UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File Nos. 3-14872, 3-15116

In the Matter of

BDO CHINA DAHUA CPA CO., LTD.,
ERNST & YOUNG HUA MING LLP,
KPMG HUAZHEN (SPECIAL GENERAL PARTNERSHIP),
DELOITTE TOUCHE TOHMATSU CERTIFIED PUBLIC ACOUNTANTS LTD., and
PRICEWATERHOUSECOOPERS ZHONG TIAN CPAs LIMITED

The Honorable Cameron Elliot,
Hearing Officer

DIVISION OF ENFORCEMENT'S PRE-HEARING BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES iv

PRELIMINARY STATEMENT 1

STATEMENT OF FACTS 6

I. Sarbanes Oxley Establishes Registration And Document Production Requirements For Audit Firms 6

II. Respondents Have Known At Least Since They Registered With The Board That They Are Required To Comply With U.S. Regulators' Demands For Documents 7

III. Respondents Participated Broadly in U.S. Markets 10

IV. Respondents Knowingly Failed To Produce Documents Requested By The Commission Under Section 106 12

A. Dahua 13

B. EYHM 14

1. Client B 14

2. Client C 15

C. KPMG Huazhen 17

1. Client D 17

2. Client E 18

3. Client F 19

D. DTTC 20

1. DTTC Client A 21

2. Client G 22

E. PwC Shanghai 24

1. Client H 24

2. Client I 25

ARGUMENT 27

I. Legal Standards and Violations Under Rule 102(e) and Sarbanes-Oxley 27

II. The Commission Issued Section 106 Requests To All Of The Respondent Foreign Firms As Provided By Section 106 28

III. All Respondent Foreign Firms Willfully Refused To Comply With The Section 106 Requests 30

A. The Term "Willful" In Section 106(e) Should Be Given Its Ordinary Meaning Under The Securities Laws 31

1. "Willful" Is A Term of Art Used Throughout The Securities Laws 31

2. The Case Law Overwhelmingly Demonstrates That "Willful" Means Only Volitional Conduct In The Securities Law Context 32

3. "Willful" Under Section 106(e) Means Only Intentional Conduct 35

B. Respondents' Refusal To Comply With The Requests Was "Willful" 36

C. Strong Policy Interests Support The Conclusion That Respondents "Willfully Refused" To Comply Under Section 106(e) 40

D. Respondents Made Insufficient Efforts To Achieve Compliance With The Requests In Light Of Chinese Law 42

IV. COMITY CONSIDERATIONS DO NOT MAKE RESPONDENTS' CONDUCT LESS "WILLFUL" 44

A. The Comity Factors Do Not Apply 45

1. The Comity Factors Do Not Apply To These Proceedings Because The Division Does Not Seek To Compel Compliance With The Requests 45

2. The Comity Factors Do Not Apply Because Respondents Have Not Shown, And Are Unlikely To Show, An Actual Conflict Of Law 46

B. The Comity Factors Only Further Demonstrate That Respondents Willfully Refused To Comply With the Requests 50

1. Respondents Have Not Acted In Good Faith 50

2. The U.S. Has A Stronger Interest In Preventing Non-Transparent Audits Then China Has In Blocking Regulators' Full Access to Workpapers 52

3. The SEC Has No Alternative Means Of Obtaining Documents Sought By the Requests 54

4. Audit Workpapers Are Important To SEC Financial Fraud Investigations 56

5. Respondents Willfully Courted Whatever Hardship They Would Face Through De-Barment, Or Would Have Faced In Producing The Requested Documents 57

V. RESPONDENTS SHOULD BE BARRED FROM ISSUING AUDIT REPORTS AND PERFORMING CERTAIN OTHER AUDIT SERVICES FOR U.S. ISSUERS 57

A. Debarment Is Justified By The Serious Harm To The Commission's Processes That The Respondents Have Caused Through Their Willful Violations 59

1. Legal Standard for Imposing 102(e) Remedies 59

2. Respondents' Willful Violations Justify Debarment 59

3. Debarment Is Not Unfair, Regardless of Chinese Law 62

B. The Division's Proposed Bar Is Authorized Under Rule 102(e) 62

C. The Proposed Bar Is Appropriately Tailored 63

1. The Bar Remedies the Harms Caused by Respondents' Willful Violations 64

2. The Proposed Bar Properly Balances the Relevant Interests 66

CONCLUSION 68

TABLE OF AUTHORITIES

CASES

Altman v. SEC, 666 F.3d 1322 (D.C. Cir. 2011).....36

Amaroq Asset Management, LLC, Initial Decision Release No. 351, 93 SEC Docket 2231, 2008 WL 2744866 (Jul. 14, 2008) 34

Robert W. Armstrong, III, 85 S.E.C. Docket 2321, 2005 WL 1498425 (June 24, 2005).....63

Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir. 1976) 30, 33

Butler v. Social Security Admin., 331 F.3d 1368 (Fed. Cir. 2003) 35

Gregory M. Dearlove, CPA, 92 SEC Docket 1427, 2008 WL 281105 (Jan. 31, 2008).....59, 60

Dennis v. United States, 171 F.2d 986 (D.C. Cir. 1948) 32

Department of Revenue of Oregon v. ACF Industries, Inc., 510 U.S. 332 (1994) 35, 36

Dohan & Co., CPA, Initial Decision Rel. No. 420, 110 SEC Docket 1973, 2011 WL 2544473 (June 27, 2011) 59

Dominick & Dominick, Inc., 50 S.E.C. 71, 1991 WL 294209 (May 29, 1991).....34, 38

Gearhart & Otis, Inc., Inc. v. SEC, 348 F.2d 798 (D.C. Cir. 1965) 33

Gucci America, Inc. v. Weixing Li, No. 10cv4974 (RJS), 2011 WL 6156936 (S.D.N.Y. Aug. 23, 2011) 45

Gustafson v. Alloyd Company, Inc., 513 U.S. 561 (1995) 35

Harrington v. U.S., 504 F.2d 1306 (1st Cir. 1974) 35

Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949).....32, 33, 36, 38, 40

Marrie v. SEC., 374 F.3d 1196 (D.C. Cir. 2004).....41, 64

Mathis v. SEC, 671 F.3d 210 (2d Cir. 2012).....33

James Thomas McCurdy, CPA, 82 SEC Docket 282, 2004 WL 210606 (Feb. 4, 2004).....59

Minpeco v. Conticommodity Services, 116 F.R.D. 517 (S.D.N.Y. 1987).............43, 50, 51

Molzof v. United States, 502 U.S. 301 (1992) 37

Morissette v. United States, 342 U.S. 246 (1952)...37

National Organization of Veterans' Advocates, Inc. v. Secretary of Veterans' Affairs, 260 F.3d 1365 (Fed. Cir. 2001)...35

Paz Securities, Inc. v. SEC, 494 F.3d 1059 (D.C. Cir. 2007) 39

Peak Wealth Opportunities, LLC, Admin. Proc. File No. 3-14979, Exchange Act Release No. 69036, 2013 WL 812635 (ALJ Order Mar. 5, 2013)..30, 34, 59, 60

Richmark Corp. v. Timber Falling Consultants, 959 F.2d 1468 (9th Cir. 1992) 50, 51, 52, 54, 58

Barry C. Scutillo, CPA, Initial Decision Release No. 183, 74 SEC Docket 1944, 2001 WL 461287 (May 3, 2001) 60

SEC v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981)..............50, 53, 58

SEC v. Brown, 878 F. Supp. 2d 109 (D.D.C. 2012) 65

SEC v. Euro Security Fund, No. 98 Civ. 7347 (DLC), 1999 WL 182598 (S.D.N.Y. Apr. 2, 1999)..44, 46, 50, 53

SEC v. Prince, 2013 WL, at 36 (D.D.C. May 2, 2013) 65

In re Sealed Case, 825 F.2d 494 (D.C. Cir. 1987)...44

Societe Internationale Pour Participations Industrielles et Commerciales v. Rogers, 357 U.S. 197 (1958) 31, 51

Societe Nationale Industrielle Aerospatiale v. U.S. District Ct. for Southern District of Iowa, 482 U.S. 522 (1987) 43, 44, 50, 55

Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979)...60, 62, 64

Tager v. SEC, 344 F.2d 5 (2d Cir. 1965) 34

Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979)..40

United States v. Arthur Young & Co., 465 U.S. 805 (1984)................................41, 53, 66

United States v. Bank of Nova Scotia, 691 F.2d 1384 (11th Cir. 1982) 50

Vineland Fireworks Co., Inc. v. Bureau of Alcohol, Tobacco, Firearms & Explosives, 544 F.3d 509 (3d Cir. 2008) 36

Wonsover v. SEC, 205 F.3d 408 (D.C. Cir. 2000) 4, 31, 34, 37

Wultz v. Bank of China, No. 11 Civ. 1266, 2012 WL 5378961 (S.D.N.Y. Oct. 29, 2012) 52, 55

Wultz v. Bank of China, No. 11cv1266 (SAS), 2013 WL 1832186 (S.D.N.Y. May 1, 2013) 46

STATUTES, RULES AND REGULATIONS

Fed.R. Civ. P. 37(b) 31, 32

Sarbanes-Oxley Act, Pub. L. 107-204, 116 Stat. 745 § 602 (2002) 37

Sarbanes-Oxley Act

Section 3(b)(1) [15 U.S.C. § 7202(b)(1)] 29

Section 101 [15 U.S.C. § 7211] 7

Section 102(a) [15 U.S.C. § 7212(a)] 7

Section 102(d) [15 U.S.C. § 7212(d)] 7

Section 104 [15 U.S.C. § 7214] 7

Section 104(d) [15 U.S.C. § 7214(d)] 7

Section 104(e) [15 U.S.C. § 7214(e)] 7

Section 105 [15 U.S.C. § 7215] 7

Section 105(b)(2) [15 U.S.C. § 7215(b)(2)] 7

Section 105(b)(3)(ii) [15 U.S.C. § 7215(b)(3)(ii)] 7

Section 106(b) [15 U.S.C. § 7216(b)] 29

Section 106(b)(1) [15 U.S.C. § 7216(b)(1)] 7

Section 106(d) [15 U.S.C. § 7216(d)] 11

Section 106(e) [15 U.S.C. § 7216(e)] 3, 8, 11, 29

Section 106(f) [15 U.S.C. § 7216(f)] 56

Section 106(g) [15 U.S.C. § 7216(g)] 7

Section 107 [15 U.S.C. § 7217] 7

Securities Exchange Act of 1934

Section 4C(a)(3) [15 U.S.C. § 78d-3(a)(3)] 3

Section 15(b)(4) [15 U.S.C. § 78o(b)(4)] 34

Section 15(b)(4)(A) [15 U.S.C. § 78o(b)(4)(A)] 32

Section 15(b)(4)(D) [15 U.S.C. § 78o(b)(4)(D)] 32

Section 15(b)(4)(E) [15 U.S.C. § 78o(b)(4)(E)] 32

Section 15(b)(6)(B) [15 U.S.C. § 78o(b)(6)(B)] 33

Section 15B(c)(2) [15 U.S.C. § 78o-4(c)(2)] 32

Section 15C(c)(1)(A) [15 U.S.C. § 78o-5(c)(1)(A)] 32

Section 15E(d)(1) [15 U.S.C. § 78o-7(d)(1)] 32

Section 21B [15 U.S.C. § 78u-2] 32

Investment Company Act of 1940

Section 9(b) [15 U.S.C. § 80a-9(b)] 33

Section 9(d)(1) [15 U.S.C. § 80a-9(d)(1)] 33

Investment Adviser Act of 1940

Section 207 [15 U.S.C. § 80b-7] 33

Securities and Exchange Commission's Rules of Practice

Rule 102(e)(iii) [17 C.F.R. § 201.102(e)(iii)] 3, 28, 65

Rule 102(f)(ii) [17 C.F.R. § 201.102(f)(ii)] 65

Amendment to Rule 102(e) of the Commission's Rules of Practice,
63 Fed. Reg. 57164 (1998) 61

Public Company Accounting Oversight Board Rules

Rule 5103(a)....................7

Rule 5103(b) 7

Rule 5110(a)....................7

Rule 5200(a)(3)....................7

Rule 5300(b) 7

MISCELLANEOUS

BLACK'S LAW DICTIONARY (6th abridged ed. 1991)....................32

David M. Stuart & Charles F. Wright, *The Sarbanes-Oxley Act: Advancing the SEC's Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations,* 2002 Colum. Bus. L. Rev. 749 ....7, 41

Restatement (Third) of Foreign Relations Law of the United States (1987)....................45, 50

The Division of Enforcement (the "Division") of the U.S. Securities and Exchange Commission ("SEC" or "Commission") respectfully submits this Prehearing Brief.

PRELIMINARY STATEMENT

Respondents are public accounting firms based in the People's Republic of China ("China").[1] They have chosen voluntarily to participate in U.S. capital markets by registering with the Public Company Accounting Oversight Board ("PCAOB" or "Board") and performing audit work for clients that issue securities traded in the U.S. Despite this, Respondents have failed to comply with U.S. statutory requirements that expressly apply to them by virtue of their affirmative conduct. Specifically, each Respondent has declined to produce audit workpapers and related documents for certain U.S. issuer-clients in response to Commission requests under Section 106 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "the Act"), as amended by Section 929J of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") ("Section 106"). Respondents contend that producing the requested documents would subject them to possible penalties under Chinese law, a circumstance they acknowledge they have known about at least since they first registered with the Board between 2004 and 2006. Ostensibly to avoid these alleged penalties, Respondents have chosen to deny the Commission access to documents to which it is statutorily entitled, and which the Commission needs to conduct ongoing investigations and to supervise accounting professionals who are registered

[1] Order on Motions For Summary Disposition As To Certain Threshold Issues (Apr. 30, 2013), at 2 ("April 30 Order"). Respondents are BDO China Dahua CPA Co., Ltd. (now known as Dahua CPA Co., Ltd.) ("Dahua"), Deloitte Touche Tohmatsu CPA Ltd. (now known as Deloitte Touche Tohmatsu CPA LLP) ("DTTC"), Ernst & Young Hua Ming LLP ("EYHM"), KPMG Huazhen (Special General Partnership) ("KPMG Huazhen"), and PricewaterhouseCoopers Zhong Tian CPAs Limited ("PwC Shanghai"). At the time these proceedings commenced, each Respondent was a member of a global network of accounting firms. April 30 Order at 2. Dahua now represents that it is neither associated with nor a member firm of BDO International Limited. *See* Dahua Notice To All Parties (Jun. 7, 2013).

with the Board and whose work is incorporated into Commission filings and relied upon by U.S. investors.

Respondents contend that the above-described status quo, under which, in the firms' view, they may freely avail themselves of the financial and reputational benefits of participating in U.S. markets while relying on the supposed restrictions of foreign law to exempt themselves from U.S. rules, is allowed by Sarbanes-Oxley. The Division disagrees. Respondents' decisions to enter U.S. markets and willfully refuse to comply with the SEC's requests under Section 106 violated Sarbanes-Oxley. This Court can and should impose an appropriate remedy that addresses these violations and prevents future harm to Commission processes and U.S. investors caused by the firms' failures to produce the critical, needed documents.

Under Rule 102(e)(iii) of its Rules of Practice, which Sarbanes-Oxley codified, "[t]he Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found . . . [t]o have willfully violated . . . any provision of the Federal securities laws or the rules and regulations thereunder." 17 C.F.R. § 201.102(e)(iii); *see also* 15 U.S.C. § 78d-3(a)(3). Sarbanes-Oxley Section 106(e) provides that "[a] willful refusal to comply" with a Section 106 request "shall be deemed a violation of this Act." *Id.* § 7216(e). Because Respondents' knowing failures to produce the requested documents constituted willful refusals to comply, the Commission should seek to rectify the improper status quo by suspending Respondents' privilege of appearing or practicing before it.

