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DISCLOSURE

Caught Between a Great Wall and a Hard Place: Issues For U.S. Public Companies in Responding to Regulatory Requests for Chinese Data



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Introduction.

In January 2014, a Securities and Exchange Commission administrative law judge (“ALJ”) sanctioned five Chinese affiliates of major U.S. public accounting firms (the “Firms”) for their failure to produce work

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papers related to their auditing of ten U.S. issuers with operations in China.¹ At the time of the document requests, the issuers were under investigation by the SEC for alleged fraud. The ALJ ordered the sanctions despite the fact that Chinese regulators had expressly forbidden the Firms from producing their work papers, and notwithstanding the Firms’ documented concerns that direct production could subject them to criminal prosecution under China’s State Secrets Law.² The ALJ had “little sympathy” for the Firms, pointing to the lucrative

¹ *In re BDO China Dahua CPA Co., Ltd., et al.*, Initial Decision Release No. 553, Administrative Proceeding File Nos. 3-14872, 3-15116, 102 (Jan. 22, 2014). Deloitte LLP’s China-based affiliate was the subject of a separate, earlier administrative proceeding. *In re Deloitte Touche Tohmatsu Certified Public Accountants Ltd.*, Exchange Act Release No. 66948, Administrative Proceeding File Nos. 3-14872 (May 9, 2012) (“DTTC”). The two proceedings were consolidated by the ALJ (collectively “Dahua”). The four other Firms were affiliated with BDO, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP.

² See *Dahua*, *supra* note 1, at 7 (noting Chinese auditor’s citations to “Article 21 of the Law on Guarding States Secrets of China . . . and to Article 22 of Measures for Implementation of the State Secrets Law”).

audit work they had obtained and stating that if they were between a rock and a hard place, “it is because they wanted to be there.”³

Whether in the context of securities fraud, anti-corruption, antitrust, or consumer protection, U.S. enforcement agencies now routinely investigate the Chinese operations of U.S. issuers. Public companies operating in China are almost certain to face SEC requests seeking the production of materials located in China. Moreover, even a company’s responsible efforts to conduct an internal investigation raises significant questions of how (or whether) to export Chinese data. Increasingly, professional services firms engaged to process data for internal investigations demand representations from clients that their China-based data does not contain sensitive information that could trigger potential violations of the State Secrets Law.

Given this dilemma—chance criminal prosecution in China or face sanctions in the U.S.—companies encountering these conflicting legal obligations should adopt practical solutions to mitigate the risks. Focusing on the specific concerns facing U.S. issuers with operations in China, this article: (1) describes how the Firms in *Dahua* attempted to navigate between the SEC and the Chinese government; (2) outlines an approach for mitigating some of the risks of responding to U.S. information requests for Chinese data; and (3) suggests other areas where these issues may impact U.S. public companies, including: independent auditor engagements, enforcement resolution negotiations with U.S. authorities, and the ongoing involvement of the *Dahua* Firms in the preparation of their audited financials.

The Approach Taken by the Chinese Accounting Firms. In the investigations of the ten Chinese issuers, the SEC served subpoenas directly on the issuers and the Chinese auditors’ U.S. affiliates, and sent voluntary production requests to the Firms. When these methods failed to secure production of the work papers, the SEC served Sarbanes-Oxley Act (“SOX”) § 106 demands on each of the Firms.⁴

The Firms used a two-pronged approach to navigate between the China Securities Regulatory Commission (“CSRC”)⁵ and the SEC. They attempted to convince the SEC that their fears of criminal prosecution in China were genuine and that they had done everything possible to obtain permission from the CSRC, while simultaneously urging the CSRC to either permit direct production of their work papers or implement an approved process for delivery of the materials to the SEC.

Each of the Firms indicated to the SEC that they were willing but unable to comply with the SOX § 106 demands. They explained to the SEC staff that production could subject them to, among other sanctions, criminal prosecution under the State Secrets Law. The Firms

³ *Id.* at 105.

⁴ The *Dahua* decision is narrowly premised on the Firms’ obligations under SOX § 106(e). The SEC claimed that the five Firms – as “foreign public accounting firms” under SOX § 106(g) – had violated SOX § 106(e) by their “willful refusal to comply” with the SEC’s requests for audit work papers.

