

CLIENT ALERT - S. 945

United States Senate Acts to Address Concerns About Audit Integrity of Foreign Issuers Trading on United States Markets – With a Focus on Chinese Companies

THE PROPOSED LEGISLATION

The United States Senate has passed S. 945, the “Holding Foreign Companies Accountable Act,” a bipartisan bill to amend the Sarbanes-Oxley Act of 2002 (“SOX”).¹ The bill is directed at foreign companies trading on United States securities markets whose financial audits have not been subject to required reviews by the Public Company Accounting Oversight Board (“Board”). A provision of the bill also requires foreign companies to disclose whether a foreign governmental entity owns shares in, or has a controlling financial interest in, the issuer.

While the new provisions apply to foreign issuers generally, other provisions of the bill make it clear that a primary focus is on Chinese companies. The bill would require certain covered issuers to disclose the name of each official of the Chinese Communist Party who is a member of the board of directors of the issuer or its operating entity and whether the issuer’s organizing document “contains any charter of the Chinese Communist Party.”²

The bill would require the Securities and Exchange Commission (“SEC”) to prohibit trading of the securities of issuers that are required to file public reports under Sections 13 or 15(d) of the Securities Exchange Act of 1934 (“Exchange Act”) if the Board had been unable to inspect the audit reports by the issuer’s registered public accounting firm (“RPAF”) for three consecutive years because of a position taken by an authority in a foreign jurisdiction (termed a “non-inspection year”).³ The scope of the trading prohibition is comprehensive: it would apply to trading on national securities exchanges and “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.” That would cover trading on Alternative Trading Systems and traditional over-the-counter markets. The trading prohibition is of indefinite duration, but the SEC can terminate it if the issuer submits a certification to the SEC that it has retained a RPAF that

¹ <https://www.kennedy.senate.gov/public/cache/files/0/4/04065c9e-9ae9-482c-952b-3380781545c5/B51AE5FF25469574442B23D689389132.05-20-20-holding-foriegn-companies-accountable-act.pdf>.

² The focus on Chinese companies is emphasized in the statement of Senator John Kennedy (R, LA), a sponsor of the bill, upon the Senate passage of the bill (“... It’s asinine that we’re giving Chinese companies the opportunity to exploit hardworking Americans—people who put their retirement and college savings in our exchanges—because we don’t insist on examining their books. There are plenty of markets all over the world open to cheaters, but America can’t afford to be one of them. China is on a glidepath to dominance and is cheating at every turn. ...”), <https://www.kennedy.senate.gov/public/2020/5/senate-passes-kennedy-and-van-hollen-s-bill-to-kick-deceitful-chinese-companies-off-u-s-exchanges>.

³ This timing element is somewhat surprising given the purposes of the bill, particularly because the determination of whether the issuer had three consecutive non-inspection years would not begin to run until the legislation is enacted. That means that a foreign issuer could have up to six years where the PCAOB was unable to review audit reports. Even allowing three consecutive years of non-inspection reports could mean that United States investors may be trading for an extended period on the basis of potentially false, misleading, or incomplete information about the issuer.

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the Board has inspected. If the issuer has a subsequent non-inspection year, the SEC must prohibit trading that can be terminated after five years if the issuer provides the required certification.⁴

OBSERVATIONS

In the context of the current geopolitical climate, the bill could receive a favorable reception in the House of Representatives and the White House. The bill passed without opposition in the Senate, and in this current political environment, it may be difficult to identify a party constituency that would oppose the legislation.

The bill presents some interpretive issues. For example, some terms may require additional definition within the bill or by subsequent rulemaking by the SEC, such as “governmental entity,” “official of the Chinese Communist party,” “owned or controlled by a governmental entity,” and “controlling financial interest.”

The SEC is directed in Section 2 to issue rules requiring covered issuers to submit documentation to the SEC establishing that the issuer is “not owned or controlled by a governmental entity.” Other SEC rulemaking, however, may be required, such as:

1. To establish a process for notifying the SEC that a non-inspection year had occurred with respect to a covered issuer;
2. To establish a process for SEC determination that a covered issuer has had three consecutive non-inspection years; and
3. To specify the content of certifications that may be submitted to the SEC regarding an issuer that is subject to a trading prohibition.

