ADMINISTRATIVE PROCEEDING
FILE NOS. 3-14872, 3-15116

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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 DTTC'S PRE-HEARING BRIEF

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Respondent Deloitte Touche Tohmatsu Certified Public Accountants Ltd. ("DTTC") respectfully submits this Prehearing Brief pursuant to Rule 222 of the U.S. Securities and Exchange Commission (the "SEC" or "Commission") Rules of Practice, 17 C.F.R. § 201.222, and the June 10, 2013 Order on Joint Motion to Amend Hearing and Prehearing Schedules.[1]

I. PRELIMINARY STATEMENT

This is an extraordinary proceeding in which the Division of Enforcement (the "Division") seeks sanctions against Respondents because they have refused to commit a crime or otherwise violate China law and the express directives of Respondents' China regulators.[2] Consistent with disclosures Respondents made beginning nearly a decade ago, Respondents cannot produce audit workpapers and other documents directly to the SEC, and the Division must seek them through customary regulator-to-regulator channels. Apparently dissatisfied with the pace of progress of negotiations with its counterpart in China (the China Securities Regulatory Commission ("CSRC")), the Division initiated this proceeding against Respondents, using the threat of severe sanctions as a bargaining chip in those international negotiations. The Division alleges that Respondents' inability to comply with the Staff's document demands constitutes a "willful refusal" to comply under Section 106(e) of the Sarbanes-Oxley Act ("SOX"), and therefore a willful violation of the federal securities laws for purposes of Rule

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

[2] DTTC is joined in this brief by Respondents Dahua CPA Co., Ltd. ("Dahua"), Ernst & Young Hua Ming LLP ("EYHM"), KPMG Huazhen (Special General Partnership) ("KPMG Huazhen"), and PricewaterhouseCoopers Zhong Tian CPAs Limited ("PwC Shanghai"). Accordingly, DTTC focuses on common facts and arguments on behalf of all Respondents.

102(e)(1)(iii). But the Division is unable to satisfy its burden under these provisions for multiple reasons.

First, under Section 106, it is not enough—as the Division apparently contends—that Respondents did not produce the requested documents. The Division must prove that Respondents "*willfully refused*" to comply with the Section 106 Requests to impose sanctions. The term "willful refusal" is a rare and exacting formulation in the U.S. Code. There are numerous statutes in which the word "willful" is used (including the statutes upon which the Division relies) and there are other statutes in which a simple "refusal" is enough to trigger action. But here Congress paired the term "willful" with "refusal." The term "refusal" already requires knowing and intentional conduct, and the combination of those terms must be given meaning. If Congress had intended Section 106(e) to reach every knowing failure to produce documents (as the Division asserts), Congress would have omitted the word "willful" because a mere "refusal to comply" is, by definition, a knowing and voluntary act. One cannot refuse inadvertently or unknowingly. *See, e.g.*, *United States v. Seigel*, 168 F.2d 143, 147 (D.C. Cir. 1948) (reasoning that conduct may have constituted either a "refusal" or an "inadvertent failure"). Thus, the plain language demonstrates that Congress intended the "willful refusal" standard to require proof of more than just conscious conduct; it requires a culpable state of mind. *See Fed. Power Comm'n v. Metro. Edison Co.*, 304 U.S. 375, 387 (1938) ("[t]he qualification that the refusal must be 'willful' fully protects one whose refusal is made in good faith"). This construction is reinforced by the principle of prescriptive comity, by which courts must construe statutes to "avoid unreasonable interference with the sovereign authority of other nations." *F. Hoffman-La Roche Ltd. v. Empagran, S.A.*, 542 U.S. 155, 164 (2004). That principle does not permit a reading of Section 106 under which good faith efforts to comply with

foreign law, including foreign criminal and other fundamental laws, constitutes a violation of U.S. securities laws. *See id.*; *see also Societe Internationale pour Participations Industrielles et Commerciales v. Rogers*, 357 U.S. 197 (1958) (good faith inability to comply based on foreign law should preclude sanctions). The "willful refusal" standard thus requires the Division to prove that Respondents acted with bad intent or a lack of good faith.

