Global Accounting Firms Caught in the Crossfire as SEC Fails to Reach Agreement with Chinese Regulators on Document Sharing

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OVERVIEW

The China affiliates of the biggest accounting firms in the world have been placed in real jeopardy due to the stalled negotiations between U.S. and Chinese regulators over document sharing. On December 3, the U.S. Securities and Exchange Commission brought an administrative proceeding against BDO China Dahua CPA Co., Ltd., Deloitte Touche Tohmatsu Certified Public Accountants Ltd., Ernst & Young Hua Ming LLP, KPMG Huazhen (Special General Partnership), and PricewaterhouseCoopers Zhong Tian CPAs Limited based on their refusal to produce audit work papers and other documents relating to Chinese companies under investigation by the SEC. The accounting firms claim that their hands are tied because their Chinese regulators have refused to authorize the document production. A decision in favor of the SEC could result in these Chinese affiliates being denied the ability to appear and practice before the Commission, rendering it difficult for Chinese companies who rely on their services to list on American exchanges, and ultimately hindering the competitiveness of U.S. markets.

CATCH-22 FOR ACCOUNTING FIRMS

Last week's administrative proceeding brings to a head a simmering dispute between public accounting firms operating in China and the SEC. The conflict first surfaced in September 2011, when the SEC brought a federal court action to compel Deloitte Touche Tohmatsu CPA Ltd. ("DTTC") to comply with a subpoena calling for the production of documents relating to one of its clients, Longtop Financial Technologies Limited, a Chinese company that the SEC later charged with failing to provide current and accurate financial reports. In court papers, DTTC argued that producing the requested documents would run afoul of Chinese law and could result in Chinese regulators dissolving the firm entirely and seeking prison sentences up to life in prison for any partners and employees who participated in the violation. In July 2012 the SEC sought a six month stay of the action to permit it to continue ongoing discussions with the China Securities Regulatory Commission ("CSRC") regarding cross-border enforcement cooperation.

Last week, it became apparent that the SEC's negotiations with the CSRC over document sharing had broken down. In addition to instituting the administrative proceeding against the five Chinese accounting firms, the SEC also filed a motion to lift the stay in its federal court action against DTTC. In its brief, the SEC disclosed it had reached an impasse with the CSRC, accusing the Chinese regulator of being "unwilling or unable to provide the SEC with

meaningful assistance in its enforcement investigations." The SEC made plain that going forward it will seek production directly from Chinese audit firms in connection with its investigations of Chinese issuers.

UNCHARTERED LEGAL TERRITORY

The law in this area is quite unsettled. The December 3 administrative proceeding was brought under Section 106(b) of the Sarbanes-Oxley Act of 2002, which directs a foreign public accounting firm that issues an audit report, performs audit work, or conducts interim reviews to produce its audit work papers and other documents related to its audit work to the Commission or Public Company Accounting Oversight Board ("PCAOB") upon request. In the first decade after Sarbanes-Oxley was enacted, the Commission never brought an enforcement action under Section 106. Then, in May of this year, the SEC instituted a first-of-its kind administrative proceeding against DTTC under Section 106. The SEC alleged that DTTC had refused to provide the agency with audit work papers relating to an unidentified China-based company under investigation for potential accounting fraud. That proceeding is separate from both the subpoena enforcement action filed in federal court against DTTC last year in connection with the Longtop investigation and last week's administrative proceeding against DTTC and the four other Chinese accounting firms. There has been no reported decision in the earlier Section 106 proceeding.

Adding to the complexity are the amendments to Section 106 contained in Section 929J of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among other additions, Dodd-Frank added a subsection (f) to Section 106 under which the SEC "may allow a foreign public accounting firm…to meet production obligations under this section through alternative means, such as through foreign counterparts of the Commission or the [PCAOB]." DTTC has argued in the federal court action that Congress intended for this subsection to alleviate the burden of firms trying to mediate the competing demands of the SEC and their home regulators. However, the SEC has taken the position that the statute's inclusion of the term "may" means that it is not required to work through foreign regulators to obtain audit papers. Considering the current lack of cooperation between the SEC and the CSRC, it seems unlikely that the SEC will view cooperation with the CSRC as a viable option for the foreseeable future. In addition, Section 929J amended Section 106(b)(1)(B) to make clear that U.S. courts have jurisdiction over foreign public accounting firms for enforcement of any SEC or PCAOB document requests.

As DTTC has done in the federal court action, the accounting firms are likely to invoke principles of international comity to defend against the administrative proceeding. Where there is a conflict of laws, courts generally weigh a number of factors to determine which law will control, including evaluating the competing interests of each state in enforcing its laws, the hardship imposed on the accounting firms if the U.S. law is enforced, and whether the SEC has an alternative means of obtaining the documents sought by the subpoena. The outcome of this balancing test, as applied to these facts, is not clear.

In general, the balancing of competing state interests is considered the most important factor in a comity analysis. While the case law in this area is still developing, courts typically find the U.S. interest in regulating corporations traded on domestic exchanges and ensuring the integrity of its financial markets to be important. However, courts can also be sensitive to the dictates of non-U.S. laws, particularly when the likelihood of enforcement of such laws is relatively high and the consequences of violating such laws are relatively severe. Courts also seem to be particularly sensitive to the difficulties faced by non-parties that are caught up in U.S. litigation and/or investigations while simultaneously being subject to non-U.S. law.