The Court can and should find that Respondents willfully refused to comply with the Requests based on what the Division believes will be undisputed facts. Respondents undeniably entered U.S. markets knowing they could be required to produce documents to U.S. regulators,

and, by their own interpretations of Chinese law, could face sanctions from Chinese authorities for complying with such requests. Respondents further confirmed their knowledge of U.S. obligations when, after Congress amended Section 106 in 2010, they designated U.S. agents for receipt of service of document demands as required by the amendment. Respondents also continued to accept audit engagements with U.S. issuers after the 2010 amendments. Given all of this voluntary conduct, their knowing refusals to comply with the Requests were "willful" under Section 106, because Respondents "intentionally committ[ed] the act[s] which constitute[d] the violation[s]." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000). The exact nature of the constraints imposed on Respondents under Chinese law, and their various communications with Chinese regulators *after* they received the Section 106 requests (or even before these requests in connection with other inquiries for the same information), are irrelevant to the willfulness inquiry under Section 106. This Court can conclude immediately that Respondents willfully violated the securities laws under Rule 102(e), dispense with the planned hearing on liability issues, and move on to consideration of an appropriate remedy.

In any event, a hearing on a broader range of factual issues will only confirm that Respondents willfully refused to comply with the Commission's requests. There is no record evidence that a single audit workpaper has been determined by an audit client, the Chinese government, or any Respondent to contain state secrets. Indeed, there is no record evidence that Respondents have even conferred with their Clients on this point, even though the Clients had an independent obligation to identify any state secrets that they transmitted to Respondents.

Respondents contend that the ALJ should consider the full range of "comity" issues that a federal court would apply in determining whether to compel a party to produce documents from a foreign country under foreign law. The ALJ, of course, already has ruled that the Division

does not seek to "enforce" the Section 106 requests through these proceedings. For this reason alone, the comity factors must be considered very differently in this proceeding (if they are considered at all) because the Division does not seek to have Respondents violate any foreign law. No sovereign interest of a foreign country is implicated, and the only possible "hardship" to Respondents is the removal of a benefit that they assumed for themselves when they voluntarily entered U.S. markets.

Traditional comity analysis under the Restatement of Foreign Relations Law is inapposite for the additional reason that, as the Hearing record likely will show, Respondents cannot carry their burden of showing that an actual conflict of law exists. Respondents claim that, in October 2011, the China Securities Regulatory Commission ("CSRC") instructed them not to produce documents directly to the SEC. However, the CSRC letters that Respondents rely upon do not contain such an instruction. Thus it appears Respondents will try to prove the alleged prohibition through their own hearsay testimony about meetings or other oral communications with the CSRC from this time period. Respondents will not provide any testimony from the CSRC. This is a very slender evidentiary reed – and, the Division submits, an insufficient one – upon which to prevent the SEC from remedying the severe harm to its processes, caused by Respondents' noncompliance, under Rule 102(e).

Whatever evidence the ALJ decides to credit on this point, however, Respondents' proof of a prohibition under Chinese law would not make their refusals to comply less willful. They have not acted in good faith, because (among other reasons) they entered U.S. markets – and profited thereby – with knowledge that they might well find themselves in this predicament. In addition, under any comity analysis the Commission might apply, the interests of the United States in obtaining the requested documents for its enforcement investigations far outweighs the

Chinese government's interest in asserting its sovereignty through indeterminate secrecy laws, or by withholding indefinitely the "approvals" allegedly needed for Respondents to comply with the Requests.

Assuming, *arguendo*, China *could* have a legitimate interest in channeling all information requests of foreign securities regulators through the CSRC, the SEC's actual experience with the CSRC over the last several years belies such an interest. As testimony from the SEC's Office of International Affairs ("OIA") will conclusively establish, the SEC requested the CSRC's assistance with respect to DTTC's audit workpapers for DTTC Client A over *three years* ago; and although the CSRC has had the documents in its possession for virtually this entire time, to date it still has not produced any of these documents – or any workpapers for any other investigation – to the SEC. Thus, the Division presently does not have an "alternative means" for obtaining audit workpapers from China.

For these and other reasons discussed below, the Court should find that Respondents willfully violated the securities laws under Rule 102(e) by willfully refusing to comply with the Section 106 requests. The Court should also impose an appropriate remedy. Given the severe harm to Commission processes that appears to have little chance of abating, the Court should censure Respondents and permanently deny them the privilege of appearing or practicing before the Commission through activities that consist of (1) issuing audit opinions filed with the Commission, or (2) playing a 50% or greater role in the preparation or furnishing of audit opinions filed with the Commission. The Division reserves its right to modify this proposal after considering all of the evidence presented at the hearing.

STATEMENT OF FACTS

I. Sarbanes-Oxley Establishes Registration And Document Production Requirements For Audit Firms

In 2002, Congress enacted Sarbanes-Oxley to combat fraud and enhance transparency after a series of massive corporate scandals shook public confidence in the U.S. capital markets. Sarbanes-Oxley "has been called 'the most radical redesign of the federal securities laws since the 1930s' and 'the most sweeping legislation affecting accounting, disclosure and corporate governance in a generation.'" David M. Stuart & Charles F. Wright, *The Sarbanes-Oxley Act: Advancing the SEC's Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations*, 2002 COLUM. BUS. L. REV. 749, 750 (quoting sources).

Sarbanes-Oxley created the PCAOB and subjected it to Commission oversight. 15 U.S.C. §§ 7211, 7217. The Act requires public accounting firms to register with the Board if they prepare or issue, or participate in the preparation or issuance of, any audit report with respect to any issuer. *Id.* § 7212(a). Once registered, firms are subject to comprehensive Board oversight, including inspections, investigations, and a reporting regime. *Id.* §§ 7212(d), 7214, 7215. Recognizing that audit firms' documents (including specifically workpapers) are critical to Board oversight, the Act authorized the Board to create rules requiring their retention, availability, and production, *id.* §§ 7214(d), (e), 7215(b)(2), and to suspend or revoke firms' registrations upon their failure to produce documents in connection with a Board investigation, *id.* § 7215(b)(3)(ii). The Board has issued such rules. *See* Board Rules 5103(a) & (b), 5110(a), 5200(a)(3), 5300(b).

Section 106 of Sarbanes-Oxley specifically addresses the registration status of foreign public accounting firms ("foreign firms")[2] and the obligations of firms, both foreign and domestic, to produce foreign firms' documents. Section 106(b) requires any foreign firm that engages in certain specified activities (*i.e.*, "triggering conditions") to produce documents directly to either the Board or the Commission upon request. *Id.* § 7216(b)(1). Section 106(e) provides, "A willful refusal to comply, in whole or in part, with any request by the Commission or the Board under this section, shall be deemed a violation of this Act." *Id.* § 7216(e).

II. Respondents Have Known At Least Since They Registered With The Board That They Are Required To Comply With U.S. Regulators' Demands For Documents

Respondents have known at least since they registered with Board that (1) they are required to comply with document demands from U.S. regulators, including the SEC, with respect to audit work for U.S. issuers; (2) Chinese law may impair their ability to comply with such demands; and (3) Respondents bear the risk of any conflict of law caused by their audit work for U.S. issuers. Respondents' knowledge of these facts is demonstrated by the following:

First, Section 106, as enacted in 2002, stated that if a foreign firm "issues an opinion . . . contained in an audit report," or meets certain other criteria, the firm "shall be deemed to have consented (A) to produce its audit workpapers for the Board or the Commission in connection with any investigation by either body with respect to that audit report; and (B) to be subject to the jurisdiction of the courts of the United States for purposes of enforcement of any request for production of such workpapers." Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act), Pub. L. No. 107-204, § 106(b) (emphasis added) **(Division Hearing Exhibit No. 279) (hereinafter "ENF").**

[2] The Act defines "foreign public accounting firm" to mean "a public accounting firm that is organized and operates under the laws of a foreign government or political subdivision thereof." 15 U.S.C. § 7216(g).

Second, as expressly authorized by Sarbanes-Oxley, the Board created rules that require audit firms to retain, make available, and produce audit workpapers. Board rules provide for possible suspension or revocation of firms' registrations upon their failure to produce documents in connection with a Board investigation. *See supra* Facts Section I.

Third, the Board expressly informed Respondents when the firms first registered, between 2004 and 2006, that the firms were responsible for complying with requests for information, regardless of possible impediments to production under Chinese law. Specifically, in the Form 1 registration applications that they had submitted, Respondents had left blank the consents requested by Exhibit 8.1 of the form.[3] The firms also had provided, with their Form 1s, letters from foreign legal counsel contending that the firms would not be able to comply with the requested consents because of restrictions imposed by Chinese law. *See* Respondents' Form 1s **(ENF 1-5).**[4] However, upon approving the firms' registrations, the Board wrote a letter to each firm stating that the Board's approvals – despite the firms' omissions of the consents – ***did not***

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[3] Exhibit 8.1 requested the applicant to consent or agree: (a) "to cooperate in and comply with any request for testimony or the production of documents made by the [Board] in furtherance of its authority and responsibilities under the Sarbanes-Oxley Act of 2002"; (b) "to secure and enforce similar consents from each of its associated persons as a condition of their continued employment by or other association with the firm"; and (c) "that cooperation and compliance, as described in the firm's consent in paragraph (a), and the securing and enforcement of such consents from its associated persons in accordance with paragraph (b), shall be a condition to the continuing effectiveness of the registration of the firm with the [Board]." *E.g.*, DTTC Registration Form 1, at 16, Ex. 8.1 **(ENF 2)**.

[4] As part of DTTC's Form 1, for example, DTTC's foreign legal counsel stated: "The requirement that the applicant cooperate in and comply with any request for testimony or the production of documents made by PCAOB under Item 8.1(a), will violate certain provisions of PRC Laws and Regulations which prohibit disclosure of documents obtained during professional work by a certified public accountant ('CPA'), including audit workpapers, in particular given that there are no express provisions in PRC law which exempt the applicant from compliance with its confidentiality obligations under relevant PRC Laws and Regulations in the event of a request from PCAOB or SEC." DTTC Form 1, at 212, 16 April 2004 Letter from Century-Link & Xin Ji Yuan Law Office ¶4.4.1(i) **(ENF 2)**. The Form 1s for the other Respondents contained similar statements from the Century-Link law firm. *See* EYHM Form 1, at 31 **(ENF 3)** KPMG Huazhen Form 1, at 32 **(ENF 4)**; PwC Shanghai Form 1, at 31 **(ENF 5)**; Dahua Form 1 **(Respondents' Exhibit 40)**.

relieve Respondents of their obligations to comply with future information requests. The Board's letter stated, in relevant part:

> ***Moreover, the Board's approval of [the firm's] registration application despite [the firm's] failure to supply a "Consent to Cooperate with the Board" (Item 8.1 of Form 1) does not relieve [the firm] of the obligation to cooperate in and comply with Board demands (including for documents or testimony) and to enforce such cooperation and compliance by [the firm's] associated persons. If [the firm] prepares or issues, or plays a substantial role in preparing or issuing, an audit report with respect to any issuer (as "issuer" is defined in the Sarbanes-Oxley Act of 2002), U.S. law and the Board's rules impose cooperation and compliance requirements that apply to [the firm] despite the absence of a consent under Item 8.1.***

See Board Letters to Respondents **(ENF 6-10)** (emphasis added). The Board's letter was consistent with the Board's rules, which did not allow a firm, once registered, to avoid cooperation obligations, even where the firm had omitted an advance cooperation commitment from its registration form.[5]

Additionally, in 2004, the Board issued guidance to the firms emphasizing that a firm's failure to cooperate with the Board's production requests could subject the firm to disciplinary sanctions, including substantial civil money penalties and revocation of the firm's registration. This guidance stated:

> A registered firm's failure to cooperate with Board requests [for production of documents] in these contexts may subject the firm to disciplinary sanctions, including substantial civil money penalties and revocation of the firm's registration. In the staff's view, if a firm fails to cooperate with the Board, the fact that the firm has not obtained a client consent that might be necessary (under non-U.S. law) to allow the firm to cooperate is not a defense to a disciplinary action for failure to cooperate.
>
> As a practical matter, therefore, a firm must choose whether (1) to satisfy itself in advance that the non-U.S. client will provide any necessary consent if and when the Board demands documents or information

[5] PCAOB Rule 2105 permitted a firm, under certain circumstances, to withhold certain information from the registration form itself, but not in response to any future information request from a regulator. *See* PCAOB Rule 2105(a), available at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_2.aspx.

> concerning the client, (2) to proceed without such assurance and take a risk that it may later have to choose between providing information without the client's consent or facing a Board sanction for failing to provide the information, or (3) to decline the audit engagement. The Board has not attempted to dictate which of these choices a firm should make.

See FAQ 4 **(ENF 11)**.

Fourth, in 2010, as part of the Dodd-Frank Act, Congress amended Section 106 to *expand* the production requirements of Section 106(b). *See* Dodd-Frank § 929J (relevant portion of amendment captioned "Expansion of Audit Information to Be Produced and Exchanged") **(ENF 277)**. In particular, the amended provision now contains additional triggering conditions for a foreign firm's production obligation, such as where the firm performs "audit work" and "interim reviews." *See* Division's Consolidated Opposition to Motions for Summary Disposition on Threshold Issues, at 19-20 (Feb. 22, 2013) ("Consolidated Opp."). The amendments also added other important features to the provision, including: (1) the requirement that foreign firms that meet the triggering conditions (as Respondents do here) designate a U.S. agent for receipt of information requests under Section 106 and service of process to enforce such request, 15 U.S.C. § 7216(d); and (2) "Sanctions" for "[a] willful refusal to comply, in whole or in part" with any such request, *id.* § 7216(e).

Fifth, after the 2010 amendments, all Respondents submitted designations of U.S. agents under Section 106(d), confirming the Respondents' awareness of and consent to the revised production obligations of Section 106(b). *See* Certified copies of designations **(ENF 165)**. The Section 106 requests at issue in these proceedings were served upon Respondents in accordance with the designations that Respondents themselves had provided under Section 106.

III. Respondents Participated Broadly in U.S. Markets

Despite their knowledge of U.S. production requirements and the possibility that Chinese law might impair compliance with those requirements, after registering with the Board

Respondents took on numerous audit engagements with companies whose securities are registered with the SEC and traded on U.S. exchanges. According to Respondents' annual reports filed with the Board within the last four years, Respondents have all prepared or furnished or played substantial roles in the preparation of or furnishing of audit reports for U.S. issuers.[6] Specifically, in its Annual Report Form 2s for the years ending March 31, 2010, 2011, and 2012, KPMG Huazhen stated that it played a substantial role with respect to 24, 23, and 25 audit reports, respectively. **(ENF 21-23)**[7] The remaining Respondents stated that they issued audit reports for the following numbers of issuers (as the term "issuer" is defined by Board Rule 1001), respectively, during the years ending March 31, 2010, 2011, and 2012:

- Dahua: 3, 9, and 3 issuers **(ENF 12-14)**
- DTTC: 32, 45, and 45 issuers **(ENF 15-17)**
- EYHM: 11, 24, and 21 issuers **(ENF 18-20)**
- PwC Shanghai: 17, 27, and 31 issuers **(ENF 24-26)**

In addition, the Division expects the full trial record to show that DTTC, EYHM, and PwC Shanghai also have taken on numerous substantial role and referred work engagements for U.S.

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[6] Each Respondent acknowledges a portion of this recent activity in its filings in these proceedings. *See* PwC Shanghai Sum. Disp. Mot., at 3; EYHM Sum. Disp. Mot., at 3; Dahua Sum Disp. Mot., at 4; KPMG Huazhen Answer at 2; DTTC's Motion To Dismiss, File No. 3-14872 (Jun. 20, 2012), at 5.

