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PCAOB Announces Agreement With China on Production of Audit Work Papers – A Step Forward or Lip Service?

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On May 24, 2013, the Public Company Accounting Oversight Board ("PCAOB" or the "Board") announced that it had signed a Memorandum of Understanding ("MOU") with Chinese securities regulators that would enable the PCAOB under certain circumstances to obtain audit work papers of China-based audit firms. The MOU is the product of a nearly two-year effort by US regulators to gain access to audit records of US-listed Chinese companies suspected of improper accounting practices or fraudulent financial statements.

In theory, the MOU is an important step because it establishes a framework under which the PCAOB can request and obtain audit papers previously withheld on the basis that their production would violate Chinese law. The MOU is also significant in that it explicitly permits the PCAOB to share the work papers it obtains with the SEC, subject to certain requirements. But the MOU, which is non-binding, is also limited by its own terms. For instance, Chinese regulators may refuse to produce documents in specified circumstances, including where production would violate Chinese law or run contrary to the public interest. Moreover, the MOU does not provide the PCAOB with the ability to conduct on-the-ground inspections of auditors in China, an important part of the Board's oversight function. Like most international agreements to cooperate, the true test of the MOU's efficacy will be not what the agreement says, but how the parties act in light of their "understanding."

Background

The early 2000s saw a dramatic increase in the number of privately held Chinese companies going public on US exchanges, often through a process known as a "reverse merger," which involves less time, money and regulatory scrutiny than a traditional initial public offering ("IPO"). In a reverse merger, a private company seeking access to US markets merges with an existing public "shell company." Although the shell company survives the merger, its

remaining assets are generally only those of the private company, and the private company's management typically takes over the board and management of the shell company. It is estimated that, between 2007 and 2010 alone, over 150 Chinese companies went public on US exchanges through either a reverse merger or an IPO.

Over time, however, the increase in US-listed Chinese companies, combined with a wave of reports issued online by short sellers accusing many of these companies of various forms of corporate malfeasance, led to a corresponding spike in shareholder class action lawsuits against the Chinese issuers. In the past three years alone, over fifty China-based US issuers have been named as defendants in shareholder lawsuits, many of which were filed on the heels of these short-seller reports usually alleging improper accounting practices, fraudulent financial statements and/or undisclosed related party transactions.

US Enforcement and Regulatory Efforts

Not surprisingly, the din of accusations leveled against publicly traded Chinese companies caught the attention of US regulators, namely, the Securities and Exchange Commission ("SEC") and the PCAOB, which stepped up efforts to investigate listed Chinese companies publicly accused of engaging in improper accounting or securities fraud. As a means of obtaining information, the SEC issued administrative subpoenas and/or document requests to China-based member firms of several of the largest global international accounting firms, and thereby sought the direct production of work papers for the audits of Chinese companies under investigation.

In response to these subpoenas, however, the China-based audit firms took the position that the direct production of audit papers would violate Chinese state secrets laws and archives laws, and that the proper method for the SEC to obtain audit papers was through a request to the China Securities Regulatory Commission ("CSRC"), the chief regulator of accounting firms in China. According to the SEC, this proposed solution is untenable because the CSRC has to date been either unwilling or unable to provide meaningful assistance to the SEC's enforcement efforts (including its efforts to obtain the audit papers of firms that audited Chinese companies listed in the United States).

The SEC's response to this impasse has been two-fold. First, in response to the refusal of Shanghai-based Deloitte Touch Tohmatsu CPA Ltd. ("DTT Shanghai") to comply with an administrative subpoena and a separate administrative document request, the SEC brought a subpoena-enforcement action in the US District Court for the District of Columbia, and an administrative proceeding for the imposition of sanctions against DTT Shanghai. See *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, Misc. No. 11-512 (D.D.C., filed Sept. 8, 2011); *In the Matter of Deloitte Touche Tohmatsu CPA Ltd.*, A.P. No. 3-14782 (filed May 9, 2012). Second, this past December, the SEC filed an additional administrative proceeding against BDO China Dahua CPA Co., Ltd., Ernst & Young Hua Ming LLP, KPMG Huazhen (Special General Partnership), PricewaterhouseCoopers Zhong Tian CPAs Limited, and DTT Shanghai seeking the imposition of sanctions (including a possible bar from conducting audit work for SEC-registered companies) for noncompliance with administrative document requests related to the investigation of nine China-based issuers. See *In the Matter of BDO China Dahua CPA Co., Ltd.*, A.P. No. 3-15116 (filed Dec. 3, 2012). The two administrative proceedings have been consolidated.