The accounting firms may also challenge the SEC's calculated decision to bring a public administrative proceeding under Rule 102(e)(1)(iii) of the SEC's Rules of Practice. The SEC likely chose to proceed in this setting because an administrative law judge (ALJ) has the power under Rule 102(e)(1)(iii) to prohibit the accounting firms from continuing to practice before the SEC. This carries a bigger stick than a subpoena enforcement action in federal court. But the standard is also higher. The ALJ must find there to have been a "willful" violation of the securities laws. Although the SEC generally has adopted a broad interpretation of the term "willful," there may be a defense in this case that the accounting firms acted under compulsion and duress as a result of the severe sanctions they faced from Chinese regulators if they complied with the SEC's document requests. In addition, even if the ALJ finds there to have been a willful violation of the securities laws, the ALJ has discretion to impose a less severe sanction, including censuring the accounting firms or a time-limited bar from practicing before the Commission. It is interesting to note that each of the Big Four and BDO's China affiliates put securities regulators on notice when they initially registered with the PCAOB and stated in their registration forms that they may not be able to comply with any future document requests due to conflicting Chinese laws. In addition to highlighting this issue, none of the firms signed the form's consent to comply with future document production requests, notwithstanding that such a consent is a condition to registration with the PCAOB. Despite this, the PCAOB approved all five audit firms for registration.[1] Should the ALJ find a willful violation, perhaps his or her discretion regarding sanctions will be impacted by the five firms having highlighted this issue at the time of their initial PCAOB registrations.

Finally, there may be jurisdictional and service related defenses available to the accounting firms. As mentioned above, Section 106(b)(1)(B) of Sarbanes-Oxley mandates that foreign accounting firms be subject to the jurisdiction of the "courts of the United States." However, the December 3 filing instituted a public administrative proceeding, not a U.S. court action. Similarly, with respect to the validity of service, the Order instituting the administrative

1 Perhaps the PCAOB permitted registration of the audit firms despite these issues because it viewed Section 21(b) of the Exchange Act as broad enough to reach foreign auditor work papers even if the firms did not consent to compliance with Section 106(b) and the PCAOB's production requirements. Section 21(b) permits the SEC to take a variety of actions in connection with its general investigative powers, including compelling production of documents. Indeed, the SEC instituted the federal court action against DTTC pursuant to Section 21(b) rather than Section 106(b), arguing that long before Sarbanes-Oxley and Dodd-Frank, it had authority under Section 21(b) to compel production of documents. DTTC argues Section 21(b) does not extend to documents located outside the U.S. and that only Section 106 can reach them.

proceeding specified a number of methods through which the firms could be served but it remains to be seen whether service can be perfected.

IMPLICATIONS

The administrative proceeding filed on December 3 may have significant ramifications for Chinese companies doing business within the U.S. The largest and most important Chinese companies would be forced to scramble to replace their auditors if the China affiliates of the Big Four accounting firms are prohibited from practicing before the SEC. Moreover, any replacement auditors would likely face the same competing demands from U.S. and Chinese regulators in future investigations. As such, it is not beyond the realm of possibility that some of these companies would reconsider the feasibility and attractiveness of their U.S. listings and turn to foreign exchanges. This could especially be the case if the ALJ finds a willful violation of securities laws in the SEC's administrative action and a similar finding by the PCAOB follows, which could result in the revocation of the audit firms' registration with the PCAOB. The SEC Division of Corporate Finance's Financial Reporting Manual notes that it is the SEC's view that financial statements previously audited by a de-registered firm, even those of companies not under SEC investigation, would need to be re-audited by a registered firm to be included in future filings. Alternatively, it is possible that the SEC may provide some administrative accommodation for Chinese companies that have not been the target of SEC investigation but whose registered public accountants have nonetheless been de-registered. For example, in the wake of the 2002 criminal indictment of Arthur Andersen LLP, the SEC instituted temporary rules to give certain of Arthur Andersen's auditing clients time to address the temporary disruptions they faced due to the loss of their registered public accountant, while still ensuring investors would be provided with the timely financial information required under the federal securities laws.

Also placed in jeopardy by last week's filing are the well established mechanisms traditionally used by the SEC to obtain documents in other countries, including through the use of multilateral, bilateral, and ad-hoc agreements. It undeniably takes substantial time and effort to proceed through the proper judicial channels. Should the SEC be successful in overriding Chinese law in this instance to demand document production directly from the accounting firms, the SEC may be emboldened to bypass foreign regulators in the future in favor of employing aggressive tactics on the firms themselves.

CONCLUSION

The failure of the SEC and CSRC to reach an agreement on document sharing is unwelcome news for everyone involved. We hope that the regulators can return quickly to the negotiating table and reach a compromise that enables the SEC to obtain the documents it needs for its current investigations. In the long term, it is clear that there needs to be a comprehensive and durable framework through which audit work papers and other documents maintained by accounting firms based in China can be accessed by the U.S. regulator.

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