The Division cannot make such a showing here, and, in fact, it does not even allege an absence of good faith in the OIP. The Division argues instead for a legally flawed interpretation of "willful refusal" that would authorize the Division to punish virtually any failure to produce documents—even where, as here, Respondents have acted with utmost good faith. SEC's Consolidated Opposition to Respondents' Motions for Summary Disposition as to Certain Threshold Issues ("SEC's Opp."), at 3 (citing *Mathis v. SEC,* 671 F.3d 210, 217 (2d Cir. 2012); *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000)). Under the correct legal standard, the Division simply cannot prove that Respondents *willfully refused* to comply with the Section 106 Requests. Rather, Respondents will show through their fact and Chinese law expert witnesses that they have acted in the good faith (and correct) belief that Chinese law and the express directives of Chinese regulators prohibit Respondents from producing the requested documents directly to the SEC.

Respondents have been transparent about these limitations, which are well known to and otherwise acknowledged by the SEC. And when the SEC asked them to produce documents in violation of these laws, Respondents did their utmost to facilitate production of the documents to the SEC Staff by producing documents (or attempting to do so) directly to the CSRC so as to allow production of the documents to the SEC, and by otherwise working diligently with the CSRC on production issues with the SEC's knowledge and encouragement. Respondents

continue to stand ready to produce the documents to the SEC directly, or to take any further action to facilitate production by the CSRC, at the moment they are authorized by Chinese regulators to do so. What Respondents could not and cannot do is what the Division's China law expert proposes: pretend that the CSRC directives and China law did not exist or do not mean what they say, and surreptitiously sneak the workpapers out of China and hand them over to the SEC. If any of the Respondents had followed that proffered course of conduct, its responsible personnel could be imprisoned and the firm could receive the corporate death penalty of dissolution.

Second, the Division cannot prevail because the underlying Section 106 Requests are unenforceable under well-established principles of international comity, and the Division has never made any effort to enforce them. There can be no "willful refusal" if the underlying requests are unenforceable.

Third, any sanction imposed on Respondents would constitute arbitrary and capricious agency action because it would be inconsistent with the SEC's current and historical positions. In particular, the SEC has for many years permitted initial public offerings by foreign private issuers that are audited by these Respondents, knowing that Respondents have said they will be unable to produce documents except in accordance with Chinese law. That SEC policy continues to this day. Further, this proceeding represents an unexplained departure from the Commission's longstanding policy and practice of seeking cooperative mechanisms for resolving conflicts of law such as the one presented here.

The SEC has an array of options to access audit workpapers in China. It can continue its negotiations with the CSRC, which give every indication of bearing fruit. In that regard, it can follow the lead of the Public Company Accounting Board ("PCAOB"), which last month

entered into a Memorandum of Understanding ("MOU") with the CSRC and China's Ministry of Finance ("MoF") authorizing the cross-border exchange of workpapers in enforcement investigations. Or the SEC can attempt to access workpapers through the PCAOB MOU, which expressly allows such sharing between the PCAOB and the SEC. The SEC has chosen instead to go forward with this disciplinary proceeding, in which the Division cannot meet its burden of meeting the "willful refusal" standard established by Congress under Section 106.

II. FACTUAL BACKGROUND

A. Respondents Are China-Based Firms Subject to Regulation by the CSRC and MOF

Respondents are accounting firms headquartered in China and which provide audit and other professional services throughout mainland China. Order on Motions for Summary Disposition as to Certain Threshold Issues, at 2 (Apr. 30, 2013). Whether they are or were (in the case of Dahua) members of global networks of accounting firms, each firm is a separate and independent legal entity, subject to the local laws of the particular country or countries in which it operates. *See United States v. Deloitte & Touche USA LLP*, 623 F. Supp. 2d 39, 41 (D.D.C. 2009), *aff'd in part, vacated in part*, 610 F.3d 129 (D.C. Cir. 2010). Respondents audit China-based companies, including those whose securities are listed on exchanges throughout the world, such as the Shanghai Stock Exchange, the Hong Kong Stock Exchange and the New York Stock Exchange. Respondents also perform audit procedures at the request of other firms with respect to SEC-registered multinational corporations with significant operations in China.

