Legal Commentary

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The Holding Foreign Companies Accountable Act-2021 Developments

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On December 2, 2020, the U.S. House of Representatives passed the *Holding Foreign Companies Accountable Act* (the "**China De-Listing Law**") by unanimous voice vote. The U.S. Senate also passed the China De-Listing Law on May 20, 2020 by unanimous voice vote. On December 18, 2020, President Trump signed the China De-Listing Law, making it effective on that day. On March 24, 2021, the Securities and Exchange Commission ("**SEC**") issued an interim final rule (the "**First Implementation Rule**") implementing portions of the China De-Listing Law and requesting public comment on the implementation of other portions of the China De-Listing Law, including the procedures for de-listing. On May 13, 2021, the Public Company Accounting Oversight Board ("**PCAOB**") issued a proposed rule setting forth a framework for determining the audit firms that it is unable to inspect as required by the Sarbanes-Oxley Act of 2002 (the "**Act**"), which came into effect on November 4, 2021 (the "**PCAOB Rule**"). On December 2, 2021, the SEC issued a final rule (the "**Final Amendments**"), wherein it amended disclosure forms, announced the creation of a public website that will list Subject Issuers (defined below), and provided a clarification about the disclosure requirements under the China De-Listing Law also applying to group companies within a VIE structure. The Final Amendments will be effective on January 10, 2022.

Main points of the China De-Listing Law

The China De-Listing Law purports to address the inability of the PCAOB to inspect the Hong Kong and PRC based auditors of Chinese companies listed in the U.S. The issue is not new, and has been raised by the SEC during three Presidential administrations (Trump, Obama, Bush). The main points of the China De-Listing Law are as follows:

1. The SEC is required to identify issuers whose audits cannot be inspected as determined by the PCAOB ("**Subject Issuer**"). Each Subject Issuer will be required to submit to the SEC documentation proving that it is not owned or controlled by a governmental entity in a jurisdiction that does not permit the PCAOB audits.

2. If an issuer is a Subject Issuer for three (3) consecutive years, it will be required to be de-listed, including from national exchanges (such as NYSE and Nasdaq), as well as over-the-counter.

3. The Subject Issuer is required to disclose in its SEC filings (i) the percentage of shares of the issuer owned by governmental entities in the issuer's place of incorporation, (ii) whether government entities in the auditor's place of incorporation have a "controlling financial interest" in the issuer, (iii) each "official of the Chinese Communist Party" who is a board member of the issuer and operating entity of the issuer, and (iv) whether the articles of association of the issuer contains any "charter of the Chinese Communist Party, including the text of any such charter."

Main points of the first implementation rule and final amendments

The First Implementation Rule amends annual report forms by incorporating the provisions of #1 and #3 above and lays the foundation for determining Subject Issuers. Namely, the PCAOB, which is regulated by the SEC, is required under the First Implementation Rule to "act quickly" to determine the Subject Issuers. The SEC will confirm the Subject Issuers and then publish a list, currently set at May 15 of each year. A "non-inspection" year is the year in which the SEC identifies a Subject Issuer based on the annual report filed by such Subject Issuer for the prior year. The earliest a Subject Issuer may be identified as such is 2022, for the annual report filed for 2021. Accordingly, under the First Implementation Rule, the earliest a Subject Issuer may be forcibly de-listed is 2024, though practically such Subject Issuer will need to prepare for the de-listing well in advance (e.g. re-listing public shares in Hong Kong, a take private and re-listing in Hong Kong or the PRC, or a take private). The date may also be moved forward to 2023 pursuant to the Accelerating Holding Foreign Companies Accountable Act (see below).

I Final amendments

The Final Amendments amended the form annual reports that are required to be completed and filed by Subject Issuers by incorporating the required disclosures under the China De-Listing Law. With respect to the disclosure of shares owned by governmental entities in the issuer's place of incorporation, the Final Amendments expanded the requirements to all group companies in a VIE structure, such that disclosure of government ownership in a VIE company in the VIE structure will now be required in addition to disclosure of government ownership in the parent entity. The Final Amendments also stated that Subject Issuers will be identified on a public website at: www.sec.gov/HFCAA.