[7] PCAOB Rule 1001(p)(ii) defines "Play a Substantial Role in the Preparation or Furnishing of an Audit Report" to mean: "(1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, or (2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer." *Infra* Argument, Part V.

issuers, and that KPMG Huazhen has taken on numerous referred work engagements for U.S. issuers. **(ENF 170-189)**[8]

IV. Respondents Knowingly Failed To Produce Documents Requested By The Commission Under Section 106

As relevant to these proceedings, Respondents were engaged to conduct or to participate in audits for certain clients in China (the "Clients"). *See* Order on Motions For Summary Disposition As To Certain Threshold Issues, at 2 (Apr. 30, 2013) ("April 30 Order"); Consolidated Opp. at 8 n.4. In March 2011, in connection with a potential accounting fraud investigation, the Commission sent DTTC a demand for audit work papers and related documents for one of its China-based clients, "DTTC Client A," pursuant to Section 106. *See* April 30 Order at 2-3; Second Corrected OIP, File No. 3-14872 ¶¶ 3, 10 (May 9, 2012) ("DTTC Proceeding OIP"). Between February and April 2012, the Commission sent Section 106 requests to each Respondent in the Omnibus Proceeding regarding certain of their China-based clients for a total of ten requests (including the earlier demand to DTTC). *See* April 30 Order at 3; OIP, File No. 3-15116 ¶¶ 8-16 ("Omnibus OIP"). Respondents acknowledged receipt of the requests (the "Section 106 Requests" or "Requests") but in all instances refused to provide the requested documents. Following these refusals the Division issued Wells notices to each Respondent; each Respondent submitted a brief answering the Wells notice but continued to withhold the requested documents and to perform audit work for U.S. issuers.[9] Additional details concerning each of the respondents, their client engagements, and their knowing failures to produce documents are as follows:

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[8] The Division has sought information about Dahua's substantial role and referred work for the same years in its Request for Subpoena, filed June 7, 2013. In addition, all Respondents are required to file their Form 2s for the year ended March 31, 2013, by the end of June 2013.

[9] *See* Wells Notices to Respondents **(ENF 140-147)**, and Respondents' responding briefs and exhibits **(ENF 148-163)**.

A. Dahua

Dahua audited the financial statements for Dahua Client A for the fiscal year ended December 31, 2010, among other years April 30 Order at 2 n. 5; Dahua Answer, p. 2.

Dahua Client A is a Nevada corporation with its primary operations in Fujian, China. *See* 10-K filed 3/26/13 **(ENF 30)**; 10-K filed 3/12/11 **(ENF 31)**. Dahua Client A purports to process, distribute, and sell seafood, marine catch and algae-based drink products. *Id.* Dahua Client A's securities are registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), *id.*, and began trading on the New York Stock Exchange ("NYSE") Amex on August 10, 2009. *See* Bloomberg Report **(ENF 33)**.

In an SEC filing on March 2, 2011, Dahua Client A included a Report of Independent Registered Public Accounting firm, signed by Dahua on that same date; the Report stated that Dahua had audited Client A's financial statements for the year ended December 31, 2010, and set forth an opinion that those statements were presented fairly and in conformity with U.S. generally accepted accounting principles. *See* Form 10-K (filed 3/2/11) **(ENF 31)**.

On February 1, 2012, in connection with an investigation involving potential financial fraud at Dahua Client A, the Commission issued a Section 106 demand to Dahua seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [Dahua Client A] for the fiscal year ending December 31, 2010." *See* Section 106 Request to Dahua, Feb. 1, 2012 **(ENF 34)**; Dahua Answer ¶ 8. On April 2, 2012, Dahua, through its U.S. counsel, sent a letter to the Division in response to the demand, stating that Dahua would not produce the requested documents based, among other reasons, on alleged instructions from certain China agencies that the documents' production would violate China law. *See* Dahua Letter **(ENF 35)**; Dahua Answer ¶ 6.

B. EYHM

EYHM was engaged to audit the financial statements for Client B for the fiscal year ended December 31, 2010, and of Client C for the fiscal years ended September 30, 2010 and 2011. April 30 Order, at 2 n. 5; EYHM Answer ¶ 2.

1. Client B

Client B is a Delaware corporation with its headquarters and principal operations in China. *See* Exchange Act Rel. No. 68060 (10/17/12) **(ENF 48);** EYHM Sum. Disp. Mot., at 8 (Feb. 1, 2013). Client B claims to be a leading developer, manufacturer, and distributor of organic compound fertilizers in China. EYHM Mot. at 8. Client B's common stock was registered with the SEC under Exchange Act Section 12(b), and was listed on NASDAQ from September 2009 to July 2011. Exchange Act Rel. No. 68060. Client B engaged EYHM as its independent auditor in November 2010. Form 8-K (filed 11/17/10) **(ENF 41)**; EYHM Sum. Disp. Mot., at 8. After Client B formally engaged EYHM as its independent auditor, EYHM sent letters to the Audit Committee of Client B's Board of Directors in which EYHM:

- Described certain matters that, if not appropriately addressed in a timely manner, might result in audit adjustments, significant deficiencies or material weaknesses and/or delays in meeting Client B's 10-K filing deadline, and that could have materially impacted Client B's internal controls over financial reporting as of December 31, 2010; and
- Stated that it had encountered issues and concerns that required additional information and procedures, including an independent investigation, in order to verify certain transactions and balances recorded on Client B's financial statements and records for the year ended December 31, 2010.

See Form 8-K (filed 3/18/11) **(ENF 42)**. On March 13, 2011, Client B issued a press release stating that it had formed a special committee of its Board of Directors to investigate certain allegations made by third parties with respect to Client B. *See* Form 8-K (filed 3/16/11) **(ENF 43)**. On March 14, 2011, Client B dismissed EYHM as its independent auditor. *See* Form 8-K (filed 3/18/11) **(ENF 42)**. The next day, EYHM sent a Section 10A Report to Client B that, among other things, "stat[ed EYHM's] belief that Client B's audit committee had failed to make the company's management take appropriate remedial action with respect to the audit issues raised by EYHM." EYHM Sum. Disp. Mot., at 9; *see also* EYHM Section 10A Report re Client B **(ENF 45)**. EYHM's Section 10A Report also summarized those audit issues. *See* EYHM 10A Report **(ENF 45)**.

On April 26, 2012, in connection with an investigation involving potential financial fraud at Client B, the Commission issued a Section 106 demand to EYHM seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [Client B] for the fiscal year ending December 31, 2010." *See* Section 106 Request to EYHM, Apr. 26, 2012 **(ENF 46)**; EYHM Answer ¶ 9. On May 25, 2012, EYHM sent a letter to the Division in response to the demand, stating that EYHM would not produce the requested documents because, among other reasons, such production allegedly would violate Chinese law. *See* Cohen letter to Johnson (5/25/12) **(ENF 47)**. The Commission revoked the registration of Client B's securities previously registered under Section 12 of the Exchange Act on October 17, 2012. *See* Exchange Act Rel. No. 68060 (10/17/12) **(ENF 48)**

2. Client C

Client C is a Cayman Islands corporation with its primary operations in China. *See* Exchange Act Rel. 67073 (5/30/12) **(ENF 51)**. Client C claims to provide enhanced recovery

services for oil and gas exploration. *See* Form 20-F (filed 3/31/11) **(ENF 50)**. Client C's American Depository Shares were registered with the SEC, and traded on NASDAQ from November 2010 to October 2011. *See* Exchange Act Rel. 67073. In an SEC filing on March 31, 2011, Client C included a Report of Independent Registered Public Accounting firm, signed by EYHM on that same date; the Report stated that EYHM had audited Client C's financial statements for the year ended September 30, 2010, and set forth an opinion that those financial statements were presented fairly and in conformity with U.S. generally accepted accounting principles. *See* Form 20-F (3/31/11) **(ENF 50)**.

In August 2011, an Internet report alleged, among other things, that Client C's importer and customers were shell companies that had no significant business and that Client C's SEC filings were false and misleading. *See* Internet report **(ENF 53)**. In September 2011, EYHM issued a letter to Client C under Exchange Act Section 10A, reporting, among other things, that Client C's Chairman had engaged in unauthorized transactions resulting in the transfer of more than $40 million from Client C to another entity related to the Chairman, and that this transfer was not publicly disclosed and had a material effect on Client C's financial statements. *See* Section 10A Letter **(ENF 54)**. In September 2011, EYHM withdrew its opinion with respect to Client C's financial statements for the year ended September 30, 2010 and resigned as Client C's independent registered public accounting firm. *See* Form 6-K (filed 9/27/11) **(ENF 52)**.

On February 2, 2012, in connection with an investigation involving potential financial fraud at Client C, the Commission issued a Section 106 request to EYHM seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [Client C] for the fiscal year ending September 30, 2010 and subsequent periods." *See* 106 Request to EYHM (2/2/12) **(ENF 55)**; EYHM Answer ¶ 10. On April 4, 2012, EYHM sent a

letter to the Division in response to the Request, stating that EYHM would not produce the requested documents based, among other reasons, on alleged instructions from the Chinese government that the documents' production would violate Chinese law. Cohen Letter to Gordimer (4/4/12) **(ENF 56)**. On May 30, 2012, the Commission revoked the registration of Client C's securities that were previously registered pursuant to Section 12 of the Exchange Act. Exchange Act Rel. No. 67073 **(ENF 51)**.

C. KPMG Huazhen

KPMG Huazhen played substantial roles in the preparation or furnishing of audit reports for Client D for the year ended December 31, 2010, *see* PCAOB Form 2 (filed 6/30/11) **(ENF 22)**, and Client F for the year ended December 31, 2009, *see* PCAOB Form 2 (filed 6/20/10) **(ENF 21)**, and performed audit work for Client E for the year ended December 31, 2010. KPMG Huazhen Answer ¶ 3.

1. <u>Client D</u>

Client D is a Delaware corporation with its primary operations in Xi'an, China. *See* Form 10-K (filed 3/16/11) **(ENF 62)**. Client D purports to engage in the wholesale distribution of finished oil and heavy oil products, the production and sale of biodiesel, and the operation of retail gas stations. *Id.* Client D's securities are registered with the SEC pursuant to Section 12(g) of the Exchange Act, *id.*, and were traded on NASDAQ from June 2009 until June 2011. *See* Client D Bloomberg Report **(ENF 63)**. KPMG Huazhen played a substantial role, as the "Subcontractor Assist Principal Auditor", with respect to Client D's audited financial statement for the year ended December 31, 2010. *See* PCAOB Form 2 (filed 6/30/11) **(ENF 22)**.

In April 2011, a pair of Internet reports alleged, among other things, that Client D overstated both its revenue and cash balance in its December 31, 2010 financial statements, that

it failed to disclose multiple related-party transactions, and that it overstated the output of its main biodiesel fuel production facility. *See* Internet Reports **(ENF 64, 65).** On February 6, 2012, in connection with an investigation involving potential financial fraud at Client D, the Commission issued a Section 106 request to KPMG Huazhen seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [Client D] for the fiscal year ending December 31, 2010." Section 106 Request to KPMG Huazhen **(ENF 66)**; KPMG Huazhen Answer ¶ 11.

2. Client E

Client E is a Nevada corporation with its primary operations in Ningbo, China. *See* Form 10-K (filed 4/13/12) **(ENF 70)**. Client E purports to manufacture and supply various petrochemical products in China. *Id.* Client E's securities are registered with the Commission pursuant to Section 12(g) of the Exchange Act, *id.*, and traded on NASDAQ from September 15, 2010 until October 7, 2011, *see* Client E Bloomberg Report **(ENF 72)**. On April 1, 2011, Client E disclosed that it would be unable to timely file its annual report on Form 10-K for the year ended December 31, 2010, because of "unexplained issues regarding certain cash transactions and recorded sales" that had been identified by its then-auditor KPMG Hong Kong. *See* Form 8-K (filed 4/1/11) **(ENF 71)**; KPMG Memo on Client E's 12/31/10 Financial Statements **(ENF 77)**.

On February 9, 2012, in connection with an investigation involving potential financial fraud at Client E, the Commission issued a Section 106 request to KPMG Huazhen seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [Client E] for the fiscal year ending December 31, 2010." Section 106 Request to KPMG Huazhen re Client E **(ENF 73)**; KPMG Huazhen Answer ¶ 12.

On February 28, 2013, the Commission brought a civil action against Client E and its former CFO charging each with violating or aiding and abetting violations of antifraud and other securities law provisions and alleging, among other things, that they failed to disclose properly certain related party and off-balance sheet transactions. *See* Lit. Rel. No. 22627 **(ENF 76)**. Also on February 28, 2013, the Commission, Client E, and Client E's former CFO filed a settlement with the court that, if approved, would enjoin Client E and Client E's former CFO from violating or aiding and abetting violations of antifraud and other securities law provisions and would require them to pay civil penalties. *Id.*

3. Client F

Client F is a Nevada corporation, with its primary operations in Shanghai, China. *See* Form 10-K (filed 3/15/10) **(ENF 80)**. Client F purportedly manufactures chemical additives used in the production of consumer and industrial products. *Id.* Client F's securities were previously registered with the SEC pursuant to Section 12(b) of the Exchange Act, *id.*, and traded on NASDAQ from approximately May 2007 through June 2011. *See* Client F Bloomberg Report **(ENF 82)**. KPMG Huazhen played a substantial role with respect to Client F's audit report for the year ended December 31, 2009, among other years. *See* PCAOB Form 2 (filed 6/30/10) **(ENF 21)**.

On March 15, 2011, Client F disclosed its appointment of a special committee of the Board "to investigate potentially serious discrepancies and unexplained issues relating to [Client F] and its subsidiaries' financial records identified by [Client F]'s auditors in the course of their audit of the consolidated financial statements for the fiscal year ended December 31, 2010." *See* Form 8-K (filed 3/15/11) **(ENF 81)**. On April 20, 2011, KPMG Hong Kong issued a letter to Client F under Exchange Act Section 10A, describing, among other things, "potentially serious

discrepancies and/or unexplained issues relating to [Client F]'s financial records that were identified during the course of our audit for the year ended 31 December 2010." *See* Section 10A letter (4/20/11) **(ENF 83)**.

On February 3, 2012, in connection with an investigation involving potential financial fraud at Client F, the Commission issued a Section 106 request to KPMG Huazhen seeking "[a]ll audit work papers and all other documents related to any audit reports issued, audit work performed, or interim reviews conducted for [Client F] from January 1, 2008 to the present." *See* 106 Request to KPMG Huazhen re Client F **(ENF 84)**; KPMG Huazhen Answer ¶ 13.

* * *

On March 27, 2012, KPMG Huazhen, through its U.S. counsel, sent a letter to the Division that responded to the three above-mentioned Requests related to Clients D, E, and F. With respect to all three of those requests, KPMG Huazhen acknowledged that virtually all of the requested materials resided in China in the possession of KPMG Huazhen, but stated that the firm would not produce the requested documents based, among other reasons, on alleged instructions from the Chinese government that the documents' production would violate Chinese law. *See* Aronow letter (3/27/12) **(ENF 67, 74, 85)**.

D. DTTC

DTTC audited DTTC Client A's financial statements for the fiscal year ended December 31, 2008 and 2009, among other years. *See* Forms 20-F (filed 6/8/09, 8/19/10) **(ENF 120-121)**. In addition, DTTC served as Client G's independent auditor from March 2, 2010 through September 6, 2010. *See* Forms 8-K (filed 3/3/10, 9/13/10) **(ENF 91, 92)**; DTTC Omnibus Answer ¶ 5.

