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The Holding Foreign Companies Accountable Act: Investor Protection or Geopolitics?

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Since US and Chinese authorities reached an agreement last August in the controversy over information disclosure by the auditors of China-based US-listed companies (Chinese issuers), the threat that these companies would be delisted en masse has receded. The US Public Company Accounting Oversight Board (PCAOB) has begun inspections of the accounting firms that prepare audit reports for Chinese issuers. American investors may be breathing sighs of relief.

But the risks to investors are not being mitigated, and in fact may be worsened by the approach chosen by the US Congress and Securities and Exchange Commission (SEC). Even if the threat of delisting will induce higher quality control over the auditors of Chinese issuers, the benefits are likely to be limited. US securities laws are being used to promote a geopolitical agenda rather than investor protection. Moreover, the approach undermines the reputation of the US market as a global financial gateway while boosting other markets as alternatives. It has also given China ammunition to justify its tightening of control over its companies' offshore listings and cross-border data flows in ways that could further disadvantage investors' interests.

The threat to delist Chinese issuers arose when Congress passed the Holding Foreign Companies Accountable Act (HFCA) in December 2020. For years, US securities regulators had been unable to inspect the audits of Chinese issuers due to regulatory barriers imposed by Chinese information-sharing laws. The HFCA, promoted as protecting investor interests and safeguarding the integrity of US capital markets, effectively prohibited trade in Chinese issuers' securities (including over-the-counter) within three years (later shortened to two) unless the PCAOB could carry out the audit inspections. In 2022, the SEC identified 165 Chinese issuers as non-compliant for the year 2021, subjecting them to potential delisting under the act. It was likely this intense pressure that finally induced China to permit PCAOB inspections of Hong Kong and Chinese audit firms.

As my co-author Jesse Fried and I argue in a forthcoming paper, the US regulatory approach completely misses the mark. First, while there is evidence that PCAOB inspections contribute to audit quality, the data about the overall shareholder wealth contribution of periodically better audits is inconclusive. Second, there are multiple other ways besides accounting fraud for insiders to loot firms and abuse investors. The main weaknesses in the system were not addressed: namely, neither the HFCA nor the cooperation agreement address enforcement challenges or the lack of remedy for injured investors. (This conclusion is based on publicly available information, as the agreement itself was not disclosed.) When it comes to Chinese firms specifically, once fraud or any other violation by a Chinese issuer occurs, the fact that the insiders, the operating firm, and their assets are located in China makes the insiders legally unreachable, as Jesse Fried and Ehud Kamar rightly point out.

Third, while the potential benefits of the HFCA to investors are limited, the costs are significant. US investors will bear substantial costs if Chinese-US cooperation in future inspections falters and the act's trading prohibitions and threat of delisting resurface. Beyond the loss of valuable investment opportunities, US investors will endure tangible costs as well. Chinese issuers will be forced to offer share swaps with shares tradable in other markets, where relevant, or sell their public float in a going-private transaction. As Fried and I detail in our analysis, in the share-swap scenario, US investors that can hold and trade shares in a foreign market will lose the protections offered to them by US securities laws. Others will likely exit at temporarily depressed prices. A total of 31 Chinese issues have initiated going private transactions in the lead-up to and since the HFCA's enactment. Some of these firms listed their shares on a different exchange shortly after. In these depressed buyout situations, founders and insiders stand to make a double windfall at the expense of US investors.

The investor protection functions of the HFCA seem even more tenuous when analyzing its documentation and disclosure rules. The rules require identified Chinese issuers to disclose ownership ties to the Chinese government and certain formal functions of the Chinese Communist Party (CCP) in the firm. The premise of these requirements is a parochial and oversimplified view of ownership and control that is ill-equipped to handle the complexities of China's corporate governance and political-economic systems. The act underestimates the routes for potential party-state influence on Chinese firms on the one hand, while implicitly overstating actual party-state interference on the other hand. As a result, the documentation and disclosure rules are likely to generate information that is either irrelevant or misleading. Moreover, Congress' failure to require similar disclosure at the initial public offering stage suggests that it does not believe the information is material to investors. More than 53 China-based firms have conducted an IPO in the US market since the HFCA took effect. They were not required to make similar disclosures in their prospectuses.

