

## SEC RELEASES A PROVISIONAL LIST OF COMPANIES THAT HAVE ENGAGED AUDITORS NOT SUBJECT TO FULL PCAOB INSPECTION

In early March 2022, the U.S. Securities and Exchange Commission (the "**SEC**") released a list, [available here](#), that provisionally identifies five U.S. listed companies that have retained an audit firm with a branch or office located in a non-U.S. jurisdiction, which the U.S. Public Company Accounting Oversight Board ("**PCAOB**") has determined it is unable to inspect or investigate completely because of a position taken by an authority in that jurisdiction. Each company on this list has significant operations in the People's Republic of China ("**PRC**" or "**China**"). The release of this list is the latest in a series of steps taken by the SEC to implement the Holding Foreign Companies Accountable Act (the "**HFCA Act**," [available here](#)). This briefing provides an overview of the HFCA Act and the steps that the SEC and the PCAOB have taken to implement the HFCA Act. It also discusses the SEC's related enhanced disclosure expectations as well as U.S. enforcement and private litigation risks.

### BACKGROUND

The China Securities Regulatory Commission ("**CSRC**") issued a rule in 2009 that effectively stated that audit work papers involving any state secrets cannot be transmitted outside China, and that overseas securities regulatory authorities cannot conduct inspections of Chinese auditing firms, without its prior approval. In 2010, the PCAOB sought to inspect the PRC-based affiliates of the international "Big Four" accounting firms. Chinese authorities refused to provide the PCAOB with access. In 2012, the SEC charged these PRC-based affiliates with U.S. securities law violations for failing to produce documents; the charges were subsequently settled. In 2013, negotiations between the SEC, PCAOB, CSRC and China's Ministry of Finance ("**MOF**") regarding joint inspections of Chinese

accounting firms undertaking audits of U.S.-listed firms culminated in a non-binding memorandum of understanding providing for cooperation between the PCAOB, MOF and CSRC on the exchange of audit documents in certain circumstances. The issue of cross-border inspections, however, remains unresolved to this day – negotiations between the PCAOB and Chinese authorities stalled at the end of 2015. Since then, companies that are based in the PRC or have significant Chinese operations have been permitted to list on U.S. exchanges, though the PCAOB remains unable to access their accounting work papers.

## **OVERVIEW OF THE HFCA ACT**

The HFCA Act was enacted in 2020 to address ongoing concerns about the inability of the PCAOB to conduct inspections of PRC-based auditors of companies listed on U.S. stock exchanges. The HFCA Act amends the Sarbanes-Oxley Act to require the SEC to identify any company listed on a U.S. exchange, the auditor of which has a foreign branch or office that cannot be fully inspected or investigated by the PCAOB as a result of a position taken by an authority in that jurisdiction (an "**Uninspected Audit Firm**"). Section 2 of the HFCA Act requires each of these SEC-identified companies submit to the SEC documentation that establishes that the company is not owned or controlled by a governmental entity of the relevant foreign jurisdiction. Companies that are unable to provide this documentation could face adverse consequences, which the HFCA Act does not specify.

If the PCAOB is unable to inspect the relevant branch or office of a U.S.-listed company's audit firm for three consecutive years, Section 2 of the HFCA Act requires the SEC to prohibit that company's securities from being traded on any U.S. securities exchange (including the NYSE and NASDAQ) or through any other method that the SEC regulates, including the U.S. over-the-counter (OTC) market. While issuers located in some other jurisdictions may also be affected, these provisions of the HFCA Act expose U.S.-listed companies that are PRC-based or have significant Chinese operations to the risk of being delisted from U.S. security exchanges after a three-year period.

Section 3 of the HFCA Act requires all SEC-identified companies not organized or incorporated in the United States to include the following disclosures in their annual reports:

- that, during the period covered by the annual report, an Uninspected Audit Firm has prepared an audit report for the company;
- the percentage of the shares of the company owned by governmental entities in the foreign jurisdiction in which the company is incorporated or otherwise organized;
- whether governmental entities in the applicable foreign jurisdiction with respect to the Uninspected Audit Firm have a controlling financial interest with respect to the company;
- the name of each official of the Chinese Communist Party ("**CCP**") who is a member of the board of directors of the company or the operating entity with respect to the company; and

- whether the articles of incorporation of the company (or equivalent organizing document) contains any charter of the CCP, including the text of any such charter.