1. DTTC Client A

DTTC Client A is incorporated in the Province of Ontario, Canada and has its principal operations and principal place of business in China. DTTC Client A designs and manufactures solar products. *See* Form 20-F (filed 4/26/13) **(ENF 124)**. DTTC Client A's securities are registered with the SEC under Section 12(b) of the Exchange Act, and trade on NASDAQ. *Id.* DTTC audited Client A's financial statements for the fiscal years ended December 31, 2008 through December 31, 2012. *See* Forms 20-F (filed 6/8/09, 8/19/10, 5/17/11, 4/27/12, 4/26/13) **(ENF 120, 121, 122, 123, 124)**, and remains DTTC Client A's auditor to this day.

On June 1, 2010, DTTC Client A disclosed that it was postponing the release of its full financial results for the first quarter ended March 31, 2010 and its quarterly conference call, scheduled for June 2, as a result of the commencement of an investigation by the Audit Committee of DTTC Client A's Board of Directors. *See* Form 6-K (filed 6/3/10) **(ENF 125)**. DTTC Client A disclosed that "the investigation was launched after the Company received a subpoena from the [Commission] requesting documents from [DTTC Client A] relating to, among other things, certain sales transactions in 2009." *Id.* On August 19, 2010, DTTC Client A filed its delayed Form 20-F in which it disclosed material weaknesses in its internal controls. (ENF 121). On August 20, 2010, DTTC Client A filed a Form 6-K, attaching a press release from the day before in which it disclosed that the company was revising its previously reported financial results for 4Q09, resulting in a reduction of net revenues of $32.8 million.

On June 7, 2010, in connection with an investigation involving potential financial fraud at DTTC Client A, the SEC's OIA sent a request for assistance to the CSRC seeking DTTC's audit workpapers with respect to DTTC Client A. **(ENF 192)** Over the course of the next three years, the OIA sent numerous written communications, and participated in meetings and phone

calls, trying to obtain the CSRC's assistance with respect to these documents. **(ENF 193-195, 197-198, 200-210, 212-228, 231- 232, 235-242, 274, 276)**. Thus far, the CSRC has not produced any of the requested documents to the SEC.

On March 11, 2011, in connection with the same investigation, the Commission issued a Section 106 request to DTTC seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [DTTC Client A] for the fiscal year ending December 31, 2009." Section 106 Request to DTTC re DTTC Client A **(ENF 127)**; DTTC Answer ¶ 10 (6/4/12). On April 29, 2011, DTTC, through its U.S. counsel, sent a letter to the Division in response to the demand, stating that DTTC would not produce the requested documents based on DTTC's alleged concerns that the documents' production would violate Chinese law. *See* Cox Letter to Friedman (4/29/11) **(ENF 128)**.

2. Client G

Client G is a Wyoming corporation with its primary operations in Beijing, China. *See* Form 10-K/A (filed 11/5/09) **(ENF 90)**. Client G purportedly designs, manufactures, and sells offset printing equipment. *Id.* Client G's securities are registered with the Commission pursuant to Section 12(g) of the Exchange Act, *id.*, and traded on the NYSE from November 2009 through April 2011, *see* Client G Bloomberg Report **(ENF 95)**.

On March 3, 2010, Client G disclosed that it had engaged DTTC as its independent registered accounting firm effective March 2, 2010. *See* Form 8-K (filed 3/3/10) **(ENF 91)**. On September 13, 2010, Client G disclosed, among other things, that:

- Client G had terminated DTTC's engagement as independent auditor effective September 6, 2010;

- During the course of DTTC's audit of Client G for the fiscal year ended June 30, 2010, Client G had denied DTTC's request for permission to access original bank statements to verify the identity of certain individuals and entities;
- Several "reportable events," as defined in Item 304(a)(1)(v) of Regulation S-K, occurred during DTTC's audit of Client G; and
- Between September 6 and September 8, 2010, Client G's CEO, CFO, and several directors, including the Chair of its Audit Committee, all resigned their positions.

See Form 8-K (filed 9/13/10) **(ENF 92)**.

On June 30, 2011, in connection with an investigation involving potential financial fraud at Client G, the SEC's OIA sent a request for assistance to the CSRC seeking DTTC's audit workpapers with respect to Client G. **(ENF 211)** Thus far, the CSRC has not produced any of the requested documents to the SEC.

On February 14, 2012, in connection with the same investigation, the Commission issued a Section 106 request to DTTC seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [Client G] for the fiscal year ending June 30, 2010." *See* Section 106 Request (2/14/12) **(ENF 93)**; DTTC Answer ¶ 14. On April 17, 2012, DTTC, through its U.S. counsel, sent a letter to the Division in response to the request, stating that DTTC would not produce the requested documents based, among other reasons, on alleged instructions from the Chinese government that the documents' production would violate Chinese law. *See* Warden Letter to Ma (4/17/12) **(ENF 94)**.

E. PwC Shanghai

PwC Shanghai was independent auditor, and performed audit work, for Client H between April 2010 and September 2011, and for Client I between December 2010 and December 2011. April 30 Order at 2 n. 5; PwC Shanghai Answer ¶ 5.

1. Client H

Client H is a Cayman Islands corporation with its primary operations in Shijiazhuang, China. *See* Form 20-F/A (filed 12/6/11) **(ENF 99)**. Client H purports to be China's largest commercial vehicle sales, servicing, leasing, and support network. *See* Form 6-K (filed 4/27/10) **(ENF 100)**. Client H's securities are registered with the SEC pursuant to Section 12(g) of the Exchange Act, *see* Form 20-F/A (filed 12/6/11), and traded on NASDAQ from October 2009 until October 2011, *see* Client H Bloomberg Report **(ENF 103)**. On April 27, 2010, Client H disclosed that it had engaged PwC Shanghai on April 13, 2010 as its independent registered public accounting firm to audit Client H's financial statements for the fiscal year ending December 31, 2010. *See* Form 6-K (filed 4/27/10) **(ENF 100)**.

Client H dismissed PwC Shanghai as its independent registered public accounting firm on September 16, 2011. *See* Form 6-K (filed 9/27/11) **(ENF 102)**; PwC Shanghai Sum. Disp. Mot., at 3. Internet reports published in October 2011 alleged, among other things, that Client H overstated revenue and earnings by accounting for lease revenues upfront instead of recognizing this revenue over the duration of the leases, and that there were discrepancies between Client H's cash flow and reported net income, as well as unreported executive compensation via stock earn-outs to the CEO, and other potential misrepresentations in Client H's public statements and Commission filings. *See* Internet reports **(ENF 104)**. On April 11, 2012, the Commission sued Client H and eleven other defendants alleging that they manipulated the price of Client H's stock

in order to increase the volume of trading in the stock and thereby increase its chances of obtaining financing on favorable terms. *See* SEC Complaint **(ENF 105)**.

On February 8, 2012, in connection with an investigation involving potential financial fraud at Client H, the Commission issued a Section 106 request to PwC Shanghai seeking "[a]ll audit work papers and all other documents related to any audit work or interim reviews performed for [Client H] for the fiscal year ending December 31, 2010." Section 106 request to PwC Shanghai re Client H **(ENF 106)**; PwC Shanghai Answer ¶ 15. On April 12, 2012, PwC Shanghai, through its U.S. counsel, sent a letter to the Division in response to the request, in which it stated that it had segregated the requested materials about Client H at its offices in China, and stated that PwC Shanghai would not produce the requested documents based, among other reasons, on alleged instructions from the Chinese government that the documents' production would violate Chinese law. *See* Flynn letter to Kaleba (4/12/12) **(ENF 107)**.

2. Client I

Client I is a Nevada corporation with its primary operations in Jinzhou, China. *See* Exchange Act Rel. 68249 (11/16/12) **(ENF 108)**. Client I purportedly manufactures automotive electrical parts in China. *Id.* Client I's securities were previously registered with the Commission pursuant to Section 12(g) of the Exchange Act, *id.*, and traded on the NASDAQ Global Market from August 2007 through May 2011, *see* Client I Bloomberg Report **(ENF 119)**. On December 6, 2010, Client I engaged PwC Shanghai to audit Client I's financial statements for the fiscal year ending December 31, 2010. *See* Form 8-K (filed 12/6/10) **(ENF 109)**; PwC Shanghai Sum. Disp. Mot., at 4.

On March 1, 2011, Client I disclosed, among other things, that:

- Client I had concluded, on February 23, 2011, that the financial statements for the years ended December 31, 2008 and 2009 that were included in its Form 10-K for the year ended December 31, 2009, and the financial statements included in each of its Quarterly Reports on Form 10-Q filed during 2008 and 2009, should no longer be relied upon; and
- Client I intended to engage PwC Shanghai to re-audit Client I's consolidated financial statements for the years ended December 31, 2008 and 2009.

See Form 8-K (filed 3/1/11) **(ENF 110)**.

On October 5, 2011, Client I issued a press release that described an independent investigation, previously announced in a Form 8-K filed on May 12, 2011, which among other things:

- Concluded certain transactions between an employee of a company acquired by Client I and a Client I 5% shareholder should have been disclosed;
- Found that certain accounting errors existed in prior periods; and
- Directed Client I's management, in consultation with its auditors, to determine if the errors required restatement.

See Form 8-K (filed 10/5/11 **(ENF 111)**. On December 6, 2011, PwC Shanghai resigned as Client I's independent auditor. *See* Form 8-K (filed 12/14/11) **(ENF 112)**; PwC Shanghai Sum. Disp. Mot., at 4.

On March 22, 2012, in connection with an investigation involving potential financial fraud at Client I, the Commission issued a Section 106 request to PwC Shanghai seeking "[a]ll audit work papers and all other documents related to any audit work performed for [Client I] for the year ended December 31, 2010." Section 106 Request to PwC Shanghai re Client I **(ENF**

117); PwC Shanghai Answer ¶ 16. On April 12, 2012, PwC Shanghai, through its U.S. counsel, sent a letter to the Division in response to the request, stating that PwC Shanghai would not produce the requested documents based, among other reasons, on alleged instructions from the Chinese government that the documents' production would violate Chinese law. *See* Flynn letter to Kaiser (4/ 12/12) **(ENF118)**. On November 16, 2012, the Commission issued an Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934, pursuant to which the registration of Client I's securities previously registered under Section 12 was revoked. *See* Exchange Act Rel. 68249 **(ENF 108)**.

ARGUMENT

I. Legal Standards and Violations Under Rule 102(e) and Sarbanes-Oxley

Rule 102(e)(iii) of the Commission's Rules of Practice provides that "[t]he Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found . . . [t]o have willfully violated . . . any provision of the Federal securities laws or the rules and regulations thereunder." 17 C.F.R. 201.102(e)(iii).

Sarbanes-Oxley Section 106(b) states, in pertinent part:

> **(1) Production by foreign firms**
>
> 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—
>
>> (A) produce the audit work papers of the foreign public accounting firm and all other documents of the firm related to any such audit work or interim review to the Commission or the Board, upon request of the Commission or the Board . . . .

15 U.S.C. § 7216(b). Sarbanes-Oxley Section 106(e) provides that a foreign firm's "willful refusal to comply, in whole or in part, with any request by the Commission or the Board under [Section 106], shall be deemed a violation of this Act." 15 U.S.C. § 7216(e). Such a willful refusal would violate both Sarbanes-Oxley and the Exchange Act. *See* Sarbanes-Oxley Section 3(b), 15 U.S.C. § 7202(b)(1) ("A violation . . . of this Act . . . shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 . . . ."). Consequently, a foreign firm willfully violates Section 106, and, therefore, may be censured or barred from appearing or practicing before the Commission under Rule 102(e), if the following circumstances occur:

1. One or more of the triggering conditions under Section 106(b)(1) is met – *i.e.*, a foreign firm [i] performs material services upon which a registered public accounting firm relies in the conduct of an audit or interim review, [ii] issues an audit report, [iii] performs audit work, or [iv] conducts interim reviews;
2. The Commission properly issues to the foreign firm a "request" for audit workpapers or other documents of the firm related to any such audit work or interim review; and
3. The foreign firm "willful[ly] refus[es] to comply, in whole or in part," with the request.

II. The Commission Issued Section 106 Requests To All Of The Respondent Foreign Firms As Provided By Section 106

The first two prongs of a willful Section 106 violation, set forth above, are indisputably met for all of the Respondents in this case. All of the Respondents are foreign firms that have satisfied at least one of the triggering conditions of Section 106(b)(1) for their respective China-based clients that are at issue in this proceeding. *See* April 30 Order, at 2 n.5; *id.* at 15

("Respondents do not dispute that they were engaged to audit the financial statements of issuers of securities registered in the U.S., or in the case of KPMG Huazhen, provided some level of assistance to another firm in auditing financial statements, and that they performed certain audit work in the course of those engagements."). Specifically, as described above (*supra* Statement of Facts, Section II):

- Dahua audited the financial statements of Dahua Client A for the fiscal year ending December 31, 2010 (among other years).
- DTTC audited DTTC Client A's financial statements for the fiscal years ended December 31, 2008 and 2009 (among other years), and served as Client G's independent auditor from March 2, 2010 through September 6, 2010.
- EYHM was engaged to audit the financial statements of Client B for the fiscal year ended December 31, 2010, and audited the financial statements of Client C for the fiscal year ended September 30, 2010.
- KPMG Huazhen played substantial roles in the preparation or furnishing of audit reports for Client D for the year ended December 31, 2010, and Client F for the year ended December 31, 2009, and performed audit work for Client E for the year ended December 31, 2010.
- PwC Shanghai served as independent auditor, and performed audit work, for Client H between April 2010 and September 2011, and for Client I between December 2010 and December 2011.[10]

In addition, each of the Respondents received from the SEC a valid Section 106 request for all audit workpapers and all other documents related to any audit work or interim reviews performed for their respective China-based clients for time periods in which they performed the work. *See supra* Statement of Facts, Section IV. There is no dispute that the SEC properly

[10] Respondents appear not to dispute that they performed "audit work" in all of the client engagements at issue in these proceedings, including the engagements that did not result in a completed audit report. *See, e.g.*, First Prehearing Conference Tr. 13:22-25 (statement of PwC counsel) ("[T]here's no . . . . I think there's no dispute, Your Honor, that for PWC China that we did some audit work for Clients H and I."); *see also* EYHM Powerpoint Presentation for Client B **(ENF 49)**; Form 8-K filed by Client G (filed 9/13/10) (reflecting audit work by DTTC) **(ENF 92)**; KPMG Huazhen Answer ¶3 (addressing audit work for Client E); Email chain and draft letter re Client E **(ENF 77)**; Client F letter to SEC (4/20/11) (reflecting audit work by KPMG Huazhen) **(ENF 83)**.

issued these requests by delivering them to the Respondents' respectively designated U.S. agents. Each of the Respondents acknowledged receipt of these requests, demonstrating that they were aware of them. *See id.*

III. All Respondent Foreign Firms Willfully Refused To Comply With The Section 106 Requests

The third prong for a willful Section 106 violation is also met in this case for all of the Respondents, because all of the Respondents willfully refused to comply with their respective Section 106 requests. "A finding of willfulness does not require intent to violate the law, but merely intent to do the act which constitutes a violation of the law." *In the Matter of Peak Wealth Opportunities, LLC*, Exchange Act Rel. No. 69036, Admin. Proc. 3-14979, 2013 WL 812635, at *7 (ALJ Order Mar. 5, 2013) (citing *Wonsover*, 205 F.3d at 414; *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976)). "'Refusal' implies the positive denial of an application or command, or at least a mental determination not to comply." BLACK'S LAW DICTIONARY at 887 (6th abridged ed. 1991); *see also Societe Internationale Pour Participations Industrielles et Commerciales v. Rogers*, 357 U.S. 197, 208 (1958) (construing "refusal" to be synonymous with "failure" under former version of FRCP 37(b)). Under these standards, Respondents willfully violated Sarbanes-Oxley and the Exchange Act because, throughout the relevant time periods: (1) Respondents knew the Board or the SEC could require them to produce audit workpapers and other documents under Section 106 (among other provisions); (2) Respondents knew that Chinese law could impair their ability to comply with U.S. regulators' demands for information; (3) notwithstanding this knowledge Respondents voluntarily accepted audit engagements with their respective Clients; and (4) Respondents knowingly failed to produce documents in response to the Requests.