As China-based audit firms, Respondents are supervised and regulated by the CSRC and MOF. *See* Declaration of Xin Tang ("Tang Decl.") ¶¶ 33-34. The CSRC is China's principal securities regulator and has been explicitly vested with authority over cross-border securities supervision and regulation issues. *Id.* ¶¶ 33, 45. Together with other regulators, these

agencies enforce China's prohibition on the disclosure of audit workpapers and other documents. *See, e.g., id.* ¶¶ 11-17, 36-37, 41-42. Violation of these laws could result in suspension or dissolution of Respondents and imprisonment or other serious punishment for their personnel. *Id.* ¶¶ 68-79. Notwithstanding these prohibitions, the CSRC has consistently entered into agreements with foreign securities regulators in order to produce documents while respecting China sovereignty and law. To date, the CSRC has entered into cross-border securities agreements with over fifty national security regulators, including the SEC and last month's MOU with the PCAOB.[3] Each of the agreements between the SEC and CSRC recognizes the importance of the two regulators providing assistance to the other, "*consistent with the domestic laws of the*[*ir*] *respective states*."[4]

B. Section 106 of SOX

In 2002, as part of the Sarbanes-Oxley Act ("SOX"), Congress established a process by which the SEC could seek, in defined circumstances, the production of audit workpapers from "foreign public accounting firm[s]." 15 U.S.C. § 7216(b)(1)(A). In 2010, as part of the Dodd-Frank amendments to SOX, Congress made certain important modifications to this process. Congress recognized that administrative demands for foreign workpapers implicated sensitive issues of international comity and had the potential for exposing foreign public accounting firms to competing demands between U.S. law and regulators, on the one hand, and the firms' home

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3 *See* Respondents' Exh. 250, (CSRC, List of Bilateral MOUs Signed Between CSRC and its Overseas Counterparts (as of the end of February 2012) (Mar. 15, 2012)).

4 *See* Respondents' Exh. 194, at ¶ 2 (Memorandum of Understanding Regarding Cooperation, Consultation and the Provision of Technical Assistance between the SEC and the CSRC (Apr. 28, 1994)); *see also* Respondents' Exhs. 212, 213 (SEC and CSRC Announce Terms of Reference for Enhanced Dialogue (May 2, 2006)) (agreeing to "provide timely and thorough assistance to one another, *consistent with domestic laws*"); Respondents' Exh. 195, at Definition 7 (Int'l Org. of Sec. Comm'ns, Multilateral MOU Concerning Consultation and Cooperation and the Exchange of Information (May 2002)) (agreeing to "provide each other with the fullest assistance permissible to secure compliance with the respective Laws and Regulations" of the other signatories).

country laws and regulators, on the other. To mitigate this potential for conflict, Congress established a number of procedural protections for foreign public accounting firms. For example, under the original SOX version of Section 106, a foreign public accounting firm's failure to produce documents was not a violation of the federal securities laws at all. Dodd-Frank's amendments to Section 106 provided that such noncompliance violated the Exchange Act, *but only if it reached the level of a "willful refusal."* Similarly, to facilitate cooperation among the SEC and foreign regulators, Congress established a mechanism by which foreign public accounting firms could satisfy their obligations to produce workpapers by making a production directly to a foreign counterpart of the SEC, such as their home country regulator. *Id.* § 7216(f).

C. Respondents Register with the PCAOB

SOX also required that all public accounting firms (including Respondents) that audit "issuer" financial statements register and file annual reports with the PCAOB. In its implementing rules, the PCAOB explicitly permitted a foreign public accounting firm to register, notwithstanding that it would be required to withhold certain information under the laws of its home country. *See* PCAOB Rules 2105, 2207.6. Pursuant to its oversight responsibilities, the SEC itself approved these rules. *See* Order Approving Proposed Rules Relating to Registration System, Exchange Act Release No. 48,180, File No. PCAOB-2003-03, 68 Fed. Reg. 43,242 (July 21, 2003). In doing so, the SEC expressly "applaud[ed]" the PCAOB's "initiative to work with its foreign counterparts to find ways to accomplish the goals of the Act without subjecting foreign firms to unnecessary burdens or conflicting requirements," and "urge[d]" the PCAOB to continue to do so. *Id.* at 43, 243.

