NOTE

THE SEC'S VIE PROBLEM: WHY THE AGENCY'S APPROACH CONTRADICTS ITS RHETORIC

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In July 2021, the SEC temporarily banned securities issuances by Chinese companies listing in the United States with a stated rationale of protecting average investors from the complicated and opaque corporate structure known as a variable interest entity ("VIE"), often employed by Chinese operating companies listed in the United States. The subsequent rule changes for VIE disclosure illustrate the disconnect between the agency's rhetoric and its actions. The SEC's continued invocation of retail investors rings hollow when they are unlikely to be affected by tweaks to disclosure rules. The SEC should make an effort to be more transparent about whom its disclosure rules serve: institutional investors, who are most likely to read disclosure documents and most able to use the information contained within them to price the securities efficiently. Academic literature suggests professional investors should be the agency's main priority, and the current regime, as seen in the case of VIE disclosure rules, can only make sense when viewed through that lens. Investor confidence, internal rulemaking, and market efficiency would all be improved if the SEC were more transparent about its goals and methods.

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I. INTRODUCTION

> Any serious examination of the role and function of securities regulation must sidestep the widespread, yet misguided, belief that securities regulation aims at protecting the common investor. Securities regulation is not a consumer protection law.[1]

In July 2021, the SEC "put a pause on new offerings"[2] from Chinese companies listing in the United States because "average investors may not realize that they hold stock in a shell company rather than a China-based operating company."[3] Within a few months, Chinese companies began conducting U.S. offerings again,[4] but with new requirements in place for issuers using commonplace shell company

[1] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 713 (2006) (citation omitted).

[2] Gary Gensler, *SEC Chair: Chinese Firms Need to Open Their Books*, WALL ST. J. (Sept. 13, 2021, 6:00 PM), https://www.wsj.com/articles/china-accounting-standards-shell-company-vie-investment-sarbanes-oxley-sec-gensler-11631563524 [https://perma.cc/T67S-KY77].

[3] Gary Gensler, *Statement on Investor Protection Related to Recent Developments in China*, SEC (July 30, 2021), https://www.sec.gov/news/public-statement/gensler-2021-07-30 [https://perma.cc/LFR5-DHCK].

[4] *See, e.g.*, Filipe Pacheco, *China-Focused Biotech LianBio Raises $325 Million in U.S. IPO*, BLOOMBERG NEWS (Oct. 31, 2021, 9:51 PM), https://www.bloomberg.com/news/articles/2021-11-01/china-focused-biotech-lianbio-raises-325-million-in-u-s-ipo [https://perma.cc/CJC7-N96X].

structures.[5] Known as "variable interest entities" (VIEs), these shell structures are now required by the SEC to disclose that "investors are not buying shares of a China-based operating company but instead are buying shares of a shell company" along with the uncertainty risk related to potential regulation.[6]

Puzzlingly, though, VIEs were already explaining their complicated structures and a raft of associated risks at length in registration statements.[7] Further, evidence indicates the "average investors" invoked in the SEC's public statements do not even read registration statements at all.[8] This all begs the question of why the SEC felt the issue was so urgent it needed to pause *all* Chinese listings while it reformulated disclosure rules when, in the prior year, companies based in China had raised approximately $12 to $19 billion on U.S. exchanges.[9] Nearly all Chinese companies that list on U.S. exchanges use a holding company to circumvent Chinese laws prohibiting foreign investment in Chinese companies[10] and foreign oversight of Chinese auditors.[11]

[5] *See, e.g.*, Jing Yang, *U.S. and Chinese Regulators Are in a Bind Over a Three-Letter Acronym*, WALL ST. J. (Sept. 30, 2021, 6:50 AM), https://www.wsj.com/articles/u-s-and-chinese-regulators-are-in-a-bind-over-a-three-letter-acronym-11632999033 [https://perma.cc/YNU3-WF7D].

[6] Gensler, *supra* note 3.

[7] *See, e.g.*, *Alibaba Tweaks a Controversial Legal Structure*, THE ECONOMIST (Aug. 11, 2018), https://www.economist.com/business/2018/08/09/alibaba-tweaks-a-controversial-legal-structure[https://perma.cc/AAN7-C4Q5]; Alibaba Group Holding Limited, Registration Statement (Form F-1) (May 6, 2014), https://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111df1.htm [https://perma.cc/DC5C-MV7D].

[8] *See infra* Part III.

[9] Karen Sutter, *U.S. Capital Markets and China: Issues for Congress*, CONG. RSCH. SERV. (Sept. 2, 2021), https://sgp.fas.org/crs/row/IF11803.pdf [https://perma.cc/ZQ38-4MHU].

[10] Yang, *supra* note 5 ("VIE structures [are used] to circumvent Chinese restrictions on foreign investments in domestic businesses.").

[11] Gensler, *supra* note 2.

The SEC has a mandate to craft a disclosure regime which works for the public.[12] Regulators are concerned about the risks VIEs pose to U.S. securities markets. Indeed, "[a]s of May 2021, there were 248 Chinese firms listed on the three major U.S. stock exchanges . . . accounting for a market capitalization of $2.1 trillion."[13] These stocks are subject to risk if Chinese regulators determine that VIEs violate Chinese law, wiping out their position overnight.[14] Investors are also subject to jurisdictional risk, as contract disputes may be resolved in a Chinese jurisdiction, rather than in the United States.[15] This risk becomes more pronounced because the VIE structure may misalign incentives—in fact, "[a] dozen U.S.-listed Chinese internet companies haven't been remitting profits generated by the VIEs to the offshore holding companies like they are supposed to."[16] However, institutional investors comprise the constituency which should be protected—in an efficient market, they are the ones who use disclosure information to collectively determine a security's proper value, and consequently, average investors cannot buy VIE stocks for more than they're worth because the securities are priced accurately.[17] Despite its mandates of accessibility, the complex and lengthy documents which are required show that these institutional investors are the ones whom the SEC has in mind when promulgating rules.

This Note argues that the SEC's current disclosure requirements only make sense when divorced from the agency's rhetoric. Specifically, it proposes that the SEC be

12 Exec. Order No. 13563, § 1, 4, 76 Fed. Reg. 3821-22 (Jan. 18, 2011). ("Our regulatory system . . . must measure, and seek to improve, the actual results of regulatory requirements . . . [E]ach agency shall identify and consider regulatory approaches that reduce burdens and maintain flexibility and freedom of choice for the public.").

13 Sutter, *supra* note 9.

14 Chris Prentice & Aurora Ellis, *U.S. SEC Warns Investors of Risks From Certain Chinese Business Entities*, REUTERS (Sept. 20, 2021, 9:45 PM), https://www.reuters.com/business/us-sec-warns-investors-risks-certain-chinese-business-entities-2021-09-20/ [https://perma.cc/KJ4B-Y758].

