

SEC finalizes rules that may delist China-based companies

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The SEC finalized rules to implement the Holding Foreign Companies Accountable Act. The law was enacted in 2020 in response to the inability of the PCAOB to inspect the audits of China-based, U.S.-listed firms. Pursuant to this law, the SEC will ban companies from trading in the U.S. securities markets if the PCAOB is unable to inspect the audits of such companies for three consecutive years. The earliest any trading prohibitions would be imposed on a non-compliant company would be in 2024.

Recap of Holding Foreign Companies Accountable Act

In December 2020, then-President Donald Trump signed the [Holding Foreign Companies Accountable Act \(S. 945\)](#) (the HFCA Act) into law, after the bill was unanimously passed by the Senate and the House of Representatives. The HFCA Act requires the Securities and Exchange Commission (the SEC) to prohibit the trading of securities of a Chinese or non-U.S. company on U.S. stock exchanges or the over-the-counter market if the Public Company Accounting Oversight Board (the PCAOB) has determined that it has been unable to inspect the company's accounting firm for three consecutive years because of a position taken by an authority in the company's jurisdiction. The HFCA Act also requires such companies to make certain disclosures about their ownership by governmental entities and their relationships with the ruling political party in China. The HFCA Act does not apply to initial listings on a U.S. stock exchange.

What led to Holding Foreign Companies Accountable Act

The HFCA Act is a culmination of many years of concern by U.S. authorities regarding the lack of transparency of Chinese companies listed on U.S. stock exchanges. Under the Sarbanes-Oxley Act, the PCAOB is required to inspect registered accounting firms to ensure their compliance with auditing standards. However, Chinese laws generally prohibit, without the approval of the Chinese government, (i) foreign securities regulators from engaging in any inspection activities within China and (ii) any person or entity from providing any documents or materials relating to capital markets activities to foreign parties.

The SEC and the PCAOB have held discussions with their Chinese counterparts over the years to find solutions to allow the PCAOB to inspect the audit work papers and practices of accounting firms in mainland China and Hong Kong with respect to their audit work of U.S.-listed, China-based companies. In recent months, amid certain regulatory developments in China in the areas of overseas listings and cybersecurity, the SEC issued multiple disclosure guidelines regarding risks associated with investing in China-based issuers. SEC Chair Gary Gensler also stated that he was directing the SEC staff to "take a pause, for now" in green-lighting their listings on a U.S. stock exchange.

SEC finalized rulemaking of Holding Foreign Companies Accountable Act

On December 2, 2021, the SEC adopted rules to implement the requirements of the HFCA Act. As discussed in detail below, the SEC established procedures to identify companies (the Commission-Identified Issuers) that have retained an accounting firm (i) that is located in a foreign jurisdiction and (ii) which the PCAOB is unable to inspect or investigate due to a position taken by an authority in the foreign jurisdiction (as determined by the PCAOB). In addition, the SEC implemented the submission and disclosure requirements under the HFCA Act by amending the relevant requirements in Forms 20-F, 40-F, 10-K and N-CSR. Further, the SEC finalized the process to prohibit the trading of the securities of such Commission-Identified Issuers as required by the HFCA Act.

Identification of non-compliant companies

A company will not be subject to the trading prohibition and other requirements under the HFCA Act until the SEC affirmatively identifies it as a Commission-Identified Issuer. The SEC will start making the determination of Commission-Identified Issuers on an annual basis based on the PCAOB's determination and on the company's annual reports filed for fiscal years beginning 2021.

The SEC will first "provisionally identify" such company as a Commission-Identified Issuer on the SEC's website at www.sec.gov/HFCAA. Such company will not be a Commission-Identified Issuer until a "conclusive determination" has been made by the SEC. For a period of 15 business days after the "provisional identification," a company may contact the SEC if it believes it has been incorrectly identified and provide supporting evidence. If the SEC agrees with the company's analysis, it will remove such company from the "provisional identification" list. If the SEC does not agree with the company's view, the determination that such company is a Commission-Identified Issuer will be conclusive.

"Three-year clock" for trading prohibitions

An initial trading prohibition will not be imposed until an issuer has been a Commission-Identified Issuer for three consecutive years. According to the SEC, the earliest that it could identify Commission-Identified Issuers would be after companies file their annual reports for fiscal year 2021 (for calendar year companies, this would be the spring of 2022). As a result, the earliest any trading prohibitions would apply would be in 2024, once a company has been a Commission-Identified Issuer for three consecutive years based on such company's annual reports filed in 2022, 2023 and 2024 for fiscal years 2021, 2022 and 2023, respectively.

