

12 / 03 / 20

Holding Foreign Companies Accountable Act Poised To Be Signed Into Law

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On December 2, 2020, the U.S. House of Representatives approved the Holding Foreign Companies Accountable Act (Act). The Act is identical to the bill the U.S. Senate passed in May 2020. Most significantly, the Act requires the U.S. Securities and Exchange Commission (SEC) to prohibit the securities of foreign companies from being listed or traded on U.S. securities markets if the company retains a foreign accounting firm that cannot be inspected by the Public Company Accounting Oversight Board (PCAOB) for three consecutive years, beginning in 2021, because the accounting firm is located in a foreign jurisdiction that does not permit PCAOB inspection.

President Donald Trump is expected to sign the bill into law later this month.

Background

In order for their securities to be listed on a U.S. securities exchange, registrants, whether located in the U.S. or abroad, must comply with the registration and reporting provisions of the Securities Exchange Act of 1934, including the requirement to annually file audited financial statements with the SEC. As required by the Sarbanes-Oxley Act of 2002, the auditor of those financial statements — whether a U.S. auditor or a non-U.S. auditor — must be registered with, and therefore subject to the jurisdiction of, the PCAOB. This includes undergoing regular PCAOB inspections to assess the auditor's compliance with U.S. law and professional standards in connection with its audits of public companies.

China's state security laws, including governing the protection of state secrets and national security, have been invoked in recent years to limit the ability of the PCAOB to oversee PCAOB-registered audit firms in mainland China and Hong Kong. As a result, for certain China-based companies listed on U.S. stock exchanges, the SEC and PCAOB have not had access to the books and records and audit work papers of PCAOB-registered firms in China and, to the extent their audit clients have operations in China, Hong Kong. Due to these obstacles, investors or potential investors in U.S. capital markets who rely on the audit reports of PCAOB-registered firms in China and Hong Kong are deprived of the potential benefits of PCAOB inspections of these auditors.

On December 7, 2018, the SEC and the PCAOB issued a joint public statement highlighting continued challenges faced by the U.S. regulators in their oversight of financial statement audits of U.S.-listed companies with significant operations in

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China. In April 2020, SEC Chairman Jay Clayton issued a [joint public statement](#) with the chairman of the PCAOB and officials from the SEC regarding possible risks associated with investing in China, including due to the PCAOB's inability to inspect audit work papers in China.

On August 6, 2020, the President's Working Group on Financial Markets (PWG) released a [report](#) recommending that the SEC take steps to implement the five recommendations outlined in the report. In particular, to address companies from jurisdictions that do not provide the PCAOB with sufficient access to fulfill its statutory mandate (NCJs), the PWG recommended enhanced listing standards on U.S. stock exchanges. This would require, as a condition to initial and continued exchange listing, PCAOB access to work papers of the principal audit firm for the audit of the listed company. Companies unable to satisfy this standard as a result of governmental restrictions on access to audit work papers and practices in NCJs could satisfy this standard by providing a co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the co-audit firm. The new listing standards would provide for a transition period until January 1, 2022, for listed companies, but would apply immediately to new listings once the necessary rulemakings and/or standard-setting were effective.

Congressional Response – Holding Foreign Companies Accountable Act

Delisting and Prohibition on Trading

The Act directs the SEC to prohibit securities of any registrant from being listed on any of the U.S. securities exchanges if the auditor of the registrant's financial statements was not subject to PCAOB inspection for three consecutive years, beginning in 2021. As an example, a registrant whose financial statements are not subject to PCAOB inspection would be prohibited from being listed on any U.S. securities exchange starting with the registrant's filing of its 2023 annual report filed in early 2024. The Act further directs the SEC to prohibit the trading in such securities in the U.S. over-the-counter market.

Cure Provision

The Act contains a cure provision. If, following the delisting of a registrant for noncompliance, the registrant certifies that it has retained a registered public accounting firm that is subject to PCAOB inspection, the bill directs the SEC to no longer prohibit the registrant from listing on a U.S. securities exchange under the rule. However, following a re-listing, should the SEC determine

that the auditor of the registrant's financial statements was not subject to PCAOB inspection for a one-year period (as compared to the consecutive three-year period), then the registrant would not be permitted to list on any U.S. securities exchange for five years.

Clarifying Statement

The sponsors of the Act, Sen. John Kennedy, R-La., and Rep. Brad Sherman, D-Calif., entered a statement into the congressional record in order to guide interpretation of the Act. The interpretation, which is aimed at protecting U.S. companies that use foreign audit firms for part of their annual audit, clarifies congressional expectation that the SEC will not prohibit trading in the securities of companies under the Act "as long as not more than one-third of the company's total audit is performed by a firm beyond the reach of the PCAOB inspection. The Act provides the [SEC] with the authority to determine how the size of an audit would be measured and whether you would look at total revenue, assets or some other metric."

Disclosure of Foreign Government Ownership or Control

The Act requires all SEC registrants to submit a form of certification that establishes whether the registrant is owned or controlled by a governmental entity in a foreign jurisdiction that does not allow PCAOB inspection. After being signed into law, the SEC would have 90 days to issue rulemaking to establish the "manner and form" by which registrants are to submit such information.

This certification appears to apply only to registrants with financial statements audited by an auditor not subject to PCAOB inspection.

Additional Annual Disclosures for Issuers With Auditors Not Subject to PCAOB Inspection

The Act requires additional disclosures. Specifically, each foreign registrant filing a Form 10-K or 20-F that includes an audit report from an auditor that did not permit PCAOB inspection will need to include in the subject Form 10-K or 20-F the following disclosures:

- That, during the period covered by Form 10-K or 20-F, the auditor that prepared the audit report was not subject to PCAOB inspection;
- The percentage of shares of the registrant owned by governmental entities in the foreign jurisdiction where the registrant is incorporated or organized;
- Whether governmental entities in the applicable foreign jurisdiction have a controlling financial interest with respect to the registrant;

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- The name of each official of the Chinese Communist Party who is a member of the board of directors of (i) the registrant or (ii) the operating entity with respect to the registrant; and
- Whether the articles of incorporation of the registrant (or equivalent organizing document) contains any charter of the Chinese Communist Party, including the text of any such charter.

The legislative text does not directly contemplate SEC rulemaking to implement these disclosure requirements, but it appears that rulemaking or official guidance from the SEC would be necessary.

SEC Response – Potential Proposed Rules

On August 10, 2020, the SEC announced that Chairman Clayton had directed its staff to prepare proposals in response to the PWG report's recommendations for consideration by the commission. Similar to the congressional legislation, the proposals would prohibit foreign companies from listing securities on U.S. securities markets if the company retains a foreign accounting firm that cannot be inspected by the PCAOB. Recent media reports contend the SEC may issue proposed rules before current Chairman Clayton departs at the close of 2020.

It is unclear how the proposals would be impacted if the Act is signed into law as expected.

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