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The Implications of the "Big Four" Suspension Ruling




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The long-running dispute between the Securities and Exchange Commission ("SEC") and the Chinese affiliates of the "Big Four" accounting firms took a surprising turn on January 22, 2014, when a U.S. Administrative Law Judge ("ALJ") ruled that the Chinese affiliates of the Big Four should be suspended for six months for refusing in the past to turn over audit documents for certain U.S.-listed Chinese companies under investigation by the SEC. The Big Four filed an appeal of that decision on February 12, 2014, staying the ALJ's ruling and allowing the Big Four to continue practicing before the SEC while the appeal is pending. However, if the ALJ decision stands, it could leave more than 130 U.S.-listed Chinese companies and numerous multi-nationals with Chinese operations scrambling to replace their China-based auditors. While the lengthy appeals process is likely to delay the decision's full impact, the ruling already has generated significant uncertainty for U.S.-listed Chinese companies, as well as U.S.-listed multi-nationals with significant operations in China. The decision may complicate ongoing efforts to resolve the diplomatic dispute between U.S. regulators and the Chinese authorities at a time when these efforts appear to be making significant headway. Diplomatic negotiations recently led to an agreement between U.S. and Chinese authorities to share previously embargoed audit documents, resulting in the SEC's dismissal of a similar action against Deloitte's Chinese affiliate. Nevertheless, the SEC has continued to seek harsh sanctions in the Big Four matter, creating uncertainty as to whether the recent diplomatic progress will resolve the matter for the Big Four and their clients any time soon.

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The Prelude to the ''Big Four'' Suspension

Recent years have seen a marked increase in the number of China-based companies traded on U.S. stock exchanges. These U.S.-listed Chinese companies, as well as U.S. companies with substantial Chinese operations, have encountered questions about their accounting and disclosure practices from U.S. regulators.

In investigating potential fraud involving China-based companies, the SEC has relied heavily on Section 106 of the Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley''), which requires foreign affiliates of U.S. accounting firms to produce their audit work papers to the Public Company Accounting Oversight Board (the ''PCAOB'') and SEC in connection with any investigation with respect to that audit report. This provision was strengthened with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank''), Section 929J, which requires any accounting firm that relies on the work of a foreign affiliate in issuing an audit to produce the foreign firm's audit work papers upon request, and to secure the foreign firm's agreement that it will cooperate as a condition of such reliance.

Against this backdrop, China-based affiliates of the Big Four accounting firms—Ernst & Young, Deloitte, KPMG and PricewaterhouseCoopers—were asked to provide audit papers to U.S. regulators after a series of accounting scandals involving U.S.-listed Chinese companies in 2011. The Big Fours' affiliates refused to comply with the SEC's Section 106 requests, arguing that they were not at liberty to produce the documents because doing so could violate China's Law on Guarding State Secrets, thus risking severe criminal sanctions, including jail time, for their employees. In December 2012, the SEC initiated a proceeding charging the Chinese affiliates of the Big Four, and a former affiliate of BDO International, Ltd.—now Dahua CPA—with violating the Securities Exchange Act and Section 106 of Sarbanes-Oxley, as amended, by refusing to produce the audit documents and work papers in violation of their legal obligations as foreign public accounting firms.

The action was not the first of its kind. In September 2011, the SEC brought an action in district court seeking to enforce a subpoena against Deloitte's Chinese affiliate demanding audit documents related to the SEC's investigation of one of its former China-based clients. In July 2012, however, the SEC sought—and the court later granted—a six month stay in the proceedings so that the SEC could continue negotiations with Chinese regulators regarding cross-border enforcement cooperation and sharing the requested audit documents. The SEC engaged in discussions with its Chinese counterpart, the China Securities Regulatory Commission (the ''CSRC''), in the hopes of reaching a resolution. However, on the same day that the SEC brought charges against the Big Four in December 2012, it also filed a motion to lift the stay in the Deloitte proceedings, citing stalled negotiations.

With the December 2012 proceeding pending against the Big Four, United States and Chinese regulators continued periodic negotiations throughout 2013 with the aim of reaching an agreement to allow for the production of China-based audit papers to U.S. authorities. In May 2013, the PCAOB announced it had reached a Memorandum of Understanding (''MOU'') with the CSRC and Ministry of Finance of China that was intended to make it easier for regulators from both countries to gain access to audit information when investigating potential accounting and securities fraud.

