Comply at Your Own Risk: Reconciling the Tension between Western Due Diligence Practices and Chinese State Secrets Law

By Raymond Tran*

INTRODUCTION

万事开头难 (Ten-thousand different matters, the first step is difficult).1

Since China's market opened in 1978, its maturing companies sought to be listed in U.S. markets to access potentially billions in U.S. capital.2 However, to access such capital, Chinese companies and their accounting firms face the quandary of conflicting laws. Complying with U.S. regulatory requirements and satisfying investor expectations for transparency risks violating China's vague State Secret Law. Resolving this conundrum requires the United States and China to overcome their differences in business practice, corporate governance, and accounting regulations. Recognizing this issue, the U.S. Securities Exchange Commission (SEC) and China Securities Regulatory Commission (CSRC) attempted to cooperate by signing a Memorandum of Understanding; but rather than facilitating cooperation, this memorialized the problem. The SEC insisted on cross-border oversight to facilitate inspection, and the CSRC refused to allow cross-border oversight or inspections to protect China's sovereign interests.3 China cannot ignore this problem; even if Chinese companies redirect efforts to other markets, without the solution discussed in this article, similar problems will surface.4

Given the failure of prior attempts for joint solutions, China needs to take an approach that aligns with international precedent. China should create the regulatory body discussed in this article that would allow requests from foreign regulators, and enable an approach that addresses U.S. investors' needs to rely on the quality of audits,5 Chinese concerns about state sovereignty,6 and bi-national desires for clearer procedures.7

This article advocates for creating this body with a few caveats. First, the article addresses state secret claims8 raised as a result of materials sought for the purpose of due diligence audits, not materials pre-classified by Chinese authorities as state secrets.9 Second, this article acknowledges the current heightened U.S. listing requirements for Chinese reverse merger companies,10 even though reverse mergers are an acceptable means to finance a company and go public.11 Finally, this article does not undertake the task of capturing and fixing all “ten-thousand different matters;” instead it argues for China to design a regulatory body on its own soil tasked to resolve the gap in compliance.

Part I summarizes the factors and circumstances that arose when complying with one nation’s laws created a dilemma in complying with another nation’s laws. Chinese corporate governance and reverse mergers are briefly discussed before the key occurrences which revealed this gap in the law are summarized. Part II discusses the historical issues that need to be addressed to resolve this stalemate, beginning with a discussion on the United States zealously wielding sections of the Sarbanes-Oxley Act to compel compliance, and continuing with an analysis of how China’s corporate governance regime is not yet caught up with global standards, as well as a discussion of the interplay of vague statutes and a complex bureaucracy within that regime. Part III is devoted to discussing the proposed solution and analyzing how it resolves the issues presented. It discusses the regulatory body’s application in resolving the tension and providing proactive mechanisms for cooperation, and then compares the body to Japan’s precedent to illustrate its effectiveness.

I. REGULATORS AND FIRMS: LOST IN TRANSLATION AND FACING SUSPENSION

冰冻三尺, 非一日之寒 (Three feet of ice does not form over one cold day).12

The underlying differences in Chinese and U.S. corporate governance regimes, combined with the influx of Chinese reverse mergers, has revealed the incongruence of Chinese State Secret Law and U.S. regulations. This section discusses the bigger picture of the Chinese corporate governance regime, the phenomenon of Chinese reverse mergers and the occurrences that revealed this gap in the law.

A. Distinguishing Chinese Corporate Governance

Chinese companies face the dual challenge of raising capital while being restricted from accessing
private forms of equity and competing against public companies that can access funds from public investors.\textsuperscript{11} Public listing on the U.S. exchange grants access to capital-rich American public investors and also signals to other potential investors that the Chinese company is capable of meeting the higher U.S. governance standards.\textsuperscript{14}

Whereas most corporate governance regimes are driven to put assets into private control, the Chinese corporate governance regime is driven by a desire to allow the state to retain control over the listed assets while providing a private alternative.\textsuperscript{13} Although China looks to transform its current State-Owned Enterprise framework by converting it into shareholding companies and selling shares to private investors, it still lacks an internal governance regime with adequate fiduciary obligations and oversight structures.\textsuperscript{16} Externally, China also lacks governance rules to resolve and enforce budget constraints, accounting standards, financial disclosure requirements, imperfect information, hostile takeovers, and bankruptcy proceedings.\textsuperscript{17}

B. The Insurgence of Chinese Companies Entering the U.S. Market Without Oversight

The traditional route of going public is an expensive process, and some private companies try to get listed without the traditional public disclosure procedures by acquiring a public company and reorganizing its capital—a process called a reverse merger.\textsuperscript{18} The herculean procedures to underwrite a traditional Initial Public Offering (IPO) make the reverse merger particularly attractive: the company legitimately sidesteps the due diligence required of a traditional IPO, accesses capital that it might not afford otherwise, and may also increase its “intangible value” from listing in “a more credible Exchange while crystallising [sic] the raising of capital.”\textsuperscript{19} When reverse mergers show signs of suspicious behavior, counterparties to the transaction or the SEC request audits to conduct due diligence and verify compliance with standards and regulations.\textsuperscript{20}