The HFCA Act does not include any provisions that would directly prohibit the initiation of any U.S.-listing in connection with initial public offerings. Accordingly, the HFCA Act will permit companies that have significant Chinese operations to file registration statements with the SEC for initial public offerings in the United States and apply for listings on U.S. exchanges. Once such a company obtains a U.S. listing, however, they will become subject to the provisions of the HFCA Act.

## **SEC AND PCAOB STEPS TO IMPLEMENT THE HFCA ACT**

### **SEC Implementation of Disclosure and Submission Requirements**

In March 2021, the SEC adopted interim final rules, [available here](#), to implement the submission and disclosure requirements of the HFCA Act. In December 2021, the SEC adopted final rules, [available here](#), to implement the submission and disclosure requirements of the HFCA Act. As part of these implementing actions, the SEC amended its annual report forms to specify under which items disclosure required by the HFCA Act should be provided. For example, Item 9C has been added to Form 10-K and Item 16I has been added to Form 20-F for this purpose. If a company uses a variable interest entity ("**VIE**") (or similar structure), it will be required to provide HFCA Act mandated disclosures for any foreign operating entity that it consolidates in its financial statements as well as for itself. The SEC has confirmed that the HFCA Act mandated disclosures need not be provided in any registration statements.

SEC-identified companies not owned or controlled by a government entity in the relevant foreign jurisdiction will be required to electronically submit to the SEC, on a supplemental basis, documentation that establishes that the company is not so owned or controlled. Submissions are to be made through the EDGAR system on or before the due date of the company's relevant annual report form. The SEC interprets the phrase "owned or controlled" in Section 2 of the HFCA Act, and "owned" and "controlling financial interest" in Section 3 of the HFCA Act, as intended to reference a person's or governmental entity's ability to "control" the company, as that term is used for purposes of the U.S. Securities Exchange Act of 1934, as amended.

### **PCAOB Determination of Uninspected Audit Firms**

To implement Section 2 of the HFCA Act, the PCAOB annually identifies any registered public accounting firms that it determines to be Uninspected Audit Firms. The PCAOB has adopted PCAOB Rule 6100 to provide a framework for making these determinations. In December 2021, the PCAOB issued its first determinations report pursuant to Rule 6100, [available here](#), which informed the SEC that the PCAOB is unable to inspect or investigate completely registered public accounting firms in mainland China and Hong Kong due to positions taken by authorities in those jurisdictions.

## **SEC Identification of U.S. Listed Companies audited by Uninspected Audit Firms**

Using the determinations provided in the PCAOB's report, the SEC has begun to identify U.S.-listed companies that have used an Uninspected Audit Firm to audit their financial statements. In early March 2022, the SEC released a list of five companies that it had provisionally identified pursuant to the HFCA Act. As more companies file their annual reports during 2022, it is likely that the SEC will provisionally identify companies that include in their annual report an audit report signed by an Uninspected Audit Firm. For 15 business days after a provisional identification, a company may email the SEC if it believes it has been incorrectly identified, providing evidence supporting its claim. After reviewing the information, the SEC will notify the company whether it will conclusively identify the company pursuant to the HFCA Act. If a provisionally identified company does not contact the SEC to dispute the provisional identification within that time period, the SEC will conclusively identify the company pursuant to the HFCA Act.

Once a company has been conclusively identified by the SEC, it will become subject to all applicable document submission and disclosure provisions of the HFCA Act described above. For example, any company that has December 31st as its fiscal year end and becomes an SEC-identified company during 2022 will be expected to submit documentation related to its control or ownership to the SEC by the time its annual report for the year ended December 31, 2022 is due. A foreign private issuer that has December 31st as its fiscal year end and becomes an SEC-identified company during 2022 will be required to provide Item 16I disclosures in the annual report on Form 20-F that it files for the year ended December 31, 2022. Similarly, a non-US company that does not qualify as a foreign private issuer, has December 31st as its fiscal year end and becomes an SEC-identified company during 2022 will be required to provide Item 9C disclosures in the annual report on Form 10-K that it files for the year ended December 31, 2022.

## **Uncertainty Around Future Listing Rules**

The SEC has not yet proposed rulemaking to implement the trading prohibitions of Section 2 of the HFCA Act. Any listing-related rules that the SEC may adopt will likely require U.S. exchanges to propose and adopt responsive amendments to their respective listing rules, which could take several months to implement. In addition, it is currently uncertain whether the SEC will propose any rules that would impose any new restrictions on initial listings by companies that provide investors with financial statements audited by an Uninspected Audit Firm.

