THE EFFECTIVENESS OF THE HOLDING FOREIGN COMPANIES ACCOUNTABLE ACT

Carissa Lee[*]

ABSTRACT

The Holding Foreign Companies Accountable Act was passed in 2020 to counter audit inspection issues of U.S.-listed foreign based companies. Despite it being allegedly neutral, the act largely targets Chinese companies due to conflicting Chinese laws which bar access to auditinformation. However, the act fails to capture the complex involvement of the Chinese Communist Party within corporations and oversimplifies the structure of Chinese state-owned enterprises. Additionally, the act is both overinclusive and underinclusive due to insufficient guidance on U.S.-based issuers whose nature of businesses are in China and variable interest entities. In order for the Holding Foreign Companies Accountable Act to achieve its objectives of investor transparency and protection, the act should be amended to require more extensive disclosures of interactions with the Chinese Communist Party and the standard should shift from a jursidiction-based approach to a case-by-case approach.

---

* Copyright © 2023 Carissa Lee. J.D. Candidate, University of California, Davis, School of Law, 2023. Many thanks to Professor William Dodge for his ongoing support and guidance throughout this process.

TABLE OF CONTENTS

I. INTRODUCTION 40
II. BACKGROUND 42
A. Before the Implementation of the HFCAA 42
1. The Sarbanes-Oxley Act ("SOX") of 2002 42
2. The Exemption of Chinese Companies 43
B. The Holding Foreign Corporations Accountable Act ("HFCAA") 44
1. HFCAA of December 2020 44
2. The "Amendments" and the Acceleration 44
3. The Didi Incident and the "Final Rule" 45
III. PROBLEMS ARISING FROM THE ACT 47
A. The HFCAA's Oversimplification of the Categorization of Firms in China 47
1. Chinese State-Owned Enterprises ("SOE"s) and the Impact of Recent Chinese Laws 48
2. The HFCAA's Failure to Address the CCP's Control 49
3. Negative Impacts on Chinese SOEs 50
B. The HFCAA's Reach 51
1. The HFCAA's Overinclusiveness: Failure to Protect U.S. Firms 51
2. The HFCAA's Underinclusiveness: Failure to Address the Issue of Variable Interest Entities ("VIE"s) 52
IV. IMPLICATIONS OF THE HFCAA 55
A. Alternative Stock Markets 55
B. The Value and Cost of PCAOB Audit Inspections 56
C. Amending the HFCAA 56
D. Potential Retaliation by the Chinese Government 57
V. CONCLUSION 57

I. INTRODUCTION

On December 18, 2020, President Trump signed the Holding Foreign Companies Accountable Act ("HFCAA") into law, which targeted ongoing concerns regarding challenges facing the Public Company Accounting Oversight Board ("PCAOB") in audit inspections of U.S.-listed foreign based companies.[1] The HFCAA amends Section 104 of the Sarbanes-Oxley Act ("SOX") of 2002 and requires the U.S. Securities and Exchange Commission ("SEC") to identify each issuer that retains a registered public accounting firm

---

[1] Jay Clayton, *Statement after the Enactment of the Holding Foreign Companies Accountable Act*, U.S. SEC. & EXCH. COMM'N (Dec. 18, 2020), www.sec.gov/news/public-statement/clayton-hfcaa-2020-12.

having a branch or office (1) located in a foreign jurisdiction and (2) for which the PCAOB is "unable to inspect or investigate completely because of a position taken by an authority in that foreign jurisdiction."[2] If a company fails to comply with the audit inspection requirements for three consecutive years, they will be forced to delist from the U.S. stock exchange.[3]

The PCAOB has faced challenges in their audit inspections because of certain foreign jurisdictions that do not allow the PCAOB to conduct such inspections, either due to security concerns or conflicting laws. China is such a case, as Chinese law requires business records produced within China to be maintained there and restricts them from being transferred out of China due to national security concerns.[4] Therefore, the HFCAA could result in a massive number of delistings of U.S.-listed Chinese companies, leading to a potential $1.8 trillion loss in market value.[5] This could bolster the decoupling sensation that is already apparent between the U.S. and Chinese markets and lead to negative implications on U.S.-China relations.[6]

Though the HFCAA is specifically noted to not be "anti-China,"[7] a majority of the U.S.-listed foreign based companies are Chinese companies and the HFCAA itself specifically requires the identification of any Chinese Communist Party ("CCP") members on the board of directors or any charters of the CCP within the articles of incorporation.[8] Furthermore, many commentators have directly pointed out that this is a "discriminatory and unfair" act passed to target Chinese corporations specifically.[9] Hence, one of

---

[2] Holding Foreign Companies Accountable Act, Pub. L. No. 116-222, § 2, 134 Stat. 1063, 1063 (2020).

[3] *See id.* § 2(i)(3).

[4] Jay Clayton, et al., *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-Listed Companies with Significant Operations in China*, U.S. SEC. & EXCH. COMM'N (Dec. 7, 2018), www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other.

[5] Steve Dickinson, *China and the U.S. Stock Market: Nowhere to Go*, HARRIS BRICKEN: CHINA L. BLOG (June 16, 2019), https://harrisbricken.com/chinalawblog/china-and-the-u-s-stock-market-nowhere-to-go/?mod=article_inline.

[6] *See id.*; Evan Merritt, Note, *The Holding Foreign Companies Accountable Act: An Analysis of the Legislation's Potential Effect on Chinese Companies and U.S.–China Relations*, SMU INT'L. L. REV. (Mar. 10, 2020), https://cpb-us-w2.wpmucdn.com/smulawjournals.org /dist/1/6/files/2018/11/Merritt_Redline.pdf.

[7] Mark S. Bergman, et al., *U.S. Congress Passes Holding Foreign Companies Accountable Act*, PAUL | WEISS (Dec. 3, 2020), https://www.paulweiss.com/practices/transactional/capital-markets/publications/us-congress-passes-holding-foreign-companies-accountable-act?id=38728.

[8] *See* Holding Foreign Companies Accountable Act § 3(b)(4)-(5).

