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Congress Passes the "Holding Foreign Companies Accountable Act"

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Editor's note: Andrew Olmem, Christina Thomas, and Jason Elder are partners at Mayer Brown LLP. This post is based on their Mayer Brown memorandum.

Foreign public companies listed in the United States may soon face delisting if their auditors cannot comply with US investor protection laws. On December 2, 2020, the US House of Representatives passed by voice vote the Holding Foreign Companies Accountable Act (HFCAA), which would require auditors of foreign public companies to allow the Public Company Accounting Oversight Board (PCAOB) to inspect their audit work papers for audits of non-US operations as required by the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). If a company's auditors fail to comply for three consecutive years, then the company's shares would be prohibited from trading in the United States. The legislation passed the Senate in May and is now being sent to President Donald Trump, who is expected to sign it into law.

The HFCAA aims to address restrictions China has placed on the PCAOB's ability to inspect or investigate PCAOB-registered public accounting firms in connection with their audits of Chinese companies. Sarbanes-Oxley created the PCAOB "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." [1] Specifically, the PCAOB is responsible for registering public accounting firms, establishing standards applicable to the preparation of audit reports for companies, conducting inspections and investigations of public accounting firms to ensure they are complying with those standards, and bringing enforcement actions when they are not. [2]

Sarbanes-Oxley requires that both domestic and foreign audit firms that prepare or issue an audit opinion for a company that issues securities in the United States produce the underlying audit work papers at the request of the PCAOB or the US Securities and Exchange Commission (SEC). [3] For more than a decade, China has prohibited audit firms located in China and Hong Kong from providing the PCAOB access to audit work papers. [4] Besides preventing auditors from complying with US law, the Chinese government's refusal to allow inspections of the audit work papers has raised concerns with the SEC that Chinese companies may not be providing investors

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[1] U.S.C. § 7211.

[2] *Id.*

[3] U.S.C. § 7216.

[4] *See* President's Working Group on Financial Markets, Report on Protecting United States Investors from Significant Risks from Chinese Companies (Jul. 24, 2020), *available at* https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf.

with reliable financial disclosures. [5] These concerns were heightened earlier this year when Luckin Coffee, a Chinese coffee chain listed on the Nasdaq Stock Market, announced that several employees had fabricated its reported sales figures and that the company's financial statements could not be relied on by investors. The news sent the company's stock price plummeting, and Nasdaq delisted the shares this past July.

The HFCAA seeks to address these investor protection concerns by mandating certain disclosures and requiring the delisting in the United States of companies whose auditors do not comply with the PCAOB's inspection rules.

Disclosure Requirements

The HFCAA amends Sarbanes-Oxley and directs the SEC to identify public companies (covered issuers) that use an audit firm that has a branch or office that:

(1) is located in a foreign jurisdiction; and

(2) authorities in that foreign jurisdiction restrict the PCAOB's ability to inspect or investigate the audit firm (as determined by the PCAOB).

Each such covered issuer will be required to submit to the SEC documentation that establishes that the covered issuer is not owned or controlled by a governmental entity in the foreign jurisdiction. The SEC is required to issue rules implementing this disclosure requirement within 90 days of the enactment of the HFCAA.

In addition, each foreign issuer that is a covered issuer must provide certain disclosures during each non-inspection year in which a registered public accounting firm has prepared an audit report. The disclosures are required to be included in the covered issuer's annual report on Form 10-K or Form 20-F and must include the following information:

> "(1) that, during the period covered by the covered form, such a registered public accounting firm has prepared an audit report for the issuer;
>
> (2) the percentage of the shares of the issuer owned by governmental entities in the foreign jurisdiction in which the issuer is incorporated or otherwise organized;
>
> (3) 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 issuer;
>
> (4) the name of each official of the Chinese Communist Party who is a member of the board of directors of—

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[5] For more information about the SEC staff's response to this issue, see our Legal Update, "SEC Division of Corporation Finance Publishes Disclosure Considerations for China-based Issuers," (Nov. 30, 2020), *available at* https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/11/client-alert–sec-division-of-corporation-finance-publishes-disclosure-considerations-for-chinabased-issuers-nov-2020.pdf.

> (A) the issuer; or
>
> (B) the operating entity with respect to the issuer; and
>
> (5) whether the articles of incorporation of the issuer (or equivalent organizing document) contains any charter of the Chinese Communist Party, including the text of any such charter."

Mandatory Delisting for Non-Compliance

If the SEC determines that a company has three consecutive non-inspection years, the legislation requires that the SEC prohibit the securities of the company from being traded on a national securities exchange or through any other method regulated by the SEC, including over-the-counter trading. The legislation allows for the removal of the trading prohibition if the covered issuer "certifies to the Commission that the covered issuer has retained a registered public accounting firm that the Board has inspected under this section to the satisfaction of the Commission." However, if the covered issuer subsequently falls out of compliance again—even for having just one non-inspection year—the covered issuer must wait another five years before it can apply to have the subsequent prohibition removed.

SEC Implementation

The SEC's implementation of the HFCAA will be complicated by the fact that the agency is already working on proposing rules to implement the recommendations of the President's Working Group on Financial Markets (PWG) on how to address non-compliance with PCAOB audit inspection requirements. The SEC is expected to propose a rule to implement the PWG recommendations by the end of the year. At this time, however, it is unclear whether the SEC will propose to implement the HFCAA in its entirety when it issues its proposed rules to implement the PWG recommendations.

The PWG recommended enhanced listing standards to require, as a condition to initial and continued exchange listing in the United States, that the PCAOB have access to audit work papers of the principal audit firm for the audit of the listed company.

The recommendation also provided an accommodation for issuers from jurisdictions that restrict PCAOB access to audit work papers (non-cooperating jurisdictions): If a company that is based in a non-cooperating jurisdiction cannot meet the new standard, the company would be required to engage an affiliated US-member registered public accounting firm to serve as the principal auditor of its annual financial statements through a co-audit arrangement with the foreign audit firm.

Notably, the PWG recommendation proposed a transition period until January 1, 2022 for currently listed companies to come into compliance, in order to reduce market disruption. Hence, if the SEC incorporates rules to implement the HFCAA with its rules to implement the PWG recommendations, it is possible that the three consecutive non-inspection years required for delisting under the HFCAA would not begin to be counted until 2022, meaning that no company would be delisted until 2025 at the earliest.

The Biden administration has not yet indicated its views on the HFCAA or how it may seek to address noncompliance with Sarbanes-Oxley.