

CAPITAL MARKETS & SECURITIES LAW WATCH

Updates on Audit Oversight Cooperation Between U.S. PCAOB and Chinese Authorities

THE STATEMENT OF PROTOCOL AGREEMENT (“SOP”)

On August 26, 2022, the U.S. Public Company Accounting Oversight Board (the **PCAOB**) announced a Statement of Protocol (the **SOP**) with the China Securities Regulatory Commission (the **CSRC**) and Ministry of Finance of China (**MOF**) in respect of cooperation on the oversight of PCAOB-registered public accounting firms based in mainland China and Hong Kong. This represents a first and meaningful move to address the decade-long audit oversight conflict between the PCAOB and regulators in the People’s Republic of China (the **PRC**). Gary Gensler, the Chair of U.S. Securities and Exchange Commission (the **SEC**), said, “This agreement marks the first time we have received such detailed and specific commitments from China that they would allow PCAOB inspections and investigations meeting U.S. standards.”¹ In response to reporters’ questions, a CSRC official stated that “[t]he China-U.S. audit oversight cooperation agreement is an important first step by both sides to resolve issues concerning audit oversight cooperation.”²

The PCAOB was created by the Sarbanes–Oxley Act of 2002 (the **SOA**) to oversee the audits of public companies listed on U.S. securities

exchanges to protect the interests of investors. Its responsibilities include the registration, inspection, and investigation of PCAOB-registered accounting firms, including firms located in foreign jurisdictions that provide independent audit reports for foreign companies listed on U.S. securities exchanges.

THE COMMITMENTS UNDER THE SOP

The SOP seeks to establish a framework for the PCAOB to conduct inspections and investigations of PCAOB-registered public accounting firms based in mainland China and Hong Kong, as contemplated by the SOA. The SOP includes commitments from PRC authorities on the following issues that would grant the PCAOB complete access for the first time:

1. The PCAOB has sole discretion to select the firms, audit engagements, and potential violations it inspects and investigates — without consultation with, or input from, PRC authorities.
2. PCAOB inspectors and investigators can view complete audit working papers with all information included, without redaction, and

¹ Statement on Agreement Governing Inspections and Investigations of Audit Firms Based in China and Hong Kong, <https://www.sec.gov/news/statement/gensler-audit-firms-china-hong-kong-20220826>.

² CSRC Officials Answered Reporter Questions Regarding China-U.S. Audit Oversight Cooperation Agreement, http://www.csrc.gov.cn/csrc_en/c102030/c5572273/content.shtml.

with certain “restricted data” only viewable *in camera*, and the PCAOB can retain information it reviews, including restricted data, as needed to support its inspections and investigations.

3. The PCAOB has direct access to interview and take testimony from all personnel associated with the audits that the PCAOB inspects or investigates.
4. The PCAOB can transfer information, including restricted data, to the SEC, and the SEC can use the information for all purposes, including administrative or civil enforcement actions.

On August 26, 2022, the PCAOB and the SEC issued the following fact sheets on the SOP: *Fact Sheet: China Agreement*,³ issued by the PCAOB, and *Fact Sheet: PCAOB Agreement with China on Audit Inspections and Investigations*⁴ and *Fact Sheet: Statement of Protocol – Questions and Answers*,⁵ both issued by the SEC.

BACKGROUND

HISTORICAL OBSTACLES

- Under the SOA, all SEC-registered public companies must have their financial statements audited by public-company accounting firms registered with the PCAOB, and the PCAOB is required to inspect these registered accounting firms to ensure that their audits of U.S.-listed

public companies are in accordance with U.S. auditing standards. However, over the years, the PCAOB’s access to inspect and investigate registered accounting firms based in mainland China and Hong Kong has been obstructed by Chinese laws that generally prohibit foreign securities regulators from engaging in any inspection activities in China or any person from providing any documents relating to capital-markets activities to foreign parties without the approval of the Chinese authorities. In particular, the *Rules on Strengthening the Confidentiality and Archives Administration of Overseas Securities Offering and Listing by Domestic Enterprises* (the **2009 Rules**),⁶ issued by the CSRC on October 20, 2009, provide that where overseas securities regulatory authorities propose to conduct on-site inspection in mainland China on overseas-listed companies or securities service companies providing listing services for such overseas-listed companies, prior report to the CSRC and approvals from the relevant Chinese authorities must be obtained. In addition, under the 2009 Rules, on-site inspection must be led by the Chinese regulatory authorities or must rely on the inspection results of Chinese regulatory authorities.

AN MOU IN 2013

- In 2013, the PCAOB entered into a memorandum of understanding (**MOU**) with the CSRC and MOF that was intended to establish a cooperative framework among the parties for

3 Fact Sheet: China Agreement (Aug. 26, 2022), <https://pcaobus.org/news-events/news-releases/news-release-detail/fact-sheet-china-agreement>.