[9] Chen Jie, et al., Comment Letter on Holding Foreign Companies Accountable Act Disclosure 1 (May 4, 2021), https://www.sec.gov/comments/s7-03-21/s70321-8747407-237302.pdf.

the unspoken and yet most prevalent purposes of the HFCAA is to combat influences of the CCP within the U.S. and global markets.

Currently, the three-year time limit of the HFCAA has not been met,[10] and thus the true effects of the HFCAA are unclear. This Note explores the potential issues and effects of the HFCAA once the time limit is met. Part I reviews the purpose and function of the SOX and the contents of the HFCAA, the later Amendment, and the most recent Final Rule. Additionally, Part I discusses the recent events in the U.S. market involving Chinese companies and the current state of the U.S. and Chinese economies. Part II argues that the language of the HFCAA is an oversimplification and underestimates the complexity of structure of Chinese state-owned enterprises and the involvement of the Chinese Communist Party in the Chinese market. Furthermore, this part highlights how the HFCAA is overinclusive by failing to consider U.S.-based issuers whose nature of businesses are in China, and yet is also underinclusive by not addressing variable interest entities ("VIE"s). Finally, Part III discusses possible repercussions to the HFCAA and potential ways in which the Final Rule and the HFCAA should be amended.

II. BACKGROUND

A. Before the Implementation of the HFCAA

1. The Sarbanes-Oxley Act ("SOX") of 2002

The SOX grants the PCAOB the right to investigate and inspect public accounting firms to ensure no violations.[11] Under Section 106, non-U.S. public accounting firms are held to the same standards as U.S. public accounting firms, which entails registration with the PCAOB and submission to inspection by the PCAOB.[12] The inspections performed by the PCAOB are annual inspections involving the review of audit reports submitted by issuers in compliance with the PCAOB's requests.[13] This voluntary compliance by firms is a condition of the firm's registration under the PCAOB.[14]

However, certain jurisdictions outside of the U.S. have their own inspection programs or legal or societal concerns that bar the PCAOB's inspections.[15] The PCAOB recognizes this, and due to potential conflicts with

---

10 *See* Holding Foreign Companies Accountable Act § 2(i)(3).

11 Sarbanes-Oxley Act, Pub. L. No. 107-204, § 101(c), 116 Stat. 745, 750 (2002).

12 *See id.* § 106.

13 *See id.* § 104(a)–(b).

14 *See id* § 102(b)(3); PUB. CO. ACCT. OVERSIGHT BD., PCAOB RELEASE NO. 2003-015, RULES ON INVESTIGATIONS & ADJUDICATIONS A1–8 (2003).

15 *See* PUB. CO. ACCT. OVERSIGHT BD., PCAOB RELEASE NO. 2009-003, FINAL RULE CONCERNING THE TIMING OF CERTAIN INSPECTIONS OF NON-U.S. FIRMS, & OTHER ISSUES RELATING TO INSPECTION OF NON-U.S. FIRMS 5 (2009) [hereinafter FINAL RULE].

non-U.S. law, the PCAOB has acknowledged its commitment "to finding ways to accomplish the goals of the Act without subjecting non-U.S. firms to conflicting requirements."[16] To accomplish this, the PCAOB worked closely with different international counterparts to ensure access to information pertaining to the inspection of non-U.S. firms.[17] This was achieved through joint inspections with the non-US counterparts or reliance on the counterpart's non-US inspection reports to the extent deemed acceptable by the PCAOB.[18]

Still, China remains a jurisdiction where the PCAOB has not performed successful audit inspections. Even though China and the U.S. signed the Memorandum of Understanding in 2012, Chinese authorities have yet to provide cooperation in providing access to information.[19] As of April 2021, mainland China and Hong Kong remain the only two non-inspection jurisdictions that the PCAOB does not have access to.[20]

2. The Exemption of Chinese Companies

In recent years, the Chinese government has worked towards stabilizing its economy through lesser dependence on foreign countries and increasing their global competitiveness.[21] Additionally, with Xi Jinping's guidance, the Chinese Communist Party intends to solidify its control over the private sector.[22] Granting the PCAOB access to audits of Chinese corporations would hinder such a goal, and China has implemented many laws requiring business records produced within China to be maintained there and restricted from being transferred out of China.[23] At the same time, the number of China-based corporations listed in the U.S. has increased dramatically, and if Chinese firms are still exempt from the PCAOB oversight, the HCFAA will affect over 200

---

[16] PUB. CO. ACCT. OVERSIGHT BD., PCAOB RELEASE NO. 2003-019, INSPECTION OF REGISTERED PUBLIC ACCOUNTING FIRMS 5, A2-15-A2-16 (2003).

[17] *See* Order Approving Proposed Rules Relating to Oversight of Non-U.S. Registered Public Accounting Firms, Exchange Act Release No. 34-50291 (Aug. 30, 2004).

[18] FINAL RULE, *supra* note 15, at 5.

[19] Memorandum of Understanding Between the People's Republic of China & the United States of America Related to the Dispute, China-U.S., Sept. 25, 2015, https://ustr.gov/sites/default/files/US-China-MOU-Fin.pdf.

[20] Emmanuel T. De George, et al., Comment Letter on Holding Foreign Companies Accountable Act Disclosure (May 4, 2021), https://www.sec.gov/comments/s7-03-21/s70321-8762475-237541.pdf.

[21] J. Stewart Black & Allen J. Morrison, *The Strategic Challenges of Decoupling*, HARV. BUS. REV. (May-June 2021), https://hbr.org/2021/05/the-strategic-challenges-of-decoupling.

[22] *See* Scott Livingston, *The Chinese Communist Party Targets the Private Sector*, CTR. FOR STRATEGIC & INT'L STUD. (Oct. 8, 2020), https://www.csis.org/analysis/chinese-communist-party-targets-private-sector.

