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UNITED STATES OF AMERICA
Before The
SECURITIES AND EXCHANGE COMMISSION

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

In the Matter of

Dahua CPA Co., Ltd.;
Ernst & Young Hua Ming LLP;
KPMG Huazhen (Special General Partnership);
Deloitte Touche Tohmatsu Certified Public Accountants Ltd.;
PricewaterhouseCoopers Zhong Tian CPAs Limited

Respondents.

The Honorable Cameron Elliot,
Administrative Law Judge

RESPONDENT KPMG HUAZHEN'S PRE-HEARING BRIEF

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I. PRELIMINARY STATEMENT

Respondent KPMG Huazhen (Special General Partnership) ("KPMG Huazhen") joins in the Pre-Hearing Brief of Deloitte Touche Tohmatsu Certified Public Accountants Ltd. (the "DTTC Brief"), which is fully adopted and incorporated herein by reference.[1] KPMG Huazhen respectfully submits this separate Pre-Hearing Brief to address facts particular to KPMG Huazhen and to set forth Respondents' position on the issue of sanctions.[2]

These proceedings are unprecedented. In this action, the Division of Enforcement ("Division") seeks to sanction Respondents for becoming trapped between the conflicting demands of two sovereign states which — for reasons entirely outside of Respondents' control — those states have not yet resolved. Even if Respondents are found to have violated § 106, sanctions would be inappropriate and contrary to the public interest for four reasons.

First, imposing sanctions on Respondents would be fundamentally unfair and contrary to established precedent. This is not a simple case where a party failed to produce requested documents out of obstinacy, bad faith, or even neglect. Respondents here found themselves caught in an irreconcilable conflict between the laws of two countries. In these circumstances, the factors the Commission is required to consider weigh heavily against sanctions.

Second, sanctioning Respondents would be inconsistent with long-standing Commission policies and practices. During the past 30 years, the Commission has pursued

[1] KPMG reserves all rights with respect to whether this action was properly served on KPMG Huazhen, as well as whether Section 106 is applicable to KPMG Huazhen's work for Client E, for whom it never prepared, furnished, or issued an audit report. Likewise, KPMG Huazhen reserves all rights with respect to whether an enforceability ruling by a federal court under Section 106 is a necessary condition for the institution of this action.

[2] KPMG Huazhen is joined in this brief by Respondents Dahua CPA Co., Ltd. ("Dahua"), Ernst & Young Hua Ming LLP ("EYHM"), Deloitte Touche Tohmatsu Certified Public Accountants Ltd. ("DTTC"), and PricewaterhouseCoopers Zhong Tian CPAs Limited ("PwC Shanghai").

negotiations with foreign regulators in order to construct a web of international agreements that allow it to obtain documents located in foreign countries through the assistance of its counterparts in those countries. It also approved PCAOB rules that expressly recognized conflicts-of-laws issues and permitted foreign accounting firms from China and other jurisdictions to be registered even after they gave notice that they might not be able to produce workpapers directly to U.S. regulators outside the MOU process. Respondents reasonably relied on these long-standing policies and practices. Reversing course now — and sanctioning Respondents for failing to do something that they specifically warned they might not be able to do — would be arbitrary, capricious, and would stand the Commission's policies and past practices on their heads.

Third, sanctioning Respondents would have substantial negative collateral consequences for issuers, investors, and the U.S. securities markets. Sanctioning Respondents would bar them from continuing to participate in the audits of approximately 125 China-based issuers with an aggregate market capitalization of over $550 billion. However, there is not a large pool of experienced China-based accounting firms capable of replacing Respondents. As a result, these issuers will be required either to retain inexperienced or unqualified auditors or face delisting from U.S. securities exchanges. In addition, if Respondents are sanctioned, well-known multinational corporations (including some of the largest U.S. companies) will not be able to obtain audits covering their China operations by qualified firms and will also face the prospect of delisting. Simply put, sanctioning Respondents would inflict dramatic harm on issuers, investors, and the U.S. securities markets.

Finally, sanctioning Respondents would have no remedial effect and will not resolve the Division's difficulties in obtaining documents in China. Rule 102 does not give the Commission the authority to order Respondents to produce documents, and the Division has conceded that these proceedings cannot be used to obtain such an order. More importantly, sanctions will not resolve the conflict of laws that China-based, U.S.-registered accounting firms currently face. Even if Respondents are suspended, the firms that might replace them will be no more able to produce documents directly to the Commission than Respondents.

For these reasons, even if Respondents are found to have violated § 106, no sanctions should be imposed.

II. FACTUAL BACKGROUND

A. Structure of KPMG Huazhen

KPMG Huazhen is a special general partnership organized under the laws of the People's Republic of China ("PRC"). KPMG Huazhen provides audit and related professional services for companies whose securities are listed on, for example, the Shanghai Stock Exchange (SSE), the Shenzhen Stock Exchange (SESE), the Hong Kong Exchanges and Clearing Limited (HKEx), the New York Stock Exchange (NYSE), and the Nasdaq Stock Market (NASDAQ). KPMG Huazhen has a main office and three branch offices in Mainland China; it does not maintain any offices outside of Mainland China. KPMG Huazhen's activities are principally conducted in Mainland China. As a registered accounting firm in the PRC, its primary regulators are: (i) the Chinese Institute of Certified Public Accountants ("CICPA"); (ii) the Ministry of Finance ("MOF"); and (iii) the China Securities Regulatory Commission ("CSRC").

KPMG Huazhen is a member of the KPMG network of independent firms affiliated with the KPMG International Cooperative, a Swiss entity. Each member of the international network is a separate legal entity, typically formed under the laws of its home country. No member firm of the network has any authority to obligate or bind the KPMG International Cooperative or any other member firm. As an independent member of the international network, KPMG Huazhen maintains its own books and records and its own separate officers and management.

As reflected on its Form 2 for the period April 1, 2011 through March 31, 2012, KPMG Huazhen played a substantial role with respect to the audit reports of 25 U.S.-listed issuers. In these engagements, KPMG Huazhen performed audit procedures on the issuer's operations in Mainland China. KPMG Huazhen does not sign the audit opinions of U.S.-listed issuers and did not do so with respect to Clients D, E and F.

B. Registration with PCAOB

KPMG Huazhen is a registered accounting firm and has been registered with the Public Company Accounting and Oversight Board ("PCAOB") since 2004. KPMG Huazhen filed its application for registration with the PCAOB on April 26, 2004. At that time, KPMG Huazhen employed a total of approximately 1,168 accountants and identified nine U.S.-listed issuers for which it played, or expected to play, a substantial role in an audit. KPMG Huazhen was fully transparent in its application with respect to the legal impediments imposed by PRC laws. Indeed, KPMG Huazhen disclosed in its application for registration, which was supplemented by an accompanying legal opinion, its inability to supply a "Consent to Cooperate with the Board." See Form 1, Item 8.1, Exhibit 99.2 (Apr. 26, 2004) [Resp. Exh. 513].

