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What Investment Tensions With China Mean For US Issuers

By **Carl Valenstein, Erin Martin and David Bionghi**
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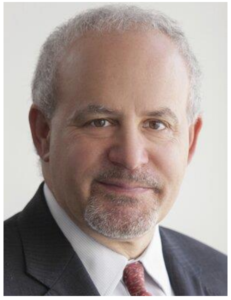

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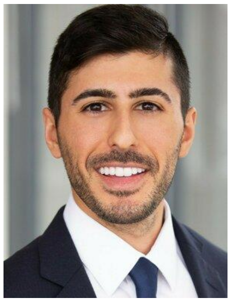

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Geopolitical, trade and investment tensions between the U.S. and China continue due to differences on such issues as the Russia-Ukraine conflict, Taiwan, Xinjiang, Hong Kong, Tibet, the South China Sea, human rights and more.

U.S. issuers should review their current exposure to the China market and adjust their risk factor disclosures in upcoming annual reports, as appropriate, to take into account recent developments.

Beginning with the Trump administration in 2017 and largely continuing with the Biden administration, the U.S. has taken a series of trade, international treaty, tax and sanctions actions against China.

These include:

- The imposition of tariffs on a substantial quantity of Chinese imports;
- The imposition of sanctions on an expanded number of Chinese companies for their support of China's military industrial complex or alleged human rights violations;
- Enhanced reviews by the Committee on Foreign Investment in the U.S. of foreign direct investments in the U.S. by Chinese companies;
- The detention by U.S. Customs and Border Protection of products made in Xinjiang involving alleged human rights violations; and
- More recently, the enhancement of extensive export controls on the semiconductor industry designed to impede Chinese semiconductor companies' access to advanced technology.[1]

These actions have in many cases triggered, or are expected to trigger, countersanctions or countermeasures from the Chinese government.[2] It remains to be seen whether recent diplomatic meetings between President Joe Biden and President Xi Jinping will have a positive effect on relations.

China and Taiwan

Additionally, in recent years, tensions between mainland China and Taiwan have further escalated, with China accelerating the development of its military capabilities in order to reunite Taiwan by force.

The U.S. government, which has maintained a long-standing policy of strategic ambiguity on whether to defend Taiwan in case of a military conflict, has steadily increased its support of Taiwan's own defense capabilities and deterrence of China's military actions against Taiwan.

The newly passed Taiwan Policy Act of 2022, among other things, provides almost $4.5 billion in security assistance over the next four years. As countermeasures, China has significantly increased its air patrol and military exercises near the Taiwan Strait and imposed sanctions on U.S. officials visiting Taiwan and U.S. defense companies selling arms to Taiwan.

Military leaderships and civilian think tanks in various countries are openly contemplating the outbreak of hostilities with varying but specific timetables.

In case of a military conflict between China and Taiwan, global manufacturers would likely lose access to advanced semiconductor chips and other products that are sourced from Taiwan.

Such a conflict would also likely limit access to key Chinese ports and exporters due to both military actions and potential international sanctions, which would create significant disruption for industries that rely on supply chain in China.

What to Expect in 2023

Further action on China is expected from the Biden administration and Congress this year.

Legislation relating to China — especially regarding supply chain security, unfair trade practices, intellectual property protection, data privacy, defense and national security, China's inbound investments into the U.S. and U.S. outbound investment flows to China, Taiwan, human rights and higher education — is one of the few areas of potential consensus between Republicans and Democrats.

Risk Factor Disclosure

As geopolitical tensions between the U.S. and China continue, issuers should consider carefully tailoring their risk factors to address specific risks facing their businesses related to China, and should benchmark these risk factors against what their peers are disclosing.

While the risk factors of Chinese-based companies publicly traded in the U.S. offer a catalog of China-related risks to consider, including those risks for which the U.S. Securities and Exchange Commission has requested explicit disclosure through staff comment letters,[3] many of these will not be relevant to U.S. issuers doing business in China.

Reliance on generic risk factors related to the risks of doing business internationally may fall short of properly informing investors of the specific risks an issuer may face when engaging in certain China-related activities, and the SEC discourages such boilerplate disclosure.

The SEC has not to date provided any tailored guidance on how U.S. companies should consider disclosing risks related to doing business in China.