Importantly, the Final Amendments do contain rules on de-listing procedures, namely that the SEC will de-list a non-compliant Subject Issuer after three consecutive years of being identified as such (may be reduced to two soon, see below). The de-listing will be effective on the fourth business day after an order is delivered by the SEC.

II Items of clarification

The sponsor of the China De-Listing Law in the House Brad Sherman (Democrat-California), who has long supported similar legislation, previously indicated that he wished to improve on the Senate version of the bill. However, this ultimately did not come to pass, leading to a bill that has the following uncertainties:

1. The term "governmental entities" is not defined, leading to uncertainty over what constitutes government ownership (e.g. the role of state owned entities, state owned limited partners).
2. The term "official of the Chinese Communist Party" is not defined, leading to uncertainty over what constitutes an "official" (e.g. a member of the Communist Party, or something else).
3. The term "controlling financial interest" is not defined, leading to uncertainty over how the matter is to be disclosed.
4. There are no provisions that state the consequences of what happens if a Subject Issuer is in fact owned or controlled by a governmental entity, in which case it will be unable to certify otherwise as required by the China De-Listing Law.
5. There are no provisions on the treatment of local audits of the Chinese subsidiaries and operations of multinational issuers[1].

The First Implementation Rule addresses #3 above by stating that the terms "owned or controlled", "owned," and "controlling financial interest" should reference the definition of "control" under the 1934 Exchange Act. The First Implementation Rule addresses #4 above by stating that Subject Issuers that are controlled by a governmental entity will not be required to provide a certification that they are not controlled by a governmental entity, but are still subject to the disclosure obligations that apply to all Subject Issuers.

The First Implementation Rule seeks public comment on defining the terms "governmental entities" (item #1 above) and "official of the Chinese Communist Party" (item #2 above). The Final Amendments stated that the SEC declines to further define the term "official of the Chinese Communist Party", as that term was "clear". The Final Amendments did not address the definition of "governmental entities".

Neither the First Implementation Rule nor the Final Amendments addresses #5 above, though the First Implementation Rule does state that based on the SEC's own internal analysis, up to 273 companies that are currently listed in the U.S. will be impacted by the China De-Listing Law.

Main points of the PCAOB Rule

The PCAOB Rule sets forth the framework for determining the audit firms that it is unable to inspect as required by the Act of 2002 ("**Subject Audit Firms**"). Pursuant to the China De-Listing Law, once the PCAOB determines Subject Audit Firms, the SEC will use the list as a basis to identify Subject Issuers (i.e. Chinese issuers whose auditors are Subject Audit Firms).

[1] In the legislative discussion on December 2, 2020, Brad Sherman read a statement by him and John N. Kennedy (Republican Senator who co-sponsored the China De-Listing Law in the Senate) on the record that the China De-Listing Law does not apply to any issuer where no more than one-third of its "total audit" is outside the scope of inspection by the PCAOB. The term "total audit" is to be defined by the SEC through implementation regulation, and can include total revenue, assets, or other metrics. In other words, the China De-Listing Law will not apply to U.S. multinationals whose China operations are also audited by auditors who cannot be inspected by the PCAOB, as long as the China portion of its "total audit" is not more than one-thirds. This discussion is not legally binding and only serves as a reference point for the SEC in any future implementation of the China De-Listing Law.

Under the PCAOB Rule, a Subject Audit Firm can be an audit firm headquartered in a jurisdiction that does not permit PCAOB access to audit working papers. In other words, China based auditors would be covered by this provision. In addition, a Subject Audit Firm may be an office of an audit firm located in a jurisdiction that does not permit PCAOB access to audit working papers. In other words, the PRC and Hong Kong offices of international audit firms such as the Big Four would be covered by this provision.

