Chinese and other emerging market companies listed in the US face increased scrutiny from Congress and Nasdaq

Financial Services Alert

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US lawmakers and regulators continue to focus on risks to investors in US capital markets posed by a perceived lack of financial accountability, governance and transparency of companies based in emerging markets, including China-based companies. Within a span of two days, the US Senate, House of Representatives and Nasdaq each took steps to safeguard investors in the US capital markets by proposing increased regulatory scrutiny on certain PCAOB-registered auditors and outlining screening criteria for identifying and regulating companies with perceived emerging market risks. In practice, nearly all of the emerging market risks addressed by Nasdaq and Congress come from companies principally based in China.

In an unusual bipartisan move, the US Senate unanimously passed the Holding Foreign Companies Accountable Act (the Accountability Act) on May 20 in an effort to safeguard investors from perceived risks related to emerging market companies accessing US capital markets, including China-based companies. As described further below, after the Senate action, a companion bill was introduced in the US House of Representatives.
The Accountability Act is designed to protect American investors, their savings and their retirement portfolios from exposure to foreign companies that are listed and traded on US stock exchanges while their home country regulations prevent them from providing US regulators with full oversight under the Sarbanes-Oxley Act. The Senate’s action is notable because Congress seldom legislates specific listing standards; rather, current law sets broad and neutral principles that generally allow exchanges to determine their own standards after public notice and comment and approval by the Securities and Exchange Commission (SEC).

Separately, just prior to the Senate’s action, Nasdaq proposed three new rules that would apply to companies operating mainly in “Restrictive Markets,” defined as a jurisdiction that has laws that restrict access to information by regulators of US listed companies in that jurisdiction, including secrecy laws, blocking statutes, national security laws or other similar laws or regulations. Nasdaq’s proposed rules would codify its authority to apply more stringent listing criteria due to concerns about a company’s auditor and apply additional initial and continued listing criteria to Restrictive Market companies, including new management qualification requirements.

We previously outlined the concerns of the SEC and the Public Company Accounting Oversight Board (PCAOB) and their anticipated actions here, here and here. The Accountability Act and Nasdaq’s proposed rules are the most recent and perhaps most significant steps taken in the US designed to address concerns about emerging market risks, particularly those in China.

The proposed Accountability Act

The Accountability Act seeks to address long-running concerns expressed by the SEC and PCAOB over laws, regulations and positions taken by non-US authorities that prevent US regulators from (i) inspecting non-US-based PCAOB-registered firms that audit certain overseas-based companies listed on US exchanges and (ii) accessing the audit work-papers prepared by those firms. The bill, if enacted into law, would impose certain requirements on US listed companies that are audited by a PCAOB-registered audit firm with a branch or office that the PCAOB cannot “inspect or investigate completely because of a position taken by an authority in the foreign jurisdiction.”

Significantly, the bill would ban trading in the securities of such issuers under certain circumstances. Separately, the bill would require certain “foreign issuers” (ie, issuers incorporated or organized under the laws of any foreign country) for which an audit report is prepared by a firm the PCAOB cannot inspect to make additional disclosures in their Forms 10-K or 20-F.

Required trading ban

The bill would require the SEC to compile a list of “covered issuers” that retain a PCAOB-registered accounting firm that has a branch or office located in a foreign jurisdiction that the PCAOB is unable to inspect or investigate completely due to a position taken by an authority in the foreign jurisdiction (Identified Issuers). If the bill is enacted, each year during which the PCAOB is unable to inspect or investigate the accounting firm completely will be defined as a “non-inspection year.” The proposed bill defines covered issuers as those required to file periodic reports under Sections 13 or 15(d) of the Securities Exchange Act of 1934. The Identified Issuers, which are a subset of covered issuers, are required to submit to the SEC documentation establishing that they are “not owned or controlled by a governmental entity in the foreign jurisdiction.”

If the SEC determines that an Identified Issuer has three consecutive non-inspection years (Banned Issuer), the agency must prohibit the securities of that Banned Issuer from trading on a US securities exchange or by any other trading method regulated by the SEC, including, for example over-the-counter trading. The proposed bill does provide for removal of the trading ban if the Banned Issuer certifies that it has retained a PCAOB-registered accounting firm that the PCAOB has inspected to the SEC’s satisfaction, but the SEC can reimpose the trading ban if the SEC determines that the issuer has another non-inspection year thereafter. The bill would require a second trading ban to last five years, after which the SEC must lift the ban if the issuer certifies that it will retain a PCAOB-registered audit firm that the PCAOB is able to inspect.