However, the SEC's Division of Corporation Finance's disclosure guidance topics — pertaining to COVID-19 disclosure considerations[4] and, in particular, the sample letter issued by the staff May 2022 in response to Russia's invasion of Ukraine and related supply chain issues — provide a useful analytical framework for considering the disclosure of China-related trade risk.[5]

Applying the frameworks articulated in the Division's guidance, companies should consider detailed risk factor disclosure, to the extent material or otherwise required, regarding the following:

- Direct or indirect exposure to China through operations, employee base, investments in China, securities traded in China, sanctions against China or Chinese individuals or entities, or legal or regulatory uncertainty associated with operating in or exiting China;
- Direct or indirect reliance on goods or services sourced in China;
- Actual or potential disruptions in the applicable supply chain; and
- Business relationships in, connections to, or assets in China.

In addition, since U.S.-China trade tensions have increased, many companies have experienced heightened cybersecurity risks, increased or ongoing supply chain challenges, and volatility related to the trading prices of commodities, regardless of whether they have operations in China that likely warrant disclosure.

Other Disclosure

In addition to risk factor disclosure, financial statements may also need to reflect and disclose the impairment of assets, changes in inventory valuation, deferred tax asset valuation allowance, disposal or exiting of a business, deconsolidation, changes in exchange rates, and changes in contracts with customers or the ability to collect contract considerations.

Companies with significant and material exposure to these risks also should consider how these matters may affect management's evaluation of disclosure controls and procedures, management's assessment of the effectiveness of internal controls over financial reporting, and the role of the board of directors in risk oversight of any action or inaction related to increased U.S.-China trade and investment tensions, including consideration of whether to continue or to halt operations or investments in China.

Outbound Risks

Specific outbound risks to consider include the following:

- China's recent relaxation of its zero-COVID-19 policy and reopening of the economy, and the impact on the issuer's current and future operations and supply chains;
- The effects of a potential military conflict between mainland China and Taiwan, possible international intervention and sanctions, and the resulting potential disruption to the issuer's regional supply chain, and sales and operations in the affected region;

- Compliance with increased export controls on certain technologies, such as semiconductors;
- Compliance with sanctions and risks of doing business with Chinese companies given the increasing designation of Chinese companies on various U.S. government lists, including the Blocked or Specially Designated National list, the Entity List, the Denied Parties list, the Unverified List and the Non-SDN Chinese Military-Industrial Complex Companies List;
- Restrictions imposed by the U.S. government on the transfer of technology or manufacturing to China derived from U.S. government funding, including the Chips Act or Bayh-Dole Act;
- Potential restrictions under consideration by the U.S. government on outbound investment in China;
- Protection of intellectual property in China;
- Dispute resolution and enforcement of court judgments and arbitral awards in China;
- Compliance with the Foreign Corrupt Practices Act given that employees of state-owned enterprises are considered foreign government officials for FCPA purposes, and the dominant roles of SOEs in China's economy;
- Compliance with Chinese legal and regulatory requirements, including compliance with China's new privacy and data protection regime; and
- Conflict of law risks created by the conflict between compliance with U.S. obligations and Chinese countermeasures or sanctions.

Inbound Risks

Specific inbound risks to consider include the following:

- Supply chain disruptions relating to trade remedy laws, including Section 337 cases involving exclusions of infringing goods imported from China, and anti-dumping and countervailing duty cases against China, including anti-circumvention cases relating to imports from third countries using Chinese inputs;
- Maintenance of increased Trump-era tariffs subject to certain exceptions on products imported from China;
- Increased risk of the ban on the importation into the U.S. from China of products under alleged human rights violations following the adoption of the Uyghur Forced Labor Prevention Act; and
- Heightened scrutiny by CFIUS of Chinese investment in the U.S. and increased restrictions on Chinese participation in the U.S. supply chain in certain sectors, such as telecommunications.

Next Steps

Companies should ensure the filings adequately reflect the risks they face from heightened U.S. — China tensions with specific, tailored disclosures in order to satisfy applicable disclosure requirements, mitigate private civil litigation risks and withstand potential regulatory scrutiny.

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[1] The US-China trade war: A timeline,China Briefing News(2022). https://www.china-briefing.com/news/the-us-china-trade-war-a-timeline/.

[2] The US-China trade war: A timeline,China Briefing News(2022). https://www.china-briefing.com/news/the-us-china-trade-war-a-timeline/.

[3] Sample Letter to China-Based Companies(2021). https://www.sec.gov/corpfin/sample-letter-china-based-companies.

[4] See CF Disclosure Guidance Topic No. 9: Coronavirus (COVID-19) (Mar. 25, 2020) and CF Disclosure Guidance Topic No. 9A: Coronavirus (COVID-19) Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources (June 2022).

[5] Sample Letter to Companies Regarding Disclosures Pertaining to Russia's Invasion of Ukraine and Related Supply Chain Issues (2022).