⁵ The CSRC, a ministry-level unit directly under China’s State Council that regulates China’s securities and futures markets, has regulatory authority over public company auditing firms in China, including the *Dahua* Firms. *About CSRC, CHINA SEC. REGULATION COMM’N*, http://www.csrc.gov.cn/pub/csrc_en/about/ (last visited Feb. 14, 2014).

supported these claims by producing evidence of their repeated efforts to obtain permission from the CSRC, the Ministry of Finance (“MOF”), the State Secrets Bureau and the Archives Bureau, by demonstrating their receipt of multiple warnings from the CSRC and MOF, and by producing Chinese legal opinions indicating that the direct production of work papers to the SEC could expose them to criminal and civil liability. The CSRC repeatedly informed the Firms—including during an unprecedented group meeting that included senior officials from the MOF—that complying with the SEC’s requests would result in significant liability, license revocation, and “personal” consequences.⁶ The CSRC declined to provide the Firms with guidance on precisely what information within their work papers could constitute “state secrets” for purposes of Chinese law.⁷

On their side, the SEC staff attorneys were frustrated by their inability to obtain copies of the work papers through their CSRC counterparts. Despite the existence of at least four cooperation agreements between the SEC and CSRC, the SEC’s Office of International Affairs (“OIA”) advised the investigating attorneys that previous similar requests to the CSRC had been fruitless. Although each of the Firms asked the SEC to utilize an agency-to-agency production process, the SEC staff insisted that they produced their work papers directly.⁸

Although the Firms notified the SEC that the CSRC had begun developing pre-production screening guidelines that would facilitate the production of their work papers to the CSRC for delivery to the SEC, the SEC nevertheless instituted administrative proceedings alleging that the Firms had willfully refused to produce their work papers in violation of SOX and the Securities Exchange Act of 1934. In January 2014, the ALJ found that the Firms had not acted in good faith in responding to the SEC’s information requests and had “willfully refused” to produce their work papers in violation of SOX § 106. The ALJ ordered six-month bars from practice and censures for four of the Firms, and censured, but did not bar, the BDO affiliate.⁹

A Practical Approach to Information Requests Related to China. Although there is no easy solution for the dilemma of conflicting cross-border regulatory demands, the facts of *Dahua* suggest that a robust document pre-screening process could be one part of an appropriate risk mitigation strategy. At the CSRC’s direction, the Firms ultimately adopted a two-part production pro-

⁶ *Dahua*, *supra* note 1, at 44.

⁷ Even Chinese officials face opacity in making state secrets determinations. Although a “clarification” of the State Secrets Law was recently released, the guidance suggests wide latitude in making such determinations, while emphasizing that officials who reveal too much will be “dealt with according to law.” See Richard Silk, *China’s Secret Anti-Secrecy Act*, WALL ST. J., CHINA (Feb. 3, 2014, 9:36 PM), <http://blogs.wsj.com/chinarealtime/2014/02/03/chinas-secret-anti-secrecy-act/>.

⁸ The Firms argued that the SEC should have used SOX § 106 (f), which permits the SEC to allow foreign public accounting firms to meet production obligations “through alternative means, such as through foreign counterparts of the Commission. . .” *Dahua* at 98 -100.

⁹ The Firms have indicated that they will appeal the decision. Alan Katz, *China Auditors Barred for Six Months for Blocking SEC*, BLOOMBERG PERS. FIN., Jan 23, 2014, available at <http://www.bloomberg.com/news/2014-01-22/china-auditors-barred-for-six-months-for-not-aiding-sec-probes.html>.

cess: pre-screening their work papers, and then producing them to the CSRC for approval and ultimate delivery to the SEC.¹⁰ For issuers responding to U.S. regulatory requests for China-based data, their principal challenge may lie in the second step: identifying a Chinese regulator (like the CSRC) that has jurisdictional coverage, an ongoing cooperation agreement with the relevant U.S. agency, and the willingness to authorize the production of pre-screened materials.¹¹ Accordingly, the level of protection that U.S. issuers can derive from adopting an internal pre-screening process may diminish in the absence of a Chinese regulator with appropriate pre-production approval authority.

