# Delisting Has Not Been Derailed

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**What happened**
The China Securities Regulatory Commission on Saturday published a proposed rule change for offshore-listed companies, removing a requirement that audit inspections be conducted by Chinese government agencies.

**The context**
China's securities regulators have been negotiating with their US counterparts over the requirement, included in the Holding Foreign Companies Accountable Act (HFCAA) passed in December 2020, that Chinese companies listed in the US fully comply with US audit oversight or be delisted.

The crux of the issue is that US regulators require full access to Chinese firms' audit working papers, which the companies cannot supply without permission from Chinese regulators.

The 2020 law requires firms to be delisted if they do not comply with US audit requirements for three straight years, so Chinese companies could be delisted as early as 2024 (and possibly sooner if the law is changed).

The US Securities & Exchange Commission has so far publicly identified 11 Chinese firms that are at risk of delisting, but the issue is the same for all the roughly 280 Chinese companies on US exchanges.

The proposed rule change seemed to be a step toward addressing US demands, and came amid reports that the CSRC is trying to offer a solution that would allow US regulators access to audit materials for most, but not all, US-listed Chinese firms. Shares of US-listed Chinese companies rose Friday on the news.

**What it means**
While the CSRC's proposal indicates it is trying to find a solution, the language of the rule does not appear to address the core US demand of unfettered access to audit materials.

The revision deletes the phrase "on-site inspection shall be conducted mainly by China's regulatory agencies, or rely on the inspection results of China's regulatory agencies" from a 2009 regulation.

On the face of it, this might appear to open the door for the US audit oversight body, the Public Company Accounting Oversight Board (PCAOB), to directly inspect the audit papers of US-listed Chinese companies.

The new language that replaces this phrase, however, still requires companies to get approval from Chinese regulators before sharing any audit materials: "domestic enterprises shall report to the CSRC or the relevant competent authorities in advance before cooperating with the overseas securities regulatory authorities."

This requirement is consistent with China's revised Securities Law from 2020, article 177 of which states that "overseas securities regulatory bodies shall not directly conduct investigations.

Without the consent of the CSRC and relevant departments…no entity or individual may provide documents and materials." The Data Security Law that came into effect in September 2021 contains similar language.

The revised regulations also emphasize that companies are responsible for getting permission for the transfer of any documents which might "disclose state secrets or harm the state and public interests."

Although the CSRC said it expects that it would be "very rare" for company materials to contain such sensitive information, the onus is still on the companies to get regulatory permission.

**What comes next**

Despite these new developments, the most likely outcome is still, as has been the case since the passage of the US law in 2020, that the majority of Chinese companies are eventually delisted from US exchanges.

Judging from the text of China's rules, for the PCAOB to inspect a US-listed firm would first require the CSRC to approve a joint inspection, and then to give specific permissions for interviews or documents requested during the inspection. This does not seem likely to make for a smooth, timely process.

The CSRC may indeed be sincerely willing to speedily approve almost all requests from US regulators. But its insistence on retaining the ability to deny access to specific companies or documents is unlikely to pass muster with US regulators, who are insisting on an all-or-nothing approach.

The PCAOB's published interpretation of the HFCAA is that it will make a "jurisdiction-wide determination" of whether it is unable to inspect firms from a particular country because of "a position taken by an authority in the foreign jurisdiction." It specifically rejected doing so on a firm-by-firm basis.

In a Bloomberg interview last week, SEC Chairman Gary Gensler also emphasized that the law requires complete access to audit materials, and that if the PCAOB is refused full access to even one firm, it would mean that Chinese regulators are not complying with the requirements.

In the short term, this move by the CSRC raises the possibility of new pilot inspections by the PCAOB, but as in the past these pilots are unlikely to satisfy US regulators. Given the legal and institutional constraints on both sides, it is highly unlikely that US and Chinese regulators will be able to reach an agreement that will avert delisting.

One possible alternative might be for Chinese companies deemed potentially "sensitive" to voluntarily delist from the US, and for the CSRC to allow unfettered audit access to the remaining uncontroversial ones. But the "sensitive" category is likely to cover both state enterprises and internet platforms, which account for most of the large and actively traded Chinese stocks in the US.

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