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Scaling Two Great Walls: Resolving the Impasse Between China's State Secrets Law and International Disclosure Requirements

Rohan Maitra

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Scaling Two Great Walls: Resolving the Impasse Between China's State Secrets Law and International Disclosure Requirements

*Rohan Maitra**

Abstract: Recent cases of corporate accounting fraud in China have presented countries attempting to prosecute these cases with legal difficulty. When non-Chinese regulators have requested financial documents from the auditors of these accused companies for investigatory purposes, the auditors have refused to produce these documents, claiming that to do so would cause them to violate Chinese law. In response, regulators in multiple countries have sued these auditors to try and force them to produce the documents, and also threatened Chinese companies operating in their jurisdictions with delisting and other sanctions. This has resulted in a counterproductive stalemate in which there exists no clear set of guidelines for foreign regulators or accounting firms to follow in obtaining necessary information for prosecution and rectification of corporate fraud. This Note will argue that it is in the Chinese government's best interests to formalize a process that satisfies the needs of both Chinese and foreign regulators without trapping accounting firms in the middle. This Note will also analyze the current state of cases regarding this issue and the potential consequences of a failure to resolve the issue.

* J.D., Northwestern University Pritzker School of Law, 2016; B.A., Middlebury College, 2009.

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I. INTRODUCTION

As the global economy becomes increasingly interconnected and large numbers of companies begin operating in multiple countries, governments have endeavored to properly regulate the global giants.¹ As companies expand past their own borders and set up shop in jurisdictions with completely different systems, however, their presence and operations may occasionally cause conflicts when they try to follow both sets of rules. When these companies are suspected of committing crimes in their new places of business, methods of resolving these crimes are not always cordial, and may raise relevant questions. For instance, who has jurisdiction over the parties? Where should the lawsuit be filed? If the result is positive, will it be necessary for the courts of a different country to enforce it? Will they, in fact, enforce any such order?

One major issue that is causing a great deal of consternation in multiple jurisdictions is financial fraud by Chinese companies, which involves false statements made to their auditors, fake revenue, and other practices that allow the companies to obtain listings on foreign stock

¹ Joseph E. Stiglitz, *Regulating Multinational Corporations: Towards Principles Of Cross-Border Legal Frameworks in a Globalized World Balancing Rights With Responsibilities*, 23 AM. U. INT'L L. REV. 451 (2008).

exchanges despite their comparatively poor financial statuses.²

In recent years, Chinese auditors have come into conflict with the laws of multiple countries because of the Chinese government's stance on the audited financial documents of these corporations.³ Regardless of whether the companies in question are listed on stock exchanges in foreign countries, Chinese law classifies these documents as "State Secrets."⁴ Due to the People's Republic of China (PRC) Law Guarding State Secrets, which forbids the production of any document classified as a State Secret to a foreign entity, any firm ordered to produce these documents to a foreign regulator, no matter whether in the U.S. or any other country, finds itself in the undesirable position of violating either Chinese law or the law of the jurisdiction making the request.⁵ Consequently, when allegations of financial fraud or other wrongdoing are levied against these corporations, the accounting firms that perform audit and tax services for them—typically large accounting firms like those that comprise the Big Four—find themselves trapped between the proverbial "rock and a hard place."⁶ Even more troubling for these firms is that governments around the world are also becoming less inclined to tolerate constant legal shielding of important corporate information. It keeps them from properly investigating companies who still wish to be listed on domestic exchanges, especially when these companies are faced with allegations of fraud and other notable wrongdoings.⁷ Courts around the world have begun expressing their displeasure with the status quo by no longer accepting the State Secrets defense.⁸ Instead, they have begun demanding that the Chinese auditors produce the audited materials in accordance with domestic law and have

² Jake Lynch, *To Control Fraud, De-Control Chinese Capital*, WALL ST. J. (Feb. 13, 2013, 11:56 AM), <http://www.wsj.com/articles/SB10001424127887324590904578289082162402440>.

³ *Chinese Audit Documents Remain out of Reach*, THOMSON REUTERS TAX & ACCOUNTING NEWS (Oct. 26, 2013), <https://tax.thomsonreuters.com/media-resources/news-media-resources/checkpoint-news/daily-newsstand/chinese-audit-documents-remain-out-of-reach/>.

⁴ Under Articles 31 and 32, companies may face liability for divulging State Secrets without governmental approval. *Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa (中华人民共和国保守国家秘密法)* [Law of the People's Republic of China on Guarding State Secrets] (promulgated by Order No. 6 of the President of the People's Republic of China, Sep. 5, 1988, effective May 1, 1989), *translated in* ASIANLII, <http://www.asianlii.org/cn/legis/cen/laws/gssl248/>.

⁵ *Id.* art. 26.

⁶ The Big Four accounting firms include Deloitte & Touche LLP, PricewaterhouseCoopers LLP, Ernst & Young LLP, and KPMG LLP. *The Big Four Accounting Firms: Shape Shifters*, THE ECONOMIST (Sep. 29, 2012), <http://www.economist.com/node/21563726>.

⁷ Nina Xiang, *Accounting Fraud is Still Widespread Among Chinese Companies*, FORBES ASIA (Apr. 16, 2014, 10:33 AM), <http://www.forbes.com/sites/ninaxiang/2014/04/16/accounting-fraud-is-still-widespread-among-chinese-companies/>.

⁸ One major example, discussed later in the paper, is Singapore's refusal to accept a face-value allegation of a State Secrets violation. *BNY Corporate Trustee Services Ltd v Celestial Nutrifooods Ltd* [2014] SGHC 155 (Sing.).

held that the Chinese auditors' refusal to do so violates local law.⁹ The most significant of these rulings to date has been the U.S. Securities and Exchange Commission's (SEC) initial finding that all four of the Big Four's Chinese affiliates violated the Sarbanes-Oxley Act.¹⁰ The SEC's decision resulted in a highly precarious standoff between the Chinese government and foreign regulators, with the auditors caught in the middle.

Had the SEC ultimately implemented its ruling in the Initial Decision, which suspended the Chinese affiliates of the Big Four from practicing in front of the SEC for six months, it could have become a precedent resulting in hundreds of U.S.-listed Chinese companies losing their listing on U.S. stock exchanges. Furthermore, allowing the ruling to stand would also have caused a significant ripple effect—once the regulatory body in any major country demonstrates a willingness to endure a mass delisting of these companies, other jurisdictions might follow suit in the hopes of producing a favorable response from the Chinese government. In the case of the SEC, the agency chose instead to forego the sentence, effectively setting the problem up for a later resurgence, and leaving U.S. investors with virtually no more protections than they enjoyed prior to the lawsuit.¹¹ In this geopolitical standoff, both these firms and the companies that perform audit services for the firms will find themselves caught in the middle, trying to comply with virtually incompatible requirements from entities with equally valid power to exercise jurisdiction over them. Auditors are effectively the battleground in this conflict, and may see adverse effects on their business and reputations before both sides reach a mutual understanding. Moreover, as more of these cases obtain standing in the courts of other countries, Chinese companies may have to deal with a growing stigma of inaccessibility.

Part II of this Note will provide an in-depth look at the background of this conflict, track the evolution of the SEC's lawsuit against the Chinese affiliates of the Big Four, carefully detail the solution that ended the Longtop Financial Technologies (Longtop) litigation, and discuss the possible negative consequences of allowing the issue to go unsolved. Part III will provide a more in-depth look at the State Secrets Law, and also look at the way other jurisdictions have begun to deal with this issue, highlighting the fact that this is not simply a China-U.S. spat. The Note will be focusing in particular on the way that each jurisdiction treats the accounting firms' argument that Chinese audit work product must be classified as State Secrets. Part IV will summarize some of the consequences of not creating a viable long-term solution to the problem and

⁹ *See id.*

¹⁰ In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879, at *80 (ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

¹¹ *The SEC Caves on China*, WALL ST. J. (Feb. 26, 2015, 11:12 AM), <http://www.wsj.com/articles/the-sec-caves-on-china-1424967173>.

will also reference other areas of the law in which the State Secrets Law has begun to create problems for Chinese companies. Part V will conclude the Note by endorsing a legally binding formalization of the currently informal agreement that ultimately solved the *Longtop* issue. Under this solution, the Public Company Accounting Oversight Board (PCAOB) will agree to allow requested documents to undergo review by Chinese regulatory authorities to redact state secrets prior to U.S. examination, and to keep any requested documents confidential. The Chinese Securities Regulatory Commission (CSRC), on the other hand, will agree to produce these documents to allow foreign regulators to determine whether or not fraud exists and will explicitly forbid Chinese auditors from hiding behind the State Secrets Law. This is a solution that requires concessions by both the Chinese government and the regulatory agencies that request access to the financial information of locally-listed Chinese companies. Moreover, it creates a viable, if cumbersome, compliance method for accounting firms and other entities to follow in fraud investigations that places them in no danger of violating either relevant country's laws.