This bill may evince an implicit criticism of the SEC and PCAOB in their regulation of foreign issuers, especially Chinese issuers, and their auditing firms. The bill presupposes that the SEC and the PCAOB have failed to exercise their existing regulatory and discretionary authority to act against companies that have not been subject to PCAOB scrutiny. The SEC is already required to conduct enhanced reviews of periodic disclosures by issuers that file reports under Exchange Act Sections 13(a) or 15(d).⁵ The bill may not materially add to the investigatory or disciplinary powers of the SEC or the PCAOB with regard to issuers and auditing firms. For example, the SEC can conduct investigations to determine whether any person has violated or is about to violate the Exchange Act or rules thereunder.⁶ The SEC already has the ability to sanction issuers that fail to comply with their Exchange Act reporting obligations.⁷ Moreover, the SEC has authority to suspend or revoke the Exchange Act registration of an issuer that fails to comply with the Exchange Act,⁸ and to suspend trading of a security on all United States markets if the SEC is of the opinion that such action is in the public interest and the protection of investors.⁹ The PCAOB is required to conduct inspections of RPAFs¹⁰ and can suspend or revoke the registration or apply other sanctions to a RPAF that fails to cooperate in an inspection or that fails to comply with PCAOB standards.¹¹ The PCAOB also can make referrals to the SEC.¹²

⁴ There is a difference between the certifications that may be filed after an initial and a subsequent trading prohibition in Section 3 of the bill: the former certification must state that the issuer “has retained” a RPAF that the Board has inspected, while the latter certification must state that the issuer “will retain” a RPAF that the Board is able to inspect.

⁵ SOX Section 408.

⁶ Exchange Act Section 21(a).

⁷ Exchange Act Sections 21(d) and 21C.

⁸ Exchange Act Section 12(j).

⁹ Exchange Act Section 12(k). Trading suspensions are limited to a period of up to ten business days.

¹⁰ SOX Section 105(b).

¹¹ SOX Section 105(b) and (c).

¹² SOX Section 105(b)(4). National securities exchanges also have rules that authorize them to suspend trading in or de-list securities of issuers that violate the Exchange Act or their own rules. The Nasdaq Stock Market recently filed a proposed rule change with the SEC that would enhance Nasdaq’s listing requirements relating to an issuer’s financial statements, including “whether the results of [a PCAOB] inspection indicate that the auditor failed to respond to any requests by the PCAOB....” Release 34-88987 (June 2, 2020), <https://www.sec.gov/rules/sro/nasdaq/2020/34-88987.pdf>. The filing states that “PCAOB is

A fundamental question in exercising the SEC's and PCAOB's existing authority would be whether an issuer that employs an auditor that the PCAOB is prevented from examining has satisfied the financial reporting requirements of the Exchange Act and SOX.¹³ The bill would directly address the question of whether the SEC or PCAOB can or should take action that would adversely affect an issuer that operates in a jurisdiction where the government prevents compliance with United States law requirements. The bill answers that question by requiring the SEC to prohibit trading in United States markets if audits of an issuer's financial statements cannot be independently examined by the PCAOB.

CONCLUSION

In essence, this legislation may be sending a message to the SEC, PCAOB, and accounting firms that questions about the integrity of an issuer's financial statements must be identified and addressed aggressively. It sends a direct message, however, to foreign (especially the Chinese) governments that access to the United States securities markets by their domestic issuers requires compliance with United States law. The bill specifically seeks to expose possible influence of the Chinese and other governments on the operation of issuers whose securities trade on United States markets.

We will provide updates if this legislation progresses.



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currently prevented from inspecting the audit work and practices of PCAOB-registered auditors in Belgium, France, China and Hong Kong (to the extent that their audit clients have operations in mainland China)." Id. at 4-5 (footnote omitted). It should be noted that an exchange's refusal to list, or action to de-list, an issuer's securities would not prevent the securities from trading in the over-the-counter market.

¹³ The Chairmen of the SEC and PCAOB repeatedly have expressed concern about impediments to SEC and PCAOB access to audit information with respect to foreign-domiciled issues whose securities trade on United States markets, in particular noting "the PCAOB's inability to inspect audit work papers in China." SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman, SEC Division of Investment Management Director Dalia Blass, "Emerging Markets Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited," (April 21, 2020), <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting>; see also SEC Chairman Jay Clayton, SEC Chief Accountant Wes Bricker, PCAOB Chairman William D. Duhnke III, "Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China," (December 7, 2018), <https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other>.