15 *Id.*

16 Yang, *supra* note 5.

17 Goshen & Parchomovsky, *supra* note 1, at 715.

more diligent in ensuring its rhetoric aligns with the current disclosure requirements. As exemplified by the recent VIE disclosure rule changes, the SEC purports to enact rules with average investors in mind, but such rules create a disclosure regime incomprehensible to retail investors. The agency is right that traditional disclosure requirements fail to properly apprise investors of the risks inherent to the VIE structure. However, without fundamentally changing investor protection mechanisms which revolve primarily around risk disclosures in proxy materials and annual reports, the SEC's rule changes do not serve the interests of retail investors. Thus, the SEC's disclosure regime is, and indeed should be, crafted with professional investors in mind—as the SEC works to enhance transparency, the agency should strive to ensure its rhetoric aligns with the actions it takes.[18]

II. LEGAL AND REGULATORY BACKGROUND

Since its inception, the SEC's primary method of investor protection has been disclosure.[19] As one scholar puts it, "[s]ecurities regulation is motivated by the assumption that more information is better than less."[20] In regulating corporate behavior through a regime of disclosure obligations, investors can choose for themselves which corporate actions they find palatable.[21]

The current regulatory framework for VIEs exists in a kind of limbo between the competing interests of Chinese and American financial regulators. Chinese officials want to protect national security interests by disallowing foreign ownership of Chinese companies in sensitive sectors; however, they also want those same companies to be able to access the

[18] *See* Jay Clayton, Chairman, Sec. Exch. Comm'n, Remarks at the PLI 49th Annual Institute on Securities Regulation (Nov. 8, 2017).

[19] Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 150–51 (2006).

[20] *Id.* at 147.

[21] *Id.* at 151 ("So long as corporations disclosed all material information about their operations and their securities, investors could make their own investment decisions.").

capital they need to operate successfully.[22] U.S. regulators want to allow investors to take part in the growth potential of Chinese companies while adequately protecting those investors who may be unaware of the risks which stem from regulation promulgated by the People's Republic of China (PRC).[23] Understanding the regulatory regime in each country illuminates the underlying tensions.

A. Regulatory Background in China

China restricts foreigners from investing in Chinese companies that operate in certain "sensitive" sectors, with different limitations applying to different sectors.[24] The country's "Foreign Investment Law" spells out what restrictions apply to which sectors[25] and theoretically bans any foreign equity ownership of Internet companies, a category which includes some the country's largest companies, such as Alibaba, JD.com, and Tencent.[26]

However, these restrictions have not stopped Chinese companies from listing on U.S. and other foreign exchanges.[27] The country's major industries have long wanted access to foreign capital, and in the mid-1990s, the "China-China-Foreign" (CCF) Model was pioneered by a Chinese telecommunications company called Unicom.[28] In need of

[22] Yang, *supra* note 5 ("Chinese officials . . . [are] concerned about shutting down an avenue that let[s] Chinese companies—and by extension the Chinese economy benefit—from foreign capital.").

[23] *See, e.g.,* Gensler, *supra* note 2.

[24] Yang, *supra* note 5.

[25] *China Further Opens its Market with New "Foreign Investment Law"*, JONES DAY (Feb. 2020), https://www.jonesday.com/en/insights/2020/02/chinas-new-foreign-investment-law [https://perma.cc/9R5S-S5PW].

[26] *China Considers Closing Loophole Used by Tech Giants for U.S. IPOs*, BLOOMBERG (July 7, 2021), https://www.bloomberg.com/news/articles/2021-07-07/china-mulls-closing-loophole-used-by-tech-giants-for-u-s-ipos [https://perma.cc/AK7J-ZL8K].

[27] *Id.*

[28] Marcia Ellis, Gordon Milner & Mark Hu, *The VIE Structure: Past, Present And Future – Part I*, HONG KONG LAW. (June 2020), http://www.hk-

funds for capital investment, Unicom created subsidiaries, each of which formed a joint venture ("JV") with a foreign telecom company.[29] Each JV then entered contracts with Unicom whereby the JV (using foreign telecom capital) would construct networks and purchase equipment to be owned by Unicom.[30]

Chinese regulators never formally declared the CCF Model illegal; however, the government issued a formal notice in 1999 requiring Unicom to rectify "accounting irregularities" related to its JVs.[31] In response, Unicom simply terminated each of its JVs, leaving "a significant cloud over the future use of [the] CCF Model."[32]

A year later, three Chinese companies successfully listed on foreign exchanges with a precursor to the modern VIE structure.[33] The companies included both control contracts and economic contracts, allowing the financial statements of the operating company and listed company to be consolidated.[34] With financial statement consolidation, China-based issuers can offer foreign investors "the rights and benefits normally associated with ownership of the VIE without holding actual equity ownership" and evade the country's foreign investment restrictions.[35] Because the structure provides no equity stake, accounting rules had previously not required consolidation.[36] Notably, however, Enron used the VIE structure to hide its liabilities offshore, and to avoid similar chicanery going forward, the Financial Accounting Standards Board changed the accounting rules so

lawyer.org/content/vie-structure-past-present-and-future-%E2%80%93-part-i [https://perma.cc/N3KX-MPLB].

29 *Id.*

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.*

35 *Id.*

36 *Id.*

that now the structure requires financial statement consolidation.[37]

The modern VIE structure typically involves contractual arrangements where an offshore holding company (the "Offshore SPV," often based in the Cayman Islands)[38] controls and receives the economic benefits of a Chinese onshore operating entity (the VIE).[39] The Offshore SPV takes a 100% direct stake in a wholly foreign-owned enterprise (WFOE) established in China which contracts with the VIE, exclusively owned by PRC nationals.[40] The onshore operating entity "holds the assets and licenses that cannot be legally owned by foreign investors" while the offshore holding company enters contracts that grant it control of the Chinese entity and allow for financial statement consolidation.[41]

The structure allows Chinese companies to access foreign capital while complying with foreign investment restrictions; however, it is not without its risks to investors (and the China-based operating companies which employ it). First, the structure itself has never been officially approved by the PRC.[42] Since the first Chinese companies used the VIE structure to list in the United States, Chinese regulators have oscillated between tacit approval of the structure to outright attacks on it.[43] We currently appear to be in a period of tacit

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37 Floyd Norris, *Accounting Rules Changed to Bar Tactics Used by Enron*, N.Y. TIMES (Jan. 16, 2003, 2:33 AM), https://www.nytimes.com/2003/01/16/business/accounting-rules-changed-to-bar-tactics-used-by-enron.html [https://perma.cc/WC8G-XS9K].

38 *See, e.g.,* Yawen Chen, *China IPO Crackdown Will Cast Chill over Caymans*, REUTERS (July 27, 2021, 2:33 AM), https://www.reuters.com/breakingviews/china-ipo-crackdown-will-cast-chill-over-caymans-2021-07-07 [https://perma.cc/R733-8N9B].

39 Ellis et al., *supra* note 28.

40 *Id.*

41 *Id.*

42 *See China Considers Closing Loophole Used by Tech Giants for U.S. IPOs*, *supra* note 26.