In July 2013, the negotiations appeared to make further headway when the CSRC announced at the 2013 annual U.S.-China Strategic and Economic Dialogue that it would begin providing audit work papers to the SEC and the PCAOB. This development seemed to bear fruit in December 2013 when auditors disclosed in legal filings that Chinese authorities had provided certain audit documents to U.S. regulators and that additional documents would be forthcoming. Although some documents requested from the Big Four began flowing to U.S. regulators as a result—a fact noted by the ALJ's January 22 order—not all of the audit documents requested were turned over.

In light of this progress, the Big Four sought to have the December 2012 administrative action dismissed, but the SEC continued to press for substantial sanctions. Of particular note is the fact that the SEC sought not only a temporary sanction or monetary penalties against the Big Four, but permanent suspension of the Big Four's affiliates in China. The SEC's aggressiveness in this regard surprised many observers who worried that a permanent Big Four suspension could have severe negative consequences for U.S. investors.

The ''Big Four'' Suspension Ruling

In spite of the diplomatic headway, on January 22, 2014, U.S. ALJ Cameron Elliot held that the Big Four auditors violated Section 106 of Sarbanes-Oxley by willfully refusing to provide the requested audit work papers to the SEC. Contrary to the predictions of many legal analysts, Judge Elliot—a former federal prosecutor—sanctioned the Chinese affiliates of the Big Four by suspending them for six months. In a strongly-worded 112 page opinion, which followed weeks of evidentiary hearings, Judge Elliot evinced little sympathy for the auditors' assertion that producing the documents would violate Chinese law and expose their employees to jail time. It is interesting to note that based on the facts relayed in the opinion, the affiliates wanted to produce documents and in some instances provided the documents to the Chinese regulators. The affiliates, however, were specifically ordered by the CSRC that any productions to U.S. authorities would violate Chinese law and that no documents should be produced. The ALJ ignored the difficult situation in which the firms found themselves, noting that ''to the extent [the Big Four] find themselves between a rock and a hard place, it is because they wanted to be there.'' Judge Elliot focused instead on the Big Four's ''flouting of the Commission's regulatory authority,'' in spite of uncontroverted testimony by representatives from each of the Big Four that they were more than willing to comply with the SEC's document requests.

In light of the evidence of their rebuffed attempts to comply with the Section 106 requests, the Big Four argued that the SEC had failed to demonstrate the requisite ''willful refusal to comply'' with Section 106 of Sarbanes-Oxley because their actions did not demonstrate bad faith or bad intent, but rather evidenced concern for their Chinese employees and compliance with Chinese law. However, under Judge Elliot's strict inter-

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pretation of the statutory language, the Big Four's motive for non-compliance was irrelevant to the question of liability. That question, Judge Elliot explained, was a simple one, ''so long as [the Big Four] knew of the request and made a choice not to comply with it.''

In deciding the level of sanction to impose, Judge Elliot relied on what he viewed as a lack of good faith, explaining that the Big Four ''[knew] that if called upon to cooperate in a Commission investigation into their business, they must necessarily fail . . . Such behavior does not demonstrate good faith, indeed, quite the opposite—it demonstrates gall.'' However, Judge Elliot declined to grant the SEC's requested permanent suspension, deciding that the SEC had failed to produce evidence of scienter. Ultimately, Judge Elliot reprimanded and suspended the Big Four from practicing before the SEC or preparing documents filed with the SEC for a period of six months. Judge Elliot also reprimanded Dahua CPA, but did not suspend the firm, explaining that the firm already had withdrawn from its China-based issuers as clients.

The Implications of the ''Big Four'' Ruling for U.S. Investors

Industry analysts have expressed concern that the Big Four suspension could create substantial challenges for non-parties to the proceeding who rely on the Big Four's services in China. However, Judge Elliot responded skeptically to that argument, countering that ''it does not follow that smaller firms would not be 'adequate' as auditor.'' It is worth noting, however, that the SEC has taken an aggressive posture recently in charging several small U.S.-based auditors of Chinese companies for failing to comply with U.S. auditing standards and exercise appropriate professional care, including Patrizio & Zhao, which the SEC proposed as a potential substitute for the Big Four.

