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SEC/CORPORATE

Holding Foreign Companies Accountable Act Signed Into Law by President Trump

In December 2020, President Donald Trump signed into law the Holding Foreign Companies Accountable Act (the HFCAA). The HFCAA requires auditors of foreign companies that are publicly traded in the US to allow the Public Company Accounting Oversight Board (PCAOB) to inspect the auditors' audit work papers for audits of non-US operations. If a company's auditors fail to comply with the inspection requirement for three consecutive years, trading in such foreign company's securities would be prohibited in US markets. The HFCAA also amends the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act), mandates that the Securities and Exchange Commission identify foreign issuers that use an audit firm that is located in a foreign jurisdiction in which the PCAOB is restricted from inspecting or investigating the audit firm, and imposes additional SEC disclosure requirements on such foreign issuers.

To protect investors, the Sarbanes-Oxley Act formed the PCAOB in order to register both domestic and foreign public company audit firms and create standards for audit reports, inspect and investigate such firms, and take action when reports fail to comply with the established standards. The Sarbanes-Oxley Act mandates that such audit firms turn over any audit work papers upon the request of the PCAOB or the SEC. For more than a decade, China has barred audit firms in China and Hong Kong from providing such paperwork to the PCAOB — a prohibition that has raised questions regarding the reliability of financial disclosures of some Chinese companies.

The US Response to China's Prohibition of Compliance: The HFCAA

Mandatory Disclosures

The HFCAA has amended the Sarbanes-Oxley Act to require the SEC to identify any "covered issuer" (i.e., a company that is required to file reports under Section 13 or 15(d) of the Securities Exchange Act of 1934) that has engaged an audit firm located in a foreign jurisdiction and which results in the PCAOB being unable to inspect or investigate completely due to a position taken by an authority in that foreign jurisdiction (hereinafter referred to as an "identified issuer"). In turn, such identified issuer must supply the SEC with documentation showing that the foreign government (or body thereof) that prohibits the auditor from complying with a PCAOB inspection or investigation does not own or control the identified issuer. The HFCAA also mandates that the SEC issue rules within 90 days of the HFCAA's enactment to implement this disclosure requirement.

The HFCAA also requires each identified issuer to make certain additional disclosures in its annual report on Form 10-K or Form 20-F covering a non-inspection year in which an audit firm prepared an audit report, including: (1) a statement that, during the period covered by the report, a foreign registered public accounting firm issued an audit report for the issuer in a foreign jurisdiction that prohibits PCAOB inspections; (2) the percentage of shares owned by governmental bodies where the issuer is incorporated or organized; (3) whether such governmental entities have a controlling financial interest in the issuer; (4) the names of any Chinese Communist Party officials who are on the board of directors for the identified issuer or an operating entity of the identified issuer; and (5) whether the identified issuer's articles of incorporation (or any other similar organizational document) contains any charter (which term is not defined in the HFCAA itself), or the text of any charter, of the Chinese Communist Party.

Repercussions for Non-Inspection

If the SEC determines that the PCAOB cannot inspect or investigate an identified issuer's audit firm for three consecutive years, the HFCAA requires the SEC to prohibit trading of the identified issuer's securities on any national securities exchange in the United States or through any other SEC-regulated method, including over-the-counter trading. The SEC will remove the trading embargo from any such identified issuer's securities if and when the identified issuer certifies that it has engaged a registered public accounting firm that has been inspected by the PCAOB to the SEC's satisfaction. If an identified issuer (1) cures an initial three-year violation by providing a satisfactory certification to the SEC; and (2) subsequently falls out of compliance (even for one non-inspection year), the SEC is required under the HFCAA to prohibit the trading of the issuer's securities for an additional five years. Following the end of such five-year suspension, the identified issuer may again have the trading prohibition removed if it certifies that it has engaged a PCAOB-inspected audit firm.

SEC Action and Reaction to the HFCAA

In a public statement issued on the same day when the HFCAA was signed into law, now former SEC Chairman Jay Clayton directed the staff of the SEC to consider consolidating SEC implementation of the HFCAA with the SEC's efforts to address recommendations made by the President's Working Group on Financial Markets in its July 2020 Report on Protecting United States Investors from Significant Risks from Chinese Companies (the PWG Report), noting the substantial overlap between the HFCAA and the staff's proposals in response to the PWG Report. Chairman Clayton also asked the staff to "consider additional issues relating to the [HFCAA's] implementation," including how its disclosure requirements can be implemented expeditiously and in a way that addresses any actual or perceived uncertainty in order to ensure "investor protection and the fair and orderly operation of our markets."

See the HFCAA text and Chairman Clayton's statement concerning the HFCAA.

BROKER-DEALER

FINRA Postpones Implementation of Mandatory Margin for Covered Agency Transactions

On December 22, 2020, the Financial Industry Regulatory Authority (FINRA) filed a rule change with the Securities and Exchange Commission that further postpones the implementation of mandatory margin for Covered Agency Transactions under FINRA Rule 4210 until October 26.