A Chinese reverse merger refers specifically to Chinese companies acquiring a publicly traded U.S. shell company with listed stock and projecting optimistic growth to float new issues of stock to enter the American market without public oversight.\textsuperscript{21} Nearly 150 Chinese companies entered the U.S. capital market through Chinese reverse mergers between 2007 and 2010.\textsuperscript{22} This spike of Chinese reverse-merger activity raised the SEC’s suspicions and resulted in the SEC requesting audit work papers prepared by firms based in China for review.\textsuperscript{23}

C. To Violate SEC Compliance or Chinese State Secret Law?

While these 150 Chinese reverse-merger companies and their accounting firms were in difficult positions, responses from the SEC and CSRC escalated the tension. Compliance with Public Company Accounting Oversight Board (PCAOB) standards would risk violating Chinese State Secret Law.\textsuperscript{24} By 2010, 130 Chinese global audit firms “encountered questions about their accounting or disclosure,” revealing “problems brought to light by auditors who resigned, regulators who suspended or delisted the companies from U.S. trading, or short-sellers and other investors who did their own research into the companies.”\textsuperscript{25}

In response, the SEC and CSRC signed a Memorandum of Understanding that provided a vague framework, and ultimately did not cover the transfer of audit work papers, leaving a procedural gap and undefined expectations for cooperation.\textsuperscript{26} The Memorandum of Understanding did not create any binding obligations; instead, it memorialized the discrepancies between U.S. regulators who sought cross-border or joint inspections, and Chinese regulators who would not allow either to occur.\textsuperscript{27} The tension increased when the CSRC did not respond to the SEC’s twenty-one requests and over thirty communications for cooperation in 2009.\textsuperscript{28} When private auditing firms in China further refused to cooperate with the SEC’s requests, the SEC filed lawsuits and administrative proceedings in U.S. courts against each of the Big Four’s Chinese affiliates.\textsuperscript{29}

In response to these lawsuits from the SEC, the Big Four’s Chinese affiliates claimed that turning over those documents risked violating Chinese State Secret Law requiring Chinese accounting firms to get prior approval from Chinese authorities before they could disclose audit work papers.\textsuperscript{30} The Big Four’s Chinese affiliates also claimed that these audit work papers contained unpublicized and potentially sensitive information that could implicate China’s national interests and sovereign authority to determine whether such information can be shared
with a foreign regulator. These SEC administrative proceedings resulted in the SEC unsheathing Section 106(e) and 102(e) of the Sarbanes-Oxley Act to suspend the Big Four accounting firms’ Chinese affiliates from practicing for six months, pressuring Chinese firms to submit to U.S. regulations over Chinese laws.

II. THE DISCORDANCE BETWEEN U.S. PRACTICES AND CHINESE SYSTEMS

The incongruence between Chinese State Secret Law and U.S. regulations, whereby compliance with U.S. regulations may result in violating Chinese laws, resulted in Congress increasing the SEC’s capacity to obtain foreign audit work papers to pressure foreign companies and their firms into compliance. This section discusses the United States’ recent actions issuing and enforcing provisions of the Sarbanes-Oxley Act against Chinese companies. It then analyzes the structural rift between Chinese and U.S. corporate governance regimes, and the internal confusion resulting from combining vague Chinese State Secret Law with complex Chinese bureaucracy.

A. Cornering China with Sections 106(e) and 102(e) of the Sarbanes-Oxley Act

Compliance with the mechanisms provided by the Sarbanes-Oxley Act exposes companies and their accounting firms to the risk of violating Chinese domestic laws, and pressures Chinese companies to risk violating Chinese laws in complying with U.S. laws instead. Combining Sections 106(e) and 102(e) of the Sarbanes-Oxley Act might call the bluff on suspected fraudulent state secret claims, but it also removes foreign firms’ desires and abilities to practice when there are potentially legitimate state secret concerns. This tips the scales in favor of compliance with U.S. laws without providing China with the means to maintain its sovereignty.

Section 106(e) of the Sarbanes-Oxley Act, introduced to “fix the China problem,” authorized the SEC to initiate disciplinary proceedings against “foreign accounting firms that willfully refuse to turn over audit work papers to the SEC.” Section 106(e) did not resolve the compliance gap, but it granted the SEC additional authority to strip foreign accounting firms of their ability to provide any audit service to U.S. or foreign issuers by barring foreign accounting firms from issuing or playing any role in the preparation or furnishing of an audit report filed with the SEC. Foreign firms are pressured because they are deemed to have consented to the authority of the SEC under Section 106, and must obtain the necessary permission from their governments to comply. Section 102(e) allows the SEC to deny any person’s privilege to appear or practice before the SEC if that individual violates federal securities laws such as the Sarbanes-Oxley Act.