Although Respondents claim that the sole reason for their noncompliance with the Requests is Chinese law (or, alternatively, instructions from Chinese regulators), the constraints now imposed by such law – whatever they may be – are legally irrelevant to the question of whether Respondents' conduct was "willful." That is because Respondents indisputably *knew* of the potential conflict of law *before* they accepted the engagements with the Clients. This prior knowledge wholly undermines any argument by Respondents that, now having performed audit work for the Clients and received the Requests from the SEC, their hands are tied. Respondents acted with "intent to do the act which constitutes a violation of the law," *id.*, and for that reason alone they are subject to an appropriate remedy under Rule 102(e).

A. The Term "Willful" In Section 106(e) Should Be Given Its Ordinary Meaning Under The Securities Laws

1. "Willful" Is A Term of Art Used Throughout The Securities Laws

Use of the term "willful" in Section 106 is consistent with its use throughout the securities laws – including Rule 102(e) – to define violations by regulated persons and circumstances in which certain remedies should be imposed upon such persons. For example, the Exchange Act authorizes the SEC to suspend or revoke a broker-dealer's registration, and to impose civil penalties on the broker-dealer, for "willfully" making false or misleading statements in reports filed with the SEC, 15 U.S.C. §§ 78o(b)(4)(A), 78u-2, or for "willfully" violating, or aiding and abetting the violations of, any provisions of the Securities Act, Exchange Act, or certain other statutes or regulations, *id.* §§ 78o(b)(4)(A) (D), (E), 78u-2. The Exchange Act also authorizes analogous actions against municipal securities dealers and municipal advisors, *id.* § 78o-4(c)(2), government securities brokers and dealers, *id.* § 78o-5(c)(1)(A), and nationally recognized statistical rating organizations, *id.* § 78o-7(d)(1); *see also id.* § 78u-2 (governing

application of civil penalties for all these actions).[11] The Investment Company Act of 1940 authorizes analogous actions against persons serving investment companies. *See* 15 U.S.C. § 80a-9(b), (d)(1). The Advisors Act of 1940 ("Advisors Act") prohibits "willful[]" untrue statements of material facts in registration applications or reports filed under that Act. 15 U.S.C. § 80b-7.

2. The Case Law Overwhelmingly Demonstrates That "Willful" Means Only Volitional Conduct In The Securities Law Context

For more than half a century, in interpreting these and other invocations of willfulness under the securities laws, federal courts and the Commission have consistently held that "willful" conduct is volitional conduct – *i.e.*, conduct about which the actor is mentally aware. In *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949), the D.C. Circuit upheld the SEC's revocation of a broker-dealer's license under Exchange Act Section 15(b), for failing to disclose a security's best price to her clients, *see id.* at 974. "There [was] no room for doubt . . . that petitioner's violations were willful" where, "[p]rior to the institution of the present proceedings petitioner had been repeatedly advised by members of the Commission's staff that her methods of conducting her business were unlawful." *Id.* at 976. "Petitioner thus intentionally and deliberately chose to continue her methods of operation in spite of repeated advice that those methods were unlawful. *This was willfulness.*" *Id.* at 977 (emphasis added). The court further explained:

> It is only in very few criminal cases that 'willful' means 'done with a bad purpose.' *Generally, it means 'no more than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law.'*

Id. (*quoting Dennis v. United States*, 171 F.2d 986, 990 (D.C. Cir. 1948)) (emphasis added).

[11] In addition, the Exchange Act also provides that, where the Commission has barred a person from various professional associations as a result of misconduct, "[i]t shall be unlawful" for such person "without the consent of the Commission, willfully to become, or to be, associated with a broker or dealer in contravention of such order." Exchange Act § 15(b)(6)(B) [15 U.S.C. § 78o(b)(6)(B)].

More recently, in *Wonsover*, the D.C. Circuit upheld the SEC's suspension of a broker for "willfully violat[ing]" the securities laws under Exchange Act § 15(b)(4) [15 U.S.C. § 78o(b)(4)], by selling un-registered securities. *See* 205 F.3d at 412 n.10. The court confirmed that under its "traditional formulation of willfulness for the purpose of section 15(b)," "'willfully' . . . means intentionally committing the act which constitutes the violation"; it does not mean "that 'the actor [must] also be aware that he is violating one of the Rules or Acts.'" *Id.* at 414 (quoting *Gearhart & Otis, Inc., Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965) (quotations omitted)). Applying this traditional standard, the court in *Wonsover* rejected the broker's defense that he was unaware that relevant rules prohibited him from selling the securities at issue in the case.[12] Other courts have long, similarly interpreted "willfulness" to require a showing only that the violator acted intentionally, and not necessarily with knowledge that the conduct was prohibited. *See Mathis v. SEC*, 671 F.3d 210, 217-18 (2d Cir. 2012) (upholding broker's statutory disqualification from industry under Exchange Act § 3(a)(39)(F) [15 U.S.C. § 78c(a)(39)(F)], for "willfully" failing to disclose tax liens in his registration applications); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 181 n.7 (2d Cir. 1976) ("[A] finding of actual knowledge is not necessary for finding criminal liability under § 24 of the Securities Act . . . for 'willful' violations of §§ 5(a) and (c) and 17(a)."); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965) (Securities Act § 24 prohibition against "willful violations" requires only intentional conduct, not knowledge that the conduct is prohibited).

Furthermore, the same construction of willfulness has been applied in SEC administrative proceedings to violations of requirements that registered persons produce or provide access to

[12] The court in *Wonsover* also upheld the Commission's finding that Wonsover's violation was willful even under the subjective willfulness finding that the respondent had proposed. *Wonsover*, 205 F.3d at 415. This additional holding, however, does not affect the D.C. Circuit's affirmation of the "traditional formulation of willfulness" that it had applied under the Exchange Act at least since *Hughes*..

documents. As this Court is aware, in *Peak Wealth*, a disciplinary proceeding under Rule 102(e), this Court permanently barred one of the respondents, a certified public accountant registered with the PCAOB, from practicing before the Commission as an accountant. This sanction was based on, among other things, the respondent's willfully aiding and abetting an investment adviser's failure to comply with SEC examination staff's document requests as required under the Advisers Act. *Peak Wealth*, 2013 WL 812635, at *2, 5-8, 10. The Court stated, "[a] finding of willfulness does not require intent to violate the law, but merely intent to do the act which constitutes a violation of the law." *Id.* at *8.

And in *In re Dominick & Dominick, Inc.*, 50 S.E.C. 71, 1991 WL 294209 (May 29, 1991), the Commission found that Dominick, a broker-dealer registered with the SEC but based in Switzerland, willfully violated Exchange Act Rule 17a-4(j) by refusing to provide its books and records to SEC staff as required by the Rule. In rejecting Dominick's claim that Swiss secrecy laws prevented its compliance, the Commission stated:

> Broker-dealers registered with the Commission which operate under the strictures of the laws of multiple jurisdictions are required to be aware of the need to conduct their operations in a manner which will ensure compliance with the U.S. securities laws. At the time it opened its Basel branch office and began to conduct business in Switzerland, Dominick was aware of its record-keeping and production obligations under the U.S. securities laws. Dominick had an affirmative obligation to implement whatever special record-keeping procedures were necessary to avoid any possible conflict with Swiss law, including its secrecy provisions.

1991 WL 294209, at *6; *see also In the Matter of Amaroq Asset Management, LLC*, Initial Decision Release No. 351, 93 SEC Docket 2231, 2008 WL 2744866, at *10 (Jul. 14, 2008) (firm willfully violated Advisers Act § 204 by failing to submit to reasonable examination of its books and records by SEC staff and failing to furnish copies of prescribed books and records to SEC in connection with scheduled examination).

Finally, cases involving other types of government enforcement efforts, outside the securities context, confirm that "willfulness," like knowledge, is not contingent on any additional requirements, and may not be mitigated by excuses, however justifiable. *See Vineland Fireworks Co., Inc. v. Bureau of Alcohol, Tobacco, Firearms & Explosives*, 544 F.3d 509, 517 (3d Cir. 2008) (endorsing and applying government agency constructions of "willfulness" that "require knowledge of the conduct, but [ ] do not require a bad purpose or allow for a justifiable excuse."); *Harrington v. U.S.*, 504 F.2d 1306, 1316 (1st Cir. 1974) ("an act is 'willful' within the meaning of Section 6672 [of the Tax Code] if it is voluntary, conscious and intentional; no bad motive or intent to defraud the United States need be shown, and a 'reasonable cause' or 'justifiable excuse' element has no part in this definition.").

3. <u>"Willful" Under Section 106(e) Means Only Intentional Conduct</u>

The term "willful" in Section 106(e) should be given the same meaning that courts, the Commission, and ALJs have given it under numerous other securities law provisions, as described above. Interpreting "willful" to mean volitional conduct adheres to basic principles of statutory construction. The interpretive canon that repeated uses of specific words should be presumed to have the same meaning "has particular force where," as here, "the words at issue are used in two different sections of a complex statutory scheme and those two sections serve the same purpose." *Butler v. Social Security Admin.*, 331 F.3d 1368, 1372 (Fed. Cir. 2003) (internal quotation marks omitted) (quoting *National Organization of Veterans' Advocates, Inc. v. Secretary of Veterans' Affairs*, 260 F.3d 1365, 1379 (Fed. Cir. 2001)); *see also Gustafson v. Alloyd Company, Inc.*, 513 U.S. 561, 570 (1995) (term "prospectus" presumptively has same meaning in §12 of the Securities Act of 1933 as in §10 of the same statute); *Department of*

Revenue of Oregon v. ACF Industries, Inc., 510 U.S. 332, 342 (1994) ("identical words used in different parts of the same act are intended to have the same meaning.").

In addition, when Congress employs a term of art, "it presumably knows and adopts the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken." *Molzof v. United States*, 502 U.S. 301, 307 (1992) (quoting *Morissette v. United States*, 342 U.S. 246, 263 (1952)). When Congress enacted Section 106(e) in 2010 as part of the Dodd-Frank Act, there was already a well-developed "cluster of ideas that were attached" to the term "willful," and so Congress should be presumed to have adopted it. This is especially true because the addition of Section 106(e) was an amendment to the Sarbanes-Oxley Act. In the original 2002 Sarbanes-Oxley, Congress had adopted the Commission's use of "willful" by codifying Commission Rule 102(e) as part of the Exchange Act. Pub. L. 107-204, 116 Stat. 745 § 602 (2002); *see Altman v. SEC*, 666 F.3d 1322, 1326 (D.C. Cir. 2011) (the language of Exchange Act Section 4C, and thus of Sarbanes-Oxley 602, "is virtually identical" to Rule 102(e)). Section 106(e) and Rule 102(e) are part of the same statutory scheme, and, therefore, the term "willful" that appears in both provisions should be similarly construed.

B. Respondents' Refusal To Comply With The Requests Was "Willful"

There can be little doubt that, under the traditional construction of "willful" that applies to Section 106(e), Respondents violated Sarbanes-Oxley by willfully refusing to comply with the Requests. All of the Respondents "kn[e]w what [they were] doing" when they registered with the Board and accepted audit engagements of U.S. issuers, *Hughes*, 174 F.2d at 977; thus, they "intentionally commit[ed] the act which constitutes the violation," *Wonsover*, 205 F.3d at 414. Respondents were fully aware when they registered with the Board that they would be required to comply with production demands of U.S. regulators – including Section 106 requests by the

SEC – for their audit work related to U.S. issuers. *Supra* Statement of Facts, Section II. They also knew that Chinese law potentially could impair their ability to comply with these demands, as Respondents acknowledged in their own registration forms. *See id.* If there was any doubt about their need to comply with the production demands under U.S. law (which there should not have been), the Board's guidance to the firms explicitly removed it: "if a firm fails to cooperate with the Board," the firm's failure to obtain approvals "under non-U.S. law . . . to allow the firm to cooperate is not a defense to a disciplinary action for failure to cooperate." FAQ 4 **(ENF 11).**[13]

Furthermore, after the 2010 Dodd-Frank Act, Respondents confirmed their understanding of the new and expanded production requirements under the amended Section 106, by designating U.S. agents for receipt of document demands and related service of process. *Supra* Statement of Facts, Section II; *see also* April 30 Order, at 10 ("The Commission's authority to discipline accountants pursuant to Commission Rule 102(e) is well established, and Respondents have been on notice since the passage of [Dodd-Frank] in July 2010 that a willful refusal to comply with a Commission request pursuant to Section 106 would constitute a violation of Sarbanes-Oxley."). Respondents did not scale back their U.S.-focused business activities. To the contrary, they maintained their Board registrations and obtained even more audit engagements with U.S. issuers. *Supra* Statement of Facts, Section III.

Yet despite knowing full well their production obligations under Section 106 (and other U.S. law requirements) and voluntarily engaging in U.S.-focused business, Respondents refused

[13] Regardless of the reservations Respondents believed they had claimed for themselves by omitting Consents to Cooperate from their registration Form 1s to the Board, those purported reservations were directed only to the Board. Nothing in Respondents' application papers addressed their obligations in response to direct production demands from the SEC, either by way of Section 106 requests or any other process.

to comply with the Requests at issue in these proceedings. "This was willfulness." *Hughes*, 174 F.2d at 977. The SEC initiated 10 different investigations into potential fraud at the Clients whose securities were registered with the SEC and traded in U.S. markets. *See supra* Statement of Facts, Section IV. It is very likely that the frauds that occurred victimized U.S. investors.[14] For each such investigation, the SEC sent a Request to the Respondent that had performed audit work for the Client, seeking audit workpapers and related documents. In each such case, the Respondent refused to produce to documents in response to the Request. Each refusal was itself knowing (and not inadvertent or otherwise unintentional), as demonstrated by the fact that in each instance the Respondent stated its refusal in writing. *Cf. Paz Secs., Inc. v. SEC*, 494 F.3d 1059, 1063 (D.C. Cir. 2007) (Commission found that respondent "actually knew about the requests for information" and therefore "failure to respond was [not] unintentional").

Although Respondents contend that they were prohibited by Chinese law or regulators' instructions from producing documents to the SEC in response to the Requests, this is of no consequence to the willfulness inquiry here. When Respondents voluntarily availed themselves of U.S. markets – and profited thereby – they were responsible for ensuring their ability to comply with U.S. securities laws. Where they took on engagements that might later present a conflict of law, they did so at their own peril. *See Dominick*, 1991 WL 294209, at *6 n.15 (rejecting broker-dealer's attempt to rely on foreign law to "invalidate [its] pre-existing statutory obligation" to produce documents"; "where an entity voluntarily elected to do business in numerous foreign host countries . . . [i]t cannot expect to avail itself of the benefits of doing

[14] As a result of its investigation involving Client C, the SEC brought suit in federal district court against the entity and related individuals and subsequently settled the charges **(ENF 57, 61)**. As a result of its investigation involving Client E, the SEC filed settled charges in district court against the entity and a related individual. **(ENF 75)**. The SEC is continuing to litigate the charges it brought against the entity and related individuals as a result of its investigation involving Client H. **(ENF 105)**.

business here without accepting the concomitant obligations." (internal quotation omitted)). Moreover, Respondents fully admit that they knew about the potential impediments of Chinese law when they first registered with the Board in 2004 to 2006. Respondents cannot complain, now that they have proven themselves unwilling to accept the consequences under Chinese law for complying with the U.S. rules they have long known about and consented to, that the SEC is acting unfairly by taking steps to discipline them and potentially curtail their future involvement in U.S. markets.