43 Marcia Ellis, Gordon Milner & Mark Hu, *The VIE Structure: Past, Present And Future – Part II*, HONG KONG LAW. (June 2020), https://www.hk-lawyer.org/content/vie-structure-past-present-and-future-%E2%80%93-part-ii [https://perma.cc/4PTT-ABVT].

approval—without addressing the issue of VIEs, last year, China's State Administration for Market Regulation officially accepted a merger control filing for concentration of operators where one of the parties uses the VIE structure.[44] While "there is no doubt that [the VIE structure] represents an attempt to avoid restrictions on foreign investment," Chinese lawyers argue that "the legality of each element that makes up the VIE structure should be reviewed separately," not as a "sum of the parts of the VIE structure."[45]

Beyond the risk of illegality, the incentives of PRC shareholders and foreign investors are often inherently misaligned—especially when the Chinese VIE owners do not have a significant equity stake in the Offshore SPV.[46] Indeed, the structure's dubious legal status may incentivize a Chinese owner of a VIE to renege on a VIE contract because there would likely be no enforcement mechanism.[47] Aggrieved foreign investors would have to subject themselves to Chinese courts which may invalidate the contracts for subverting public policy.[48]

GigaMedia Limited ("GigaMedia"), an online gaming company operated through three Chinese VIEs, provides an example of this phenomenon.[49] In 2010, the company's foreign investors attempted to remove its founder (the owner of the Chinese VIEs), but he refused to step down and took possession of the VIEs' financial and licensing

[44] *Id.*

[45] *Id.*

[46] Sue-Lin Wong, *China Court Ruling Could Threaten Foreign Investments in Country*, N.Y. TIMES (June 17, 2013, 3:09 AM), https://archive.nytimes.com/rendezvous.blogs.nytimes.com/2013/06/17/china-court-ruling-could-threaten-some-foreign-invested-companies/ [https://perma.cc/YJF7-VTZ8].

[47] *Id.*

[48] *See id.*

[49] *Id.*; Gigamedia Ltd., Annual and Transition Report of Foreign Private Issuers (Form 20-F) 14 (June 30, 2010), https://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111df1.htm [https://perma.cc/8MRQ-ZD3S].

documentation.[50] Without control over the relevant documentation, GigaMedia had to deconsolidate its financial results and take extensive write-offs, lowering the overall value of the company.[51]

More famous perhaps is the dispute between Yahoo and Alibaba over Alibaba's lucrative online payment business, Alipay.[52] To expedite the process of obtaining an essential regulatory license, Alibaba Group transferred the ownership of Alibaba Group's online payment business, Alipay, to Alibaba's founder and majority shareholder, Jack Ma.[53] As a result, Alibaba Group and Yahoo (a principal shareholder in Alibaba Group) no longer retained control over Alipay and Yahoo could no longer consolidate Alipay into its financial statements.[54] Upon disclosing this information, Yahoo's stock price dropped 9.8%.[55] Under the VIE structure used by Alibaba, Yahoo had no ability to restrict Jack Ma from doing this.[56] Ultimately, Alibaba Group, Yahoo, and Softbank reached a settlement agreement out of court.[57]

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50 Ma Mangwei, *The Perils and Prospects of China's Variable Interest Entities: Unraveling the Murky Rules and the Institutional Challenges Posed*, 43 HONG KONG L.J. 1061, 1069 (2013).

51 Ellis et al., *supra* note 28.

52 Gordon G. Chang, *China Can Expropriate Alibaba's Business—and It Just Might,* FORBES (May 11, 2014, 6:24 PM), https://www.forbes.com/sites/gordonchang/2014/05/11/china-can-expropriate-alibabas-business-and-it-just-might/. . .s#sh=560d613b565f [https://perma.cc/HLC3-ABFW].

53 *Id.*

54 Samuel Farrell Ziegler, *China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It*, 84 GEO. WASH. L. REV. 539, 551 (2016).

55 Fa Chen, *China's Recent Regulation of Variable Interest Entity Structures Has Led to a Drop in Chinese Companies' US Listings*, OXFORD BUS. L. BLOG (Apr. 19, 2022), https://www.law.ox.ac.uk/business-law-blog/blog/2022/04/chinas-recent-regulation-variable-interest-entity-structures-has-led [https://perma.cc/F6AF-FAUG].

56 Ziegler, *supra* note 54, at 552.

57 Kathrin Hille and Joseph Menn, *Alibaba Settles Alipay Dispute With Yahoo*, FIN. TIMES (July 29, 2011) https://www.ft.com/content/40a66dd2-b9ec-11e0-8171-00144feabdc0 [on file with the Columbia Business Law Review].

Because the VIE's Chinese shareholders are often natural persons, their divorce or death is another risk for foreign investors.[58] An example is the divorce of Tudou's (China's Youtube equivalent) founder that delayed Tudou's listing abroad.[59] The former wife of the founder, chairman, and CEO of Tudou brought suit in Chinese family court, claiming that the CEO's equity stake of the Tudou VIE constituted community property.[60] The company had to delay its IPO "for six months until the CEO had reached a settlement with his former wife," likely reducing "the value at which Tudou was ultimately able to list its shares."[61]

Despite the risk posed by the structure's dubious legal status in China,[62] it has proliferated: more than "80% of all U.S.-listed Chinese companies operate VIEs that are material to their operations."[63] Further, nearly all Chinese technology company use VIE structures when listing on U.S. stock exchanges "to circumvent Chinese restrictions on foreign investments in domestic businesses."[64]

B. U.S. Congressional and Regulatory Responses

To mitigate the risk American investors face from VIEs, financial regulatory agencies in the United States have responded in a variety of ways. The SEC has primarily relied on a system of disclosures to eliminate abuse and retain investor confidence.[65] By not dictating corporate action but

[58] Ellis et al., *supra* note 28.

[59] Serena Y. Shi, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 FORDHAM INT'L L.J. 1265, 1293 (2014).

[60] Ellis et al., *supra* note 28.

[61] *Id.*

[62] Sutter, *supra* note 9 ("VIE arrangements appear to have no definitive legal standing in China, which may leave U.S. investors without recourse.").

[63] Yang, *supra* note 5.

[64] *Id.*

[65] Ripken, *supra* note 19, at 150–51.

merely requiring disclosure, the agency allows investors to choose for themselves what they deem acceptable.[66]

However, there are exceptions to this general rule of disclosure. For example, the Sarbanes-Oxley Act of 2002 created substantive rules for public securities.[67] For one, it created the Public Company Accounting Oversight Board ("PCAOB").[68] The PCAOB is "a nonprofit entity created by Congress to oversee audits of U.S.-listed firms"—essentially auditing the auditors.[69] The Act includes a prohibition on corporations extending personal loans to corporate directors and officers, and it directly prohibits auditors from performing other non-audit services for their corporate clients, such as bookkeeping, appraisal or valuation services.[70] As a hybrid between pure disclosure and substantive regulation, the Act also includes adopt-or-disclose provisions.[71] The Act requires corporations to disclose whether they have at least one "financial expert" on the board of directors' audit committee—if the corporation does not have a financial expert, the company must provide an explanation.[72] The Act also requires corporations to adopt a code of ethics for senior financial officers—if a code of ethics is not adopted, the company must explain why not.[73]

The regulatory regime for VIEs, however, typifies the SEC's pure disclosure approach. Instead of taking a substantive, or semi-substantive, approach to regulating VIEs, the SEC merely requires risks be disclosed. Buried within dense, lengthy, and complicated disclosure documents,[74] local counsel in China often opine that the VIE

[66] *Id.* at 151 ("So long as corporations disclosed all material information about their operations and their securities, investors could make their own investment decisions.").