[23] *See* Clayton, et al., *supra* note 4.

current China-based companies and discourage new listings in the United States.[24]

B. The Holding Foreign Corporations Accountable Act ("HFCAA")

1. HFCAA of December 2020

The HFCAA was passed unanimously on December 18, 2020. Under the HFCAA, the SEC is required to identify any U.S. registered public accounting firm that has a branch or office abroad and that the PCAOB is unable to inspect thoroughly due to conflicting laws in the foreign country.[25] The time limit is three years, and if an issuer has noncompliance for three consecutive years, the SEC will ban them from trading on U.S. securities exchanges.[26]

The HFCAA does not state a specific target jurisdiction, but was largely influenced by the Luckin Coffee incident on April 2, 2020, where a China-based company fabricated a large number of its sales.[27] This was only made possible due to the PCAOB's inability to access the corporation's audits since their registered accounting firm was within Chinese borders.[28] The Luckin Coffee incident likely triggered or expedited the passing of the HFCAA, which was passed six weeks after the incident.[29] Furthermore, the HFCAA itself contains provisions that require the disclosure of any board of directors member who is part of the Chinese Communist Party and whether the articles of incorporation of the issuer includes any charter of the Chinese Communist Party.[30] Hence, the HFCAA is clearly passed to combat the conflicting Chinese laws that restrict PCAOB's access to audits of U.S.-listed Chinese companies.

2. The "Amendments" and the Acceleration

In May 2021, the SEC adopted final amendments to regulations of the HFCAA which formally attached Forms 20-F and 10-K in the submission and disclosure process under the HFCAA.[31] Furthermore, in June 2021, the Senate

---

[24] *See* Nancy A. Fischer, et al., *Senate Bill Could Result in De-Listing of Certain Chinese Companies and Non-Chinese State-Owned Enterprises from U.S. Securities Exchanges*, PILLSBURY (June 3, 2020), www.pillsburylaw.com/en/news-and-insights/HFCAA-holding-foreign-companies-accountable-act.html.

[25] Holding Foreign Companies Accountable Act § 2(i)(2).

[26] *Id.* § 2(i)(3).

[27] *See* Merritt, *supra* note 6, at 1.

[28] *See id.* at 1–2.

[29] *Id.*

[30] Holding Foreign Companies Accountable Act § 3(b)(4)–(5).

[31] Holding Foreign Companies Accountable Act Disclosure, Releases No. 34-91364, 86 Fed. Reg. 17528, 17529 (Apr. 5, 2021).

passed the Accelerating Holding Foreign Companies Accountable Act ("AHFCAA") which would reduce the time period from three to two years if signed into law.[32] The AHFCAA would also extend the HFCAA to apply to any Taiwan or Singapore firms which cannot provide audits because of subjection to Chinese laws.[33]

3. The Didi Incident and the "Final Rule"

On June 30, 2021, one of China's largest ride-hailing companies Didi listed for $4 billion on the New York Stock Exchange.[34] Within one day, the stock increased by 15%, bringing the company's market value to $80 billion.[35] However, on July 2, the Cyberspace Administration of China halted Didi's operations and began a cybersecurity review on Didi.[36] The Chinese government stated that this was due to national security reasons, since Didi possessed large amounts of Chinese personal data due to it being arguably the largest ride hailing company in China.[37] However, the Chinese government did not specify any violations that were being made.[38] This crackdown resulted in not only an immediate 30% drop of Didi's newly issued shares two days right after their IPO, but also a $130 billion loss in value on the Nasdaq Golden Dragon Index, a $200 billion loss in the Shanghai market, and a $500 billion loss on the Hong Kong exchange.[39]

More recently, Didi announced its plans to delist from the New York Stock Exchange and to list in Hong Kong for the second quarter.[40] This

---

32 S. 2184, 117th Cong. (1st Sess. 2021).

33 *Senate Passes Kennedy Bill to Strengthen America's Protection Against Fraudulent Foreign Companies*, JOHN KENNEDY U.S. SENATOR FOR LA. (June 22, 2021), https://www.kennedy.senate.gov/public/2021/6/senate-passes-kennedy-bill-to-strengthen-america-s-protection-against-fraudulent-foreign-companies; *see id.*

34 George Calhoun, *DiDi Means War - A Financial Cold War with China*, FORBES (July 19, 2021, 9:32 AM EDT), https://www.forbes.com/sites/georgecalhoun/2021/07/19/didi-means-war—a-financial-cold-war-with-china/?sh=181a1c215ce7.

35 *Id.*

36 Emily Cadman, *Why is China Cracking Down on Ride-Hailing Giant Didi?*, WASHINGTON POST (July 6, 2021, 3:22 AM), https://www.washingtonpost.com/business/why-is-china-cracking-down-on-ride-hailing-giant
-didi/2021/07/05/6ab85a34-dd51-11eb-a27f-8b294930e95b_story.html.

37 *Id.* ("You can't really overstate just how dominant Didi is in ride hailing in China, accounting for 88% of total trips in the fourth quarter of 2020.").

38 *Id.*

39 Calhoun, *supra* note 34.

40 *See* Alexandra Stevenson & Paul Mozur, *With Its Exit, Didi Sends a Signal: China No Longer Needs Wall Street*, N.Y. TIMES (Dec. 5, 2021), https://www.nytimes.com/2021/12/02/business/china-didi-delisting.html; Enoch Yiu, *Didi in Talks for a Second-Quarter IPO in Hong Kong in Its Way to Delisting from New York, Sources Say*, S. CHINA MORNING POST (Jan. 12, 2021, 3:28 PM), https://www.scmp.

decision suggests a shift in the financial and political relationship between U.S. and China, indicating the growing size of the Chinese economy and the Chinese government's control over it.[41] Chinese companies like Didi have listed in U.S. stock exchanges for decades, and hence Didi's delisting symbolizes the furtherance of the decoupling sensation between the two countries.[42]

Additionally, though the reasons for the Chinese government's crackdown are unclear, some commentators argued that this was a response to the ongoing economic climate between the U.S. and China, especially after the passing of the HFCAA.[43] In a letter to Chair Gary Gensler of the SEC, a number of U.S. Senators pointed out the seriousness of the situation, claiming that the timing of the crackdown was "to snatch billions of dollars from American investors" which "could be going directly into CCP coffers."[44] They pushed for the full enforcement of the HFCAA, highlighting the urgency of the situation.[45]

Soon after this incident, on September 22, 2021, the PCAOB proposed the final version of Rule 6100, or the "Final Rule," which includes specific implementation procedures of the HFCAA.[46] The Final Rule clarified that the standard for subparagraph (a)(1) would be a jurisdiction-wide determination for firms headquartered in that specific jurisdiction.[47] Where a firm is "headquartered" is defined as the place of the firm's principal place of business.[48] By adopting a jurisdiction-wide determination, the Final Rule rejects a case-by-case approach or firm-by-firm determination, stating that a firm-specific approach would lack efficiency in accomplishing the HFCAA's purpose.[49]

Additionally, the PCAOB stated that the basis of determinations can be made considering any relevant documents or information, including but not

---

com/business/banking-finance/article/3163075/didi-talks-second-quarter-ipo-hong-kong-its-way-delisting?module=perpetual_scroll_0&pgtype=article&campaign=3163075.