Respondents registered with the PCAOB in 2004 and 2005. Like numerous foreign audit firms from over fifty different countries,[5] Respondents declined, as permitted under the registration rules, to sign Exhibit 8.1 to its PCAOB registration form, which called for consent to "cooperate in and comply with any request for ... production of documents." *See, e.g.*, Respondents' Exh. 205, Item 8.1, Exh. 99.2 (DTTC Application for PCAOB Registration (Apr. 16, 2004)).[6] Respondents also provided legal opinions explaining that China law prevents them from providing "full cooperation" with overseas document requests, but that they would cooperate with those requests to the fullest extent permitted by applicable laws. *Id*, at Exh. 99.2. The SEC and PCAOB never questioned these legal opinions, and instead made the determination that, despite these potential foreign law impediments to document production, Respondents should be permitted to register, and that companies audited by Respondents would be permitted to sell securities in the United States.[7]

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[5] These countries include: Argentina, Australia, Austria, Bahamas, Bahrain, Belgium, Bermuda, Bolivia, Brazil, Canada, Cayman Islands, Chile, China, Colombia, Costa Rica, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Ireland, Isle of Man, Italy, Jamaica, Japan, Jersey, Kazakhstan, South Korea, Luxembourg, Malta, Mexico, Netherlands, New Zealand, Norway, Panama, Papua New Guinea, Paraguay, Poland, Portugal, Romania, Russian Federation, Singapore, Slovakia, South Africa, Spain, Sweden, Switzerland, Taiwan, Ukraine, and the United Kingdom. *See* www. pcaobus.org.

[6] *See also* Respondents' Exh. 40, Item 8.1, Exh. 99.2 (Dahua Application for PCAOB Registration (Sept. 25, 2005)); Respondents' Exh. 1, Item 8.1, Exh. 99.2 (EYHM Application for PCAOB Registration (May 25, 2004)); Respondents' Exh. 365, Item 8.1, Exh. 99.2 (PwC Shanghai Application for PCAOB Registration (Apr. 26, 2004)); Respondents' Exh. 513, Item 8.1, Exh. 99.2 (KPMG Huazhen Application for PCAOB Registration (Apr. 26, 2004)).

[7] In a letter notifying Respondents that it had approved their registration application, the Board stated that such approval would "not estop the Board from contesting the invocation of any particular non-U.S. law that [Respondents] might raise as an obstacle to complying with a Board demand or as a defense to a Board sanction for noncooperation." SEC's Exh. 7 (PCAOB Letter to DTT Re Application (June 4, 2004)). While the PCAOB used this statement to preserve its ability to change its approach in the future, it never did. The PCAOB never brought an enforcement action against an accounting firm for their ongoing inability to provide documents as part of the PCAOB's inspection process. Rather, the PCAOB negotiated a government to government solution through its MOU with the Chinese agencies. More importantly, this statement by the PCAOB says nothing about the SEC's own policy and practice concerning this issue.

D. The DTTC Client A and Client G Engagements

Two such U.S. issuers for whom DTTC was engaged are DTTC Client A and Client G. DTTC Client A is a corporation that produces [redacted] *See, e.g.*, Respondents' Exh. 182, 34 [redacted] DTTC Client A is headquartered in China, with manufacturing operations in China. *Id.* at 33, 34. DTTC Client A's shares are listed on the [redacted] *See* Respondents' Exh. 59, 23, 45, 75 [redacted]

Client G is headquartered in Beijing and manufactures [redacted] in mainland China and operates in China through a number of subsidiaries. Respondents' Exh. 81, 1, Exh. 99.1 [redacted]. Client G's stock traded on [redacted] *See* Respondents' Exh. 78, Exh. 99.2 ([redacted]. [redacted] Shortly after it was hired to audit Client G's financial statements for the fiscal year ended [redacted] DTTC discovered certain potential irregularities in Client G's accounting. *See* Respondents' Exh. 78 [redacted]. DTTC immediately reported its discovery to Client G's Audit Committee and attempted to expand the scope of its audit procedures. Client G management did not permit DTTC to perform the audit procedures DTTC deemed necessary. *Id.* Rather than

back down in the face of this management intransigence, DTTC held firm and was fired by Client G. *Id.* As Client G disclosed to the Commission and investors:

[redacted]

Id. [redacted]

[redacted] *Id. at* Exhs. 99.2-4.

