December 3, 2020

U.S. Congress Passes Holding Foreign Companies Accountable Act

Yesterday, the U.S. House of Representatives passed the Holding Foreign Companies Accountable Act[1] (the "Act") that, in effect, could result in the delisting of non-U.S. SEC reporting companies (particularly from China) whose financial statements have, for a period of three consecutive years, been audited by an accounting firm branch or office that is not subject to PCAOB inspection. The Act was approved by the U.S. Senate in May, and the legislation will now be sent to the President for signature. The SEC will need to promulgate rules to implement the requirements of the Act.

Background

The Act is part of a larger, coordinated effort on the part of the U.S. government to address the longstanding concerns over the constraints imposed by the Chinese government on access by the Public Company Accounting Oversight Board (the "PCAOB") to audit work papers of PCAOB-registered auditors of China-based companies listed in the United States and the ability of the PCAOB to conduct on-site inspections of audit work and practices of these accounting firms located in China and Hong Kong. Related issues have been raised regarding disclosure, transparency and accountability for companies located in so-called non-cooperating jurisdictions, including China. These concerns need to be viewed against the backdrop of the broader set of economic, trade and national security issues between the United States and China.

In the past few months, the PCAOB access issues have led to the following:

- The Presidential Working Group on Financial Markets ("PWG"), following the issuance by President Trump in June of his "Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies," released a report in August setting forth recommendations for China-based issuers and for addressing the issue of PCAOB access and investor protections more broadly (see our August 7 client alert, available here).

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1 The Act was initially introduced, in June 2019, as part of a legislative concern in the United States over regulatory access to audit and other information currently protected by national law, particularly in China, and in the context of broader concerns over accounting and disclosure practices. The text of the Act is available here.

- The Staff of the SEC's Division of Corporation Finance published in November CF Disclosure Guidance Topic No. 10 setting forth its views regarding certain disclosure considerations for companies based, or with the majority of their operations, in China (see our December 1 client alert, available here).

- Nasdaq submitted a rule proposal in May to the SEC that would add certain factors to its initial and ongoing listing requirements that would assist Nasdaq in determining whether to deny listing or apply additional and more stringent criteria to an applicant or listed company based on the qualifications of the company's auditor, including whether it has been, or can be, subject to PCAOB inspection (see our May 26 client alert, available here). This fell short of the PWG recommendations addressed to U.S. stock exchanges to take more decisive action and voluntarily seek SEC approval of amended listing standards that would condition an initial or continued listing on the resolution of the outstanding issues (either through direct PCAOB access to work papers or a work-around involving co-audits by audit firms that are subject to PCAOB oversight).

Summary of the Act

The Act requires the SEC to identify each SEC reporting company that retains a registered public accounting firm to audit its financial statements that has a branch or office located in a foreign jurisdiction as to which the PCAOB is unable to inspect, which could arise because of a positon taken by an authority in such foreign jurisdiction. Any such identified reporting company (the majority of which will be China-based companies that use accounting firm offices or branches located in China or Hong Kong) would be required under the Act to submit to the SEC documentation showing that it is not owned or controlled by a government entity in the foreign jurisdiction in which its auditor has a branch or office.

If the SEC determines that the PCAOB is unable to inspect the foreign office or branch of the reporting company's auditor for three consecutive years, the SEC would be required to prohibit the securities of such reporting company from being traded on a U.S. securities exchange or through any other method that is within the SEC's jurisdiction to regulate (including, by means of OTC trades). The prohibition on trading would be removed if the reporting company certifies to the SEC that it has retained an auditor that the PCAOB has inspected, to the satisfaction of the SEC. If following the removal of the prohibition, the SEC determines that the PCAOB is again unable to inspect the company's auditor, the SEC would be required to prohibit the issuer's securities from trading on a national securities exchange for a minimum of five years. The SEC would be permitted to end the five-year prohibition only if the reporting company certifies to the SEC that it will retain an auditor that the PCAOB is able to inspect.

Additionally, the Act requires each SEC reporting company that retains an auditor that the PCAOB is unable to inspect to provide the following disclosures regarding government ownership of the company for each year during which the PCAOB is unable to inspect the relevant auditor's branch or office:

- the percentage of shares owned by governmental entities where the issuer is incorporated;

- whether these governmental entities have a controlling financial interest;
- information related to any board members who are officials of the Chinese Communist Party; and
- whether the articles of incorporation of the issuer contain any charter of the Chinese Communist Party.

Next Steps

Some fear that the Act will lead to an exodus of China-based companies from U.S. stock exchanges, while others see the passage of the Act as an opportunity for the Chinese government and the new U.S. administration to try to reach a compromise on the outstanding access issues. In the words of House sponsor of the Act, California Democrat Brad Sherman: "This bill is not anti-China, and it is not designed to prohibit the trading of Chinese companies. Rather it provides a three-year window during which we expect China will enter into a reasonable agreement with the SEC and the PCAOB, so that we have the additional level of protection for investors that we expect and have demanded since we passed the Sarbanes-Oxley bill in 2002." As for the ultimate impact of delistings, while U.S. exchanges would lose issuers (and associated fees), affected companies would have the ability to list elsewhere, and U.S. institutional investors would continue to be able to invest. In recent months, an increasing number of U.S. listed China-based companies have completed, or applied for, secondary listings in Hong Kong, and there are media reports of companies that otherwise would have listed in the United States that are considering Hong Kong or Shanghai listings.

There have also been media reports that the SEC is preparing to issue a proposal later this month that may embrace a "co-audit" concept as contemplated by the PWG report. The PWG report did note that, in addition to voluntary filings by the U.S. stock exchanges of proposals to amend their listing standards, the SEC could pursue rulemaking on its own that would reach the same result. Ultimately, delisting provisions would need to be included in stock exchange listing standards. The Act, in any event, now provides the SEC with a mandated direction to act.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman +44-20-7367-1601 mbergman@paulweiss.com	Andrew J. Ehrlich +1 -212-373-3166 aehrlich@paulweiss.com	Roberto J. Gonzalez +1-202-223-7316 rgonzalez@paulweiss.com
Xiaoyu Greg Liu +86-10-5828-6302 gliu@paulweiss.com	Judie Ng Shortell +86-10-5828-6318 jngshortell@paulweiss.com	Betty Yap +852-2846-0396 byap@paulweiss.com
Karen R. King +1-212-373-3784 kking@paulweiss.com		

Securities practice management attorney Monika G. Kislowska contributed to this Client Memorandum.