The PCAOB approved KPMG Huazhen's registration notwithstanding KPMG Huazhen's disclosures that certain legal impediments created the possibility that KPMG Huazhen would be unable to disclose certain information to the PCAOB upon request. The existence of conflicting laws was not unique to KPMG Huazhen or even to Chinese accounting firms; accounting firms from scores of different countries declined to provide the consents in Item 8.1 of the Form 1. In approving KPMG Huazhen's registration, the PCAOB reserved the rights of the PCAOB with regard to these issues, while apparently recognizing that those legal impediments were real.

C. Audit Clients

1. Client D

KPMG (a Hong Kong partnership) ("KPMG HK"), a member of the KPMG International network and located in Hong Kong, was engaged by Client D in December of 2010 to perform an audit of Client D's consolidated financial statements and an audit of its internal control over financial reporting. KPMG HK was the principal auditor, and KPMG Huazhen served as a component auditor because Client D's business operations were substantially all based in the PRC.

Client D is a biodiesel producer in the PRC. According to its annual report, Client D acquires raw materials from local associations, some of which are governmental entities. Its key supplier is the fourth largest oil company in China. Client D's target markets include power plants, marine transportation companies, seaport operations, and other industrial customers that consume large volumes of diesel fuels. It sells finished oil and heavy oil products to regional distributors in China which, in turn, supply those products to retail service stations. Client D also provides those products directly to end users through its own retail gas stations. Accordingly, many key customers of Client D are state-owned companies, including PetroChina and SINOPEC, which are both enterprises directly controlled by the State Asset Supervision and Administrative Commission of the State Council ("SASAC").

KPMG HK terminated the client-auditor relationship with Client D on April 26, 2011. See Client D, Current Report (Form 8-K, Ex-7.1) (May 2, 2011) [Resp. Exh. 520].

2. Client E

KPMG HK was engaged by Client E in January of 2011 to perform an audit of Client E's consolidated financial statements and an audit of its internal controls over financial reporting. KPMG HK was the principal auditor, and KPMG Huazhen served as a component auditor because Client E's business operations were substantially all based in the PRC.

Client E, through PRC operating subsidiaries, is engaged in the manufacture and sale of petrochemical products in the PRC. According to its annual report, the company's operations include: (i) a production facility with an annual petrochemical production capacity of 550,000 metric tons of a variety of petrochemical products; (ii) facilities for the storage and loading of raw materials and finished goods; and (iii) a manufacturing technology that can support its manufacturing process with relatively low raw material costs and high utilization and yields.

KPMG HK resigned prior to the completion of the audit of Client E. By letter dated May 24, 2011, KPMG HK notified the Audit Committee of Client E that the client-auditor relationship had ceased. See Client E, Current Report (Form 8-K, Exh. 16.1) (May 31, 2011) [Resp. Exh. 523]. KPMG HK never issued an audit report for any period with respect to the financial statements of Client E.

3. Client F

KPMG HK was engaged by Client F in November of 2008 to perform an audit of Client F's consolidated financial statements and an audit of its internal control over financial reporting. KPMG HK was the principal auditor, and KPMG Huazhen served as a component auditor because Client F's business operations were substantially all based in the PRC.

Client F is a manufacturer in the PRC of nano-precipitated calcium carbonate ("NPCC"), which is a functional additive with a wide range of applications. Its key end products include tires, PVC, adhesives, paints and paper. According to its annual report, Client F has received various state supports in respect of its business. For example, Client F was granted with exclusive land-use and mining rights to limestone reserves, and was granted other utilities and services for manufacturing purposes by the state or local governments. In addition, being in one of the State's encouraged sectors, the group receives preferential tax treatment.

On March 9, 2011, KPMG HK issued a letter to the Audit Committee of Client F. See Letter from KPMG HK to the Client F Audit Committee Chairman (Mar. 9, 2011) [Resp. Exh. 527]. On April 29, 2011, KPMG HK notified Client F that the client-auditor relationship had ceased. See Client F, Current Report (Form 8-K, Item 4.01) (May 5, 2011) [Resp. Exh. 530].

D. KPMG Huazhen's Good Faith Efforts to Respond to SEC and PCAOB Requests

In April of 2011, the Division first sought from KPMG Huazhen the voluntary production of audit work papers and other documents related to the audit and review of Client E. From the outset, KPMG Huazhen responded that under PRC law it had a legal duty not to disclose its files to third parties, including foreign regulators.

Concurrent with the request from the SEC, KPMG Huazhen received an Accounting Board Demand ("ABD") from the PCAOB requesting audit work papers and documents concerning audits and reviews of Clients D and F. The ABD received in June of 2011 was the first formal demand relating to Clients D and F received from U.S. regulators. In response to follow-up correspondence from the PCAOB, KPMG Huazhen sought guidance from the CSRC and the MOF. During discussions that occurred in July 2011, the CSRC and MOF advised KPMG Huazhen to comply with relevant PRC laws and regulations. In its response to the PCAOB, KPMG Huazhen explained that it was unable, not unwilling, to respond fully to the

ABD, and that it was responding to the ABD to the fullest extent possible. See Letter from Geoffrey Aronow, Bingham McCutchen LLP, to PCAOB Division of Enforcement and Investigations (July 26, 2011) [Resp. Exh. 542].

In an effort to facilitate the production of materials upon the CSRC's approval, KPMG Huazhen notified Clients D and F of the PCAOB ABD and sought their consents to the production of the requested documents and information. See Letter from KPMG HK and KPMG Huazhen to the Client D Audit Committee Chairman (July 21, 2011) [Resp. Exh. 540]; Letter from KPMG HK and KPMG Huazhen to the Client F Audit Committee Chairman (July 21, 2011) [Resp. Exh. 541]. Client D provided a response that neither expressly granted nor expressly withheld consent to the production of information. Client D, however, noted, "we understand from the Company counsel that under the laws of the People's Republic of China ("PRC"), PRC audit firms (e.g., KPMG Huazhen) are prohibited from allowing Public Company Accounting Oversight Board inspection to date." See Letter from the Client D Audit Committee Chairman to KPMG HK and KPMG Huazhen (Aug. 4, 2011) [Resp. Exh. 543]. Client F did not provide a response.

On October 3, 2011, the PCAOB notified KPMG Huazhen that it intended to recommend that the PCAOB commence a disciplinary proceeding to determine whether KPMG Huazhen failed to cooperate with a PCAOB investigation by failing to comply with the ABD issued to KPMG Huazhen and to determine what, if any, disciplinary sanctions to impose. See PCAOB Division of Enforcement and Investigations Letter to Geoffrey Aronow, Bingham McCutchen LLP (Oct. 3, 2011) [Resp. Exh. 544]. Upon receipt of notices from the Enforcement staff of the PCAOB of its intent to recommend commencement of a disciplinary proceeding, the Firm continued its discussions with officials from the CSRC and the MOF.[3]

Following notice of the PCAOB recommendation, KPMG Huazhen and other similarly situated China accounting firms met with the CSRC and the MOF. During a meeting on October 10, 2011, the CSRC again told the "Big Six" China accounting firms that they were prohibited from producing any audit work papers or other documents to foreign regulators without the requisite approvals and consents. Moreover, the CSRC advised the "Big Six" firms that the PRC Law on Guarding State Secrets (the "State Secrets Law"), the Archives Laws, and the Regulations on Strengthening the Protection of Secrets and Archive Management related to Issuance and Listing of Securities Overseas (the "2009 Regulations"), among other laws and regulations, prohibit China accounting firms from producing any such materials directly to foreign regulators and that such information should only be provided through mechanisms of cooperation established between the PRC and the U.S. The CSRC and MOF also told the "Big Six" firms that the firms and their employees would face serious legal consequences if they were to act contrary to these directives.