41 *See* Stevenson & Mozur, *supra* note 40.

42 *See id.*

43 *See* Calhoun, *supra* note 34. ("The Financial Cold War, which has been brewing for a while, was openly declared some months ago, neither in China nor in New York, but in Washington D.C. – when both houses of Congress passed *unanimously* the Holding Foreign Companies Accountable Act.").

44 Dan Sullivan, et al., Comment Letter on Holding Foreign Companies Accountable Act Disclosure (July 28, 2021), https://www.sec.gov/comments/s7-03-21/s70321-9124802-247210.pdf.

45 *See id.*

46 PUB. CO. ACCT. OVERSIGHT BD., PCAOB RELEASE NO. 2021-004, RULE GOVERNING BOARD DETERMINATIONS UNDER THE HOLDING FOREIGN COMPANIES ACCOUNTABLE ACT 2 (2021).

47 *Id.* at 13.

48 *Id.* at 19.

49 *Id.* at 22.

limited to: (1) "laws, statutes, regulations, rules, ordinances, and other legal authorities . . . in the foreign jurisdiction . . . "; (2) "the existence or absence of any agreement . . . between the Board and any relevant authority in the foreign jurisdiction regarding the conduct of inspections and investigations . . . "; and (3) "the Board's experience with respect to the foreign authority's (or authorities') other conduct and positions taken relative to Board inspections or investigations."[50]

Firms not headquartered in a noncooperative jurisdiction and hence not falling under section (a)(1) could still be subject to the jurisdiction-wide determination if they fall under section (a)(2), which applies when the firm has an office in a noncooperative jurisdiction.[51] Furthermore, the Final Rule specifically rejects the granting of exceptions.[52]

On November 5, 2021, the SEC officially adopted the Final Rule, and it is immediately effective.[53]

III. Problems Arising from the Act

A. The HFCAA's Oversimplification of the Categorization of Firms in China

Under the HFCAA, one of the requirements of the audit reports that firms must provide to the SEC includes the disclosure of any association with members of the CCP and whether any parts of the articles of incorporation contains a charter of the CCP.[54] Specifically, sections 3(b)(4) and (5) state that firms must disclose:

> (4) the name of each official of the Chinese Communist Party who is a member of the board of directors of--
>
> (A) the issuer; or
>
> (B) the operating entity with respect to the issuer; and
>
> (5) whether the articles of incorporation of the issuer (or equivalent organizing document) contains any charter of the Chinese Communist Party, including the text of any such charter.[55]

The incorporation of such a requirement indicates that the HFCAA is an attempt to combat extensive influences by the CCP on Chinese-listed

---

50 *Id.* at 49.

51 *Id.* at 25.

52 *Id.* at 47.

53 *SEC Approves PCAOB Rule to Establish a Framework for Determinations Under the Holding Foreign Companies Accountable Act*, U.S. SEC. & EXCH. COMM'N (Nov. 4, 2021), https://www.sec.gov/news/press-release/2021-226.

54 Holding Foreign Companies Accountable Act § 3(b)(4)-(5).

55 *Id.*

companies in the U.S. market.[56] Furthermore, since the passing of the HFCAA, the SEC has successfully reached agreements with France and Belgium to allow for cooperative audit inspections of firms subject to inspections in both jurisdictions,[57] thus leaving China and Hong Kong as the only locations that restrict PCAOB audit inspections. Therefore, the HFCAA is a direct attempt at limiting the CCP's influence within the U.S. stock market.

However, if one of the HFCAA's main purposes is to combat CCP influences in the global market, the HFCAA largely fails to do so. This method of delisting China-listed firms based on the location of their headquarters and requiring the identification of CCP members largely underestimates the actual complexity of the CCP's reach on Chinese corporations and fails to achieve the HFCAA's unspoken purposes.

1. Chinese State-Owned Enterprises ("SOE"s) and the Impact of Recent Chinese Laws

To understand the HFCAA's oversimplification of Chinese-listed firms, it is essential to evaluate the recent reforms to the Chinese economic system adopted by the CCP. In the past decade, during the Xi Jinping era, many reforms were made directed towards integrating the CCP's role in Chinese state-owned enterprises ("SOE"s).[58] This began with Xi's 2013 economic reform agenda which aimed to restructure the role of the government and the Chinese market, ultimately shifting the Chinese government's role from an interventionist one to a regulatory one.[59] This led to many CCP issued documents requesting SOEs to involve Party committees in decisions made before presenting them to the board of directors.[60]

---

[56] *See* B. Chen Zhu, et al., *Holding Foreign Companies Accountable Act Expected to Make U.S. Exchanges Less Hospitable to Chinese Companies*, MORRISON FOERSTER (Dec. 9, 2020), https://www.mofo.com/resources/insights/201208-holding-foreign-companies-accountable-act-chinese-companies.html#_ftnref1.

[57] *See* PUB. CO. ACCT. OVERSIGHT BD., STATEMENT OF PROTOCOL BETWEEN THE HAUT CONSEIL DU COMMISSARIAT AUX COMPTES IN FRANCE & THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD IN THE UNITED STATES OF AMERICA 3 (2021); PUB. CO. ACCT. OVERSIGHT BD., STATEMENT OF PROTOCOL BETWEEN THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD OF THE UNITED STATES AND REVISORSNAMNDEN (THE SUPERVISORY BOARD OF PUBLIC ACCOUNTANTS) OF SWEDEN ON COOPERATION AND THE EXCHANGE OF INFORMATION RELATED TO THE OVERSIGHT OF AUDITORS 3 (2021).

