U.S. and China Sign Statement of Protocol on China-Based Audit Firms Inspection

September 8, 2022

Introduction

The Public Company Accounting Oversight Board (PCAOB) **announced** on August 26, 2022, that it has signed a Statement of Protocol (SOP) Agreement with the China Securities Regulatory Commission (CSRC) and China's Ministry of Finance. The SOP, together with two protocol agreements governing inspections and investigations (together, the "SOP Agreement"), establishes a framework for the PCAOB to conduct complete inspections and investigations of PCAOB-registered public accounting firms based in mainland China and Hong Kong. The SOP Agreement is the most detailed and prescriptive arrangement the PCAOB has reached with any foreign jurisdiction and it could potentially prevent trading prohibitions of approximately 200 China-based issuers from the U.S. stock exchanges under the Holding Foreign Companies Accountable Act (HFCA Act).

Background

The HFCA Act was signed into law by former President Donald Trump on December 18, 2020, (see our alert summarizing the HFCA Act **here**). On November 4, 2021, the SEC approved PCAOB Rule 6100, Board Determinations Under the Holding Foreign Companies Accountable Act (see our alert discussing Rule 6100 **here**). The HFCA Act requires the SEC to prohibit trading of securities of a "covered issuer" on any national securities exchange or other method regulated by the SEC, if the PCAOB has been unable to "inspect or investigate completely" the covered issuer's auditor in a foreign jurisdiction for three consecutive years due to a position taken by governmental authorities in that jurisdiction. Rule 6100 establishes a framework for PCAOB to make an inability to inspect or investigate determination and sets out the factors to be evaluated by the PCAOB. The rule also requires the PCAOB to annually reassess all determinations that are in effect.

According to the PCAOB, for more than a decade, the PCAOB's access to inspect and investigate registered public accounting firms in mainland China and Hong Kong has been obstructed. In 2021, the PCAOB made its first HFCA Act determination that positions taken by Chinese authorities have prevented the PCAOB from completing their inspections of PCAOB-registered auditors in mainland China and Hong Kong. The PCAOB is now required to reassess its determinations by the end of this year. If PCAOB determines for three consecutive years that positions taken by Chinese authorities have obstructed the PCAOB's ability to inspect and investigate registered public accounting firms in mainland China and Hong Kong completely, the companies audited by those firms will be subject to SEC trading prohibitions on U.S. markets. The PCAOB's determination under the HFCA Act is a jurisdiction-wide determination, not firm-specific.

Key Commitments under the SOP Agreement

According to SEC Chair Gary Gensler, the SOP Agreement with the Chinese authorities marks the first time the PCAOB has received such detailed and specific commitments from China that, if observed, would allow PCAOB inspections and investigations meeting U.S. standards. While the full text of the SOP Agreement is not published, the SEC and PCAOB have provided information summarizing the key commitments from the Chinese authorities under the new agreement.

According to the published summaries, Chinese authorities have committed to the following four critical items that have historically impeded the PCAOB's ability to inspect and investigate the China-based audit firms completely:

- *Sole Discretion to Select for Inspection*: The PCAOB will be able, in its sole discretion, to select any audit firms and clients for examination. The PCAOB can also select for investigation any potential violations of PCAOB standards, rules, and related federal securities laws by audit firms and their associated persons.

- *Direct Interview and Obtain Testimony*: The PCAOB will be able to interview and take testimony of audit firm personnel in China and Hong Kong. PCAOB investigators can question witnesses directly and use PCAOB stenographers to create official, English-language transcripts.

- *Redactions Are Not Permitted*: PCAOB inspectors and investigators will be able to review all audit documentation without redaction even if the information is deemed sensitive by the Chinese authorities. The SOP Agreement allows for in-camera or "view only" review—as the PCAOB has done in the past with certain other jurisdictions—of a limited set of "restricted data" (such as personally identifiable information). Importantly, under the SOP Agreement, the PCAOB can retain any audit information it reviews, including restricted data, as needed to support the findings.

- *Unfettered Information Sharing with the SEC*: The PCAOB has the unfettered ability to transfer information, including Restricted Data, to the SEC in the normal course. The SEC can use the information for all statutory obligations and routine uses, including administrative or civil enforcement actions.

Next Step and Real Test

The chairs of both the SEC and PCAOB cautiously welcomed the SOP Agreement and both emphasized that entering into the agreement is only the first step in the process. According to PCAOB Chair Williams, "the real test will be whether the words agreed to on paper translate into complete access in practice."

The SOP Agreement will be tested soon. The PCAOB has issued document requests to audit firms in China and testimony notifications have been sent to witnesses. Next, PCAOB inspectors will be in Hong Kong in mid-September to inspect audit documentation, interview witnesses and collect testimony. The PCAOB will need to determine whether it is able to conduct complete inspections and investigations in China and Hong Kong and make a determination under the HFCA Act by the end of this year.

If you have any questions about the SOP Agreement, the HFCA Act or Rule 6100, please contact the authors of this alert or your Miller Canfield attorneys.