SEC Bars Chinese Units of Big Four Accounting Firms

Last week, a U.S. Securities and Exchange Commission (SEC) administrative law judge ruled that, based on their refusal to turn over documents to SEC investigators, the Chinese units of the "Big Four" accounting firms—Ernst & Young, KPMG, Deloitte Touche Tohmatsu, and PricewaterhouseCoopers—were barred for six months from auditing companies that do business in the United States. Although the decision does not go into effect immediately, and the firms have already said that they intend to appeal, if upheld, the decision could have a negative impact on Chinese companies that use Big Four firms to audit their financial statements included in SEC filings, as well as U.S. companies with significant operations in China. Accordingly, as discussed below, we recommend that companies potentially affected by this decision begin considering steps to mitigate its impact.

SEC prevails in its action against the Chinese units of the Big Four accounting firms and secures an Order barring the Chinese firms from appearing or practicing before the SEC for six months.

The ruling stems from an action initiated by the SEC in December 2012 requesting that each of the accounting firms "be censured or denied the privilege of appearing or practicing before the Commission" for willfully violating the Sarbanes-Oxley Act. The SEC alleged that the accounting firms performed audit work for ten U.S. issuers whose shares were registered with the SEC. All 10 had operations that were largely based in China and were targets of SEC fraud investigations. In connection with those investigations, the SEC requested audit work papers and related documents from the accounting firms, which each of the accounting firms refused to provide on the grounds that doing so would violate Chinese laws, including State Secrecy and Privacy laws.

After a nine-day hearing, ALJ Cameron Elliot found in favor of the SEC, concluding in his 112-page decision that the firms had violated Sarbanes-Oxley Section 106(e) which provides that a willful refusal to comply with a request by the Commission (such as a request for audit work papers) shall be deemed a violation. In doing so, Judge Elliot reasoned that, "the motive for the choice [not to produce the documents] is irrelevant, so long as the Respondent knew of the request and made a choice not to comply with it. Thus, bad faith need not be demonstrated, and good faith is not a defense."

After finding that each of the firms willfully refused to comply with at least one Sarbanes-Oxley request, Judge Elliot next evaluated the appropriate sanction. He explained that the firms' actions "involved the flouting of the Commission's regulatory authority, which may not be as egregious as, say, accounting fraud, but is still egregious enough that it weighs against leniency." He also rejected the firms' arguments that their actions were in "good faith" because they were ready, willing and able to produce documents, but were unable to do so under Chinese law. There, Judge Elliot noted that "he had little sympathy" for the firms given that they "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 thereby might violate the law."

Pressure will be on U.S. and Chinese regulators to strike a compromise that avoids the worst consequences of the Order while achieving their respective regulatory interests.

Finally, the firms argued that a practice bar would have substantial negative consequences because no other auditing firm could adequately replace them and thus China-based U.S. issuers would no longer be able to trade on U.S. exchanges, reducing their market capitalization and harming investors. Judge Elliot rejected this argument as well, noting that the firms' "dire predictions of investor losses, delisting, and loss of market capitalization, which are generally predicated on a lack of adequate substitute auditors, are unrealistic and unpersuasive." In doing so, he identified multiple adequate substitute auditors that China-based U.S. issuers could use going forward. Judge Elliot thus barred the Chinese units from appearing or practicing before the SEC for six months.

Judge Elliot's ruling does not go into effect immediately. The firms' expected appeal would first be heard by the full Commission and then by the United States Court of Appeals for the D.C. Circuit and could take years to resolve. In the interim, there could be a negotiated settlement between the SEC and the firms with a more limited bar that avoids the worst consequences of Judge Elliot's decision, but still sanctions the firms. For example, the SEC could agree to a bar that would prohibit the firms from signing audit reports for six months, but allow them to conduct component audits in conjunction with their U.S. affiliates, which would obviate the need for U.S. companies with operations in China to find new auditors. Alternatively, a settlement could provide that the bar would end once the subject documents are received by SEC investigators, which has already occurred (via the Chinese government) with respect to a number of the investigations at issue and appears likely to continue.

Still, if affirmed, the decision will impact not only China-based companies listed in the United States, but also U.S. multinational companies with significant operations in China that use these accounting firms. This could have unintended consequences for U.S. investors in that the audits of large multinational companies could fall to firms that may be less equipped to handle the flood of audit work. It could also result in China-based companies not being able to sell their securities in the United States. Of course, these very arguments were raised—and rejected—by Judge Elliot.

Judge Elliot's decision will undoubtedly ramp up political pressure on the U.S. government, including the SEC, to find a solution with Chinese regulators in order to avoid what could otherwise become a recurring problem. Indeed, some progress had already been made prior to Judge Elliot's ruling. For example, On May 24, 2013, the Public Company Accounting Oversight Board (PCAOB) announced that it had signed an agreement with the China Securities Regulatory Commission (CRSC) that would enable the PCAOB under certain circumstances to obtain audit work papers of China-based audit firms. And in July 2013, the CRSC agreed to provide certain requested audit work papers to the SEC. To the extent the Chinese government perceives Judge Elliot's decision as hostile to its laws, however, it could have the opposite impact, and hinder the U.S. government's continued efforts to convince Chinese authorities to allow access to such audit work papers. The appeal of Judge Elliot's order would give authorities the time to reach a regulator-to-regulator solution to this long-simmering problem. And it is likely that large U.S. issuers will bring pressure on the government to do just that.

Companies should begin to assess the effect that this Order has on their operations and consider whether steps can be taken to avoid or minimize its impact should it be upheld on appeal.

Even though the impact of Judge Elliot's order will not be immediately felt and there is hope that the SEC and the CSRC will, as Judge Elliot stated, "continue to constructively engage each other" to find a solution, there are steps that companies based in China, or with large Chinese operations, should begin to take. As an initial matter, companies should determine whether this order relates to their Chinese-based auditors. If so, we recommend that companies have candid discussions with their auditors regarding potential work-arounds, such as whether affiliates or related audit firms could handle audits during the six month bar. Ultimately, public companies may need to face a difficult choice as to whether to retain their current auditor; indeed, in light of Judge Elliot's decision, board members may feel the need to address this issue sooner rather than later. That said, we are hopeful that an appropriate resolution can be reached to forestall the impact of this order. In the meantime, public companies should pay attention to the issue and follow the efforts on all sides to broker a compromise.

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