OPINION

The Real China Complaint

By Paul Gillis

The U.S. Securities and Exchange Commission threw down a gauntlet against Beijing last week. The SEC filed administrative proceedings against five Chinese accounting firms—all of them affiliates of global firms—for failing to hand over audit working papers related to their work for Chinese companies that are now under SEC investigation. The firms say complying with U.S. disclosure laws would violate Chinese secrecy law, with which they also must comply.

For now, investors are concerned that the auditors may lose their ability to audit U.S.-listed companies, and that the listed companies may not be able to find new auditors that would satisfy U.S. regulatory requirements. In the extreme, this could force the Chinese companies to delist entirely.

But investors' real problems with China run much deeper. The latest SEC action provides an opening to start examining some of the root causes of the Chinese fraud epidemic. The fundamental problem is Beijing's ambivalence about its companies' desire to access foreign capital markets.

Chinese private-sector companies rushed to list on U.S. markets over the last decade. Their home country's capital markets had been slow to develop for private companies, although that has been rapidly changing in recent years.

Beijing has resisted embracing this phenomenon. China still imposes onerous regulations on companies trying to raise equity capital overseas, including limits on which industries are able to do so. These rules are often out of step with the needs of the Chinese economy. For instance, some of the country's most important and successful companies, especially in the Internet industry, were technically prohibited from listing overseas without permission that was considered unobtainable.

To circumvent onerous regulations, these private companies listed through offshore holding companies that were typically organized in the Cayman Islands.

The SEC suggests the problem is accounting secrecy. But it's convoluted corporate structures that leave investors in the dark.

They also developed the so-called variable interest entity, or VIE, structure of ownership. In this model, the offshore listed company owns a Chinese shell company. That shell company forms contractual relationships with the underlying Chinese firm, under which the firm will pass all of its profits to the shell company.

The accounts of the Chinese firm can then be consolidated into the overseas-listed company. But since technically the foreign investors don't own the Chinese business, the arrangement satisfies the letter, although not the spirit, of Chinese rules.

This clumsy corporate structure has created nothing but trouble for regulators and shareholders alike. There is little clarity on the enforceability under Chinese law of the contracts at the center of VIEs, so Western shareholders risk finding themselves owning shares in a shell company with no assets and no business if the contracts fall apart.

Investors have also become concerned that many companies accumulate profits in the VIEs, with no apparent attempt to ever make them available to the public shareholders. Companies often accumulate the profit in the VIE because there is considerable tax cost to getting it out.

The offshore shell companies also leave Chinese regulators with limited jurisdiction in fraud cases since the listed company is technically not Chinese. Meanwhile, China has not allowed U.S. regulators to access the people and records of these companies because these people and records are in China. The result is a regulatory hole in which fraud propagates.

Ultimately, the solution is to close this underlying regulatory hole. Washington proposes to do this by allowing U.S. regulators access to people and records in China, and diplomatic negotiations are underway to make this possible despite Beijing's resistance on grounds of national sovereignty. However, that will not solve shareholders' biggest China challenges.

A long-term fix will have to come from the Chinese side. First, Beijing should allow its private-sector companies to list directly overseas in the same way it has allowed state-owned enterprises to list. This would eliminate the need for the VIE structure and the web of offshore entities and contractual relationships, and clarify regulatory jurisdiction. Western shareholders would almost certainly even tolerate two-tiered ownership structures in which ultimate control vested in Chinese nationals in sensitive industries, if Beijing insisted on this.

Getty Images

Private Chinese enterprises have set up shell companies in the Cayman Islands.

Such a reform would also pave the way for Beijing to rationalize its regulation of overseas-listed companies in general. Beijing long ago consolidated securities regulation for domestically listed companies at the China Securities Regulatory Commission (CSRC), which now reports directly to the State Council. But a divide persists for regulation of overseas-listed firms, for whom oversight is divided between CSRC and the Ministry of Finance. This sows confusion and encourages bureaucratic turf wars.

The CSRC has grown more sophisticated as it has gained more experience overseeing domestic markets. It also has signaled its sympathy for American regulators on the accounting issue. Beijing would do well to put regulation of all listed Chinese companies, no matter where they're listed, under one experienced regulator.

The SEC is correct that more and better disclosure, both to regulators and shareholders, will be central to cleaning up fraud cases and boosting shareholder confidence—and returns—in the future. But no one should think last week's administrative filing will fix the problem. A lasting, pro-shareholder solution will require greater reforms from Beijing.

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Italy's Berlusconi Temptation

By Philip Delves Broughton

Earlier this year, I spent an evening with Silvio Berlusconi at his apartment in Rome. The former prime minister of Italy was wearing a navy-blue cashmere jogging suit and stacked shoes, and he was on sprightly form, jocular and seemingly at ease with retirement.