II. CHINESE BIG FOUR AFFILIATES, ACCOUNTING FRAUD, AND STATE SECRETS

A. The Origins of the Longtop Conflict

The disclosure debacle originated with a simple discrepancy in the finances of Longtop Financial Technologies, a Cayman Islands company with its principal place of business in Hong Kong, China and Xiamen, China.¹² Since 2007, Longtop was listed on the New York Stock Exchange and also engaged in a secondary offering in 2009.¹³ At first glance, Longtop's business seemed innocuous enough—it provided information technology options to financial companies in China, and its customers seemed largely satisfied.¹⁴ By all accounts, Longtop's efforts in this regard were highly successful. In fiscal year 2010, it posted profits and operating margins of 62.5% and 35.8% respectively, putting it far ahead of peer companies at the time.¹⁵

Even with such consistently high profit margins in such a volatile market, however, few questioned details behind Longtop's earnings, or their truthfulness. After all, implicitly affirming the veracity of these financial statements was the well-regarded reputation of Shanghai-based Deloitte Touche Tohmatsu CPA Ltd. (Deloitte), the Chinese arm of Big

¹² *In re Longtop Financial Tech. Ltd.*, 910 F. Supp. 2d 561, 566 (S.D.N.Y. 2012).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

Four accounting firm Deloitte Touche Tohmatsu.¹⁶ Deloitte was Longtop's outside auditor, providing audit services for Longtop's Class Period financial statements.¹⁷ Deloitte also permitted Longtop to use its audit reports in its bid for registration with the SEC and allowed Longtop to incorporate its audit reports into documentation related to both its initial public offering and secondary offering.¹⁸

In 2011, however, analysts closely watching the market began to question Longtop's somewhat unbelievable roll of gains, pointing out that a company with "six times more cash than Microsoft" had relatively little to gain from a secondary offering.¹⁹

The speculation caused Longtop's shares to tumble.²⁰ In an effort to mitigate its losses, Longtop used Deloitte's reputation as a shield, calling a press conference to address the allegations and repeatedly referencing Longtop's clean bill of financial health from Deloitte.²¹

During this time, however, Deloitte also joined the crowd evincing suspicion of Longtop's numbers. In order to complete Longtop's 2011 audit, Deloitte visited a number of Longtop's banks to cross-check the information provided by its client.²² In following up with the banks, Deloitte discovered serious discrepancies between Longtop's reported information and the bank records, including falsified financial statements, off-the-record transactions, and bank loans undisclosed in its audit reports.²³ Simply put, Deloitte found evidence of Longtop's willful misrepresentation of its financial statements.

In addition to the alarming discrepancies, Deloitte began to detect disturbing hints that Longtop's representatives were stalling and trying to prevent Deloitte from getting the information necessary for a proper audit and the resolution of the financial issues.²⁴ From calls to banks "asserting that [Deloitte] was not their auditor" to demands to Deloitte to relinquish audit work product to them, Longtop's behavior raised Deloitte's hackles.²⁵ In one particularly harrowing incident, Deloitte alleged Longtop employees threatened on-site Deloitte personnel that they would not be allowed to leave the premises unless they relinquished their audit review materials.²⁶

The simmering status quo finally reached a boiling point when Longtop Chairman Ka Xiao Gong called Deloitte Regional Managing

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 568.

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 569.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

Partner Paul Siu and informed him that the discrepancies were caused by Longtop's adding of "fake revenues" to its books, and that even "senior management," was involved in its fake recordings.²⁷ Deloitte subsequently publicized a Letter of Resignation as Longtop's auditor on May 19, 2011.²⁸

After Deloitte decided to publish the letter, however, the SEC subpoenaed all of Deloitte's work product to further its investigation of the fraud allegations against Longtop.²⁹ Since Deloitte LLP in the United States had performed audit review work for some of Longtop's periodic reports, the company did not have any difficulty producing these documents.³⁰ However, the agency and the firm butted heads for the first time when the SEC demanded that Deloitte produce its Chinese audit work product for inspection "pursuant to Section 106 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), as amended by Section 929J of the Dodd-Frank Wall Street Reform and Consumer Protection Act."³¹

In what would become the common refrain of Chinese accounting firms, Deloitte pronounced the SEC's request unenforceable. Producing the Chinese audit work product, Deloitte claimed, would cause the firm to violate Chinese law, and potentially open Deloitte up to sanctions from the PRC government.³² Deloitte ultimately refused to produce the requested documents to the SEC.³³ On May 9, 2012, the SEC formally initiated proceedings against Deloitte for willfully refusing to provide the audit papers in violation of § 106 of the Sarbanes-Oxley Act.³⁴

During the administrative proceedings, the SEC also chose to pursue the documents through federal court by bringing an action in the District of Columbia ordering Deloitte to "show cause" for why the firm "should not be ordered to comply with [the SEC's] administrative subpoena."³⁵ Relying on the same arguments, Deloitte contended that it had not "willfully refused" to produce the documents because the SEC's request was unenforceable under PRC law.³⁶ Deloitte further argued that because the

²⁷ *Id.* at 570.

²⁸ *Id.* at 569; *See also* Letter from Deloitte Touche Tohmatsu CPA Ltd., to Mr. Thomas Gurnee, Chairman of the Audit Committee, Longtop Financial Technologies Ltd. (May 22, 2011), <http://www.sec.gov/Archives/edgar/data/1412494/000095012311052882/d82501exv99w2.htm>.

²⁹ Complaint, SEC v. Deloitte Touche Tohmatsu CPA Ltd., 2011 WL 12485523 (D.D.C. Sept. 8, 2011) (No. 11-512), <http://www.sec.gov/litigation/complaints/2011/comp-pr2011-180.pdf>.

³⁰ *Id.*

³¹ *In re* Deloitte Touche Tohmatsu CPA Ltd., Exchange Act Release No. 66948, 2012 WL 1612081 (May 9, 2012).

³² Peter Henning, *Deloitte's Quandary: Defy the SEC or China*, N.Y. TIMES DEALBOOK (Oct. 20, 2011), <http://dealbook.nytimes.com/2011/10/20/deloittes-quandary-defy-the-s-e-c-or-china/>.

³³ *Id.*

³⁴ *In re* Deloitte Touche Tohmatsu CPA Ltd., Exchange Act Release No. 66948, 2012 WL 1612081 (May 9, 2012).

³⁵ *U.S. S.E.C. v. Deloitte Touche Tohmatsu CPA Ltd.*, 928 F. Supp. 2d 43, 44 (D.D.C. 2013).

³⁶ *Id.* at 45.

action was substantially similar to the SEC administrative proceeding, the lawsuit should be stayed until the SEC decided whether to pursue the litigation against Deloitte in federal court.³⁷ Judge Deborah Ann Robinson of the District of Columbia District Court did not agree, holding that the stay Deloitte proposed would be too indefinite and would not promote the judicial efficiency that was the purpose of stays of that nature.³⁸

B. The Longtop Resolution

At this point, a twist occurred in the case. Instead of continuing to pursue the matter solely through SEC administrative law, the SEC and the Public Company Accounting Oversight Board (PCAOB), the U.S. accounting regulator with which Deloitte is registered in the United States, began negotiations with the CSRC, China's securities regulator, to try and convince the agency to turn over Deloitte's Longtop audit work product independently.³⁹

Although these efforts failed during 2012, they succeeded eventually. In 2013, the SEC and PCAOB reached a deal with the CSRC in which the CSRC would produce for the latter more than 200,000 pages of audit work product relating to Longtop.⁴⁰ The deal, however, notably excluded any mention of China's ability to consider audit work product as state secrets and included no admissions of error on the CSRC's part.⁴¹ In short, China never actually surrendered jurisdiction of the documents even as it turned over all of the requested audit work product to the SEC.⁴²

Ironically, just a few days after the SEC released its high-impact Initial Decision on the consolidated case against the Big Four firms, the regulatory agency released a decision to drop the Longtop charges against Deloitte.⁴³ It mattered little, however; by then, the SEC had already begun its five-pronged attack against the State Secrets Law.

