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The Holding Foreign Companies Accountable Act and Related Nasdaq Proposed Rule Changes

Recent measures from U.S. lawmakers and Nasdaq to impose additional requirements on U.S.-listed China-based companies could have wider implications.

On May 20, 2020, the U.S. Senate unanimously passed the Holding Foreign Companies Accountable Act ("Act"), which could have significant implications for China-based companies that are publicly listed in the United States, including possible mandatory delistings for companies that fail to comply. The Act focuses on the inability of the U.S. Public Company Accounting Oversight Board ("PCAOB") to inspect auditors based in China and Hong Kong as part of their regular review of auditors of publicly listed companies. Companies whose auditors fail to be inspected by the PCAOB for three consecutive years will be subject to mandatory delisting.

In early June 2020, the Securities and Exchange Commission published Nasdaq rule proposals that would apply additional restrictions on companies from so-called "restrictive markets" that have laws or regulations restricting access to information by regulators of U.S.-listed companies in such jurisdictions.

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THE BACKGROUND

U.S. securities laws generally require auditors of U.S.-listed public companies to submit to regular review and inspection by the U.S. Public Company Accounting Oversight Board ("PCAOB"), which serves as an "auditor of auditors." In this capacity, the PCAOB reviews the financial statements of the companies audited by such audit firms as well as the related audit work papers.

Many of the auditors of China-based U.S.-listed public companies are located in mainland China and Hong Kong, a territory of the People's Republic of China ("PRC"). For several years, the PRC government has resisted allowing the PCAOB to inspect auditors on Chinese soil on the grounds that such inspections would violate China's sovereignty, national security, and State secrets laws.[1] The PCAOB, the China Securities Regulatory Commission ("CSRC"), and China's Ministry of Finance have been discussing and negotiating this issue for years. They even entered into a Memorandum of Understanding on Enforcement Cooperation ("MOU") in 2013 that was meant to pave the way for a mutually agreeable resolution. However, that MOU lapsed without any final agreement having been reached.

This stalemate is not immaterial in terms of the scope of its impact. Indeed, the PCAOB reported that in the year ended December 31, 2019, 17 PCAOB-registered firms in mainland China and Hong Kong signed audit reports for 188 U.S.-listed or reporting companies that had a combined global market capitalization of approximately $1.9 trillion.

Moreover, the underlying issue is not limited to China. Two other jurisdictions, France and Belgium, also currently restrict the PCAOB from conducting auditor inspections within their respective borders. The PCAOB has stated, however, that it expects "to enter into bilateral cooperative arrangements soon that will permit the PCAOB to commence inspections in Belgium and resume inspections in France."[2]

RECENT DEVELOPMENTS

On May 20, 2020, the U.S. Senate passed the Holding Foreign Companies Accountable Act ("Act"). If signed into law, the Act would require enhanced disclosure to the Securities and Exchange Commission ("SEC") by SEC-reporting issuers that have retained a registered public accounting firm with a branch or office located in a foreign jurisdiction that prevents the PCAOB from performing inspections on that branch or office. Furthermore, if the PCAOB is unable to perform these inspections for a period of three consecutive years, the issuer's securities will be banned from trading on all national securities exchanges in the United States as well as through the U.S. over-the-counter or "OTC" market. In late May, a similar bill was introduced in the U.S. House of Representatives. It is unclear when the House may pass this bill, or when a reconciled Senate and House bill may reach the desk of the President for signature into law.

REQUIREMENTS OF THE ACT

Disclosure Requirements

The Act requires the SEC to identify any SEC-reporting issuer that uses a registered public accounting firm that has a branch or office: (i) located in a foreign jurisdiction; and (ii) where the PCAOB is unable to fully inspect the auditor of such issuer due to a position taken by a governmental authority in that jurisdiction. If an issuer falls into these categories (thereby becoming a "covered issuer" under the Act), the SEC will require it to submit documentation establishing that the covered issuer is not owned or controlled by a governmental entity in the foreign jurisdiction. The Act requires the SEC to adopt rules to establish the manner and form in which a covered issuer can meet these requirements within 90 days of the Act's passage into law.