The factors considered by the PCAOB when determining the list of Subject Audit Firms are as follows ("**Audit Determination Factors**"):

1. *the PCAOB's ability to select engagements, audit areas, and potential violations to be reviewed or investigated;*
2. *the PCAOB's access to, and the ability to retain and use,* ***any document or information (including through conducting interviews and testimony) in the possession, custody, or control of the firm(s) or any associated persons thereof that the PCAOB considers relevant to an inspection or investigation;***
3. *the PCAOB's ability to conduct inspections and investigations in a manner consistent with the provisions of the China De-Listing Law and the Rules of the PCAOB, as interpreted and applied by the PCAOB.*

The second Audit Determination Factor above re-iterates the long-standing position of the PCAOB that it has broad, sweeping powers to inspect and investigated audit firms, whether they are located in the U.S. or outside of the U.S.

The list of Subject Audit Firms will be determined annually, and may be amended by the PCAOB in its discretion.

In addition to setting forth the particulars of the PCAOB Rule, the discussion by the PCAOB preceding the text of the rule contains important clues about the position taken by the PCAOB in respect to China's proposal for a joint audit mechanism.

First, the PCAOB noted that "at this time, as reflected on the PCAOB's website, the PCAOB can conduct inspections in all but two of those jurisdictions (China and Hong Kong)." Previously, Belgium also denied the PCAOB full access to audit firms located in Belgium, but the two countries resolved their differences in April, 2021 through a joint agreement. This means that practically speaking, the China De-Listing Law is effectively targeted only at China based audit firms who perform audits of Chinese companies listed in the U.S.

Second, China proposed in August 2020 a mechanism by which the CSRC and the PCAOB would conduct joint reviews of China based audit firms. FANG Xinghai, the vice-chairman of the CSRC, recently expressed frustration over the lack of response to this proposal by U.S. authorities, stating.

We had sent over the latest version on Aug. 4 last year about a joint review with the PCAOB, but unfortunately, the atmosphere in the U.S. since the U.S. presidential election has not been favourable for China-U.S. cooperation. And we haven't received a reply from the PCAOB over whether our proposal is suitable or not. We have been sending an email every month since last August, but they just didn't reply

to us.

However, the discussion in the PCAOB Rule suggests that the Chinese proposal may be inadequate in the eyes of U.S. authorities. The discussion acknowledges that "some of the position taken by foreign authorities have been based upon 'gatekeeper' laws, which provide that a registered firm can transfer its audit work papers to the PCAOB only via a local non-U.S. regulator…the PCAOB's ability to conduct inspections or investigations could become impaired in any of these jurisdictions, however, if such an arrangement were terminated." In other words, the PCAOB appears to reject the notion of joint oversight, based on a fear that access may be curtailed or limited at the discretion of a non-U.S. regulator such as the CSRC.

The discussion then notes that non-U.S. regulators can use other substantive laws to impair the PCAOB's ability to access "firm personnel, audit work papers, or other documents or information relevant to an inspection or investigation". One set of laws mentioned was "personal data protection laws".

On December 16, 2021, the PCAOB issued a determination report (the "**2021 PCAOB Determination**") concluding that all firms registered with the PCAOB in the PRC and Hong Kong, including each of the Big Four firms, are Subject Audit Firms. The 2021 PCAOB Determination concluded that each of the Audit Determination Factors were not fulfilled as to both inspections and investigations. The effect of the conclusions in the 2021 PCAOB Determination is that all Chinese issuers using the Subject Audit Firms listed in the 2021 PCAOB Determination (including the PRC and Hong Kong offices of the Big Four) will now be designated by the SEC as Subject Issuers whose U.S. public securities will be subject to delisting pursuant to the China De-Listing Law.

