

# What Hong Kong Policy Shift Means For U.S. Finance Cos.

By Matthew Kluchenek and Matthew Bisanz (June 26, 2020)

On May 29, President Donald Trump announced in a news conference that Hong Kong is no longer sufficiently autonomous to warrant the special treatment that the U.S. has afforded Hong Kong since its handover to China.[1]

Many of the initial concerns have focused on how the revocation will be implemented with respect to customs and other trade laws, but there are other concerns that the financial services sector also should consider.[2] While it is unknown how far the consequences of the revocation will extend, we discuss some of the key issues to track over the coming months.



Matthew Kluchenek

## Public Company Audit Reports

Under U.S. federal securities laws, the Public Company Accounting Oversight Board is required to conduct regular inspections of all registered public accounting firms, both domestic and foreign, that issue audit reports for audits of U.S.-listed public companies and broker-dealers registered with the U.S. Securities and Exchange Commission or that play a substantial role in the preparation of them.[3]



Matthew Bisanz

For audit firms located outside of the U.S., the PCAOB will conduct inspections in the non-U.S. jurisdiction to the extent permitted under local law. In some situations, the PCAOB may directly conduct the inspection, but in other cases it has agreements with local regulators to conduct joint inspections or share inspection findings.

The PCAOB and the SEC historically have differentiated between audits performed in Hong Kong and audits performed in mainland China.[4]

Chinese authorities have not permitted the PCAOB to inspect the audit work and practices of PCAOB-registered auditing 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.

In contrast, the SEC has an arrangement with Hong Kong that allows the SEC to request and examine similar business books and records related to transactions and events occurring within Hong Kong and auditor's documentation of work performed in Hong Kong.[5]

This situation has persisted for several years as an uneasy stalemate between the United States and China. While the Chinese authorities have not permitted the PCAOB to inspect audit firms, the companies audited by those firms continue to have their securities listed on U.S. equity markets. The PCAOB maintains a list of all U.S.-listed companies that have an auditor that is in a jurisdiction that does not allow U.S. inspections.[6]

However, the SEC could revoke access to the U.S. equity markets for public companies that use audit firms subject to the restrictions imposed by the Chinese authorities. In fact, Trump specifically mentioned this issue in his May 29 speech when he instructed the

President's Working Group on Financial Markets to study the practices of Chinese companies listed on the U.S. financial markets.

Given the proximity of this issue to the change in Hong Kong's special status, any revocation of access to the U.S. equity markets for mainland Chinese companies could be extended to public companies based in or with significant operations in Hong Kong.

The SEC and PCAOB previously have expressed concerns with the existing access arrangements in Hong Kong, and there is the risk that the revocation of Hong Kong's special status could cause U.S. regulators to view the existing arrangement in an even less favorable light. This may be more likely to occur if China also took action to apply the mainland auditing regulations to Hong Kong or otherwise attempted to modify Hong Kong's existing arrangement with the SEC.

### **Non-U.S. Futures Trading Activities**

Under the U.S. Commodity Exchange Act, the U.S. Commodity Futures Trading Commission regulates futures and options transactions in the U.S. and in situations where there is a nexus to the U.S. These regulations include exchange, intermediary and advisory registration requirements and functional regulation of registered entities' operations and transactions.

For non-U.S. exchanges, intermediaries and advisors, these regulatory requirements can effectively prevent them from servicing most U.S. customers.

In 2015, the CFTC permitted certain approved firms in Hong Kong to solicit and accept orders from U.S. customers for otherwise permitted futures and options transactions on Hong Kong exchanges without having to register in the U.S.[7] The relief extends only to approved firms regulated by the Hong Kong Securities and Futures Commission, or HKSFC.

No similar authorization has been issued to a regulator or exchange based in mainland China. These authorizations can take years to acquire and often require extensive collaboration between the CFTC, non-U.S. financial institutions, and those institution's home-country regulators.

The CFTC generally requires assurances that the appropriate governmental or self-regulatory organization in the non-U.S. jurisdiction will share information with the CFTC on an as-needed basis. The CFTC also examines whether the non-U.S. jurisdiction's derivatives regulatory regime is comparable to that of the U.S.

The CFTC recently finalized rules that would allow it to revoke prior authorizations, such as the 2015 authorization granted to firms regulated by the HKSFC.[8]

Among other items, these rules would allow the CFTC to revoke an authorization if there are any material changes in the HKSFC's futures and options regulatory regime, including a lack of comity relating to the execution or clearing of any commodity interest subject to the CFTC's exclusive jurisdiction, or if the CFTC determines that information-sharing arrangements with the HKSFC no longer adequately support the authorization.

To date, the CFTC has taken no steps publicly to do so, but may feel obligated to do so depending on if and when Hong Kong's special status is revoked under other U.S. legal regimes.