The Ninth Circuit's decision in *Richmark Corp. v. Timber Falling Consultants*, 959 F.2d 1468 (9th Cir. 1992) reinforces this point. In *Richmark*, the district court imposed discovery sanctions and held Beijing Ever Bright Industrial Co. ("Beijing"), a corporation organized under Chinese laws and an arm of the Chinese government, in contempt for refusing to comply with a discovery order, notwithstanding the fact that complying with the order would constitute a violation of Chinese state secrecy laws. In that case, China's State Secrecy Bureau (the "SSB") had issued to Beijing a written order that explicitly prohibited the company from producing documents: "In its response to Beijing's request for guidance, the Bureau wrote: '[T]his Bureau hereby orders your Company not to disclose or provide the information and documents requested by the United States District Court . . . . Your Company shall bear any or all legal consequences should you not comply with this order.'" *Id.* at 1476 (quoting SSB order). However, the Ninth Circuit held that this express prohibition on production (which is quite unlike the Chinese government's letters to Respondents here, which merely directed Respondents to follow Chinese law, *see infra* Argument Section IV.A.2) did not excuse Beijing's failure to comply, affirming the district court's contempt order. The court of appeals emphasized: "when Beijing availed itself of business activities in this country, it undertook an obligation to comply with the lawful

orders of United States courts." *Id.* at 1479. So too here. Respondents knew the relevant risks but nonetheless took advantage of U.S. markets; once problems arose, they then hid behind Chinese law to avoid compliance with U.S. rules. Such conduct demonstrates fully supports a finding of willfulness here.

Finally, Respondents have no argument that they did not act willfully because they were uncertain about their U.S. legal obligations after receiving the Requests. Respondents already had consented to these requirements through their designations of U.S. agents under Section 106(d). In any event, SEC staff issued Wells notices to the Respondents making clear that, notwithstanding Respondents' claims about constraints under Chinese law, they were obligated to produce documents to the SEC in response to the Requests, and their failure to do so would lead to these proceedings under Rule 102(e). Because Respondents were "advised by members of the Commission's staff that [their] methods of conducting . . . business were unlawful," "[t]here is no room for doubt . . . that [Respondents'] violations were willful." *Hughes*, 174 F.2d at 976.

C. Strong Policy Interests Support The Conclusion That Respondents "Willfully Refused" To Comply Under Section 106(e)

The Commission's need to "protect the integrity of its own processes" through these proceedings further supports a finding that Respondents willfully refused to comply with the Requests. *Touche Ross & Co. v. SEC*, 609 F.2d 570, 581 (2d Cir. 1979) (construing predecessor Rule 2(e)). "The purpose of Commission Rule 102(e)(1)(iii) is remedial and the rule is directed at protecting the integrity of the Commission's own processes and the confidence of the investing public in the integrity of the financial reporting process." April 30, 3013 Order, at 7 (citations and quotations omitted). Courts have recognized that SEC oversight of auditors is particularly essential given their central role in our disclosure-based securities markets: "To

insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations." *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984). *See also Marrie v. S.E.C.*, 374 F.3d 1196, 1200-1201 (D.C. Cir. 2004) (SEC's disciplinary authority under Rule 102(e)(1)(iii) is an acknowledgement of "the particularly important role played by accountants in preparing and certifying the accuracy of financial statements of public companies that are so heavily relied upon by the public in making investment decisions").

As this Court recognized, audit workpapers play a critical role in the SEC's oversight and regulation of securities markets:

> [A]ccess to audit work papers allows the Commission to determine whether an auditor has complied with the standards of conduct set forth in Exchange Act Section 10A, address fraud that may preclude or delay the filing of an audit report, and assist the Commission in determining the accuracy of previous audit reports prepared by the issuer.

April 30 Order at 15. *See also* Consolidated Opp. at 27-30; Stuart and Wright, 2002 COLUM. BUS. L. REV. 749, 755 ("Comprehensive SEC investigations require access to the foreign audit workpapers.").

Thus, application of the "traditional" test for willfulness to Section 106(e) is not only supported by decades of case law and principles of statutory construction, as set forth above, *supra* Argument Section II.a.3; it makes sense in light of the purpose of Rule 102(e) proceedings generally. The Division seeks to remedy an obviously untenable situation, of Respondents' own making, that seriously weakens Commission processes to the detriment of U.S. investors. Respondents have accepted engagements of U.S. issuers fully anticipating that, when called upon by U.S. regulators to provide cooperation that is essential to the SEC's oversight of U.S. markets, they will not do so. Rather, without any statutory basis, Respondents seek to shift to the SEC the

burden of trying to negotiate with foreign regulators to obtain the necessary documents, regardless of whether those regulators will ever agree to help the SEC. Thus, Respondents would arrogate to themselves a special status, by denying the SEC the type of cooperation that domestic accounting firms routinely provide under other statutory mechanisms. Moreover, in Respondents' view, they can *continue* the status quo indefinitely: they can continue to flout U.S. production requirements, claiming no more than risk of sanction under Chinese law, without fear of any consequence under Rule 102(e) and Section 106(e).

There is no valid reason to construe "willful" in Section 106(e) to produce such a harmful result. "Willful" should be given its traditional meaning under the securities laws and applied here to recognize that Respondents have willfully violated Sarbanes-Oxley. Thus, the Commission can properly realize its authority to protect its processes under Rule 102(e).

D. Respondents Made Insufficient Efforts To Achieve Compliance With The Requests In Light Of Chinese Law

For the reasons stated above, Respondents' refusals to comply with the Section 106 requests were willful irrespective of Chinese law. In any event, considerations of Chinese law undermine Respondents' position. Respondents' failure to obtain appropriate determinations or clarifications that their documents contain state secrets further demonstrates that their noncompliance was willful. Such failure also undercuts their claim of good faith.

In resisting compliance with the Requests, Respondents have consistently and repeatedly claimed, purporting to rely on legal opinions of Chinese legal counsel, that at least some of the requested documents "likely" or "very likely" contain state secrets under China's broad state secrecy laws. *See, e.g.,* Linklaters Memorandum (7/29/11) **(ENF 307)**; Declaration of Professor Xin Tang ¶43 (Apr. 11, 2012) ("Tang Declaration"), Exhibit 17 to PwC Wells submission **(ENF 159)**; Expert Report of Professor Xin Tang ¶52 (filed 4/18/13) ("Tang Report"). For this reason,

they claim, Respondents' production of *any* of the requested documents would present too great of a risk that the Chinese government might later impose criminal or other sanctions on them. Respondents' reliance on China's state secrecy laws fails for several reasons, however. *First*, no Respondent has made any claim, let alone provided any proof, that any requested document has been determined by an audit client, the Chinese government, or Respondent, to contain any state secrets. *See* Expert Report of Donald Clarke, ¶¶29 ("Clarke Report"). For this reason alone, Respondents' claim that they were prohibited from producing the documents on state secrets grounds is unduly speculative. *See SEC v. Euro Security Fund*, No. 98 Civ. 7347 (DLC), 1999 WL 182598, at *3 (S.D.N.Y. Apr. 2, 1999) ("[i]llusory references to foreign secrecy without any specifics are insufficient to create a conflict").

Second, there is no evidence that Respondents have tried reasonable means for reducing, and perhaps eliminating, the uncertainty that the requested documents may contain state secrets. In particular, it appears that no Respondent has sought guidance on the issue from the Client from whom state secrets, if any, would have been initially transmitted, even though it was the Client's responsibility to identify and mark state secrets in any materials that it sent to a Respondent. *See* Clarke Report, ¶¶15-16, 20-21.[15] Furthermore, China's State Secrets Law provides, and Respondents' own Chinese law expert agrees, that a party that receives material that potentially contains state secrets can go to its local branch of the State Secrets Bureau ("SSB") and ask it to make a determination. *See* Clarke Report ¶¶22, 24, 25; Tang Decl. ¶36 **(ENF 159)**. However, Respondents DTTC, EYHM, and PwC Shanghai have not indicated that they even tried this step. *See* Clarke Report ¶¶13, 27, 29. And although Respondents Dahua and

[15] Indeed, certain Clients produced their documents directly to the SEC, casting further doubt on the idea that Respondents' workpapers derived from those documents contain state secrets. *See* Clarke Report ¶ 22 ("[I]f materials transmitted from the audit company to the auditor do not contain state secrets, then presumptively the work papers generated by the auditor should not contain state secrets, either.").

KPMG Huazhen claim they have contacted the SSB, these firms have not provided any correspondence documenting these efforts.[16]

In short, there is no proof that particular documents sought by the Requests are, in fact, subject to China's prohibition on the disclosure of state secrets, and Respondents have not undertaken appropriate steps necessary to obtaining such a determination from the Chinese government. Nor have they attempted to make an informed judgment that at least some documents do *not* contain state secrets. Under these circumstances, Respondents cannot claim that they have acted in good faith or that their refusals to comply with the Requests were not willful.

IV. COMITY CONSIDERATIONS DO NOT MAKE RESPONDENTS' CONDUCT LESS "WILLFUL"

Respondents have argued that, in determining whether they "willfully refused" to comply with the Requests, the ALJ needs to determine whether (1) the Requests are "enforceable" in light of the "comity factors" that a federal court would apply in an action by the SEC to compel compliance with the Requests; and (2) more generally, whether Respondents acted in "good faith" after receiving the Requests, notwithstanding their longstanding knowledge and affirmation of their U.S.-law obligations. *See* Second PreHearing Conf. Tr. 14:1-9 (May 29, 2013) (Counsel for PwC Shanghai: "From our perspective, the liability issues here turn first on the enforceability of the 106 request and germane to those issues are a number of factual issues,

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[16] In KPMG Huazhen's letter responding to the Requests it had received, the firm stated that it had attempted to procure a determination from the relevant branch of the SSB but was turned down on the grounds that any request for a determination must be submitted by another Chinese government body, and that requests for a determination from private entities and individuals would not be entertained. *See* Bingham letter on behalf of KPMG Huazhen to SEC staff, at 14 (Mar. 27, 2012) **(ENF 66)**. Dahua also contended, vaguely, that it had unsuccessfully sought approvals from the Ministry of Finance, the SSB, and State Archives Administration. Dahua letter to SEC staff (Apr. 2, 2012) **(ENF 35)**. The claimed unwillingness of these Chinese agencies to assist the firms, however, is inconsistent with Article 20 of China's State Secrets Law and the position of Respondents' expert, Professor Xin Tang, that an audit firm may submit documents to the SSB for a state secrets determination. *See* Clarke Report ¶¶29-30.

including the restrictions imposed by Chinese law[,] [t]he availability of alternative means, the correct application of all the principles of international com[it]y that are at play in this matter, as well as respondents' good faith . . . ."). Respondents are wrong in all respects. The comity factors that a federal court would apply under the Restatement (Third) of Foreign Relations Law of the United States (1987) ("Restatement") in the enforcement context do not apply in these Rule 102(e) proceedings. In any event, to the extent these factors – including good faith – are considered, they weigh decisively in favor of a finding that all Respondents willfully refused to comply with the Requests under Section 106(e).

A. The Comity Factors Do Not Apply

1. The Comity Factors Do Not Apply To These Proceedings Because The Division Does Not Seek To Compel Compliance With The Requests

Respondents' invocation of the comity factors is a non-sequitur. "Comity refers to the spirit of cooperation in which a domestic tribunal approaches the resolution of cases touching the laws and interests of other sovereign states." *Societe Nationale Industrielle Aerospatiale v. U.S. Dist. Ct. for Southern Dist. of Iowa*, 482 U.S. 522, 544 n. 27 (1987). Accordingly, a comity analysis based on the Restatement factors is appropriately applied "in evaluating the propriety of an [order] directing the production of information or documents located abroad where such production would violate the law of the state in which the documents are located." *Minpeco v. Conticommodity Servs.*, 116 F.R.D. 517, 522 (S.D.N.Y. 1987); *see also Gucci America, Inc. v. Weixing Li*, No. 10cv4974 (RJS), 2011 WL 6156936, at *5 (S.D.N.Y. Aug. 23, 2011) (applying factors from Restatement § 442(1)(c) "[i]n determining whether to order a party to produce documents in contravention of the laws of a foreign country").

But where, as here, the Division seeks no order to compel production, there is simply no occasion "to accord respect to the sovereignty of states in which evidence is located." *Societe*

Nationale, 482 U.S. at 543. Nothing that the ALJ or the Commission resolves through these proceedings "touch[es] the laws and interests" of China or any other country besides the United States, *id.* at 544 n.27, because "[t]he Division is plainly not seeking to enforce the requests or obtain documents through these proceedings . . . .," April 30 Order, at 7. Rather, the Commission instituted these proceedings to determine whether Respondents willfully violated Sarbanes-Oxley, and, therefore, whether they should be denied the privilege of appearing and practicing before the Commission. Thus, any remedy that might result from these proceedings implicates only the Respondents' prerogatives *within the United States*; it does not threaten to offend the decision-making authority of any foreign sovereign. Because these proceedings do not seek to compel any conduct that would occur overseas or otherwise might conflict with foreign law, there is simply no reason for the ALJ – or for the Commission generally – to exhibit comity. The comity factors are wholly inapposite to these proceedings.

2. The Comity Factors Do Not Apply Because Respondents Have Not Shown, And Are Unlikely To Show, An Actual Conflict Of Law

Comity analysis is inapplicable for the additional, separate reason that Respondents, at least to date, have not carried their burden of showing an actual conflict of law. Assuming, *arguendo*, the Division were seeking to enforce compliance with its Requests through these proceedings (which it is not), Respondents would bear the burden of showing an actual conflict of law because they are the parties that have resisted discovery. *See In re Sealed Case*, 825 F.2d 494, 498 (D.C. Cir. 1987) ("one who relies on foreign law assumes the burden of showing that such law prevents compliance with the court's order."); *Euro Security Fund*, 1999 WL 182598, at *3 (the party opposing discovery bears the burden of proving the existence of an actual conflict between the foreign law and U.S. discovery obligations). Through their correspondence with SEC staff and Wells submissions, Respondents made various assertions that Chinese law

prohibited them from producing documents directly to the SEC in response to the Requests. But Respondents have not made a sufficient showing to support these assertions. Over a year has passed since the SEC issued the Omnibus-related Requests to Respondents and over two years have passed since the SEC issued the Request related to DTTC Client A. Yet, even today, as far as the Division is aware, no documents have been determined to contain state secrets. *Supra* Argument Section III.D; *Wultz v. Bank of China*, No. 11cv1266 (SAS), 2013 WL 1832186, at *4 (S.D.N.Y. May 1, 2013) ("*Wultz II*") ("[T]he party resisting discovery must provide the Court with information of sufficient particularity and specificity to allow the Court to determine whether the discovery sought is indeed prohibited by foreign law.").

Furthermore, Respondents have not cited a single law or rule, nor have they provided a single piece of written correspondence from the Chinese government, stating that Respondents' primary Chinese regulator in this area – the CSRC – must approve Respondents' production to the SEC of any of the specific documents sought by the Requests. Although Respondents purport to rely on instructions allegedly given to them during meetings with the Chinese government, such reliance is flawed. *First*, contrary to the assertions of Respondents and their experts, Chinese law (at least apart from any *ad hoc*, unsubstantiated oral instructions) did *not* require Respondents to report the SEC's information requests to the CSRC, nor did it unequivocally prohibit Respondents from handing over documents to the SEC without approval of the CSRC. *See* Clarke Report ¶38. In arguing that they had an obligation to report requests to the CSRC, Respondents have pointed to "Regulation 29," which was issued jointly by the CSRC, the SSB, and the State Archives Administration ("SAA") in 2009. *See, e.g.*, Gibson Dunn letter on behalf of DTTC (4/29/11) **(ENF 128)**. But Regulation 29 imposes a reporting requirement on audit firms only for on-site inspections, not off-site inspections such as document requests. *See*

Clarke Report ¶¶39-48. Thus, at the time DTTC received the Section 106 Request for DTTC Client A, in March 2011, Regulation 29 did not clearly require Chinese accounting firms to obtain pre-clearance from the CSRC prior to producing workpapers abroad. *See id.* ¶¶60-62. Rather, it was DTTC's choice, and not its obligation, to seek pre-clearance from the CSRC prior to responding to the Request. *Id.*

Second, Respondents have contended that they had meetings or other communications with the CSRC and/or the Chinese Ministry of Finance ("MOF"), during which representatives from these regulators "made it clear that . . . in accordance with the relevant PRC laws, the firms could not provide work papers to foreign regulators." Orrick letter re EYHM, at 3 (5/25/12) **(ENF 47)**; *see also, e.g.*, Bingham letter re KPMG Huazhen, at 3 (3/27/12) **(ENF 66)**. But this claim of "clear" oral instructions from the CSRC is undermined by that regulator's failure to document those instructions. As DTTC concedes, after it spoke to the CSRC about the Request concerning DTTC Client A, the "CSRC could not provide a written confirmation of its position." Gibson Dunn letter on behalf of DTTC (Apr. 29, 2011) **(ENF 128)**.

