

Legal Update

PCAOB and China Sign Agreement on Audit Firm Inspections and Investigations: Too Early to Tell if it Will Prevent Delistings Under HFCAA¹

Last Friday, the United States and China appear to have taken a major step towards resolving their long-standing dispute over inspections and investigations by the U.S. Public Company Accounting Oversight Board ("PCAOB") of audit firms based in China and Hong Kong that threatens to cause the delisting of approximately \$1.5 trillion in U.S.-listed securities by issuers based in China and Hong Kong. However, it remains uncertain if the deal will prove to be a durable solution.

On August, 26, 2022, the PCAOB signed a Statement of Protocol Agreement (the "SOP Agreement") with the China Securities Regulatory Commission and the Ministry of Finance of the People's Republic of China that establishes a framework for the PCAOB to conduct inspections and investigations of PCAOB-registered public accounting firms in China and Hong Kong.² Under the SOP Agreement, the PCAOB may undertake the following actions with respect to the inspection and investigation of PCAOB registered firms in China and Hong Kong:

- *Engagement Selection.* The PCAOB has sole discretion to select the PCAOB registered firms and clients it will examine.
- *No Redaction.* PCAOB inspectors and investigators can see and retain all audit work papers and information it reviews without any redaction.
- *Testimony.* The PCAOB can interview and obtain testimony from firm personnel in China and Hong Kong.
- *Onward Sharing.* The PCAOB can transfer information to the United States Securities and Exchange Commission (the "SEC") and the SEC can use the information for all SEC purposes, including administrative or civil enforcement actions.

The SOP Agreement comes as the SEC has started, as required by the Holding Foreign Companies Accountable Act ("HFCAA"), to identify issuers that have retained a PCAOB-registered public accounting firm to issue an audit report filed with the SEC under the Securities Exchange Act of 1934 where the firm has a branch or office that: (1) is located in a foreign jurisdiction, and (2) the PCAOB has determined that it is unable to inspect or investigate the PCAOB registered public accounting firm completely because of a position taken by an authority in the foreign jurisdiction. Under the HFCAA, if the SEC determines that the PCAOB has not been able to undertake such an inspection and investigation for a PCAOB registered firm for three consecutive years, the SEC

must prohibit the issuer's securities from being traded in the United States, including on any U.S. national securities exchanges and over-the-counter trading. In December 2021, the PCAOB determined that it is unable to inspect or investigate all PCAOB registered firms headquartered in China or Hong Kong.³ Subsequently, the SEC began identifying issuers that used such PCAOB registered firms to audit their financial statements.⁴

In 2020, Congress unanimously passed the HFCAA to ensure that all issuers with securities trading in the United States comply with U.S. investor protection regulations. Due to the ability of the PCAOB to undertake inspections and investigations in China and Hong Kong, approximately 200 China-based issuers with a total market capitalization of approximately \$1.5 trillion could be impacted by the HFCAA.⁵ Recently, the U.S. Congress has been considering legislation that would amend the HFCAA to reduce the number of non-compliance years before the imposition of the trading prohibition from three to two years.⁶ The legislation has passed both the House and Senate but in different bills, neither of which has yet to be passed by the other chamber.

Now that the SOP Agreement is in place, the PCAOB has stated that it will begin the process of inspecting and investigating PCAOB-registered firms in China and Hong Kong. The PCAOB intends to notify the firms of its plans to inspect, including any specific engagements.⁷ In addition, the PCAOB has issued document requests to certain firms in China, and testimony notifications have been sent to witnesses.⁸ PCAOB inspectors and investigators are planning to be in Hong Kong in mid-September 2022 to begin inspection work, conduct interviews of witnesses and collect testimony.⁹

So far, U.S. regulators have adopted a cautious posture about whether the SOP Agreement will definitively resolve the dispute over PCAOB inspections and investigations and prevent issuers based in China and Hong Kong from having their securities become subject to the HFCAA's trading prohibition. In a statement he released upon the signing of the SOP Agreement, SEC Chair Gary Gensler stated that:

"The proof will be in the pudding. While important, this framework is merely a step in the process. This agreement will be meaningful only if the PCAOB actually can inspect and investigate completely audit firms in China. If they cannot, roughly 200 China-based issuers will be facing prohibitions on trading of their securities in the U.S. if they continue to use those audit firms. ... Going forward, will our markets include China-based issuers? That still is up to our counterparts in China. It depends on whether they comply with the requirements of U.S. law, as detailed in the framework [SOP Agreement]."¹⁰

Similarly, in her statement released upon the signing of the SOP Agreement, PCAOB Chair Erica Williams stated that the agreement was a "first step toward opening access for the PCAOB" but that:

"Now we will find out whether those promises [by the government of China] hold up. ... Whether our teams are able to complete that [inspection and investigations] work without obstruction will inform the PCAOB's determinations at the end of the year."¹¹

In light of these statements, the SOP Agreement should not be viewed as eliminating the possibility that the HFCAA results in trading bans on securities of issuers located in China and Hong Kong. Indeed, the SEC and the PCAOB have clearly signalled that if the PCAOB does not obtain unfettered access to the necessary papers and other information needed to carry out inspections and investigations of PCAOB-registered firms, the HFCAA's trading prohibition will go into effect in accordance with the statute. Hence, the focus will now shift to how the SOP Agreement is implemented by the government in China over the next few months and whether the PCAOB does in fact obtain the information promised under the SOP Agreement. Only time will tell if the SOP Agreement

represents the beginning of the end of the dispute over PCAOB inspections and investigations or merely the end of the beginning of a further protracted dispute.

For more information about the topics raised in this Legal Update, please contact any of the following authors:

Edward S. Best
+1 312 701 7100
ebest@mayerbrown.com

Thomas Kollar
+1-011-852-2843-4260
thomas.kollar@mayerbrown.com

Andrew Olmem
+1-202-263-3006
aolmem@mayerbrown.com



The Free Writings & Perspectives, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up-to-the-minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or “late stage” private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities-related topics that pique our and our readers’ interest. Our blog is available at: www.freewritings.law.

ENDNOTES

- ¹ <https://www.sec.gov/news/statement/gensler-statement-pcaob-amendments-081222>.
- ² <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-signs-agreement-with-chinese-authorities-taking-first-step-toward-complete-access-for-pcaob-to-select-inspect-and-investigate-in-china>.
- ³ <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-makes-hfcaa-determinations-regarding-mainland-china-and-hong-kong>.
- ⁴ https://www.sec.gov/hfcaa?utm_medium=email&utm_source=govdelivery.
- ⁵ <https://pcaobus.org/oversight/international/china-related-access-challenges>.
- ⁶ S. 2184, <https://www.congress.gov/bill/117th-congress/senate-bill/2184>.
H.R. 4521, <file:///C:/Users/AO008367/Downloads/BILLS-117hr4521eh.pdf>.
- ⁷ See [china-sop-qa_0.pdf \(sec.gov\)](#).
- ⁸ *Ibid.*
- ⁹ *Ibid.*
- ¹⁰ <https://www.sec.gov/news/statement/gensler-statement-pcaob-amendments-081222>.
- ¹¹ <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-signs-agreement-with-chinese-authorities-taking-first-step-toward-complete-access-for-pcaob-to-select-inspect-and-investigate-in-china>.