The SEC enforced Section 106(e) when the Big Four’s Chinese affiliates did not comply with the SEC’s request, claiming that they may violate Chinese State Secret Law. Through U.S. courts, the SEC issued and enforced subpoenas against the Chinese affiliates. Unsurprisingly, U.S. courts found that US national interests outweighed the speculative Chinese interests, and that “foreign blocking statutes” did not shield U.S.-listed foreign companies from the jurisdiction of U.S. courts. Even when a non-U.S. law prohibits disclosure, a U.S.-listed foreign firm is compelled to use its “best efforts to obtain such permission to comply with the Commission’s subpoena as may be necessary,” even if what constitutes “best efforts” is unclear. Although U.S. mechanisms can theoretically reach beyond U.S. borders, these mechanisms ring hollow without cooperation from the Chinese government.

B. The Discordance Between U.S. and Chinese Corporate Governance Regimes

China maintaining state control over certain enterprises conflicts with corporate governance practices that align with global norms. Though many western governments adopt the view that the Chinese State Secret Law “violates numerous provisions found in China’s accession to the WTO, and as such ought to be challenged,” Chinese regulations are still developing and China only began to permit a private economy to exist in 1988. Definitions of business entities expanded as categories of ownership were modified into State-Owned Enterprises, Collective Enterprises, Foreign-Invested Joint Ventures, and Wholly Foreign-Owned Enterprises. China’s rapid ascension to the WTO “stimulated increased transparency in Chinese governance,” but “the WTO does not mandate a perfect legal system, or even a basically fair one.”

A rift in understanding, stemming from Chinese bureaucracy’s nature to both coordinate efforts and establish functions, aggravates the collision between...
U.S. and Chinese corporate governance structures. Chinese bureaucrats inconsistently enforcing ambiguous laws compounds complications because overlapping interests in oversight roles, personal incentives, and career prospects of local and regional bureaucrats are often tied together. This premature corporate governance regime serves as the slippery framework from which the Chinese State Secret Law is promulgated and enforced.

C. Vague Laws Complicate China’s Complex Bureaucracy

The Chinese State Secret Law is vague, virtually anything potentially tied to national interests or that is “entrusted to a limited number of people for a given period of time,” can constitute a state secret. The Chinese State Secret Law defines activities related to “foreign countries” and “national economic and social development” as state secrets. Article 2 of the Chinese State Secret Law further defines matters that “have a vital bearing on state security and national interests” as a state secret. Article 9 broadly includes fields of domestic and international affairs, economic and social policies, defense, and diplomacy.

These vague categories are followed by a catch-all provision covering all “other secret matters” as determined by the “department administering and managing the protection of state secrets.” This catch-all provision authorizes any agency to identify matters not explicitly listed in the statute as a state secret because no language indicates that the list is exhaustive. Additionally, past prosecutions demonstrate that Chinese enforcement authorities have almost unlimited discretion to define what information may constitute a state secret. Chinese companies cannot disclose documents that may contain state secrets without prior authorization from the Chinese government. As a result, the disclosure of virtually all information obtained in the course of auditing financial statements of issuers or material subsidiaries could violate Chinese law.

Proactive accounting firms seeking to comply with U.S. standards without violating Chinese State Secret Law quickly fail because Chinese State Secret Law does not clearly identify the relevant organs nor do they explain the scope of whether and when documents involve state secrets. Chinese statutes that specifically address the transfer of audit papers to foreign authorities would, presumably, provide guidance; but even these statutes become useless due to the vague Chinese State Secret Law. It is unclear which Chinese agency has authority and whether one agency’s alleged authority will contradict another’s.

For example, after the SEC actions in 2010, the Hong Kong Court of First Instance experienced a similar incident in 2014 when the Hong Kong Securities and Futures Commission (HK-SFC) sued Ernst & Young’s Hong Kong Branch to produce audit work papers and other documents. The Hong Kong court rejected Ernst & Young’s argument that the documents contained state secrets, and placed the onus on the accounting firm to undertake steps to review the audit work papers to identify any state secret information, which exposed the firm to the risk of violating Chinese State Secret Law. Litigation ensued, but unlike the 2010 SEC action against Deloitte, the CSRC did not concede to the HK-SFC and produce documents; instead, the CSRC and the Ministry of Finance (MOF) flexed its authority over the Hong Kong Special Administrative Region and quashed the action.

Internal Chinese administrative norms further muddle the process of identifying what are state secrets. For example, rules and regulations in Special Economic Zones tend to promote investment, imports, and exports; outside the Special Economic Zones, regions flex their autonomy where central legislation does not preempt them. These regions may also inconsistently apply and interpret general company control laws, securities regulations, and bankruptcy rules. The authority of both the Chinese MOF and CSRC to regulate the accounting profession makes it unclear which agency holds more authority. Other state agencies and commissions implementing their respective regulations widen this gap of determining whether information in audit work papers constitute state secrets.

There is also a dearth of legal guidance because cases involving state secrets are not public. The Supreme People’s Court Legislation governs the Chinese State Secret Law, specifying in 2007 that “state secrets and secrets of judicial work shall be strictly kept, and the parties’ private affairs and commercial secrets shall be protected according to law.” All evidence involving state secrets are to be kept confidential and those accused of violating the Chinese State Secret Law are required to “obtain the approval of the investigation organ” first and obtain approval.
While overseas securities regulatory authorities may request Chinese accounting firms to seek approval, these Chinese accounting firms face substantial risk complying because they are required to seek approval from relevant authorities but simply do not know who these approving authorities are.

