U.S. Administrative Law Judge Suspends Chinese Affiliates of "Big Four" Accounting Firms

In a surprising turn in the long-running and widely reported dispute between the Securities and Exchange Commission ("SEC") and the Chinese affiliates of the "Big Four" accounting firms, on January 22, 2014, a U.S. Administrative Law Judge ruled that the Chinese affiliates of the "Big Four" should be suspended for a period of six months for refusing to turn over audit documents for certain U.S.-listed Chinese companies under investigation by the SEC. If the 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.

As we have reported previously, Chinese companies traded on U.S. stock exchanges and U.S. companies with substantial Chinese operations have, in recent years, encountered questions about their accounting and disclosure practices from U.S. regulators. On December 3, 2012, as part of its effort to investigate potential accounting fraud at unnamed China-based companies that are publicly traded in the United States, the SEC initiated the instant proceeding charging the Chinese affiliates of the "Big Four" accounting firms – Ernst & Young, Deloitte, KPMG and PricewaterhouseCoopers – and a former affiliate of BDO International, Ltd., now called Dahua CPA, with violating the Securities Exchange Act and the Sarbanes-Oxley Act. The SEC claimed that it had 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 willfully refused to produce such documents in violation of their legal obligations as foreign public accounting firms. The firms, for their part, claimed that they were 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.

The December 2012 action against the Big Four and BDO was not the first of its kind. 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 its Chinese counterpart, the China Securities Regulatory Commission (the "CSRC") regarding cross-border enforcement cooperation and obtaining access to the requested audit documents. Seemingly during these negotiations, the SEC brought charges against the Big Four in December 2012 and, on the same day, it also filed a motion to lift the stay in the Deloitte proceedings stating that these efforts "ended unsuccessfully" and that the CSRC remained "unable or unwilling" to produce the requested documents.

While the December 2012 proceeding has been pending, United States and Chinese regulators have continued to engage in periodic negotiations with the aim of reaching an agreement to resolve the tension between U.S. and Chinese law and allow for the production of China-based audit papers to U.S. authorities. In July 2013, the negotiations appeared to make significant 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 Public Company Accounting Oversight Board ("PCAOB"). It seemed that this development had born fruit in December 2013 when auditors disclosed in legal filings that Chinese authorities had provided certain audit documents to U.S. regulators and additional documents would be forthcoming. In light of this development, the audit firms sought to have the cases dismissed but the SEC continued to press for substantial sanctions.

In spite of the diplomatic progress, on January 23, 2014, U.S. Administrative Law Judge Cameron Elliot ruled that the auditors violated Section 106 of Sarbanes-Oxley, as amended by Dodd-Frank, by willfully refusing to provide audit work papers to the SEC upon request, which would be customary when the SEC investigates U.S.-based companies. In his strongly-worded 112 page opinion, Judge Elliot evinced little sympathy for the

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auditors' assertion that producing the documents would violate Chinese law and expose employees to jail time, 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."

Indeed, Judge Elliot ruled that the Big Four's actions "involved the flouting of the Commission's regulatory authority," in spite of the uncontroverted testimony by representatives from each of the Big Four that they had desired and attempted to comply with the SEC's document requests. During the proceeding, the Big Four offered evidence that they sought the approval of the CSRC to produce the requested documents to the SEC after receiving Section 106 requests, but were told on more than one occasion by the CSRC not to provide documents directly to U.S. regulators. In fact, the evidence showed that the CSRC went so far as to threaten auditors with "personal" consequences if they provided the audit papers directly to U.S. regulators. The reaction of the CSRC and the auditors should hardly come as a surprise given that, for years prior to the initiation of administrative proceedings, the auditors had disclosed in filings with the PCAOB that they might not be able to produce work papers to U.S. authorities because of Chinese law issues.

Although the SEC was seeking a permanent suspension, 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. In deciding the level of sanction to impose, Judge Elliot relied on what he found to be a lack of good faith by the Big Four to comply with U.S. securities laws, writing, "Respondents operated large accounting businesses for years, knowing that if called upon to cooperate in a Commission investigation into their business, they must necessarily fail to fully cooperate and might thereby violate the law… Such behavior does not demonstrate good faith, indeed, quite the opposite - it demonstrates gall." Judge Elliot also responded skeptically to the argument that suspension of the Big Four would cause investor losses by forcing firms that operate in China to use auditors of lesser quality. He countered that "it does not follow that smaller firms would not be 'adequate' as auditors", although we note that the SEC has been aggressive 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. Judge Elliot also reprimanded Dahua CPA, but did not suspend the firm.

Wednesday's ruling does not take effect for twenty-one days and, because the Big Four have already announced their intention to appeal, the ultimate impact of Judge Elliot's ruling will likely be delayed. If the decision becomes effective, the implications could be significant for U.S.-listed Chinese companies and multi-national companies with Chinese operations that use the Big Four, which may be without China-based auditors for a period of months. It seems possible that there will be further diplomatic negotiations between the U.S. and Chinese regulators to address any differences that remain in their positions and ultimately resolve this dispute. Pending any diplomatic resolution, many companies that use the Big Four's Chinese affiliates may seek to bridge the six month gap by temporarily turning to the non-sanctioned Hong Kong or Singapore affiliates of the Big Four. However, the Hong Kong affiliates of U.S. audit firms have also encountered regulatory scrutiny arising from conflicts between local Hong Kong authorities and Chinese regulators unwilling to permit the production of audit papers abroad. 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.

The sanctions are imposed on the Chinese firms and not their partners and, thus, the audit firms may be able to fashion a work around where individuals are transferred temporarily to these non-sanctioned shops to assist with the necessary work. It also remains to be seen whether the decision will impact the recent resurgence of interest by investors in the stocks of many China-based companies or by the new wave of China-based companies currently seeking U.S. listings, particularly among internet companies.

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