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Delisting from Exchanges

Tough Prospect for U.S. Listed Companies with Operations Based in China in Light of the Holding Foreign Companies Accountable Act

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Summary

On May 20, 2020, the U.S. Senate unanimously passed S. 945, the Holding Foreign Companies Accountable Act (the "Act"), as introduced by Senators John Kennedy, R-La., and Chris Van Hollen, D-Md. Later that same day, Representative Brad Sherman, D-Ca., introduced in the House of Representatives a bill identical to that passed by the Senate. The swift, unanimous passage of the Act by the Senate sent shockwaves to U.S. listed companies whose operations are based in China (hereafter, the "Chinese Companies") and those who plan to get listed on U.S. exchanges.

While the Act addresses certain issuers with ties to any foreign jurisdiction, it clearly is designed to target the Chinese Companies. The purpose of the Act is to level the playing field among the Chinese Companies and those U.S. listed companies whose audits can be inspected by the Public Company Accounting Oversight Board (the "PCAOB"). Currently, the PCAOB faces obstacles to inspect audits of the Chinese Companies due to Chinese laws and regulations. If the Act is enacted in a form similar to the present versions, the Chinese Companies will be forced to delist from U.S. exchanges within three years unless the Chinese and U.S. regulatory bodies reach an agreement to eliminate or significantly lessen difficulties presently stifling the PCAOB's ability to inspect the Chinese Companies' audits.

Background

Established by Congress in 2002 under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), and subject to oversight by the Securities and Exchange Commission (the "SEC"), the PCAOB oversees audits of public companies, brokers, and dealers, including audits of compliance reports filed pursuant to federal securities laws.[1] The PCAOB routinely inspects audits conducted by accounting firms based in the U.S. to ensure that audited financial statements are accurate and reliable, thus protecting investors and improving the reliability of corporate disclosure under the securities laws. However, over the years the PCAOB has been unable to inspect audits of auditing firms based in Hong Kong and China, including affiliates of U.S. based accounting firms, due to various Chinese laws and regulations, including the Chinese Accounting Law, State Secrecy Law, and Archive Law, which restrict auditors' paperwork performed in China, and certain business books and records related to transactions and events occurring in China, from being transferred outside of China. In addition, the China Securities Regulatory Commission (the "CSRC") recently amended the Securities Law of the People's Republic of China, including new provisions at Article 177 providing that entities or individuals must obtain approval from the securities regulatory authority under the State Council and its various components before they provide documents and/or materials relating to securities business activities overseas.[2]

Thus, under present laws and regulations, the Chinese Companies technically comply with the U.S. securities exchanges' requirement that audits be conducted by firms registered with the PCAOB despite the fact that, in reality, the PCAOB remains blind to the audits.

This issue has survived a decade's worth of unsuccessful cross-border regulatory negotiation between the United States and China,[3] U.S. Congressional and regulatory proposals, and calls for attention from investors and analysts alike. The PCAOB itself has highlighted the issue for years and continues publishing information and statistics regarding public companies to which it has no audit visibility. According to the PCAOB, the organization lacks access to inspect the audits of 188 public companies which account for a combined market capitalization of USD $1.9 trillion.

Over the past several weeks, however, pressure from all sides has ratcheted up resulting in the Senate's unanimous passage of the Act. On May 4, 2020 the SEC announced an upcoming roundtable to discuss this particular issue, followed by President Trump stating during a May 14, 2020 interview with Fox Business that his administration was looking "very strongly" at requiring Chinese companies to comply with U.S. accounting regulations. Nasdaq itself joined the fray when it issued two proposals in May which aim to increase investor confidence by expanding its scope of visibility into audits performed on companies listed on the exchange or applying to be listed. Senators Kennedy and Van Hollen subsequently introduced the Act on May 20, 2020 which quickly passed without objection.

1 In creating the PCAOB and empowering it to monitor auditors of public companies, Sarbanes-Oxley created, for the first time, an oversight regime for an industry that had previously been self-regulated. The SEC retains authority to oversee the PCAOB, including approving its rules, standards, and budgets, and it appoints the five members to the board through consultation with the Federal Reserve System and the Treasury Department. PCAOB board members, including the Chairman, serve five-year staggered terms.

2 The relevant update to the China Securities Law does two critical things: First, it incorporates language expressly prohibiting companies in China from sharing materials and information concerning the activities of listed companies with anyone overseas without the approval of the CSRC. Second, the update expressly prohibits overseas regulatory agencies from directly conducting investigations or gathering evidence in China. The relevant update reads, "…境外证券监督管理机构不得在中华人民共和国境内直接进行调查取证等活动。未经国务院证券监督管理机构和国务院有关主管部门同意，任何单位和个人不得擅自向境外提供与证券业务活动有关的文件和资料。"

3 In 2013, the PCAOB and CSRC signed a memorandum of understanding (the "MOU") establishing a cooperative framework for the effective exchange of audit documents in furtherance of the respective agencies' investigative duties. However, the MOU contains exceptions which limit the PCAOB's ability to obtain certain documents without Chinese regulatory approval. Regarding the MOU, the PCAOB publicly stated, "Chinese cooperation has not been sufficient for the PCAOB to obtain timely access to relevant documents and testimony necessary to carry out our mission…nor have consultations undertaken through the MOU resulted in improvements."