III. RECONCILING THE TENSION
又要马儿好，又要马儿不吃草 (You want a good horse, but won’t give it grass to eat).

The aforementioned mechanisms of Section 106(e) and 102(e) of the Sarbanes-Oxley Act swept the problem under the rug but did not resolve the gap that gave rise to the predicament. The United States has a right to question whether the veil of sovereignty is hiding inadequate financial practices from U.S. investors, and China needs to accept that participation in the global economy requires accepting certain limitations on its sovereign interests. At the same time, the United States can only expect China to play by U.S. rules up to a certain point to protect legitimate state secrets and will need to learn to rely on Chinese government agencies in order to maximize its benefits from this bilateral relationship.

Disclosures, without violating Chinese State Secret Law, need to be sufficiently detailed to comply with U.S. regulations. China’s policy interests render cross-border or joint inspections impractical. China should design a regulatory body to monitor auditors that can compel, investigate, inspect, verify, and redact due diligence materials with state secret claims. U.S. inspectors facing Chinese state secret claims should be able to verify compliance and access requested due diligence materials through this body.

This body should be made of representatives from the China Securities Regulatory Commission, the State Secrecy Bureau, the State Archives Administration, and the State Assets Supervision and Administration Commission to serve as a clearinghouse for state secret claims that would not default to refusing requests from foreign regulators. This solution would move U.S. and Chinese regulators past the unrealistic hope for future joint inspections without slighting U.S. regulations or Chinese sovereignty interests. Production of a single regulatory body circumvents the need for accounting firms and U.S. regulators to navigate the complex terrain of Chinese bureaucracy. This body, composed of representatives from the listed Chinese agencies, could regulate and inspect on Chinese soil, and provide Chinese companies and their accounting firms with the means to proactively cooperate rather than lose face by buckling under U.S. pressure. U.S. regulators and investors would be provided with a layer of clarity and security because this body would serve as the sole clearinghouse.

This section begins with a description of this body before discussing its application. To demonstrate the feasibility of the solution, there is a brief comparison between the proposed body and the Japanese Securities Clearing Commission. Finally, we close with an analysis of how the body would balance the interests of both the US and China.

A. A Solution Made in China

This new body to regulate auditors should be composed of officials from the China Securities Regulatory Commission (CSRC), the State Secrecy Bureau, the State Archives Administration, the Ministry of Finance (MOF), and the State Assets Supervision and Administration Commission (SASAC). The CSRC, State Secrecy Bureau and State Archives Administration are specified authorities in the Chinese State Secret Law. The MOF should be included because it regulates the accounting profession along with the CSRC, and the SASAC should be included because it supervises State-Owned Enterprises. This body should have the authority to inspect and regulate auditors in accordance with Chinese laws and U.S. regulations. This composition ensures that the Chinese can disclose when they feel that accessing new markets is worth disclosure, and refuse disclosure when a genuine state secret is at risk. This proposal would also bring China’s domestic laws closer to compliance with WTO obligations, while clarifying and carving out a security exception for its state secrecy law.

Coordination efforts of this body would be directed by Chinese government action, with reforms “injected where necessary to advance the project of economic growth and development, particularly in order to bolster the confidence of foreign investors and to hold in check the untrammeled authority of state agents.” A Chinese driven approach ensures respect for China’s interest in its sovereignty because China would have the control to “facilitate the operation of informal governance mechanisms,
including reputation effects and mutual monitoring, thus restraining abuse of dominant positions.\textsuperscript{97} This approach reflects the development of other East Asian markets, though China would have the luxury of producing this body without the weight of a major financial crisis.\textsuperscript{98}

The proposed body would serve as the undisputed authority for reviewing and producing requested materials that may have state secret claims. The body would serve as a single clearinghouse on Chinese soil for accounting firms to go to that would ultimately review requested materials for state secrets before producing them to the PCAOB. The appointed officials from each respective agency would establish the protocol of the clearinghouse. Once the points are in place, the body would begin the task of mapping out more specific processes, standards and practices for compliance with one voice.\textsuperscript{99}

Companies seeking cross-border listings would need to comply with requests from this body or be categorically rejected. In addition to categorical rejection from listings, firms that do not comply would also be subject to SEC suits and proceedings. This brings China forward in its agreement “to undertake reform to bring its legal system in line with ‘market economy-based international legal standards.’”\textsuperscript{100}

This body would streamline the process while meeting the interests of both nations. The body would serve as the main organ that regulates and determines procedures for conducting due diligence when state secrets are implicated, allowing a single channel for U.S. and Chinese regulators to meet in the middle—albeit on Chinese soil. Additionally, a Chinese accounting firm performing audit work for its issuer could utilize this body to verify a Chinese state secret claim to sufficiently demonstrate inability “to comply with an SEC section 106 request due to conflicting non-U.S. laws.”\textsuperscript{101} In such instances, this body would determine whether the disclosures were “sufficiently detailed” so that U.S. investors could appreciate the significance of the conflicts without firms risking suspension of licenses or violating laws.\textsuperscript{102}