Notwithstanding this limitation, the evidence presented by the *Dahua* Firms describe several iterations of a protocol for the pre-production screening of auditor work papers for state secrets and other sensitive materials.¹² Taken together, these descriptions sketch out a four step pre-screening procedure that could be implemented by companies as a risk-mitigation effort in processing their own Chinese data (whether for government production or internal investigations).

■ **Retain Competent Chinese Counsel:** in each iteration of the protocol, the CSRC instructed the Firms to retain Chinese counsel. In some cases the attorneys performed the document review, in some cases counsel was part of a review team that included the accountants, while in other cases the attorneys simply reviewed (or certified) the results of the accountants' analysis.

■ **Conduct a Document Review:** the review team, however constituted, then analyzed the documents to iden-

¹⁰ In a separate SEC subpoena enforcement action against Deloitte's Chinese affiliate, the affiliate used this protocol in connection with its production to the SEC through the CSRC. *Dahua* at 38. The SEC ultimately dismissed this action once the CSRC had completed its delivery of the work papers to the SEC. See Joint Motion to Dismiss without Prejudice, *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, 1:11-mc-00512, (D.D.C. Jan. 27, 2014). To date, it appears that the Firms and/or the CSRC are still working on the *Dahua*-related productions, as the SEC has not yet dismissed that proceeding.

¹¹ The CSRC has jurisdiction over Chinese public companies and public accounting firms, which provided the *Dahua* Firms with a relatively clear regulatory pathway. For U.S. issuers whose Chinese subsidiary is a private company, the likeliest relevant regulator of the subsidiary is China's State Administration of Industry and Commerce. This agency currently does not have a cooperation agreement in place with the SEC, although it has executed an MOU with the U.S. Department of Justice and the U.S. Federal Trade Commission with respect to antitrust matters (available at <http://www.justice.gov/atr/public/international/docs/273310a.pdf>). Moreover, even if an appropriate agency and pathway is identified, U.S. companies may be reluctant to voluntarily submit information to Chinese regulators for pre-production approval, when the only triggering event is a U.S. government information request. The recent detentions in China of GlaxoSmithKline executives and U.S. and U.K. nationals in connection with corruption probes that overlap with U.S.-based Foreign Corrupt Practices Act ("FCPA") investigations suggest one species of legitimate concern.

¹² According to the evidence introduced in *Dahua*, between February 2012 and June 2013 the CSRC provided several variations or iterations of the pre-screening protocol to the Firms, both individually and in group meetings. See *Dahua*, *supra* note 1, at 19, 30, 37-38.

tify any "state secrets or other sensitive information."¹³ According to testimony presented in *Dahua*, state secrets were "scattered throughout" the work papers, and included "technology know-how" and "non-public Chinese 'governance policy.'" However, state secrets "were not, 'in general,' found in bank confirmations, supplier confirmations, customer confirmations, bank statements, financial books and records, or [the auditor's] findings."¹⁴ The CSRC appeared to accept a variety of analytical methods, including both page-by-page manual reviews and the use of computerized key word searches.

■ **Create a Withholding Log:** in at least one iteration of the CSRC protocol, the Firm prepared a spreadsheet of the documents that were to be withheld from production to the SEC.¹⁵ Preparing a withholding log makes good sense, as it can be used in future regulatory discussions regarding document productions, as well as creating a solid record of the review procedures followed and the analysis conducted by the company.

■ **Create a Redacted Set of Documents for Production:** each Firm created a production set of documents, redacted as agreed to by the CSRC. The CSRC cautioned the Firms that they should use "sound judgment" in redacting the materials, and not withhold information "because it contains matter that would cast the accounting firm in a bad light."¹⁶ Companies adopting an internal pre-screening process should also heed this admonition—document over-redaction can damage credibility and sow regulatory suspicion that the screening process is designed to obstruct government inquiry rather than maintain legitimate privileges.

The CSRC screening process should feel familiar to any attorney who has performed a pre-production attorney-client privilege review in the U.S. The challenge here, however, is to accurately identify materials containing Chinese state secrets or other sensitive information and ensure appropriate redaction or withholding. Clearly, retaining competent U.S. and Chinese counsel is the first step in developing appropriate pre-screening procedures.