DTTC's engagement by Client G lasted a [redacted] and DTTC never issued an audit report for the company. *Id.* at 4. [redacted]

E. The SEC Seeks To Obtain Audit Workpapers and Other Documents from Respondents

At the request of the SEC, on July 6, 2010, the CSRC served a production request on DTTC seeking DTTC's Client A workpapers and stating as follows:

> On behalf of a foreign regulator and based on the relevant rules set out in the (1) Securities Law; (2) Memorandum of Understanding on Extra-Territorial Regulatory Cooperation between CSRC and the foreign regulator; and (3) Multilateral Memorandum of Understanding of the International Organization of Securities Commission (to which CSRC is a party), would you please provide

> us with the 2008 and 2009 audit working papers of [DTTC Client A] by 15 July 2010.

Respondents' Exh. 72. This was the first direct contact that DTTC had from *any* regulator (Chinese or U.S.) seeking its Client A workpapers. Just over two weeks later, DTTC produced to the CSRC nineteen boxes of documents related to its audits of DTTC Client A, including all final 2008 audit workpapers and in-process 2009 audit workpapers. Respondents' Exh. 92 (Letter from DTTC to CSRC regarding "[R]eporting and seeking direction regarding the request by the U.S. Securities and Exchange Commission ("SEC") for access to our working papers related to audits of [Client A] (Apr. 8, 2011). Several months passed, in which the SEC and CSRC engaged in regular discussions about various requests for assistance that the SEC made with the CSRC. *See, e.g.*, Tang Decl. ¶ 20; [redacted]

On March 11, 2011, after failing to obtain the documents through the CSRC, the SEC served a Section 106 Request on DTTC's designated agent. Respondents' Exh. 86. The Section 106 Request sought "audit workpapers and all other documents related to any audit work or interim reviews performed" for DTTC Client A in 2009. *Id.* In accordance with China law and advice from counsel versed in Chinese law—and given that it had already made a production of DTTC Client A workpapers to the CSRC in response to the earlier request from a "foreign regulator"—DTTC sought guidance from the CSRC concerning how it should respond to the SEC's direct request. *See* Respondents' Exhs. 115, 116 (Letter from DTTC to CSRC regarding "[Client A] - Request by SEC for audit working papers" (Chinese and English versions) (Aug. 10, 2011)). DTTC informed the Staff of this request and suggested that the Staff reach out to the

CSRC. A few days later, the Staff confirmed that it was in discussions with the CSRC and encouraged DTTC to follow-up with the CSRC on its own.

DTTC did so, and on April 19, 2011, an officer in the Accounting Department of the CSRC's Beijing office advised DTTC that the CSRC would address any future production of documents to the SEC and that DTTC was forbidden from producing the requested documents directly to the SEC. DTTC therefore advised the Staff that it was unable to produce directly the requested documents, but confirmed its willingness to make such a production if permitted by the CSRC. On July 6, 2011, the SEC issued a Wells Notice to DTTC indicating its intention to institute Rule 102(e) proceedings because of DTTC's inability to comply with the Section 106 Request.[8] Respondents' Exh. 110.

After having been so advised that China-based audit firms were forbidden from producing audit workpapers and other documents directly to the SEC, the Division nonetheless requested between April 2011 and October 2011 that Respondents voluntarily and directly produce such documents to the Division in connection with nine different investigations which are now at issue in this proceeding. Several Respondents dutifully informed their home country regulators (namely, the CSRC and MoF) of these cross-border requests from the SEC, and in response, the CSRC directed that they were not authorized to produce the requested documents to the SEC.