[58] *See* Xianchu Zhang, *Integration of CCP Leadership with Corporate Governance: Leading Role or Dismemberment?*, 2019-1 CHINA PERSPS. 55, 58–59 (2019), https://journals.openedition.org/chinaperspectives/8770.

[59] Arthur R. Kroeber, *Xi Jinping's Ambitious Agenda for Economic Reform in China*, BROOKINGS (Nov. 17, 2013), https://www.brookings.edu/opinions/xi-jinpings-ambitious-agenda-for-economic-reform-in-china/; *see* NARGIZA SALIDJANOVA & IACOB KOCH-WESER, THIRD PLENUM ECONOMIC REFORM PROPOSALS: A SCORECARD 3 (2013).

[60] *See* Zhang, *supra* note 58, at 58.

In 2015, the CCP further implemented a "party-building" (*dangjian*) reform that would require SOEs to include CCP organizations in their governance system by establishing this formally in their corporate charters.[61] This document was called the "Guiding Opinions on Deepening State-Owned Enterprise Reforms" and was aimed to legally formalize the CCP's position on SOEs.[62] To execute this reform, the CCP circulated model corporate charter amendments that included provisions which could essentially give CCP members more decision-making rights than the board of directors themselves.[63] Widespread adoption of these amendments by SOEs would reflect the CCP's extensive power and control over the Chinese market.[64]

However, reactions to the proposed amendments suggest a different phenomenon. At first glance, though all SOEs were expected to comply with the new reform, an actual look at the specific charter amendments of SOEs since the 2015 reform suggest resistance to such requirements.[65] Even after three years of the policy's implementation, 12.79 percent of central SOEs and 9.19 percent of local SOEs had not adopted party-building provisions in their charter.[66] Furthermore, amongst those that did adopt a party-building provision, there was a lack of uniformity as to the type of provisions adopted.[67] Additionally, SOEs that are cross-listed or have foreign shareholders are less likely to adopt more intrusive charter provisions.[68]

2. The HFCAA's Failure to Address the CCP's Control

With such a complex economic environment in China, if the HFCAA is indeed meant to combat the Chinese government's influence on corporations listed in the U.S., the HFCAA makes multiple mistakes. First, it fails to recognize the influence of the CCP in forms that are not present as officials of board of directors or in corporation charters as listed in HFCAA section 3(b)(4) and (5).[69] Second, the HFCAA fails to recognize the difference between state ownership and state control.[70]

---

[61] Lauren Yu-Hsin Lin, *Institutionalizing Political Influence in Business: Party-Building and Insider Control in Chinese State-owned Enterprises*, 45 VT. L. REV. 441, 443 (2021).

[62] Lauren Yu-Hsin Lin & Cutis J. Milhaupt, *Party Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance*, 50 J.L. STUD. 187, 193 (2021).

[63] *See id.* at 188.

[64] *See id.*

[65] *See* Lin, *supra* note 61, at 444–45.

[66] *See* Lin & Milhaupt, *supra* note 62, at 203.

[67] *See id.* at 213.

[68] *See id.* at 211.

[69] *See* Holding Foreign Companies Accountable Act § 3(b)(4)-(5).

[70] *See* Curtis J. Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665 (2015).

Under the HFCAA, Chinese SOEs that do incorporate a charter provision would inevitably fall under the categories mentioned in section 3.[71] However, it would be incorrect to assume that the CCP does not have influence outside of these methods.[72] Furthermore, the success of Chinese firms is often reliant on relationships with the CCP, and hence "large firms in China exhibit substantial similarities in their relationship with the state that distinctions based on corporate ownership simply do not pick up."[73] The HFCAA thus presents a method that fails to capture the true relations with the CCP within these Chinese firms, instead opting for a solution that is open to vague interpretations by using terms such as "official[s] of the Chinese Communist Party."[74]

Additionally, the HFCAA reveals a failure to recognize the difference between Chinese state ownership and state control. The Chinese SOEs' resistance to adopting extreme charter provisions reveals a lack of unison especially amongst shareholders and SOE managers.[75] To amend a charter in Chinese SOEs, the board of directors must first submit an amendment proposal which then has to be approved by a supermajority of shareholders.[76] The disuniformity amongst provisions adopted by SOEs reveal a resistance to state control that cannot be captured by examining only the structure of SOEs as the HFCAA requirements do.[77] The HFCAA would thus lead to detrimental effects on SOEs instead of successfully combating the CCP's influence as it intends to.

3. Negative Impacts on Chinese SOEs

The U.S. market is not the only market concerned with issues of transparency. After the CCP began implementing reforms to enhance their presence in SOEs, the Chinese market has also faced negative consequences.[78] For instance, private sector investment in China, as opposed to state-owned public sector investment, has declined from 20% of total investment in China

---

71 *See* Holding Foreign Companies Accountable Act § 3.

72 *See, e.g.*, Wendy Leutert, *The Political Mobility of China's Central State-Owned Enterprise Leaders*, 233 CHINA Q. 1 (2018) (illustrating how the CCP uses the *nomenklatura system* as a mechanism to control leaders of SOEs).

73 Lin & Milhaupt, *supra* note 62, at 188 (quoting Curtis J. Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665, 669 (2015)).

74 *See* Curtis J. Milhaupt & Launen Yu-Hsin Lin, Comment Letter on Holding Foreign Companies Accountable Act Disclosure 1 (Apr. 5, 2021), https://www.sec.gov/comments/s7-03-21/s70321-8587637-230902.pdf.

75 *See* Lin, *supra* note 61, at 444.

76 *Id.* at 457.

77 *See* Milhaupt & Zheng, *supra* note 70, at 701 ("Ownership of the firm *as such* provides relatively little information about the degree of autonomy the firm enjoys from the state.").