Lawsuits and mockery have dogged him for so long that he seemed indifferent to the latest barrage. He sipped his nonalcoholic cocktail and reeled off his accomplishments. Entrepreneur, innovator, mogul, disrespecter of class and tradition, champion of the ordinary Italian, and composer of four albums of Neapolitan love songs.

But of politics, he had had enough. Italy's financial crisis had forced him into retirement. The bond markets despised him and the world was sniggering about his "bunga-bunga" sex parties. He had never been able to manage the rivalrous branches of Italian government for long enough to push through the Thatcherite reforms he had promised since entering national politics in 1994.

There were plenty of other distractions. The soccer team he owns, AC Milan, had never been the dominating force it was before he entered politics. His television stations could always use his eerie gift for programming what Italians wanted to watch. And, as ever, there were lawsuits to be handled.

But after just a few months, including a long break at his Sardinian villa, Mr. Berlusconi is back, determined to regain for the fourth time the office of prime minister, which he ceded to Mario Monti in November 2011. Last week, after Mr. Berlusconi's Freedom People Party withdrew its support for the coalition government, Mr. Monti announced that he would resign after the 2013 budget is passed. Mr. Berlusconi promptly said that he would run to be prime minister.

He made the announcement while meeting with reporters at AC Milan's training facility, where he has been spending increasing amounts of time successfully goading his team out of mediocrity. Mr. Belusconi's popular touch has always been remarkable, and once again the contrast between the twinkling-eyed, soccer-loving 76-year-old in Milan and the hunted-looking Mr. Monti in Rome could not have been greater.

Mr. Monti has a right to look tired. He was shovel-passed a disintegrating economy in November 2011 and has made an honorable attempt with an unenviable job. His personal credibility and austerity plan enabled Italy to skirt a Greek or Spanish fate.

But the time was inevitably coming when he would have to run for election or stand down. Democracies can only take technocratic leadership for so long. The applause of the investment community is no substitute for a popular vote.

For the past few months, Mr. Monti has had to fight against fracturing support in the Italian parliament. When he lost the coalition that supported his ascent to the prime minister's office, he lost his ability to act. The worry for Mr. Monti's supporters is that the disappearance of his parliamentary base will be echoed in a popular defeat, should he decide to run as head of a new centrist party.

Tired of austerity, Italians crave growth and good cheer. That's what Silvio claims that he can deliver.

His supporters take comfort in the possibility that his early resignation, well before his mandate ends in April, may show evidence of a shrewd political sense. Mr. Monti may not be quite the unworldly technocrat he seems. His timing has forced Mr. Berlusconi onto a very tight schedule to revive his own and his party's fortunes. The elections are now likely to be held in February, and Mr. Berlusconi's party has just 15% support in the polls.

Mr. Berlusconi enjoys many advantages in his election bid. He has plenty of experience spending his own money on political advertising and turning his media outlets into 24/7 party political broadcasts. But he is also carrying new baggage: a conviction in October for tax fraud, which he is appealing, and charges of paying an underage prostitute, which will be decided in January.

Nothing about Mr. Berlusconi is new, however, for Italian voters. It's typical to see him scrapping for office while burdened by insalubrious stories. That's how it has always been, and he has dominated Italian politics like no one else in the past half-century.

Even so, the choice in February will not be a fight over character, between a scoundrel Italian voters know and a bookkeeper they don't. It will be about the tension between austerity and spending that afflicts so much of Europe.

It will be a fight between the coupon clippers in government and the Italian entrepreneurial class, the shopkeepers and small business owners who have long held Mr. Berlusconi dear. They have tired of Mr. Monti's chiseling away with new taxes and collection measures. They don't care if the European Central Bank and Angela Merkel are groaning at the prospect of a Berlusconi comeback. In fact they rather like it.

Mr. Berlusconi may lack Mr. Monti's professorial credibility with economists. But he may represent the next stage in Europe's continuing crisis: exhaustion with all the austerity, and a return to optimism, however delusional. Italians crave growth and good cheer, rather than yet more cuts, and that's what Mr. Berlusconi claims he can deliver.

His record suggests that he is better at delivering the economic goods for himself than for his country. And his re-election could well be disastrous, given how precarious Italy's economy remains and how little confidence he inspires abroad. But after 14 months of technocratic receivership under Mr. Monti, Italians may be giving serious consideration to the possibility of gambling on Mr. Berlusconi once again.

Mr. Delves Broughton, the author of "The Art of the Sale: Learning from the Masters about the Business of Life" (Penguin Press, 2012), was a visiting scholar this year at the American Academy in Rome.