## **SEC'S ENHANCED DISCLOSURE EXPECTATIONS FOR COMPANIES WITH SIGNIFICANT OPERATIONS IN CHINA**

Regardless of whether a company with significant operations in China has been identified by the SEC pursuant to the HFCA Act, the SEC Chair and the staff of the SEC's Division of Corporation Finance have communicated enhanced disclosure expectations related to the risks of having significant operations in China:

- In November 2020, the staff of the SEC's Division of Corporation Finance issued disclosure guidance specifically targeted at companies based in,

or with the majority of their operations in, the PRC (CF Disclosure Guidance Topic No.10, "Disclosure Considerations for China-based Issuers," [available here](#)). This guidance reminds these companies that they must fully disclose material risks related to their operations in China and provides a series of questions for consideration.

- In July 2021, the SEC Chair issued a statement on investor protection, [available here](#), in response to regulatory actions taken by the PRC government that may have the effect of restricting China-based companies from raising capital offshore. As directed by the SEC Chair, the staff of the SEC have been asking for certain enhanced disclosures from companies associated with PRC-based operating companies before declaring their registration statements effective. In addition, the SEC Chair has directed SEC staff to engage in targeted additional reviews of other filings by companies with significant China-based operations, which could include reviews of disclosures provided in annual reports on Form 10-K or Form 20-F.
- In December 2021, the staff of the SEC's Division of Corporation Finance provided additional disclosure guidance in the form of a sample comment letter to China-based companies, [available here](#). One of the comments included in this form directs these companies to disclose in their risk factors that the U.S. Senate has passed the Accelerating Holding Foreign Companies Accountable Act (S.2184), which, if enacted, would decrease the number of "non-inspection years" from three years to two years, reducing the time before an SEC-identified company's securities would be delisted and subject to a prohibition on over-the-counter trading.

## **U.S. LITIGATION AND ENFORCEMENT RISKS RELATED TO THE HFCA ACT**

The PCAOB inspections necessary to satisfy the HFCA Act remain forbidden by Chinese authorities. So practically speaking, the HFCA Act leaves U.S.-listed issuers that are PRC-based or have significant operations in China with two options: (1) exit the U.S. capital markets, or (2) remain, and comply with the HFCA Act's additional disclosure requirements (at least for the permitted three-year period). Both options present risks of private litigation or regulatory enforcement.

### **Risks of Exiting U.S. Capital Markets**

To avoid the HFCA Act's disclosure requirements and the related threat of compulsory delisting, a company that has retained an Uninspected Audit Firm may choose to voluntarily delist from its U.S. exchange and seek to terminate their U.S. public reporting obligations. The mechanics of such an exit strategy are complex, and not all delisted companies can meet the SEC's requirements for terminating public reporting obligations. The options—which may include acquiring shares from investors on the open market and deregistering shares with the SEC—can present a variety of risks under the general antifraud provisions of the securities laws; under general corporate law doctrine under the law of the place where the issuer is incorporated; and—depending on the form of the transaction—under SEC disclosure rules related to equity tender offers. Issuers exploring a move away from the U.S. capital markets to avoid the HFCA Act should carefully consider these options with counsel.

In addition, delisting a company's equity securities from a U.S. exchange risks negatively affecting trading and liquidity for any remaining shareholders. This risk may be mitigated by seeking a listing on a non-U.S. exchange.

### **Risks of Staying in U.S. Capital Markets**

Alternatively, companies that have retained an Uninspected Audit Firm may choose to remain listed in the U.S. and attempt to comply with the HFCA Act disclosure requirements (at least, for the three years in which they are permitted to do so). However, this too creates risk.

Specifically, companies that are PRC-based or have significant Chinese operations may find it difficult to comply with the disclosure obligations imposed by the HFCA Act (and any related SEC rules) without violating Chinese state secrecy laws. The SEC—keenly aware of this tension—will doubtless scrutinize the disclosures of companies that choose to remain. The same is true of private plaintiffs' counsel, who pursue securities fraud litigation against issuers on behalf of classes of investors. These challenges come at a time when the politicized climate and other issues have kept Chinese issuers in the spotlight, including high-profile securities fraud claims against Chinese issuers such as Luckin Coffee, and the delisting of other Chinese telecommunications companies listed on the New York Stock Exchange. We expect Chinese issuers to continue to draw the attention of private plaintiffs' attorneys. The heightened disclosure obligations of the HFCA Act could further tempt plaintiffs' lawyers to pursue class litigation against the issuer (and top executives) in connection with any material drop in share price. Even if these suits do not succeed, they can be costly to defend and attract negative publicity.

