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SEC ENFORCEMENT

SEC's Charges Against Chinese Affiliates Of U.S.-Based Accounting Firms Have Broad Implications

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The recent initiation of an administrative action by the United States Securities and Exchange Commission (the "SEC") against the Chinese affiliates of five major accounting firms significantly ups the stakes in the dispute between the SEC and its Chinese counterpart, the China Securities Regulatory Commission (the "CSRC"), over the SEC's ability to access materials related to China-based companies which are publicly listed in the U.S. While this dispute has been both long-running and increasingly public, it remains unclear how it might be resolved absent direct government-to-government negotiations. Indeed, no market consensus of likely outcomes has developed despite the far-reaching implications for not only the accounting firms charged by the SEC but also the hundreds of China-based, U.S.-listed companies (which have a combined share value running into the tens of billions of dollars), as well as those multinational corporations which rely on the Chinese affiliates of their U.S. accounting firms for purposes of completing their consolidated audits.

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What is clearer, however, is the sequence of events leading up to this point strongly suggests this is a political issue at heart – and not simply a conflict between two legal systems – that will ultimately necessitate a political compromise to achieve a long-term resolution of the matter.

This article reviews the background of the dispute and the positions of the SEC and CSRC, the current impact on the market, and possible resolutions.

Where We Are Today

As part of its effort to investigate potential accounting fraud at unnamed China-based U.S.-listed companies, on December 3, 2012 the SEC charged the Chinese affiliates of the "Big Four" accounting firms – Ernst & Young, Deloitte, KPMG and PricewaterhouseCoopers –

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and BDO[1] (collectively, ''Chinese Affiliates'') with violating the Sarbanes-Oxley Act and in turn the Securities Exchange Act.[2] In this administrative action, the SEC claims that it sought to obtain audit documents and work papers from each of these firms in connection with its investigation of nine publicly traded China-based clients and that the firms have willfully refused to produce such documents in violation of their legal obligations as foreign public accounting firms registered with the U.S. Public Company Accounting Oversight Board.[3] This administrative action builds on similar, unrelated district court and administrative proceedings brought by the SEC in September 2011 and May 2012, respectively, against Deloitte's Chinese affiliate demanding audit documents related to SEC investigations of two of its China-based clients.[4] At the request of the SEC, its May 2012 administrative action against Deloitte's Chinese affiliate has since been consolidated with its more recent industry-wide administrative action.[5]

In both the consolidated administrative action and the Deloitte district court matter, the Chinese Affiliates argue that they cannot produce the requested documents because doing so would violate China's Law on Guarding State Secrets, as well as other related laws, regulations, and policies (collectively, ''China's State Secrets Laws''), and could result in severe criminal sanctions for the firms and the individuals involved with productions.[6] Indeed, on October 10, 2011, Deloitte and five other large Chinese accounting firms met with the CSRC and China's Ministry of Finance to discuss the U.S. regulators' requests and were later informed by the CSRC that they must comply with China's States Secrets Laws that require prior authorization before providing audit archives and other documents overseas, and the failure to do so will result in legal liabilities.[7] The CSRC also informed Deloitte that the SEC should work with the CSRC to find a solution regarding the documents that it requested.[8] The SEC does not dispute that the CSRC could punish Deloitte, and presumptively the other Chinese Affiliates, if they comply with the SEC's subpoena and produce the documents.[9]

The SEC claims in its administrative action that the Chinese affiliates of the Big Four and BDO have violated Section 106 of the Sarbanes-Oxley Act, as amended by Section 929J of the Dodd-Frank Act, which requires a foreign public accounting firm to ''produce [its] audit work papers'' and ''all other documents of the firm related to any [ ] audit work'' relied upon by a registered public accounting firm.[10] At issue is whether the failure of the Chinese Affiliates to produce the documents requested on the ground that they are precluded from doing so by China's State Secrets Laws constitutes a willful violation of Section 106.[11] If the Administrative Law Judge (''ALJ'') finds in the affirmative, possible sanctions under SEC Rules of Practice Rule 102(e)(1)(iii) range from censure to being temporarily or permanently denied from appearing or practicing before the SEC in any way (i.e., they could be barred from completing audits for U.S.-listed companies).[12]

