SEC's Charges Against China-Based Accounting Firms Have Broad Implications

As part of its effort to investigate potential accounting fraud at unnamed China-based companies that are publicly traded in the United States, on December 3, 2012 the U.S. Securities and Exchange Commission (the "SEC") charged the Chinese affiliates of the "Big Four" accounting firms – Ernst & Young, Deloitte, KPMG and PricewaterhouseCoopers – and BDO with violating the Securities Exchange Act and the Sarbanes-Oxley Act. The SEC says that it has sought to obtain audit documents and work papers from each of these firms in connection with its investigation of their publicly traded China-based clients and that each has willfully refused to produce such documents in violation of their legal obligations as foreign public accounting firms. The firms, however, claim that they are not at liberty to produce the documents because doing so could violate China's Law on Guarding State Secrets and result in severe criminal sanctions for their auditors. This apparent conflict between U.S. and Chinese law, which U.S. and Chinese regulators have been unable to resolve, may pose significant problems for any China-based, U.S.-listed companies, as well as multinational corporations which may need to rely on the Chinese affiliates of these auditing firms for purposes of completing their consolidated audit.

The SEC's 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." Specific to the charges against these firms, Robert Khuzami, 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." In fact, if an administrative law judge were to find in favor of the SEC, the Chinese affiliates of these firms could potentially be prohibited from practicing before the SEC, meaning their audit reports could not be included in required filings with the SEC.

This action is not the first of its kind, but it 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 fallen apart. In September 2011, the SEC brought a similar action 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 it could continue to negotiate with Chinese regulators regarding cross-border enforcement cooperation and obtaining access to the requested audit documents. While the SEC engaged in discussions with its counterpart, the China Securities Regulatory Commission (the "CSRC"), in hopes of reaching a resolution, on the same day that the SEC brought charges against the Big Four, it also filed a motion to lift the stay in the Deloitte proceedings stating that these efforts "ended unsuccessfully" and that the CSRC remains "unable or unwilling" to produce the requested documents.

It seems, therefore, that the SEC may be using this current action as a means to put pressure on both the firms and Chinese regulators in light of the failed negotiations. However, while some of the firms have expressed the desire to comply with the requests of the SEC, with severe criminal sanctions under the Chinese laws looming, these firms are left in a near impossible situation without an agreement in place between U.S. and Chinese regulators. In the court documents recently filed by the SEC in the Deloitte matter, Deloitte's counsel stated, and the CSRC confirmed, that in relation to one investigation, Deloitte provided its working papers to the CSRC and the CSRC refused to provide the papers to the SEC because it could not come to terms with the SEC over restrictions related to the use of the documents. This shows a willingness on the part of the firm to turn over documents when doing so is legal and permissible. Yet, these firms feel that they cannot risk turning the type of documents over to the SEC that the CSRC itself is not willing to provide.

The SEC is not alone in its stalemate with Chinese regulators and fight for documents from Chinese affiliates of U.S.-based accounting firms. In August 2012, Hong Kong's Securities and Futures Commission (the "SFC") brought a similar action against an Ernst & Young affiliate for its failure to produce accounting records related to a former China-based client.

The 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 announcement, 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. Moreover, there remains a sizeable pipeline of China-based companies seeking to list in the U.S., particularly internet and social media companies including one which listed on NASDAQ last week, 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 reply to SEC requests or provide reasonable assurance as to the adequacy of their work.

Although a long-term solution will require an agreement between the U.S. and Chinese governments, it seems that the SEC will 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. In connection with its increased enforcement efforts, the SEC has deregistered nearly 50 companies and filed fraud cases against over 40 foreign issuers and executives, including numerous China-based companies. Conversely, while the CSRC has not publicly evidenced a willingness to accede to what it views as extraterritorial demands of the SEC, many of the China-based, U.S.-listed companies such as those listed above are considered national champions and crippling their U.S. listings may entail some very real and undesirable reputational harm to the Chinese government. The outcome of these competing interests is difficult to predict.

Pending any long-term political solution, 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, thereby eliminating the problem. 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. And in light of the unprecedented action recently brought against Ernst & Young's Hong Kong affiliate by the SFC, there is no guarantee that after putting in substantial effort and resources to move to the

Hong Kong market, China-based companies and their auditors would not find themselves in the same predicament with the SFC. 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.

We will continue to monitor developments in this area.