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US SEC SETTLES DISPUTE WITH BIG FOUR OVER CHINESE ACCOUNTING RECORDS ACCESS

Introduction

United States Securities and Exchange Commission (**SEC**) sanctions against the Big Four accounting firms have been imposed as part of the settlement of a dispute between the SEC and the Chinese affiliates of the Big Four accounting firms over their refusal to hand over audit working papers for US-listed Chinese companies. The SEC started the proceedings in 2010 following the firms' refusal to provide requested documents based on claims that to do so would put them in breach of Chinese secrecy laws. The settlement on 6 February 2015 saw the Chinese units of the four firms, Deloitte Touche Tohmatsu Certified Public Accountants Ltd. (**Deloitte**), Ernst & Young Hua Ming LLP (**EYHM**), KPMG Huazhen (Special General Partnership) and PricewaterhouseCoopers Zhong Tian CPAs Limited (**PwC**), agree to a fine of US\$500,000 each and to procedures for compliance with requests for records from the regulator in the next four years. They also admitted that they had failed to provide documents requested by the SEC prior to 2012.

Crucially, however, the settlement did not suspend the firms from auditing US-listed Chinese companies. The initial January 2014 ruling that the firms had wilfully violated section 106 of the Sarbanes-Oxley Act 2002 (**SOA**) by refusing to comply with SEC requests for documents resulted in an order that the firms should be suspended from conducting audits of US-listed Chinese companies for six months. That order was suspended pending the firms' appeal and has been further suspended in the latest settlement. It may however be implemented if any of

the firms breaches the terms agreed for complying with SEC record requests specified in the settlement in the four years after the settlement date.

Regulatory Background

In the US, public accounting firms preparing audit reports for listed companies are required to register with the Public Company Accounting Oversight Board (**PCAOB**). Section 106 of the SOA requires foreign public accounting firms to register with the PCAOB and subjects foreign auditors to US oversight if part or all of their audit work is relied on by the listed companies' domestic auditors.

Section 106(b) of the SOA stipulates that registered foreign auditors have an obligation to produce their audit working papers to the PCAOB, if requested, and are subject to the jurisdiction of the US courts for the purposes of enforcement of such requests.

Longtop Investigation

In August 2011, Longtop Financial Technologies Limited (**Longtop**), a China-based company listed on the New York Stock Exchange in 2007, was delisted following SEC charges of accounting irregularities. Deloitte had resigned as Longtop's auditor in May 2011, stating that it had discovered a number of financial improprieties and experienced "deliberate interference by certain members of Longtop management" when preparing an audit report for the company for the year ended 31 March 2011.

Longtop's share price dropped by more than fifty per cent from its 2007 IPO to when it delisted in 2011. Its collapse triggered widespread investor concern over accounting irregularities at US-listed Chinese companies and the SEC formed a task force to investigate potential fraud at other US-listed overseas companies.

2012 Proceeding and 2013 Production of Documents

In the Longtop investigation, the SEC subpoenaed the audit working papers for the company from Deloitte under section 106 of the SOA. Deloitte however refused to hand over the documents, all of which were in China, citing potential violation of China's regulations on national security which could result in the dissolution of the firm, and severe penalties, including life imprisonment, for the firm's partners and employees involved in the disclosure, if the papers were classified state secrets. Deloitte consulted the China Securities Regulatory Commission (**CSRC**), the Chinese authority responsible for classifying state secrets and enforcement of relevant proceedings, and notified the SEC that the CSRC did not agree to it handing over the papers requested and urged the US court to direct the SEC to deal with the CSRC directly.

A wave of investigations into more than 170 Chinese companies led to proceedings against twenty-five China-based companies with securities registered in the US which employed the Big Four firms and another firm, BDO China Dahua CPA Co. Ltd (**Dahua**) (together the **5 Firms**) as their auditors. The SEC served a number of requests for audit working papers and other related documents in connection with investigations of nine clients of the 5 Firms between March 2011 and April 2012. All firms responded to the production orders in a similar way as Deloitte. Administrative proceedings were initiated against the 5 Firms and none of them produced any documents directly to SEC before 3 December 2012.

A twelve-day hearing started in July 2013. The SEC then started to receive the firms' audit working papers through the CSRC under the Multilateral Memorandum of Understanding (**MMOU**) of International Organization of Securities Commissions (**IOSCO**).

2014 Suspension Order and Appeal

Based on the SEC's investigations and documents produced, SEC ALJ Judge, Cameron Elliot, made the initial decision on 22 January 2014 that the 5 Firms had each wilfully violated section 106 of the SOA, notwithstanding that their refusal to produce the requested working papers was due to Chinese

regulatory restrictions. The ruling found that the 5 Firms "did not act in good faith" in auditing US-listed companies knowing that they would likely be barred from fulfilling their obligations under section 106 of the SOA. In the initial decision, the judge discussed the ongoing efforts of the US and Chinese authorities to negotiate a long-term solution. This part of the opinion was, however, redacted since, according to the judge, "some passages of this initial decision discuss the Commission (SEC), the CSRC, and their interaction more candidly than is customary in diplomatic circles. I am therefore concerned that some of my factual findings and legal discussion may interfere with any ongoing discussions between the Commission and the CSRC, and this consideration is of paramount importance."