The 2021 PCAOB Determination was accompanied by a detailed analysis of its positions and justifications. The material differences between the two sides are as follows:

The right of prc regulators to withhold or redact information: A common theme throughout the 2021 PCAOB Determination is the PCAOB's disagreement with the right of PRC regulators to review audit papers in advance and have the right to withhold or redact information contained in them. In addition to disagreeing with this right on principle (given that a fundamental tenant of the Audit Determination Factors is the PCAOB's unfettered access to information it deems relevant in its inspection), the 2021 PCAOB Determination cited a pilot inspection exercise in December 2014 that led to the PCAOB not, in its view, receiving the information it needed to perform the inspection due to PRC regulators withholding or redacting information in the relevant audit papers. While the 2021 PCAOB Determination acknowledged proposal tabled by the CSRC from 2019-2021, it noted that "the CSRC proposals continue to permit withholding or redacting information and fail to create a mechanism whereby withheld documents and redacted information can be provided to the PCAOB in recognition of the PCAOB's need to review them to complete its inspection".

The PCAOB's right to determination who to inspect and the scope of inspection: The 2021 PCAOB Determination did not accept purported proposals by PRC regulators to limit inspections of issuers deemed sensitive by PRC regulators. Two industries cited were state-owned enterprises and "large technology-related companies". The 2021 PCAOB Determination also expressed frustration at the PCAOB's inability to complete "a regular program of inspections" of the Subject Audit Firms.

The PCAOB's purported inability to complete audit investigations: The 2021 PCAOB Determination concluded that the PCAOB was unable to conduct audit investigations as it would not receive requested information or interview witnesses, both of which are fundamental tenants of the Audit Determination Factors. Specifically, the PCAOB alleged that PRC regulators did not comply with a 2013 Enforcement MOU signed by the parties to facilitate the exchange of information for investigations. The PCAOB claims that the CSRC has not produced requested documents for investigations pursuant to the 2013 Enforcement MOU since 2013, and has not produced any documents for investigations of Subject Audit Firms in Hong Kong. Furthermore, it has not been granted the authority to take testimony from witnesses due to the absence of an arrangement between them in this regard. The 2021 PCAOB Determination cited a 2017 meeting between the PCAOB and the CSRC and Ministry of Finance in Beijing, which did not result in additional information being provided pursuant to the 2013 Enforcement MOU, or an arrangement on interviewing witnesses.

Recent developments related to the China De-Listing Law

I Accelerating holding foreign companies accountable act

On June 22, 2021, the U.S. Senate passed by unanimous consent a bill[2] that would amend the de-listing deadline for Subject Issuers from three years to two years (the "**Accelerating Holding Foreign Companies Accountable Act**"). On October 26, 2021, the U.S. House Committee on Financial Services' Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets held a hearing discussing the Accelerating Holding Foreign Companies Accountable Act and other potential actions impacting Subject Issuers (the "**House Hearing**").

The fact that the Accelerating Holding Foreign Companies Accountable Act passed the U.S. Senate by unanimous consent and has been given a hearing in the U.S. House, indicates that its chances of passing the U.S. House and being signed by the President in the near term are high. If passed, the earliest date of de-listing for Subject Issuers will be 2023.

II Proposed listing and U.S. investment prohibitions

On May 27, 2021, Senator Marco Rubio (Republican – Florida), a frequent and long-time China critic, introduced a bill *No IPOs for Unaccountable Actors Act* (the "**Proposed Listing Prohibitions Act**"). The Proposed Listing Prohibitions Act would prohibit, commencing one year after the date of enactment, any U.S. listing of a company whose audit working papers may not be inspected by the PCAOB, including a company that proposes to list through a business combination with a special purpose acquisition company (SPAC). The Proposed Listing Prohibitions Act may have been introduced to address the significant increase in the volume of Chinese listings in the U.S. in 2021 notwithstanding the enactment of the China De-Listing Law[3].

[2] The full name of the bill is *S.2184 - A bill to amend the Sarbanes-Oxley Act of 2002 to institute a trading prohibition for certain issuers that retain public accounting firms that have not been subject to inspection by the Public Company Accounting Oversight Board, and for other purposes.*

[3] See Financial Times article of April 26, 2021, citing a 440% annualized increase in funds raised by Chinese companies through U.S. equity offerings, at https://www.ftchinese.com/story/001092291/ce?archive.

