May 26, 2020

Disclosure and Other Considerations: Update for Chinese SEC Reporting Companies

As many Chinese companies with SEC reporting obligati0ns[1] have taken advantage of the relief provided by the U.S. Securities and Exchange Commission (the "SEC") to delay the filings of their annual reports on Form 20-F (which otherwise would have been due for calendar year-end companies at the end of April), we list below a few reminders and updates as reporting companies finalize their annual reports and also consider their investor relations messaging. These include:

- disclosing in any delayed report, reporting company's reliance on the SEC order and the reasons for the delay;[2]
- considering the disclosure items set out in the April 21, 2020 joint statement of senior staff of the SEC and the Public Company Accounting Oversight Board ("PCAOB") directed at emerging market reporting companies, in particular from China;[3]
- considering from a disclosure perspective, but also more broadly, the potential implications of recent developments in the U.S. Congress relating to Chinese reporting companies; and
- considering from a disclosure perspective, but also more broadly, the potential implications of Nasdaq rule clarifications.

Disclosure of Reliance on SEC Order

One of the conditions to the relief provided in the SEC's order is that the delayed report include two disclosures: the delayed report must state that the reporting company is relying on the SEC order and it must state the reasons why the report could not be filed on a timely basis. In the case of annual reports,

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1 For this purpose, we include companies incorporated in the Cayman Islands or other offshore jurisdictions that are primarily administered or managed from China, including through variable interest entity structures.

2 *See* Order Under Section 36 of the Securities Exchange Act of 1934 Modifying Exemptions From the Reporting and Proxy Deliver Requirements for Public Companies, SEC Release No. 34-88465, March 25, 2020 (available here). For a summary of the SEC relief, see our prior Client Memorandum entitled "SEC Extends Conditional Reporting Relief, CorpFIN Staff Issues COVID-19 Disclosure Guidance" (available here).

3 *See* joint statement by SEC Chairman Jay Clayton, SEC Division of Corporation Finance Director William Hinman, SEC Chief Accountant Sagar Teotia, SEC Division of Investment Management Director Dalia Blass and PCAOB Chairman William D. Duhnke III entitled "Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited" (April 21, 2020) (available here).

many reporting companies are including these disclosures as an explanatory note in the front of the annual report.

Reporting companies should keep in mind that they need to file their delayed reports no later than 45 days after the original due date, although they do have the option of extending that period for an additional 15 days (five days if the report was a quarterly report) by complying with Rule 12b-25 (and filing a Form 12b-25). [4]

Additional Disclosure Considerations

In their April joint statement, senior staff of the SEC and PCAOB set out their views regarding disclosure, financial reporting and other risk considerations relevant to reporting companies in emerging markets. The joint statement is framed in terms of emerging market disclosures, but the key focus is China, and it appears to be another salvo in the long-running conflict, dating back some years, between the PCAOB and Chinese authorities over access to audit work papers maintained by the local offices and branches in China of the "Big 4" accounting firms and other accounting firms that audit the financial statements of SEC reporting companies. While the joint statement is addressed to investors and the broader markets as well, there are specific disclosure points addressed to emerging market reporting companies, which include:

- disclosing risks and uncertainties that are specific to the environment in which the company operates, which could include assessing whether the company has sufficient controls, processes and personnel to address accounting and financial reporting issues, and in any event should avoid boilerplate disclosures;
- ensuring that relevant financial reporting matters are discussed with the independent auditors and, where applicable, the audit committee;
- in the case of Chinese reporting companies, disclosing material risks relating to the current inability of the PCAOB to inspect audit work papers in China;
- disclosing risks related to the difficulties U.S. regulators face in bringing and enforcing actions against reporting companies and their directors and officers; and
- disclosing any material limitations on shareholder rights, including the ability of shareholders to seek legal redress in the local jurisdiction, recognizing that shareholder claims common in the United States, such as class actions and fraud claims, generally are difficult or impossible to bring as a practical matter outside the United States.

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4 SEC Compliance and Disclosure Interpretations (available here and here). For summary of the relevant C&DIs, see our prior Client Memorandum entitled "Covid-19 Update: SEC and Nasdaq Response and Updated SEC C&DIs" (available here).

Holding Foreign Companies Accountable Act

On May 20, 2020, the U.S. Senate passed the Holding Foreign Companies Accountable Act[5] that, in effect, could result in the delisting of non-U.S. reporting companies (particularly from China) whose financial statements have, for a period of three consecutive years, been audited by an accounting firm branch or office that is not subject to PCAOB inspection.[6] The Act had bipartisan support, and must next be considered by the House of Representatives. If passed by the House of Representatives, it would then be sent to the President for signature, failing which it becomes law if there are sufficient votes to override a veto. The SEC must then promulgate rules to implement the requirements of the Act.

The Act would require the SEC to identify each SEC reporting company that retains a registered public accounting firm to audit its financial statements that has a branch or office located in a foreign jurisdiction as to which the PCAOB is unable to inspect, which could arise because of a positon taken by an authority in such foreign jurisdiction. This action clearly is directed at reporting companies based in China, which often would be using accounting firm offices or branches located in China. Any such reporting company would be required under the Act to submit to the SEC documentation showing that it is not owned or controlled by a government entity in the foreign jurisdiction in which its auditor has a branch or office.

