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BLOG

Open Your Books or Be Delisted: SEC Finalizes Rules for Non–PCAOB Compliant Foreign Companies

DECEMBER 9, 2021

On December 2, 2021, the Securities and Exchange Commission (the **SEC**) announced new final rules implementing the submission and disclosure requirements of the Holding Foreign Companies Accountable Act (the **HFCAA**) enacted in December 2020. The final rules apply to companies that the SEC identifies as having filed an annual report with an audit report issued by a registered public-accounting firm that is located in a foreign jurisdiction and that the Public Company Accounting Oversight Board (the **PCAOB**) is unable to inspect or investigate (such companies, **Commission-Identified Issuers**). Under PCAOB Rule 6100, the PCAOB must identify any registered public-accounting firm that the PCAOB was unable to inspect or investigate completely because of a position taken by an authority in a foreign jurisdiction (a **PCAOB-Identified Firm**).[1]

The final rules require a Commission-Identified Issuer to (1) submit documentation to the SEC verifying that it is not owned or controlled by a governmental entity in the PCAOB-Identified Firm's foreign jurisdiction and (2) provide certain additional annual-report disclosures for itself and any of its consolidated foreign-operating entities if the Commission-Identified Issuer is a "foreign issuer" under Rule 3b-4 of the Securities Exchange Act of 1934.

The final rules also provide a mechanism for implementing the HFCAA provisions requiring the delisting and prohibition of trading on national exchanges or over-the-counter markets for registrants that have been identified as Commission-Identified Issuers for three consecutive years and that do not certify that they will use a non–PCAOB Identified Firm. The final rules will be effective 30 days after publication in the Federal Register.

Final Rules

ITEM	DESCRIPTION

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Documentation Submission Requirements	The HFCAA amended the Sarbanes–Oxley Act of 2002 (the **Sarbanes–Oxley Act**) to require any Commission-Identified Issuer to submit to the SEC relevant documentation establishing that the issuer is not owned or controlled by a governmental entity in a relevant foreign jurisdiction. The SEC amended Forms 10-K, 20-F, 40-F, and N-CSR to implement this provision, and this information must be submitted through EDGAR (which will be made publicly available) on or before the due date of the relevant annual-report form. Recognizing that the type of documentation that could be relevant varies, the SEC will give registrants the flexibility to determine which documents best satisfy this requirement according to their organizational structure and other registrant-specific factors. The SEC declined to provide an exclusive or nonexclusive list of documents that could be used to satisfy the submission requirement, because "such a list may be too limiting or become the *de facto* means of satisfying the requirement."
Disclosure Requirements	The HFCAA requires that Commission-Identified Issuers that are "foreign issuers" (**Commission-Identified Foreign Issuers**) provide the following additional disclosures in their annual report for the year in which the SEC identifies the issuer as a Commission-Identified Issuer: • that during the period covered by the form, a PCAOB-Identified Firm prepared an audit report for the issuer; • the percentage of the shares of the issuer owned by governmental entities in the foreign jurisdiction in which the issuer is incorporated or otherwise 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 name of each official of the Chinese Communist Party (the **CCP**) who is a member of the board of directors of the issuer or the operating entity with respect to the issuer; and

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	• whether the articles of incorporation of the issuer (or equivalent organizing document) contain any charter of the CCP, including the text of any such charter. The final rules amend Forms 10-K, 20-F, 40-F, and N-CSR to reflect these new disclosure requirements for each year in which the registrant is a Commission-Identified Foreign Issuer. The SEC took note of comments received that indicated that the interim rules could be interpretated to mean that a Commission-Identified Foreign Issuer listed in the United States using a variable-interest entity (a **VIE**) or similar corporate structure that is incorporated in one jurisdiction but that has a consolidated operating company or is otherwise organized in another jurisdiction may not be required to disclose government ownership of the operating company's shares, which was not the intent of the SEC's interim rulemaking and may be inconsistent with the intent of the HFCAA. As a result, the final rules make clear that registrants must, in addition to providing the required disclosures for Commission-Identified Foreign Issuers, look through a VIE or any structure that results in additional foreign entities being consolidated in the financial statements of the registrant and provide the required disclosures about any consolidated operating company or companies in the relevant jurisdiction.
Inline XBRL Tagging	The final rules include a new XBRL-tagging requirement to facilitate the SEC's accurate and efficient identification of Commission-Identified Foreign Issuers. The additional data elements in annual-report filings must identify: • the audit firm that provided an opinion related to the financial statements presented in the annual report; • the location where the report was issued; and • the PCAOB ID number of the audit firm providing the opinion.