An initial resolution to the Staff's administrative action against the Chinese Affiliates should be reached in a fairly quick manner. Under the SEC's Rules of Practice and the order initiating this proceeding, the ALJ ''shall issue an initial decision no later than 300 days after the filing of the order.''[13] In the typical SEC administrative matter, the hearing happens within four months of filing, then the parties have two months to complete post trial briefing, and the judge takes four months to issue his or her initial decision. Following an initial decision by the ALJ, the parties may petition the

[1] These Chinese affiliates include Deloitte Touche Tohmatsu Certified Public Accountants Ltd., Ernst & Young Hua Ming LLP, KPMG Huazhen (Special General Partnership), PricewaterhouseCoopers Zhong Tian CPAs Limited and BDO China Dahua Co. Ltd.

[2] *See SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents*, SEC Release 2012-249, Dec. 3, 2012, http://www.sec.gov/news/press/2012/2012-249.htm [hereinafter SEC Release 2012-249]; Order Instituting Administrative Proceedings, *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116 (SEC Dec. 3, 2012), *available at* http://www.sec.gov/litigation/admin/2012/34-68335.pdf.

[3] *See* SEC Release 2012-249, *supra* note 2; Order Instituting Admin. Proceedings [hereinafter Admin. Order], *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116 (SEC Dec. 3, 2012).

[4] *See SEC Files Subpoena Enforcement Action Against Deloitte & Touche in Shanghai*, SEC Release 2011-180, Sept. 8, 2011, http://www.sec.gov/news/press/2011/2011-180.htm; *SEC Charges Deloitte & Touche in Shanghai with Violating U.S. Securities Laws in Refusal to Produce Documents*, SEC Release 2012-87, May 9, 2012, http://www.sec.gov/news/press/2012/2012-87.htm.

[5] *See* Case Docket, *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116 (SEC Jan. 18, 2013).

[6] *See* Admin Order at ¶ 17, *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116; Respondent DTTC's Statement of Points and Authorities Opposing the SEC's Application for Order to Show Cause and Order Requiring Compliance with a Subpoena [hereinafter DTTC's Show Cause Opposition] at 1, 5-6, 24-25, *SEC v. Deloitte Touche Tohmatsu CPA LTD.*, No. 11-0512 (D.D.C. April 11, 2012) (No. 23) (citing Tang Declaration).

[7] DTTC's Show Cause Opposition at 24-25, *Deloitte Touche Tohmatsu*, No. 11-0512 (No. 23) (citing Warden Declaration, Exhibit 20).

[8] *Id.*

[9] *See* Opposition of Deloitte Touche Tohmatsu CPA LTD. to Motion to Lift Stay at 6-7, *Deloitte Touche Tohmatsu*, No. 11-0512 (Jan. 7, 2013) (No. 42).

[10] Section 106 of the Sarbanes-Oxley Act, 15 U.S.C. § 7216(b)(1); *see also* Admin. Order at ¶¶ 7, 19-21, *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116.

[11] *See* Division of Enforcement Motion to Consolidate at 4-5, *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116 (Dec. 7, 2012).

[12] SEC Rules of Practice, Rule 102(e)(1)(iii).

[13] Admin Order at 6, *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116; SEC Rules of Practice, Rule 360(a)(2).

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SEC to review the decision or the SEC on its own initiative may order a review.[14] ''A person aggrieved by a final order of the Commission'' may then obtain review by the U.S. Court of Appeals and move to have the SEC's decision stayed pending the outcome of the appeal.[15]

What Brought Us to This Point

The SEC's Perspective

The SEC's administrative action stems from its difficulty obtaining the documents necessary to conduct its investigations of China-based companies. As SEC Commissioner Luis Aguilar recently noted, these investigations have been ''hampered by the lack of access to relevant documents, many of which are overseas.''[16] Specific to the charges against these firms, Robert Khuzami, former Director of the SEC's Division of Enforcement, stated that ''[o]nly with access to work papers of foreign public accounting firms can the SEC test the quality of the underlying audits and protect investors from the danger of accounting fraud,'' and ''[f]irms that conduct audits knowing they cannot comply with laws requiring access to these work papers face serious sanctions.''[17] As to Khuzami's latter point, however, the issue of whether and to what extent these Chinese Affiliates and similarly situated firms can be sanctioned by the SEC for failing to produce the requested documents hinges on the outcome of its consolidated administrative proceeding.