If the SEC determines that the PCAOB is unable to inspect the foreign office or branch of the reporting company's auditor for three consecutive years, the SEC would be required to prohibit the securities of such reporting company from being traded on a U.S. securities exchange or through any other method that is within the SEC's jurisdiction to regulate (including, by means of OTC trades). The prohibition on trading would be removed if the reporting company certifies to the SEC that it has retained an auditor that the PCAOB has inspected, to the satisfaction of the SEC. If following the removal of the prohibition, the SEC determines that the PCAOB is again unable to inspect the company's auditor, the SEC would be required to prohibit the issuer's securities from trading on a national securities exchange for a minimum of five years. The SEC would be permitted to end the five-year prohibition only if the reporting company certifies to the SEC that it will retain an auditor that the PCAOB is able to inspect.

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5 The bill was initially introduced, in June 2019, as part of a legislative concern in the United States over regulatory access to audit and other information currently protected by national law, particularly in China, and in the context of broader concerns over accounting and disclosure practices. The bill was introduced around the time that a second bill (the Ensuring Quality Information and Transparency for Abroad-Based Listings on our Exchanges (EQUITABLE) Act) was introduced, also with bipartisan support.

6 In December 2018, a joint statement by senior staff at the SEC and the PCAOB (available here) identified the concern that the PCAOB was (and still is) denied access to the China-based offices and branches of the accounting firms that audit the financial statements of SEC reporting companies headquartered in China. The PCAOB seeks access in order to conduct inspections of audits (including work papers and practices) of SEC reporting companies.

Additionally, the Act would require disclosures regarding government ownership for each year during which the PCAOB is unable to inspect the relevant auditor's branch or office.

The Act has only passed in the Senate, but with bipartisan support. This bill and a similar bill were introduced last year, with significant bipartisan support. Moreover this comes in the context not only of a widely reported accounting scandal, but also concerns articulated in a very pointed (and public) way by the SEC. Whether the Act is signed into law or otherwise becomes part of the trade discussions between the United States and China remains to be seen.

Many Chinese reporting companies have a PCAOB risk factor, which would likely be updated for recent developments such as this.

Nasdaq Proposes New Criteria Tied to Jurisdictions That Restrict Access by U.S. Regulators

Under existing Nasdaq Rule 5101, Nasdaq has broad discretionary authority to deny initial or continued listing or to apply additional and more stringent criteria in order to maintain the quality of and public confidence in its market, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. Nasdaq may use its discretion to deny initial listing, apply additional or more stringent criteria for the initial or continued listing of particular securities, or suspend or delist particular securities based on any event, condition or circumstance that exists or occurs that makes initial or continued listing of the securities on Nasdaq inadvisable or unwarranted in the opinion of Nasdaq, even though the securities meet all enumerated criteria for initial or continued listing on Nasdaq.

Nasdaq's broad discretionary authority can extend to situations where the auditor of an applicant or a Nasdaq-listed company: (1) has not been subject to an inspection by the PCAOB (either historically or because it is newly formed and as therefore not yet undergone a PCAOB inspection), (2) is an auditor that the PCAOB cannot inspect or (3) otherwise does not demonstrate sufficient resources, geographic reach or experience as it relates to the company's audit, including in circumstances where a PCAOB inspection has uncovered significant deficiencies in the auditors' conduct in other audits or in its system of quality controls.

Nasdaq proposes to amend its rules (IM-5101-1) to codify its existing discretionary authority under Rule 5101 over initial and ongoing listing requirements, by adding certain factors that would assist Nasdaq in determining whether to apply additional and more stringent criteria to an applicant or listed company based on the qualifications of the company's auditor, including whether it has been, or can be, subject to PCAOB inspection.

Nasdaq will assess these factors holistically and may conclude it is satisfied with an auditor's qualifications even if the auditor raises concerns with respect to some of the factors set out in IM-5101-1. For example, the inability of the PCAOB to inspect the auditor and the related risk of undetected deficiencies may be mitigated if the auditor belongs to a global network of auditors with global common standards, tools and methodologies.

Nasdaq proposes to clarify that it may also apply additional and more stringent criteria to obtain comfort that the company satisfies the financial listing requirements and is suitable for initial or continued listing, including higher equity, assets, earnings or liquidity. It also proposes to clarify that it may also use its discretionary authority to impose additional or more stringent criteria, in other circumstances, including when a company's business is principally administered in a jurisdiction that Nasdaq determines to have secrecy laws, blocking statutes, national security laws or other laws or regulations restricting access in such jurisdiction to information by regulators of U.S.-listed companies.

From a disclosure perspective, this development is related to the broader risk of the PCAOB's lack of access and the related general concerns.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman +44-20-7367-1601 mbergman@paulweiss.com	John (Jack) Lange +852-2846-0333 jlange@paulweiss.com	Xiaoyu Greg Liu +86-10-5828-6302 gliu@paulweiss.com
Judie Ng Shortell +86-10-5828-6318 jngshortell@paulweiss.com	Betty Yap +852-2846-0396 byap@paulweiss.com	Tong Yu +81-3-3597-6306 tyu@paulweiss.com

Securities practice management attorney Monika G. Kislowska contributed to this Client Memorandum.