C. The Expansion of the Lawsuit and the Initial Decision

As the administrative proceedings against Deloitte continued through 2012 with no clear end in sight, the problem that caused those

³⁷ *Id.* at 48.

³⁸ *Id.* at 51.

³⁹ Michael Rapoport & Dinny McMahon, *China to Hand Over Audit Documents*, WALL ST. J. (July 11, 2013, 10:44 PM), <http://online.wsj.com/news/articles/SB10001424127887324425204578600582169764600>.

⁴⁰ *Id.*

⁴¹ Rapoport & McMahon, *supra* note 39.

⁴² *See id.*

⁴³ Raymond Doherty, *SEC drops Deloitte China case*, ECONOMIA (Jan. 28, 2014), <http://economia.icaew.com/news/january-2014/sec-drops-deloitte-china-case>.

proceedings—financial fraud—began to appear more frequently and seriously damaged Chinese corporations’ credibility with the SEC.⁴⁴ The agency identified at least nine more U.S.-listed Chinese companies dealing with allegations of financial fraud, and the SEC gradually became aware that Longtop’s financial practices could not be considered an isolated phenomenon in China.⁴⁵ In order to facilitate SEC investigations into these nine corporations and perhaps to determine just how many U.S.-listed Chinese companies were practicing this kind of financial statement manipulation, the SEC initiated administrative proceedings against no fewer than five of China’s largest accounting firms, including all of the Big Four’s Chinese affiliates – Ernst & Young Hua Ming (EYHM), Deloitte Touche Tohmatsu CPA Ltd. (Deloitte), PricewaterhouseCoopers Zhong Tian (PwC), BDO Dahua CPA (Dahua), and KPMG Huazhen.⁴⁶

All of the accounting firms filed separate defenses, but all of their arguments shared at least one major common denominator: that the production of the requested documents would cause them to violate Chinese law and were therefore unenforceable.⁴⁷ Two of the firms, however, came up with another argument rationalizing how production would put them in violation of Chinese law.⁴⁸ Dahua and PwC argued that in addition to the Law Guarding State Secrets, the SEC’s demand for production would also force it to violate the equally restrictive Archives Law.⁴⁹

The SEC was largely unsympathetic to these arguments. In January 2014, SEC administrative judge Cameron Elliott issued a one-hundred-plus page opinion suspending the right of the Chinese affiliates of the U.S.-based to practice before the commission for six months.⁵⁰ Ultimately, only Dahua CPA Co., having already withdrawn from the U.S. issuers market, escaped the practice ban since the court saw no reason to ban the firm in an area

⁴⁴ Zigan Wang, *US-Listed Chinese Firm in Credibility Crisis: Who are They? Where are They?* (Columbia Univ., Working Paper, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2177450.

⁴⁵ *Id.*

⁴⁶ Daniel O’Connor, Kim Nebirow & Paul Boltz Jr., *SEC’s Charges Against Chinese Affiliates of U.S.-Based Accounting Firms Have Broad Implications*, ROPES & GRAY LLP (Apr. 15, 2013), <https://www.ropesgray.com/~media/Files/alerts/2012/12/secs-charges-against-china-based-accounting-firms-have-broad-implications.ashx>.

⁴⁷ Respondent Dahua CPA Co.’s Prehearing Brief at 2, SEC Admin. Proceeding File No. 3-15116; Respondent KPMG Huazhen’s Prehearing Brief at 2, SEC Admin. Proceeding File Nos. 3-14872, 3-15116; Respondent PwC Shanghai’s Prehearing Brief at 2, SEC Admin. Proceeding File Nos. 3-14872,3-15116; Respondent Ernst & Young Hua Ming’s Prehearing Brief at 2, SEC Admin. Proceeding File No. 3-15116; Respondent Deloitte Touche Tohmatsu CPA’s Prehearing Brief at 5, SEC Admin. Proceeding File Nos. 3-14872, 3-15116.

⁴⁸ Respondent Dahua CPA Co.’s Prehearing Brief at 2, SEC Admin. Proceeding File No. 3-15116; Respondent PwC Shanghai’s Prehearing Brief at 2, SEC Admin. Proceeding File Nos. 3-14872,3-15116.

⁴⁹ Respondent Dahua CPA Co.’s Prehearing Brief at 2, SEC Admin. Proceeding File No. 3-15116; Respondent PwC Shanghai’s Prehearing Brief at 2, SEC Admin. Proceeding File Nos. 3-14872,3-15116.

⁵⁰ In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879, at *80 (ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

from it had already withdrawn.⁵¹

In response to the argument that the firms could not produce the audit work because of the Law Guarding State Secrets, the court held that the firms' exposure to civil and criminal liability in the PRC was not a sufficient reason to free the firms from their production obligations.⁵² The court reasoned that when each firm individually registered with the SEC for the authority to provide these services, they knew of the risk that some of their clients might be accused of financial fraud and of their obligations in such situations.⁵³ The court found that in effect, the firms deliberately commenced business in the United States with the knowledge that if they were called upon to comply with U.S. law, they would "necessarily fail to fully cooperate."⁵⁴ The court used pointed language in its assessment of the practice, finding that the firms demonstrated gall in place of good faith, and that they were willfully violating U.S. law.⁵⁵

Additionally, the court also disagreed with the firms' contention that the proposed practice ban could result in severely negative consequences for all parties involved.⁵⁶ Although the court conceded that the necessary switch to a smaller auditor might impose major costs on Chinese companies, the court could find no reasonable basis to quantify those costs.⁵⁷ The court also opined that delisting was unlikely to be harmful for the individual companies in the long run, because the delisting would theoretically be the result of disciplinary action against the auditor rather than disciplinary action against the company itself.⁵⁸

D. The SEC Steps Back

Perhaps realizing that results of the Initial Decision could negatively impact parties without a direct relation to the case, the SEC ultimately chose to forego the implementation of the Initial Decision. Instead, the agency opted to settle with the Big 4.⁵⁹ Under its Order, each Chinese arm of the Big 4 would ultimately pay \$500,000, admit only to the facts set forth in the Order and be allowed to continue practicing before the SEC.⁶⁰ In the Order, the SEC did signal an intention to revisit the issue in four years'

⁵¹ *Id.* at *84.

⁵² *Id.* at *79.

⁵³ *Id.*

⁵⁴ *Id.* at *80–81.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.* at *81.

⁵⁸ *Id.* at *82.

⁵⁹ In the Matter of BDO, EY, KPMG, PwC, & DTTC, Corrected Order On The Basis Of Offers Of Settlement Of Certain Respondents Implementing Settlement, 2014 WL 242879, at *80 (Feb. 6, 2015), <https://www.sec.gov/litigation/admin/2015/34-74217.pdf>.

⁶⁰ *Id.*

time, but the decision did not make clear what needed to happen in order to avoid a redux of the same issue.⁶¹ Although this was hardly an unexpected outcome,⁶² critics showed no hesitation in blasting the decision.⁶³ They opined that the SEC was merely kicking the can down the road and possibly allowing all sorts of abuses to continue in the meantime. Critics also noted that the Chinese government had effectively called the SEC's bluff, and the "upshot [was] that investors in U.S. capital markets still lack basic protections against Chinese fraudsters."⁶⁴

III. THE STATE SECRETS LAW IN A GLOBAL CONTEXT

A. The Confidentiality Protections: The State Secrets Law

The PRC's Law Guarding State Secrets very broadly defines state secrets, encompassing national interests and state security, as well as a large rubric of other categories including financial information.⁶⁵ According to Article 10:

[The] specific scopes and categories of state secrets shall be stipulated by the State Secret Guarding Department together with the Ministries of Foreign Affairs, Public Security and State Security and other central organs concerned. The specific scopes and categories of state secrets related to national defense shall be stipulated by the Central Military Commission. Stipulations on the specific scopes and categories of state secrets shall be made known within relevant quarters.⁶⁶

Regardless of other passages in the law that create categories for state secrets, the above passage essentially provides the Chinese government with the power to classify anything as a state secret and refuse to produce it to a foreign entity. Under this broad scope, audit work product relating to

⁶¹ *See id.*

⁶² *The SEC Shouldn't Forget that Beijing Always Wins*, CHINA ECONOMIC REVIEW (Feb. 10, 2014), <http://www.chinaeconomicreview.com/china-on-wall-street-sec-csrc-showdown-big-four-auditors>.

