

## **The Holding Foreign Companies Accountable Act and its Potential Repercussions**

U.S. capital markets are beginning to experience the effects of the passage of the Holding Foreign Companies Accountable Act (HFCAA). Amid continuing tensions between the United States and China, then-President Trump signed the HFCAA into law on December 18, 2020. The HFCAA was introduced in the United States Senate on March 28, 2019 by Senator John Kennedy (R-LA) and Senator Chris Van Hollen (D-MD). The HFCAA passed the Senate by unanimous consent on May 20, 2020. That same day, Representative Bradley Sherman (D-CA) introduced companion legislation in the United States House of Representatives. Subsequently, the HFCAA unanimously passed the House, without amendment, on December 2, 2020.

### **Regulatory Tension with Chinese Reporting Issuers**

In order for a U.S. Securities and Exchange Commission (SEC) reporting issuer's securities to be listed and traded on any U.S. securities exchange (including those securities traded "over-the-counter"), each reporting issuer, whether domestic or foreign, must comply with certain U.S. legal requirements, including the requirement to periodically file audited financial reports with the SEC. Pursuant to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), 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 (PCAOB). Each PCAOB-registered public accounting firm's records and operations are regularly inspected by the PCAOB to assess compliance with U.S. legal and professional standards in connection with the issuance of audited financial reports.

Chinese law presently restricts the PCAOB access to accounting firms located in China and Hong Kong. Chinese law also prevents its citizens and companies from cooperating or complying with information requests from non-Chinese securities regulators without the permission of its own local regulator and other applicable departments of the Chinese government.

The drafters of HFCAA cited certain facts in urging its passage, including a June 2020 PCAOB report which stated that China had 202 public companies listed on U.S. securities exchanges representing \$1.8 trillion in market capitalization, the auditors for which companies the PCAOB have been unable to fully and adequately inspect as mandated by Sarbanes-Oxley.

### **HFCAA Disclosure & Reporting Requirements**

The HFCAA requires the SEC to identify reporting issuers who engage audit firms that have a branch or office in a jurisdiction outside of the U.S. and where authorities in such jurisdiction restrict the PCAOB's ability to fully inspect or investigate such audit firms.

The HFCAA also requires any such 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.

In addition, every non-U.S. reporting issuer whose audit reports are prepared by an auditor not then inspected by the PCAOB would be subject to the following enhanced reporting obligations in their Form 10-K or 20-F during such year(s) that their auditor has not been inspected by the PCAOB:

- “that [whether], during the period covered by the covered form, such a 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 in which the issuer is incorporated or otherwise organized;
- 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;
- 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 of the issuer (or equivalent organizing document) contains any charter of the Chinese Communist Party, including the text of any such charter”.

#### **Non-Compliance with the HFCAA & Trading Prohibition**

If the SEC determines that a reporting issuer’s audited financial reports have been prepared for three consecutive years by a non-PCAOB-inspected auditor, such reporting issuer’s securities would be subject to a prohibition on trading on any U.S. securities exchange or “over-the-counter” in the U.S. A reporting issuer could cure this trading prohibition if, subject to the satisfaction of the SEC, it certifies that it has retained a PCAOB-inspected auditor. However, if the reporting issuer subsequently re-engages a non-PCAOB inspected auditor, it must wait five years before it can apply to have any subsequent trading prohibition lifted.

#### **Rulemaking and Implementation of the HFCAA**

The HFCAA directs the SEC to issue rules that outline the manner and form for submitting the required disclosure information within 90 days of its passage (*i.e.*, by March 18, 2021).

Last year, the SEC staff began drafting new rules regarding enhanced listing standards for U.S. securities exchanges in response to recommendations from the President’s Working Group on Financial Markets contained in its *Report on Protecting United States Investors from Significant Risks from Chinese Companies* (Report) that was issued on July 24, 2020. Aligned with the mandate of the HFCAA, the Report recommended that the PCAOB have access to the work papers of the principal audit firm of a reporting issuer as a condition to such reporting issuer’s initial and continued listing on a U.S. securities exchange. If a reporting issuer is unable to satisfy this audit requirement due to local law preventing the PCAOB inspection of its auditor, the Report suggests that it could satisfy this audit standard by having a co-audit from an auditor with comparable resources and experience where the PCAOB determines it has sufficient access to conduct an appropriate and thorough inspection of the co-audit firm. To reduce market disruption, the Report stated that new listing standards addressing this recommendation could provide for a transition period until January 1, 2022 for reporting issuers from non-compliant jurisdictions, such as China, to become compliant. Any new listing standards issued in response to this recommendation would apply immediately to new reporting issuers.

