THE
NATIONAL LAW REVIEW

Between a Rock and a Hard Place: Navigating Disclosures to U.S. Regulators Within the Framework of China's State Secrets Law

Thursday, November 20, 2014

Article By Eugene I. Goldman
James M. Commons
McDermott Will & Emery
Focus on China Compliance

Constitutional Law
Securities & SEC
Litigation / Trial Practice
China
All Federal

U.S. **Securities and Exchange Commission (SEC)-registered companies operating in China** face unique challenges when **responding to requests for documents from U.S. regulators**. Under China's State Secrets Law, Chinese companies cannot disclose any document that contains "state secrets" without prior authorization from the Chinese government. China's broad prohibition on disclosure of state secrets may encompass workpapers and other documents prepared in the course of audits of the financial statements of Chinese issuers or material subsidiaries. However, U.S. regulators believe that reviewing workpapers and other documents is a fundamental component of investigating potential misconduct and ensuring the quality of the audit work.

As a result, U.S. regulators will likely continue to request workpapers and other documents from the auditors of U.S.-listed Chinese companies. Such requests place the companies and their audit firms in a difficult position. If the firms comply with the requests, they risk violating Chinese law and incurring severe sanctions, including potential imprisonment of individual partners. Although U.S. and Chinese regulators are working to address the tension between U.S. and Chinese law, companies can take steps to mitigate their risks until the issue has been resolved.

China's State Secrets Law defines state secrets as "matters which have a vital bearing on state security and national interests and which are entrusted to a limited number of people for a given period of time." The law further defines state secrets to include "[o]ther matters that are classified as state secrets by the National Administration for Protection of State Secrets." Because the definition of state secret is both ambiguous and expansive, it potentially encompasses a broad array of information that is routinely captured in audit documents. Although recent remarks from China's Ministry of Finance (MOF) clarified that there is no "blanket ban" on disclosure of audit documents relating to Chinese companies, the MOF cautioned that documents containing state secrets must not be disclosed.

Under U.S. law, however, "[a]ny foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer" is subject to the Sarbanes-Oxley Act, as well as the rules promulgated under the act. Section 106 requires foreign accounting firms to produce their audit workpapers to the SEC or the Public Company Accounting Oversight Board (PCAOB) in connection with an investigation by either body. The incongruence in the requirements under U.S. and Chinese law places accounting firms, and their audit clients, in a difficult position. Because China's State Secrets Law carries criminal exposure, U.S.-registered accounting firms and their foreign affiliates have been reluctant to produce documents to regulators outside of China.

In an effort to address this dilemma, U.S. and Chinese regulators have been working to develop procedures that would grant U.S. regulators access to information necessary to ensure market transparency, while also allowing China to protect sensitive information. On May 24, 2013, the PCAOB announced that it had entered into a Memorandum of Understanding (MOU) on Enforcement Cooperation with the China Securities Regulatory Commission (CRSC). The MOU allows the PCAOB to obtain access to the audit workpapers of China-based audit

firms for enforcement purposes. The MOU does not, however, allow the PCAOB to conduct inspections of Chinese auditors, including the Chinese affiliates of the "Big Four" accounting firms.

The PCAOB inspections program is an integral part of its mission to improve audit quality. When we asked about the status of achieving PCAOB inspections of Chinese audit firms, a board member said, "Progress is being made and I am hopeful for a positive outcome in the near future." If a deal is not reached, it is possible that the PCAOB will deregister Chinese audit firms, which would preclude the firms from auditing or playing a substantial role in the audit of SEC-registered companies.

After the MOU was signed, the CRSC announced a new procedure for screening audit documents for state secrets. Now, when a foreign regulator requests audit documents, accounting firms are required to: (1) screen audit documents and redact or otherwise remove all state secrets or other sensitive information; (2) retain independent law firms to certify that the screening was done properly; and (3) obtain client certification that the accounting firm performed its work properly. After completing the screening process, the accounting firm must submit the documents to the CRSC for review. The CRSC is then responsible for disclosing the documents to the foreign regulator.

In a case involving Deloitte Touche Tohmatsu CPA Ltd. (DTTC), the CRSC's process seems to have worked. In that case, the SEC issued an administrative subpoena for audit workpapers and other documents concerning DTTC's audits of a China-based issuer. When DTTC refused to comply with the SEC's subpoena citing Chinese secrecy laws, the SEC filed a legal action to compel DTTC's compliance. In early July 2013, almost a year after the SEC requested the CRSC's assistance in procuring DTTC's workpapers, the CRSC notified the SEC that it intended to release certain of the workpapers. Shortly thereafter, the CSRC produced scores of documents and provided logs of documents (or portions thereof) that had been withheld on the grounds that they were designated as state secrets under Chinese law. In January 2014, based on the CRSC's continued cooperation, the SEC agreed to dismiss its action against DTTC.

Despite the successful resolution of the DTTC matter, questions remain as to the CRSC's willingness to cooperate with SEC investigations. As a result, the SEC has continued to pursue legal action to compel auditors of Chinese issuers to disclose their workpapers. In early 2014, a SEC administrative law judge issued an order suspending the Chinese units of the Big Four firms for their refusal to disclose audit documents of Chinese clients to the SEC. The SEC had sought the audit documents in connection with its investigations of more than 130 Chinese companies that are publicly traded in U.S. markets. The accounting firms refused to produce the requested documents, claiming that they contained state secrets and, therefore, could not be disclosed to foreign parties under Chinese law. The SEC filed an administrative proceeding against the firms, arguing that disclosure of the audit documents was required under U.S. law. The administrative judge agreed with the SEC and barred the firms from leading audits of companies traded in the United States. The accounting firms have appealed the judge's order to the SEC commissioners and the case is currently pending. If the judge's ruling is upheld on appeal, the firms will be suspended from practicing in the United States for six months. It would not be surprising if a resolution is achieved while the matter is on appeal. Indeed, recent filings with the SEC state that the parties are negotiating a settlement.

While a complete remedy for the conflicting regulatory requirements remains elusive, U.S.-listed Chinese companies can take certain steps to mitigate their potential exposure. First, companies should execute audit engagement letters that require their audit firms to provide notification upon receipt of a foreign regulator's request for audit documents. The engagement letter should also specify how the audit firm will respond to such requests. Second, upon learning of such a request, the company should engage competent, outside counsel to review the audit documents for state secrets. Alternatively, outside counsel can review and assess the reasonableness of the auditor's analysis of whether the documents implicate state secrets. Third, the company should coordinate with the CSRC on the foreign regulator's request, work with the CSRC on any redactions and obtain authorization to disclose the prescreened documents. Lastly, the company should maintain a record of any information redacted or withheld from foreign regulators on the basis of the State Secrets Law. By taking these steps, the company and its audit firm can persuasively argue that they have complied with the regulator's request to the fullest extent allowable under Chinese law.