Administrative Law Judge Temporarily Bars Chinese Affiliates of "Big Four" Auditing Firms From Practice

February 18, 2014

On January 22, 2014, U.S. Administrative Law Judge Cameron Elliott issued an initial decision censuring the Chinese affiliates of Ernst & Young, KPMG, Deloitte, and Pricewaterhouse Coopers, and denying them the privilege of practicing or appearing before the Securities and Exchange Commission ("SEC" or the "Commission") for six months, due to their willful refusal to produce requested audit work papers to the SEC in violation of Section 106 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and the Securities Exchange Act of 1934 ("Exchange Act").[1] The four auditing firms appealed the decision to the five members of the SEC on February 12, 2014.

I. FACTS

The four Chinese accounting firms performed audit work for ten China-based U.S. issuers whose securities are registered with the SEC. At some point, each of the ten issuers became the subject of a fraud investigation by the SEC's Division of Enforcement (the "Division"). During the course of these investigations, the Division served the issuers' respective auditing firms (through their designated U.S. agents) with requests for audit work papers and related documents, pursuant to Sarbanes-Oxley Section 106.[2] Each of the accounting firms declined to produce the work papers despite their expressed willingness to cooperate, citing Chinese law prohibiting the production of work papers and related documents to U.S. regulators and the potentially serious penalties that could be imposed on them for violating this directive.

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[1] *See* *In the Matter of BDO China Dahua CPA Co., et al.*, Initial Decision Release No. 553, File Nos. 3-14872, 3-15116 (Jan. 22, 2014). The judge also censured a fifth firm – BDO China Dahua CPA Co., Ltd. – but did not bar it from practice.

[2] Sarbanes-Oxley Section 106(b)(1), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), provides, in relevant part: "If a foreign public accounting firm performs material services upon which a registered public accounting firm relies in the conduct of an audit or interim review, issues an audit report, performs audit work, or conducts interim reviews, that foreign public accounting firm shall— (A) produce the audit work papers of the foreign public accounting firm and all other documents of the firm related to any such audit work or interim review to the Commission or the [Public Company Accounting Oversight] Board, upon request of the Commission or the Board." 15 U.S.C. § 7216(b)(1).

II. THE INITIAL DECISION

In determining whether the auditing firms' actions violated the law, Judge Elliott focused on Sarbanes-Oxley Section 106(e), which provides that "a willful refusal to comply . . . with any request by the Commission . . . under this section, shall be deemed a violation of this Act."[3] The judge interpreted the word "refusal" as a "failure to comply" with a request for audit papers.[4] He also determined, based on "analogous provisions of the Exchange Act . . ., the language of Sarbanes-Oxley overall, and pertinent opinions and releases from the Board and the Commission," that "willfulness" simply means "choosing to act or not to act after receiving notice that action was requested," and does not require a showing of bad faith.[5] The judge, therefore, held that since each auditing firm received notice of at least one Sarbanes-Oxley Section 106 request but chose not to comply with it, each firm willfully refused to comply with the request.

Having found that the auditing firms willfully violated a provision of the federal securities laws, Judge Elliott held that they may be sanctioned, as long as it is in the public interest to do so. The judge weighed various factors in determining whether and which sanctions would be in the public interest. Judge Elliott explained that on the one hand, the auditing firms "have failed to recognize the wrongful nature of their conduct, their occupation presents opportunities for future violations, and their assurances against future violations are insincere. On the other hand, their violations were not particularly egregious, the recurrent nature of their violations carries little weight, and they did not act with scienter."[6] Under these circumstances, the judge opined that a permanent practice bar would be too severe a sanction, but that a mere censure would not serve as an effective deterrent, and thus concluded that a censure coupled with a six-month practice bar would be in the public interest.

Notably, in evaluating the appropriate sanction, Judge Elliott rejected the auditing firms' contention that they acted in good faith as they were willing to produce the requested documents but were prevented from doing so by Chinese law. The judge expressed "little sympathy" for the firms, each of which "registered with the Board knowing that it might be required to provide audit work papers" and was later "notified by the Board that it was subject to all applicable U.S. laws," yet made the affirmative decision to perform audit work for U.S. issuers at their own risk, "knowing that a failure to directly produce documents pursuant to Sarbanes-Oxley 106 might be a violation of Sarbanes-Oxley."[7] In Judge Elliott's opinion, the auditing firms' position that they should now be relieved of a duty of which they were well aware "does not demonstrate good faith, indeed, quite the opposite – it demonstrates gall."[8]

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[3] *In the Matter of BDO China Dahua CPA Co., et al.*, at 88 (citing 15 U.S.C. § 7216(e)).

[4] *Id*. at 89.

[5] *Id*. at 88-93.

[6] *Id*. at 109.

[7] *Id*. at 105.

[8] *Id*.

III. POTENTIAL IMPLICATIONS OF THE DECISION

Since the Chinese auditing firms appealed the initial decision to the SEC (and are likely to appeal any unfavorable decision by the SEC to the U.S. Court of Appeals), the sanctions imposed by the initial decision will not yet take effect. If, however, after their appeals are exhausted – a process which could take months or even years – the auditing firms are temporarily suspended from practicing before the SEC, their suspension may have a significant impact not only on U.S. issuers based in China, but also on those with operations in China.

During the six-month suspension period, the Chinese branches of U.S.-traded corporations, many of which currently use the Chinese affiliates of the "big four" public accounting firms, will be unable to rely on these local firms to perform their audits. This will likely cause some disruption, as audit work will need to be transferred to smaller Chinese public accounting firms or to accounting firms located in other countries; however, the potential magnitude of any disturbance is unclear. In their appeal, the "big four" Chinese auditing firms argue (as they did before Judge Elliott) that the collateral consequences of their suspension will be severe, likely leaving many China-based U.S. issuers without an auditor and complicating the audits of countless multinational companies that rely on Chinese audit firms. Judge Elliott, however, was unconvinced; in his view, the Division "persuasively demonstrate[d]" that there are "adequate substitutes" for China's "big four" accounting firms that have produced audit work papers without objection.[9] Thus, the precise impact of the suspension – if it is upheld – remains to be seen. In the meantime, U.S. issuers that use one of the Chinese affiliates of the "big four" public accounting firms may consider getting their auditors' views regarding the expected impact of the potential sanction and inquiring whether their auditors suggest devising a prospective action plan.

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If you have any questions or would like additional information, please do not hesitate to contact [Yafit Cohn](#) at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

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[9] *Id*. at 107.

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