Subsequent to the in-person meeting, the CSRC, after consultation with the MOF, issued a letter confirming the legal impediments that precluded KPMG Huazhen from supplying the requested audit work papers and other documents to foreign regulators absent authorization by the China government. Such authorizations, despite the repeated discussions with KPMG Huazhen, have not been granted as of this date.

KPMG Huazhen, through local counsel, also took steps to identify the relevant bureaus for the maintenance of State secrets and archives administration. KPMG Huazhen did

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[3] KPMG Huazhen provided a letter of formal report to the CSRC on October 12, 2011. Letter from KPMG Huazhen to CSRC Accounting Department (Oct. 12, 2011) [Resp. Exh. 545].

so in a further effort to facilitate the production of materials upon CSRC's approval. The relevant bureaus responded to local counsel that any request for an assessment must be submitted by another PRC regulator or the PRC government, not by a non-governmental entity. KPMG Huazhen advised the CSRC of this limitation, and the CSRC has confirmed the same. See Letter from KPMG Huazhen to Jia Wen-qin, CSRC Chief Accountant (Feb. 24, 2012) [Resp. Exh. 551].

In February 2012, despite knowledge that KPMG Huazhen was legally prohibited from producing materials directly to U.S. regulators, the Division sent demands pursuant to Section 106 of the Sarbanes-Oxley Act of 2002 as amended by Section 929J of the Dodd-Frank Act relating to each of the three issuers, seeking "all audit work papers and all other documents" related to audit reports issued, audit work performed, or interim reviews conducted in each of the matters (the "Section 106 Requests").[4] Following receipt of the Section 106 Requests, KPMG Huazhen attended meetings with each of the CRSC and the MOF on February 24, 2012, to inform them of the Section 106 Requests and to seek their directions. During those meetings, both PRC regulators reiterated that any such requests for documents should be directed by the SEC to the CSRC and handled through inter-government arrangements and that KPMG Huazhen did not have the PRC government's authorization to produce any documents to the Division directly in response to the Section 106 Requests.

Subsequent to those meetings, on March 8, 2012, KPMG Huazhen sent the CSRC and MOF a formal report and request for direction in connection with the Section 106 Requests.

[4] Specifically, the Firm received the following: a February 6, 2012 Request regarding Client D (Letter from Barry Kamar, SEC Senior Counsel, to Joseph Loonan, KPMG General Counsel (Feb. 6, 2012) [Resp. Exh. 548]); a February 9, 2012 Request regarding Client E (Letter from Jeffrey Finnell, SEC Senior Counsel, to Joseph Loonan, KPMG General Counsel (Feb. 9, 2012) [Resp. Exh. 549]); and a February 3, 2012 Request regarding Client F (Letter from Roger Boudreau, SEC Accountant, to Joseph Loonan, KPMG General Counsel (Feb. 3, 2012) [Resp. Exh. 547]).

See KPMG Huazhen Letter to CSRC and MOF (Mar. 8, 2012) [Resp. Exh. 553]. In the meantime, KPMG Huazhen took measures to collect the responsive materials and to prepare those materials for production to the CSRC upon the CSRC's request. To date, KPMG Huazhen has not received instructions from the CSRC to do so.

KPMG Huazhen submitted a single response to the Section 106 Requests on March 27, 2012, reiterating that it was unable to produce the audit work papers and other documents under various PRC laws and the specific directions of the PRC regulatory authorities. See Letter from Bingham McCutchen LLP, counsel for KPMG Huazhen, to SEC Barry Kamar, Jeffrey Finnell and Roger Boudreau (Mar. 27, 2012) [Resp. Exh. 556] ("March 27, 2012 Response"). In its response, KPMG Huazhen reaffirmed that it wished to cooperate with the Division and expressed its strong desire that the issues between the PRC and U.S. governments be resolved in a mutually satisfactory manner.

On May 2, 2012, the Division informed KPMG Huazhen of its intent to recommend that the Commission institute an administrative proceeding against KPMG Huazhen for its failure to comply with the Section 106 Demands. See Wells Submission Notice Letter from Fuad Rana, SEC Division of Enforcement to Geoffrey Aronow, Bingham McCutchen LLP (May 2, 2012) [Resp. Exh. 559]. On May 30, 2012, KPMG Huazhen submitted a Wells Submission to the Division reiterating the PRC legal impediments preventing compliance with the Section 106 Requests and detailing the legal arguments supporting its position that disciplinary action by the Commission would be unprecedented and unwarranted.

III. KPMG HUAZHEN'S INABILITY TO PRODUCE WORK PAPERS DIRECTLY TO THE DIVISION DOES NOT CONSTITUTE A "WILLFUL REFUSAL" UNDER SECTION 106

For the reasons stated in the DTTC Brief, which is fully adopted and incorporated herein by reference, KPMG Huazhen's failure to produce work papers for Clients D, E, and F cannot be deemed a "willful refusal" within the meaning of Section 106 under either the law or the facts.

IV. SANCTIONS ARE NOT APPROPRIATE IN THIS CASE AND ARE CONTRARY TO THE PUBLIC INTEREST

As demonstrated in the DTTC Brief, Respondents did not willfully refuse to produce documents in response to the Commission's § 106 requests. They were ready and willing to produce work papers and other documents in response to the Division's requests, but were unable to do so under Chinese law. They did not act contumaciously or with bad intent. Nor did they manufacture the current dispute between the Commission and the CSRC. On the contrary, they found themselves trapped between the conflicting demands of two sovereign states which — for reasons entirely outside of Respondents' control — those states have not yet resolved. These proceedings, in which the Division seeks to sanction Respondents for becoming caught in an irreconcilable conflict of laws, are unprecedented. In these circumstances, sanctioning Respondents would be manifestly unfair and would conflict with long-standing Commission policies and practices. Sanctions would also carry substantial negative collateral consequences for third parties such as issuers and investors. Finally, sanctions would serve no remedial purpose — they will not resolve the Division's difficulties in obtaining documents in China. For the reasons stated below, even if Respondents were found to have violated § 106, no sanctions should be imposed.