On October 10, 2011, all five Respondents (along with another China-based firm) were summoned to a meeting with representatives of the CSRC and the MoF. During the

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[8] Shortly thereafter, the SEC initiated a subpoena enforcement action in federal district court against DTTC concerning a subpoena it issued for audit workpapers and other documents related to DTTC's audit of Longtop Financial Technologies, Ltd. (the "*Longtop* action"). DTTC is prohibited by China law from producing the documents requested by the subpoena at issue in that case, which remains pending.

meeting, the CSRC and MoF representatives unequivocally stated that, under China law, the firms were not permitted to produce audit workpapers and other documentation directly to foreign regulators (including the SEC) without the consent of the CSRC and MoF. Following the meeting, the CSRC and MoF reiterated this position in a series of official letters from the CSRC, which included letters dated October 11 and October 17, and culminated in a letter dated October 26, 2011, titled *CSRC's Reply Letter Concerning Providing Archive Files Including Audit Workpapers Overseas by Certain CPA Firms*. Respondents' Exh. 20. Directed "To the Relevant Accounting Firms," the October 26, 2011 letter stated:

> Recently, certain accounting firms asked the Commission [CSRC] for instructions concerning the provision of audit working papers and other file documents abroad. After studying the matter and consulting with the Ministry of Finance, our reply regarding the relevant matters is as follows:
>
> The provision of audit working papers and other audit file documents abroad by accounting firms has to comply with the *Securities Law of the People's Republic of China*, the *Law of the People's Republic of China on Certified Public Accountants*, the *Law of the People's Republic of China on Guarding State Secrets*, the *Archives Law of the People's Republic of China*. These relevant laws, regulations, rules and regulation must be followed, together with the corresponding legal procedures.
>
> 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 cooperation mechanisms with the Chinese regulatory authorities.
>
> Accounting firms must adhere to the relevant Chinese laws, regulations, rules and systems, and properly respond to the relevant matters. *Any breach of the laws, rules and regulations, including providing working papers and other documents without authorization, would be held legally responsible by our relevant departments, according to law..*

Id. (emphasis added). The Division's expert on China law will testify that these letters should be read to *allow* the production of workpapers directly to the SEC. Had any of the Respondents read the letter this way (and none did at the time nor do Respondents' China law experts), such an interpretation easily could have led to a corporate death sentence for Respondents and jail time for the personnel who allowed such a production.

Respondents engaged in further dialogue with the CSRC and MoF, but ultimately were unable to secure permission to produce the requested documents directly to the SEC. Respondents were in close communication with the Division and each relayed to the SEC that the Chinese regulatory authorities would not permit Respondents to produce the requested documents directly to the SEC. Indeed, DTTC provided a copy of the CSRC's October 11, 2011 letter to the SEC Staff shortly after receiving it. Respondents' Exh. 130 (Letter from M. Warden to H. Schwartz (Nov. 10, 2011)).

By this time, the Division was well aware that Respondents were prohibited under China law and by the express directives of their regulators from producing audit workpapers and related documents directly to the Staff. Nonetheless, and in lieu of requesting the CSRC's assistance in obtaining the documents, the Division issued the Section 106 Requests at issue here between February and April 2012.[9] In the context of their ongoing discussions, Respondents again contacted the CSRC, and again were forbidden from producing the documents directly to the SEC.

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[9] Respondents' Exh. 48 (Section 106 Request for Dahua Client A (Feb. 1, 2012)); Respondents' Exh. 29 (Section 106 Request for Client B (Apr. 26, 2012)); Respondents' Exh. 23 (Section 106 Request for Client C (Feb. 2, 2012)); Respondents' Exh. 548 (Section 106 Request for Client D (Feb. 6, 2012)); Respondents' Exh. 549 (Section 106 Request for Client E (Feb. 9, 2012); Respondents' Exh. 547 (Section 106 Request for Client F (Feb. 3, 2012)); Respondents' Exh. 141 (Section 106 Request for Client G (Feb. 14, 2012)); Respondents' Exh. 382 (Section 106 Request for Client H (Feb. 8, 2012)); Respondents' Exh. 408 (Section 106 Request for Client I (Feb 16, 2012)).