In an effort to harmonize any new rules promulgated in response to the Report and the new rules required under the HFCAA, former SEC Chairperson Jay Clayton stated on December 18, 2020 that “because of the substantial overlap between the staff’s proposal and the Act [HFCAA], I have directed the staff to consider providing a single consolidated proposal for the Commission’s consideration on issues related to the PCAOB’s access to audit work papers, exchange listing standards, and trading prohibitions. I have also asked the staff to consider additional issues relating to the Act’s implementation, including how the Act’s disclosure requirements can be implemented expeditiously and how any actual or perceived uncertainty can be addressed in a manner consistent with congressional intent as well as investor protection and the fair and orderly operation of our markets.”

### **Recent Market Activities Related to the HFCAA & the Delisting of Certain Chinese Issuers**

On November 12, 2020, then-President Trump signed Executive Order 13959 (Executive Order) which prohibited U.S. companies and individuals from investing – either by purchasing publicly traded securities or holding securities through investment funds – in certain Chinese companies designated by the U.S. Department of Defense as supporting China’s military. On January 13, 2021, then-President Trump amended the Executive Order to clarify that all U.S. companies and individuals who held any securities as of January 11, 2021 in such identified Chinese companies must divest their holdings by November 11, 2021. This amendment to the Executive Order further stated that if the U.S. Department of Defense designates additional Chinese companies pursuant to the Executive Order, then U.S. investors will have 365 days from the date of each such designation to divest all of their holdings in such companies.

In connection with the Executive Order, the New York Stock Exchange (NYSE) announced on December 31, 2020 that it was delisting the American Depositary Shares (ADSs) of three Chinese telecommunication operators: China Telecom Corporation Limited, China Mobile Limited, and China Unicom (Hong Kong) Limited. On January 4, 2021, the NYSE reversed course, stating that it would no longer delist these issuers’ ADSs after “further consultation with relevant regulatory authorities in connection with U.S. Department of the Treasury’s Office of Foreign Assets Control (OFAC)”. Then, on January 6, 2021, the NYSE announced that it would, in fact, proceed with delisting the ADSs of all three issuers after further consultation with the U.S. Department of the Treasury. The delisting of the ADSs of each of the targeted companies was effective before the open of trading on January 11, 2021. Subsequently, the NYSE announced on February 26, 2021 that it was delisting the ADSs of CNOOC Limited, China’s largest offshore oil producer, before the open of trading on March 9, 2021. The NYSE cited both the Executive Order and updated guidance from OFAC that prompted its action against the CNOOC Limited ADSs.

### **Conclusion**

It is unknown how SEC-reporting issuers – especially Chinese SEC-reporting issuers – will respond to the HFCAA and the new rules issued by the SEC. On January 18, 2021, then-President-Elect Biden nominated Gary Gensler to be the next SEC Chairperson. If his nomination is confirmed by the U.S. Senate, it remains to be seen if he will focus regulatory efforts on the priorities outlined by the Report in tandem with promulgating the rules and regulations mandated by the HFCAA, or if the SEC and the Biden Administration will take a more conciliatory approach towards China and wait to gauge the full effect of the HFCAA on U.S. capital markets. Based on the recent action taken by the NYSE against CNOOC, it appears that the Biden Administration will not only continue to maintain pressure on Chinese issuers to ensure their compliance with U.S. regulations, but that it will continue to require adherence to the Executive Order.

In recent years, U.S. capital markets have provided a reliable and popular source of capital for numerous Chinese companies. Certain Chinese reporting issuers which were initially single-listed in the U.S. have subsequently listed their shares on non-U.S. securities exchanges, presumably as a hedge in response to the potential consequences of non-compliance with the HFCAA. It remains to be seen if Chinese issuers will continue to list on non-U.S. securities exchanges, if they will initiate going-private transactions in order to delist from U.S. securities exchanges completely, or if they will lobby the Chinese government to find a workable solution that would enable compliance with the HFCAA and, thus, maintain their listings on U.S. securities exchanges and access to U.S. capital markets. Another variable is the impact the new rules Chinese authorities passed on January 9, 2021 – presumably in response to the HFCAA – that prohibit Chinese companies and citizens from complying with non-Chinese regulations that they deem “unjustified”. These new rules require Chinese companies subject to non-Chinese regulations to report to the Chinese State Council and allow Chinese citizens and companies to sue for compensation in Chinese courts if they incur losses as a result of such non-Chinese regulations. It is also unknown what effect the HFCAA will have on new SEC-reporting issuers that are considering listing on a U.S. securities exchange for the first time.

We will continue to monitor developments in this arena and will report on the new rules to be issued by the SEC as required by the HFCAA, along with other relevant developments occurring across the U.S. and international capital markets.

**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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