A. The Commission May Only Impose Sanctions That Are Warranted Under the Circumstances, Remedial in Nature, and Consistent With its Prior Policies and Practices

The Division has not yet disclosed what sanctions it intends to seek in this action. Rule 102(e)(1) provides that the Commission may either "censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it." The Commission has made clear that "[n]ot every violation of law . . . may be sufficient to justify invocation of the sanctions available under" Rule 102(e)(1) and that sanctions are not appropriate unless "[t]he violation [is] of a character that threatens the integrity of the Commission's processes in the way that the activities of unqualified or unethical professionals do." Carter, Exchange Act Release No. 17597, 1981 WL 384414, at *6 (Feb. 28, 1981) (dismissing proceedings). The Commission elaborated that Rule 102(e) "is not intended to provide an administrative remedy as an alternative to our power to seek injunctive relief for violations of provisions of the securities laws . . . . It is addressed to a different problem — professional misconduct — and its sanction is limited to that necessary to protect the investing public and the Commission from the future impact on its processes of professional misconduct." Id. at *5.

If a sanction is warranted under this standard, the Commission must then select the appropriate sanction by considering a variety of factors, including, among others: the "egregiousness of the [Respondent's] actions," the "isolated or recurrent nature of the infraction," and the "degree of scienter involved." Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981). Although the Commission may consider "the likely deterrent effect its sanctions will have on others" as one factor among many, id. at 1142, such "general deterrence" concerns are by themselves insufficient to support the imposition of sanctions, see PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1066 (D.C. Cir. 2007). The Commission's inquiry into these factors is "flexible . . . no one factor is dispositive." Peak

Wealth Opportunities, LLC, Exchange Act Release No. 69036, Investment Company Act Release No. 30414, 2013 SEC LEXIS 664, at *22 (ALJ Mar. 5, 2013).

There are three important limits on the Commission's ability to impose sanctions under Rule 102(e)(1). First, the sanctions must be remedial in nature, not punitive. Rule 102(e)(1) was adopted to permit the Commission to discipline professionals appearing before it for failures to conform to the Commission's standards of practice, not "to usurp the jurisdiction of federal courts" to punish violations of the federal securities laws. See Touche Ross & Co. v. SEC, 609 F.2d 570, 579 (2d. Cir. 1979). The rule has been upheld precisely because "the Commission has made it clear that its intent in promulgating Rule 2(e)[5] was *not to utilize the rule as an additional weapon in its enforcement arsenal*, but rather to determine whether a person's professional qualifications, including his character and integrity, are such that he is fit to appear and practice before the Commission." Id. (emphasis added). Accord Checkosky v. SEC, 23 F.3d 452, 456 (D.C. Cir. 1994). In order for a sanction to be considered remedial, it must focus principally on — and be rationally related to — preventing future recurrence of misconduct. See SEC v. Patel, 61 F.3d 137, 142 (2d Cir. 1995). Sanctions that would have no remedial effect, but would instead merely punish, are impermissible.

Second, a decision to impose sanctions requires "reasoned decisionmaking" by the Commission. Allentown Mack Sales & Serv., Inc. v. NLRB, 522 U.S. 359, 374-75 (1998). The Commission's decision must be rationally connected to the facts of the case. See, e.g., Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983). It must consider all important aspects of the problem the sanctions are meant to address, including whether the sanctions will appropriately resolve the problem. See, e.g., Saad v. SEC,

[5]Rule 2(e) was recodified as Rule 102(e) in 1995. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,671 n.11 (Dec. 2, 2002).

No. 10-1195, 2013 WL 2476807, at * 5 (D.C. Cir. 2013). The Commission also is required to consider any relevant mitigating factors raised by a respondent. See, e.g., PAZ, 494 F.3d at 1065. Finally, if sanctions are imposed, they must be proportionate to the conduct at issue. See, e.g., Chambers v. NASCO, Inc., 501 U.S. 32, 40 n.5 (1991). The greater the sanction imposed, the greater the Commission's burden to show that the sanction is justified and that lesser sanctions would be insufficient to serve the public interest. See PAZ, 494 F.3d at 1065; Steadman, 603 F.2d at 1139. See also Harrison Secs., Inc., SEC Initial Decision Release No. 256, 2004 WL 2109230, at *57 (ALJ Sept. 21, 2004) (rejecting Division's request for broad sanction because the Division had failed to explain why "the broadest possible sanction under Rule 102(e) should always be automatic in every case under Rule 102(e)").

Finally, the Commission's decision to impose sanctions may not arbitrarily and capriciously conflict with long-standing policies or practices. A basic requirement of the Administrative Procedure Act is that when an agency departs from its existing policies or practices, it "must display awareness that it is changing position. An agency may not, for example, depart from a prior policy sub silentio . . . ." FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009). And it must also "show that there are good reasons for the new policy." Id. Under this principle, agencies are prohibited from imposing disciplinary sanctions that depart from or are inconsistent with its prior (or existing) policies or practices without expressly acknowledging and explaining the change. See Ramaprakash v. FAA, 346 F.3d 1121, 1125 (D.C. Cir. 2003) (Roberts, J.) ("An agency's failure to come to grips with conflicting precedent constitutes 'an inexcusable departure from the essential requirement of reasoned decision-making.'" (citation omitted)); see also Morall v. DEA, 412 F.3d 165, 181 (D.C. Cir. 2005) (DEA acted arbitrarily and capriciously by revoking a physician's registration where it had consistently declined to revoke such registration in comparable circumstances in the past).

B. Sanctions Would be Fundamentally Unfair and Inappropriate Under Carter and Steadman

Even if Respondents are found to have violated § 106, their conduct in this case simply does not warrant sanctions. As the Commission's decision in Carter made clear, even when a violation has occurred, the imposition of sanctions is not automatic. See SEC Release No. 17597, at *6. Instead, the Commission must decide, using "reasoned decisionmaking," whether a sanction is in the public interest and would be fair using the relevant factors provided by Steadman as a starting point. Those factors — the "egregiousness of the [Respondents'] actions," the "isolated or recurrent nature of the infraction," and the "degree of scienter involved" — all show that Respondents should not be sanctioned.[6] Steadman, 603 F.2d at 1140. Respondents' actions were not in any sense "egregious," and they did not "threaten[] the integrity of the Commission's processes in the way that the activities of unqualified or unethical professionals do." Carter, SEC Release No. 17597, at *6. Despite the Division's claims to the contrary, this is not a simple case where a party failed to produce requested documents out of obstinacy, bad faith, or even neglect. Respondents here found themselves caught in an irreconcilable conflict between the laws of two sovereign countries. To the extent Respondents were unable to produce all of the documents called for by the Division's § 106 requests, that was only because doing so would have violated Chinese law on Chinese soil, subjecting Respondents to serious potential legal consequences under Chinese law. Nor have Respondents engaged in recurrent violations of § 106(e). These disciplinary proceedings are based on the very first § 106

[6] Several other factors noted in Steadman — "the sincerity of the defendant's assurances against future violations," "the defendant's recognition of the wrongful nature of his conduct," and "the likelihood that the defendant's occupation will present opportunities for future violations" — are not germane where, as here, the respondent actions were dictated by an irreconcilable conflict between U.S. and foreign law. In any event, these factors are all designed to determine whether a bar order is reasonably designed to prevent a future recurring violation. See Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981). As shown in the text, in light of Chinese law, over which Respondents have no control, no bar order could prevent or mitigate the recurrence of the conduct that the Division, erroneously, considers unlawful.

requests that the Commission made to Respondents. Finally, no scienter — "a mental state embracing intent to deceive, manipulate, or defraud," Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) — was involved. Quite to the contrary, Respondents have at all times been completely transparent and candid about the limitations imposed by Chinese law on the production of documents, and even included specific disclosures accompanied by legal opinions in their PCAOB registration applications.

