

U.S. Bill Threatens to Delist China-Based Companies

December 7, 2020

Holding Foreign Companies Accountable Act

On December 2, 2020, the U.S. House of Representatives passed by unanimous consent the ***Holding Foreign Companies Accountable Act (S. 945)*** bill (the “HFCA Act”), which was previously approved by the Senate. The HFCA Act would require the United States Securities and Exchange Commission (the “SEC”) to delist non-U.S. companies, including those with business operations in China, if the Public Company Accounting Oversight Board (the “PCAOB”) is not permitted to inspect a company’s accounting firm for three consecutive years. The HFCA Act would also require foreign companies to make certain disclosures about their ownership by governmental entities. While primarily aimed at China-based companies, the bill would apply to any other non-U.S. companies located in jurisdictions where the PCAOB is not permitted access. As drafted, the HFCA Act would *not* apply to initial listings of stock on a U.S. exchange, but it is unclear if the final rules promulgated by the SEC will be expanded to include initial listings.

Following the passage of the HFCA Act by the House, the bill has gone to President Trump, who is expected to sign it into law. Once enacted, the HFCA Act will require the SEC to issue new rules within 90 days to implement the bill’s requirements; however, in the past it has not been unusual for the SEC to not meet these deadlines.

Background of the HFCA Act

The HFCA Act is a culmination of many years of complaints by U.S. authorities regarding the lack of transparency of Chinese companies listed on U.S. exchanges. Companies that file annual reports with the SEC, including non-U.S. companies, must file financial statements that have been audited by an independent, PCAOB-registered accounting firm. Under the Sarbanes-Oxley Act (the “SOX”), the PCAOB is required to inspect registered accounting firms to assess compliance with auditing standards and bring enforcement actions for non-compliance with such standards.

In 2012, the SEC charged China affiliates of each of the “Big Four” accounting firms and another large U.S. accounting firm with refusing to produce audit work papers and other documents related to China-based companies under investigation by the SEC for potential accounting fraud against U.S. investors. In response, in 2013 the PCAOB entered into a Memorandum of Understanding (the “PCAOB MOU”) on Enforcement Cooperation with the China Securities Regulatory Commission (the “CSRC”) and the Ministry of Finance (the “MOF”), which was intended to establish a cooperative framework between the parties for the production and exchange of audit documents relevant to investigations in both countries’ respective jurisdictions.

Despite the PCAOB MOU, the Chairmen of each of the SEC and the PCAOB issued a joint statement in December 2018 alleging continuing, significant issues relating to the ability of the PCAOB to inspect the audit work papers and practices of PCAOB-registered accounting firms in China (including Hong Kong-based audit firms, to the extent their audit clients have operations in Mainland China) with respect to their audit work of U.S.-listed companies with operations in China. The statement noted that should the barriers to the PCAOB continue to exist, “remedial actions involving U.S.-listed companies may be necessary or appropriate,” including, for example, requiring affected companies to make additional disclosures and placing additional restrictions on new securities offerings. Since then, the staff of the SEC has continued to release statements emphasizing the need for high-quality financial disclosure and reiterating the PCAOB’s inability to inspect audit work papers in China, and last month issued **disclosure guidance** regarding risks associated with China-based issuers.

The Chinese regulator, emphasizing the importance of Chinese companies having access to international capital markets, stated in November 2020 that it was seeking discussions with the SEC as soon as possible on specific plans to improve joint U.S.-China audit oversight and had proposed an updated

version of its plans for joint inspections of accounting firms to the PCAOB. However, the new Chinese securities law (Article 177) prohibits, without the approval of the securities regulatory authority under China's State Council, (i) foreign securities regulators from engaging in any inspection activities within China and (ii) anyone from providing any documents or materials relating to capital markets activities to foreign parties.

