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Congress Passes the Holding Foreign Companies Accountable Act – Chinese Public Companies Confront the Risk of Delisting from U.S. Securities Exchanges

By [Michael L. Zuppone](#)

On December 2, 2020, with a bipartisan voice vote, the House approved Senate Bill S. 945 to enact the Holding Foreign Companies Accountable Act (the "Act").¹ The Senate previously approved the bill by unanimous vote and both the Senate and House expect it to be signed into law by the President. Once implemented by the Securities and Exchange Commission ("SEC"), China-based foreign private issuers will confront the risk of a delisting of their securities from U.S. securities exchanges and prohibition on trading of such securities within the United States. According to the Public Company Accounting Oversight Board ("PCAOB"), there are 17 PCAOB-registered audit firms in mainland China and Hong Kong that have signed audit reports for 202 listed and unlisted Chinese public companies with a combined \$1.8 trillion in market capitalization.²

The SEC and PCAOB have long expressed frustration concerning the inability of the PCAOB to carry out Sarbanes-Oxley Act mandated inspections of registered public accounting firms engaged by China-based foreign private issuers to conduct audits of financial statements required by the federal securities laws. In 2013, the PCAOB entered into a memorandum of understanding on enforcement cooperation with the China Securities Regulatory Commission and the Ministry of Finance, but in the ensuing years, the PCAOB determined that Chinese cooperation has not been sufficient for the PCAOB to obtain timely access to relevant documents and testimony necessary for the PCAOB to carry out enforcement matters.

The new legislation will apply to China-based foreign private issuers without regard to industry or affiliation with China's military. This contrasts with the President's November 12, 2020, executive order which, effective as of January 11, 2021, prohibits the trading of publicly traded securities (or derivative with respect to the same) of any "Communist Chinese military company" as designated by the Secretaries of Defense and Treasury.³

Categories of Issuers Subject to the Act

The Act imposes obligations with respect to two distinct categories of foreign private issuers. It amends the Sarbanes-Oxley Act to create effectively:

- a category of SEC reporting issuers with PCAOB registered auditors located in foreign jurisdiction for which the PCAOB is unable to inspect or investigate completely due to the positions taken by a foreign authority ("*Non-Inspected Issuers*"); and
- a sub-category of Non-Inspected Issuers with prescribed board of director ties to the Chinese Communist Party (referred to as "*CCP Non-Inspected Issuers*").

The Act covers China-based foreign private issuers, but also applies to issuers organized within any jurisdiction with a governmental authority that takes a position that leaves the PCAOB unable to inspect or investigate completely any PCAOB-registered audit firm that audits the financial statements of foreign private issuers with securities trading in the United States.⁴

SEC Disclosure Program Related to Non-Inspected Issuers

The SEC is tasked by the legislation to develop a disclosure program that implements provisions of the Act. Specifically, the SEC must identify each Non-Inspected Issuer with reference to the audit reports on the issuer's financial statements for which the PCAOB is unable to inspect or investigate completely (each year commencing after the date of enactment for which reports are filed with the SEC without the ability of the PCAOB to inspect or investigate completely is referred to as a "Non-Inspection Year"). Each Non-Inspected Issuer must submit documentation to the SEC that establishes that the Non-Inspected Issuer is not owned or controlled by a governmental entity in the relevant foreign jurisdiction.

We expect the SEC will develop a disclosure program that requires foreign private issuers to disclose in their Form 20F or Form 10-K annual reports the existence of each Non-Inspection Year and include disclosure or an officer certification that confirms the lack of governmental entity control, or alternatively, requires that the governmental entity with control over the Non-Inspected Issuer be identified. The legislation requires the SEC to issue rules within 90 days of enactment to establish the manner and form of the required submission of documentation concerning governmental entity control.

Trading Prohibition Applicable to Non-Inspected Issuers

The SEC will be obligated to impose a trading prohibition on the securities of a Non-Inspected Issuer listed on any national securities exchange or traded in the over-the-counter market if it determines that the issuer has experienced three (3) consecutive Non-Inspection Years. Assuming the Act is signed into law by the President in December, companies with a calendar fiscal year end that experience successive Non-Inspection Years will first confront a trading ban following the December 31, 2023, fiscal year end. The trading prohibition would freeze all trading in the United States; thus investors would need to migrate their securities to a foreign broker-dealer that can trade in a foreign market in order to obtain trading liquidity.

The Act requires the SEC to end the trading prohibition once affected issuer certifies to the SEC that it has retained a PCAOB-registered audit firm that the PCAOB has inspected to the satisfaction of the SEC. However, if the SEC subsequently determines that an issuer has experienced a non-inspection year, the SEC shall again prohibit the trading of the securities of the affected issuer. If at the end of the 5-year period, after the imposition of the resumed trading prohibition, the issuer certifies to the SEC that it will retain a PCAOB-registered audit firm, the SEC shall end the resumed trading prohibition.

Additional Disclosure Obligations for Non-Inspected Issuers

The Act directly imposes additional disclosure obligations that do not require SEC rulemaking. During the Non-Inspection Years, each Non-Inspected Issuer would be required to disclose within its Form 20F or Form 10-K the following:

- The fact that its PCAOB-registered audit firm has prepared an audit report;
- The percentage of shares of the issuer owned by government entities in the foreign jurisdiction of its incorporation or organization; and
- Whether government entities in the foreign jurisdiction have a controlling financial interest with respect to the issuer.

CCP Non-Inspected Issuers must also disclose:

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



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¹ See *S. 945 - Holding Foreign Companies Accountable Act* (116th Congress) (available at <https://www.congress.gov/bill/116th-congress/senate-bill/945/text>).

² See *China-Related Access Challenges* (available at <https://pcaobus.org/oversight/international/china-related-access-challenges>).

³ See *Executive Order on Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies* (available at <https://www.whitehouse.gov/presidential-actions/executive-order-addressing-threat-securities-investments-finance-communist-chinese-military-companies/>). As of August 28, 2020, 31 Chinese companies have been designated as a Communist Chinese military company. See Department of Defense lists available online at the following embedded hypertext links: [Tranche 1](#); [Tranches 2 and 3](#); and [Tranches 4](#).

⁴ According to the Congressional Record of the proceedings to pass the bill, the PCAOB has been unable to reach agreements with regulators that allow for full inspection in Belgium, France, Hong Kong, and China; although the PCAOB “is currently working on agreements that would lead to cooperation in Belgium and France and expects to have a final cooperative agreement to facilitate access in the near future.” Congressional Record – House (December 2, 2020) at H6032 (available at <https://www.congress.gov/116/crec/2020/12/02/CREC-2020-12-02-pt1-PqH6031.pdf>).

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