The Commission also must consider whether the likely impact of sanctions would be disproportionate to the conduct at issue, particularly in the case of a suspension. See PAZ, 494 F.3d at 1065. As will be shown at the hearing, Respondents have spent years recruiting, training, and developing a corps of Chinese professionals able to apply U.S. GAAP and PCAOB auditing standards. They have been instrumental to the Commission's goal of improving the disclosure practices and governance of Chinese companies seeking to list in the United States. See, e.g., Christopher Cox, Chairman, SEC, Remarks Before Securities Industries Association/Tsinghua University Conference, (Oct. 18, 2005) (available at http://www.sec.gov/news/speech/spch101805cc.htm ("Going through the listing process in the U.S. will improve Chinese company disclosure practices. And this will serve to achieve China's objective of upgrading governance of its firms . . . ."). Sanctioning Respondents would impede further improvements in this area, would place the jobs of literally thousands of accountants at risk, and would be grossly disproportionate to the violations at issue in these proceedings.

C. Imposing Sanctions Against Respondents Would Be Inconsistent With the Commission's Policies and Practices

As discussed above, Steadman does not provide an exhaustive list of the factors the Commission must weigh before imposing sanctions. The Commission also is required to consider, among other things, whether imposing sanctions would be unfair in the circumstances or would be inconsistent with its long-standing policies and practices. See, e.g., Ramaprakash, 346 F.3d at 1125; Morall, 412 F.3d at 181. As set forth below, imposing sanctions on Respondents in this case would be arbitrary, capricious, and would stand the Commission's policies and past practices on their heads.

1. The Commission Has Relied on Inter-Regulator Cooperation to Obtain Documents From Foreign Countries For Three Decades

Almost from its inception, the Commission has recognized that obtaining documents and information from parties located in foreign countries would implicate, and at times be complicated by, the laws of those countries.[7] Until this case, the Commission has never attempted to solve that problem by seeking disciplinary sanctions against foreign parties that were unable to comply with its document requests because of restrictions imposed by the laws of those parties' home countries. Instead, the Commission has relied on diplomatic avenues and agency-to-agency negotiations to obtain cooperation from its counterparts in foreign countries.

The Commission first began to pursue formal mechanisms to allow it to obtain documents and information from foreign countries over 30 years ago. In the early 1980s, the Commission found that its efforts to prosecute several insider trading cases involving parties in Switzerland were frustrated by that country's strict secrecy laws. See Michael Mann, et al., International Agreements and Understandings for the Production of Information and Other Mutual Assistance, 29 Int'l Law. 780, 795 (1995). The Commission initially attempted to address this issue unilaterally by filing civil actions in U.S. courts to compel the production of

[7] *See, e.g.*, Memorandum from Walter C. Loucheim Jr. (SEC) to Sam Klaus (Foreign Economic Administration) (Feb. 3, 1945), SEC Historical Society, http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1940/1945_0203_LouchheimKlausT.pdf) (noting "difficulties" in obtaining information from "Swiss principals and their agents").

evidence located in Switzerland. Id. Those actions, although occasionally successful, were "time consuming and expensive and strained international relations." Id.

Its experience with these cases led the Commission to change course and instead begin agency-to-agency negotiations with its counterparts in foreign countries See, e.g., Barbara Thomas, Commissioner, SEC, Extraterritoriality In An Era of Internationalization Of The Securities Markets: The Need To Revisit Domestic Policies (Nov. 12, 1982) (available at http://www.sec.gov/news/speech/1982/111282thomas-1.pdf). Those negotiations were successful, and in 1982, the Commission entered into its first bilateral memorandum of understanding ("MOU"), with Switzerland. See Memorandum of Understanding, U.S.-Switz., Aug. 31, 1982, http://www.sec.gov/about/offices/oia/oia_bilateral/switzerland.pdf. As then-Commissioner Schapiro explained, an MOU "allows the Commission to avoid the problems of foreign secrecy and blocking statutes, and permits [it] to obtain the information [it] need[s] without risk of causing an international incident." Mary L. Schapiro, Commissioner, SEC, Enforcement Initiatives of the SEC: 1989 (Sept. 20, 1989) (available at http://www.sec.gov/news/speech/1989/092089schapiro.pdf).

Since 1982, the Commission has negotiated and executed bilateral enforcement MOUs with its counterparts in over 20 countries. See International Enforcement Assistance, SEC (June 20, 2013), http://www.sec.gov/about/offices/oia/oia_crossborder.shtml. Congress has supported this approach. In 1990, it enacted the International Securities Enforcement Cooperation Act ("ISECA"), Pub. L. No. 101-550, 104 Stat. 2713, 2715 (codified as amended at 15 U.S.C. § 78x(d)), to "strengthen international cooperation in the enforcement of securities laws and thereby enhance the ability of the [Commission] to prevent and detect violations of United States securities laws . . . whose investigation may require the [Commission] to obtain substantial foreign-based evidence," Securities Acts Amendments of 1990, H.R. Rep. No. 101-

240, at 2 (1989), reprinted in 1990 U.S.C.C.A.N. 3888.[8] The Commission provided recommendations on and actively supported this "important and needed" legislation. Id. at 34.

In addition to bilateral arrangements, the Commission has also actively pursued multilateral agreements with its foreign counterparts. In 1983, the Commission helped to form the International Organization of Securities Commissions ("IOSCO"), an international body dedicated to fostering cooperation between securities regulators around the world. In 2002, IOSCO developed a Multilateral Memorandum of Understanding ("MMOU"), which specified procedures for the exchange of certain information by regulators in securities investigations and enforcement proceedings. See Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, May 2002, http://www.iosco.org/ library/pubdocs/pdf/IOSCOPD126.pdf. The Commission was one of the first signatories of the MMOU. The CSRC signed the MMOU in 2007.

It bears noting that bilateral negotiations between U.S. regulators and the CSRC have continued while these proceedings have progressed. Even after the Commission unilaterally advised the CSRC that it would not continue to discuss workpaper access and initiated this proceeding, the CSRC contacted the Commission with a new proposal for such access. And just last month, the PCAOB entered into a MOU with the CSRC and MOF regarding the production of documents from China-based audit firms. See Memorandum of Understanding on Enforcement Cooperation Between the Public Company Accounting Oversight Board of the United States and the China Securities Regulatory Commission and the Ministry of Finance of China, May 7, 2013,

[8] In 1994, the Commission entered into an MOU with the CSRC regarding cooperation, consultation, and the provision of technical assistance. See Memorandum of Understanding Regarding Cooperation, Consultation and the Provision of Technical Assistance, U.S.-China, Apr. 28, 1994, http://www.sec.gov/about/offices/oia/oia_bilateral/china.pdf.

http://pcaobus.org/International/Documents/MOU_China.pdf. Importantly, that MOU specifically permits the PCAOB to share information it obtains with the Commission. See id. at Art. IX(b), (c).