Other Issues for Consideration. *Dahua* raises at least three other issues for U.S. public companies to consider. First, issuers need to understand how their auditor's Chinese affiliate will respond to an SEC request for their work papers—well before the request arrives. For example, in negotiating engagement letters, companies should determine whether their auditor is required to notify them of such requests, and whether the company can obtain indemnification from the U.S. audit firm if its Chinese affiliate fails to produce materials to U.S. authorities or violates foreign laws in making such a production.

Second, companies resolving SEC and other government enforcement matters should consider whether they might be required to produce Chinese data in the future under ongoing cooperation obligations. Compliance with a blanket commitment to cooperate may not be easy or legal under all circumstances. Counsel should attempt to include qualifying language that ad-

¹³ *Id.* at 30.

¹⁴ *Id.* at 37.

¹⁵ *Id.* at 37.

¹⁶ *Id.* at 38.

equately addresses potentially-conflicting foreign laws, particularly if the client operates in China.¹⁷

Finally, issuers should anticipate and proactively address the potential collateral consequences of the ongoing involvement of the *Dahua* Firms in their audited financials, especially on the SEC staff's treatment of issuers' securities filings. Issuers' efforts should include reviewing their effective registration statements or planned securities offering filings for additional disclosure on the risks to investors of the imposition of the *Dahua* ban,¹⁸ preparing for the use of alternative auditors (including drafting interim reports for notification of a change in auditors), and reviewing other commitments relating to audited financial statements and maintaining public company status (e.g., listing agreements, bank and bond covenants, filings with rating agencies).

¹⁷ See, e.g., *In re Total, S.A.*, Exchange Act Release No. 6954, Administrative Proceeding File No. 3-15338, 6 -7 (May 29, 2013) (addressing potential data protection issues). Cf., *Deferred Prosecution Agreement*, U.S. Sec. and Exch. Comm'n and Tenaris S.A., ¶ 3(a) (May 17, 2011), available at <http://www.sec.gov/news/press/2011/2011-112-dpa.pdf> (agreeing to produce all non-privileged materials "wherever located").

¹⁸ See, e.g., *JD.com, Inc.*, Registration Statement Under the Securities Act of 1933 (Form F-1) 36 - 37 (Jan. 30, 2014) (Risk Factors disclosure includes upholding of *Dahua* bar, which could result in its financial statements being "determined to not be in compliance with the requirements of the Exchange Act" and could "lead to the delay or abandonment of this offering, delisting of our Class A ordinary shares from the NYSE/NASDAQ Global Market or deregistration from the SEC, or both, which would substantially reduce or effectively terminate the trading of our ADSs in the United States").

Conclusion. The focus of U.S. authorities on issuers' China operations will continue to generate information requests for data located in that market. But responding to such requests poses real risks. No pre-screening process or internal procedure can prevent a company from being accused of violating China's State Secrets Law, it can only mitigate the risk. And given the size and scope of China's myriad administrative and regulatory agencies, it is impossible to anticipate the reaction of every Chinese agency to a U.S. company's direct production of China-based data to U.S. authorities using the pre-screening procedures described in *Dahua*. On the U.S. side, at least some regulators have recognized that conflicting foreign laws may raise legitimate controversies that should be addressed in a responsible fashion.¹⁹ The *Dahua* case, however, suggests that the SEC ultimately will be unforgiving of a U.S. issuer's failure to produce documents on the grounds of incompatible Chinese law.

¹⁹ For example, in the context of cross-border FCPA matters, the U.S. Department of Justice has credited companies for producing materials in compliance with conflicting foreign laws. See, e.g., Department of Justice Sentencing Memorandum, *United States v. Siemens Aktiengesellschaft*, No. 1:08-cr-00367-RJL, at 21 (D.D.C. Dec. 12, 2008). ("Siemens has worked hard to take necessary steps, and where necessary, obtain approval from foreign authorities, to make the documents available to the Department and the SEC as promptly as possible and in compliance with relevant data privacy laws and other legal restrictions. Siemens extensive efforts . . . have been exemplary and serve as a model to other multi-national companies seeking to cooperate with law enforcement authorities.")