B. Implementing Effective Mechanisms

China can present the SEC with a more familiar resolution: a body that has a system under which due diligence requests are not presumptively refused.\textsuperscript{103} If U.S. regulators request documents from a member state of the European Union, for example, the member state’s accounting firm sends requested audit documents “to its home country authority, which can then transfer the documents if it has already had a reciprocal arrangement with the requesting foreign authority” because U.S. regulators trust that member states will not routinely reject its requests.\textsuperscript{104} The member state can reject the foreign authority’s request if providing the audit work paper “would adversely affect the sovereignty, security, or public order of the Community or of the requested Member State,” if “judicial proceedings have already been initiated in the requested member state ‘in respect of the same actions and against the same persons,’” or if “the transfer would violate EU-wide data protection laws.”\textsuperscript{105}

Though this proposed body would be directed by the Chinese government, it should establish mechanisms that are “consciously structured to achieve coordination among key players by ensuring that they share decision-making powers.”\textsuperscript{106} China, a centralized government, is more likely to make progress with a collective or coordinative system that supports its sovereignty, similar to that of Japan or the European Union, than a decentralized rights-focused mechanism similar to that of the United States.\textsuperscript{107} This collective or coordinative model of corporate governance has proven successful and trustworthy before.\textsuperscript{108}

1. Japan Provides Established Precedent

When Japan experienced a similar conflict and encountered a similar gap in the law with the United States, it designed the Japanese Securities Clearing Commission and successfully increased cooperation between the two nations.\textsuperscript{109} This article’s proposed solution for China would serve a similar role and function as the Japan Securities Clearing Commission. It would signal increased Chinese cooperation and compliance with the United States, provided that the United States reciprocates by accepting and cooperating with the developing Chinese regulatory authority.

Similar to Chinese laws, when Japanese entities sought to be listed in the U.S. exchange, Japanese laws clashed with U.S. practices.\textsuperscript{110} Just as compliance with U.S. regulations exposed Chinese companies to the risk of violating Chinese State Secret Law, Japanese companies and firms that
would comply with U.S. regulations also risked violating Japanese law, which "does not directly extend to include the laws and judicial proceedings of foreign countries."\textsuperscript{111} Specifically, Japanese auditing and accounting companies breached Japanese confidentiality requirements if they tried to meet PCAOB requirements.\textsuperscript{112} Just like with China, the United States had practical and structural reasons to not trust Japanese corporate governance.\textsuperscript{113} The corporate governance structure of Japan also did not accommodate the mechanisms of the Sarbanes-Oxley Act.\textsuperscript{114}

In response, Japan established the now-trusted Japan Securities Clearing Commission to serve as a clearinghouse to disclose the necessary information to U.S. financial regulators without breaching its own interests.\textsuperscript{115} This stance signaled to the SEC and PCAOB that Japan did not allow cross-border or joint inspections to bridge the existing gap in the law between the two nations; instead, it would require the SEC or PCAOB to "achieve its goals through bi-lateral cooperation with the Japanese regulatory authority."\textsuperscript{116}

C. The Current Stalemate is Unsustainable

Many Chinese agencies and commissions may assert their authority and override the authority of another, making the PCAOB approach where "the Board works in the first instance with the non-U.S. regulator or through the use of special procedures such as voluntary consents and waivers” futile,\textsuperscript{117} resulting in unsustainable enforcement mechanisms.\textsuperscript{118}

The SEC’s enforcement action against the Big Four’s Chinese affiliates demonstrated the SEC’s willingness to aggressively induce compliance from Chinese accountants and regulators.\textsuperscript{119} In \textit{SEC v. Deloitte Touche Tohmatsu CPA Ltd.},\textsuperscript{120} after Deloitte’s Chinese affiliate refused to turn over documents, ostensibly to avoid violating Chinese State Secrecy law, the SEC issued a Section 106(e) and Section 102(e) order that resulted in precluding the firm from appearing and practicing before SEC unless it turned over its documents.\textsuperscript{121} When Deloitte’s Chinese affiliate faced a potential conviction for non-compliance with the SEC and the risk of a criminal conviction if it disclosed a potential state secret, the CSRC notified the SEC that it intended to release certain documents initially withheld on state secret grounds.\textsuperscript{122} Incentivized by the desire to lift Deloitte’s suspension, Chinese regulators reviewed and processed the documents before a making a coordinated handover to the SEC.\textsuperscript{123} Though the CSRC complied, this mechanism of inducing compliance through lawsuits or administrative actions signals U.S. encroachment on China’s sovereignty.

D. The Proposed Solution Avoids Repeating Past Mistakes

Under this article’s proposed solution, the SEC would not have to wait and litigate against each private firm, but could instead go directly to the body to request audit materials. Documents provided by the body would be reviewed and firms that do not produce documents would be categorically suspended from appearing before the SEC and PCAOB, unlisted, or both, without the PCAOB needing to wait for the company’s dance from one agency to the other to end. Rather than assume that one agency would not comply for fear of overstepping the authority of another agency, this body, composed of representatives from each agency, would unite all potential authorities into a singular regulatory entity that makes a determination of whether to produce the requested documents for Chinese companies listed in the U.S. Stock Exchange.