The CSRC's opaque communications that it did put in writing do not fix this shortcoming. After Respondents' alleged meeting with the CSRC in October 2011, the CSRC issued letters that did *not* clearly prohibit Respondents from producing documents absent CSRC approval. At most, these letters stated only that the firms must follow applicable laws and regulations, and that "[t]hose, who *in violation of relevant laws* . . . provide the audit archives and other documents overseas without authorization shall be subject to legal liabilities." Tang Report, Ex. 2, Item 4 (emphasis added).[17] The letters do not state when, how, or from whom "authorization" must be obtained, or even that authorization must be obtained at all.[18]

[17] A different CSRC letter from the same month, offered by KPMG Huazhen, is equally vague in its direction to the firms. The letter, which KPMG Huazhen purports to have received in response to its

At bottom, Respondents' assertion that they are uniformly prohibited from producing *any* documents responsive to the Requests must rest on their proof of the CSRC's *oral* instructions to them at meetings held over a year ago. But this proof will be thin at best. It necessarily will be hearsay by biased witnesses, because Respondents do not plan to call any witness from the CSRC at the Hearing. *See* Respondents' Consolidated Witness List (Jun. 14, 2013). As such, assuming the testimony is provided at all, it should not be relied upon by the Court because it has low "probative value and reliability." *In the Matter of Rooney A. Sahai*, Admin. Proc. File No. 3-11652, 2005 SEC LEXIS 864, at *24 (Apr. 15, 2005). In deciding whether to rely on such hearsay, the ALJ should consider, among other factors, "the possible bias of the declarant, the type of hearsay at issue, [and] whether the statements are signed and sworn to rather than anonymous, oral or unsworn." *Id.* Here, the SEC's ability to protect its processes – and U.S. investors – from non-transparent audits should not turn primarily on a non-compliant auditor's self-serving hearsay testimony (or even several such testimonies) about the oral, unsworn statements of a foreign regulator.

request for direction regarding a document demand from the PCAOB, states: "Any production of audit work papers and other documents overseas without appropriate permission *in accordance with law* shall be subject to legal liability." Bingham letter and attached Opinion on Legal Impediments in connection with Investigations conducted by the US Securities and Exchange Commission, Appendix 3 to KPMG Wells Submission **(ENF 151)** (emphasis added). Thus, the letter does not state that the firm necessarily must obtain *any* Chinese regulator's approval before producing workpapers to the SEC; rather, the letter merely reiterated that KPMG Huazhen was required to obtain permission when such permission is required.

[18] The letter provided by EYHM also states: "In the event that foreign regulatory agencies require relevant audit working papers and other file documents in the performance of their statutory responsibilities, they should resolve such matters through joint consultations using regulatory mechanisms with the Chinese regulatory agencies." Orrick letter, Ex. 2 **(ENF Ex. 47)**. This admonition does not speak to the obligations of Chinese audit firms, including Respondents.

B. The Comity Factors Only Further Demonstrate That Respondents Willfully Refused To Comply With the Requests

In any event, the comity factors, to the extent considered, only reinforce the conclusion that Respondents willfully violated Sarbanes-Oxley. Following Supreme Court precedent, where a party resists compliance with discovery in reliance on foreign law, courts consider the party's good faith along with factors drawn from the Restatement, including: (a) the competing interests of the nations whose laws are in conflict; (b) the extent and nature of hardship of compliance for the party or witness from whom discovery is sought; (c) the extent to which the required conduct is to take place in the territory of the other state; (d) the nationality of the person; (e) the importance to the litigation of the information and documents requested; and (f) the ability to obtain the subpoenaed information through alternative means. *See, e.g.*, *Societe Nationale*, 482 U.S. at 544 n.28 (endorsing Restatement factors as relevant to comity analysis); *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111, 116-17 (S.D.N.Y. 1981) (collecting cases); *Minpeco*, 116 F.R.D. at 523; *Euro Security Fund*, 1999 WL 182598, at *3; *cf. United States v. Bank of Nova Scotia*, 691 F.2d 1384, 1389-91 (11th Cir. 1982) (applying similar balancing test in the context of a grand jury subpoena).

1. Respondents Have Not Acted In Good Faith.

Respondents cannot make "an affirmative showing" that they have acted in good faith by their participating in U.S. markets and their simultaneously refusing to produce the requested documents to the SEC. *Richmark*, 959 F.2d at 1479 (upholding contempt finding against Beijing where company "made no such affirmative showing" of good faith). Assuming, *arguendo*, the Division has the burden of proof on the issue, the result is no different: Respondents have not acted in good faith.

Respondents' claim of good faith is based on the predicate that Chinese law is the sole cause of their noncompliance with the Requests. But this predicate is untrue. Respondents' professed "inability to produce documents as a result of foreign law prohibitions was fostered by [their] own conduct prior to the commencement of the litigation." *Minpeco*, 116 F.R.D. at 522-23. Respondents knew, no later than 2006, when they were all registered with the PCAOB, that their production obligations under U.S. law potentially could conflict with Chinese law. Respondents cannot now claim that they have acted in "good faith" when they knew all along that their own purposeful, profit-motivated conduct could land them in precisely the circumstances in which they now find themselves. *See Richmark*, 959 F.2d at 1479; *Minpeco*, 116 F.R.D. at 528-29 (party could not demonstrate good faith where by entering U.S. markets it had "'courted legal impediments to production [of the requested documents and information]'" (quoting *Societe Internationale*, 357 U.S. at 209)).

Moreover, Respondents provide no evidence that they sought actual waivers from the purported Chinese laws and directives that allegedly prohibited them from complying with the Requests. See *Minpeco*, 116 F.R.D. at 528 (noting bank's "extensive attempts to secure waivers of bank secrecy rights from its trading customers" under foreign law in evaluating bank's good faith). In *Richmark*, the court found that Beijing's letter to Chinese regulators was insufficient because the letter had "requested only 'guidance' on the legal question'" and "did not in fact seek . . . permission" to disclose the requested materials. 959 F.2d at 1479. Similarly, here, Respondents' correspondence does not demonstrate that they sought from Chinese authorities a waiver that would allow them to produce the requested documents directly to the SEC. There is no written request for a waiver to the CSRC, nor is there any request to the State Archives

Administration ("SAA") that it approve the firms' production of materials deemed "archives." Clarke Report ¶¶41-42.

2. The U.S. Has A Stronger Interest In Preventing Non-Transparent Audits Then China Has In Blocking Regulators' Full Access to Workpapers.

"[T]he most important" of the Restatement factors is the "Balance of National Interests." *Richmark*, 959 F.2d at 1476; *Wultz v. Bank of China*, No. 11 Civ. 1266, 2012 WL 5378961, at *7 (S.D.N.Y. Oct. 29, 2012) ("[T]his factor – the balancing of national interests – is the most important, as it directly addresses the relations between sovereign nations." (internal quotation omitted)). Here, the United States' interests in obtaining the requested documents, which are necessary for ongoing investigations into financial frauds on the domestic securities markets, far outweigh China's interests in secrecy and sovereignty. Prior courts have reached a similar conclusion when considering whether foreign states' secrecy laws preclude compliance with SEC information requests. *See, e.g.*, *Euro Sec. Fund*, 1999 WL 182598, at *4; *Banca Della Svizzera*, 92 F.R.D. at 117. Now that the SEC has been denied the documents that it sought, the U.S. has an equally paramount interest, on a prospective basis, in protecting U.S. investors from relying on filed financial statements over which the SEC cannot exercise appropriate oversight by virtue of auditors' non-compliance with information requests. *See United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

Respondents contend that they may be subject to sanctions if they contravene the Chinese regulators' instructions. That does not mean, however, that the instructions are backed by strong national interests. To the contrary, the record shows only a weak national interest in protecting all of this information on state secrets grounds:

- As Respondents themselves have emphasized, the definition of state secrets in China is very broad and malleable. *See* Tang Report ¶39 ("the scope [of the State

Secret Law] is still broad under Chinese law"); Clarke Report ¶19. Thus, China has only a speculative interest in these laws. *Munoz v. China Expert Tech.*, No. 07 Civ. 10531 (AKH), 2011 WL 5346323, at *1-2 (S.D.N.Y. Nov. 7, 2011) (China had only a "speculative" national interest in "state secrecy and other related laws [that] have broad sweep and can preclude disclosure of a host of nebulously defined categories of information").

- Even though the CSRC took possession of DTTC's audit workpapers for DTTC Client A three years ago, there is no indication that any of these documents have been determined to contain state secrets. *See* Gibson Dunn letter on behalf of DTTC to SEC staff (4/29/11) **(ENF 128)**,
- When two Respondents allegedly asked their local SSB branch to perform a state secrets review, the SSB allegedly declined, notwithstanding that Chinese law states the SSB should provide such assistance. *See* Clarke Report ¶¶27-30.

Even if some or all of the requested documents *are*, finally, determined to contain state secrets, this still would not demonstrate a national interest that overrides the U.S. interests at stake here. Much or all of the information contained in the documents should be related to, or reflective of, information already publicly disclosed by the Clients through SEC filings, among other means. *See Munoz*, 2011 WL 5346323, at *2. Respondents cannot explain how production of their audit workpapers for their Clients would actually harm China's economic interests that its secrecy laws are purportedly designed to protect. Here, as in *Richmark*, there is "no indication that [Respondents or the customers of their Clients], much less the economy of the

PRC as a whole, will be adversely affected at all by disclosure of this information." 959 F.2d at 1477.[19]

At bottom, the interests underlying the CSRC's alleged instructions to Respondents appear to be unrelated to secrecy or confidentiality. Rather, the instructions reflect only an interest in channeling foreign regulators' document requests through the CSRC. Be that as it may, the CSRC has not created a viable and expeditious framework within which the SEC's investigative interests can be met. As SEC witnesses will explain at the Hearing, for at least the last three years, the CSRC has been unable or unwilling to facilitate the SEC's access to audit workpapers in China. The sum total effect, then, has been simply to block the SEC's ability to conduct investigations of China-based issuers, by preventing the SEC from obtaining the workpapers from China. This is not, according to the Supreme Court, a legitimate interest. *See Société Nationale*, 482 U.S. at 544 n.29 (holding that a nation's statutes requiring confidentiality are "relevant to the court's particularized comity analysis only to the extent that its terms and its enforcement identify the nature of the sovereign interests in nondisclosure of specific kinds of material.").

3. The SEC Has No Alternative Means Of Obtaining Documents Sought By the Requests

Relatedly, Respondents' noncompliance should be deemed "willful" because the SEC has no other way of obtaining all of the requested documents. Where "information cannot be *easily obtained* through alternative means," the factor "weighs in favor of disclosure." *Wultz*, 2012 WL

[19] In *Richmark*, the court of appeals observed that "the State Secrecy Bureau did not express interest in the confidentiality of this information prior to the litigation in question. Indeed, Beijing routinely disclosed information regarding its assets, inventory, bank accounts, and corporate structure to the general public, for example, through a trade brochure and to companies with whom it did business. The State Secrecy Bureau did not object to the *voluntary* disclosure of any of this information. It is only now, when disclosure will have adverse consequences for Beijing, that the PRC has asserted its interest in confidentiality." *Id.* at 1476.

5378961, at *6 (internal quotation omitted; emphasis in original)). Here, there are no third parties from which the Commission could obtain all of the requested information—Respondents are the sole entities that possess all or substantially all of their audit work papers and related information.

Respondents have argued that the SEC was *obligated* to abstain from demanding direct productions of documents from Respondents under Section 106(b); rather, they contend, citing Section 106(f), the SEC was *required* to pursue the documents by seeking assistance from the CSRC. Respondents are wrong. Section 106(f) states: "Notwithstanding any other provisions of this section, the staff of the Commission or the [PCAOB] may allow a foreign public accounting firm that is subject to this section to meet production obligations under this section through alternate means, such as through foreign counterparts of the Commission or the [PCAOB]." 15 U.S.C. § 7216(f). Thus, Section 106 gives the Commission the *option* of allowing a foreign firm to satisfy its duties under that section by producing audit workpapers to foreign regulators; however, that is a discretionary decision.

Furthermore, the Division's pursuit of the documents through the CSRC would have been – and still would be – futile. Thus, no viable "alternative means" exists. The SEC's OIA already has explained in the Longtop matter in federal district court,[20] and will explain again in these proceedings, that the CSRC currently is not a viable gateway for audit workpapers and related documents from China. In particular, an OIA witness can be expected to testify that:

[20] *See* Declaration of Alberto Arevalo and Second Declaration of Alberto Arevalo, both filed in *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, 11mc512 (GK) (May 1, 2013) (Dkt. Nos. 62-14, 62-15); *see also* Respondents' Request for the Issuance of a Subpoena Directed at the SEC (filed May 24, 2013) (Exhibits 3 and 4).

- Although the SEC requested assistance from the CSRC over *three years ago* – in June 2010 – with respect to the audit workpapers of DTTC Client A, the SEC has not received any of those documents;
- Although the SEC requested assistance from the CSRC over *two years ago* – in June 2011 – with respect to the audit workpapers of DTTC's Client G, and again over 10 months ago – in August 2012 – with respect to the audit work papers of DTTC's client Longtop Financial Technologies Limited, the SEC has not received of any of those documents either;
- These conditions have persisted despite numerous attempts by OIA to obtain the CSRC's cooperation;
- The CSRC's representation earlier this year that it has developed "new procedures" and would be able to send documents to the SEC "in a matter of weeks" has not resulted in the production of any audit workpapers.

In short, any additional efforts to obtain the workpapers sought by the Requests, by seeking the assistance of the CSRC, would have been pointless. The Division's discretionary decision not to continue spinning its wheels in this fashion did not render Respondents' refusal to comply any less "willful."

4. Audit Workpapers Are Important To SEC Financial Fraud Investigations

The importance of the requested documents to the 10 SEC investigations involving the Clients cannot be seriously disputed. *See* April 30 Order, at 15. ("In addition to combatting fraud in audit reports, Section 106(b) assists the Commission in carrying out its statutory role over auditors and combatting fraud generally."); Consolidated Opp. at 27-29. In any event, at the Hearing, the Division's witnesses will testify as to the need for the workpapers that the SEC

sought through the Requests – both generally and with respect to the specific Client investigations.

5. Respondents Willfully Courted Whatever Hardship They Would Face Through De-Barment, Or Would Have Faced In Producing The Requested Documents

Respondents have claimed that, had they complied with the Requests, they would have been subject to potential civil and criminal sanctions. First, those claims are speculative, because nothing as yet has been deemed a state secret.[21] Second, whatever the risks that exist under Chinese law, Respondents knowingly accepted them by availing themselves of the U.S. securities markets. *See Richmark*, 959 F.2d at 1477; *Banca Della*, 92 F.R.D. at 117 (rejecting defendant's request to preclude discovery based on Swiss secrecy laws and observing that "[the defendant] invaded American securities markets and profited in some measure thereby. It cannot rely on Swiss nondisclosure law to shield this activity.").