F. The SEC Initiates Rule 102(e) Proceedings

In early 2012, DTTC and other Respondents were in frequent contact with the SEC and CSRC regarding the issue of audit workpaper access, in an effort to facilitate production. In April 2012, the CSRC offered to produce the DTTC Client A workpapers to the SEC on certain conditions. The SEC rejected the offer, and initiated a Rule 102(e) proceeding against DTTC (the "DTTC Proceeding") on May 9, 2012.

Shortly thereafter, the SEC apparently recognized that a negotiated solution with the Chinese authorities remained the best course (and the only way the SEC could obtain the documents). Thus, on two separate occasions, the SEC sought to delay or stay the DTTC Proceeding—with support from DTTC—while the SEC pursued a negotiated resolution. Most notably, on July 18, 2012, the SEC sought a six-month stay of the proceeding "because, at that time, the SEC was attempting to negotiate with [the CSRC] to develop a mechanism by which the SEC could obtain audit workpapers and other documents from audit firms based in China (including DTTC) in connection with enforcement investigations." Division of Enforcement's Motion to Consolidate ("Mot. To Consolidate"), at 3 (Dec. 7, 2012). The following day, the Administrative Law Judge determined that a six-month postponement of the proceedings was warranted under Rule 161(c)(1). *Id.* at 4.

Negotiations between the two regulators followed. But before an agreement could be reached (and while the PCAOB apparently continued to make progress with the CSRC), [redacted] On December 3, 2012, the Division sought to terminate the postponement of the DTTC Proceeding and filed the instant

omnibus administrative proceeding against Respondents.[10] The Division justified this approach on the grounds that its "negotiations with [sic] CSRC ha[d] ended unsuccessfully," that the "SEC Staff ha[d] concluded that the CSRC is not a viable gateway for the production of audit workpapers from China," and "that there is no realistic possibility that international sharing mechanisms will affect the resolution" of these proceedings. Mot. to Consolidate at 4. Declarations filed by the SEC in the *Longtop* action make clear that, notwithstanding the SEC's halting of negotiations, the CSRC came back to the SEC with a proposal for new procedures to allow for production of the audit workpapers. Respondents' Exh. 418, ¶¶ 12-14 (Second Declaration of A. Arevalo, filed in *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 11 Misc. 512 (D.D.C.) (Apr. 29, 2013)).

Further, on May 24, 2013, the PCAOB announced that it had entered into a MOU with the CSRC and MOF regarding the production of documents from China-based audit firms. Respondents' Exh. 277 (PCAOB News Release, "PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators"). The MOU took effect immediately and specifically provides for the CSRC, MOF, and PCAOB to provide each other with mutual assistance in obtaining, among other things, audit workpapers and other audit documents. Respondents' Exh. 274, Arts. III, IV, and XII (Memorandum of Understanding on Enforcement Cooperation between the PCAOB and the CSRC and the Ministry of Finance of China (May 10, 2013)). Under the MOU, the requesting party may use the documents and information in "enforcement proceedings," "any investigation," or "any other purpose permitted or required by ... authorizing statute, regulations or rules." *Id.* Art. VII. Importantly, the MOU provides that the PCAOB may "share such information" with the SEC pursuant to Section 105(b)(5)(B) of the Sarbanes-

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[10] Order Instituting Administrative Proceedings Pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice and Notice of Hearing (Dec. 3, 2012).

Oxley Act. *Id.* Art. IX(b), (c); *see also* 15 U.S.C. § 7215(b)(5)(B) ("Without the loss of its status as confidential and privileged in the hands of the Board, all information referred to in subparagraph (A) may ... be made available to the Commission ... ."). Indeed, the SEC has the statutory authority to compel the PCAOB to provide it with all such information. *Id.*

Despite these alternate means to obtain the requested audit workpapers, the Division has pressed ahead with its effort to sanction Respondents for their good faith inability to produce the requested documents without violating China law and exposing themselves to severe sanctions.