⁶³ Paul Gillis, *SEC Settles with China Big Four*, China Accounting Blog (Feb. 7, 2015, 1:03 PM), <http://www.chinaaccountingblog.com/weblog/secsettleswithchinabig.html>.

⁶⁴ *See The SEC Caves on China*, *supra* note 11.

⁶⁵ The Law Guarding State Secrets in China has generally been interpreted in a broad variety of ways, and encompasses a broad rubric of documents. Since the documents must be under the jurisdiction of the United States, however, this creates controversy. *See generally* Chang, *Deconstructing the Audit Controversy*, 32 INT'L FIN. L. REV. 28 (2013); Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa Shishi Banfa (中华人民共和国保守国家秘密法实施办法) [Measures for Implementing the Law on the Protection of State Secrets of the People's Republic of China] (promulgated by the Nat'l Admin. for the Protection of State Secrets, May 25, 1990), http://www.stats.gov.cn/tjgl/swdcglgg/xgfg/t20041118_402209111.htm.

⁶⁶ *See supra* note 10, art. 10.

U.S.-listed Chinese firms, particularly those firms that do business with Chinese state-owned entities, qualify as state secrets.⁶⁷ Major concerns over citing or even dealing with the Law Guarding State Secrets include the highly relevant fact that, as of yet, there exists no public basis for determining what constitutes a state secret leading critics to contend that the designation is arbitrary and granted at whim rather than through a consistently applied system.⁶⁸

B. China's Incentives to Preempt Further Problems

Despite the SEC's ultimate decision to avoid the "parade of horrors" that the Initial Decision might have unleashed, the ruling's harsh language nonetheless created shockwaves that still might produce a significant effect. Since the filing of the SEC case in December 2012, structural changes of varying significance have already taken place within the accounting world. For instance, Dahua CPA, one of the defendants in the SEC case, chose to end its longtime affiliation with accounting power player BDO International in April, 2013, likely as a direct result of the case.⁶⁹ BDO Dahua was named as a party in the case as a result of the aforementioned expansion of the case, and Dahua itself has withdrawn from the U.S. market as a result.⁷⁰

The Initial Decision also seems to have sparked a flicker of defiance from other courts as well, particularly those in Singapore and Hong Kong. While neither of these courts suggested anything as draconian as a practice ban for the auditors, both refused to accept at face value the contention that the auditors would violate Chinese law through production, and have berated the respective accounting firms for not producing any direct evidence supporting this argument.⁷¹ Regardless, it is clear that the State Secrets Law is causing problems in several jurisdictions of significant financial importance.

In August 2014, PricewaterhouseCoopers Shanghai (PwC) lost a similar case in Singapore's High Court having refused to produce audit work papers relevant to Singapore-listed Celestial Nutrifoods' bankruptcy

⁶⁷ Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa Shishi Banfa (中华人民共和国保守国家秘密法实施办法) [Measures for Implementing the Law on the Protection of State Secrets of the People's Republic of China] (promulgated by the Nat'l Admin. for the Protection of State Secrets, May 25, 1990), http://www.stats.gov.cn/tjgl/swdcglgg/xgfg/t20041118_402209111.htm.

⁶⁸ Richard J. Silk, *China's Secret Anti-Secrecy Act*, WALL ST. J. CHINA REALTIME BLOG (Feb. 3, 2014, 9:36 PM), contending that every step toward openness in the Chinese system runs up against a barrier of vague legal definitions that stymie the purpose of the steps themselves, since no one can know beyond a reasonable doubt what can and cannot be made public.

⁶⁹ In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879, at *28 (ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

⁷⁰ *Id.* at *1.

⁷¹ BNY Corporate Trustee Services Ltd v Celestial Nutrifoods Ltd [2014] SGHC 155 (Sing.).

and assets in China.⁷² In this case, instead of fraud allegations, the conflict came about as a result of the liquidation of Celestial Nutrifooods (Celestial).⁷³ Similar to Longtop, Celestial maintained a fairly complex legal connection to the PRC.⁷⁴ Celestial, an investment holding company incorporated in Bermuda in 2003, whose main business was producing soybean protein-based foods, owned a number of subsidiaries incorporated in the British Virgin Islands that in turn owned subsidiaries incorporated in the PRC.⁷⁵

In spite of this complicated business structure, the company carried out its main operations in China, and it obtained listing status on the Singapore Stock Exchange in 2004.⁷⁶ In 2006, the company issued bonds to investors with a put option that allowed them to redeem the bonds at more than 100% of their face value.⁷⁷ When the global financial crisis struck two years later, a large number of investors chose to exercise this option in the same time period, and the company was unable to meet its subsequent financial obligations.⁷⁸ As a result, the plaintiff, who was the trustee of those bonds, commenced winding up proceedings and appointed a provisional liquidator to oversee the process.⁷⁹

Upon commencing the process, the liquidator discovered that the company's main operations and senior management were based in China and reached out to them for assistance with the winding up process.⁸⁰ In addition to finding the Chinese management branch unresponsive, the liquidator also found evidence that the company's assets were being moved around "in a series of suspicious transactions," which led him to believe that Celestial's investors owned shares in a "worthless company whose assets had been stripped away."⁸¹ Still unable to prompt any kind of response from the PRC arm of the company, the liquidator filed suit in Singapore in the hope of getting the answers he needed from Celestial's auditor, which was PwC Shanghai.⁸²

According to Singapore law, when a company undertakes the liquidation process, the court is free to summon before it "any person whom the court considers capable of giving information concerning the

⁷² See *PwC Loses Case on Producing China-Related Audit Papers in Singapore*, CFO INNOVATION (Aug. 27, 2014), <http://m.cfoinnovation.com/story/8760/pwc-loses-case-producing-china-related-audit-papers-singapore>

⁷³ BNY Corporate Trustee Services Ltd v Celestial Nutrifooods Ltd [2014] SGHC 155 (Sing.).

⁷⁴ *Id.* ¶ 4.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.* ¶ 5.

⁷⁸ *Id.*

⁷⁹ *Id.* ¶ 6.

⁸⁰ *Id.* ¶ 7.

⁸¹ *Id.*

⁸² *Id.*

promotion, formation, trade dealings, affairs or property of the company.⁸³ When the liquidator summoned PwC Shanghai to court, PwC argued that producing the documents would expose the company to liability in the PRC.⁸⁴ In particular, PwC argued through expert testimony that because the documents requested could contain evidence of loans or other transactions signed by local governments and correspondence with government officials, it was in fact very likely that the documents contained state secrets as classified under Chinese law.⁸⁵ They further opined that if the documents did contain state secrets under Chinese law, the consequences for producing those documents to a foreign entity could be severe.⁸⁶

However, the court rejected this argument, pointing out that even if the Law Guarding State Secrets was applicable in this instance, PwC Shanghai simply had not provided any evidence that the documents did in fact contain state secrets.⁸⁷ The court emphasized in particular that PwC Shanghai had not even provided the documents in question to its experts so that they could offer a more informed opinion than just generalizing about China's expansive use of the law.⁸⁸ In light of the lack of certainty in the defense, the court held that PwC Shanghai failed to provide sufficient evidence to free it from production obligations and ordered that PwC Shanghai produce the requested documents.⁸⁹

It is also worth noting that unlike the U.S. holding, the High Court in Singapore did not directly address whether Chinese law could actually provide sufficient reasons for refusal to produce the audit documents.⁹⁰ Instead, the court found that PwC Shanghai did not provide sufficient evidence that they could not produce the documents without violating Chinese law.⁹¹ This distinction leaves open the question of whether the result would have been different if PwC Shanghai had gone to more of an effort to provide evidence of state secrets existing in the documents.

On April 8, 2015, the Court of Appeals affirmed the judgment of the High Court, weighing in with substantially similar arguments to those offered by the High Court.⁹² As of now, the documents have been produced by branches of PwC based outside China. No Chinese entity has weighed in on the production of the documents, leaving the issue still unresolved.⁹³

⁸³ *Id.* ¶ 1.

⁸⁴ *Id.* ¶¶ 51–52.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* ¶ 58.