The congressional record also reveals that on May 26, 2021, Senator Rubio tried to insert the text of the Proposed Listing Prohibitions Act as an amendment to another bill that is further along in the legislative process, the *Endless Frontier Act*[4],a bill proposed by Senator Schumer and co-sponsored by 13 other Senators, among which 7 are Republicans[5]. This is a common legislative tactic used to bypass the need to vote on a bill separately, instead inserting its terms as an amendment to another bill that has more pressing urgency[6]. Given that the *Endless Frontier Act* is also purportedly aimed at China, there is at least a basis that Senator Rubio can use to convince Senate leadership to include the text of the Proposed Listing Prohibitions Act as an amendment to the *Endless Frontier Act*, thereby potentially accelerating passage of the Proposed Listing Prohibitions Act.

At the House Hearing, Congressman Sherman also raised the prospect of new proposed laws that would (i) require the SEC to investigate whether Chinese companies should continue to avail themselves of the right to list in U.S. public markets as "foreign private issuers" as designed by U.S. securities laws and (ii) prohibit index funds from investing in Subject Issuers with VIE structures. If the SEC concludes that Chinese companies cannot list as foreign private issuers in U.S. public markets, which Mr. Sherman noted was originally designed for companies in jurisdictions such as the United Kingdom with similar sets of investor protections, then Chinese companies will in effect be prevented from listing in the U.S. As a large proportion of Subject Issuers have VIE structures, including virtually all TMT companies that are not health care and life sciences companies, if index funds cannot invest in Subject Issuers with VIE structures, the market impact may be significant. The impacted index funds may have to engage in a costly restructuring of their offerings through a segregation of index funds with U.S. investors and those without U.S. investors.

The Proposed Listing Prohibitions Act was co-sponsored by Senator Bob Casey (Democrat – Pennsylvania) and Congressman Sherman is a liberal Democrat, indicating bipartisan support for further actions that would decouple Chinese companies from U.S. public markets and U.S. investors generally.

III SEC public statement

On July 30, 2021, the SEC Chairman Gary Gensler issued a public statement, which stated that he had instructed SEC staff to seek additional disclosures from prospective Chinese issuers. The specified new disclosures in the public statement on the VIE structure and the China De-Listing Law are already in prospectuses of Chinese issuers in one form or another, but will need to be enhanced to comply with the public statement. What was new in the public statement was the requirement to disclose whether PRC regulatory approval is required for the U.S. IPO, and if so, whether it could be

[4] See the Congressional Record of the Senate of May 26, 2021, pages 5-6, at https://www.congress.gov/117/crec/2021/05/26/167/92/CREC-2021-05-26-pt1-PgS3512.pdf.

[5] The *Endless Frontier Act* has the stated goal of "strengthening of U.S. leadership in critical technologies through basic research in key technology focus areas, such as artificial intelligence, high performance computing, and advanced manufacturing, and the commercialization of those technologies to businesses in the United States". The legislative record of the bill reveals that both Democrats and Republicans agree the bill should be designed to counter competition from China, with Republicans stating the bill does not go far enough in this regard.

[6] In fact, the revised CFIU.S. (*The Foreign Investment Risk Review Modernization Act of 2018*) and export control laws (*Export Control Reform Act of 2018)* were actually amendments to a "must pass" annual defense bill.

denied or rescinded. The intent appears aimed preventing another Didi listing, which was subject to a continuous PRC regulatory investigation on its data practices immediately after its U.S. IPO.

On August 17, 2021, in a video presentation posted on Gary Gensler's Twitter account, Mr. Gensler stated that the SEC will pause processing the listing applications of Chinese issuers with VIE structures until the SEC receives "full and fair disclosure" of the risks enumerated in the public statement. On or after August 13, 2021, the SEC began issuing detailed follow-up requirements to prospective Chinese issuers, which had the effect of enhancing present disclosures (such as PRC regulatory developments having the possibility to "cause the value of such [listed] securities to significantly decline or be worthless"). In addition, prospective Chinese issuers are required to disclose whether PRC regulatory approval is required for the U.S. IPO, and if so, whether it could be denied or rescinded. In particular, there are specific references in the requirements to compliance with the data security requirements of the Cyberspace Administration of China generally and as it relates to the U.S. IPO.