Despite the attention Judge Elliot's decision has garnered, the ruling is unlikely to have an immediate impact. On February 12, 2014, the Big Four appealed Judge Elliot's ruling, which is stayed pending resolution of the appeal. In their appeal, the Big Four argue that the potential effects of the suspension—which could leave dozens of U.S.-traded Chinese companies without an auditor—are so sweeping and damaging that the Commission itself should weigh in on the matter. The Commission could uphold, overturn or modify the ruling, or send it back for further proceedings, a decision complicated by the fact that the Commission itself approved the enforcement action. A decision by the SEC could be months away or longer, however, and any SEC decision could be appealed to the U.S. Court of Appeals in Washington. The SEC's enforcement division also asked the Commission to review the ruling, arguing that harsher penalties are warranted. Sticking to its guns, the enforcement division claimed the SEC should consider whether the firms should be suspended for a longer period, or even permanently barred. Dahua CPA also joined the Big Four's appeal.

Judge Elliot's ruling therefore will not directly impede the 2013 annual reporting of U.S.-listed Chinese stocks. Nevertheless, the decision sparked a sell-off in shares of many premier U.S.-listed Chinese companies. Whether the decision will impact the recent surge in U.S. initial public offerings by Chinese companies—in 2013, Chinese companies flocked to the U.S. public securities markets in the greatest numbers since 2010—remains to be seen.

Continued Diplomatic Progress

Further diplomatic negotiations between U.S. and Chinese regulators may be forthcoming to address any remaining policy differences and ultimately resolve the dispute. The public version of Judge Elliot's opinion included significant redactions because, according to Judge Elliot, ''some passages of this initial decision discuss the [SEC], the CSRC, and their interaction more candidly than is customary in diplomatic circles.''

Recent Chinese-language press has also reported continuing discussions between the CSRC and the SEC in the wake of the suspension ruling. In fact, the CSRC has been sharply critical of Judge Elliot's ruling, announcing that the six-month suspension ''disregards China's efforts and progress made in providing audit documents and pushing China-U.S. cross-border law-enforcement cooperation ahead.''

Curiously, and in stark contrast to the SEC's continuing advocacy for harsher sanctions again the Big Four, recent diplomatic progress has prompted a more lenient approach by the SEC with respect to the subpoena enforcement action against Deloitte's Chinese affiliate in September 2011. On January 27, 2014, less than a week after Judge Elliot's ruling, the SEC agreed to dismiss the action, citing Deloitte's cooperation with the CSRC, who in turn provided a ''substantial volume of documents'' to the SEC. While the dismissal does not directly impact the Big Four case, the announcement portends a desire on the Commission's part to ultimately resolve the matter through diplomatic means.

Furthermore, on February 5, 2014, the PCAOB announced that it was close to reaching an agreement with Chinese authorities permitting it to inspect the audit work of PCAOB-registered firms based in China. PCAOB chairman Jim Doty acknowledged that draft agreements were being exchanged and that the parties had yet to finalize a protocol for inspecting the documents. However, in a possible nod to Judge Elliot's ruling, Doty noted the need to resolve the conflict soon, emphasizing that ''[t]his is the end of the line.'' The U.S. Chamber of Commerce also has thrown its weight behind a diplomatic resolution, recently announcing plans to lobby U.S. officials to reach a diplomatic deal with China.

Planning for the Worst

Pending any diplomatic resolution, more than 130 U.S.-listed Chinese companies and numerous multinationals with Chinese operations will be forced to replace their China-based auditors or risk de-listing from U.S. exchanges, should the ruling ever take effect. The large U.S.-listed Chinese companies will face particular challenges, as—leaving aside concerns regarding the audit quality—smaller audit firms may not employ sufficient personnel to manage their audits.

Instead, some companies that use the Big Four's Chinese affiliates are making contingency plans to bridge the potential six month gap by reportedly temporarily turning to the non-sanctioned Hong Kong or Singapore affiliates of the Big Four. These affiliates themselves have not been immune to scrutiny—in August 2012,

Hong Kong's Securities and Futures Commission brought an enforcement action against an Ernst & Young affiliate for its failure to produce accounting records related to a former China-based client—but as long as U.S.-listed companies do not have a Hong Kong or Singapore listing, they are not subject to the jurisdiction of local audit authorities in either location.

Finally, because the suspension sanction was imposed on the Chinese affiliates and not their partners, the audit firms may be able to fashion a work-around whereby individuals are transferred temporarily to non-sanctioned affiliates of their firms to assist with the necessary audit work.

Conclusion

The problem is ultimately a diplomatic one. In our view, in light of the Commission's reversal in the Deloitte matter and continued diplomatic progress, the most likely result will be that a diplomatic solution will be reached before the ruling—now stayed by the Big Four's appeal—ever takes effect. However, companies doing business in China should be aware of the significant risks posed by the suspension and put in place contingency plans in the event that a diplomatic solution cannot be reached.

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