⁸⁸ *Id.*

⁸⁹ *Id.* ¶ 82.

⁹⁰ *Id.* ¶ 58.

⁹¹ *Id.*

⁹² *Id.* ¶¶ 63–65.

⁹³ *Id.*

C. Standard Water Limited in Hong Kong

In another groundbreaking (and arguably the most significant to date) decision in May, 2014, a Hong Kong court ordered Big Four Chinese affiliate Ernst & Young Hong Kong (EYHM) to turn over its audit papers regarding Standard Water Limited, a Chinese water treatment company listed in Hong Kong.⁹⁴ From a factual perspective, however, this case differs greatly from the other two. Similar to the case in Singapore, the difference may have allowed Hong Kong to sidestep a full answer to the Law Guarding State Secrets question.⁹⁵

Since 2009, Ernst & Young acted as Standard Water Limited's auditor in China and performed field work for them. When the company applied for a listing on the Hong Kong Stock Exchange in 2010, however, Ernst & Young also engaged the services of EYHM, its affiliate in Hong Kong. In mid-2010, Ernst & Young resigned from the auditorship of Standard Water Limited, citing the now-familiar reason of inconsistent statements in the company's documents that made it impossible for Ernst & Young to properly perform its audit.⁹⁶

After the company withdrew its application for listing, the Securities Financial Commission in Hong Kong (SFC) began investigating the company for possible instances of fraud and noncompliance.⁹⁷ In order to facilitate its investigation, the SFC requested that Ernst & Young submit a detailed explanation for its resignation and all of its work product for the client.⁹⁸ Ernst & Young only offered limited compliance, claiming that the vast majority of the work performed for Standard Water Limited had been performed by its Mainland China affiliate, Ernst & Young Hua Ming.⁹⁹ The Hong Kong auditor did not have the authority, or so it claimed, to exercise control over these documents in a manner that would allow for their

⁹⁴ CLIFFORD CHANCE LLP, HONG KONG COURT ORDERS ERNST AND YOUNG TO HAND OVER AUDITING RECORDS TO HONG KONG REGULATOR 1-5 (June 3, 2014), <https://onlineservices.cliffordchance.com/online/freeDownload.action?key=OBW1bFgNhLNomwBI%2B33QzdFhRQAhp8D%2BxrIGReI2crGqLnALtlyZewNWp3T0bqeSZk8ZLj4%2F1Lp%0D%0A5mt12P8Wnx03DzsaBGwsiB3EVF8XihbSpJa3xHNE7tFeHpEbaelf&attachmentsize=108313>.

⁹⁵ Joan Hon, *EY Appeals Hong Kong Court Order To Produce Audit Working Papers Notwithstanding Holding That EY 'Deliberately Withheld From SFC' and State Secrets Not at Issue*, REED SMITH GLOBAL REGULATORY ENFORCEMENT LAW BLOG (July 2, 2014, 11:40 AM), <http://www.globalregulatoryenforcementlawblog.com/2014/07/articles/securities-litigation/ey-appeals-hong-kong-court-order-to-produce-audit-working-papers>.

⁹⁶ See CLIFFORD CHANCE LLP, *supra* note 94, at 5.

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ Peter So & Karen Dicks, *Ernst & Young Ordered to Produce Accounting Records & Audit Papers to the SFC*, DEACONS NEWSLETTER (Sept. 16, 2014), <http://www.deacons.com.hk/news-and-insights/publications/ernst-and-young-ordered-to-produce-accounting-records-and-audit-papers-to-the-sfc.html>.

production to the SFC.¹⁰⁰ As the case appeared to draw to a close, however, Ernst & Young produced a laptop with audit work product for Standard Water on its hard drive and claimed that the data had been brought to Hong Kong “by mistake.”¹⁰¹ Ernst & Young also produced two additional hard drives and a witness, a partner specializing in quality and risk management who claimed that he had no memory or personal knowledge whatsoever of the relevant facts in the case.¹⁰²

With the last-minute evidence and haphazard testimony, the Hong Kong Court of First Instance held that Ernst & Young had actively withheld relevant information from the court.¹⁰³ The court further found that Ernst & Young’s relationship with EYHM in China was that of principal and agent, and that Ernst & Young did in fact have the authority to demand production of the documents from EYHM.¹⁰⁴ Significantly, the court placed squarely on the auditor the burden of proving that the documents requested contained state secrets and other liability-creating content.¹⁰⁵

Unlike the case in the United States, however, the court in Hong Kong chose an approach similar to that of the Singapore High Court and avoided grappling directly with the question of whether the Law Guarding State Secrets extends to audit work product.¹⁰⁶ Indeed, there was no reason to deal with these questions, since the party in question was a Hong Kong Big Four affiliate rather than the Chinese affiliate, which is Ernst & Young Hua Ming.¹⁰⁷ Accordingly, the Hong Kong court declared the Chinese legal issues to be a large “red herring” in the case and did not engage in any in-depth discussion of their implications.¹⁰⁸ Instead, the court emphasized that the case concerned only the obligations of an audit firm practicing in Hong Kong, effectively sidestepping the State Secrets issue altogether.¹⁰⁹ The case ultimately turned on whether Ernst & Young did in fact have the authority to produce the documents requested. It is worth noting that the court might not have been able to do this had Ernst & Young not been found to be withholding information without a reasonable basis for doing so.¹¹⁰

In July 2015, the SFC announced that E&Y had decided to discontinue its appeal of the Court of First Instance’s Order, citing the already successful production of the accounting documents requested as the chief

¹⁰⁰ *Id.*

¹⁰¹ Hon, *supra* note 95.

¹⁰² *Id.*

¹⁰³ CLIFFORD CHANCE LLP, *supra* note 94, at 1–5.

¹⁰⁴ *See* So & Dicks, *supra* note 99.

¹⁰⁵ Hon, *supra* note 95.

¹⁰⁶ *See* So & Dicks, *supra* note 99.

¹⁰⁷ *Id.*

¹⁰⁸ *See* Hon, *supra* note 102.

¹⁰⁹ *Id.*

¹¹⁰ *See* So & Dicks, *supra* note 99.

reason for the halt to proceedings.¹¹¹ Observers were quick to point out that the decision offered no guidance for production of documents going forward and that several factors in the decisions rather heavily implied that both the SFC and EYHM were working with CSRC to produce those documents without violating the law.¹¹² In the meantime, however, the Ministry of Finance in China published the “Interim Provisions on Accounting Firms’ Provision of Auditing Services for the Overseas Listing of Enterprises in Chinese Mainland,” almost as if in anticipation of EYHM’s decision to drop the appeal and produce the papers.¹¹³ The provisions only slightly resemble the haphazard and secrecy-filled *Longtop* solution, and firmly state that overseas accounting companies and Chinese companies listed abroad may not transfer the documents containing state secrets out of the country. The presence of relevant audit documents outside of Mainland China is the decisive factor that forced EYHM to produce those documents in Hong Kong, and PwC to produce the documents in Singapore.¹¹⁴ The provisions very conspicuously fail to mention what should be done in cases where documents containing state secrets are requested for production from the mainland, and the matter remains unsolved to this day.

D. Geopolitical Showdowns

The above decision is key in a geopolitical sense because of the “one China, two systems” phenomenon, which means in practice that although Hong Kong is officially a province of the PRC, it follows a different system of rules composed of a mixture of its laws under the previous British system and PRC laws.¹¹⁵ As a result, residents of Hong Kong lead their lives

¹¹¹ *EY’s Appeal Over Audit Working Papers Discontinued*, SECURITIES & FUTURES COMMISSION HONG KONG (July 23, 2015), <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR79>.

¹¹² Enoch Yiu, *Beijing’s State Secrets Law Will Lead To Further Legal Disputes Unless Procedures Are Clarified*, SOUTH CHINA MORNING POST (July 28, 2015, 12:30 PM), <http://www.scmp.com/print/business/china-business/article/1844099/sfc-wins-hong-kong-case-against-ey-future-problems-loom>.

¹¹³ Caizheng Bu Guanyu Yinfa Kuaijishi Shiwu Suo Congshi Zhongguo Neidi Qiye Jingwai Shangshi Shenji Yewu Zhan Hang Guiding De Tongzhi (财政部关于印发《会计师事务所从事中国内地企业境外上市审计业务暂行规定》的通知) [Notice of the Ministry of Finance on Issuing the Interim Provisions on Accounting Firms’ Provision of Auditing Services for the Overseas Listing of Enterprises in Chinese Mainland] (promulgated by Ministry of Fin. May 26, 2015), <http://lawinfochina.com/display.aspx?id=19399&lib=law>.