Over the same period, the PCAOB, which supervises accounting firms that audit publicly-traded companies, undertook its own efforts to monitor audit firms in China. Each of the firms named in the SEC proceedings is registered with the PCAOB and therefore obligated to cooperate with the Board's investigations and to submit to inspections by the Board. Although the PCAOB announced in October 2012 that it had signed an agreement with Chinese authorities that purportedly allowed periodic observational visits by the PCAOB in mainland China, the PCAOB has still been unable to obtain permission from China to conduct on-the-ground inspections of Chinese audit firms, which the Board views as a critical part of its investigative role.

The Pre-Existing Framework For US-China Cooperation

The SEC and the CSRC have entered into a series of agreements over the past two decades designed to facilitate the sharing of information related to securities enforcement actions. Specifically, in April 1994, the SEC and the newly-formed CSRC entered into a non-binding Memorandum of Understanding Regarding Cooperation, Consultation and the Provision of Technical Assistance (the "1994 MOU"). The 1994 MOU memorialized the SEC's and CSRC's intent to assist each other in obtaining information and evidence for enforcement purposes, but it lacked any provisions specifying the means for requesting and receiving such assistance. Eight years later, the SEC and the CSRC (along with almost 90 other securities regulators), as members of the International Organization of Securities Commissions ("IOSCO"), signed a non-binding Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (the "IOSCO MMOU"). While the IOSCO MMOU provided an enhanced framework within which to share information for purposes of securities enforcement, it still lacked an enforceable commitment to cooperate. Finally, in 2006, the SEC and CSRC signed a Terms of Reference for Cooperation and Collaboration, which set forth an enhanced relationship between the agencies and identified three objectives: (i) to identify and discuss regulatory developments of common interest; (ii) to improve cooperation in cross-border securities enforcement matters; and (iii) to expand upon the program of technical assistance established in the 1994 MOU. Notably, with respect to (ii), the Terms of Reference acknowledged the growing number of cross-border listings and dually registered entities, and provided that the CSRC and SEC would work to communicate quickly on matters involving potential securities fraud and to provide timely and thorough assistance to one another, consistent with domestic law. But as discussed further below, according to the SEC, the CSRC has failed to provide meaningful assistance pursuant to any of these prior agreements.

The May 2013 MOU

In the latest attempt to facilitate cooperation in securities investigations, the PCAOB has now entered into a Memorandum of Understanding on Enforcement Cooperation with the CSRC and China's Ministry of Finance ("MOF"), dated May 7, 2013. The purpose of the MOU is to establish a channel of cooperation between US and Chinese regulators, with specific reference to audit papers. By its reciprocal provisions, the parties agree to provide each other with access to audit documents relevant to investigations in the United States and China. From the US perspective, the MOU thus gives the PCAOB the ability to seek access to audit work papers, documents regarding an audit firms' quality control systems, and documents that identify the nature and scope of services provided by an audit firm in a particular matter under investigation. Information received through the MOU may be used solely for the purpose(s) set forth in the request and for the purpose of conducting administrative enforcement proceedings and investigations, including the imposition of sanctions on audit firms based in China.

The MOU also contains a strict confidentiality provision under which the fact that a request has been made, as well as its contents and the information provided thereunder, must not be disclosed. There is, however, one important exception, which allows the PCAOB to share information received under the MOU with US law enforcement and regulatory authorities, including the SEC, as provided by the Sarbanes-Oxley Act (and similarly permits the CSRC and MOF to share information with Chinese enforcement and regulatory authorities). Interestingly, however, while the PCAOB must first receive prior written consent from Chinese authorities before sharing such information with other US authorities, the Board need only provide advance notice of its intention to share information with the SEC, without first receiving consent from the CSRC or MOF.

The MOU has a few other notable provisions. *First*, like past agreements between US and Chinese regulators, the MOU is not legally binding on the parties. *Second*, the MOU provides four grounds upon which either side may deny a request:

(i) where providing documents is contrary to a party's domestic law; (ii) where the request is not made in accordance with provisions of the MOU; (iii) on grounds of public interest or essential national interest; and (iv) where the request lacks sufficient specificity. *Third*, while information obtained under the MOU may be used for administrative enforcement proceedings and investigations, the MOU defines investigations as inquiries into the actions or omissions of audit firms only, and not the companies they audit. *Finally*, the MOU does not take the additional step of providing the PCAOB with the ability to conduct on-the-ground inspections of Chinese audit firms, a critical oversight tool that the PCAOB has been seeking for some time.