The public statement also reiterated the requirements under the China De-Listing Law and the need for prominent disclosure of potential de-listing risks. In an interview with *Bloomberg*, Mr. Gensler reiterated the need for the PCAOB to inspect the audit work papers of Subject Issuers, stating "the path is clear, the clock is ticking… I have not been informed about anything yet that is a clear path forward[7]".

On September 20, 2021, the SEC released an Investor Bulletin that reiterated the public statement's principles, including the risks associated with investing in VIE structures that may be banned in the future by the PRC government[8].

IV SEC sample letter to China-Based Companies

On December 20, 2021, the SEC's Division of Corporation Finance released the *Sample Letter to China-Based Companies* (the "**Sample Letter**") on its website, which sets forth the SEC's expectations for enhanced disclosures to be made by Subject Issuers, in particular those with VIE structures and PRC companies that propose to list by way of merger with a special purpose acquisition vehicle. In addition to requiring additional disclosure of the Accelerating Holding Foreign Companies Accountable Act and the implementation of the China De-Listing Law and amendments to prospectuses that separate VIEs from the rest of the group structure, the Sample Letter reveals the SEC's general understanding of PRC regulatory developments that may impact U.S. IPOs of PRC issuers, as follows:

Statements by PRC Regulators Covered In Addition to PRC Laws and Regulations: The Sample Letter requires PRC issuers to "address how recent statements and regulatory actions by China's government, such as those related to the use of variable interest entities and data security or anti-monopoly concerns, have or may impact the company's ability to conduct its business, accept foreign investments, or list on a U.S. or other foreign exchange… given recent statements by the Chinese government indicating an intent to exert more oversight and control over offerings that are conducted

[7] Bloomberg, *SEC Chief Warns 'Clock Is Ticking' on Delisting Chinese Stocks*, August 25, 2021, available at: https://www.bloomberg.com/news/articles/2021-08-25/sec-chief-warns-clock-is-ticking-on-delisting-chinese-stocks.

[8] Investor Bulletin: U.S.-Listed Companies Operating Chinese Businesses Through a VIE Structure, available at: https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-95.

overseas and/or foreign investment in China-based issuers, acknowledge the risk that any such action could significantly limit or completely hinder your ability to offer or continue to offer securities to investors and cause the value of such securities to significantly decline or be worthless." These requirements reveal the SEC's belief that market sentiment and pronouncements of intent are material for any proposed U.S. listing of PRC issuers.

Specific References to CAC and the CSRC: The Sample Letter requires additional disclosure on potential approvals required for U.S. listings and the consequences if they are not obtained or if the issuer misjudges whether an approval applies to them. Namely, the Sample Letter requires as follows, "State whether you, your subsidiaries, or VIEs are covered by permissions requirements from the China Securities Regulatory Commission (CSRC), Cyberspace Administration of China (CAC) or any other governmental agency that is required to approve the VIE's operations, and state affirmatively whether you have received all requisite permissions or approvals and whether any permissions or approvals have been denied. Please also describe the consequences to you and your investors if you, your subsidiaries, or the VIEs: (i) do not receive or maintain such permissions or approvals, (ii) inadvertently conclude that such permissions or approvals are not required, or (iii) applicable laws, regulations, or interpretations change and you are required to obtain such permissions or approvals in the future…In light of recent events indicating greater oversight by the Cyberspace Administration of China (CAC) over data security, particularly for companies seeking to list on a foreign exchange, please revise your disclosure to explain how this oversight impacts your business and your offering and to what extent you believe that you are compliant with the regulations or policies that have been issued by the CAC to date." These requirements reveal that the SEC is well aware of PRC regulatory developments that may substantially impact PRC issuers during the period from their proposal to the issuance of final rules. The requirements can be interpreted as written in a way so as to strongly discourage a U.S. IPO in the absence of PRC regulatory approval, as specific disclosure would render the listing meaningless due to heightened regulatory risk.

Important Announcement

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