

## Navigating the Holding Foreign Companies Accountable Act – The Road to Delisting or Redemption for China-based Companies

Since March, pursuant to the new Holding Foreign Companies Accountable Act (HFCAA), the U.S. Securities and Exchange Commission (SEC) has “identified” more than 135 companies that relied on auditors headquartered in mainland China and Hong Kong, which have been deemed to be “non-compliant” by the Public Company Accounting Oversight Board (PCAOB), for their FY 2021 annual report filings. Under the HFCAA, companies so-identified by the SEC in 2022 are on track to become subject to a securities trading ban and probable delisting from U.S. exchanges by 2024. As Congress considers legislation to accelerate the imposition of that trading ban up to 2023 and U.S. and Chinese regulators negotiate the terms of an agreement to permit PCAOB access to auditors in mainland China and Hong Kong, here are the **key points** to understand about the HFCAA and those developments.

- The HFCAA is intended to address the U.S. government’s long-standing concerns with the limitations on the PCAOB’s ability to access China-based auditors imposed by the Chinese government based on Chinese laws governing the protection of state secrets and national security.
- The HFCAA sets up a framework by which the SEC is required to ban trading in the U.S.-listed securities of China-based companies if obstacles to PCAOB access are not removed within the time period prescribed by the law.
- In December 2021, the PCAOB determined that all registered audit firms headquartered in the jurisdictions of mainland China or Hong Kong are not accessible to it and, to date, the SEC has identified over 135 issuers that relied on principal auditors headquartered in those jurisdictions for their FY 2021 annual reports, the bulk of which have their principal places of business in China.
- Under the HFCAA, the SEC must “identify” any such covered issuer when its required report filings are accompanied by audit reports that were prepared by an audit firm that (a) is located in a foreign jurisdiction, and (b) the PCAOB is unable to inspect or investigate completely because of a position taken by an authority in that jurisdiction, as determined by the PCAOB.
- Once the SEC identifies an issuer under the HFCAA for three consecutive years, it is required to prohibit that issuer’s securities from being traded on a national

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securities exchange or through any other method that is within the SEC's jurisdiction to regulate, including "over-the-counter" trading.

- In addition, identified issuers must subsequently submit documentation to the SEC that establishes it is not owned or controlled by a governmental entity in the relevant foreign jurisdiction and *foreign* identified issuers must begin making the following disclosures in their subsequent annual reports:
  - That, during the period covered by the report, the issuer retained a "non-compliant" public accounting firm, as determined by the PCAOB, to prepare 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 of the issuer's non-compliant audit firm have a controlling financial interest with respect to the issuer;
  - The name of each official of the Chinese Communist Party (CCP) who is a member of the board of directors of the issuer or the operating entity with respect to the issuer; and
  - Whether the articles of incorporation of the issuer (or equivalent organizing document) contains any charter of the CCP, including the text of any such charter.
- Under its implementing rule – Rule 6100 – the PCAOB intends to reassess any determinations at least annually and can also initiate a reassessment whenever warranted by changes in facts and circumstances. In the latter case, the PCAOB does not anticipate modifying or vacating a determination until it has first tested the efficacy of any change by conducting inspections or investigations in that jurisdiction.
- As it currently stands, issuers identified in 2022 will become subject to a trading ban in 2024 (the third consecutive year of identification), unless in the meantime they either retain an auditor the PCAOB is able to inspect or the PCAOB changes its determinations regarding its access to audit firms in mainland China and Hong Kong.
- The PCAOB and Chinese regulators appear to be actively negotiating an agreement on PCAOB access to audit firms based in mainland China and Hong Kong. Assuming an agreement is reached, PCAOB inspections will have to be completed this year before the PCAOB determines whether audit firms in China and Hong Kong are accessible to it.
- In the meantime, some Chinese companies are repositioning themselves with dual listings or take-private deals, and others are seeking out U.S.-based auditors.
- For the time being, market participants, including investors, seemingly have to prepare simultaneously for both the possibility of a slate of delisted China-based companies, as well as the possibility of a resolution on PCAOB access, which would avert the delistings.

We have produced a more in-depth analysis [here](#).

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