This action comes at a crucial time as it appears that negotiations between U.S. and Chinese regulators to reach a resolution regarding their conflicting laws have stalled or even fallen apart entirely. The briefing papers filed by both parties in the district court case against Deloitte's Chinese affiliate shed light on these negotiations and indicate that the SEC attempted to reach a resolution with the CSRC on a number of occasions. According to the court papers filed by the SEC, since 2009 the SEC has sent 21 requests to the CSRC for assistance in connection with various ongoing investigations and had over 30 communications with the regulator, but received no work papers or meaningful response.[18] In July 2012, the SEC successfully sought a stay in its Deloitte district court proceeding so that it could continue to negotiate with Chinese regulators regarding cross-border enforcement cooperation and obtaining access to the requested audit documents.[19] While the CSRC eventually agreed with the SEC, in October 2012, that these requests for audit work papers are covered by a memorandum of understanding signed between the U.S. and China, it has said that it will not produce documents unless the SEC refrains from using the documents in relation to legal proceedings and allows the CSRC to determine which documents are responsive to the requests.[20] These are terms to which the SEC will not agree.

The SEC seems to have given up on a possible resolution with the CSRC, acknowledging in court papers that ''at this point in time SEC staff believes there is nothing left to negotiate or discuss with the CSRC on this topic, unless and until the CSRC produces documents'' in response to the SEC's outstanding requests.[21] As a result of this stalemate, on December 3, 2012, the SEC both moved to lift the stay in the Deloitte district court proceeding and brought its administrative action against the Chinese Affiliates.[22] Because of overlapping issues, Deloitte asked that the stay in the district court proceeding be extended at least until the SEC's consolidated administrative action is resolved.[23] On March 4, 2013, the Court granted the SEC's motion and lifted the stay.[24]A hearing on the merits in which the Court apparently focused on the technicalities in the case, including service by the SEC, took place on March 13, 2013.[25]

Rather than continuing to pursue a resolution with the CSRC, it seems that the SEC is taking matters into its own hands to determine the course that will be followed going forward regarding the treatment of the Chinese Affiliates and similarly situated foreign public accounting firms. The SEC recently acknowledged that ''[t]he issues presented [in this administrative proceeding] are important and have far-reaching implications; resolution of these issues will govern whether and how the SEC can protect its processes in the face of decisions by the largest foreign public accounting firms in China to withhold documents that are essential to the SEC's oversight of audit work for U.S. issuers, as well as to investigating and prosecuting financial fraud.''[26]

The CSRC's Perspective

The CSRC has not released any official statements regarding the SEC's new administrative action, but prior statements and reports in the Chinese media indicate that, unsurprisingly, the CSRC takes a different view of the situation. Based on these sources, it appears that the CSRC's fundamental concern is that while cooperation among securities regulators is necessary and appropriate, such cooperation does not give other regulators the right to presumptuously apply their legal standard extraterritorially. Tong Daochi, the Chief of the CSRC's Department of International Affairs, stated in a speech in November 2012, ''[w]e share the common objectives of protecting investors, including foreign investors. CSRC is ready to work with any other jurisdiction. The

[14] SEC Rules of Practice, Rules 400(a) and 410.

[15] Securities Exchange Act § 25(a)(1); SEC Rules of Practice, Rule 401(c).

[16] Luis Aguilar,*Capital Formation from the Investor's Perspective*, Dec. 3, 2012, http://www.sec.gov/news/speech/ 2012/spch120312aa.htm.

[17] SEC Release 2012-249, *supra* note 2.

[18] *See* Securities and Exchange Commission's Reply Memorandum in Support of its Application for Order Requiring Compliance with Subpoena [hereinafter SEC Reply] at 12, 18, 21-23, *Deloitte Touche Tohmatsu*, No. 11-0512 (Dec. 3, 2012) (No. 38) (citing Arevalo Declaration at ¶¶ 4, 29-42).

[19] *See* Unopposed Motion for Stay of this Action at 2-3, *Deloitte Touche Tohmatsu*, No. 11-0512 (July 18, 2012) (No. 29).

[20] *See* SEC Reply at 21-23, *Deloitte Touche Tohmatsu*, No. 11-0512 (No. 38) (Arevalo Declaration at ¶¶ 60-65).