Legislative history further suggests that the HFCA is an attempt to use securities laws to advance a geopolitical agenda. Until recently, Chinese firms were accepted into the US market with open arms. China's economic ascent was widely viewed as compatible with the economic and political interests of the United States. Chinese firms listed on US capital markets even before China established its own legal framework for public offerings. The first direct offering of a PRC-domiciled company took place on the New York Stock Exchange in August 1994, only *one month* after the PRC Company Law took effect and on *the very same day* that China released its overseas offering and listing rules. The SEC even granted waivers to PRC issuers from the already lax US accounting disclosure regime generally applicable to foreign issuers.

A wave of reverse merger frauds by Chinese issuers in the early 2010s, causing investor losses in the hundreds of billions of dollars, did not induce

Congress to take action. But by 2017, concern about China as a rising threat to US interests grew larger in US policy circles, and by 2019 a decoupling discourse took over. The focus has mainly been on technology. But technological prowess is dependent on financing, which was thus set to be curbed as well.

When broadening the lens of analysis beyond the HFCA itself, it becomes clear that the act joins several schemes that advance financial decoupling from China. These include repeated efforts to discourage and even ban federal employees' retirement funds from investing in Chinese companies; executive orders banning US portfolio investments in companies tagged as "Communist Chinese Military Companies" and in China's surveillance technology sector; additions to the Department of Commerce Entity List; proposals to ban or screen outbound investments; and proposals to deny certain tax exemptions for US organizations and legal persons who invest in Chinese companies (the DITCH Act). These steps, among many others, seek to limit the flow of capital to Chinese firms and thereby slow China's economic, technological, and military ascent.

The HFCA is just as political as the other steps taken in this blitz. Regrettably, not only has the act failed to protect American investors' interests, but it has largely backfired geopolitically. In the wake of the HFCA, the Chinese government actually heightened control over the worldwide affiliates of Chinese firms. When accounting firms provide information to US inspectors, they still must first pass the information to PRC regulators for review, even if the PRC authorities formally cannot redact or alter the information. (See CSRC Q&A answer 5 and Measures for Overseas Offering and Listing, art. 26). The leverage that PRC authorities hold over firms and control of information sharing has not diminished but intensified.

The act helped the Chinese party-state justify domestically, and was the final catalyst for, the expansion of its extraterritorial regulatory authority over offshore-listed firms. Over the past few years, the party-state has tightened its oversight over the accounting industry; expanded its offshore listing rules; and intensified regulations and enforcement actions limiting the free flow of data. See, for example, its amended Archives Law (arts. 22, 25), newly enacted Data Security Law (arts. 36, 48) and Personal Information Protection Law (Chapter III), as well as mandatory cybersecurity reviews (Cybersecurity Review Measures art. 7) and data-protection assessments. From a largely unsupervised practice, indirect listings outside mainland China suddenly have become highly dependent on the party-state's strategic considerations and subject to stringent regulatory approvals. While more party-state oversight is not necessarily bad, it is doubtful that this particular outcome aligns with the US Congress' intentions or American investors' interests.

Furthermore, China continues to encourage firms in designated emerging industries to list at home. It coordinated the voluntary delisting of Chinese SOEs from the US markets, and pushed private firms such as Didi Chuxing to delist preemptively. The expected result is an orchestrated restructuring of the whole body of China's offshore affiliates in the service of the party-state's development goals.

Finally, the HFCA seems to damage the reputation of the US market as a global financial gateway while accelerating interconnectedness between China and other Asian stock markets and business hubs. The HFCA has handed the party-state several gifts on a silver platter.

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