

## SEC Judge Issues Initial Decision Regarding Chinese Affiliates of the Big Four Accounting Firms

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On January 22, 2014, U.S. Securities and Exchange Commission Administrative Law Judge Cameron Elliot (the ALJ) issued an initial decision censuring the Chinese accounting firms affiliated with Ernst & Young LLP, KPMG LLP PricewaterhouseCoopers LLP, and Deloitte LLP (the Big Four Accounting Firms), as well as a fifth firm, BDO China Dahua CPA Co., Ltd. (collectively, the Accounting Firms). The initial decision found that the Accounting Firms each willfully violated Section 106 of the Sarbanes-Oxley Act of 2002 and the Securities Exchange Act of 1934 by failing to comply with investigative requests from the Securities and Exchange Commission (the SEC or the Commission) for audit work papers related to their audit work for China-based companies whose securities were registered with the SEC and that were under investigation for potential securities fraud. The initial decision sanctions the Chinese affiliates of the Big Four Accounting Firms by suspending them from practicing before the Commission for six months pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(iii). That suspension will prevent the Chinese affiliates of the Big Four Accounting Firms from issuing audit reports that their China-based SEC registrant audit clients are required to file to comply with the SEC reporting requirements for at least six months after an order of finality is issued by the SEC confirming the initial decision.<sup>1</sup>

### Tension Between US and PRC Laws

This ruling is a dramatic development in a long-standing dispute arising from the tension between the requirements under U.S. law that regulators have investigative access to work papers associated with the financial statement audits of companies that access the U.S. capital markets, and the Accounting Firms' concerns that complying with such requests will violate the secrecy laws of the People's Republic of China (PRC). As recounted in the initial decision, the Accounting Firms did not comply with requests from the Commission to turn over audit work papers relating to audits of ten China-based SEC registrants. The SEC responded by instituting administrative enforcement proceedings against the Chinese affiliate of Deloitte in May 2012 and against all the Accounting Firms in December 2012. On December 20, 2012, the two proceedings were consolidated. The ALJ's Initial Decision yesterday follows weeks of evidentiary hearings and extensive briefing.

The initial decision turns in large part on a relatively narrow legal question — whether the Accounting Firms' declination to produce the requested work papers in light of restrictions imposed by PRC law amounts to a "willful refusal to comply" within the meaning of Section 106 of the Sarbanes-Oxley Act. The ALJ accepted the SEC's argument, and rejected the Accounting Firms' position that so declining was not a "willful refusal" as it did not occur as a result of any bad faith or bad intent. However, the ALJ

<sup>1</sup> The respondents named in the proceeding are: (1) Ernst & Young Hua Ming LLP, (2) KPMG Huazhen (Special General Partnership), (3) PricewaterhouseCoopers Zhong Tian CPAs Limited, (4) Deloitte Touche Tohmatsu Certified Public Accountants Ltd., and (5) BDO China Dahua CPA Co., Ltd. While all five respondents were censured by the initial decision, BDO China Dahua CPA Co., Ltd. did not receive a suspension because it no longer provides services to China-based U.S. companies.

also recognized that the issues in this proceeding are merely one facet of the larger political dispute involving the SEC and the China Securities Regulatory Commission (the CSRC) on this issue. Indeed, the initial decision acknowledges the existence of ongoing efforts by the relevant authorities to reach a broader solution to this dispute. Interestingly, the portions of the decision that discuss those efforts have been redacted from the public version of the initial decision because, as the ALJ explained, “some passages of this initial decision discuss the Commission, 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.”

### **Appeals Process**

Despite its conclusion, the initial decision will not necessarily have any immediate impact on those China-based companies that rely on the Big Four Accounting Firms to audit their financial statements or on those global corporations that rely on the Big Four Accounting Firms to audit the financial statements of their PRC subsidiaries and affiliated entities. The sanctions ordered in the initial decision will not go into effect until an order of finality is issued by the Commission. No such order will be issued before the end of the 21-day appeal period, during which, pursuant to Rule 410 of the Commission’s Rules of Practice, 17 C.F.R. § 201.410, any party may file a petition for review appealing the initial decision to the SEC. If there is an appeal, there will be no sanctions until the appeal is concluded and sanctions are upheld. Under the Commission’s Rules of Practice, a final order on an appeal is to be issued within seven months from the petition for review, unless the matter “presents unusual complicating circumstances,” which would extend the period to 11 months from the date of the petition for review. 17 C.F.R. § 201.900(a)(iii). Once the Commission issues that final decision, a party may seek judicial review through a further appeal to a U.S. court of appeals. The Big Four Accounting Firms already have indicated that they will file a petition for review. Although this lengthy appeals process mitigates the immediate impact of the regulatory sanctions in the initial decision, there is no doubt that this development will raise the temperature of this long-simmering dispute.

### **Other Considerations**

Notwithstanding the effectiveness of the sanctions, it is unclear at this time what impact this decision may have on, among other things, the SEC staff’s views of issuing effectiveness orders for registration statements that include reports of the impacted Accounting Firms or whether the Accounting Firms continue to meet the SEC’s qualification requirements. The SEC staff most likely will expect that at least some additional disclosure be provided in a registration statement about the risks that the decision could have on an investment in a company that relies on an impacted Accounting Firm to audit its financial statements.