If actual state secrets or national interests are implicated, the body would serve as a clearinghouse for those secrets and interests, and could either redact information or not produce the documents. The PCAOB would accept and review the produced documents before issuing and enforcing its decision with the knowledge that it went through a single authoritative regulatory body, rather than having to navigate through the various agencies wrought with vague hierarchy and suspicious exceptions.

This solution would have prevented the current standstill that resulted from the Chinese reverse merger activity. As discussed above, the SEC had a difficult time pressuring BDO China Dahua (BDO), and the Chinese affiliates of Ernst & Young (EY), KPMG, Deloitte Touche Tohmatsu (Deloitte) and Price Water House Coopers (PWC) to produce audit materials for due diligence review.\textsuperscript{124} The SEC requested materials from these accounting firms connected to the Chinese reverse-merger activity of at least ten of each of their clients, yet these companies refused to produce audit papers and therefore violated Section 106 of the Sarbanes-Oxley Act and the Exchange Act.\textsuperscript{125} Each firm
argued that complying with the PCAOB request exposed the firms and their respective employees to criminal liability under Chinese State Secret Law. U.S. regulators sought materials from BDO, BDO consulted the CSRC, MOF, State Secrecy Bureau, and State Archives Administration; however, each agency failed to claim authority over the matter, placing the onus on the firm to navigate the PCAOB request and risk violating Chinese State Secret Law. When the Chinese affiliates of EY, KPMG, and PWC consulted with the CSRC and MOF, both of them also rejected the request to produce documents for the PCAOB. After failing to garner cooperation from the accounting firms and agencies, the court enforced the SEC’s requests by issuing and enforcing sanctions, including suspension from practicing or appearing before the SEC.

Under the proposed body, BDO would have produced materials to a single and authoritative regulatory body that would be responsible for the matter, made of representatives not only from the CSRC, MOF, State Secrecy Bureau, and State Archives Administration, but also from the SASAC if needed. The Chinese affiliates of EY, KPMG and PWC would have been able to clear any state secret claims through a single clearinghouse before producing the documents to the PCAOB.

If a company’s accounting firm does not utilize this body, it would signal that its state secret claim is hollow, likely raised to veil inadequate accounting practices. Under this solution, the accounting firm would still have a similar experience to that when the SEC utilized the Sarbanes-Oxley Act to compel the production of documents; but the result would have the additional benefit of eliminating the lingering question of whether the State Secrecy Bureau or State Archives Administration could assert their authority over the CSRC’s authority to not produce documents.

E. Balancing U.S. and Chinese Interests

As it did with similar bodies in the European Union and Japan, U.S. regulators accepting this body and allowing Chinese regulators to conduct and control inspections on its own soil would demonstrate respect for Chinese control over its sovereignty.

Although it appears on first glance that the United States would need to blindly rely on this body’s objectivity as an effective monitor on Chinese soil, this concern would be allayed by two important factors: (1) the economic incentive of Chinese companies, and (2) the fact that U.S. regulators are willing to issue and enforce the more forceful mechanisms of the Sarbanes-Oxley Act. China would be incentivized to adhere to the standards and protocol set by this body because its own market cannot handle the billions in private equity tied up in Chinese firms looking for an IPO. This body also aligns with publicly declared Chinese plans and provides an additional benefit to Chinese regulators by signaling an increase in China’s formal legal governance, on its own accord, through the administrative coordination of state and private sector interests.

With one clear authoritative regulatory body, U.S. regulators may deliver a more forceful sting through the Sarbanes-Oxley Act, and U.S. investors and auditing firms would no longer need to rely on approval from a supposed or ambiguous authority that may be blocked by another.

CONCLUSION

山不转路转 (A mountain cannot turn, but a road can). The current gap in the law highlights China’s unyielding position to allow foreign regulators to inspect on its soil, and the United States’ inclination to impose conformity to its regulations.

The proposed body, through which U.S. and foreign inspectors can verify compliance and access requested due diligence materials when state secret claims are raised, would strike a balance by incentivizing compliance with U.S. regulations without infringing on Chinese sovereignty interests. This body would create a road for Chinese companies, their accounting firms and U.S. regulators that bypasses the vague forest of Chinese State Secret Law and the complex mountain of Chinese bureaucracy. The SEC would have a regulatory body to cooperate with as it did with other equivalent international boards before instigating more punitive actions, and Chinese companies and their accounting firms would have a proactive means of compliance.

Understanding the full impact of this solution would be improved by additional research regarding the development, globalization and regulation of the Chinese accounting profession, which play key roles in determining whether Chinese accounting could
be trusted.137 Accurately measuring the success of this body would rely on additional research in the available legal mechanisms that mitigate the risk of divulging Chinese state secrets when documents are produced, and additional analysis to determine whether to relax or maintain the current heightened U.S. listing requirements for Chinese reverse merger companies.138 Research that determines the intricacies of trade secrets and issues that arise in the arena of intellectual property and military security would also help determine the validity of raised state secret claims.