[67] *Id.* at 141.

[68] 15 U.S.C. § 7211 (2010).

[69] Sutter, *supra* note 9.

[70] Ripken, *supra* note 19, at 142–43.

[71] *Id.* at 144.

[72] *Id.*

[73] *Id.* at 145.

[74] *Alibaba Tweaks a Controversial Legal Structure*, *supra* note 7.

structure is legal; with the caveat, however, that there are "substantial uncertainties."[75] In other words, "the VIE Structure is legal until the relevant regulator responsible for interpreting the regulations says that it is not legal."[76]

The focus on regulatory risks associated with investing in Chines companies intensified in the summer of 2021 after Chinese regulators pulled the ride-hailing app Didi from app stores days after the company's IPO in the United States.[77] Chinese regulators were concerned that riders' data privacy might be compromised, and they were especially wary of Didi after circumventing foreign investment restrictions by going public in the US.[78] Chinese listings in the United States ground to a halt, as U.S. investors' appetites dried up due to concerns of future regulatory action by China. By the end of July 2021, the SEC paused all new offerings from Chinese operating companies and their shell-company affiliates as it re-vamped its disclosure guidance for VIEs.[79] The SEC's stated rationale was that retail investors "may not realize" that the structure entails holding stock in shell companies rather than the underlying operating companies.[80] The SEC now requires VIE issuers to disclose that "investors are not buying shares of a China-based operating company but instead are buying shares of a shell company"[81] and to disclose the significant uncertainty risk related to potential regulation.[82]

The SEC's disclosure approach to VIEs may be advanced by Congress's pending Holding Foreign Companies

[75] Ellis et al., *supra* note 28.

[76] *Id.*

[77] Clay Chandler, Grady McGregor & Eamon Barrett, *How Didi's Data Debacle Doomed China's Love Affair with Wall Street*, FORTUNE (July 9, 2021), https://fortune.com/2021/07/09/didi-ipo-stock-data-crackdown-china-wall-street-investors/ [https://perma.cc/LS4J-U9T3].

[78] *Id.*

[79] Gensler, *supra* note 2.

[80] *Id.*

[81] Gensler, *supra* note 3.

[82] *Id.*

Accountable Act ("HFCAA").[83] In principle, the PCAOB should oversee the audits for all companies listed in the United States;[84] however, the Chinese government has prohibited the PCAOB from inspecting auditors based in China and Hong Kong.[85] Because the PCAOB is unable "to confirm the financial health of U.S.-listed Chinese firms," Congress felt that U.S. investors in those firms may be exposed to material risks.[86] As such, Congress passed the HFCAA last year, which will prohibit trading in an issuer's stock if a foreign jurisdiction prevents the PCAOB from "inspecting the company's audit firm for three consecutive years."[87] Because the clock began ticking in 2021, the SEC may be required to halt trading in approximately 270 China-based companies by early 2024 if the country makes no changes to its current PCAOB inspection prohibition.[88] Further, the Senate recently passed the Accelerating Holding Foreign Companies Accountable Act, "which, if enacted, would wind the three-year clock down to two," potentially accelerating the decoupling of U.S. and Chinese capital markets to early 2023.[89]

Despite these challenges, China-based operating companies are still seeking capital from U.S. investors. In early November 2020, LianBio launched the first major Chinese-based, U.S.-listed IPO since the SEC's pause.[90] The biotechnology company, while not a VIE, is incorporated in the Cayman Islands relying on local subsidiaries to run its China

[83] 15 U.S.C. § 7214 (2020).

[84] *Id.* § 7212.

[85] Gensler, *supra* note 2.

[86] Sutter, *supra* note 9.

[87] Gensler, *supra* note 2.

[88] *Id.*

[89] *Id.*

[90] Robyn Mak, *Chinese IPOs Return to New York with a Whimper*, REUTERS (Nov. 2, 2021, 10:51 AM), https://www.reuters.com/breakingviews/chinese-ipos-return-new-york-with-whimper-2021-11-02/ [https://perma.cc/8PMW-PYUF].

operations.[91] It does not handle sensitive data[92] (the issue that Didi ran into[93]), uses American auditors subject to PCAOB oversight,[94] and outlines "a deluge of regulatory risks"[95] buried in its prospectus among other typical business and financial risks. Shares in the company fell 14% in their first day of trading, indicating institutional investors may still be wary of Chinese regulatory risks.[96]

Other smaller companies using VIEs have updated their prospectuses in response to SEC concerns as they seek IPO approval.[97] The updates of a camelia-seed oil producer included language stating that the "VIE Agreements may not be effective in providing control over [the company]" and that "PRC laws and regulations governing our current business operations are sometimes vague and uncertain, and therefore, these risks may result in . . . a complete hindrance of our ability to offer or continue to offer our securities to

91 *Id.*

92 Filipe Pacheco, *China-Focused Biotech LianBio Raises $325 Million in U.S. IPO*, BLOOMBERG NEWS (Oct. 31, 2021, 9:51 PM), https://www.bloomberg.com/news/articles/2021-11-01/china-focused-biotech-lianbio-raises-325-million-in-u-s-ipo [https://perma.cc/UZ2C-UL7C].

93 Chandler et al., *supra* note 77.

94 Pacheco, *supra* note 92. *See also* 15 U.S.C. § 7211 (2010); Sutter, *supra* note 9.

95 Mak, *supra* note 90; *see also* LianBio, Registration Statement (Form S-1) (Oct. 1, 2021) (outlining "[r]isks related to the regulation of our business" and "[r]isks related to doing business in China" across a combined twenty-two pages).

96 Mak, *supra* note 90.

97 Filipe Pacheco & Julia Fioretti, *Here's What Some Chinese Firms Are Adding to U.S. IPO Filings*, BLOOMBERG (Aug. 24, 2021, 4:45 AM), https://www.bloomberg.com/news/articles/2021-08-24/here-s-what-some-chinese-firms-are-adding-to-u-s-ipo-filings [https://perma.cc/8D68-MPUK]; *SEC Gives Chinese Companies New Requirements for U.S. IPO Disclosures*, CNBC (Aug. 23, 2021, 4:16 PM), https://www.cnbc.com/2021/08/23/sec-gives-chinese-companies-new-requirements-for-us-ipo-disclosures.html [https://perma.cc/Z9QR-KHNY].

investors."[98] VIEs are also required to disclose that investors are not buying shares in the underlying company, as illustrated by a health products retailer's recent disclosure: "Investors are cautioned that you are not buying shares of a China-based operating company but instead are buying shares of a shell company issuer that maintains contractual arrangements with the associated operating company."[99]

All this comes at a time when the makeup of the U.S. investor base is changing dramatically, with an increase in the type of retail investors the SEC's recent policies have invoked. In the first months of 2021, U.S. retail investors "generated about as much equity trading volume as mutual funds and hedge funds combined."[100] With the advent of no-minimum accounts, zero-commission trading, and fractional share trading, investing in individual stocks has found broader appeal.[101] Given the concurrent rise of app-based mobile trading,[102] the gamification of investing,[103] and social

98 Huake Holding Biology Co., Registration Statement (Amendment No. 1 to Form F-1) (Aug. 23, 2021); *see also* Pacheco & Fioretti, *supra* note 97.

