

The U.S. Senate passes the Holding Foreign Companies Accountable Act

The United States Senate passed S. 945, the "Holding Foreign Companies Accountable Act" (the HFCAA), by unanimous consent on May 20, 2020. The HFCAA was first introduced in the Senate on March 28, 2019 by Senator John Kennedy (R-LA) and co-sponsored by Senator Chris Van Hollen (D-MD). On the same day of the HFCAA's passage in the Senate, Representative Bradley Sherman (D-CA) introduced companion legislation in the United States House of Representatives that is identical to the HFCAA. The HFCAA, which amends the Sarbanes-Oxley Act of 2002, (i) imposes potential trading prohibitions for non-compliance with certain audit-related requirements, and (ii) mandates additional reporting and disclosure requirements on reporting issuers whose securities are listed for trading on any U.S. securities exchange or are traded "over-the-counter" in the U.S., in each case effectively limiting access to U.S. capital markets for non-compliant reporting issuers.

The Public Company Accounting Oversight Board

In order for a reporting issuer's securities to be listed and traded on any U.S. securities exchange, each reporting issuer, whether located in the U.S. or abroad, must comply with certain U.S. legal requirements, including the requirement to periodically file audited financial reports with the U.S. Securities and Exchange Commission (the SEC). Pursuant to the Sarbanes-Oxley Act of 2002, an auditor who produces financial reports – whether a U.S. auditor or a non-U.S. auditor – must be registered with the Public Company Accounting Oversight Board (the PCAOB). Except as further described herein, each PCAOB-registered public accounting firm's records and operations are regularly inspected by the PCAOB to assess such auditor's compliance with U.S. legal and professional standards in connection with the issuance of its audited financial reports. As used in this alert, the term "registered public accounting firm" means an accounting firm that has registered with the PCAOB. Local law in certain foreign jurisdictions has prevented the PCAOB from inspecting registered public accounting firms located in those foreign jurisdictions.

Disclosure & Reporting Requirements

If passed by the House of Representatives and signed into law by the President, the HFCAA would:

- Require the SEC to identify each reporting issuer whose audited financial reports are prepared by a registered public accounting firm that has a branch or office in a foreign jurisdiction that the PCAOB is unable to fully inspect or investigate due to restrictions or regulations imposed by an authority in that foreign jurisdiction (an Uninspected Accounting Firm).
- Require any reporting issuer that has been so identified by the SEC to submit documentation to the SEC that it is neither owned nor controlled by a governmental entity in the jurisdiction that prevents inspection or investigation by the PCAOB of registered public accounting firms.

We note that this section of the HFCAA purports to apply to all reporting issuers who employ an Uninspected Accounting Firm for their audited financial reports, and not just to reporting issuers organized outside the U.S.

Trading Prohibitions

If the SEC determines that a reporting issuer's audited financial reports have been prepared by an Uninspected Accounting Firm which has not been inspected by the PCAOB for three consecutive years, it would prohibit such reporting issuer's securities from being listed for trading on any U.S. securities exchange or traded "over-the-counter" in the U.S.

A reporting issuer would be able to cure the trading prohibition by certifying to the SEC that it has retained a registered public accounting firm that the PCAOB has inspected to the satisfaction of the SEC. If, after its securities have resumed trading, such reporting issuer re-engages an Uninspected Accounting Firm, the SEC would be required to impose a new U.S. trading prohibition for a five-year period on such reporting issuer's securities.

Additional Disclosure & Reporting Requirements for Foreign Issuers

Every reporting issuer organized outside the U.S. whose audit reports are prepared by an Uninspected Accounting Firm would be subject to the following enhanced reporting obligations in their Form 10-K or 20-F:

- That, for the period being reported, an audit report for the reporting issuer has been prepared by a registered public accounting firm;
- The percentage of its shares that are owned by governmental entities in the foreign jurisdiction where it is incorporated or organized;
- Whether governmental entities in the applicable non-U.S. jurisdiction with respect to that registered public accounting firm have a controlling financial interest with respect to the reporting issuer;
- The name of each official of the Chinese Communist Party who is a member of the Board of Directors of either the reporting issuer or the operating entity with respect to the reporting issuer; and
- If its Articles of Incorporation (of equivalent organizing document) contain any charter of the Chinese Communist Party, including the text of such charter.

SEC Rulemaking

If enacted, the HFCAA would require the SEC to issue rules that outline the manner and form for submitting the required disclosure and governmental entity ownership information within 90 days of the HFCAA becoming law. We expect further clarity on the specific disclosure and reporting obligations once the SEC promulgates the applicable rules.

Regulatory Tension

Certain reporting issuers are based in, or have affiliates in, China, Belgium and France. Currently, those jurisdictions each have laws that ban registered public accounting firms from allowing the PCAOB to fully access their records or to inspect their operations. The PCAOB is presently in negotiations for bilateral cooperative arrangements that would permit it to commence inspections in Belgium and to resume inspections in France.

The Revised Securities Law of the People's Republic of China has imposed disclosure and reporting prohibitions on Chinese issuers that preclude them from sharing documents and certain other securities business activity information with non-Chinese regulators, such as the PCAOB, without the requisite approvals of various governmental authorities and regulators. These prohibitions create a regulatory dilemma for reporting issuers who have PRC operations that are subject to audit and whose securities are listed for trading on a U.S. securities exchange or whose securities trade "over-the-counter" in the U.S.

Presidential Memorandum

On June 4, 2020, the President of the United States issued a memorandum entitled "Protecting United States Investors From Significant Risks From Chinese Companies" (the Presidential Memorandum). The Presidential Memorandum directs the President's Working Group on Financial Markets, which is chaired by the Secretary of the Treasury and includes the Chairperson of the Board of Governors of the Federal Reserve System, the Chairperson of

the SEC, and the Chairperson of the Commodity Futures Trading Commission, to submit a report to the President within 60 days of the date of the Presidential Memorandum that includes the following:

- Recommendations to the executive branch of the U.S. government to protect investors in U.S. financial markets from the failure of the Chinese government to allow PCAOB-registered public accounting firms to comply with U.S. securities laws and investor protections;
- Recommendations to the SEC or the PCAOB, including inspection or enforcement actions, with respect to PCAOB-registered public accounting firms that fail to provide requested audit working papers and records or that otherwise fail to comply with U.S. securities laws; and
- Recommendations to the SEC or other U.S. federal agencies or departments to protect investors in Chinese companies, or companies from other countries that do not comply with U.S. securities laws.

Conclusion

If enacted, the HFCAA would ultimately require every reporting issuer to (i) utilize a PCAOB-inspected registered public accounting firm and (ii) appropriately disclose that it is not owned or controlled by a governmental entity, in order to maintain its U.S. listing or the trading of its securities on U.S. securities exchanges or for the trading of its securities "over-the-counter" in the U.S. If the HFCAA becomes law, it may result in the de-listing of, or prohibition of trading of, certain reporting issuers' securities who are unable to comply with the PCAOB auditor inspection requirements or who are unable or unwilling to comply with the increased SEC reporting or disclosure requirements.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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