Notably, the legislation follows the recent implosion of Luckin Coffee, a China based, would-be Starbucks competitor, which now faces potential delisting from Nasdaq after executives admitted to fabricating more than USD $300 million in revenue. Once valued at nearly USD $12.7 billion and now valued at less than USD $800 million, Luckin Coffee joins the growing list of Chinese companies listed on U.S. exchanges that have combined to cause billions in losses to investors over the last several years, attributed by many to the lack of parity in visibility to audits.

Analysis of the Holding Foreign Companies Accountable Act

Select Provisions of the Act

The Act, among other things, "amend[s] the Sarbanes-Oxley Act of 2002 to require certain issuers to disclose to the Securities and Exchange Commission information regarding foreign jurisdictions that prevent the Public Company Accounting Oversight Board from performing inspections under that Act."

SEC. 2. DISCLOSURE REQUIREMENT.

Section 104 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7214) is amended by adding at the end the following:

"(i) Disclosure Regarding Foreign Jurisdictions That Prevent Inspections.

"(1) DEFINITIONS.

"(2) DISCLOSURE TO COMMISSION. – The Commission shall –

"(A) identify each covered issuer that, with respect to the preparation of the audit report on the financial statement of the covered issuer that is included in a report described in paragraph (1)(A) filed by the covered issuer, retains a registered public accounting firm that has a branch or office that –

"(i) is located in a foreign jurisdiction; and

"(ii) the Board is unable to inspect or investigate completely because of a position taken by an authority in the foreign jurisdiction described in clause (i), as determined by the Board; and

"(B) require each covered issuer identified under subparagraph (A) to, in accordance with the rules issued by the Commission under paragraph (4), submit to the Commission documentation that establishes that the covered issuer is not owned or controlled by a governmental entity in the foreign jurisdiction described in subparagraph (A)(i).

"(3) TRADING PROHIBITION AFTER 3 YEARS OF NON-INSPECTIONS

"(A) IN GENERAL.—If the Commission determines that a covered issuer has 3 consecutive non-inspection years, the Commission shall prohibit the securities of the covered issuer from being traded –

"(i) on a national securities exchange; or

"(ii) through any other method that is within the jurisdiction of the Commission to regulate, including through the method of trading that is commonly referred to as the 'over-the-counter' trading of securities.

"(B) REMOVAL OF INITIAL PROHIBITION.—If, after the Commission imposes a prohibition on a covered issuer under subparagraph (A), the covered issuer certifies to the Commission that the covered issuer has retained a registered public accounting firm that the Board has inspected under this section to the satisfaction of the Commission, the Commission shall end that prohibition.

"(C) RECURRENCE OF NON-INSPECTION YEARS.— If, after the Commission ends a prohibition under subparagraph (B) or (D) with respect to a covered issuer, the Commission determines that the covered issuer has a non-inspection year, the Commission shall prohibit the securities of the covered issuer from being traded—

"(i) on a national securities exchange; or

"(ii) through any other method that is within the jurisdiction of the Commission to regulate, including through the method of trading that is commonly referred to as the 'over-the-counter' trading of securities.

"(D) REMOVAL OF SUBSEQUENT PROHIBITION.—If, after the end of the 5-year period beginning on the date on which the Commission imposes a prohibition on a covered issuer under subparagraph (C), the covered issuer certifies to the Commission that the covered issuer will retain a registered public accounting firm that the Board is able to inspect under this section, the Commission shall end that prohibition.

"(4) RULES.—Not later than 90 days after the date of enactment of this subsection, the Commission shall issue rules that establish the manner and form in which a covered issuer shall make a submission required under paragraph (2)(B).".

SEC. 3. ADDITIONAL DISCLOSURE.

(a) Definitions.—In this section—

(5) the term "foreign issuer" has the meaning given the term in section 240.3b–4 of title 17, Code of Federal Regulations, or any successor regulation.

(b) Requirement.—Each covered issuer that is a foreign issuer and for which, during a non-inspection year with respect to the covered issuer, a registered public accounting firm described in subsection (i)(2)(A) of section 104 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7214), as added by section 2 of this Act, has prepared an audit report shall disclose in each covered form filed by that issuer that covers such a non-inspection year—

(1) that, during the period covered by the covered form, such a registered public accounting firm has prepared an audit report for the issuer;

(2) the percentage of the shares of the issuer owned by governmental entities in the foreign jurisdiction in which the issuer is incorporated or otherwise organized;

(3) whether governmental entities in the applicable foreign jurisdiction with respect to that registered public accounting firm have a controlling financial interest with respect to the issuer;

(4) the name of each official of the Chinese Communist Party who is a member of the board of directors of—

(A) the issuer; or

(B) the operating entity with respect to the issuer; and

(5) whether the articles of incorporation of the issuer (or equivalent organizing document) contains any charter of the Chinese Communist Party, including the text of any such charter.