This is the fifth postponement of the effective date of these rules, which were adopted in 2015 and establish margin requirements for (1) To Be Announced transactions, inclusive of adjustable rate mortgage transactions; (2) Specified Pool Transactions; and (3) transactions in Collateralized Mortgage Obligations, issued in conformity with a program of an agency or Government-Sponsored Enterprise, with forward settlement dates.

See SEC Release No. 34-90852.

SEC Issues No-Action Letter Regarding Institutional Family Offices

On December 23, 2020, the Securities and Exchange Commission issued a no-action letter regarding family offices and Regulation Best Interest.

Specifically, the SEC staff indicated that the SEC would not treat Institutional Family Offices as "retail customers" for broker dealers for purposes of Regulation Best Interest and broker dealers' Form CRS. An Institutional Family Office is defined as "a family office that has one or more experienced securities or financial services professionals, manages total assets of $50 million or more, does not rely on the broker-dealer for recommendations, and has professionals who are independent representatives of their family clients."

See the SEC no-action letter.

DERIVATIVES

See "CFTC Approves NFA's Swap Dealer Capital Model Review Program" in the CFTC section.

CFTC

CFTC Approves NFA's Swap Dealer Capital Model Review Program

On January 13, the Commodity Futures Trading Commission's Market Participants Division determined that the National Futures Association's (NFA) swap dealer capital model requirements and review program are comparable with the CFTC's swap dealer capital model requirements and review program. As a result, a capital model approved by NFA will be accepted as an alternative means of compliance with CFTC Regulation 23.102.

CFTC Regulation 23.102 permits a swap dealer to apply to the CFTC or to the registered futures association of which it is a member to obtain approval to use internal models for purposes of making model computations for capital under the CFTC's rules. The regulation further requires the CFTC to determine whether NFA's model requirements and review process are comparable to those of the agency.

Swap dealers are required to comply with newly adopted capital requirements by October 6, 2021. See the CFTC's release with a link to the CFTC Staff Letter No. 21-03.

UK DEVELOPMENTS

FCA Updates COVID-19 Webpage With Guidance on Market Trading and Reporting

On January 8, the UK's Financial Conduct Authority (FCA) updated its webpage providing information for firms relating to COVID-19 (the Webpage).

The Webpage notes that the FCA's key considerations include:

- expecting firms to take reasonable steps to address the challenges caused by the pandemic on their customers, staff and business continuity plans;
- encouraging transparency between firms and their consumers;
- requiring firms to take all steps to prevent market abuse risk, including implementing enhanced monitoring and submitting regulatory data without undue delay; and
- maintaining a record of all relevant communications (including voice calls) while working outside of the office.

On this final point, the FCA further addresses its expectations for firms on recording telephone conversations and electronic communications in the 66th edition of its Market Watch Newsletter, published on January 11.

The FCA advises firms with concerns about meeting their obligations due to the COVID-19 pandemic to contact the FCA through their regulatory supervisory channels as soon as possible.

See the FCA COVID-19 Webpage.

BREXIT/EU DEVELOPMENTS

ESMA Reminds Firms of MiFID II Rules on Reverse Solicitation Post-Brexit

On January 13, the European Securities and Markets Authority (ESMA) published a statement reminding firms of the requirements under the Markets in Financial Instruments Directive (MiFID II) relating to the provision of investment services to retail or professional clients by firms not established or situated in the EU (the Statement).

Following the end of the transition period on December 31, 2020, ESMA recognized certain practices by firms around reverse solicitation have emerged. For example, some firms appear to be attempting to avoid MiFID II requirements by including general clauses in their Terms of Business or using an online "I agree" pop-up boxes where clients state that any transaction is executed on the exclusive initiative of the client.

In the Statement, ESMA reminds firms that where a third-country firm — such as a UK firm — solicits clients or potential clients in the EU or promotes investment services by any means of communication, it would not be deemed as a services provided at the own exclusive initiative of the client. In ESMA's view, this is the case — regardless of any contractual clause or disclaimer stating otherwise (i.e., if any non-EU investment firm has a website promoting its services and the website is open to prospective EU clients, the non-EU firm will not be able to justify that a request for services from an EU person is exempt from MiFID II rules under reverse solicitation because it is not a request at the own exclusive initiative of the EU client).

ESMA further highlights the following in the Statement:

- the provision of investment services in the EU, without appropriate authorization in line with EU Member States' law(s), could lead to services providers at risk of administrative or criminal proceedings for the application of relevant sanctions; and
- when using the services of investment services providers that are not authorized in line with EU and Member States' law, investors may lose protections granted to them under EU laws. This includes investor compensation schemes under the Investor Compensation Schemes Directive.

See ESMA's Statement.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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