### **PCAOB ENFORCEMENT CONSIDERATIONS**

The HFCA Act and other developments in the United States may also increase the risk of PCAOB enforcement actions against PRC-based audit firms and their principals/employees. As discussed in our May 2020 briefing, [available here](#), the PCAOB has been focused for some time on audits of non-U.S. issuers listed on U.S. exchanges. Resolutions of enforcement matters with non-U.S. firms and individuals represented approximately 33% of the PCAOB's enforcement activity between 2015 and 2019. For non-U.S. PCAOB disciplinary orders against auditing firms, the average penalty was U.S.\$226,784. The PCAOB also regularly fines individual respondents, often the audit partner, though other audit professionals are not immune from sanction. Financial penalties for individuals typically range from U.S.\$5,000 to U.S.\$50,000. Many penalties against individuals are accompanied by a censure and, oftentimes, a temporary or permanent bar from being an associated person of a registered public accounting firm. Areas of focus in recent PCAOB examinations have included firm competency, competency and training of personnel, independence, focus on deadlines, focus on integrity, PCAOB reporting and payments, and tailored audit work papers.

PRC-based audit firms and their personnel should be prepared for increased PCAOB enforcement scrutiny. For example, the PCAOB recently took enforcement action against three PRC-based firms for failing to disclose reportable events and fined each firm U.S.\$10,000. The PCAOB's Enforcement Division's reported resolutions of enforcement matters with non-U.S. firms and

individuals are [available here](#). While these were simple reporting failures and therefore the fines are relatively low, they may be indicative of the increased PCAOB scrutiny to come.

## **CONCLUSION**

While much remains to be seen, U.S.-listed companies that have significant Chinese operations face significant risks because of the HFCA Act and enhanced SEC scrutiny. While the HFCA Act and the SEC still permits the affected companies to file registration statements with the SEC for initial public offerings in the U.S. and apply for listings on U.S. securities exchanges, the SEC could adopt rules that impose additional restrictions on these listings. In addition, the HFCA Act imposes new disclosure burdens on companies that have significant Chinese operations. Required disclosures will call attention to companies that are audited by an Uninspected Audit Firm. The PCAOB may also increase its scrutiny of PRC-based accounting firms and seek more substantial fines for noncompliance with its audit and reporting standards. Finally, the HFCA Act may also lead companies to voluntarily delist and seek to exit the SEC's public reporting regime, which would raise its own complex regulatory issues and potential regulatory enforcement and private litigation risks.



## CONTACTS

### Beijing

**Tim Wang**  
Partner

**T** +86 10 6535 2266  
**E** tim.wang  
@cliffordchance.com

### Hong Kong

**Liu Fang**  
Partner

**T** +852 2825 8919  
**E** fang.liu  
@cliffordchance.com

**Yuling Geng**  
Counsel

**T** +852 2825 8926  
**E** yuling.geng  
@cliffordchance.com

### Shanghai

**Lorna Lyu**  
Counsel

**T** +86 21 2320 7238  
**E** lorna.lyu  
@cliffordchance.com

### Singapore

**Jean Thio**  
Partner

**T** +65 6506 1956  
**E** jean.thio  
@cliffordchance.com

### New York

**Robert Houck**  
Partner

**T** +1 212 878 3224  
**E** robert.houck  
@cliffordchance.com

**John Friel**  
Partner

**T** +1 212 878 3386  
**E** john.friel  
@cliffordchance.com

**Jonathan Zonis**  
Partner

**T** +1 212 878 3250  
**E** jonathan.zonis  
@cliffordchance.com

**Meredith George**  
Associate

**T** +1 212 878 8163  
**E** meredith.george  
@cliffordchance.com

**Minji Reem**  
Associate

**T** +1 212 878 8027  
**E** minji.reem  
@cliffordchance.com

**Rebecca Hoskins**  
Professional Support  
Lawyer

**T** +1 212 878 3118  
**E** rebecca.hoskins  
@cliffordchance.com

### Washington DC

**Steve Nickelsburg**  
Partner

**T** +1 202 912 5108  
**E** steve.nickelsburg  
@cliffordchance.com

**David Adams**  
Associate

**T** +1 202 912 5067  
**E** davidg.adams  
@cliffordchance.com

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Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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