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Endnotes

1 A widely used Chinese idiom.


6 See Bu, supra note 3, at 30; see Luo, supra note 4, at 224.

7 See generally, Luo, supra note 4.

8 A state secret refers broadly to information and materials that may be claimed as state secrets under Chinese State Secret Law and is distinguishable from a trade secret—an entirely separate legal category under intellectual property law.


10 Because the CSRC did not move the needle forward with the SEC regarding cross-border or joint inspections, the SEC had no choice but to heighten restrictions on Chinese reverse merger companies. See generally, Bu, supra note 6, at 17.


12 A widely used Chinese idiom.

13 Bu, supra note 3, at 19.

14 Id.

15 CURTIS MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM, 139 (2008) [hereinafter Milhaupt & Pistor].

16 Lubman, supra note 11, at 82.

17 Id.

18 Reverse mergers are an acceptable means to finance a company or go public; there is nothing inherently illegal in the reverse-merger process. Id. at 17. See James Dunn, Reverse Mergers Offer Companies Quick Route to Going Public, THE NORTH BAY BUS. J. (June 20, 2016), http://www.northbaybusinessjournal.com/industrynews/5741474-181/reverse-merger-going-public?ref=related.

19 Lubman, supra note 11 at 19-20.

20 Id. at 82.


23 Some of these were prepared by the Chinese Big Four affiliates. Rapoport, supra note 21.

24 Bu, supra note 3, at 25; see generally, Rapaport, supra note 21.

25 See generally, Rapaport, supra note 21.
The SEC and CSRC expressed “intent to provide each other assistance in obtaining information and evidence to facilitate the enforcement of their respective laws,” provided that the assistance is “consistent with the domestic laws of the respective States,” and may be “denied” if it “would be contrary to the [State’s] public interest.” Memorandum of Understanding Between the United States Securities and Exchange Commission and the China Securities Regulation Commission Regarding Cooperation, Consultation, and the Provision of Technical Assistance, SEC Release No. IS-662, 56 SEC Docket 1717, 1994 WL 163-73, at *2, 4 (Apr. 28, 1994), https://www.sec.gov/about/offices/oia/oia bilateral/china.pdf.

Firms included BDO China Dahua Co. Ltd., Deloitte Touche Tohmatsu Certified Public Accountants Ltd., Ernst & Young Hua Ming LLP, KPMG Huazhen and PricewaterhouseCoopers Zhong Tian CPAs for “refusing to produce audit work papers and the documents related to China-based companies under investigation ... potential accounting fraud ... violating the Securities Exchange Act and the Sarbanes-Oxley Act.” China Affiliates of Big Four Violating U.S. Securities Laws, supra note 5.

Rapoport, supra note 21.

Luo, supra note 4, at 202-03.

Id. at 185.

Id. at 187, 190-91; Sarbanes-Oxley Act of 2002 § 106(e), 15 U.S.C. § 7216, § 105(b)(5)(A), 15 U.S.C. § 7215(b)(5)(A) (2012). Although § 105(b)(5)(A) of the Sarbanes-Oxley Act provides that documents received by the PCAOB are considered “confidential and privileged,” these documents are often not able to be transmitted by firms without risking violation of Chinese laws. Luo, supra note 4, at 187.

See infra Part II.C and accompanying text.

Jonathan Shirley, International Law and the Ramifications of the Sarbanes-Oxley Act of 2002, 27 B.C. INT’L & COMP. L. REV. 501, 502, 526 (2004) (“[I]n order to adopt SOX’s corporate governance model, foreign corporations are forced to either compromise or abandon their own cultural values ... ironic from the perspective of foreign corporations because the U.S. Congress crafted SOX as a response to corporate scandals that were very much an American phenomenon.”); see also Alen Mattich, London Stock Exchange Lures Foreign Firms Listed in U.S., WALL ST. J., Jan. 6, 2003, at M1.

Luo, supra note 4, at 196.

Shirley, supra note 35, at 501-02.

Accounting and Auditing Standards: Pending Proposals and Emerging Issues: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs., 111th Cong. 23, 24 (2010) (Introduced by Congressman Kanjorski) (“The House regulatory reform bill on section 106 of Sarbanes-Oxley that would give us greater ability to subpoena work papers from foreign audit firms ...would be of assistance.”).


“Practice” is defined as “the preparation of any statement, opinion or other paper by any ... accountant ... filed with the Commission in any registration statement, notification, application, report or other document with the consent of such... accountant”). 17 C.F.R. § 201.102(f) (2013).

A foreign public accounting firm that “issues an opinion or otherwise performs material services upon which a registered public accounting firm relies” has consented to “produce its audit workpapers for the Board or the Commission” upon request and is “subject to the jurisdiction” of a U.S. court. Sarbanes-Oxley Act of 2002, § 106(b), 15 U.S.C. § 7216(b).


Courts have generally applied the test in United States v. Powell, 379 U.S. 48 (1964), a four part test: SEC must show that “the investigation serves a purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the [agency’s] possession, and that the administrative steps required by the [agency] have been followed.” SEC v. Kanter, 1998 U.S. Dist. LEXIS 10902 (N.D. Ill. July 9, 1998); RNR Enters., Inc. v. SEC, 122 F.3d 93 (2d Cir. 1997).