99 Loha Co., Registration Statement (Amendment No. 9 to Form F-1) (Aug. 18, 2021); *see also* Pacheco & Fioretti, *supra* note 97.

100 DELOITTE, THE RISE OF NEWLY EMPOWERED RETAIL INVESTORS 1 (2021), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-the-rise-of-newly-empowered-retail-investors-2021.pdf [https://perma.cc/K64R-5ECJ].

101 *Id.* at 4.

102 *See, e.g.*, Ryan Browne, *Online Trading App Usage Surges as Redditors Take on Wall Street*, CNBC (Jan. 27, 2021, 9:50 AM), https://www.cnbc.com/2021/01/27/online-trading-app-usage-surges-as-redditors-take-on-wall-street.html [https://perma.cc/U7MG-UB3C]; Omri Barzilay, *New Fintech Platforms Herald the Rise of Mobile Trading*, FORBES (Apr. 12, 2017, 8:00 AM), https://www.forbes.com/sites/omribarzilay/2017/04/12/new-fintech-platforms-herald-the-rise-of-mobile-trading/. . .s#sh=466a5afe10ba [https://perma.cc/4MSH-SZRY].

103 *See, e.g.*, Editorial, *How to Handle the Gamification of Investing*, FIN. TIMES (Mar. 26, 2021), https://www.ft.com/content/bce7c9d4-2d45-4b48-af01-e3177a4679a9 [https://perma.cc/6YSQ-DBPV]; Ben Soppitt, *The Gamification of Investing Brings Opportunity – And Risks*, FORBES (Jan. 8, 2021, 7:00 AM),

media misinformation,[104] these investors are among the least likely to be aided by lengthy, complex disclosures.[105]

The SEC has acted by targeting various tactics used by these online brokerage platforms that the agency believes are taking advantage of retail investors. For example, the SEC fined Robinhood (among the largest of these zero-commission mobile trading platforms) $65 million in 2020 (and FINRA fined the company $70 million in 2021) for misleading investors,[106] and the agency is examining the company's "gamification" practices (i.e., "the use of game-like features to encourage trading").[107] However, the SEC continues to rely

https://www.forbes.com/sites/forbesbusinesscouncil/2021/01/08/the-gamification-of-investing-brings-opportunity—and-risks/. . .s#sh=41260546c08e [https://perma.cc/265D-TJ96].

104 *See, e.g.*, Carmen Reinicke, *Former SEC Chair Clayton Says Social Media Will Continue to Influence Investing*, CNBC (Oct. 26, 2021, 11:15 AM), https://www.cnbc.com/2021/10/26/former-sec-chair-clayton-says-social-media-will-continue-to-influence-investing.html [https://perma.cc/NE5A-7UAP]; Michelle Fox, *Social Media Top Pick of Young Investors for Ideas, CNBC Survey Finds*, CNBC (Aug. 26, 2021, 8:00 AM), https://www.cnbc.com/2021/08/26/social-media-top-pick-of-young-investors-for-ideas-cnbc-survey-finds.html [https://perma.cc/54JL-66UV].

105 As an SEC study put it, "U.S. retail investors lack basic financial literacy" and "investors have a weak grasp of elementary financial concepts and lack critical knowledge of ways to avoid investment fraud." OFFICE OF INV. EDUC. & ADVOCACY OF THE U.S. SEC. AND EXCH. COMM'N, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS iii (Aug. 2012), https://www.sec.gov/files/917-financial-literacy-study-part1.pdf [https://perma.cc/P4LF-AUZL].

106 Khristopher Brooks, *Robinhood Financial fined $65 million by SEC for misleading users*, CBS NEWS (Dec. 16, 2020), https://www.cbsnews.com/news/robinhood-sec-fine-65-million [https://perma.cc/UNG2-7A9P]; Jonathan Ponciano, *Robinhood Fined $70 Million for 'Significant Harm' to Customers Ahead of IPO*, FORBES (June 30, 2021, 11:50 AM), https://www.forbes.com/sites/jonathanponciano/2021/06/30/robinhood-fined-70-million-for-significant-harm-to-customers-ahead-of-ipo/?sh=6e7dfb2c5757 [https://perma.cc/3L5N-7TFX].

107 *See* Chris Prentice & Michelle Price, *Explainer: The Regulatory and Legal Headwinds Facing Robinhood*, REUTERS (July 2, 2021), https://www.reuters.com/technology/regulatory-legal-headwinds-facing-robinhood-2021-07-02/ [https://perma.cc/H533-UDUQ].

primarily on its existing disclosure regime to protect these investors from the risks associated with individual securities.

III. INADEQUACY OF CURRENT DISCLOSURE RULES

The tension between the SEC's institutional-investor-oriented approach to disclosure and its retail-investor-oriented rhetoric is particularly evident as it reformulates its rules for China-based issuers. VIEs listed in the United States already produce substantial disclosures about their control and equity structure.[108] While all investors are subject to the cognitive limitations associated with parsing a registration statement, a reformulation to protect the investors trading on no-account-minimum, no-fee platforms seems appropriate, as these investors are especially susceptible to misunderstanding the risks of investing in this complex accounting structure. There is ample evidence that burying these risks in hundreds of pages of dense legalese is ineffective for retail investors, regardless of the phrasing of specific disclosures.[109]

A. Increased Disclosure Can Be Counterproductive

The vast disclosure regime required by the SEC helps to increase transparency, but works against human psychology by flooding readers with more information than they could ever hope to process. Public companies that list in the United States are required to produce copious pages of disclosure on

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108 *See, e.g.*, *Alibaba Tweaks a Controversial Legal Structure*, *supra* note 7.

109 *See, e.g.*, Tamar Frankel, *The Failure of Investor Protection by Disclosure*, 81 U. CIN. L. REV. 421 (2013); Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089 (2007); Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417 (2003); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 682 (1996); Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973).

an ongoing basis.[110] From the company's registration statement upon going public to its annual Form 10-K to ongoing disclosures required in Form 8-K, investors can make investment decisions informed by an abundance of mandatory disclosures. Buried within these documents are paragraphs of dense legalese[111] describing the company's legal structure, its accounting methods, and the risks it faces. Prospectuses are "so elaborate that many investors [are] unable to detect even blatant fraud solely by reading [them]."[112] Securities issuers bury the most relevant information in nonessential but mandatory disclosure.[113]

Given this raft of disclosure, one might expect investors to be fully informed about any investment decision they make. However, the investors who read these documents are often not equipped with the skills to parse them.[114] Moreover, evidence indicates most nonprofessional investors ignore these disclosure documents, and if they do read them, they often do not understand their meaning.[115]

More information is not always better. People can only handle so much complexity, and at a certain point, providing more information becomes counterproductive, forcing users to use shortcuts which risk cutting valuable information in favor of irrelevant information.[116] If a document is too long and

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110 *See, e.g.*, Paredes, *supra* note 109, at 418.