¹¹⁴ HERBERT SMITH FREEHILLS LLP, INTRODUCTION OF NEW PRC REGULATIONS REITERATING RULES ON STATE SECRETS POST SFC V EY JUDGMENT (Sept. 25, 2015), <http://www.herbertsmithfreehills.com/insights/legal-briefings/introduction-of-new-prc-regulations-reiterating-rules-on-state-secrets-post-sfc-v-ey-judgment>.

¹¹⁵ See William I. Friedman, *China’s One Country, Two Systems Paradigm Extends Itself Beyond The Mainland’s Borders to the Southern Provincial Government Of Hong Kong*, 11 J. TRANSNAT’L L. &

subject to a significantly different set of laws from those of their PRC “cousins,” especially with regard to technology.¹¹⁶ Indeed, the most prominent example lies in the fact that Hong Kong residents have for years been able to access blocked social media websites like Twitter and Facebook freely whereas those websites are blocked in the mainland.¹¹⁷

Despite the differences, however, Hong Kong is still part of the PRC and should theoretically be subject to the Law Guarding State Secrets.¹¹⁸ From a geopolitical perspective, this helps dispel the perception that this is simply another “China vs. the West” issue, and Singapore’s participation in this particular conflict also helps to emphasize the need for China to address this problem effectively and quickly. If even one of China’s provinces is beginning to run into difficulties with this law’s implementation, it behooves the Chinese government to provide clarification on these issues as soon as possible, instead of sidestepping them.¹¹⁹

In every individual case involving production of audit work product, the accounting firm at issue has cited the Chinese Law Guarding State Secrets in its defense.¹²⁰ Hong Kong did not directly address the issue.¹²¹ Both the U.S. and Singapore have refused to accept this argument, although the latter left some leeway for the firms.¹²² All of these countries have different political and legal systems, and all have reached the conclusion that the State Secrets Law is no longer a viable shield for Chinese auditors to use in protecting information. These decisions are instrumental in setting up a largely political showdown with the PRC and trapping the accounting firms in the middle of what they claim is a largely political showdown that

POL’Y 65 (2001). This paper describes how the life of the average citizen in Hong Kong is relatively unchanged after the British followed through on their agreement to relinquish control of the territory.

¹¹⁶ See *id.*

¹¹⁷ Alexandra Stevenson, *Facebook in Hong Kong: Closer to China*, FIN. TIMES (Feb. 9, 2011), <http://blogs.ft.com/beyond-brics/2011/02/09/facebook-hong-kong-one-step-closer-to-china/>.

¹¹⁸ Donna Wacker, *High Court Set to Decide on State Secret Law’s Reach*, SOUTH CHINA MORNING POST (Sep. 19, 2012, 12:42 PM) <http://www.scmp.com/business/article/1040076/high-court-set-decide-state-secrets-laws-reach>, detailing the implications of allowing Mainland law to be applied in Hong Kong.

¹¹⁹ Donna Wacker, *High Court Set to Decide on State Secret Law’s Reach*, SOUTH CHINA MORNING POST (Sept. 19, 2012, 12:42 PM), <http://www.scmp.com/business/article/1040076/high-court-set-decide-state-secrets-laws-reach>.

¹²⁰ Respondent Dahua CPA Co.’s Prehearing Brief, SEC Admin. Proceeding File No. 3-15116; Respondent KPMG Huazhen’s Prehearing Brief, SEC Admin. Proceeding File Nos. 3-14872, 3-15116; Respondent PwC Shanghai’s Prehearing Brief, SEC Admin. Proceeding File Nos. 3-14872,3-15116; Respondent Ernst & Young Hua Ming’s Prehearing Brief, SEC Admin. Proceeding File No. 3-15116; Respondent Deloitte Touche Tohmatsu CPA’s Prehearing Brief, SEC Admin. Proceeding File Nos. 3-14872, 3-15116.

¹²¹ BNY Corporate Trustee Services Ltd v Celestial Nutrifoods Ltd [2014] SGHC 155 (Sing.); In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879(ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

¹²² *Id.* ¶58.

they claim is best resolved by government-to-government negotiation instead of enforcement through the court system.¹²³

In the United States, the charged accounting firms have also cited the Chinese Archives Law in their defenses.¹²⁴ For example, in the SEC case mentioned above, Dahua argued that its work cases should be considered archives under Chinese regulations.¹²⁵ Similar to the Law Guarding State Secrets, the Archives Law provides a broad mantle of authority to Chinese regulators, requiring that the CSRC or governing body whose role is closest to the document in question provide approval for the production of all “archives” whose preservation is in the interest of the state to be delivered to a non-Chinese entity.¹²⁶ Just as the nature of “state secrets” is undefined in the Law Guarding State Secrets, it is unclear from the text of the Archives Law what can be classified as an “archive.”¹²⁷

The SEC has rejected this argument, contending that the firms have provided no evidence that the documents could be considered archives or that their production would expose the firms to liability in the PRC.¹²⁸

Again, under the definitions of both laws, audit work product may qualify for protection since the Chinese government has a vested interest in protecting Chinese companies’ financial information and might have a national security interest in protecting that of state-owned entities, which make up a significant and increasingly important portion of China’s economy.¹²⁹

¹²³ O’Connor, Nebirow & Boltz Jr., *supra* note 46.

¹²⁴ In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879 (ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

¹²⁵ In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879, at *4 (ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>; Respondent Dahua CPA Co.’s Prehearing Brief, SEC Admin. Proceeding File No. 3-15116.

¹²⁶ Zhonghua Renmin Gongheguo Dangan Fa (中华人民共和国档案法) [Archives Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Sept. 5, 1987, effective July 5, 1996), <http://www.lawinfochina.com/display.aspx?lib=law&id=286&CGid=>. Articles 14 through 18 of the Law govern the transportation of archives, and require approval of government authorities, similar to the Law Guarding State Secrets. Article 24 discusses liability and sanctions for those who violate the law, which the Big Four might well do in producing audit work papers.

¹²⁷ *Id.*

¹²⁸ See Kathy Chu, *SEC Probe Puts China Listings in Doubt*, WALL ST. J. (Dec. 4, 2012), <http://online.wsj.com/article/SB10001424127887323401904578158652523742958.html>; In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879, at *1 (ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

¹²⁹ Richard J. Silk, *China’s Secret Anti-Secrecy Act*, WALL ST. J. CHINA REALTIME BLOG (Feb. 3, 2014, 9:36 PM), contending that every step toward openness in the Chinese system runs up against a barrier of vague legal definitions that stymie the purpose of the steps themselves, since no one can know beyond a reasonable doubt what can and cannot be made public.

IV. CONSEQUENCES AND TIME LIMITS

A. The Potential Consequences of Inaction

Conflicts between Chinese entities and U.S. companies are not a new phenomenon. The past two years alone have included allegations of theft and breach of contract against entities as prominent as Sinovel Wind Group Company, a formerly state-owned power player in China's wind energy industry.¹³⁰ Beyond that, China's extensive state involvement has also conflicted with national security interests in other jurisdictions.¹³¹ This has caused some notable transaction cancellations, possibly because of suspicions of spying and scientific espionage.¹³² Most conflicts are limited to disputes between large players like Sinovel and American Superconductor Corporation (AMSC), but the State Secrets issue could have some rather large implications for both U.S. markets and Chinese companies both currently in the U.S. market and looking to access those markets in the future.¹³³ Furthermore, it may have some severe implications for China-based accounting firms that may no longer be able to avoid violating the laws of multiple jurisdictions when, perhaps through no fault of their own, their clients are accused of securities fraud.¹³⁴ Additionally, the SEC's ruling could have severely limited Chinese companies' overall access to U.S. capital markets, freezing them out of these markets. Without access to Chinese affiliates of the Big Four, large Chinese corporations would have been unable to find new auditors in time to file their periodic reports. When companies fail to file their periodic reports in a timely fashion, the penalty could include the loss of their public exchange listing.¹³⁵ Without auditors with the prestige and trust of the Big Four,

¹³⁰ Michael Riley, *China's Sinovel Charged with Stealing Trade Secrets*, BLOOMBERG NEWS (Jun. 27, 2013, 10:09 PM), <http://www.bloomberg.com/news/2013-06-27/china-s-sinovel-charged-with-stealing-trade-secrets.html>. In this case, AMSC accused Sinovel of corporate espionage and theft of trade secrets, and is currently pursuing the case through the Chinese legal system. An initial ruling favored AMSC, allowing them to avoid moving the case into arbitration.

