



New Law to Deny Chinese Firms Access to U.S. Capital Markets

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On December 18, 2020, President Trump signed into law the “Holding Foreign Companies Accountable Act” (the Act), requiring foreign companies and their auditing firms to submit to U.S. regulator inspections of their audits—or face trading prohibitions on U.S. stock exchanges and over-the-counter markets for failure to have an inspection for three consecutive years. As discussed in previous Capital Markets Watch [posts](#), China has not permitted the U.S. Public Company Accounting Oversight Board (the PCAOB) routine access to auditors of Chinese companies for review of the quality of the issuers’ financial accounting. The U.S. federal government, as well as the Nasdaq stock exchange, has taken action recently to impose stricter compliance requirements on noncompliant foreign issuers, particularly China-based companies. On December 2, 2020, the U.S. House of Representatives [unanimously approved](#), without amendment, the legislation passed by the U.S. Senate in [May 2020](#).

The new law requires foreign companies and their auditors to grant access to PCAOB inspections or else be prohibited from trading on U.S. stock exchanges or over-the-counter markets for failure to comply for three consecutive years. The new law also has requirements to disclose information about the company’s ties to foreign governments and the Chinese Communist Party. While, by its terms, the new law applies to noncompliant companies from any foreign jurisdiction, it is clearly targeting China-based companies, because it is a violation of current Chinese law for Chinese companies to provide the PCAOB with access to the Chinese auditors.

While it is unclear whether Chinese firms would move their listings to non-U.S. exchanges, such as Hong Kong or Shanghai, or take themselves private in response to the new law, any movement toward delisting could cause significant shifts in the U.S. capital markets, which have been a popular source of capital for Chinese companies in recent years. Several Chinese companies, such as Alibaba, have already listed their shares in other non-U.S. markets as a hedge against a possible delisting from the U.S. markets.

Prior to the enactment of the Act, the staff of the Securities and Exchange Commission (the SEC) had been preparing new proposed rules regarding enhanced listing standards for U.S. securities exchanges and enhanced auditor qualifications, to implement recommendations of the President’s Working Group on Financial Markets (PWG). However, following the President’s signature of the Act, SEC Chairman Jay Clayton [commented](#) that “because of the substantial overlap between the staff’s proposal and the Act, I have directed the staff to consider providing a single consolidated proposal for the Commission’s consideration on issues related to the PCAOB’s access to audit work papers, exchange listing standards, and trading prohibitions. I have also asked the staff to consider additional issues

relating to the Act's implementation, including how the Act's disclosure requirements can be implemented expeditiously and how any actual or perceived uncertainty can be addressed in a manner consistent with congressional intent as well as investor protection and the fair and orderly operation of our markets."

Implementing the PWG recommendations, the SEC's Division of Investment Management's Disclosure Review and Accounting Office (DRAO) issued on [December 14, 2020 guidance](#) on "*Registered Funds' Risk Disclosure Regarding Investments in Emerging Markets*," which encourages funds to "provide tailored disclosures of risks in the emerging markets in which they invest, and related risks, so that investors are able to make informed investment decisions about and among funds." In particular, the guidance highlighted the limited availability and reliability of financial information from jurisdictions like China that restrict the PCAOB's ability to inspect audit firms, access audit papers, and enforce its rules on auditors. The guidance highlighted several factors for funds to consider when drafting their disclosures:

- Risks related to, but not limited to, lack of liquidity, market manipulation concerns, limited reliable access to capital, political risk, and foreign investment structures;
- Whether and how emerging markets' risks arising from differences in regulatory, accounting, auditing, and financial reporting and recordkeeping standards could impede an adviser's ability to evaluate local companies or impact the fund's performance. Funds may wish to consider highlighting issues related to restrictions on PCAOB audit inspections;
- Any limitations on the rights and remedies available to the fund, individually or in combination with other shareholders, against portfolio companies;
- If an index fund, whether the index provider will have less-reliable or less-current information (e.g., due to issues associated with the regulatory, accounting, auditing, and financial reporting and recordkeeping standards in the relevant emerging market) when assessing if a company should be included in an index or determining a company's weighting within the index;
- If an index fund, any limitations concerning the adviser's ability to assess the index provider's due diligence process over index data prior to its use in index computation, construction, and/or rebalancing; and
- Whether the limitations stated above could impact the stated investment objective of the fund.

Capital Markets & Securities Law Watch will continue to monitor developments in this area and will provide any updates.

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