[21] *Id.*

[22] *See* Securities and Exchange Commission's Motion to Lift the Stay, *Deloitte Touche Tohmatsu*, No. 11-0512 (Dec. 3, 2012) (No. 36).

[23] *See* Opposition of Deloitte Touche Tohmatsu CPA LTD. to Motion to Lift Stay at 1, *Deloitte Touche Tohmatsu*, No. 11-0512 (No. 42).

[24] *See* Memorandum Opinion and Order, *Deloitte Touche Tohmatsu*, No. 11-0512 (Mar. 4, 2013) (No. 49).

[25] Sarah N. Lynch, *SEC Stumbles in Deloitte's Chinese Audit Case*, Mar. 13, 2013, http://www.reuters.com/article/2013/03/14/us-court-sec-deloitte-idUSBRE92D00R20130314.

[26] Division of Enforcement's Motion to Consolidate at 5-6, *BDO China Dahua CPA Co. Ltd.*, File No. 3-15116.

difficulty is there are some legal issues we need to handle both in China and other jurisdictions.''[27] In a May 17, 2012 speech at the annual conference of the International Organization of Securities Commissions, Yang Jiang, the CSRC's Assistant Chairman, was even blunter, stating ''a country should not extend its power of supervision to other countries'' and indicating that the matter should be resolved by the adoption of bilateral or multilateral agreements between the regulators.[28]

There is also speculation that the CSRC has been irritated by what is perceived as an eagerness by the SEC to politicize the dispute in order to put pressure on the CSRC to accede to its requests for documents. One unnamed CSRC official was recently quoted in the Chinese media as saying that it views the SEC's moves against the accounting firms as simply ''a negotiating tool'' between the two governments.[29] While the scope and application of China's State Secrets Laws have evolved over time, such laws have been around in one form or another for many years and would have been in place when China-based companies applied for listing in the U.S. The potential limitations and difficulties these laws impose with respect to typical discovery requests should not have come as a surprise to U.S. regulators. The SEC has been dealing with similar privacy laws in the European Union for years, and it seems a bit naive on the part of the SEC to think that its rules would have the ability to push aside relevant local law considerations without significant involvement of foreign regulators.

Implications for Those Caught in the Middle

While some of the accounting firms have expressed the desire to comply with the requests of the SEC,[30] with severe criminal sanctions under the Chinese laws looming, these firms seem to be left in a near impossible situation without an agreement in place between U.S. and Chinese regulators. As such, failure to reach an agreement between the U.S. and Chinese authorities, and the outcome of these ongoing actions, have the potential to negatively impact not only the Chinese affiliates of these big U.S. accounting firms, but also the several hundred China-based, U.S-listed companies who rely on their audits to satisfy their SEC reporting obligations and are essentially caught in the middle of this dispute. In fact, the potential severity of the situation and lack of clear solutions for issuers were not lost on investors and directly contributed to an immediate decline in the share prices of many such companies. These include market leaders, such as certain large cap China-based companies that saw their share prices decline in excess of 5% following the SEC's December 2012 action, who had arguably been largely immune thus far from the so-called ''China discount'' being applied to some Chinese issuers due to a perceived lack of transparency in their businesses and/or questions about their corporate structures.[31]

Moreover, there remains – at least up until recently – a sizeable pipeline of China-based companies still seeking to list in the U.S., particularly Internet and social media companies including one which listed on NASDAQ in November 2012, and this situation would appear to present a huge obstacle to those companies and any private equity investors backing them in achieving a listing for the foreseeable future. In addition, the audits of multinational corporations could also be affected because the Chinese affiliates of their auditors are not able to comply with the SEC's requests or provide reasonable assurance as to the adequacy of their work.

Which Way Forward?

The one thing that is clear about the dispute between the SEC and CSRC is that its outcome is uncertain at the present time. With that said, some observations can be made:

- The SEC's administrative action could possibly produce a rather extreme resolution of the dispute, but it is unlikely to result *by itself* in any sort of coherent solution. The extreme resolution would be a court order that permanently denies the Chinese Affiliates from appearing or practicing before the SEC, meaning that, among other things, companies which rely on such accounting firms would be unable to complete their required financial audits and would essentially be forced out of the U.S. markets. For most China-based, U.S.-listed companies, the U.S. markets are their only trading markets, and a forced exit would likely severely impair valuations and liquidity for investors, including those in the U.S. Equally important, this extreme result would still not address the original issue of the availability of audit work papers in China.