78 *See* Zhang, *supra* note 58, at 59.

in 2000 to a mere 1.2% in 2016, suggesting a decline in market transparency.[79] Furthermore, the charter amendment requirement has also raised issues of the lack of protection for minority shareholders, with some companies, especially those in Hong Kong, facing such strong opposition from majority shareholders against the charter amendment requirement that they have been forced to list overseas.[80] With both the HFCAA and the mandatory charter amendment requirements, SOEs may be forced into a predicament and perhaps would have to seek other markets overseas to list in.[81]

B. The HFCAA's Reach

The SEC's three-part mission is to "[p]rotect investors," "[m]aintain fair, orderly, and efficient markets," and "[f]acilitate capital formation."[82] The HFCAA is meant to not only bolster the first goal of protecting U.S. investors, but also guarantee that these U.S. investors are being given the same benefits and guarantees that result from PCAOB inspections.[83] Hence, the HFCAA ultimately aims to protect U.S. investors from foreign companies by promoting transparency because investors may have insufficient knowledge about these foreign companies.

However, the HFCAA fails to achieve this goal because the unclear standards result in the act being both overinclusive and underinclusive. Due to the overinclusiveness of the HFCAA, certain U.S. companies inevitably fall under the HFCAA, hence barring U.S. investors from access to such companies. Additionally, the underinclusiveness of the HFCAA puts U.S. investors at risk because it fails to protect investors from foreign firms that are structured as Variable Interest Entities ("VIE"s). Therefore, the HFCAA falls short of protecting U.S. investors and also bars their access to potential opportunities.

1. The HFCAA's Overinclusiveness: Failure to Protect U.S. Firms

One of the issues that the HFCAA and the Final Rule fail to address is the treatment of U.S. corporations that inevitably conduct business with China. This is most clearly visible through Yum China Holdings, Inc. ("Yum China"), which submitted a comment in response to the SEC's request for

---

[79] *Id.*

[80] *See id*.

[81] *See id.*

[82] *The Role of the SEC*, INVESTOR.GOV: U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/role-sec (last visited Nov. 12, 2021).

[83] *See* Clayton et al., *supra* note 4 ("Where the PCAOB is not able to conduct inspections of audits of foreign-based companies listed in the U.S., investors in these companies do not receive the tangible, quality-enhancing benefits that can result from PCAOB inspections.").

comments regarding the HFCAA.[84] Yum China is incorporated in Delaware with approximately $26 billion in market capitalization.[85] The corporation has been an independently publicly traded company on the NYSE since 2016 and holds the exclusive right to operate brands such as KFC, Pizza Hut, and Taco Bell in China.[86] Furthermore, their common stock has been widely traded and held by many U.S. investors.[87] Yum China also claims that they are governed by Delaware and U.S. federal securities laws and that their Audit Committee exceeds the standards required by the SEC and the NYSE.[88] However, Yum China specifies that due to the nature and structure of their business, it is inevitable that their public accounting firm and the related documentation for the audit reports are all located in China.[89]

Yum China represents a type of case that the HFCAA overlooks. If one of the underlying purposes of the HFCAA is to prevent the CCP from "find[ing] ready investors on U.S. soil to fund their military operations and human rights abuses,"[90] a delisting of corporations such as Yum China would not help achieve this objective. Even in the Final Rule, the PCAOB fails to address this issue.[91] Therefore, the HFCAA presents an oversimplification of the structures of U.S. domestic issuers who may have relations to noncooperative jurisdictions, especially those incorporated in the United States. As Yum China's comment states, "the trading prohibition would force a low-risk U.S. company operating well-known American brands off of the NYSE and restrict its access to the U.S. capital markets."[92] This cannot possibly be the result that Congress was aiming for in passing the HFCAA.

2. The HFCAA's Underinclusiveness: Failure to Address the Issue of Variable Interest Entities ("VIE"s)

One of the purposes of the HFCAA is to require disclosure of the ownership structure of companies such that any Variable Interest Entities ("VIE"s) within the company will be made known to investors. China-based

---

84 *See* Joseph Chan, *Re: File Number S7-03-21*, YUM CHINA HOLDINGS, INC., (May 4, 2021), https://www.sec.gov/
comments/s7-03-21/s70321-8753106-237388.pdf.

85 *See id.* at 2.

86 *About Yum China*, YUMCHINA, https://ir.yumchina.com/about-yum-china (last visited Nov. 12, 2021).

87 Chan, *supra* note 84, at 2.

88 *Id.* at 2–3.

89 *See id.* at 3.

90 John Kennedy, Comment Letter on Holding Foreign Companies Accountable Act Disclosure (Mar. 25, 2021), https://www.sec.gov/comments/s7-03-21/s70321-8734569-237144.pdf.

91 *See* FINAL RULE, *supra* note 15.

92 *See* Chan, *supra* note 84, at 9.

operating companies often structure themselves as VIEs in order to bypass the restrictions in Chinese law that do not allow for companies in certain sectors to have foreign ownership or list exchanges abroad.[93] As VIEs, they have offshore shell companies that help facilitate operations and issue stocks to offshore shareholders via IPOs.[94] VIEs are thus often owned by Chinese citizens but headquartered in cooperative jurisdictions such as the Cayman Islands.[95] The number of Chinese VIEs is extremely high, and even one of the largest e-commerce internet companies in China, Alibaba is structured as a VIE in order to list on the New York Stock Exchange.[96]

VIEs are only made possible because they are conducted through a strictly contractual relationship.[97] These contracts are only enforceable in China, and only if Chinese courts are willing to enforce them.[98] However, VIEs are not officially recognized by the Chinese government, and the Chinese courts have refused to enforce such contracts.[99]

VIEs represent potential risks to U.S. investors who may not necessarily understand the nature of their investments.[100] More specifically, VIEs could potentially be invalidated by China-based issuers or regulators in its entirety with little legal recourse for their foreign investors.[101] Since VIEs are not legally recognized in China and yet are largely owned by Chinese citizens, the CCP could potentially strike down on VIEs at any given moment.[102] Furthermore, if the CCP did choose to do so, it is unclear when and how this would occur, hence posing an extremely large risk to U.S. investors. Even so,

---

93 Gary Gensler, *Statement on Investor Protection Related to Recent Developments in China*, U.S. SEC. & EXCH. COMM'N (July 30, 2021), https://www.sec.gov/news/public-statement/gensler-2021-07-30 [https://perma.cc/9FK3-Y5Y4].