Implications

Real Cooperation or Another Agreement to Talk?

While the PCAOB has heralded the MOU as "an important step toward cross-border enforcement cooperation," whether the agreement will translate into actual cooperation is by no means certain. As discussed above, the MOU contains multiple grounds for either side to refuse cooperation, including the gaping provisions that permit each side to refuse cooperation if it would violate domestic laws or run contrary to the public interest. These exceptions could conceivably swallow the MOU itself, particularly in light of Chinese laws that strictly prohibit the disclosure of certain documents outside of China – which the MOU may or may not trump – and the flexible notion of the public interest.

The CSRC's recent track record under the IOSCO MMOU does not lend much comfort either. According to filings by the SEC in the DTT Shanghai subpoena case, the CSRC has failed to provide any meaningful assistance in response to 21 requests for cooperation made by the SEC since 2009 in connection with 16 separate investigations. Those requests also included three requests for audit work papers, which the CSRC refused to produce unless the SEC agreed not to use the work papers in any legal action without the CSRC's advance written authorization. Although recent filings in the case note that the CSRC has now claimed it will produce the documents, no such productions have been made.

On the other hand, MOF's participation in the MOU could signal that China is taking its commitment to produce audit papers more seriously. At the very least, MOF's presence has the appearance of streamlining the process of responding to requests by eliminating an extra layer of bureaucratic approval that the CSRC has in the past indicated was necessary.

The MOU's Effect on the SEC's Ongoing Proceedings

The most immediate use of the MOU was in the SEC's ongoing subpoena enforcement action and administrative proceedings against the five China-based audit firms. Less than one week after the PCAOB announced the MOU, counsel for DTT Shanghai in the subpoena enforcement action filed a notice of supplemental authority attaching the MOU and pointing out that it permits the PCAOB to share with the SEC materials received from the CSRC, and thereby gives the SEC another means to obtain and use the documents requested in its subpoena. Similarly, counsel for the audit firms in the SEC's administrative proceeding cited the MOU as "clearly alternate means of production" and a sign that "bilateral cooperation between Chinese and US regulators is not only continuing, but is resulting in concrete agreements."

The SEC's response has been dismissive. In papers filed in the proceedings, the SEC has taken the position that the MOU is irrelevant, noting that the IOSCO MMOU "has long been in place" and yet "that agreement has not resulted in the production of any audit workpapers to the SEC." It appears that, despite the MOU, the SEC will stay the course until it receives actual audit papers from China, through whichever channel they may come.

A New Wave of Enforcement?

If the MOU does indeed put audit papers in the hands of US regulators, particularly the SEC, it could potentially result in a new wave of SEC enforcement actions against US-listed Chinese companies. The MOU permits the PCAOB to share the

materials with the SEC, but it is unclear whether the SEC may then use such materials for independent purposes. The spirit, if not the letter, of the MOU probably weighs against such practice, especially considering that the MOU requires the PCAOB to obtain consent from Chinese authorities prior to using any audit materials for purposes other than those expressly authorized. In addition, because there is no indication that the MOU was designed to end the stalemate between the SEC and the CSRC, it is possible that sharing between the PCAOB and SEC would make the CSRC less willing to cooperate under the MOU.

Chinese regulators must nevertheless be mindful of the potential implications of refusing to cooperate under the MOU. The PCAOB has the authority to deregister audit firms that do not comply with its investigations. If the CSRC refuses to provide documents to the PCAOB under the MOU, Chinese companies that rely on China-based audit firms to prepare their audited financial statements could effectively be forced out of US capital markets.

Conclusion

The MOU unquestionably signals progress in the relations between US and Chinese regulators, but it remains to be seen whether the agreement will bear fruit. Most notably, the CSRC still has the same grounds to refuse producing audit papers to US authorities as it did prior to signing the MOU. The first signals of the MOU's efficacy will likely play out in the SEC's ongoing proceedings against the five China-based audit firms, but only time will tell whether the MOU will have a lasting effect or simply be another non-binding agreement to talk.

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