The Act would also require each "covered issuer" that files with the SEC an audit report that has not been inspected by the PCAOB, to disclose the following in its annual report filed with the SEC:

- The fact that, for the duration of the period detailed in the annual report containing such financial statements, such registered public accounting firm has prepared an audit report for the issuer;
- The percentage of the shares of the issuer owned by governmental entities in the foreign jurisdiction where the issuer is organized;
- Whether governmental entities in the foreign jurisdiction have a controlling financial interest in the issuer;

- The name of any official of the Chinese Communist Party who is a member of the board of directors of the issuer or an operating entity of the issuer; and
- Whether the articles of incorporation of the issuer contain any charter of the Chinese Communist Party (including the text of any such charter).

Trading Prohibition

Under the Act, if the SEC determines that the auditor of a covered issuer has not been inspected by the PCAOB for three consecutive years (starting from the Act's adoption into law), it will prohibit the securities of the covered issuer (including any American depositary receipts of such issuer) from being traded on any U.S. national securities exchange, including the NYSE and Nasdaq, or through any other trading method within the SEC's regulatory jurisdiction, including trading on the OTC markets.

A covered issuer can have the SEC lift such a trading prohibition by certifying to the SEC that it has retained a registered public accounting firm that the PCAOB has inspected and the SEC has approved. If there is a recurrence of a non-inspection year, the Act requires the SEC to again prohibit trading in the covered issuer's securities. To overcome any such repeat trading prohibition, the covered issuer will have to wait five years from the date of its last prohibition to recertify to the SEC that the covered issuer has retained a registered public accounting firm that the PCAOB is able to fully inspect.

NASDAQ RULE CHANGES

On June 8, 2020, the SEC published a Nasdaq rule proposal that complements the Act. The proposed Nasdaq rule, which is intended to "ensure that there are sufficient shares available for trading to facilitate proper price discovery," adds a new definition of "restrictive market" as "a jurisdiction that Nasdaq determines to have secrecy laws, blocking statutes, national security laws or other laws or regulations restricting access to information by regulators of U.S.-listed companies in such jurisdiction."[3]

Where an issuer's business is principally administered in a restrictive market, the proposal would require that the issuer's IPO offer a minimum amount of securities to public holders in the United States—the lower of $25 million and 25% of the issuer's post-offering market value of listed securities. The rule proposal would impose an analogous requirement for listings in connection with a business combination transaction.

Finally, the rule proposal would permit such issuers to conduct direct listings only on Nasdaq's Global Market and Global Select Market. Such issuers would not be permitted to conduct a direct listing on the Nasdaq Capital Market even if they otherwise met the applicable listing requirements. In a separate rule proposal also published on June 8, 2020, Nasdaq also proposed an additional listing requirement to require that issuers from restrictive market countries must: (i) have a director or member of senior management with prior experience at a U.S.-listed public company that makes him or her generally familiar with the requirements of U.S. public reporting and Nasdaq listing; or (ii) engage an acceptable advisor to provide guidance in this regard on an ongoing basis.[4] To date, the New York Stock Exchange ("NYSE") has not proposed similar rule changes.

These two most recent proposals come on the heels of another Nasdaq proposed rule change published on June 2, 2020. That proposed ruled clarified that Nasdaq can use its discretionary authority to deny initial listing or continued listing or apply additional or more stringent criteria for listing based on considerations related to a company's auditor or when its business is principally administered in a restrictive market, including China and France.[5] These could include requiring: (i) higher equity, assets, earnings, or liquidity measures than otherwise required; (ii) that any offering be underwritten on a firm commitment basis, which typically involves more due diligence by the broker-dealer than would be done in connection with a best-efforts offering; and/or (iii) that companies impose lock-up restrictions on officers and directors to allow market mechanisms to determine an appropriate price for the company before such insiders can sell shares in certain circumstances. Under the proposal, Nasdaq could also impose additional liquidity measures, such as requiring a higher public float percentage, market value of unrestricted publicly held shares, or average OTC trading volume.

