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July 9, 2020

Via Email and Open Letter

The Honorable Jay Clayton
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Roundtable on Emerging Markets

Dear Mr. Chairman:

China-based issuers have committed – and continue to commit – fraud on a stunning scale in the United States' capital markets. Protecting individual investors from the devastating financial impact of these frauds requires a profoundly different policy and regulatory approach. That is because the U.S. and PRC legal systems are fundamentally incompatible with one another. The root cause of the extensive fraud by China-based issuers is the riskless reward China-based fraudsters enjoy when harming U.S. investors – i.e., the knowledge that our regulatory bodies are unable to inflict any meaningful punishments against the responsible individuals, and therefore deliver effectively zero deterrent to these criminal activities. A new attitude and approach is necessary to convert U.S.-based institutions that are currently enabling these abuses – particularly the U.S. member firms of the global auditors – into true gatekeepers who are strongly incentivized to ensure the integrity of the issuers' financial reporting and disclosures. We respectfully submit two proposals that we believe will substantively improve the quality of audits of China-based issuers.

Analysis of the Problem

As documented in the 2018 film The China Hustle, in the previous decade, literally hundreds of companies from China collectively raised tens of billions of dollars from U.S. investors, only to have their stock prices subsequently collapse. U.S. investors experienced near-total losses as a result. To the best of our knowledge, no PRC-based company chairman (i.e., controlling shareholder) has been held materially accountable. In the best case for U.S. investors, the perpetrators settle for pennies on the stolen dollar. As a result, we believe that fraud committed by China-based issuers in the U.S. markets is a significant ongoing problem, as is glaringly illustrated by GSX Techedu Inc.

As of 2012, U.S. investors appeared to have learned their lesson, and valuations of China-based companies reached a nadir. We believe that China's Communist Party officials viewed the

reduction in valuations of China-based companies as a significant personal problem. We firmly believe that many of the CCP officials (both national and regional) have undisclosed holdings in U.S.-listed China companies through an opaque web of proxies.

In the early part of the last decade, the CCP addressed the lack of U.S. investor enthusiasm by having state-owned banks, such as China Development Bank, finance management-led buyouts of several outright fraudulent companies, such as Harbin Electric. We assess that the CCP's goal was to reopen the U.S. capital markets to listings from China. They were successful in achieving this objective. This is but one example of the CCP thoroughly understanding our economy, markets, and people, and strategically exploiting our values as weaknesses.

At the same time, the CCP aggressively stymied investigations into these frauds. When the SEC requested auditors' working papers, the PRC government advised the PRC-based auditors that provision of these papers would constitute a violation of China's State Secrets Law. It is worth reflecting on this because it shows clearly that the CCP's policy is to promote consequence-free exploitation of U.S. individual investors. No other interpretation of these actions is accurate.

Last year, China codified into written law this blanket protection to PRC-based executives who seek to defraud U.S. and other foreign investors with Article 177 of its Revised Securities Law. This law expressly prohibits China-based issuers from cooperating with investigations by foreign regulators (obviously the SEC and DOJ). This development should stun U.S. policymakers, regulators, and investors, but we settle instead for disclosures that admit investors in China-based companies have no recourse to executives or assets in the event of fraud.

We struggle to think of any parallel in the history of capital markets where issuers from one country so frequently, obviously, egregiously, and systematically defrauded investors of another country. By providing blanket immunity to the perpetrators of these crimes against American investors, China is acting as a hostile foreign power. Once again, no other interpretation of these actions is accurate.

Regarding the public duty of the auditors, China has made it possible for yet another player in the process to dodge investors. To be blunt, even if the PCAOB were granted the right to inspect these issuers' auditors, investors would gain little substantive additional protection. We have no reason to believe that such inspections would be free of CCP manipulation and interference. In other words, we see little assurance to be gained through obtaining the long-awaited access to these inspections.

One should be asking: Why is China completely intransigent on the auditor inspection issue? We believe the reason is that China is trying to exhaust our political will so that we have no political energy left to focus on more substantive protective measures – measures that would make it harder for insiders and CCP officials to enrich themselves by defrauding U.S. investors.

Against this backdrop, the U.S. has unfortunately mishandled the China-based auditor issue. At one point, a SEC administrative judge imposed six-month suspensions of the practice licenses of the Big Four's PRC affiliates. The penalties were subsequently softened to token fines. This close call convinced the auditors' China member firms that they could now act with impunity,

creating the perverse incentive to ignore evidence of fraudulent behavior because finding fraud would create the need to cooperate with U.S. investigations. Cooperating with the U.S. government would potentially subject them to severe penalties from the Chinese government. Their rational response is effectively to rubber-stamp unqualified audit opinions and save everyone the grief. We believe this is the reason why until the implosion at Luckin Coffee in April of this year, there had been no auditor resignations of note. It is not because fraud among these companies is so rare – it is because the courage to point it out among their auditors is.

Regulation works only when there is a deterrent. When it comes to China-based issuers, there is effectively no deterrent to malicious conduct, particularly given that such misconduct is openly condoned and protected by the CCP. If we had a different legal and regulatory system, we could require foreign citizens who exert control influence over U.S.-listed companies to post significant assets as collateral against misdeeds. While that mechanism is seemingly impractical in our system, we could use a similar concept to help ensure that the guardrails, at least, are substantive.

Our Proposals

We first propose that the U.S. member firms for auditors of China-based issuers bear significant potential financial liability in the event of audit failures of their U.S. listed clients. China-based issuers have repeatedly used the credibility of Big Four auditor brands to defraud U.S. investors. If global auditors are happy to rent their names to entities that are prohibited from cooperating with U.S. regulators, the lessors of these monikers should bear responsibility similar to how parents are often financially responsible for the misdeeds of their minor children.

The Big Four have created a global network of "member firms" or "affiliates" in order to ringfence liability for audit failures. In good times, the U.S. entities advertise the global brand aggressively, encouraging investors to focus on the promise of seamless service delivery without regard to the legal fiction of ringfencing liability when things go wrong. During good times, people and information move freely through these global networks, as does money. However, when an audit failure becomes apparent in China, the U.S. entities completely disclaim responsibility, pointing their fingers at the PRC affiliates. As discussed, the PRC affiliates are prohibited from cooperating by the CCP, and additionally have significant disincentives to cooperate.

If the U.S. were to require that these China-based auditors, which are currently beyond the reach of our laws and inspections, post "collateral" in the form of guarantees by all U.S. entities of the networks with which they are affiliated, we believe there would be a marked improvement in audit quality and much greater selectivity in taking on audit clients. We think the effect would be instantaneous.

We next propose a corollary rule that would provide auditors a safe harbor for failed audits prior to the enactment of the new rule, provided that they exercise a high degree of diligence on a go-forward basis – particularly after being made aware of allegations of fraud by an issuer. The rationale here is to change the incentive / disincentive structure to encourage auditors to report

on wrongdoing by issuers, rather than the current system, which effectively discourages them from doing so if they have already issued at least one unqualified audit opinion.

Conclusion

As with so many aspects of China's relationship to the outside world, with overseas listings, China has sought to exploit what it perceives as weaknesses in its strategic competitors' systems. So long as the Communist Party governs China, China will never be what we want it to be. It will be a reflection of the predatory and corrupt Communist system. It is clearly beyond the remit and ability of market policymakers and regulators to change China, but we can substantively protect American investors from this form of predation. All these issues we face with China matter, and Muddy Waters Capital believes that despite our current challenges, America has the strength and ability to defend our long-term interests. All we need is the resolve.

Sincerely,

Carson C. Block

Carson C. Block
Chief Investment Officer