94 *See id.*

95 *See* Jessica Kelly, Comment Letter on Holding Foreign Companies Accountable Act Disclosure 8 (Apr. 30, 2021), https://www.sec.gov/comments/s7-03-21/s70321-8747294-237262.pdf.

96 *See* Kaitlyn Johnson, Note, *Variable Interest Entities: Alibaba's Regulatory Work-around to China's Foreign Investment Restrictions*, 12 LOY. UNIV. CHI. INT'L L. REV. 240, 250 (2015).

97 *See* Ma Mengwei, T*he Perils and Prospects of China's Variable Interest Entities: Unraveling the Murky Rules and the Institutional Challenges Posed*, 43 H.K.L.J. 1061, 1063 (2013) (describing how VIEs are structured as a set of contracts between the wholly foreign-owned company, a Chinese domestic company, and Chinese individuals).

98 Johnson, *supra* note 96, at 253.

99 *See* Samuel Farrell Ziegler, Note, *China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It*, 84 GEO. WASH. L. REV. 539, 548-49 (2016).

100 Gensler, *supra* note 93.

101 *See* Kelly, *supra* note 95, at 9.

102 *See* Johnson, *supra* note 96, at 261 (stating how the Chinese government has been reluctant to strike down on VIEs because they have been beneficial to the Chinese economy, but that recent studies show that they are gradually becoming more likely to nullify the VIE structure).

U.S. investors have invested over $70 billion in VIEs and will still continue to invest in VIEs with little knowledge of the possible repercussions.[103]

The HFCAA's requirement of the disclosure of ownership structure to identify any VIEs within companies is meant to protect U.S. investors from investing in companies that may lead to unforeseen dangers to them. Though the HFCAA attempts to address the issue of VIEs by requiring their disclosure to increase transparency for U.S. investors, the HFCAA fails to address the core issue of VIEs. Currently, even if U.S. investors are aware of the VIE structure of companies, the amount of investment into VIEs is still overwhelming.[104] Requiring disclosure of the VIE structure of companies under the HFCAA may provide transparency in terms of revealing the existence of VIEs within companies but would not provide a solution to the lack of knowledge about VIEs amongst U.S. investors. The SEC has recently attempted to address this issue by releasing disclosure guidelines regarding companies structured as VIEs, requiring information such as the possible risks of the VIE structure and its relationship to Chinese laws.[105] However, it is still unclear whether such disclosures would truly disincentivize investors in investing in VIEs due to current overwhelming numbers, and hence if one of the HFCAA's goals is to decrease VIE investment, it fails to do so.

Furthermore, the HFCAA fails to address situations where companies are organized only in cooperative jurisdictions as VIEs. Based on the terms of HFCAA Section 1, corporations with VIEs could report information stemming from the VIEs themselves instead of those of the underlying corporation and thus would not fall under the regulations of the HFCAA because the VIEs are not headquartered in noncooperative jurisdictions.[106] This would undermine the purpose of the HFCAA, and though multiple comments have been made regarding the issue of VIEs, the Final Rule does not address this problem.[107] Though the SEC's recent guidelines provide certain disclosure requirements for VIEs,[108] neither these new guidelines nor the HFCAA guarantee effective disincentivizing against investment in VIEs,

---

[103] *See* Ziegler, *supra* note 99, at 539.

[104] *See id.* at 542.

[105] *See Sample Letter to China-Based Companies*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/corpfin/sample-letter-china-based-companies (last visited Jan. 14, 2021) ("The Division's comments focus on the need for clear and prominent disclosure regarding the structure of the company, including the relationship between the entity conducting the offering and the entities conducting the operating activities, risks associated with a company's use of the VIE structure, and the potential impact on the company's operations and investors' interests if such structure were disallowed or the contracts were determined to be unenforceable.").

[106] *See* Kelly, *supra* note 95, at 17.

[107] *See, e.g.*, Jeffrey P. Mahoney, Comment Letter on Holding Foreign Companies Accountable Act Disclosure (May 5, 2021), https://www.sec.gov/comments/s7-03-21/s70321-8762476-237521.pdf.

[108] *See Sample Letter to China-Based Companies*, *supra* note 105.

leaving U.S. investors exposed to uncertainty and high risks, which is contradictory to what the HFCAA's purpose is.

IV. IMPLICATIONS OF THE HFCAA

A. Alternative Stock Markets

As the HFCAA continues to delist and push out Chinese companies, many of these companies may inevitably look to list on other markets. Several other countries have already begun to respond to this potential change. For instance, places like the Hong Kong Exchange and London Stock Exchange ("LSE") started to create secondary listings for issuers who may be impacted by the HFCAA.[109] In the case of Didi, the company turned to possibly relisting in Hong Kong.[110] Furthermore, in 2021, the LSE has significantly lowered its standards for listings, including considerably lowering the minimum public ownership level requirement of each company from 25% to 10%.[111] Previously, the differential voting rights structure of Chinese companies, which involves the issuance of multiple classes of shares, prevented them from listing on the LSE.[112] However, the 2021 UK Listing Review for the LSE included a suggestion to allow for companies with dual class share structures to list, thus opening up the path for Chinese companies to list on the LSE.[113]

Therefore, by delisting Chinese companies from U.S. stock exchanges, the HFCAA would be decreasing opportunities for U.S.-China market growth and instead pushing potential investors and issuers to other countries, especially due to the undeniably large size and influential presence of Chinese companies. This can lead to increased competition with other stock exchanges, creating a disadvantage for U.S. markets.

---

[109] *See* Thomas Egan, et al., *North America: Holding Foreign Companies Accountable Act – How Will It be Implemented and What Can Companies Do?,* GLOB. COMPLIANCE NEWS (Mar. 10, 2021), https://www.global compliancenews.com/2021/03/10/north-america-holding-foreign-companies-accountable-act-how-will-it-be-implemented-and-what-can-companies-do-02032021/.

[110] *See* Yiu, *supra* note 40. However, Didi did not ultimately follow through with their Hong Kong relisting. *See Didi Plunges 44% After Halting Planned Hong Kong Stock Listing*, BLOOMBERG (Mar. 10, 2022, 8:25 PM PST), https://www.bloomberg.com/news/articles/2022-03-11/didi-said-to-halt-hong-kong-listing-plan-on-cybersecurity-probe#xj4y7vzkg.

