

[Securities Regulation Daily Wrap Up, TOP STORY—Senate passes bill to authorize SEC ban on trading of foreign companies over auditor access, \(May 21, 2020\)](#)

Securities Regulation Daily Wrap Up

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The bill would address long-running concerns by the SEC and PCAOB over foreign companies for which U.S. regulators cannot access audit papers because of positions taken by overseas authorities.

The Senate passed by unanimous consent a bill that would allow the SEC to temporarily ban trading in the securities of foreign companies whose auditors are not inspected by the PCAOB. The SEC and the PCAOB have for many years expressed concerns about the quality of audits and the lack of access by U.S. regulators to audit papers in jurisdictions whose authorities make such access difficult or impossible. The Holding Foreign Companies Accountable Act ([S. 945](#), See p. S2520), sponsored by Sen. John Kennedy (R-La) and Sen. Chris Van Hollen (D-Md), is phrased mostly in neutral language that does not identify any particular foreign jurisdiction, although a disclosure requirement for foreign companies filing Forms 10-K and 20-F specifically calls for information about the Chinese Communist Party.

A [press release](#) announcing that the Senate had passed the bill was more explicit about which country the bill targets. "The SEC works hard to protect American investors from being swindled by American companies. 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," said Sen. Kennedy.

Senator Van Hollen likewise emphasized the need for a level global playing field and for greater transparency: "As we continue to experience the economic fallout and volatility caused by the COVID-19 pandemic, the need to protect main street investors is all the more important. For too long, Chinese companies have disregarded U.S. reporting standards, misleading our investors."

Trading bans mandated. The bill would require the Commission to identify covered issuers (i.e., Exchange Act reporting companies) that have retained registered public accounting firms with a branch or office in a foreign jurisdiction that the PCAOB is unable to inspect or otherwise completely investigate because of a position taken by an authority in the foreign jurisdiction. In such instances, the Commission would have to require each covered issuer to provide documentation establishing that it is neither owned nor controlled by a governmental entity in the foreign jurisdiction.

The bill also mandates that the Commission ban trading in the securities of a covered issuer that has experienced three consecutive non-inspection years. "Non-inspection year" means a year, following the date of enactment of the bill, in which a covered issuer has been identified by the Commission as violating the bill's requirements regarding every report filed by the covered issuer during that year.

A covered issuer can overcome a trading ban if it certifies to the Commission that it has retained a registered public accounting firm that has been inspected by the PCAOB to the Commission's satisfaction. The Commission, however, must reinstate a trading ban if the covered issuer has a subsequent non-inspection year. A covered issuer subject to a subsequent trading ban can overcome the subsequent trading ban if, after a five-year period, it certifies to the Commission that it will retain a registered public accounting firm that the PCAOB is able to inspect.

It should be noted that there is a significant difference in the language used to describe what a covered issuer must certify to the Commission to overcome an initial trading ban versus a subsequent trading ban. An initial

trading ban must be lifted if the covered issuer certifies that it "has" retained a registered public accounting firm that the PCAOB "has" inspected to the Commission's satisfaction. The language applicable to lifting a subsequent trading ban could be construed to be more lenient because it requires the covered entity to certify that it "will" retain a registered public accountant that the PCAOB "is able to" inspect. The language regarding the removal of a subsequent trading ban also does not state that a PCAOB inspection must be "to the satisfaction of the Commission," as is required to lift an initial trading ban.

The Commission must adopt implementing rules within 90 days of enactment. The rulemaking provision, however, specifies only that the Commission adopt rules for the submission to be made by a covered issuer establishing that the covered issuer is not owned or controlled by a governmental entity in the foreign jurisdiction.

Annual report disclosures. The bill further would require a covered issuer that is a foreign issuer for which a registered public accounting firm that cannot be inspected by the PCAOB prepared an audit report during a non-inspection year disclose the following in its Form 10-K or Form 20-F filed that year:

- That a registered public accounting firm not inspected by the PCAOB prepared the issuer's audit report;
- The percent of the issuer's shares owned by governmental entities in the foreign jurisdiction where the issuer is incorporated or 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 names of Chinese Communist Party officials who are members of the board of directors of the issuer or its operating entity; and
- Whether the issuer's articles of incorporation contain any charter (or charter text) of the Chinese Communist Party.

Form 10-K is the familiar annual report filed by most public companies. By contrast, Form 20-F can be used by a foreign private issuer that is not an asset-backed issuer for multiple purposes, including as an annual or transition report under Exchange Act Sections 13(a) or 15(d) or as a registration statement under Exchange Act Section 12.

With respect to Form 20-F, the Kennedy-Van Hollen bill uses the term "foreign issuer" while Form 20-F uses the term "foreign private issuer." A "foreign issuer" 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" (See, Exchange Act Rule 3b-4(b)). A "foreign private issuer" is a foreign issuer that is not a foreign government and provides an exception for any issuer for which (1) more than 50 percent of its outstanding voting securities are held by U.S. residents; and (2) any of the following apply: U.S. citizens or residents constitute a majority of the issuer's executive officers or directors; more than 50 percent of the issuer's assets are located in the U.S.; or the issuer's business is administered principally in the U.S. (See, Exchange Act Rule 3b-4(c)).

SEC's April 2020 statement. A [joint statement](#) issued in April 2020 by SEC Chairman Jay Clayton, SEC Chief Accountant Sagar Teotia, PCAOB Chairman William D. Duhnke III, and the directors of the SEC's Division of Corporation Finance and Division of Investment Management, reiterated U.S. regulators' frustrations with certain countries, including China, regarding the lack of access to audit work papers. The joint statement suggested the following guidance regarding China: "Investors and financial professionals should consider the potential risks related to the PCAOB's lack of access to inspect PCAOB-registered accounting firms in China. Issuers should clearly disclose the resulting material risks. Auditors should have appropriate quality controls in place related to executing quality audits."

Another set of bipartisan bills known as the Ensuring Quality Information and Transparency for Abroad-Based Listings on our Exchanges (EQUITABLE) Act were introduced in June 2019. Although these bills cover much of the same ground as the SEC's April 2020 joint statement and the Holding Foreign Companies Accountable Act, both bills were referred to committees and have seen no further action. A [previous report](#) on the EQUITABLE Act bills detailed the long-running concerns of the SEC and the PCAOB about foreign countries that limit the ability of U.S. regulators to inspect audit papers.

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