- A less extreme result of the SEC's administrative action is that it puts pressure on both the SEC and CSRC to negotiate a compromise within the potentially short lifespan of the administrative action. While statements in the media and court papers suggest that a resolution is not imminent, the threat of a catastrophic outcome for China-based companies may bring the two sides back to the table. For the CSRC, a number of the China-based, U.S.-listed companies are considered Chinese national champions and crippling their U.S. listings may entail some very real and undesirable reputational harm to the Chinese government.

- In any case, the SEC will likely remain steadfast in its efforts to investigate China-based companies as well as other foreign U.S. issuers. Over the past year, the SEC has increased these efforts particularly because of concerns arising from such companies entering the market through reverse mergers which were popular among Chinese businesses for a number of years.[32] In connection with its increased enforcement

[27] Eastday.Com, *Strengthen Cross-Border Supervision Cooperation to Resolve Issue of Working Papers Disclosure*, November 29, 2012, http://jingji.cntv.cn/2012/11/29/ARTI1354146892241545.shtml.

[28] Xinhua News Agency, *CSRC: Supervision Should not be Extended to Other Countries*, May 17, 2012, http://news.xinhuanet.com/fortune/2012-05/17/c_111978337.htm.

[29] *See* Zhang Tao and Lu Yuan, *Auditing Spat Dividing U.S. and China Turns Ugly*, Caixin, Dec. 20, 2012, http://english.caixin.com/2012-12-20/100474777.html.

[30] *See* Kathy Chu, SEC Probe Puts China Listings in Doubt, WALL STREET JOURNAL, Dec. 4, 2012, http://online.wsj.com/article/SB10001424127887323401904578158652523742958.html.

[31] *See* CAIJING.COM.CN, *Chinese Stocks Drop on SEC Charges against Chinese Units of ''Big Four''*, Dec. 5, 2012, http://english.caijing.com.cn/2012-12-05/112335517.html.

[32] *See* SEC Release 2012-249, *supra* note 2.

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efforts, the SEC has deregistered nearly 50 companies and filed fraud cases against over 40 foreign issuers and executives, including numerous China-based companies.[33]

Pending any long-term political solution and/or the outcome of this administrative action, the interim path forward for those companies caught in the middle – and their investors – remains murky at best. We are aware that some investors in China-based, U.S.-listed companies have already been raising the question whether the companies could quickly migrate their listing to Hong Kong or Mainland China, thereby eliminating the problem. However, moving to the Hong Kong market may not alleviate the issue of conflicts with Chinese laws. In August 2012, Hong Kong's Securities and Futures Commission brought a similar action against an Ernst & Young affiliate for its failure to produce accounting records related to a former China-based client.[34] The Hong Kong market may also take issue with allowing China-based companies that failed to meet the regulatory requirements necessary to list in the U.S. to seek refuge on its exchanges, possibly tarnishing its reputation and jeopardizing its relationship with investors. Also, there are multiple legal and regulatory hurdles for such companies to list on a stock exchange in Mainland China.

In addition, while delisting from the U.S. markets and deregistering from the SEC's reporting requirements has been a notable trend among China-based companies in the last two years, that requires significant time and financing to achieve and does not represent an obvious quick fix solution. Likewise, engaging the Hong Kong or other non-Mainland Chinese affiliate of an auditor would not by itself eliminate the need for audit work to be performed within China and the possible production of documents related to that work to the SEC that would once again involve issues under China's State Secrets Laws.

While the SEC and CSRC are unlikely to reach an agreement any time soon, if at all, the path forward for all parties involved in and impacted by this administrative proceeding will become clearer in the coming months and with an initial decision by the ALJ in the not too distant future. In the meantime, we will continue to monitor developments in this area.

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[33] *Id.*

[34] Anne Marie Roantree and Rachel Armstrong, *Hong Kong Regulator Takes Ernst & Young to Court for Work Papers*, Aug. 28, 2012, http://www.reuters.com/article/2012/08/28/us-sfc-ernstyoung-idUSBRE87R10920120828.