Bu, supra note 3, at 27, 29.

See supra note 44.

Bu, supra note 3, at 30 (“[L]ittle that can be done if a Chinese firm declines to produce documents, unless the Chinese government chooses to cooperate ... delivery of a subpoena in China requires the assistance of local authorities, and there are no means to ensure that these local authorities will actually deliver a subpoena.”).
This matter is complicated by the fact that municipal and provincial authorities exercise their own authority to determine State Secrecy claims. Sky Canaves, "Murky State Secrets Laws at Issue in Rio Tinto Case," WALL ST. J., July 9, 2009.


64 An Inevitable Conflict, supra note 9.

65 On the evolving state of the law in the United States

66 National People’s Congress Standing Committee Issues Revised State Secrets Law, supra note 55.


68 See Paul J. Davies, HK Regulator Files E&Y China Secrecy Test Case, FIN. TIMES, http://www.ft.com/intl/cms/s/0/13c9ed1c-f0ea-11e1-89b2-00144feabdc0.html#axzz3IMETJsS. This was despite the signing of the 1993 International Organization of Securities Commission Multilateral Memorandum of Understanding. This was entered into between the Hong Kong Securities and Futures Commission and CSRC, and was the Hong Kong equivalent of the Memorandum of Understanding between the SEC and CSRC. Id.

69 See id.

70 See id.


72 Milhaupt & Pistor, supra note 15, at 142.

73 Id. at 140-41.


75 The CSRC issued an agency rule jointly with the Chinese State Secrets Bureau in 2009. About the evolving state of the law in the United States

76 Id.


78 See supra, note 77.

79 Id.

80 See Davies, supra note 68.

81 Id.

82 A widely used Chinese idiom. The equivalent to “you cannot have your cake and eat it too.”

83 See supra Part II.A. and accompanying text.

84 See Luo, supra note 4, at 202-03.

85 Id.; see generally, Bu, supra note 3, at 30.

86 See supra Part II.B-C and accompanying text.

87 See supra Part II.A and accompanying text.

88 See infra Parts III.B.1, III.E, and accompanying text.


91 The State Assets Supervision and Administration Commission supervises one hundred and twenty state-owned companies. Bu, supra note 3, at 32; Lubman, supra note 11.

92 It is important that this body is composed of representatives from the listed agencies, commissions and bureaus because of the collective and coordinative nature of Chinese administration. For example, although the State Secrecy Administration Bureau promulgates rules regarding state secrets protection, other administrative ministries or departments such as Agricultural Affairs, are authorized to promulgate detailed rules to further regulate state secrets protection in various industries. See Milhaupt & Pistor, supra note 15, at 125-125, 194.


94 See Jernudd, supra note 49.

95 See Milhaupt & Pistor, supra note 15, at 147.

96 Id.

97 Id. at 147-48.

98 Id. at 133-34.


101 Supra note 4.

102 Id.


104 See Luo, supra note 4, at 198; see generally, supra note 103.

105 See supra note 104.

106 Milhaupt & Pistor, supra note 15, at 33.

107 Id. at 126, 194.

108 Id. at 125, 194; see generally Shirley, supra note 35, at 501.


110 See id.


112 Id.

113 Unlike its U.S. counterpart, for example, the Japanese Commercial Code did not require auditing to be performed by independent committee members. Whereas Sarbanes-Oxley requires independent board members to appoint and supervise an outside auditing firm, Japan’s Commercial Code not only allows the auditing function to be performed by non-independent committee members, it requires that the shareholders select the outside auditors. Matthew Senechal, Reforming The Japanese Commercial Code: A Step Toward an American Style Executive Officer System in Japan, 12 PAC. RIM. L. & POL’Y. J. 535, 544 (2003).

114 Shirley, supra note 35, at 513 (“[Sarbanes-Oxley] applies terms that simply have no equivalent in Japan.”).
115 See supra note 109.
116 See Letter from Akio Okuyama, supra note 111.
118 This article’s proposal to design a single, authoritative body would resolve this issue.
120 Id.
121 China Affiliates of Big Four Violating U.S. Securities Laws, infra note 5.
123 See Luo, supra note 4, at 194.
125 Id.
126 Id. at *10-23.
127 Id. at *25-54, 76-81, 111-36.
128 Id.
129 Id. at *86-108.
132 Shirley, supra note 35 at 514-15.
134 Section 8 requires overseas security regulatory authorities to report to the relevant in-charge authorities in advance in order to “obtain prior approvals from the relevant authorities for matters for which such prior approvals are required to be obtained.” Case 1:11-mc-00512-GK-DAR Document 23-1 Filed 04/11/12 Page 98 of 105, Announcement of China Securities Regulatory Commission, State Secrecy Bureau, State Archives Admin. (2009 No. 29) China Securities Regulatory Commission State Archives Admin., Oct. 20, 2009, Provisions on Strengthening Confidentiality and Archives Administration in Overseas Issuance and Listing of Securities.