4 Fact Sheet: PCAOB Agreement With China on Audit Inspections and Investigations (Aug. 26, 2022), <https://www.sec.gov/files/china-sop-fact-sheet.pdf>.

5 Fact Sheet: Statement of Protocol – Questions and Answers (Aug. 26, 2022), https://www.sec.gov/files/china-sop-qa_0.pdf.

6 Its official Chinese name is “關於加強在境外發行證券與上市相關保密和檔案管理工作的規定”, which was revised on April 2, 2022 for public comments.

future cooperation. The MOU primarily focused on the provision and exchange of information for the purpose of cross-border enforcement cooperation but did not resolve the regulatory audit oversight issue. After signing the MOU, the PCAOB has repeatedly stated that it has not received sufficient cooperation to conduct complete on-site inspections and investigations of audit firms based in mainland China and Hong Kong.

PILOT INSPECTION IN 2016

- In 2016, the PCAOB, the CSRC, and the MOF entered into an agreement with respect to a pilot inspection of one mainland China-based accounting firm as a confidence-building exercise among the parties. However, the PCAOB ultimately could not complete its pilot inspection because the PRC authorities withheld and redacted certain work papers that the PCAOB's inspection team needed to conclude its inspection, citing concerns that the documents contained sensitive information or state secrets.⁷

ENACTMENT OF HFCAA IN 2020

- The Holding Foreign Companies Accountable Act (the **HFCAA**) was signed into law on December 18, 2020. The HFCAA specifically requires the SEC to identify and prohibit the trading of securities of non-U.S. companies listed on U.S. securities exchanges or the over-the-counter (the **OTC**) market if the PCAOB has determined that it has been unable to inspect those companies' accounting firms located in a

foreign jurisdiction for three consecutive years beginning in 2021 because of a position taken by an authority in the relevant company's jurisdiction.

THE PCAOB'S HFCAA DETERMINATION IN 2021

- In the PCAOB's HFCAA Determination Report dated December 16, 2021,⁸ the PCAOB concluded that the position taken by PRC authorities impairs its ability to execute its statutory mandate with respect to inspections and investigations of PCAOB-registered audit firms based in mainland China and Hong Kong. As a result, 2021 would be the first year under the HFCAA for which Chinese companies would report the PCAOB's inability to inspect the company's auditors, and those Chinese companies face the risk of being delisted from U.S. securities exchanges and prohibited from trading their securities in the OTC market as early as 2024 if the PCAOB continues to make the same determination in 2022 and 2023.

THE COMMISSION-IDENTIFIED ISSUERS IN 2022

- In March 2022, the SEC began to identify a number of Chinese companies listed on U.S. securities exchanges as "commission-identified issuers,"⁹ based on disclosures in their annual reports on Form 10K or Form 20-F for fiscal years ended after December 8, 2021. To date, 165 Chinese companies are on the "conclusive" list of commission-identified issuers, and four are on the "provisional" list of commission-identified

7 HFCAA Determination Report dated December 16, 2021, <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/international/documents/104-hfcaa-2021-001.pdf>.

8 *Ibid.*

9 "Commission-identified issuer" is defined as an issuer that has retained a registered public accounting firm to issue an audit report where that firm has a branch or office located in a foreign jurisdiction and the PCAOB has determined that it is unable to inspect or investigate completely because of a position taken by an authority in the foreign jurisdiction. Please see *Holding Foreign Companies Accountable Act Disclosure*, Release No. 34-93701, <https://www.sec.gov/rules/final/2021/34-93701.pdf>.

issuers under the HFCAA.¹⁰ Under the HFCAA, the SEC will continue to review Forms 10K and 20-F and update the list of commission-identified issuers on a rolling basis for subsequent fiscal years.

Provisionally commission-identified companies have 15 business days to contact the SEC to dispute such identification with supporting documents, after which the identification becomes conclusive. Note that the SEC does not notify companies that are designated as provisionally commission-identified companies, and it is up to the affected companies to monitor the SEC website for notice of such designation. Once a company is conclusively identified as a commission-identified issuer by the SEC for three consecutive years, the SEC will issue an order prohibiting the trading of its securities on U.S. securities exchanges or the OTC market. Therefore, for a company that is conclusively identified as a commission-identified issuer for the first time with respect to fiscal year 2021 based on its annual report on Form 10K or 20-F filed in 2022 and continues to be a commission-identified issuer with respect to fiscal years 2022 and 2023, the trading prohibition would be imposed as early as 2024 after its Form 10K or 20-F filing for fiscal year 2023 is made.

POTENTIAL OUTCOME

Pursuant to the SOP, by the end of 2022, the PCAOB is required to reassess its 2021 determination with respect to the position taken by PRC authorities impairing its ability to execute its statutory mandates with respect to inspections and investigations of PCAOB-registered audit firms based in mainland China and Hong Kong.