Regardless of whether the Act becomes a law, Nasdaq's proposed changes in its listing requirements, if approved by the SEC, may themselves create additional hurdles for China-based companies seeking to list in the U.S. market, as well as any other companies incorporated in a "restrictive market."

LOOKING AHEAD

The Act passed the Senate in a rare 100–zero vote. This landslide approval is attributable to the current state of tensions between the United States and China. It could also be viewed as a natural next step in the nearly decade-long effort to close the gap on regulation of China-based U.S.-listed companies, particularly in light of the recent admission of serious financial fraud by one of China's most recently U.S.-listed companies, Luckin Coffee. Luckin Coffee admitted in April 2020 that most of its 2019 revenue had been fabricated and has been cited as evidence in the argument for the need for PCAOB review and inspection of audits of China-based companies.

In light of the unanimous passage of the Senate bill and the general U.S.–China tensions, it is likely that the Act (or some variation on it) will eventually become law. However, the timing of this is uncertain and could be impacted by other events and circumstances affecting the overall U.S.–China relationship, including the ongoing talks regarding the U.S.–China Phase 1 trade deal.

If adopted, the Act would not, however, result in an immediate delisting of any China-based company. Under the Act, any such delisting would not occur until there had been three consecutive years of non-inspection by the PCAOB. Thus, the Act effectively provides at least three more years for the PCAOB and the CSRC to potentially work out a resolution, and to do so against the backdrop of significant consequences for U.S.-listed China-based companies. In the meantime, however, the Act increases the uncertainty for China-based companies that are currently listed in the United States or those that may be contemplating a U.S. listing.

Furthermore, although the Act primarily will affect Chinese companies, its provisions as adopted by the Senate would apply to any issuer whose auditors are not subject to oversight and inspection by the PCAOB, including auditors located in France and Belgium (at least until an expected agreement is reached that allows the PCAOB to conduct inspections in those countries). The Act may also affect U.S.-listed companies with significant subsidiaries in China that are audited by China-based auditing firms.

CONCLUSION

The Act and the proposed Nasdaq rule changes are clearly meant to enhance information-sharing and require inspections by the PCAOB on Chinese soil. However, the immediate impact is likely to be increased compliance costs and some degree of uncertainty for the future of U.S. listings of China-based companies. The Act may also result in more challenges for those it was intended to protect, in particular U.S. investors, U.S. multinational companies with business in China, and U.S. stock exchanges that are in danger of losing the listings of large Chinese companies to stock exchanges in China, Hong Kong, or elsewhere in Asia or Europe. As with many aspects of the U.S.-China relationship, the consequences of the Act could be far-reaching, complex, and unpredictable.

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ENDNOTES

1 Article 177 of the Revised Securities Law of the PRC blocks any entity in China from providing securities-related information to foreign regulators without the approval of the China Securities Regulatory Commission ("CSRC"). Accounting firms operating in China have said they are barred from sharing information with foreign entities under this legislative provision.

2 *See* Securities and Exchange Commission Release No. 34-88987; File No. SR-NASDAQ-2020-028) (June 2, 2020), at note 9.

3 *See* Securities and Exchange Commission Release No. 34-89027; File No. SR-NASDAQ-2020-027 (June 8, 2020).

4 *See* Securities and Exchange Commission Release No. 34-89028; File No. SR-NASDAQ-2020-026 (June 8, 2020).

5 *See* SEC Release No. 34-88987, supra n. 2. Under this proposed rule change, among the factors Nasdaq may consider in applying additional and more stringent criteria to an applicant or listed company based on the qualifications of the company's auditor are whether the auditor has been subject to a PCAOB inspection and the inspection results, the adequacy and expertise of auditor personnel in the offices participating in the audit, and the auditor's training program for such personnel.

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