ITEM	DESCRIPTION
Timing Issues	The HFCAA provides for the identification of Commission-Identified Issuers required to file reports under Section 13 or 15(d) of the Exchange Act during a year that begins after the date of the HFCAA's enactment. Accordingly, the SEC will identify registrants under the HFCAA from the PCAOB's determination and registrants' annual reports for fiscal years beginning after December 18, 2020. The earliest that the SEC could identify a Commission-Identified Issuer would be after registrants file their annual reports for 2021 and identify the accounting firm that audited their financial statements. A registrant will be required to comply with the submission and disclosure requirements in the annual report for each year in which it was identified as a Commission-Identified Issuer. As a result, a registrant may need to include the required disclosures in its annual report for the year in which it is identified, even if the report includes an audit report issued by a non–PCAOB Identified Firm.

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Determination of a Commission-Identified Issuer	Registrants will not be required to comply with the submission or disclosure requirements until the SEC identifies a registrant as having a non-inspection year. Promptly after the filing of an annual report, the SEC will evaluate, using Inline XBRL tagging or other structured data, whether the annual report contains an audit report signed by a PCAOB-Identified Firm. Once a registrant has been identified using that data, the SEC will "provisionally" identify that registrant as a Commission-Identified Issuer on the SEC's website, which will delineate between provisional identifications and conclusive identifications. For a period of 15 business days after the provisional identification, a registrant may contact the SEC by email if it believes that it has been incorrectly identified and may provide evidence supporting such claims. If the registrant does not dispute the SEC determination, it will be conclusive after 15 business days. The SEC will not individually notify registrants of the identification, so it will be the registrant's responsibility to monitor the SEC website. The SEC further noted that the lists of Commission-Identified Issuers on its website will indicate the number of consecutive years that a Commission-Identified Issuer has been published on the list and whether it has been subject to any prior trading prohibitions under the HFCAA.

ITEM	DESCRIPTION
Process for Trading Prohibition	The Sarbanes–Oxley Act requires that the SEC impose a trading prohibition on a national securities exchange or through any other method that is within the jurisdiction of the SEC to regulate, including over-the-counter trading, for a registrant that is determined to be a Commission-Identified Issuer for three consecutive years (an **Initial Trading Prohibition**). The SEC is required to terminate an Initial Trading Prohibition if the issuer certifies to the SEC that it has retained a registered public-accounting firm that the PCAOB has inspected to the satisfaction of the SEC and has filed financial statements that include an audit report signed by a non–PCAOB Identified Firm. If the SEC ends a trading prohibition and, thereafter, the registrant again is determined to be a Commission-Identified Issuer, the SEC will be required to impose a subsequent trading prohibition for a minimum of five years, which can be terminated if, at the end of the five-year period, the issuer certifies that it will retain a non–PCAOB Identified Firm and has filed financial statements that include an audit report signed by a non–PCAOB Identified Firm. Initial Trading Prohibitions and subsequent trading prohibitions will be effective four business days after the SEC order is published.

Timing

The SEC will begin identifying Commission-Identified Issuers for fiscal years beginning after December 18, 2020, and these registrants will be required to comply with the new submission and disclosure requirements in the annual report for each year in which they were identified. If a registrant is identified as a Commission-Identified Issuer in 2022 from its annual report for the fiscal year ended December 31, 2021, it will be required to comply with the new requirements in its fiscal-year-2022 annual report due in 2023.

Implications

SEC Chairman Gary Gensler commented, “We have a basic bargain in our securities regime, which came out of Congress on a bipartisan basis under the Sarbanes-Oxley Act of 2002. If you want to issue public securities in the U.S., the firms that audit your books have to be subject to inspection by the PCAOB . . . . This final rule furthers the mandate that Congress laid out and gets to the heart of the SEC’s mission to protect investors. The [SEC] and the PCAOB will continue to work together to ensure that the auditors of foreign companies accessing U.S. capital markets play by our rules. We hope foreign governments will, working with the PCAOB, take action to make that possible.” Mr. Gensler went on to comment that while over fifty jurisdictions have complied with PCAOB requirements, “two historically have not: China and Hong Kong.”

As Capital Markets & Securities Law Watch discussed in earlier posts, Congress, the executive branch, independent agencies like the SEC, and the national securities exchanges have taken increasingly forceful measures to safeguard investors from noncompliant foreign-based companies and to ensure that the auditors of foreign companies accessing U.S. capital markets play by U.S. rules. In response to these changes in policy, it is possible that foreign regulators, particularly in China, will push their domestically incorporated entities that are listed on U.S. exchanges, including the NYSE or Nasdaq, to delist or potentially draw up protective measures directing further noncompliance with U.S.-based directives. Just one day after the final rules were adopted, one prominent Chinese company, Didi Chuxing, which completed its IPO on the NYSE in June 2021, announced that it would delist from the NYSE and transfer its listing to the Hong Kong Stock Exchange. In particular, the tug of war between the United States and China over the rules that will govern disclosure and inspection of publicly traded companies incorporated in one jurisdiction and trading in another will likely continue. Capital Markets & Securities Law Watch will monitor developments in this area and will provide updates to our readers as they become available.

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[1] *See* Capital Markets & Securities Law Blog Post of November 17, 2021.

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