## **Non-U.S. Swaps Activities**

Under Title VII of the Dodd-Frank Act, the CFTC regulates swap transactions that occur outside of the U.S. only if the transactions have a direct and significant connection with activities in, or effect on, commerce of the U.S., or contravene the CFTC's anti-evasion rules.[9]

The CFTC has used its authority to regulate the swap dealing activities of non-U.S. persons whose business involves a U.S. person or a person related to a U.S. person.[10] The CFTC's regulations in this area can be particularly burdensome for such non-U.S. swap dealers because the dealers must comply with the CFTC's regulations and the requirements imposed by home country regulators.

In 2013, the CFTC issued a comparability determination with respect to the Hong Kong Monetary Authority's swap dealer requirements for (1) chief compliance officers, (2) risk management and (3) swap data record-keeping.

No similar determination has been issued for a regulatory regime from mainland China. The CFTC has stated that a key prerequisite to issuing such determinations is the non-U.S. dealer's home country legal regime must provide the CFTC with direct access to the dealer's books and records.

The CFTC's determination for Hong Kong allows CFTC-registered swap dealers that are located in Hong Kong to comply with the Hong Kong Monetary Authority requirements as a reasonable substitute for compliance with the CFTC's requirements.

The CFTC has indicated that this determination may become invalid if there are material changes in Hong Kong Monetary Authority's regime. This could include, for example, if the CFTC concludes that it no longer has the requisite level of access to the Hong Kong dealer's books and records or is no longer able to examine the U.S.-related swap activities of the Hong Kong dealer.

## **International Capital Reporting**

Under the Treasury International Capital Reporting System, U.S. depository institutions, including U.S. branches of non-U.S. banks, and their U.S. holding companies; U.S. broker-dealers; and other U.S. financial institutions must report certain claims on or liabilities owed to non-U.S. residents on the Form B reports.[11]

The thresholds for filing Form B reports are if the claims or liabilities of the institution or its U.S. customers exceed \$50 million in total or exceed \$25 million with respect to a single country.

Hong Kong and mainland China historically have been treated as separate countries for purposes of this reporting obligation. U.S. financial institutions may need to begin filing Form B reports if Hong Kong is treated as having been merged into mainland China and the aggregate activity exceeds the \$25 million-per country threshold.

## **Takeaways**

On May 27, the U.S. Secretary of State Mike Pompeo certified to Congress that Hong Kong does not continue to warrant treatment under U.S. laws in the same manner as U.S. laws were applied to Hong Kong before July 1997.[12]

This certification does not directly affect the financial services requirements discussed in this article, but on June 11, the U.S. Secretary of the Treasury Steven Mnuchin confirmed that the President's Working Group is deliberating on the response that the U.S. should take with respect to China and Hong Kong.[13]

Therefore, the true impact for the financial services sector will depend on the results of those deliberations and how the U.S. moves forward with the revocation of its special treatment of Hong Kong.

These deliberations may move quickly, particularly if Congress also takes action through legislation, and financial institutions should start identifying and addressing the issues that are relevant to their operations.

Looking at recent, similar situations, such as the exit of the United Kingdom from the European Union, we expect the financial services industry will encounter issues like those discussed in this article, as well as unknown unknowns.

Proactive planning is particularly important for issues where the resolution may require engagement with U.S. regulators and/or policy makers. U.S. regulators sometimes have limited bandwidth to address multiple issues simultaneously and may be slowed down by the requirements of the Administrative Procedures Act and other rulemaking requirements.

U.S. policymakers also have limited capacity, particularly in light of the COVID-19 pandemic and during an election year. Early engagement with these decision makers can mean the difference between timely resolution and last-minute scrambling.

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*Matthew Kluchenek is a partner and Matthew Bisanz is an associate at Mayer Brown LLP.*

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[1] White House, Remarks by President Trump (May 29, 2020).

[2] See Mayer Brown's Legal Update on the customs and other trade law implications of the revocation of Hong Kong's special status: <https://www.mayerbrown.com/en/perspectives-events/publications/2020/05/trump-announces-revocation-of-hong-kongs-special-trade-status>.

[3] 15 U.S.C. §§ 7214, 7216; PCAOB, Rule 4000 (Aug. 13, 2009).

[4] SEC, Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally (Dec. 7, 2018).

[5] *Id.* at n.19 ("While there is existing protocol for the SEC to request such documentation [in Hong Kong], we believe this protocol needs further refinement").

[6] PCAOB, Public Companies that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections (Apr. 1, 2020).

[7] 80 Fed. Reg. 15,680 (Mar. 25, 2015).

[8] 85 Fed. Reg. 15,359 (Mar. 18, 2020).

[9] 7 U.S.C. § 2(i).

[10] See 78 Fed. Reg. 45,292 (July 26, 2013).

[11] U.S. Department of the Treasury, Reports by Financial Institutions of Liabilities to, and Claims on, Foreign Residents by U.S. Residents (Oct. 2019).

[12] U.S. Department of State, PRC National People's Congress Proposal on Hong Kong National Security Legislation (May 27, 2020).

[13] David Lawder and Andrea Shalal, U.S. looking at various responses to China's law on Hong Kong, Reuters (June 11, 2020).