¹³¹ In India, Huawei has been banned from bringing in locally made equipment. Juro Osawa, *Why Huawei Will Stay in India*, WALL ST. J. DIGITS BLOG (Feb. 7, 2014, 7:10 AM), <http://blogs.wsj.com/digits/2014/02/07/why-huawei-will-stay-in-india/>.

¹³² Recently, China was found to be using somewhat reprehensible means to steal technology secrets from Japan. Julian Ryall, *Chinese Hostesses Catch Japanese Hi-Tech Executives in Honey Trap*, SOUTH CHINA MORNING POST (Oct. 22, 2013), <http://www.scmp.com/news/asia/article/1336808/chinese-hostesses-catch-japanese-hi-tech-executives-honey-trap>.

¹³³ See generally Respondents' Posthearing Brief, SEC Admin. Proceeding File Nos. 3-14872,3-15116. This is the accounting firms' first reaction to the practice bar, and they list out some significant, although probably exaggerated, consequences of not allowing the firms to audit U.S.-listed Chinese firms.

¹³⁴ O'Connor, Nebirow & Boltz Jr., *supra* note 46.

¹³⁵ See Kathy Chu, *supra* note 128; O'Connor, Nebirow & Boltz Jr., *supra* note 46; Respondent's

Chinese companies will have only limited options for U.S. filings.¹³⁶ They will not be able to perform initial public offerings and navigate the requirements to raise capital in the United States.¹³⁷ This result could seriously damage one of the largest cross-border trading relationships in the world and cause major setbacks for both Chinese companies and U.S. multinational corporations, who may wish to hire the Big Four in China as well.¹³⁸

V. THE COMMON GROUND SOLUTION

A. Progress on Cross-Border Law: Areas of Compatibility

Given the threat of a mass delisting of publicly listed Chinese companies in the U.S. exchanges, the Chinese government has not ignored the situation. The CSRC, for instance, has been negotiating multiple agreements that allow for production of the necessary documents on a case-by-case basis.¹³⁹ However, this process has yet to result in a single binding agreement between China and any other country on corporate information, and the case-by-case basis on which the CSRC has been proceeding is not a long-term solution to the problem.

Also, Chinese legislators have been openly speculating about both reducing and defining the actual scope of State Secrets, which would go a long way toward providing the long-suffering audit firms with clear guidelines for production or refusal.¹⁴⁰ The status of this proposal, however, is still completely uncertain. Furthermore, there exists no guarantee that the scope of the Law Guarding State Secrets will even be defined to include audit work product, let alone reduced to exclude audit work product.¹⁴¹

Even under current Chinese law, however, a solution to this quandary exists. This solution involves the Chinese government finding common ground with the reasonable requests of foreign regulators who simply want to make sure that the firms applying for listing on domestic stock exchanges are being open and honest about their financial positions. If reasonably interpreted, the relevant Chinese laws may allow for production of the work papers for fraud-related investigative purposes, pending concessions from

Posthearing Brief, SEC Admin. Proceeding File Nos. 3-14872, 3-15116.

¹³⁶ See Kathy Chu, *supra* note 128.

¹³⁷ See *id.*

¹³⁸ See *id.*

¹³⁹ CHINA SEC. REGULATORY COMM'N, PUB. CO. ACCOUNTING OVERSIGHT BD., CIRCULAR ON ON-SITE REGULATION OF THE 2012 ANNUAL REPORTS OF LISTED COMPANIES (Dec. 27, 2013), http://pcaobus.org/International/Documents/MOU_China.pdf.

¹⁴⁰ Hui Lu, *China Exclusive: Lawmaker Proposes Reducing Scope of State Secrets*, XINHUA (Oct. 28, 2014), http://news.xinhuanet.com/english/china/2014-10/28/c_133749032.htm.

¹⁴¹ *Id.*

both foreign regulators and the Chinese government.¹⁴² For instance, at the end of the negotiation process, the CSRC ultimately decided to produce the requested Longtop documents after an exhaustive review process to determine whether or not the documents contained any state secrets.

According to Section 106(b) of the Sarbanes–Oxley Act, “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, the foreign public accounting firm shall be subject to the jurisdiction of the courts of the United States for purposes of enforcement of any request for such documents.”¹⁴³ Similarly, under Singaporean law, an extraterritorial authority applies.

Under S 285 of the Companies Act (Cap 50, 2006 Rev Ed), when a company is in liquidation, the court may summon before it any person whom the court considers capable of giving information concerning the promotion, formation, trade dealings, affairs or property of the company. Such person may be examined on oath regarding the aforesaid matters and the court may also require him to produce any books or papers in his custody or power relating to the company.¹⁴⁴

In the latter half of the sentence lies the problem; one condition of the CSRC’s negotiation with the PCAOB is very firm and states that none of the relevant audit work product shall be used in any kind of litigation.¹⁴⁵ This means that the documents, produced or not, are not actually subject to U.S. jurisdiction.¹⁴⁶ Given the magnitude of the negotiations, it is not unreasonable to infer that the CSRC would be similarly unwavering with regard to other jurisdictions. Chinese law, however, does allow for a solution to this issue.

Articles 21-22 of the Law Guarding State Secrets allow for “state secrets” to be produced to a foreign party, provided that the foreign party is willing to reciprocate in kind and that the information produced is subject to nondisclosure requirements.¹⁴⁷ This clause provides a solution that allows for the documents to be placed under foreign jurisdiction, and allows the

¹⁴² See generally Chang, *supra* note 65.

¹⁴³ 15 U.S.C.A. § 7216 (2012).

¹⁴⁴ BNY Corporate Trustee Services Ltd v Celestial Nutrifooods Ltd [2014] SGHC 155 (Sing.).

¹⁴⁵ See generally Chang, *supra* note 65.

¹⁴⁶ See *id.*

¹⁴⁷ Zhonghua Renmin Gongheguo Dangan Fa (中华人民共和国档案法) [Archives Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Sept. 5, 1987, effective July 5, 1996), arts. 21–22, <http://www.lawinfochina.com/display.aspx?lib=law&id=286&CGid=>. Both articles offer general guidelines for the production of sensitive documents for foreign assessment. All documents containing state secrets must be approved for production by the Chinese government.

CSRC to point out which sections, if any should be redacted.¹⁴⁸ In fact, the CSRC has signed a nonbinding Memorandum of Understanding with the PCAOB, the U.S. accounting industry's chief regulator, noting that this is a possibility and outlining initial requirements for cooperation.¹⁴⁹ Under these requirements, Chinese auditors will undergo a process under the jurisdiction of the CSRC by which certain items can be approved for production via declassification or determination that no state secrets exist in the relevant documents.¹⁵⁰ As noted in *Standard Water Limited* in Hong Kong, there is no blanket ban on production of audit documents to foreign securities regulators, implying that there are circumstances in which production will be allowed.¹⁵¹ The actual procedure described in the MOU, however, is still very murky, and the inescapable conclusion upon reading it is that if a Chinese agency decides to declare that a document contains secrets and cannot be produced, a U.S. agency has no legal recourse to address this.¹⁵²

In spite of these drawbacks, some progress has been made toward this particular end already. In 2013, the Chinese government authorized production of audit documents for at least one company, which was Longtop Financial Technologies, to United States regulators.¹⁵³ It is worth noting that the Memorandum, while a significant step forward, still contains cautionary language; it still specifies that these requests will not be enforceable in a situation "where the request would require the Requested Party to act in a manner that would violate domestic law."¹⁵⁴ The Law Guarding State Secrets is a domestic law in the PRC, as is the Archives Law and the other laws mandating that certain pieces of Chinese information be kept a secret. As such, these laws and their status may ultimately raise the same issue currently hampering the process. Under the vague standards for state secrets, the CSRC may refuse to turn over documents requested by regulators without providing an explicit reason for doing so, i.e. specifying the type of state secrets contained therein rather than a blanket citation of the law, similar to how PwC Shanghai lost *Celestial Nutrifoods* in Singapore.¹⁵⁵ Furthermore, although the topic arose during the extensive negotiation process, the CSRC has still refused to allow PCAOB inspectors to enter Chinese soil and perform review services in the PRC.¹⁵⁶

¹⁴⁸ *Id.*

¹⁴⁹ See CHINA SEC. REGULATORY COMMM'N, *supra* note 139.