Additional disclosures

The proposed bill has additional provisions that apply to each covered issuer that is a “foreign issuer” for which an
audit report (as defined in the Sarbanes-Oxley Act) is prepared by a firm the PCAOB cannot fully inspect during a 
non-inspection year. Such registrants would be required to include the following additional disclosures in their Form 
10-K or Form 20-F filed that year:

- that a registered public accounting firm not inspected by the PCAOB prepared the registrant’s audit report
- the percent of the registrant’s shares owned by governmental entities in the foreign jurisdiction where 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 names of each official of the Chinese Communist Party who is a member of the board of directors of the 
  issuer or its operating entity, and
- whether the issuer’s articles of incorporation (or equivalent organizing document) contains any charter of the 
  Chinese Communist Party, including the text of any such charter.

Significantly, while the Senate bill is couched in terms of “foreign” companies and jurisdictions, the latter two 
disclosure requirements clearly evidence the Senate’s focus on China and Chinese companies.

Congressman Brad Sherman (D-CA), who chairs the House Financial Services Subcommittee on Investor 
Protection, Entrepreneurship and Capital Markets and co-chairs the Congressional Caucus on CPAs and 
Accountants, introduced a companion and virtually identical measure following the Senate vote. Speaker Nancy 
Pelosi has said the House will review the bill but stopped short of promising a vote. Regardless, it is clear that 
companies based in China that have sold or intend to sell securities to investors via US stock exchanges are 
increasingly coming under scrutiny. Similar bipartisan measures were proposed in the last Congressional session 
but did not move forward.

Nasdaq’s proposed rules

Each of Nasdaq’s three proposed rules would apply to companies whose business is principally administered in a 
“Restrictive Market.” Through its rule proposals, Nasdaq is seeking to address concerns about inadequate 
disclosures, lack of transparency from certain emerging markets, and accountability and access to information for 
Nasdaq listed companies that operate principally in Restrictive Markets.

“Restrictive Markets” definition

Nasdaq proposes to define a “Restrictive Market” as a jurisdiction that has laws that restrict access to information 
by regulators of US listed companies in that jurisdiction. Laws that restrict access would include secrecy laws, 
blocking statutes, national security laws or other similar laws or regulations. In determining whether a company’s 
business is principally administered in a Restrictive Market, Nasdaq would consider factors such as the geographic 
locations of the company’s (a) main business segments, operations or assets, (b) board and shareholders’ 
meetings; (c) headquarters or principal executive offices; (d) senior management and employees; and (e) books 
and records. The proposed rules would apply to companies based in Restrictive Markets and companies based in 
the US or elsewhere that maintain their operations principally in a Restrictive Market.

Proposal #1: more stringent listing criteria based on auditor concerns

Consistent with concerns expressed by the SEC and the PCAOB, and now Congress, regarding constraints on the 
PCAOB’s ability to inspect auditor work in Restrictive Market countries, Nasdaq is proposing to amend the existing 
interpretation of its rule related to its discretionary authority over the initial and continued listing of securities on 
Nasdaq. Its proposal would formalize Nasdaq’s interpretation of its existing discretionary authority to apply 
additional or more stringent listing or continued listing criteria based on the qualifications of the auditor of the 
applicant or listed company. Under the proposed interpretation, Nasdaq would specify the factors it will consider in 
applying additional or more stringent criteria based on auditor qualifications, including:

1. whether the auditor has been subject to a PCAOB inspection, including whether the auditor, or an accounting 
   firm engaged to assist with the audit, is located in a jurisdiction that limits the PCAOB’s ability to inspect the 
   auditor
2. if the company’s auditor has been inspected by the PCAOB, whether the results of the inspection indicate 
   that the auditor failed to respond to any requests from the PCAOB or the inspection uncovered significant
deficiencies in the auditor’s conduct in other audits or in its systems of quality controls
3. whether the auditor can demonstrate that it has adequate personnel in its offices participating in the audit with expertise in applying US GAAP or International Financial Reporting Standards as applicable, in the company’s industry
4. whether the auditor’s training programs are adequate
5. for non-US auditors, whether the auditor is part of a global network or other affiliation of individual auditors where the auditors draw on globally common technologies, tools, methodologies, training and quality assurance monitoring, and
6. whether the auditor can demonstrate to Nasdaq sufficient resources, geographic reach or experience as it relates to the company’s audit.

