposit Insurance Corporation, the U.S. Commodity Futures Trading Commission, the Financial Industry Regulatory Authority, and others.⁴⁰

Finally, we also note that the provisions of the Transparency Act are similar to legislation introduced in 2016 by former Representative Scott Garrett, the Chair of the predecessor to this Subcommittee.⁴¹ Chair Garrett's bill—H.R. 6251⁴²—was publicly supported by then PCAOB Chairman James R. Doty.⁴³ Chairman Doty was reported at indicating that he believed the bill would "give investors and audit committees valuable information they need." We wholeheartedly agree.

³⁶ See H.R. ____, the PCAOB Enforcement Transparency Act of 2019, § 2.

³⁷ See News Release, Senator Jack Reed, Reed, Grassley, Renew Bi-Partisan Push to End Secrecy Surrounding Accounting Watchdog Enforcement Proceedings (May 2, 2019), <https://www.reed.senate.gov/news/releases/reed-grassley-renew-bipartisan-push-to-end-secrecy-surrounding-accounting-watchdog-enforcement-proceedings> (announcing a Senate bill, S. 1256, similar to H.R. ____, the PCAOB Enforcement Transparency Act of 2019).

³⁸ *Id.*

³⁹ Council of Institutional Investors Governance Policies, § 2.13a Audit Committee Responsibilities Regarding Independent Auditors (Updated Oct. 24, 2019), https://www.cii.org/files/10_24_18_corp_gov_policies.pdf.

⁴⁰ News Release.

⁴¹ Memorandum from FSC Majority Staff to Members op. cit. at 3 ("This draft bill is similar to a bipartisan bill in the Senate, (S. 1256), as well as, a House bill from the 114th Congress that was sponsored by former Republican Representative Scott Garrett (H.R. 6251).").

⁴² H.R. 6251, the PCAOB Enforcement Act Transparency Act of 2016, 114th Cong. (Sept. 28, 2019), <https://www.congress.gov/bill/114th-congress/house-bill/6251/text> (text of bill).

⁴³ Stephen Barlas, Governance, Transparency of Accountant Discipline Actions at PCAOB, SF (Dec. 1, 2016), <https://sfmagazine.com/post-entry/december-2016-transparency-of-accountant-discipline-actions-at-pcaob/>.

If we can answer any questions or provide additional information that would be helpful to you or the Subcommittee, please do not hesitate to contact me at 202.822.0800 or jeff@cii.org.

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney". The signature is written in black ink and is positioned above the typed name.

Jeffrey P. Mahoney
General Counsel