The SEC will impose an initial trading prohibition on a Commission-Identified Issuer for **three consecutive years**.¹ If the SEC ends the initial trading prohibition and, thereafter, the company is again determined to be a Commission-Identified Issuer, the SEC will impose a subsequent trading prohibition on such company for **a minimum of five years**. An order issuing a trading prohibition will become effective on the fourth business day after the order is published by the SEC. Delisting from a U.S. stock exchange alone does not eliminate public reporting requirements. Companies subject to a trading prohibition will continue to be subject to public reporting obligations until they deregister the shares under the Securities Exchange Act of 1934.

To end a trading prohibition, a Commission-Identified Issuer must certify to the SEC that it has retained or will retain an accounting firm that the PCAOB has determined it is able to inspect or investigate. In order to make such certification, the Commission-Identified Issuer must file financial statements that include an audit report signed by such an accounting firm. In situations where the audit of a company involves more than one accounting firm, only the accounting firm that serves as the "principal accountant" will, upon signing the accountant's report on the company's financial statements, be deemed "retained" for purposes of this determination. The Chinese branch of a global accounting firm network is a separate legal entity from its U.S.-based affiliated firm, and if that Chinese branch signs the accountant's report in its own name, the SEC will look to the PCAOB determination for that Chinese branch and not apply that determination to the U.S.-based affiliate of that accounting firm network.

Submission and disclosure requirements

The SEC requires a Commission-Identified Issuer to submit documentation through the EDGAR system on or before its annual report due date that establishes that it is not owned or controlled by a governmental entity in its accounting firm's jurisdiction.² The SEC declined to specify what documentation would be required to demonstrate that the company is not owned or controlled by the relevant governmental entity. Each Commission-Identified Issuer should make a determination of what documentation meets the requirement for that particular company. The SEC also noted that the meaning of "owned or controlled" and "controlling financial interest" as used in the HFCA Act references a person's or governmental entity's ability to "control" the company as that term is used in the SEC rules.

The SEC also requires a Commission-Identified Issuer to include additional disclosures in its annual report, including:

- that, during the period, its accounting firm has prepared an audit report for the company;
- the percentage of the shares of the company owned by governmental entities in the foreign jurisdiction in which the company is incorporated or otherwise organized;
- whether governmental entities in the applicable foreign jurisdiction with respect to that registered public accounting firm have a controlling financial interest with respect to the company;
- the name of each official of the Chinese Communist Party who is a member of the board of directors of the company or its operating entity, including any variable-interest entity (VIE); and
- whether the articles of incorporation of the company contain any charter of the Chinese Communist Party, including the text of any such charter.

The Commission-Identified Issuer will need to comply with the submission and disclosure requirements in the annual report for each year in which it is identified. This means that if a company is identified as a Commission-Identified Issuer based on its annual report filing made in 2022 for the fiscal year ending December 31, 2021, the company will be required to comply with these requirements in its annual report filing covering the fiscal year ending December 31, 2022, that it is required to file in early 2023.

What to expect next

In response to the SEC's rulemaking, the Chinese Securities Regulatory Commission (the CSRC), emphasizing the importance of Chinese companies having access to the U.S. capital markets, recently stated that it had always been open to Chinese companies' choice of listing venues in compliance with the relevant laws and regulations, and that it had been proactively seeking discussions with the SEC and the PCAOB to work out a mutually satisfactory solution under the principle of "joint U.S.-China audit inspection." Calling for continued China-U.S. cooperation on audit oversight, the CSRC mentioned that "positive progress" had been made in talks on regulatory cooperation with the U.S. regulators.

In the same statement, the CSRC, denying reports of a possible ban on overseas stock listings by Chinese firms using a VIE structure, also said that it was not asking Chinese firms to drop their U.S. listing plans, and that it was aware that companies were actively working with Chinese and U.S. regulators to pursue their capital markets debut on a U.S. stock exchange. It remains to be seen whether the regulators in both countries will be able to find a path forward to resolve the long-lasting audit issue in order to prevent the exit of hundreds of China-based companies from U.S. markets.

In light of the regulatory uncertainties, companies with substantial Chinese operations seeking a listing in the United States should carefully evaluate impacts of both the HFCA Act and the evolving regulatory environments in their respective industries in China in order to comply with the disclosure and regulatory approval requirements in both the United States and China. China-based companies currently listed on a U.S. stock exchange are encouraged to assess opportunities to mitigate the risks of the trading prohibition under the HFCA Act, including seeking a potential "home-coming" listing in Hong Kong and other appropriate transactions.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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- ¹ In June 2021, the Senate passed the *Accelerating Holding Foreign Companies Accountable Act*, which, if signed into law, would reduce the time period for the delisting under the HFCA Act to **two years**, instead of three years.
- ² For this submission requirement, the SEC estimates that approximately 5% of the affected companies are state-owned enterprises in China and will not be required to prepare the submission.