111 *See, e.g.*, Alan B. Levenson, *The Role of the SEC as a Consumer Protection Agency*, 27 BUS. LAW. 61, 63 (1971).

112 *See, e.g.*, Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 325 (1974).

113 *See, e.g.,* Ray J. Groves, *Here's the Annual Report. Got a Few Hours?*, WALL ST. J., Aug. 4, 1994, at A12.

114 *See, e.g.*, Kripke, *supra* note 109.

115 *See, e.g.*, Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 682 (1996) ("[A]necdotal evidence, supported by many people's assumptions about investment practices, indicates that most nonprofessional investors do not read the prospectuses and other legal disclosure documents they are given.") (citing Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973)).

116 *See, e.g.*, HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 49 (Thomas Gilovich, Dale Griffin, & Daniel Kahneman eds.,

complex, retail investors may forego reading it at all, preferring not to waste their time with a document they know they will not understand.[117] When presented with more information, the quality of decision making initially increases and then plateaus, but the quality of decision making will eventually decline once the decisionmaker is overloaded with information.[118] More effective disclosure does not simply mean more disclosure.

Exacerbating this problem is the fact that people consistently exhibit overconfidence in their ability to avoid future risks.[119] In the investing context, a feedback loop reinforces this overconfidence. As certain picks do well, investors attribute their success to their stock-picking ability. If investments lose value, people tend to ignore them as outliers, blaming the results on chance and outside factors beyond their control.[120] This feedback loop strengthens as bull markets assure investors with positive results, which distort their evaluation.[121]

These behavioral factors combine to spell doom for the current disclosure system's ability to protect the average investor from a company's most salient risks. An issuer's discussion of risk factors is too dense to penetrate, and its discussion of mundane, catch-all risks assumed to apply to all

2002); Kevin Lane Keller & Richard Staelin, *Effects of Quality and Quantity of Information on Decision Effectiveness*, 14 J. CONSUMER RES. 200, 200–01 (1987) (including a review of the literature).

117 *See, e.g.*, Norman I. Silber, *Observing Reasonable Consumers: Cognitive Psychology, Consumer Behavior and Consumer Law*, 2 LOY. CONSUMER L. REP. 69, 72 (1990).

118 *See, e.g.*, Brad Tuttle & F. Greg Burton, *The Effect of a Modest Incentive on Information Overload in an Investment Analysis Task*, 24 ACCT., ORG. & SOCIETY 673, 673–74 (1999).

119 Baruch Fischhoff et al., *Knowing with Certainty: The Appropriateness of Extreme Confidence*, 3 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 552 (1977).

120 Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers*, 84 CAL L. REV. 627, 639 (1996).

121 Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 159 (2002).

companies works to hide unusual or extraordinary risks drafted in legalese. Combine this with investor overconfidence and the fact that people tend to disregard non-salient risks whose occurrence may be far in the future, and the result is that, if an investor does open a disclosure document, they are almost certain to miss the company's most salient risk factors.

B. Susceptibility of New Retail Investors

Current disclosure mechanisms' failures are more pronounced in the context of retail investors, whose prominence has been growing in recent years.[122] As future Supreme Court Justice William O. Douglas noted nearly 90 years ago:

> [T]hose needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant.[123]

Much of the SEC's work is in the name of making disclosure accessible to the average investor.[124] Certainly, the SEC invoked retail investors to justify its revisiting of VIE disclosure.[125] However, it is something of a paradox that SEC rules operate through a regime illegible to lay investors. The "myth of the informed layman" has long been noted,[126] and as retail investing's importance faded with the rise of institutional investors, commentators have called on the SEC to change its rules to reflect the professionalization of investing—today's "capital marketplace [is] very different

[122] DELOITTE, *supra* note 100, at 1, 3.

[123] William O. Douglas, *Protecting the Investor*, 23 YALE L. REV. 521, 523-24 (1934).

[124] *See, e.g.*, Langevoort, *supra* note 121, at 173.

[125] *See supra* Section II.B.

[126] *See, e.g.*, Kripke, *supra* note 113, at 631.

from that of the 1930s."[127] It is important that the SEC adjusts its rules according to the environment in which it operates. Even though retail investing's importance is now trending in the opposite direction, lay investors should not be a focus for the agency.[128]

Any disclosure rule change is unlikely to reach lay investors who are less likely to read or understand disclosure documents than professional investors.[129] Investors feel more empowered and in control of their investments when they eschew an intermediary,[130] and because these investors gather their investment information online, the overwhelming amount of information (and disinformation[131]) available online bolsters investors' illusion of control.[132]

Even if retail investors did read issuers' filings, the SEC should still prioritize institutional investors who create the efficient market that provides accurate price information as the prices reflects all available information with no

127 Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1026–27 (2009).

128 DELOITTE, *supra* note 104, at 3.

129 *Recommendation on Disclosure Effectiveness: As Approved by Investor as Purchaser Subcommittee*, SEC. EXCH. COMM'N (Apr. 2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/disclosure-effectiveness-recommendation.pdf [https://perma.cc/GSH7-TR2N].

130 Brad M. Barber & Terrance Odean, *The Internet and the Investor*, 15 J. ECON. PERSP. 41, 42 (2001).

131 As early as 2000, the SEC was pursuing enforcement against those who posted misleading investment advice on the Internet. Then-teenager "Jonathan Lebed, allegedly bought stock in small, thinly traded high-tech companies. He then would make multiple postings on various investment web sites, under different web addresses, extolling these stocks . . . He would provide some basic, presumably accurate information about the company in question. The hype, in bold and billed with exclamations, would be phrased in recommendations like 'next stock to gain 1000%,' or 'the most undervalued stock ever.' . . . Lebed, according to the SEC, amassed a sufficient presence on the Internet such that online investors would buy the stock, causing its price to rise. Lebed would then sell out." *See* Langevoort, *supra* note 121, at 156.

132 Barber & Odean, *supra* note 130, at 42, 47.

opportunity for investment gain.[133] Academics theorize that securities markets are more efficient, if institutional investors are credited with achieving accurate prices for the market.[134] The "professionally informed trading" mechanism allows for rapid price equilibration without widespread dissemination of information.[135] Once only a minority of knowledgeable traders have access to the information, that information is rapidly assimilated into price because these professional investors control a critical volume of trading activity.[136]

Information traders detect discrepancies between value and price and then trade to capture the value of their informational advantage.[137] These professional investors provide efficiency to financial markets by searching for information, verifying its accuracy, and analyzing it—leading to a price determination for the security in question. These can be costly activities, and the SEC can lower that cost by mandating disclosure, helping to increase market efficiency. Since information traders do not have to engage in high-cost efforts to uncover nonpublic information, disclosure duties lower the cost of obtaining firm-specific information—it "is a mere by-product of managing the firm."[138]

Retail investors, on the other hand, "rely on old information that is already reflected in [the security's] price."[139] Any information that is disclosed to these investors "does them no good because it is all old hat to professional traders."[140] Retail investors do not have the resources or

[133] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554–65 (1984).