The PCAOB's teams of audit inspectors reportedly started their on-site inspections and investigations under the SOP on September 19, 2022, at the offices of accounting firms PwC and KPMG in Hong Kong, reviewing hundreds of audit working papers¹¹ for the purpose of reassessing and determining by the end of 2022 whether the PCAOB has the requisite ability to execute its statutory mandate with respect to inspections and investigations of PCAOB-registered audit firms based in mainland China and Hong Kong.

While the SOP is widely regarded as a milestone in the process of mutual cooperation between the U.S. and China on reaching a framework for listed companies based in China and Hong Kong to remain listed on U.S. securities exchanges or traded on the OTC markets under the HFCAA regime, the fate of such Chinese companies is still subject to uncertainties in the implementation of the agreed-upon protocols. As SEC Chair Gensler stated, "While important, this framework is merely a step in the process. This agreement will be meaningful only if the PCAOB actually can inspect and investigate completely audit firms in China. If it cannot, roughly 200 China-based issuers will face prohibitions on trading of their securities in the U.S. if they continue to use those audit firms."

POTENTIALLY DIFFERING INTERPRETATIONS OF THE SOP

- The execution of the SOP is just the first step, and the resolution of the audit oversight issue depends on how the SOP will be implemented in practice. At this stage, Chinese and U.S. parties may have a different understanding of certain terms of the SOP. For example, the PCAOB's Fact Sheet states that the PCAOB has "sole discretion to select the firms, audit engagements ... [and] has direct access to interview and take

¹⁰ Lists of provisional and conclusive issuers identified under the HFCAA are posted on the SEC website: <https://www.sec.gov/hfcaa>.

¹¹ <https://www.scmp.com/business/article/3193829/what-are-us-audit-regulators-inspectors-doing-hong-kong>.

testimony from all personnel associated with the audits.” However, the CSRC’s public comments on the SOP emphasized that “[t]he materials such as audit work papers that the U.S. regulator need[s] access to be obtained by and transferred through the Chinese side. The Chinese side will also take part in and assist in the interviews and testimonies of relevant personnel of audit firms requested by the U.S. side.”

In addition, the CSRC’s public comments note that “it is the audit firms, not the listed companies being inspected, that are subject to audit oversight.” However, the SEC’s Fact Sheet notes that “[t]he PCAOB can transfer information, including Restricted Data, to the SEC, and the SEC can use the information for all SEC purposes, including administrative or civil enforcement actions” (emphasis added). In theory, this could include enforcement actions against the U.S.-listed companies audited by the auditor being inspected.

These differing interpretations of the key terms of the SOP may become barriers to its smooth implementation in practice.

PRESSURE FROM THE U.S. CONGRESS

- Since June 2021, both the U.S. Senate and the House of Representatives have introduced bills to accelerate the timeline for potential termination of trading under the HFCAA from three years to two years. The Accelerating Holding Foreign Companies Accountable Act (Senate bill S. 2184¹² and House bill H.R. 6285¹³) (the **AHFCAA**) was

approved by the Senate in June 2021 and submitted to the House Committee on Financial Services on December 14, 2021, where it is still pending approval. The America COMPETES Act of 2022 (House bill H.R. 4521¹⁴), which incorporates the acceleration provisions of the AHFCAA, was approved by the House of Representatives and Senate, but has not yet been enacted into law. If either the AHFCAA or the America COMPETES Act is eventually passed and signed into law in its current state, the trading restrictions under the HFCAA for Chinese companies could occur as early as 2023.

At the same time, some U.S. senators have urged the SEC and the PCAOB to continue to enforce the HFCAA strictly. For example, Senator John Kennedy of Louisiana released the following statement on the date the SOP was executed: “The Accelerating Holding Foreign Companies Accountable Act would allow the SEC to kick lying companies off our exchanges even faster. Here’s our message to China: We’ve got the regulatory hammer, and we will use it without flinching.”¹⁵

CHINA’S STRENGTHENED LEGAL REGIME ON DATA SECURITY

- Meanwhile, since 2019, China has amended various domestic laws in the areas of securities, data security, personal-information protection, overseas offerings of securities and listing, and related confidentiality and archive-administration issues.

12 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: <https://www.congress.gov/bill/117th-congress/senate-bill/2184/text>.

13 H.R. 6285 – Accelerating Holding Foreign Companies Accountable Act: <https://www.congress.gov/bill/117th-congress/house-bill/6285?s=1&r=41>.

14 H.R. 4521 – United States Innovation and Competition Act of 2021: <https://www.congress.gov/bill/117th-congress/house-bill/4521/text/eh>.

15 Kennedy statement on U.S.–China agreement on auditing Chinese firms: <https://www.kennedy.senate.gov/public/press-releases?ID=21A1F7B1-9C1A-47B7-87B1-8CE2074E6E7F>.