Summary of the Act

The Act expands the enforcement ability of the SEC by charging the agency to take three primary actions:

1. Identify issuers that retain a registered public accounting firm which has a branch or office that (i) is located in a foreign jurisdiction; and (ii) the PCAOB is unable to inspect or investigate completely because of a position taken by a foreign jurisdiction.
2. Require each issuer covered by (1) above to certify to the SEC that the issuer is not owned or controlled by a governmental entity in a foreign jurisdiction.
3. Prohibit the securities of the issuer from being traded on a national securities exchange or through any other method under the regulatory purview of the SEC, including "through the method of trading that is commonly referred to as the 'over-the counter' trading of securities" if the PCAOB remains unable to inspect the issuer for three consecutive years.

Some Observations of the Act

A. "Foreign Companies"

The full name of the Act is "Holding Foreign Companies Accountable Act." However, "Foreign Companies" here is really misleading because, for example, the Act applies to all U.S. companies that file reports with the SEC and that retain a registered accounting firm with a branch or office located in China (as defined above "the 'Chinese Companies'"). As discussed earlier, the Chinese Companies are prohibited from disclosing certain information which leads to the PCAOB's inability to inspect their audits, which in turn falls under section 2(A) of Act, i.e., employs an auditing firm located in a foreign jurisdiction, and to which the PCAOB lacks the ability to inspect the audits conducted by those firms under section 3(A) of the Act.

B. Ambiguity of the Act

First, it is unclear what consequence the Chinese Companies that fall under section 2(A) of the Act face if they fail to certify that they are not owned or controlled by the Chinese government. Would they be forced to delist from exchanges immediately?

Secondly and more importantly, what constitutes "owned or controlled by a foreign government" for purposes of the Act remains unknown at this point, but adoption of this same language by other government agencies can guide initial predictions of its ultimate scope. For example, the U.S. Department of Defense (the "Department"), incorporates parallel language in requiring suppliers involved in government or defense-related contracts to make a similar disclosure. In its use of the phrase, the Department intends "effectively owned or controlled" to mean situations where a "foreign government or any entity controlled by a foreign government has the power, either directly or indirectly…to control the election, appointment, or tenure of the Offeror's officers or a majority of the Offeror's board of directors by any means, e.g., ownership, contract, or operation of law..."

What's Next?

The Act still must pass a vote in the House of Representatives and then be signed by President Trump before it becomes law. If the Act is enacted in a form similar to the present versions, the Chinese Companies may be forced to delist from U.S. exchanges if the SEC determines that the Chinese Company has three consecutive non-inspection years.

In addition, if any of these Chinese Companies is a foreign issuer (as defined under 17 CFR § 240.3b-4)[4] and has a registered public accounting firm described in section 2 of this Act prepare an audit report during a non-inspection year, it must make additional disclosure under section 3(b) of the Act, including "the percentage of the shares of the issuer owned by governmental entities in the foreign jurisdiction in which the issuer is incorporated or otherwise organized" for such a non-inspection year.

Awkward Position of the Chinese Companies

The Act presents a dilemma for the Chinese Companies insofar as they will now be required to comply with directly conflicting laws: the relevant laws and regulations of China and those governing U.S. securities. We hope that Chinese and U.S. regulatory bodies can reach an agreement to resolve the issue of the PCAOB's inability to inspect audits of the Chinese Companies, in an effort to both promote U.S.-China collaboration and protect investors and the U.S. capital markets. Otherwise, we could see a wave of delisting of the Chinese Companies from the U.S. exchanges once the Act is signed into law.

Given the fact that Rep. Sherman has already introduced an identical bill in the House, combined with the long history of bipartisan support for similar measures and the recent outspoken attention given by President Trump and the SEC, we anticipate that at least some form of the measures will indeed become law. If a bill passes in the House and receives President Trump's approval, the SEC will then have 90 days to issue rules establishing the manner and form in which the applicable companies must submit certification that those companies have retained a registered public accounting firm that the PCAOB has inspected to the satisfaction of the SEC.

4 Under 17 CFR § 240.3b-4(b), the term "foreign issuer" means any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country:

"(c) The term foreign private issuer means any foreign issuer other than a foreign government except for an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter:

(1) More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and

(2) Any of the following:

(i) The majority of the executive officers or directors are United States citizens or residents;(ii) More than 50 percent of the assets of the issuer are located in the United States; or(iii) The business of the issuer is administered principally in the United States."

Conclusion

The Act seeks to bridge the visibility gap by equipping the SEC with powerful enforcement mechanisms through which the SEC could cause the delisting of entities presently skirting audit inspections by the PCAOB, regardless of whether the entities intend to or not. Thinly veiled as applying to issuers with ties to any foreign jurisdiction, the Act is a poignant and intentional effort to thwart influence within U.S. exchange markets by the Chinese government by bringing parity to inspection transparency.

We continue to carefully monitor the status of this legislation.

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