2. Respondents Were Permitted to Register with the PCAOB After Giving Notice That They Could Not Produce Workpapers Directly to the Commission

Against the background of international agreements and cooperation, the Commission has encouraged foreign companies — including Chinese companies — to register their securities in the United States and to trade on U.S. exchanges. The first Chinese company registered with the Commission and began trading on the NYSE in 1993. Currently, over 150 companies either incorporated in or with 100% of revenues or assets in China are publicly traded on a U.S. exchange or the OTC Bulletin Board. Although the Commission is fully aware — as evidenced by these proceedings — of the restrictions that Chinese law places on the production of workpapers directly to foreign regulators, it has taken no action to prevent additional Chinese companies from registering in the U.S. Indeed, the Commission has continued to approve initial public offerings of these kinds of companies even since commencing these proceedings against DTTC in May 2012.

In parallel to these efforts, foreign public accounting firms have also been encouraged to audit issuers with securities traded in the U.S. In 2003, the PCAOB proposed, and the Commission approved, rules allowing foreign public accounting firms to register with the PCAOB and perform audits of issuers with securities traded in the U.S. See Order Approving Proposed Rules Relating to Registration System, SEC Release No. 34-48180, 68 Fed. Reg. 43242 (July 16, 2003). In particular, they permitted foreign accounting firms to register without disclosing information they were prohibited from disclosing under foreign law. See PCAOB Rules 2105, 2207 (effective pursuant to Exchange Act Release No. 48180, 68 Fed. Reg. 43242

(July 16, 2003)).[9] Those rules — on which many foreign securities regulators had commented — explicitly recognized that U.S. law and foreign laws might conflict.

In accordance with PCAOB rules, the Respondents all registered with the PCAOB. In its application, KPMG Huazhen expressly noted that it was unable to sign Exhibit 8.1 of the Form 1 application, which called for it to consent to "cooperate in and comply with any request for testimony or the production of documents made by [PCAOB] in furtherance of its authority and responsibilities under the Sarbanes-Oxley Act of 2002." See KPMG Huazhen, PCAOB Form 1 [Resp. Exh. 513]. Instead, as permitted under PCAOB Rule 2105, it submitted a legal opinion explaining the prohibitions of Chinese law against producing certain information to the PCAOB upon request. See id. The other Respondents all registered with similar limitations. Despite being on notice that Respondents might be prohibited by Chinese law from complying with document requests from U.S. regulators, the PCAOB (which the Commission supervises) approved their applications. Indeed, as will be shown at the hearing, Respondents' conduct was consistent with that of numerous foreign public accounting firms from countries (including Switzerland and the European Union) with laws prohibiting production of documents directly to U.S. regulators. During the last ten years, the PCAOB has routinely approved the registration of such firms after they provided notifications similar to those provided by Respondents in this case.

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[9] PCAOB Rule 2105 ("Conflicting Non-U.S. Laws") and Rule 2207 ("Assertions of Conflicts with Non-U.S. Laws") permit foreign accounting firms to withhold information from their registration applications and other submissions if submitting such information would violate foreign law. In approving these rules, the Commission "urge[d] the Board to continue its dialogue with oversight bodies outside the United States in order to try to find ways to reduce administrative burdens and coordinate in areas of common programmatic interest, such as annual reporting, inspections and discipline." Order Approving Proposed Rules Relating to Registration System, SEC Release No. 34-48180, 68 Fed. Reg. 43242 (July 16, 2003).

3. In Light of the Commission's Policies, Sanctioning Respondents Would be Arbitrary and Capricious

This case represents an abrupt reversal of the Commission's policies and practices over the last three decades. Indeed, there is evidence that the purpose of these proceedings is to provide the SEC with leverage to influence the behavior of the CSRC. After initiating these proceedings, the Commission has suggested to the CSRC that it would discontinue them if certain conditions are met, as a recent letter to the CSRC demonstrates:

[redacted]

[redacted] As the Court of Appeals for the District of Columbia Circuit has made clear, however, sanctioning one party solely in order to influence the behavior of another is an illegitimate use of the Commission's disciplinary authority. See PAZ, 494 F.3d at 1065.

Even holding this issue aside, sanctioning Respondents for being unable to produce documents in response to the Commission's § 106 requests would be unfair to the point of being arbitrary and capricious. During the past 30 years, the Commission has consistently pursued negotiations with foreign regulators in order to construct a web of international agreements that allow it to obtain documents located in foreign countries through the assistance of its counterparts in those countries. It also approved PCAOB rules that expressly recognized conflicts-of-laws issues and permitted foreign accounting firms from China and other

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[10] The Commission communications to CSRC stands in stark contrast to the positions is has taken in these proceedings. See, e.g., Division of Enforcement's Opp'n to Request for Issuance of Subpoena at 4 (May 28, 2013) ("Whether the SEC can obtain certain of the requested workpapers from the CSRC (or through other alternative means) after the OIPs were issued is irrelevant to the merits of the Division's claim against Respondents.")

jurisdictions to be registered even after they gave notice that they might not be able to produce workpapers directly to U.S. regulators outside the MOU process.

Respondents reasonably relied on these long-standing policies and practices. To reverse course now, and to sanction Respondents for failing to do something that they specifically warned they might not be able to do, would be manifestly unfair. It would also conflict with the long-standing policies and practices of the Commission.

The Division will likely argue that Respondents "assumed the risk" that, if the SEC ever asked them to produce documents, they would not be able to comply and would be sanctioned under Rule 102(e). In recent briefing in this matter, the Division starkly contended that "[w]hether the SEC could have obtained certain of the requested workpapers [through cooperation with the CSRC] is irrelevant to whether Respondents willfully refused to comply with SEC's direct requests to them." Division of Enforcement's Opp'n to Req. for Issuance of Subpoena at 5 (May 28, 2013).