[111] Sophie Mellor, *How London Became 2021's Hub for Hot New Tech IPOs*, FORTUNE (July 31, 2021, 3:00 AM PDT), https://fortune.com/2021/07/31/london-lse-tech-ipos-2021-wise-darktrace-deliveroo-klarna-revolut-monzo/.

[112] Qingxiu Bu, *The Anatomy of Holding Foreign Companies Accountable Act (HFCAA): A Panacea or a Double-Edge Sword?*, 16 CAP. MKTS. L.J. 503, 516 (2021).

[113] *Improving the environment for companies to go public in London,* UK LISTING REVIEW 11 (Mar. 3, 2021), https://assets.publishing.service.gov.uk/government/uploads/system /uploads/attachment_data/file/966133/UK_Listing_Review_3_March.pdf.

B. The Value and Cost of PCAOB Audit Inspections

Due to the prevailing cross-border nature of current businesses, capital markets now place a strong emphasis on transparency, which has been reflected through audit inspections.[114] Hence, some research shows that not granting PCAOB the power to conduct audit inspections actually had a negative impact on the stock markets of those countries, including China.[115] Though it is true that the companies may receive some benefits from granting such inspections and increasing transparency, ultimately, the choice of whether or not to grant audit inspections still falls within the power of authorities of the jurisdiction. Companies that are being affected by the HFCAA first-hand have essentially no choice but to delist since they are unable to make such changes themselves. Thus, though some may argue that the HFCAA is beneficial for countries since granting audit inspections will be beneficial to them, it is still the companies themselves who directly carry the burden of the negative effects.

C. Amending the HFCAA

To combat the lack of understanding of Chinese corporations, the HFCAA should be amended to better capture the influence of the CCP amongst companies. Specifically, instead of requiring the disclosure of CCP members on the board of directors, which would inevitably be a majority if not all of the board, the HFCAA should be amended to require disclosure of each board member's past interactions with the CCP.[116] This includes possible roles or positions they have served in within the CCP and other individual links to the CCP.[117] Though this is still not a concrete determination of the influence of the CCP within the company, this type of disclosure would serve as a much more detailed portrayal of the individual's relation to the CCP instead of a mere disclosure of membership. Through this, the PCAOB would more likely be able to make a determination of the CCP's influence in the particular company.

The current Final Rule adopts a jurisdiction-based approach based on a company's headquarters to determine whether they are subject to the HFCAA. However, this approach is problematic because as seen in Part II, it is overinclusive and exposes U.S. companies engaged in extensive business in China to unfair expectations.[118] Therefore, in order to better fulfill the purpose

---

[114] *See* TRACY GU, ET AL., DOES THE PCAOB'S CROSS-BORDER AUDIT OVERSIGHT AFFECT THE VALUE OF CROSSLISTINGS? EVIDENCE FROM A REGULATORY BREAKDOWN 13 (2017), https://af.polyu.edu.hk/media/6538/6_dan_a_simunic.pdf.

[115] *See id.* at 41.

[116] *See* Kelly, *supra* note 95, at 3–4.

[117] *See id.*

[118] *See supra* Section II.B.1.

of the HFCAA and protect U.S. based issuers, the SEC should implement a case-by-case or firm-by-firm approach. This would enable the PCAOB to maintain the autonomy to request audit information if deemed necessary but would not subject low-risk U.S. based companies to the risk of having to delist from the U.S. stock market. Due to the large number of U.S. investors in such companies, it would thus be best for the SEC to adopt a case-by-case approach.

In terms of the underinclusiveness of the HFCAA in its failure to address companies with the VIE structure, the HFCAA should be amended to have two sets of standards for VIE structured companies and non-VIE structured companies. The main issue of VIEs is its unpredictability and the lack of knowledge that U.S. investors possess about them,[119] and thus the SEC should adopt stricter standards for companies with the VIE structure than those without. Such a change would lower the incentive for companies to switch into a VIE structure in order to surpass the audit inspection standards proposed under the HFCAA and would prevent further creation of VIEs.

D. Potential Retaliation by the Chinese Government

One of the main concerns going forward after the full implementation of the Final Rule is the reaction of the Chinese government. In the worst-case scenario, some speculate that the Chinese government could implement the same standards for U.S. companies conducting business in China.[120] This would largely harm U.S. companies' abilities to compete, and one of the main sectors where U.S. companies will likely suffer is in the technology field. If U.S. companies are unable to compete in the Chinese market as a result of retaliation from the Chinese government, this would significantly impact the U.S.'s stance as one of the leading producers in the technology industry.[121] Therefore, it is important to consider not only the present effects of the HFCAA, but also the potential long-term and future ramifications as well when considering how the HFCAA should be implemented.

V. CONCLUSION

As capital markets continue to expand globally, the law should be structured in ways that can successfully protect investors while also minimizing unwarranted damages to unintended parties. The HFCAA was created to grant the PCAOB the ability to conduct audit inspections in

---

119 *See supra* Section II.B.2.

120 *See* Tianjiu Zou, *The 'Holding Foreign Companies Accountable Act' May Harm US Tech Leadership*, ATLANTIC COUNCIL (Sept. 3, 2020), https://www.atlanticcouncil.org/blogs/new-atlanticist/the-holding-foreign-companies-accountable-act-may-harm-us-tech-leadership/.

121 *See id.*

noncooperative jurisdictions.[122] However, the HFCAA presents an oversimplification and lack of understanding of Chinese corporations, leading to the inability to accomplish the purpose of limiting CCP influences in global markets.[123] Additionally, the HFCAA is too overinclusive, which may lead to the unforeseen delistings of U.S. based issuers.[124] On the other hand, the HFCAA is also underinclusive as it provides no guidance on how to combat VIEs.[125] Therefore, in order to combat these issues, the HFCAA must be amended to be able to fully accomplish Congress's intended purposes of increasing transparency amongst the U.S. stock market and promoting fairness and integrity for U.S. investors.

---

122 *See* Holding Foreign Companies Accountable Act.

123 *See supra* Section II.A.

124 *See supra* Section II.B.1.

125 *See supra* Section II.B.2.