V. RESPONDENTS SHOULD BE BARRED FROM ISSUING AUDIT REPORTS AND PERFORMING CERTAIN OTHER AUDIT SERVICES FOR U.S. ISSUERS

The Commission instituted these proceedings to "determine whether Respondents should be censured or denied the privilege of appearance and practice before the Commission for having willfully violated Section 106 of Sarbanes-Oxley." OIP ¶ 32. Respondents' willful violations of Section 106 satisfy all of the factors that the Commission consider when deciding whether to censure or debar accounting firms: they are egregious, recurrent, and willful; Respondents have made no assurances against future violations; Respondents refuse to acknowledge the wrongfulness of their conduct; and Respondents give every indication that they will continue to violate the same provisions of the securities laws unless the Commission imposes remedies that

[21] Nor have Respondents offered any actual cases in which the workpapers of accounting firms have been found to contain state secrets. For documents that do not contain state secrets, separate criminal liability under the Archives law is unlikely, because the documents at issue appear not to involve state-owned archives. *See* Clarke Report ¶¶22, 40.

prevent them from doing so. These are more than adequate grounds for denying Respondents the privilege of appearance and practice before the Commission.

The Division respectfully requests that Respondents:

(1) be censured;

(2) be permanently barred from issuing audit reports filed with the Commission ("Principal Auditor Bar"); and

(3) be permanently barred from playing a 50% or greater role in the preparation or furnishing of an audit report filed with the Commission ("50% Role Bar"). The details of this proposed bar are explained below, *infra* Argument Section V.C.1.

The Division's proposed remedy directly addresses the harm caused to the Commission's processes by Respondents' willful violations of Sarbanes-Oxley. Respondents have issued audit reports or played a substantial role in the preparation or furnishing of audit reports for the Clients and other issuers, and they apparently have every intention of continuing similar audit engagements in the future. By willfully refusing to produce their audit workpapers in response to Section 106 requests, Respondents have effectively eliminated a central means for the SEC's oversight of these activities. Moreover, Respondents will presumably refuse to produce their documents in response to any future Section 106 requests. The Division's proposed bars rectify this harm by preventing Respondents from serving as the principal auditor, or *de facto* principal auditor, for issuers whose securities are traded in the U.S. The Division reserves the right to modify its proposed remedy after considering the submissions of experts in this case and the evidence provided at the Hearing.

A. Debarment Is Justified By The Serious Harm To The Commission's Processes That The Respondents Have Caused Through Their Willful Violations

1. Legal Standard for Imposing 102(e) Remedies

The purpose of disciplinary measures ordered under 102(e) "is not to punish, but to protect the public." *In the matter of Dohan & Co., CPA,* Initial Decision Release No. 420, 110 SEC Docket 1973, 2011 WL 2544473, at *16 (Jun. 27, 2011). In determining what remedial measures to impose against auditors who are liable under 102(e), the Commission typically focuses on the seriousness of the misconduct at issue. *See, e.g., In the Matter of Gregory M. Dearlove, CPA*, 92 SEC Docket 1427, 2008 WL 281105, at *30 (Jan. 31, 2008); *In the Matter of James Thomas McCurdy, CPA*, 82 SEC Docket 282, 2004 WL 210606, at *9 (Feb. 4, 2004). In addition, the Commission may consider the so-called "*Steadman* factors":

> [1] the egregiousness of the defendant's actions, [2] the isolated or recurrent nature of the infraction, [3] the degree of scienter involved, [4] the sincerity of the defendant's assurances against future violations, [5] the defendant's recognition of the wrongful nature of his conduct, and [6] the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979). *See, e.g., Peak Wealth* (applying Steadman factors in Rule 102(e) proceeding against CPA); *Barry C. Scutillo, CPA*, 74 SEC Docket 1944, 2001 WL 461287 (May 3, 2001) (same).

2. Respondents' Willful Violations Justify Debarment

Respondents' willful refusals to provide documents requested under Section 106(b) of Sarbanes-Oxley are serious infractions that warrant a stringent remedy. Auditors play a critical gatekeeping role in the U.S. securities markets. "[B]oth the Commission and the investing public rely heavily on accountants to assure corporate compliance with federal securities law requirements and disclosure of accurate and reliable financial information." Amendment to Rule

102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57164, at 57165 (1998). When an accounting firm issues an audit report for a company traded in U.S. markets, U.S. investors rely on that firm's work. Investors also rely on the work of accounting firms that play a substantial role in preparing or furnishing that report. The SEC, in turn, needs access to audit workpapers and related documents to exercise appropriate oversight of auditors and their clients' financial reporting. *See supra* Argument Section III.C. Where, as here, a foreign firm willfully refuses to produce documents requested under Section 106, thereby impeding effective oversight of U.S. markets by the SEC, the harm is severe. A bar is necessary "to ensure that the Commission's processes continue to be protected, and that the investing public continues to have confidence in the integrity of the financial reporting process." *Dearlove*, 2008 WL 281105, at *30 (internal quotation omitted); *see also* April 30 Order, at 7 ("The purpose of Commission Rule 102(e)(1)(iii) is remedial and the rule is directed at protecting the integrity of the Commission's own processes and the confidence of the investing public in the integrity of the financial reporting process.") (citations and quotations omitted).

The *Steadman* test further confirms that Respondents' willful violations warrant a bar against practicing before the Commission, as each of the six *Steadman* factors weighs in favor of significant remedial measures:

> [1] Egregiousness. Respondents' willful violations are at least as egregious as other misconduct that has resulted in bars against accountants. In *Dearlove,* the Commission recognized that, "a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive," and "that under some circumstances, unreasonable conduct is not necessarily a less egregious disciplinary matter than either intentional or reckless conduct." 2008 WL 281105, at

*30. Here, Respondents' willful conduct was egregious, among other reasons, because it caused extreme harm to the Commission's processes; it prevented the Commission from performing its basic oversight of auditors and issuers. *See Peak Wealth*, Release No. 69036 (imposing total bar against accountant for conduct including failure to produce documents).

[2] Recurrence. Respondents' willful violations were recurrent. Four of the five Respondents committed their violations on multiple engagements at issue in these proceedings. There is no suggestion that, had the SEC sent additional Section 106 requests to Respondents in connection with other investigations, the result would have been any different.

[3] Scienter. Respondents acted willfully, by purposefully participating in U.S. markets with knowledge that Chinese law would impair their compliance with U.S. rules, and then by consciously refusing to produce documents. Such willful conduct is more than sufficient to justify a bar.

[4] Assurances against future violations. Respondents make no assurances against future violations of Section 106. To the contrary, they continue to take on audit engagements with U.S. issuers that could directly lead to future violations of this provision.

[5] Acknowledgment of "wrongful nature of [their] conduct." Respondents, of course, do not make such an acknowledgment. To the contrary, they continue to argue that they did not violate the law and acted only in good faith.

[6] Likelihood of opportunities for future violations. The likelihood is very high. Respondents effectively argue that they should continue to profit from U.S. markets,

> while disregarding U.S. rules, indefinitely. Only a bar against practicing before the Commission will prevent the near certainty of future violations by some or all of these Respondents.

In summary, each of the six *Steadman* factors weighs strongly against Respondents. Censure and a bar against practicing or appearing before the Commission are therefore appropriate remedies.

3. Debarment Is Not Unfair, Regardless of Chinese Law

Even assuming (without conceding) Chinese legal impediments on Respondents, debarment is still justified. The harms caused by Respondents' willful violations exist independently of Chinese law; they also result from Respondents' decisions to insert themselves into U.S. markets while purporting unilaterally to exempt themselves from compliance with the U.S. securities laws. Respondents remain accountable for their own choices. They alone are responsible for the decisions that culminated in their willful violations: (1) registering with the PCAOB; (2) designating agents for receipt of Section 106 Requests, as required after Dodd-Frank; and (3) performing audit work for issuers of securities traded on U.S. markets.

Moreover, Respondents have chosen to violate U.S. law rather than violate Chinese law. The Division does not argue that Respondents should have chosen to violate Chinese law, nor does the Division now seek to compel Respondents to do so. The Division seeks only to prevent Respondents from continuing their willful violations of U.S. law in a manner that impedes the SEC's oversight of U.S. markets.

B. The Division's Proposed Bar Is Authorized Under Rule 102(e)

Rule 102(e)(iii) provides, "The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission . . . [t]o have willfully violated . . . any provision of the Federal

securities laws or the rules and regulations thereunder." 17 C.F.R. § 201.102(e)(iii). The Division's proposed bar is authorized under Rule 102(e), as the activities covered by the bar constitute "practicing before the Commission." Rule 102(f) provides that for accountants, "practicing before the Commission" includes "[t]he preparation of any statement, opinion or other paper . . . filed with the Commission in any registration statement, notification, application, report or other document with the consent of" the accountant. 17 C.F.R. § 201.102(f)(2). This definition unquestionably encompasses the Principal Auditor Bar, which prevents Respondents from issuing audit reports filed with the Commission. The conduct prohibited by the 50% Role Bar also constitutes "practicing before the Commission." The Commission has held that "practicing before the Commission includes computing the figures and supplying the data incorporated into Commission filings and consenting to their incorporation." *In the Matter of Robert W. Armstrong, III*, 85 S.E.C. Docket 2321, 2005 WL 1498425, at *11 (Jun. 24, 2005). Thus, "an individual may . . . be found to have practiced before the Commission if he or she participated in the preparation of financial statements filed with the Commission by, for example, creating, compiling or editing information or data incorporated into" filings. *SEC v. Prince*, 2013 WL 1831841, at *36 (D.D.C. May 2, 2013) (quoting *SEC v. Brown*, 878 F. Supp. 2d 109, 125 (D.D.C. 2012)). The conduct that would be subject to the 50% Role Bar plainly meets this definition of "practicing before the Commission." The Division's proposed remedy is therefore authorized under Rule 102(e).

C. The Proposed Bar Is Appropriately Tailored

As commanded by Rule 102(e), the Division's proposed bar is prophylactic rather than punitive, designed to protect the public from Respondents' willful violations in a way that avoids unnecessary collateral effects on third parties.

1. <u>The Bar Remedies the Harms Caused by Respondents' Willful Violations</u>

First, the Division's proposed bar would prohibit Respondents from signing audit reports for issuers of securities that trade on U.S. markets. This component remedies the most significant harm done to the Commission's processes by Respondents' willful violations: the inclusion, in publicly filed financial statements, of affirmative representations to U.S. investors that could not in fact be verified. "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. . . ." *Arthur Young & Co.*, 465 U.S. at 817-18. Consequently, "To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations." *Id.* at 818; *see also Marrie*, 374 F.3d at 1200-1201. Respondents, through their willful refusals to provide documents that support their depictions of issuers' financial conditions, shirk those public obligations; a bar against Respondents signing audit reports will prevent them from doing so in the future.

In addition, the proposed bar would prohibit Respondents from playing a 50% or greater role in the preparation or furnishing of an audit report. Section 106 authorized the PCAOB to issue rules with respect to "a foreign public accounting firm (or a class of such firms) that does not issue audit reports [but] nonetheless plays . . . a substantial role in the preparation and furnishing of such reports for particular issuers"). Sarbanes-Oxley, Section 106(a)(2). Pursuant to this authority, the PCAOB issued Rule 1001(p)(ii), which explains what it means for an audit firm to "Play a Substantial Role in the Preparation or Furnishing of an Audit Report":

(1) to perform material services[22] that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, or

(2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer.

PCAOB Rule 1001(p)(ii).

The Division's proposed bar would preclude Respondents from performing a portion of their "substantial role" work as the PCAOB has defined that term. Under the Division's proposed 50% Role Bar:

(A) Respondents would be barred from performing audit work that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, where the engagement hours or fees for such services constitute 50% or more of the total engagement hours or fees, respectively, provided by the principal auditor in connection with the issuance of all or part of its audit report with respect to any issuer; and

(B) Respondents would be barred from performing the majority of audit work with respect to a subsidiary or component of any issuer, the assets or revenues of which constitute 50% or more of the consolidated assets or revenues of the issuer.

The 50% Role Bar thus protects U.S. investors by ensuring that a majority of the audit work on the financial statements of any issuer of securities traded in U.S. markets will be subject to meaningful oversight by the SEC. It also seeks to prevent Respondents from making an end-run

[22] "Material services" are "services, for which the engagement hours or fees constitute 20% or more of the total engagement hours or fees, respectively, provided by the principal accountant in connection with the issuance of all or part of its audit report with respect to any issuer. The term does not include non-audit services provided to non-audit clients." PCAOB Rule 1001(p)(ii), Note 1.

around the Principal Auditor Bar by performing all or substantially all of the audit work for an audit report signed by another firm.[23]

2. The Proposed Bar Properly Balances the Relevant Interests

As explained above, the Division's proposed bar comports both with the language of Rule 102(e) and with judicial precedent applying it. It also strikes an appropriate balance among competing interests and policy concerns. "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." *See* http://www.sec.gov/about/whatwedo.shtml. The proposed bar satisfies each of the three prongs of this mission. First, by preventing Respondents from filing audit opinions or performing half or more of the audit work on which filed opinions are based, the bar protects investors from issuers whose financial statements cannot meaningfully be tested. Second, the bar helps maintain fair, orderly, and efficient markets by ensuring that filings from issuers and auditors based in China will be equally transparent, and equally subject to oversight, as those from elsewhere. And third, the bar will facilitate capital formation by enhancing investors' confidence in the veracity of filings emanating from China; the current, uncertain situation, in which U.S. investors and regulators lack the ability to verify those filings, is hardly conducive to capital formation. *See* Michael Rapaport, *Schumer Urges U.S. to Press China on Accounting*, THE WALL STREET JOURNAL (online), Jun. 6, 2013.

The bar is also tailored to address Respondents' specific violations without restricting unduly the investment choices available to U.S. investors or impeding capital formation in the U.S. The proposed bar generally should not affect the performance of audit work for

[23] The 50% Role Bar has particular relevance to KPMG Huazhen's current business model. Since 2010, the firm has performed audit work on subsidiaries or components of various issuers the assets or revenues of which constitute well over 50% of the consolidated assets or revenues of such issuers; the principal auditor in these situations is KPMG Hong Kong, another member of KPMG Huazhen's global network of firms.

multinational registrants that do not have a majority of revenues or assets in China. The Division expects that, under its proposed framework, most large multinational issuers would remain able to procure auditing services from Respondents for China-based operations. Similarly, while investors may be affected somewhat by the bar insofar as some issuers – *e.g.*, issuers with all or substantially all of their operations in China – conceivably might not be able to issue securities in U.S., this potential impact is necessary to protect investors and maintain fair markets.[24] At trial, the Division expects to show through expert or summary testimony that the Division's proposed bar would have only a limited impact on the ability of large multinational issuers to obtain necessary audit services from Respondents, and should not affect this group's ability to file consolidated audited financial statements with the SEC.

Accordingly, the Court should permanently bar Respondents from 1) issuing audit reports filed with the Commission, and 2) playing a 50% or greater role in the preparation or furnishing of an audit report filed with the Commission.

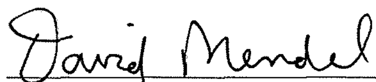
[24] It may be possible for U.S. issuers that are foreclosed from hiring Respondents to retain other auditors who can comply with the U.S. securities laws, including by producing audit workpapers in response to Section 106 requests.

CONCLUSION

For the foregoing reasons, and in light of the additional factual showings to be made during the Hearing, the Court should find that that Respondents willfully violated Sarbanes-Oxley, and should impose the Division's remedy outlined above.

Dated: June 24, 2013

Respectfully submitted,



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