This argument is deeply flawed. First, there is no evidence that Respondents assumed the risk that they would be subject to sanctions if — for reasons that were unforeseeable and entirely outside their control — the Commission was unable to obtain documents through the CSRC under a long-established system of international cooperation. To the contrary, the evidence shows that Respondents fully and reasonably expected that the Commission would continue its decades-long policy of obtaining documents for foreign countries under the web of international agreements that it had built. Respondents gave express notice in their PCAOB registration applications that documents would have to be produced through the CSRC, and the PCAOB accepted their applications despite such notice. After the Division requested documents from them, Respondents communicated with the CSRC and were specifically advised that existing procedures had to be followed and that documents could only be produced to the

Commission through the CSRC. DTTC even produced its Client A workpapers to the CSRC with the understanding that they would be provided to the Commission.[11]

Second, if the Division's logic is accepted, then permitting foreign public accounting firms from numerous countries with secrecy laws or blocking statutes to register with the PCAOB amounted to a devious trap laid by the Commission and the PCAOB. Indeed, under the Division's logic, every foreign public accounting firm from a country with secrecy laws or similar statutes is unfit to practice before the Commission and is subject to suspension at the Commission's discretion. The Division is quite forthright about this, contending that § 106(f) gives the Commission staff the sole and unreviewable discretion to choose between (i) respecting reasonable and justified expectations that the Commission would seek and obtain workpapers under applicable MOUs or (ii) forcing a foreign public accounting firm into the untenable choice between violating foreign law or violating § 106. See id. at 4-5. In this case, however, the Commission never even gave the MOU process a chance to succeed — it unilaterally cut off negotiations with the CSRC last November and never even submitted requests to the CSRC for the workpapers of any of the audit clients of KPMG Huazhen, Dahua, EYHM, or PwC. In the context of sanctions, the Division's position veritably smacks of arbitrary and capricious agency behavior.

Third, the Division's position ignores the fact that the Commission itself assumed certain risks by (and obtained benefits from) permitting China-based accounting firms to register with the PCAOB even after they gave notice that Chinese law would prevent them from producing workpapers outside of the MOU process. The current impasse between the SEC and

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[11] Respondents will also demonstrate at the hearing that they have devoted substantial resources in terms of training, time, and money in developing their expertise in U.S. GAAP and PCAOB auditing standards. Any suggestion that they would have done so knowing that they might be suspended if bilateral negotiations between the Commission and the CSRC to resolve the issue of workpaper access proved difficult defies credulity.

CSRC was almost certainly no more foreseeable to the Commission than to Respondents. See, e.g., Christopher Cox, Message from US Securities and Exchange Commission Chairman Christopher Cox, China Bus. Rev., May-June 2006, at 17. ("[I]n my view, our two nations have but one wise course, and that is to work together to . . . nourish our markets and protect our investors."). But it would be unfair to the point of irrationality to sanction Respondents because of unexpected complications in the Commission's dealings with the CSRC. It is uniquely within the power of the Commission — and entirely outside the power of Respondents — to work with the CSRC to overcome such problems, as confirmed by the new MOU recently entered into by the PCAOB and the CSRC and MOF.

D. Imposing Sanctions Against Respondents Would Have Substantial Negative Collateral Consequences

In deciding whether sanctioning Respondents would be in the public interest, the Commission must consider mitigating factors such as the collateral impact on Respondents and third parties, including investors. See PAZ, 494 F.3d at 1065; Saad, 2013 WL 2476807 at *5. The Division has not yet disclosed what sanctions it will seek, but it is likely that it will request that the Commission enter an order barring the Respondents, on either a temporary or permanent basis, from appearing or practicing before the Commission. It if does, such sanctions would not be in the public interest, but would instead inflict substantial harm not only on Respondents, but also on issuers, investors, and the U.S. securities markets. These negative effects are not a speculative "parade of horribles"; they are the natural, and substantially automatic, consequences of imposing any sanction on Respondents.

1. Respondents Would Be Unable to Participate in Audits of Issuers With Operations in China

Issuers of securities registered to be traded on national securities exchanges must file periodic reports with the Commission, including annual reports on Form 10-K or 20-F. See

Exchange Act, 15 U.S.C. §78m(a)(2); 17 C.F.R. § 240.13a-1. Such reports must include audited financial statements along with a report from the auditor expressing its opinion on the financial statements. See, e.g., 17 C.F.R. §§ 210.2-02; 210.3-01-04; 210.3-19. As will be established at the hearing in this matter, KPMG Huazhen and the other Respondents currently audit and prepare audit opinions for approximately 100 issuers with operations in China whose securities are traded publicly in the U.S. They play a substantial role (as defined in PCAOB Rule 1001(p)(ii)) in the audits of an additional approximately 25 such issuers.[12] These issuers have an aggregate market capitalization of approximately $550 billion.

The term "practicing before the Commission" is defined to include the "preparation of any statement, opinion or other paper by any . . . accountant . . . filed with the Commission in any registration statement, notification, application, report or other document." 17 C.F.R. § 201.102(f). The Commission defines "practicing" in this context broadly; for the purposes of Rule 102(f) the accountant need not even have played a substantial role in an audit to have "practiced." The Commission has held, for instance, that merely preparing data to be included in a document filed with the Commission is sufficient to constitute "practicing before the Commission." See Armstrong, Exchange Act Release 51920, 2005 WL 1498425, at *11 (June 24, 2005) Thus, an order suspending or debarring Respondents from "practicing before the Commission" would likely prohibit them entirely from continuing to participate in the audits of approximately 125 China-based issuers and require them to withdraw from those engagements.

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[12] Under PCAOB Rule 1001(p)(ii)(2), a firm plays a "substantial role in the preparation or furnishing of an audit report if it "perform[s] 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."

2. Respondents' Audit Clients Have No Reasonably Available Substitute

The collateral impact on China-based issuers resulting from such an eventuality will be substantial. These issuers will be forced to attempt to find and retain new auditors. Indeed, depending on the timing of the Commission's decision, they may be required to do so on an expedited basis shortly before the ends of their financial years and the due dates of their annual reports. The task for these issuers will not be easy. Under §§ 102 and 106(a)(1) of the Sarbanes-Oxley Act, any accountant seeking to audit an issuer must be registered with the PCAOB. Under Chinese law, any accountant seeking to perform audit services in Mainland China must either be licensed by the CICPA or have obtained specific prior approval from the Chinese authorities. See Tang Report ¶ 35.

As will be shown at the hearing, as of June 2013, only 45 China-based accounting firms are registered with the PCAOB. Respondents are among the largest and most experienced of those firms. Indeed, holding Respondents and members of their international networks aside, only 4 of those 45 firms have previously issued an audit report for an issuer, and only 7 have played a substantial role in the audit of an issuer. Simply put, apart from the professional corps that Respondents have developed,[13] there is not a large pool of experienced, China-based, PCAOB-registered accounting firms standing ready to assume — or capable of assuming[14] — responsibility for the audits currently being performed by Respondents.

[13] The Division has suggested in a related proceeding, and will likely do so here as well, that Respondents have earned substantial revenues from their audits and audit work performed for U.S.-listed companies. As will be shown at the hearing, those revenues pale in comparison to the costs, in dollars and resources, expended in building practices throughout China capable of performing audit work under U.S. standards. Respondents built for the long-term, reasonably believing that the SEC and the CSRC would resolve any differences that unexpectedly arose.

[14] A recent decision by the PCAOB highlighted the dangers of unqualified firms attempting audits of Chinese issuers. See Brock, Schechter & Polakoff, LLP, PCAOB Release No. 105-2012-002 (May 22, 2012) (firm with no previous experience auditing under PCAOB standards or auditing companies based in China, and no ability to understand or communicate in Chinese); Waggoner, PCAOB Release No. 105-2012-002 (May 22, 2012) (imposing sanctions against affiliated accountant).

