SEC Moves Against Accounting Firms—What Does This Mean For U.S.-Listed Chinese Companies?

by Thomas M. Shoesmith

On December 3, 2012, the U.S. Securities and Exchange Commission (SEC) began administrative proceedings against five leading accounting firms which could result in their being barred from auditing U.S.-listed Chinese companies. The ultimate outcome is months if not years away, but this is certain to send a chill through an already-chilled market.

On December 3, 2012, the SEC began administrative proceedings against the Chinese member firms of the Big Four +1: Deloitte, Ernst & Young, KPMG, PriceWaterhouseCoopers and BDO. The proceedings are based on the SEC's inability so far to obtain the firms' work papers relating to audits of U.S.-listed Chinese companies. If the accounting firms are ultimately barred from auditing these companies, it could force the delisting of all China-based companies from the U.S. markets.

There are sound arguments on both sides of this question, and the parties have been arguing for years. Failure to find a solution risks falling into one of two extremes: on the one hand, there is the danger posed by the SEC's continuing inability to look closely at the auditing work behind the financial statements of U.S.-listed Chinese companies; and on the other hand, there is risk of a complete closing of the U.S. markets to companies whose principal operations are in China.

The solution may ultimately lie in government-to-government talks, but so far these talks have not produced a result. The November 2012 transition of power in China to a more conservative faction, and the continued political pressure in the U.S. to tighten the screws on Chinese companies, lead some observers to believe that solution is still months if not years away. It is not at all clear what the markets will do in the meantime.

The SEC Action

On December 3, 2012, the SEC issued an Order initiating administrative proceedings against the Chinese member firms of the Big Four and BDO—Deloitte Touche Tohmatsu CPA Ltd, Ernst & Young Hua Ming

LLP, KPMG Huazhen, PricewaterhouseCoopers Zhong Tian CPAs Limited and BDO China Dahua Co. Ltd. All five firms are the PCAOB-registered auditors of U.S.-listed Chinese companies.

The Order notes the SEC has initiated fraud investigations against nine U.S.-listed companies whose principal operations are based in the PRC. The companies are only identified in the Order by letters of the alphabet. Each of these companies is or was an audit client of one of the five audit firms named in the proceeding. In each case the SEC served requests for “all audit work papers and all other documents related to any audit work or interim reviews” performed by the firms for their named clients. In each case the audit firms “informed the Commission that [they] will not produce the documents … because, among other things, [they] interpret the law of the People’s Republic of China as prohibiting [them] from doing so.”

The Order characterizes the behavior of the audit firms as “willful,” and the SEC therefore is seeking a determination “whether Respondents should be censured or denied the privilege of appearing and practicing before the Commission.” An Administrative Law Judge will now hear competing arguments and issue an initial decision within 300 days.

Background

Since the late 1990s, hundreds of companies whose principal operations are in the PRC have listed in the U.S. markets. A large number, but by no means all, did so in the mid-2000s through reverse mergers. A minority of those companies subsequently came under scrutiny by short-sellers, the press, and regulators for a variety of reasons, in some cases for what appeared to be egregious misrepresentations in their public filings. In many cases the charges proved baseless. But the spotlight clearly had been turned on these companies.

The SEC’s investigations into Chinese companies began at least as long ago as 2010. Partly as a result of the efforts of the SEC’s Cross-Border Working Group, the agency has by now deregistered the securities of almost 50 companies and filed fraud cases involving more than 40 foreign issuers and executives, according to the SEC’s press release on its December 3 Order. Not all these companies were based in China, but a large percentage were. SEC investigations often seek work papers and other documents from the companies’ auditors, and these investigations were no exception. Here, however, all five of the audit firms named in the Order declined to turn over work papers and other documents located in China, citing PRC laws relating to national security and the risk of criminal penalties to their staff in China.

One of the SEC’s investigations, into Longtop Financial Technologies Limited, led to a federal court action seeking enforcement of a subpoena issued to Deloittte Touche Tohmatsu CPA Ltd. (Deloitte), the Shanghai-based member organization of the Big Four firm, Deloitte Touch Tohmatsu Limited. The briefs filed in that case lay out the arguments for and against production of work papers and documents from China. The SEC argued U.S. law empowered it to subpoena documents maintained in China as part of its investigation into Longtop. Deloitte acknowledged the legitimacy of the SEC’s investigation but protested that turning over the documents would directly contradict an order of the Chinese Securities Regulatory Commission, run afoul of the PRC Ministry of Finance, the State Secrets Bureau and the State Archives Bureau, expose it to potential dissolution in China and risk imprisonment of its employees. Deloitte made other arguments as well, but this was the most hair-raising. The SEC argued the interests of the U.S. government in enforcing its laws and protecting investors in U.S.-listed companies was more important than the risk to Deloitte of complying.

The Consequences

This isn't the first time one country has tried to enforce an order that would require someone to violate the laws of another country, as the cases cited by both the SEC and Deloitte make clear. In this case, the lawsuit is taking place in the context of extended government-to-government talks, as well as discussions involving the PCAOB, to find some reasonable solution. There are many political reasons to be pessimistic about these talks, however. The Chinese tend to see these requests as infringing their sovereignty; U.S. readers can understand their position by imagining the attitude in Washington if the Chinese government sought documents we thought were protected from disclosure under U.S. laws. The SEC's document requests also arise out of a culture of disclosure; whereas China often seems to be a culture of confidentiality. Finally, if there have in fact been bad actors in the Chinese companies under investigation, or even in the accounting firms, Beijing likely will be very sensitive to the reputational damage of laying Chinese misconduct on the public record. Set against these considerations is the agitation on the part of U.S. regulators and the investing public about the allegations made against U.S.-listed Chinese companies. U.S. regulators are known for their patience and persistence and are not likely to stop before getting to the bottom of these questions.

Still, the potential consequences of failure to find common ground are almost too frightening to contemplate. Hundreds of U.S.-listed companies have significant, and many have their principal, operations in the People's Republic of China. Each one of them must have an independent accounting firm registered with the PCAOB and acceptable to the SEC. If these five accounting firms are barred from practicing before the SEC, it seems certain that companies with major Chinese operations will find it difficult or impossible to find accountants. Their only option will be to withdraw from U.S. public markets.

It is not only the middle-market reverse merger companies that are faced with this conundrum. Flagship internet companies as well as other major multinationals are waiting for the reaction of the accounting community and the results of the SEC's administrative action.

For the moment, the direct pressure is on the accounting firms—not just one or two, but an entire industry. The secondary pressure is on the issuers. They have to anticipate whether it will continue to be possible for them to list in the world's deepest and most liquid equity capital market. No doubt other markets around the world would see this as America's potential loss and their gain. If the two countries, the U.S. and China, really believe in the importance of their bilateral economic relationship, a meeting of the minds between Beijing and Washington must happen soon. Rudyard Kipling to the contrary notwithstanding, the twain must—and in the end, probably will—meet.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author below.

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