[134] *See, e.g.*, *id.* at 569–72; Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 694 (1984); Goshen & Parchomovsky, *supra* note 1, at 720–32 (2006).

[135] Gilson & Kraakman, *supra* note 133, at 569.

[136] *Id.* at 569–71.

[137] Goshen & Parchomovsky, *supra* note 1, at 726.

[138] *Id.* at 738.

[139] *Id.* at 725.

[140] Easterbrook & Fischel, *supra* note 134, at 694.

expertise to underwrite efficient markets.[141] Nor are they at risk of being swindled by issuers—professional investors have incorporated all the information to reflect an accurate price.[142] In other words, even if a retail investor valued a security for much more than its true worth, such an investor can only buy at the prevailing market (i.e., accurate, assuming efficient markets) price.

While the SEC is right to create a disclosure regime for issuers to follow, it should not be (and is not) doing so with retail investors in mind. Retail investors are not able to read and understand complex disclosure documents, and as such are incapable of creating a more efficient market for securities. Institutional investors, however, can rapidly incorporate any new information into the price of a security—it is for them that issuers should be required to craft their disclosure documents.

C. Particular Issues with VIE Disclosure

The paradox of the SEC's current disclosure regime is magnified as the SEC finalizes its updated guidance for China-based issuers. As the SEC acknowledges, few investors are aware that the Chinese companies they invest in are shell companies in the Cayman Islands with no equity ownership of the listed company.[143] Even when informed of the situation, though, retail investors are unlikely to fully apprise themselves of the various risks involved given the structure's complexity and unique legal status.[144] Additionally, these companies already often describe in detail the specifics of their ownership and control along with the wide variety of risks associated with the VIE structure.[145] Updated guidance to

141 Charles Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581, 1604 (2017) ("Ordinary retail investors will almost never possess speed or analytical advantages over sophisticated information investors.").

142 Easterbrook and Fischel, *supra* note 134, at 694.

143 Gensler, *supra* note 2.

144 *See generally* OFFICE OF INVESTOR EDUCATION & ADVOCACY, *supra* note 109.

145 Ripken, *supra* note 19, at 186–87.

ensure clarity when issuers inform investors that they will own no equity stake in the underlying company is certainly laudable.[146] However, this approach fails to advance the SEC's stated goal because it ignores the fact that these disclosure statements are not read by much of the retail investing public.[147]

The SEC is right to address VIE disclosure. It is arguably misleading for an issuer to name itself after an operating company in which it has no equity stake, only control contracts. Further, the HFCA Act creates delisting risk for Chinese companies if China continues to refuse to allow the PCAOB to oversee the audits of Chinese companies.[148] With the VIE structure's dubious legal status in the operating company's home country and the resulting contractual fragility, there is a raft of information in need of disclosure.[149] But the SEC must also be mindful of the ways in which investors use and process disclosures—and it should be more transparent about how the rule changes which expose these risks are made with institutional investors in mind.

IV. RECOMMENDATIONS FOR THE SEC

If the SEC meant what it said about informing retail investors about the risks VIEs pose, it should incorporate teachings from behavioral psychology into its regulatory structure. Instead of retooling the wording a VIE uses in its risk factor discussion, the SEC should work to ensure the disclosure is both visible and comprehensible to the average investor. The disclosure would be more effective if made at the point of sale by either a broker or platform, akin to disclosures required for penny stocks, than by the issuer itself. And if the risks are so great as to need elevated visibility, the agency

146 Pacheco & Fioretti, *supra* note 97.

147 Korsmo, *supra* note 141, at 1595 ("Perhaps the oldest and most obvious criticism of targeting disclosures to ordinary investors is that it is simply unrealistic because they do not read them and, moreover, would be wasting their time and effort if they did.").

148 15 U.S.C. § 7214 (2020).

149 Gensler, *supra* note 3.

should consider substantive regulation—disallowing the practice entirely amongst issuers.

However, the agency's actions speak louder than its words. The SEC prioritizes institutional investors in its disclosure regime, as the academic literature suggests it should. Instead of continuing to invoke the average investor during the rule-making process, the agency should adopt a more transparent approach which acknowledges the importance of institutional investor access to full and fair disclosure.

A. Substantive Regulation

The SEC has adopted a general policy of disclosure over substantive regulation; though, as noted above, there are exceptions.[150] Congress may choose to address its concerns with the VIE structure in the same way it has PCAOB oversight—threaten to delist if China does not change its rules to allow foreign ownership of its companies in "sensitive sectors."[151] And perhaps the U.S. will adopt this strategy if Congress views the VIE as comparable in risk and disrespectful toward U.S. law as China's PCAOB ban. Alternatively, the SEC could change its accounting guidance to disallow financial statement consolidation for VIEs. However, this reintroduces the potential to hide liabilities offshore—a risk that consolidation rules tried to eliminate.[152]

Given the SEC's incentives against cutting investors off from the growth potential of Chinese stocks, especially in the technology sector, disallowing the structure's use is likely not feasible.[153] Ultimately, the SEC should not substantively disallow the VIE structure without direct guidance from Congress. Disclosure is the appropriate remedy for investor protection as it relates to VIEs. However, this disclosure should target those most likely to read it and those capable of incorporating that information into the security's price—institutional investors, not retail investors.

150 *See* Ripken, *supra* note 19, at 151, 202.

151 *See supra* Section III.C.

152 *See supra* notes 36–37.

153 Gensler*, supra* note 2.

B. Platform-Based Disclosure Requirements

If the SEC were to create a disclosure regime with retail investors in mind, it should not only require the issuer to disclose risks in official filings—it should also require risks related to the VIE structure and lack of PCAOB oversight be disclosed at the point of sale. Requiring brokers, dealers, and platforms (not just the issuer) to disclose these categorical risks would substantially increase the likelihood that investors will be made aware of them.[154] While most lay investors are unlikely to read an issuer's filings, they may be more engaged with the investment decision at the point of sale and thus more amenable to reading disclosure documents then.

There is precedent for this platform-based disclosure. Penny stocks are another class of securities which regulators have decided pose a special risk to lay investors. Any investor who purchases a penny stock must receive a Schedule 15G document from their broker before their first penny stock trade.[155] The form warns of the general risks associated with investing in penny stocks. These warnings include statements such as, "it may be difficult to sell penny stock shares once you have them," "be prepared for the possibility that [you] may lose [your] whole investment," and "remember that your salesperson is not an impartial advisor," among others.[156] Further, brokers must wait at least two days before executing the customer's first trade to allow the customer ample time to weigh the risks and rewards of investing in penny stocks generally.[157]

China-based equity securities also pose a unique risk to lay investors.[158] Like penny stocks, these securities are subject to certain risks as a class of investment beyond the

154 *See, e.g.*, Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers*, 84 CAL L. REV. 627, 693 (1996).

155 17 C.F.R. § 240.15g-2 (2005).

156 *Id.* § 240.15g-100.