More fundamentally, any China-based, PCAOB-registered accounting firms that step forward to replace Respondents will confront exactly the same Chinese restrictions on the direct production of workpapers to the Commission as Respondents. Such firms will be no more able to produce workpapers directly to the Division than Respondents. Given the current impasse between the SEC and CSRC, it is highly doubtful that many (if any) of these firms would find it in their interests to undertake new audits and risk becoming embroiled in disciplinary proceedings identical to this one. It is also highly doubtful that the audit committees of issuers would find it prudent to engage auditors willing to incur such risks. Thus, it is quite unreasonable to assume that the issuers currently audited by Respondents will be able to quickly and seamlessly find qualified replacement auditors.

3. The Lack of Audited Financial Statements Will Have Serious Consequences for Issuers and Investors

Issuers that are not able to find China-based, PCAOB-registered auditors to replace Respondents will face serious additional consequences. An issuer's failure to timely file periodic reports as required under Exchange Act § 13(a) is grounds for the Commission to suspend or revoke the registration of its securities. See 15 U.S.C. §78l(j). These consequences are not, however, automatic; the Commission must choose to initiate such proceedings.

Other consequences are automatic and are largely outside the Commission's control. Securities exchanges in the United States impose a variety of requirements on issuers as conditions of continued listing. These requirements include, among others, the timely filing of annual reports containing audited financial statements with the Commission. See NASDAQ Equity Rule 5250(c)(1)-(2); NYSE Listed Company Manual § 802.01E.[15] Under exchange rules,

[15] The NASDAQ further requires that issuers be audited by an independent accountant registered with the PCAOB. See NASDAQ Equity Rule 5250(c)(3).

violation of these requirements automatically set in motion procedures which — if the failure is not cured — may result in the suspension and delisting of the issuer's securities. See NASDAQ Equity Rule 5810(c)(2); NYSE Listed Company Manual §§ 802.01E; 804. FINRA similarly requires that issuers' periodic filings be current in order to be quoted on the OTC Bulletin Board. See FINRA Rule 6530(a)(2).

A natural and likely consequence of suspending Respondents in this case would, thus, be to move the securities of scores of China-based issuers from the liquid and transparent exchanges on which they are currently traded to the over-the-counter market, a market known for its illiquidity, opacity, and risk. As will be demonstrated at the hearing, such moves are typically associated with substantial declines in share value — and corresponding losses to current investors — regardless of the reason for the move. Although large, sophisticated investors may be able to use over-the-counter transactions to dispose of their investments in such issuers, small investors may not. Indeed, some commentators believe that investors in China-based, U.S.-listed companies have already been harmed by the prospect of such a move. See R. Daniel O'Connor, et al., SEC's Charges Against Chinese Affiliates of U.S.-Based Accounting Firms Have Broad Implications, 45 Sec. Reg. & Law Rep. 675 (Apr. 15, 2013) ("The potential severity of the situation and lack of clear solutions for issuers were not lost on investors and directly contributed to an immediate decline in the share prices of many such [companies] . . . following the SEC's December 2012 action.").

4. U.S.-Based Multinational Corporations That Do Business in China Will Also Suffer Collateral Consequences

It is critical to note that the collateral consequences of sanctioning Respondents will not be limited to China-based issuers. Four of the Respondents also routinely support audits by members of their international networks of well-known multinational companies based outside of China that trade on U.S. exchanges, a service they would no longer be able to provide if suspended. As will be shown at the hearing, a number of large multinational companies have operations in China — including some of the Fortune 500. Those companies' financial statements must cover their Chinese operations and must be audited. And, as previously discussed, audit work performed in China must be performed by licensed Chinese accountants or accountants who have obtained specific prior approval from the Chinese authorities. See Tang Report ¶ 35. If Respondents are suspended, multinational issuers will be forced to (i) enlist less experienced Chinese auditors who are willing to violate Chinese law to fill Respondents' roles or (ii) risk being unable to obtain unqualified audit reports from their principal auditors — an event that can trigger delisting proceedings. See, e.g., NYSE Listed Company Manual § 802.01E. Moreover, experienced and qualified professionals may be deterred from serving on the audit committees of multinational companies if they are required to make such choices. Any sanction preventing Respondents from continuing to support audits of both China-based companies and multinationals with operations in China, thus, poses grave threats to those companies and their investors.

E. Imposing Sanctions Against Respondents Would Not Have Any Remedial Effect

Under Rule 102(e), any sanction imposed must be remedial in nature, not punitive. See McCurdy v. SEC, 396 F.3d 1258, 1264 (D.C. Cir. 2005) ("The Commission may impose sanctions for a remedial purpose, but not for punishment."); Touche Ross, 609 F.2d 570 at 579.

The imposition of sanctions against Respondents in this case will do nothing to resolve the Division's difficulties in obtaining work papers located in China. Rule 102(e) does not give the Commission the authority to order the production of documents. And — although this proceeding is indisputably about Respondents' inability to produce such documents — the Division has conceded that these proceedings cannot be used to obtain such an order.

More importantly, sanctions would serve no remedial purpose given the unique circumstances of this case. The Commission's authority under Rule 102(e) is limited to imposing sanctions that are truly remedial — and not punitive — in nature. See, e.g., McCurdy, 396 F.3d at 1264. This requires the Commission to "do more than say, in effect, [Respondents] are bad and must be punished." Blinder, Robinson & Co. v. SEC, 837 F.2d 1099, 1113 (D.C. Cir. 1988) To the contrary, particularly in cases of suspensions from practice, the Commission must show that the sanction is rationally related to the risks that the sanctioned party will commit future violations and that lesser sanctions would be insufficient to protect the public interest. See PAZ, 494 F.3d at 1065; Steadman, 603 F.2d at 1142. Sanctions that fail to meet this standard are considered punitive and are not permitted. See, e.g., Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996).

In this case, sanctioning Respondents will do nothing to reduce the occurrence of future violations of § 106(e) for the simple reason that it will not resolve the conflict of laws that China-based, U.S.-registered accounting firms currently face. As will be demonstrated at the hearing, Respondents did not fail to produce documents in response to the Commission's § 106(e) requests because they were "incompetent or unethical," Touche Ross, 609 F.2d at 581, or predisposed to flouting their obligations to the SEC, or even "bad," but because complying with the Commission's requests would have required them to break the laws of the foreign country in which they are located. If Respondents are censured, they remain unable to comply with the Commission's requests without violating Chinese law. If they are suspended, any accounting firm that replaces them will face the same intractable conflict of laws that led to these proceedings. In short, sanctioning Respondents will not remedy anything and would only punish Respondents for having been caught in an international dispute between the SEC and the CSRC.

V. CONCLUSION

For reasons stated above and in the DTTC Brief, the Division will be unable to prove that Respondents willfully refused to produce documents requested by the SEC. Even if Respondents are found to have violated § 106, however, imposing sanctions on them would be inappropriate under the circumstances, impermissibly arbitrary and capricious, and against the public interest.

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