Nasdaq’s proposed rule interpretation provides examples of additional or more stringent criteria that Nasdaq might apply to an applicant or already listed company based on auditor concerns, including (i) higher equity, assets, earnings or liquidity measures; (ii) requiring all offerings to be firm commitment offerings, which generally involve greater broker-dealer due diligence than a best efforts offering; and (iii) trading restrictions imposed on officers and directors. Importantly, the proposed interpretation notes that in some cases Nasdaq may determine that listing is not appropriate and deny initial or continued listing to a company. There is a separate proposed interpretive paragraph that specifically provides that Nasdaq may use its discretionary authority to impose additional or more stringent listing criteria if a company’s business is principally administered in a Restrictive Market.

In making its proposal, Nasdaq noted that the PCAOB is currently prevented from inspecting the audit work and practices of PCAOB-registered auditors in Belgium, France, China and Hong Kong (to the extent their audit clients have operations in mainland China). Nasdaq stated, however, that the PCAOB expects to enter into cooperative agreements with Belgium and France and that only in China and Hong Kong does the position taken by Chinese authorities serve as an obstacle to inspection of all, or nearly all, registered firms in the jurisdiction. Therefore, while Nasdaq’s proposals are facially neutral and not specifically directed at China, in practice the proposals nonetheless appear to have the greatest impact on that country.

Proposal #2: management standards for listing applicants from restrictive market countries

Nasdaq proposes to require, as a condition of listing on the exchange, that listing applicants from Restrictive Markets certify that they have and will continue to have a member of senior management or a director with relevant employment experience at a US-listed public company under Nasdaq rules and federal securities laws. As an alternative, the company can retain on an ongoing basis an advisor or advisors, acceptable to Nasdaq, that will provide such guidance to the company. The experienced senior manager, director or advisor is expected to provide expertise on compliance with the securities laws, governance and internal controls.

Once listed, the Restricted Market company would have an ongoing obligation to have the required experienced senior manager or board member or advisor acceptable to Nasdaq. Failure to satisfy this listing standard would put the company at risk of delisting if it does not develop a plan to regain compliance within 180 days. During that time, the company must disclose that it is not in compliance with the standard, which would alert investors to the heightened risk. The rule does not impose a similar standard on companies already listed on Nasdaq that may be Restricted Market companies.

Proposal #3: minimum offering size or public float for restrictive market companies

Based on concerns that transparency and accountability issues in Restrictive Markets are compounded when a company based in such markets lists on Nasdaq through an initial public offering (IPO) or a business combination with a small offering size or low public float percentage, Nasdaq is proposing to impose minimum offering or public float requirements for Restrictive Market companies seeking to list on Nasdaq through an IPO or a business combination. For an IPO, Nasdaq proposes that the company offer a minimum amount of securities in a firm commitment offering in the US to public holders that would result in gross proceeds to the company of at least $25 million or that would represent at least 25 percent of the company’s post-offering market value of listed securities, whichever is lower. Similar requirements would apply to a business combination involving a Restrictive Market company. In addition, Nasdaq would no longer allow Restricted Market companies seeking to list through a direct listing to list on the Nasdaq Capital Market, which has lower requirements for unrestricted publicly held shares than the Nasdaq Global Select or Nasdaq Global Markets. Similar limits would apply to a business combination involving...
a Restrictive Market company.

With these proposed listing limitations on Restricted Market companies, Nasdaq seeks to address concerns about lack of liquidity, increased volatility, and increased risks of price manipulation and insider trading in small offerings, concerns it views as compounded where a company is administered principally in a Restricted Market.

Key takeaways

While none of these actions currently have the force of law, they are emblematic of an increased desire by the US to take steps to prevent companies seeking to benefit from US capital markets, particularly companies in China, from evading oversight of those charged with regulating US markets. The Senate sponsors of the Accountability Act specifically identified Chinese companies as having a disregard for US reporting standards and exploiting Americans.

The stakes are high. As reported by *Fortune*, 224 US-listed companies representing more than $1.8 trillion in combined market capitalization are in countries where there are obstacles to the PCAOB inspections that US law mandates. It appears that it may be less a question of whether the US will act but when and in what form. We note that Nasdaq could have combined its proposals into a single rule filing but appears to have separated them so that if any one proves to be controversial, it would not delay the others. Comments are due within 21 days after the Nasdaq proposals are published in the Federal Register, and the SEC is permitted to approve them within 45 days after such publication.

We anticipate that these developments may be part of the discussion that takes place during the SEC’s July 9, 2020 Roundtable on Emerging Markets. Market participants with interests in this area should assess how best they can become part of the process so that their voices can be heard and their interests considered to the extent possible.

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