In addition to the HFCA Act, the SEC is currently working on new rules in response to a report issued by the President's Working Group on Financial Markets (the "PWG") in August 2020. The report, among other things, recommended that the SEC take steps to enhance the listing standards on U.S. exchanges for access to audit work papers. The PWG recommendations require, as a condition to **both** initial and continued listing, PCAOB access to work papers of the principal audit firm of the listed company. The PWG report recommends a transition period until January 1, 2022 for listed companies, but would apply immediately (upon effectiveness of the new rules) to new listings by Chinese companies.

Hong Kong MOU

It is worth noting that, in 2019, the Hong Kong Securities and Futures Commission (the "HK SFC") signed a tripartite memorandum of understanding (the "HK MOU") with the CSRC and the MOF. This followed a lengthy legal battle between the HK SFC and a "Big Four" accounting firm in which the HK SFC sought audit work papers held by that accounting firm's Mainland China affiliate. That dispute was ultimately resolved through cooperation with and between the SFC and the CSRC. Consistent with this approach, under the HK MOU, the CSRC and the MOF pledged to provide the fullest assistance by providing audit work papers of Hong Kong listed issuers in response to requests from the SFC for investigative assistance. The effect of the HK MOU is that requests from the HK SFC remain subject to the endorsement of the Chinese regulators on a case-by-case basis. It therefore differs from the unrestricted, free access to audit work papers sought by the PCAOB.

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Imposition and Removal of Trading Prohibitions

The HFCA Act would amend the SOX to require the SEC to determine each company that is required to file periodic reports with the SEC (a "covered company") that has retained a registered public accounting firm: (i) that is located in a foreign jurisdiction and (ii) whom 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). If the SEC determines that the PCAOB has been unable to inspect or investigate such accounting firm for three consecutive years, it will prohibit the covered company from trading its securities on a U.S. securities exchange or in any "over-the-counter" exchange.

The SEC will end a prohibition on trading if the covered company certifies to the SEC that it has retained a registered public accounting firm that the PCAOB has inspected to the satisfaction of the SEC. If there is a recurrence of a non-inspection year after the prohibition has been removed, the SEC is required to ban the covered company again for at least five years. If a prohibition on trading has been in place for at least five years, the SEC will end the prohibition if the covered company certifies to the SEC that it will retain a registered public accounting firm that the PCAOB is able to inspect.

Required Certification and Disclosure Obligations under the HFCA Act

Each covered company described above will be required to submit to the SEC documentation certifying that the company is not owned or controlled by a governmental entity in the foreign jurisdiction in which its registered public accounting firm is located.

In addition, for each year that the PCAOB is unable to inspect a covered company's accounting firm, the company will be required to disclose in a form filed with the SEC:

- that, during the period, its registered public accounting firm has prepared an audit report for the company;
- the percentage of the company's shares owned by governmental entities in the foreign jurisdiction in which the company is incorporated;

- 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
 - the operating entity with respect to the company; and
- whether the articles of incorporation of the company contain any charter of the Chinese Communist Party, including the text of any such charter.

Uncertainties Related to the HFCA Act

Until the SEC provides the required rulemaking related to the HFCA Act, a number of issues will remain uncertain. This includes the definitions of terms in the bill such as “governmental entities,” “official of the Chinese Communist Party,” and “controlling financial interest.” We anticipate that these terms will be clarified through the SEC’s rulemaking. In addition, the HFCA Act does not specify what will happen to a company that is unable to certify that it is not owned or controlled by a governmental entity as required. The HFCA Act also does not address the audit practices of the Chinese subsidiaries of multinational companies, which may have audit work papers located within China.

It is also unclear how the SEC will address the rulemaking mandated under the HFCA Act, while incorporating new rules based on the PWG recommendations. Including the PWG proposal to impose similar conditions for initial listings on U.S. exchanges in the new rules would seem to contradict the intent of Congress, as shown both in the HFCA Act and in the Senate’s failure to pass a competing bill proposed by U.S. Senator Marco Rubio in June 2019 that had proposed a ban on initial listing of non-compliant foreign companies. In addition, the current SEC Chairman, Jay Clayton, has announced plans to step down by the end of this year. This may make it less likely that a new SEC Chairperson, to be appointed by President-elect Joe Biden, will comply with the priorities set by the PWG

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