Specifically, on December 28, 2019, China amended the PRC Securities Law (中华人民共和国证券法), which, on the one hand, stipulates that the CSRC may establish supervision and administration cooperative mechanisms with the securities regulatory authorities of other countries to implement cross-border supervision and administration but, on the other hand, reasserted that overseas securities regulatory authorities may not directly conduct investigation and evidence collection in China and no one may provide documents related to securities business activities to other countries without the consent of the CSRC.

The *Data Security Law* that came into effect in September 2021 contains an express prohibition on providing any important data generated in the territory of mainland China to the overseas entities.

In addition, the *Administrative Measures for Filing of Overseas Securities Offering and Listing by Domestic Companies (Draft for Comments)*,¹⁶ issued by the CSRC on December 24, 2021, still requires domestic Chinese companies and securities service providers (including accounting firms) to report to Chinese authorities before providing documents to overseas securities regulators. A provision related to the cross-border regulatory-cooperation mechanism was added, under which the investigation, inspection, and evidence collection by overseas securities regulators will be conducted through such a mechanism. The *Provisions on Strengthening the Confidentiality and Archives Administration of Overseas Securities Offering and Listing by Domestic Enterprises (Draft for Comments)* (the

2022 Draft Rules),¹⁷ issued by the CSRC on the same date, contains a similar clause.

The phrase “where the audit work papers involve any state secrets, state security or vital interests, such audit work papers shall not be stored, processed or transferred in nonconfidential computer information systems,” previously contained in the 2019 Rules, was deleted in the 2022 Draft Rules. This might reflect the attitude of the Chinese regulatory authorities on what types of information should be included in the audit work papers in the future, which was echoed in the CSRC’s public comments on the SOP, where the CSRC official said that “the main function of audit work papers is to document whether or not an auditor has fulfilled its due diligence in verifying the accuracy of the financial records of a company Therefore, audit work papers generally do not contain state secrets, individual privacy, companies’ vast user data or other sensitive information.”¹⁸

Based on the language quoted above related to cross-border data security, there is a growing concern from PRC authorities on the protection of important data related to the PRC’s strategic economic development. In practice, for large Chinese state-owned enterprises in strategic sectors that are listed on U.S. securities exchanges, it is hard to say whether any information or data contained in their audit work papers will indirectly disclose national strategic plans.

16 The Chinese name is “境内企业境外发行证券和上市备案管理办法(征求意见稿).”

17 The Chinese name is “關於加強境內企業境外發行證券和上市相關保密和檔案管理工作的規定(征求意见稿).” As of the date of the newsletter, the 2022 Draft Rules have not been formally adopted and the final version is subject to change.

18 CSRC Officials Answered Reporter Questions regarding China-U.S. Statement of Protocol Agreement, http://www.csrc.gov.cn/csrc_en/c102030/c5572273/content.shtml.

VOLUNTARY DELISTING AND ALTERNATIVE LISTING OPTIONS

- Facing the escalating tensions between the U.S. and China and the potential delisting and OTC-trading-ban risk imposed by the HFCAA, a number of Chinese companies listed on U.S. securities exchanges have planned to transfer their primary listings from U.S. securities exchanges to other exchanges or have sought dual-primary or secondary listing in other markets, including the Hong Kong Stock Exchange (the **HKSE**) due to its natural connection with mainland China. Based on public records, after the enactment of the HFCAA, more than 10 Chinese companies have completed a dual-primary or a secondary listing on the HKSE. Just two weeks before the announcement of the SOP, five of China's largest state-owned companies,¹⁹ whose audits are under the review authority of

U.S. securities regulators, have declared that they will voluntarily delist from the New York Stock Exchange. This is likely a signal by the Chinese government that national security risks related to data sharing will override the economic benefits of listing on the more liquid U.S. exchanges.

The SOP represents a significant step in resolving the long-standing audit oversight issues between the U.S. and China. However, uncertainties remain in the interpretation of the details of the SOP and its implementation, which will be affected by political and economic considerations between the two countries. Chinese companies listed on U.S. securities exchanges should closely monitor subsequent developments and, at the same time, may want to explore listing alternatives in other international markets.

19 China Petroleum & Chemical Corporation (known as "SinoPec") (600028.SS), China Life Insurance (601628.SS), Aluminum Corporation of China (known as "Chalco") (601600.SS), PetroChina (601857.SS) and Sinopec Shanghai Petrochemical Co (600688.SS).

Contributors



SEY-HYO LEE
PARTNER
New York
+1 (212) 294-6655
shlee@winston.com



IVY LIU
LEGAL MANAGER
Hong Kong
+852 2292 2207
iliu@winston.com



SIMON LUK
PARTNER
Hong Kong \ Shanghai
+852 2292 2222
sluk@winston.com

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