157 *Id.* § 240.15g-2.

158 *See supra* Part II.

particularized risks associated with each operating company.[159] In both cases, the risk to investors both allows for and requires a warning mechanism which departs from the agency's traditional disclosure regime.

Specifications about the presentation of the disclosure can greatly influence the effectiveness of the disclosure. *How* information is presented is often more important than *what* is presented.[160] Whether information is pictorial (such as a chart or graph), verbal, or numerical has an impact;[161] whether the information is presented as abstract or concrete makes a difference;[162] and the size and wording of any information are important. Clarity and simplicity can be the most important factors—information that is accurate will be ineffective if it is too "abstract, vague, detailed, complex, poorly framed, or overwhelming to be useful."[163]

Improving a warning's visibility or salience can have a marked impact on behavior. U.S. agencies incorporate these findings in a variety of ways: the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 requires clear and conspicuous disclosure of annual percentage rates (APR) and finance charges; the Family Smoking Prevention and Tobacco Control Act of 2009 requires vivid pictures of the adverse outcomes associated with smoking;[164] and the SEC itself has undertaken various initiatives to incorporate these principles, from the "plain English" initiative in official filings to the requirement that executive compensation information be disclosed in tables.[165]

Informing investors at the point of decision with a brief summary of relevant information would interrupt the decision-making process, forcing the investor to stop and

159 *Id.*

160 *See, e.g.*, Paredes, *supra* note 113, at 475.

161 *Id.*

162 Cass R. Sunstein, *Empirically Informed Regulation*, 78 U. CHI. L. REV. 1349, 1352 (2011).

163 *Id.* at 1369.

164 *Id.* at 1367, 1381.

165 Paredes, *supra* note 113, at 475–76.

consider the choice more carefully.[166] For instance, alcohol taxes identified in the posted price tend to decrease alcohol consumption more than when alcohol taxes applied at the register after the customer has already decided to make the purchase.[167] These summary disclosures should be brief and simple, only emphasizing the most relevant information with full disclosure complementing the summary elsewhere.[168]

Applying these principles, the SEC could require brokers and platforms to clearly identify to customers at the point of sale that VIE shares offer no equity interest in the underlying operating company. Regulations can accomplish this in a variety of ways. A "VIE" callout before the ticker would alert investors to the stock's ownership structure. Alternatively, the description of the security could begin with a short sentence informing investors that they will not be purchasing any equity stake in the operating company and providing links for resources to learn more (likely the company's own disclosure documents or agency-published materials on VIEs generally). However, copying the Schedule 15G strategy for penny stocks would likely prove ineffective because the Schedule 15G strategy protects customers from their brokers as much as from the securities themselves.[169] Here, the investor is likely not operating through a broker at all, and if he is, it is unlikely that the broker is specifically pushing VIE shares on customers. The SEC should thus tailor the rules to the reality of today's capital marketplace, and that means ensuring that online platforms adequately represent the securities that are available for trading.

This strategy is less costly than many of the current disclosure requirements. The current disclosure regime is incredibly costly for issuers, requiring many man-hours to compile and publish the required data.[170] Instead of requiring

[166] Langevoort, *supra* note 131, at 693.

[167] Raj Chetty, Adam Looney & Kory Kroft, *Salience and Taxation: Theory and Evidence*, 99 AM. ECON. REV. 1145, 1163 (2009).

[168] Sunstein, *supra* note 162, at 1383.

[169] 17 C.F.R. § 240.15g-100 (2005).

[170] William M. Sage, *Regulating Through Information: Disclosure Laws and American Health Care*, 99 COLUM. L. REV. 1701, 1721–22 (1999).

companies to hire teams of accountants and attorneys to comply with disclosure regulations, here, platforms and brokers would need only add a short sentence or label to certain products. The warning would be a pre-written risk summary written by the SEC with specific securities flagged by the agency.

The SEC should limit these platform-issued disclosures in both length and number. Customers should not be inundated at the point of sale (like they are when reading SEC filings)—otherwise, the disclosure's purpose is undone. If platforms require traders to review a dense, lengthy form disclosure before every trade, investors will learn to ignore it, rendering the warning useless.[171] The disclosure warnings issued by platforms should be limited to only unique, class-based characteristics which pose great risk to investors and are not commonly known.

The VIE structure and lack of PCAOB oversight are exactly the type of risks that would qualify for platform-issued disclosures. The SEC put a pause on new China-based listings while it refined disclosure requirements, and Congress has even acted to delist securities in the future if China does not change its policy.[172] These issues are complex and arcane, and the securities at issue involve some of the largest companies from one of the world's largest and fastest-growing economies. There is a real disconnect between these operating companies' appeal hold and lay knowledge of their investing risks.

Yet the SEC is not moving in this direction at all. Despite the penny stock example, the agency has made little effort to bring disclosure to retail investors in ways other than through traditional filings, even with the full knowledge that it is often

[171] *See, e.g.,* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 101 (1955); Brad Tuttle & F. Greg Burton, *The Effects of a Modest Incentive on Information Overload in an Investment Analysis Task*, 24 ACCT., ORG. & SOCIETY 673, 674 (1999); Richard E. Nisbett, Henry Zukier & Ronald E. Lemley, *The Dilution Effect: Nondiagnostic Information Weakens the Implications of Diagnostic Information*, 13 COGNITIVE PSYCHOL. 248, 248 (1981); Philip E. Tetlock & Richard Boettger, *Accountability: A Social Magnifier of the Dilution Effect*, 57 J. PERSONALITY & SOC. PSYCHOL. 388 (1989) (discussing the "dilution effect").

[172] 15 U.S.C. § 7214 (2020).

only professional investors who actually read these documents. The agency simultaneously invokes retail investors while crafting a disclosure regime that ignores them.

V. CONCLUSION

The SEC's rule changes for VIE disclosure introduced last summer perfectly encapsulate the disconnect between the agency's rhetoric and its actions. When it determined that the structure's details and risks were not adequately disclosed to investors, the SEC invoked the retail investors unlikely to be affected by any change in disclosure requirements, not the institutional investors who are most likely to read the documents and use the information to price the securities. The SEC has identified the VIE structure as one with the potential to be particularly misleading and risky for investors. Instead of engaging in merit regulation to ban the structure's use in U.S. securities market or adopting a new, empirically-informed approach to disclosure, which would reach average investors, the agency continued down its well-trodden path of filing disclosures—an approach that can only benefit institutional investors.

The SEC should continue its transparency efforts[173] and be more honest about who its disclosure rules serve. The academic literature suggests institutional investors should be the agency's main priority.[174] In fact, current rules only make sense viewed through that lens. Investor confidence, internal rulemaking, and market efficiency would all be improved if the SEC were more transparent about its goals and methods.

[173] Jay Clayton, Chairman, SEC, Remarks at the PLI 49th Annual Institute on Securities Regulation (Nov. 8, 2017) (transcript available at https://www.sec.gov/news/speech/speech-clayton-2017-11-08 [https://perma.cc/EFH8-NJEA]).

[174] Goshen & Parchomovsky, *supra* note 1, at 781.