¹⁵⁰ *Id.*

¹⁵¹ See So & Dicks, *supra* note 99.

¹⁵² See Memorandum of Understanding on Enforcement Cooperation, U.S.-China, May 7, 2013, https://pcaobus.org/International/Documents/MOU_China.pdf.

¹⁵³ Rapoport & McMahon, *supra* note 39.

¹⁵⁴ In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879, at *1 (ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

¹⁵⁵ See CHINA SEC. REGULATORY COMMM'N, *supra* note 139, at 5.

¹⁵⁶ *Id.*

Given this initial success of the *Longtop* result, however, the Chinese government has shown a willingness to negotiate and may be open to accepting a compromise that preserves its right to protect its state secrets while fulfilling the foreign regulators' need for basic documentation to determine the veracity of fraud allegations.¹⁵⁷ Under these circumstances, the U.S. regulatory authorities would be well advised to focus on formalizing the process that ultimately produced Longtop's documents, and which is loosely detailed in the aforementioned Memorandum.¹⁵⁸ Although this has not been repeated in any other instance, it nonetheless remains a process which at least temporarily satisfied both the PCAOB and the CSRC over a major issue.¹⁵⁹ Formalizing it into a binding agreement would remove the need for the SEC's ominous caveat that it might once again require the aid of the courts and remove the Big Four from their quandaries.¹⁶⁰

Even taking this into account, however, foreign regulators like the PCAOB can work within their own rules and can simultaneously avoid becoming overbearing in their demands for Chinese government information.¹⁶¹ For instance, in the United States, PCAOB rules do not explicitly state that the board must have the unrestricted right to inspect every aspect of a process that is truly the CSRC's jurisdiction.¹⁶² In fact, PCAOB rules explicitly state that the board may rely on a foreign regulator's work product for purposes of Sarbanes-Oxley compliance.¹⁶³ So, what the PCAOB can do in order to resolve this situation is to slightly revise its demand that the documents be turned over with no strings attached and rely on the results of CSRC's investigations and numbers to determine whether litigation is necessary.¹⁶⁴ In practice, this replicates the exchange that occurred in the deal that finally produced the Longtop documents, but such a solution would also require some concessions for jurisdictional requirements on the CSRC's part, which were not referenced in the Memorandum of Understanding. If the CSRC's main concern is to preserve state secrets, it can do so either by redacting the state secrets in any given page or withholding documents judged to contain too many of these,

¹⁵⁷ *Id.*

¹⁵⁸ *See id.*

¹⁵⁹ *Chinese Audit Documents Remain out of Reach*, *supra* note 3. Press Release, U.S. Sec. & Exch. Comm'n, SEC, Joined by Deloitte China, Files a Motion to Dismiss Without Prejudice the Subpoena Enforcement Action (Jan. 27, 2014), <http://www.sec.gov/litigation/litreleases/2014/lr22911.htm>.

¹⁶⁰ *Id.*

¹⁶¹ *See generally* Chang, *supra* note 65.

¹⁶² *Cooperation with Non-U.S. Regulators*, PCAOB (last visited Dec. 10, 2014), <http://pcaobus.org/international/pages/default.aspx>. This release discusses the possibility of relying on the statements of a foreign regulator to draw conclusions regarding a foreign company's compliance with the Sarbanes-Oxley Act.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

rather than treating every request as unenforceable simply because of the mere possibility that state secrets might exist in the documents.

By using the aforementioned rule, the PCAOB can allow the CSRC to retain control of the oversight process in China and still fulfill its desired goal of compliance with foreign regulatory requirements like Sarbanes-Oxley. It also fulfills the all-important avoidance of the nightmare scenario of a mass delisting or other bans on practicing before foreign regulators. This solution may be possible in other countries as well, depending upon their jurisdictional requirements and need for authority over the documents.

Of course, this solution is not a magic bullet. It may not satisfy the sensibilities of those on both sides who value the ability to exercise full control over these documents and may create further tension if agencies on both sides refuse to provide substantial reasons for requesting production of sensitive documents or denying those selfsame requests.¹⁶⁵ Furthermore, there are those who believe in taking a zero-tolerance approach to the issue and actually implementing the measures described—the discussion, after all, centers around corporate fraud and misinformation, a charged topic and grievous crime that is difficult to deal with at the best of times.¹⁶⁶ It is nonetheless the solution that most effectively preserves Chinese discretion and gives foreign governments the access they need to be able to successfully prevent and prosecute future instances of financial fraud from Chinese companies listed on their jurisdiction's stock exchanges. As the situation

If a solution acceptable to foreign regulators and to the Chinese government is not both found and implemented on a timely basis, it is highly likely that cases like the ones detailed above will start to occur more frequently. It is only since the SEC's Initial Decision, in fact, that other jurisdictions have begun to levy similar orders for production against the Big Four.¹⁶⁷ In this situation, it is almost exclusively the largest accounting firms—the Big Four—that will suffer litigation costs and potential penalties and sanctions in both the foreign jurisdiction and under Chinese law.¹⁶⁸

It is true that the SEC ultimately opted to avoid causing the doomsday scenario described in this Note. Its decision, however, has sparked general derision in accounting and legal circles, and further violations by Chinese companies may cause the SEC—and perhaps other less permissive jurisdictions—to reconsider taking no action.¹⁶⁹ Moreover, the ubiquity of

¹⁶⁵ See Chang, *supra* note 65.

¹⁶⁶ See Phillip Barber, *Bull in the China Market: The Gap Between Investor Expectations and Auditor Liability for Chinese Financial Statement Frauds*, 24 DUKE J. COMP. & INT'L L. 349 (2013).

¹⁶⁷ *Id.*

¹⁶⁸ Candice Tewell, *ALJ Bars the Big Four's China Units from SEC Practice for Six Months*, DAVIS WRIGHT TREMAINE LLP (Apr. 2014), <http://www.dwt.com/ALJ-Bars-the-Big-Fours-China-Units-from-SEC-Practice-for-Six-Months-04-14-2013/>.

¹⁶⁹ Two of the best known accounting blogs, Going Concern and China Accounting Blog, have

this problem still sets the stage for this to become the eventual method for punishing the auditors. This, in turn, creates a situation in which Chinese companies will have fewer options for a crucial type of corporate review that is vitally important to both the companies and government.¹⁷⁰ If Chinese companies cannot use the Big Four as their auditors in outbound jurisdictions, their only options will be a series of smaller firms that may lack the resources to perform a thorough review of a large client's periodic reports or other financial statements.¹⁷¹ Instead of solving the fraud issue, this will only exacerbate the problem. With smaller firms and fewer resources for oversight, a company like Longtop or Sino-Forest might actually slip under the radar with its financial fraud going unnoticed, and companies with healthy balance sheets may be effectively banned from being listed overseas.¹⁷²

VI. CONCLUSION

Currently only two methods exist for dealing with China's refusal to produce accounting information. The first is the approach laid out in the SEC's settlement with the Big 4: an informal approach that allows requests to unknown agencies lacking any guarantees of results that can provide a foundation for a formal investigation. The second is the approach set forth in the Initial Decision, which seeks to hold the accounting firms responsible for the standoff and threatens a mass delisting profitable to no one. Both of these approaches represent extremes and are wholly impractical going forward. In spite of this, however, the U.S. and China have managed to informally put one major instance of litigation to rest. Going forward, the best solution would be to formalize a process that allows both Chinese and foreign regulators to fulfill their obligations, protects investors from market fraud, and that provides clear guidelines for disclosure compliance to accounting firms and corporations alike.

disparagingly described the SEC's new decision as a capitulation to the Big 4. Paul Gillis, *supra* note 63.

¹⁷⁰ See In the Matter of BDO, EY, KPMG, PwC, & DTTC, Initial Decision Release No. 553, 2014 WL 242879(ALJ Jan. 22, 2014), <https://www.sec.gov/litigation/apdocuments/ap-3-15116.xml>.

¹⁷¹ See Candice Tewell, *supra* note 168.

¹⁷² See *id.*