Pursuant to Rule 102(e)(1)(iii) of the SEC's Rules of Practice, a 6-month suspension from conducting audit work on US-listed Chinese companies was recommended for the Big Four and a censure instead of a ban was recommended for Dahua, since it no longer had any US-listed clients. The 5 Firms appealed the initial decision and commenced settlement talks with the SEC.

The 5 Firms argued that they were caught between the US requirement for investigatory access and Chinese state secret disclosure restrictions. Their appeal alleged that the court's decision had erred in not taking into account the CSRC's cooperation and claimed that the negative impact of the proposed suspension outweighed the benefits. At that time, there were about two hundred US-listed Chinese companies which would be forced to find new auditors not among the Big Four, the major firms in the market.

2015 Settlement

On 6 February 2015, the SEC announced its landmark deal with the Big Four.

Regarding the SEC's findings set out in the settlement order, the Big Four neither admitted nor denied any of the allegations, but merely acknowledged that they had failed to turn over documents sought by the SEC before the commencement of proceedings.

Although the fine of US\$500,000 imposed on each of the Big Four firms was relatively modest, the settlement sets out specified undertakings by the Big Four as to how they will respond to future requests for documents covered by section 106 of the SOA. The settlement also specifies three possible consequences for failure to comply with those undertakings.

- **An Automatic Bar**

Failure to produce requested documents may result in the automatic imposition of a 6-month suspension order.

- **Summary Proceedings**

If documents produced are deficient in certain respects, the SEC may start separate, expedited administrative proceedings against the relevant firm.

- **A Restart**

The SEC may request the termination of the stay and resumption of the current proceedings if the production of documents on two or more occasions are substantially delayed, are deficient in certain respects, or lack substantial numbers of requested documents (or portions of documents) in violation of, or without justification under, US law.

The current proceedings are stayed for a period of four years under the settlement, allowing the Big Four firms to temporarily escape the suspension order. The proceedings will lapse unless a restart is instigated within the four-year undertaking period. The settlement agreement however ensures that the Big Four must play by the rules for the next four years.

Despite the settlement reached between the SEC and the Big Four, proceedings continue against Dahua.

Andrew Ceresney, Director of the SEC's Enforcement Division commented that "obtaining an audit firm's workpapers is critical to enforcement staff's ability adequately to protect investors from the dangers of accounting fraud".

Related Issues

The related issue of whether PCAOB inspectors, who conduct regular inspection visits of global firms that audit US-listed companies, will be allowed to inspect the work of Chinese audit firms has not been addressed. PCAOB inspectors are currently banned from entering China by the Chinese government and US shareholders are deprived of the potential benefits of these inspections. The ban applies not only to audit firms in Mainland China, but also to Hong Kong accounting firms which outsource auditing to their Chinese arms.

The Hong Kong Position: SFC Proceedings against Ernst & Young

Hong Kong's securities regulator finds itself in the same position as its US counterpart when it comes to obtaining access to the audit working papers for Hong Kong-listed Chinese companies from the Chinese affiliates of the Big Four accounting firms, as illustrated in the proceedings brought by the Hong Kong Securities and Futures Commission (SFC) against Ernst & Young (EY). In 2010, EY contracted with a China-based client, Standard Water Limited (SW) to review its books and the field work was conducted by its Chinese affiliate, EYHM.

The SFC commenced proceedings against EY in 2012 to compel production of audit working papers relating to SW in relation to its investigation into SW's failed listing on the Hong Kong Stock Exchange. EY refused to hand over the documents requested, claiming that it was prohibited from doing so by Chinese state secrecy laws. It argued that a joint statement issued by the Chinese authorities in October 2009, which stated that accounting records and audit working papers may be the subject of claims of state secrecy under PRC law, meant that the handing over of such documents to the SFC would require the consent of the Chinese authorities, even if the records were kept in Hong Kong.

On 23 May 2014, the Court of First Instance ordered EY to produce to the SFC the audit work relating to SW pursuant to section 185 of the Securities and Futures Ordinance. EY's argument that it was prevented from handing over the documents by Chinese state secrecy laws was rejected, with Hon Mr. Justice Ng describing the argument as "a complete red herring". Both PRC law expert witness engaged by the SFC and EY, Professor Fu Hualing of the Department of Law, University of Hong Kong, and Professor Liu Yan from the Law School of Peking University respectively, agreed that the relevant regulation "does not impose a *blanket* prohibition on cross-border transmission of audit working papers to overseas securities regulatory authorities – such transmission is permissible if prior approval from the relevant government departments has been obtained". The court found that whether the audit working papers constituted State or commercial secrets depended entirely on their contents. The papers were not however produced to the court and had not been seen by the PRC law experts: the court thus concluded that EY could not establish to the court's satisfaction that the papers contained State or commercial secrets which would prohibit their transmission to EY in Hong Kong. Since the relationship

between EY and EYHM was one of principal and agent, EYHM had “a duty to produce to EY all books and documents ... relating to the audit field work”.

EY subsequently produced a disc of documents it held in Hong Kong to the SFC and applied for an appeal on 20 June 2014 in relation to the documents held by EYHM. No date has been set for the hearing of EY’s appeal.

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Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com