Securities Regulation Daily Wrap Up, ACCOUNTING AND AUDITING—House passes foreign company delisting bill, setting stage for possible presidential signature, (Dec. 3, 2020)

Securities Regulation Daily Wrap Up

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Senator Kennedy (R-La) and Rep. Sherman (D-Cal) issued a joint statement upon House passage calling on the SEC to interpret the bill to delist a company only if more than one-third of the company's audit is done by a firm beyond the reach of PCAOB inspections.

The House passed the Holding Foreign Companies Accountable Act (S. 945), sponsored by Sen. John Kennedy (R-La) and Sen. Chris Van Hollen (D-Md), by voice vote. The bill provides for the delisting from U.S. exchanges of foreign companies whose auditors are located in jurisdictions that do not permit PCAOB inspections. The bill is phrased mostly in neutral language that does not identify a 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. The Senate had passed the bill in May 2020 by unanimous consent. The Senate version of the bill now goes to the president's desk for possible signature.

Congress, however, may not be finished with its work related to companies' accounting practices. Shortly after the Holding Foreign Companies Accountable Act passed the House, Rep. Brad Sherman (D-Cal) announced that he plans to introduce legislation mandating additional disclosures about public companies' internal control over financial reporting.

Bill seeks foreign regulator cooperation. Representative Sherman, Chairman of the House Financial Services Committee's Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, along with Congressman Anthony Gonzalez (R-Ohio), had sponsored the House version of the Holding Foreign Companies Accountable Act (H.R. 7000). Both Reps. Sherman and Gonzalez spoke in favor of passage of the Senate version.

Representative Sherman said on the House floor that the bill would address 224 publicly traded companies that account for $1.8 trillion in market capitalization. "This bill is not anti-China, and it is not designed to prohibit the trading of Chinese companies. Rather, it provides a 3-year window, during which we expect China will enter into a reasonable agreement with the SEC and the PCAOB so that we have the additional level of protection for investors that we expect and have demanded since we passed the Sarbanes-Oxley bill in 2002." Representative Sherman also issued a press release noting passage of the bill by the House.

According to Rep. Gonzalez, the PCAOB is currently working on cooperation agreements with Belgium and France, but China and Hong Kong have yet to enter into similar agreements.

Senator Kennedy also issued a press release emphasizing in somewhat stronger language how the bill seeks to level the playing field between U.S. companies and companies operating in foreign jurisdictions. "Communist China is right now using U.S. stock exchanges to exploit American workers and families—people who put their retirement and college savings in public companies. U.S. policy is letting China flout rules that American companies play by, and it's dangerous," said Sen. Kennedy. "Today, the House joined the Senate in rejecting a toxic status quo."

Legislative guidance for SEC. The Commission must adopt rules to implement the bill within 90 days of enactment. The rulemaking provision, however, specifies only that the Commission adopt rules for the "manner and form" of 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.

A statement submitted to the House by Rep. Sherman, however, expressed the view of Sen. Kennedy that the SEC should have discretion in implementing the bill's trading ban provisions (See, Congressional Record, December 2, 2020 at H6033-H6034). Specifically, the Kennedy statement addressed how much of the audit must be done within the PCAOB's jurisdiction. "[I]t is our expectation that the Commission will not prohibit trading in the securities of companies under this act, as long as not more than one third of a company's total audit is performed by a firm beyond the reach of PCAOB inspections," said the statement.

The statement also said the SEC should have discretion to choose the metric by which the one-third of the audit work is measured. For example, the statement suggested that the SEC could use total revenues, assets, or another metric.

Moreover, the statement counseled that the bill's drafters intended for the bill to apply to public companies relying on foreign audit firms that have an ownership and/or an affiliate relationship with a PCAOB-registered public accounting firm.

Representative Sherman co-signed the Kennedy statement, but he also added his own remarks regarding the breadth of the bill's trading ban provisions. Said Rep. Sherman: "[T]he trading prohibitions required under this bill are intended to be applied when a significant portion of the audit is prepared by an audit firm or the branch, or office, or affiliate of an audit firm which the PCAOB is unable to inspect, and the SEC has the authority to interpret this provision."

How the bill works. 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 investigate completely 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. The trading ban would apply to trading of a covered issuer's securities on national securities exchanges and in over-the-counter markets. "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 having violated the bill's requirements regarding every report filed by the covered issuer under Exchange Act Sections 13 or 15(d) during that year.

A covered issuer can overcome an initial 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 following the lifting of an initial trading ban or the lifting of a subsequent trading ban. A covered issuer subject to a subsequent trading ban, however, 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 firm that the PCAOB "is able to" inspect. The difference in language is the use of the present perfect tense ("has retained") for an initial trading ban and the use of future tense ("will retain" and "is able to inspect") for a subsequent trading ban. Moreover, the language regarding the removal of a subsequent trading ban does not state that a certification must be "to the satisfaction of the Commission," as is required to lift an initial trading ban.

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 (or other equivalent forms or other forms filed by a foreign issuer) 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 foreign jurisdiction with respect to the registered public accounting firm have a controlling financial interest regarding 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 or other organizing document contain any charter (or charter text) of the Chinese Communist Party.

Form 10-K is the familiar annual report field 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 bill uses the term "foreign issuer" while Form 20-F's eligibility provision (See, General Instructions A.(a)) 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 but the definition 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)).

Existing SEC guidance on audit quality. 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 the 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 regrading 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."

Clayton, Teotia, and Duhnke (but without the directors of the CorpFin and Investment Management divisions) issued another statement on November 24, 2020 reiterating many of the same concerns about PCAOB-registered audit firms in China and Hong Kong. On the previous day, the CorpFin staff had issued CF Disclosure Guidance: Topic No. 10 (November 23, 2020) setting forth numerous risks that can arise from the inability of the PCAOB to conduct inspections in certain jurisdiction, including China and Hong Kong. Specifically, the guidance noted risks regarding: (1) financial reporting; (2) access to information and regulatory oversight; (3) company organizational structure (e.g., variable interest entity structures); and (4) regulatory environment. The guidance further observed that, among other things, there may be differences regarding shareholder rights, shareholder recourse, corporate law and governance, and reporting requirements. The guidance concluded with an extensive list of questions for issuers to mull when contemplating disclosures about the material risks related to their business operations in China.

New internal controls bill. A bill recently introduced and co-sponsored by Rep. Sherman and Rep. Eric Swalwell (D-Cal) would require a covered issuer that files reports under Exchange Act Section 13(a) to disclose whether it had completed a general ledger accounts reconciliation for the most recent fiscal quarter and year.

"Covered issuer" would mean an issuer that is subject to a civil or criminal penalty because, as part of their internal control over financial reporting, the issuer failed to reconcile its general ledger accounts.

Representative Sherman said the Internal Control Disclosure Improvement Act of 2020 seeks to fill a gap in financial reporting regulations for companies that fail to adopt adequate internal controls over financial reporting. "Our country's capital markets have long been, and remain, the envy of the world. I believe that key to maintaining this position is ensuring that investors have not only visibility into the financial health of the companies they buy, but also confidence that the disclosures they receive are accurate and reliable," said Rep. Sherman.

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