III. SECTION 106'S WILLFUL REFUSAL STANDARD REQUIRES LACK OF GOOD FAITH

A. Section 106's Willful Refusal Standard Requires the Division to Establish that Respondents Did Not Act in Good Faith

Under Section 106, only a "*willful refusal*" to comply with an SEC request for audit workpapers or other documentation constitutes a violation of SOX or the Exchange Act. 15 U.S.C. § 7216(e) (emphasis added). The term "willful refusal" is an extremely rare formulation in the U.S. Code. It requires the Division to prove that Respondents lacked good faith. The Division, however, has contended that the "willful refusal" standard is satisfied merely if Respondents "were in fact cognizant of their refusal to produce the requested documents." SEC's Opp. at 3 (citing *Mathis*, 671 F.3d at 217; *Wonsover*, 205 F.3d at 414). The SEC's construction is wrong, and relies on inapposite legal authority based on statutes that use the word "willful" rather than the "willful refusal" formulation at issue here. Here, the entire context of Section 106—its language, structure, and legislative history, as well as the principle of prescriptive comity—all demonstrate that establishing a violation of the "willful refusal" standard requires proof that Respondents did not act in good faith.

1. The Plain Language and Structure of Section 106 Are Inconsistent With the SEC's Interpretation of "Willful Refusal"

The plain language and structure of Section 106(e) make clear that the Division must prove a lack of good faith. Section 106 pairs the term "willful" with an act, "refusal," that already requires knowing and intentional conduct. *Seigel*, 168 F.2d at 147 (contrasting a "refusal" with an "inadvertent failure"); Black's Law Dictionary (4th ed. 1951) (refusal is defined as "the declination of a request or demand, or the omission to comply with some requirement of law, as the result of a positive intention to disobey"). In construing Section 106(e), each term must be given meaning, and neither "willful" nor "refusal" can be rendered superfluous. *See Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 112 (1991); *see also Bailey v. United States*, 516 U.S. 137, 146 (1995) ("We assume that Congress used two terms because it intended each term to have a particular, nonsuperfluous meaning"); *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883) (courts should "give effect, if possible, to every clause and word of a statute...."). Congress typically reserves the use of such "paired modifiers" for criminal statutes that address heightened culpability. *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 60 (2007); *see also Felton v. United States*, 96 U.S. 699, 702 (1878) (construing standard of "knowingly and willfully" to "impl[y] not only a knowledge of the thing, but a determination with a bad intent to do it or to omit doing it.") Congress's use of these two terms together in Section 106 makes clear its intent that "willful refusal" requires a lack of good faith.

The Division's construction of "willful refusal" runs afoul of these basic canons of statutory construction and simply ignore Congress's use of these two terms. The Division argues that it need only prove Respondents "intentionally commit[ed] the act which constitutes the violation," and not that Respondents' actions were taken with "bad purpose." *See, e.g.*, *Wonsover*, 205 F.3d at 414 (quotation and citations omitted). The Division thus reads "willful

refusal" so narrowly and illogically that the two word phrase is reduced to one. The Staff's interpretation might be correct if the statute simply said "willful" or "refusal," but not both. Thus, the Division's authority is inapplicable here, as it involves statutory language in which the term "willful" modifies terms that, unlike the word "refusal," do not themselves inherently require knowledge and intentionality (*e.g.*, "failure," "violation").[11]

The Division's position also ignores that Section 106 stands in sharp contrast to other provisions of the Securities Act and the Exchange Act. First, Section 22(b) of the Securities Act and Section 21(c) of the Exchange Act permit the SEC to seek judicial enforcement of a subpoena "[i]n case of contumacy by, or *refusal* to obey a subpoena," and even if such a court order is violated, that is not deemed a violation of the federal securities laws. *See* 15 U.S.C. § 78u(c) (emphasis added); 15 U.S.C. § 77v(b). In contrast, the standard in Section 106(e) is "willful refusal"—not just "refusal"—and such a "willful refusal" is deemed a violation of the Exchange Act. Both of these differences indicate that Congress intended to set a higher standard for culpability for violations of Section 106 than mere conscious action. Second, with respect to provisions governing document demands to brokers and dealers, Exchange Act Rule 17a-4(j) requires brokers and dealers to "furnish promptly" copies of their records upon request by the Commission. 17 C.F.R. § 240.17a-4(j). It does not provide that only a "willful refusal" is a violation of the Exchange Act. Thus, in *In re Dominick & Dominick, Inc.*, for example, when a broker failed to furnish promptly such records on the grounds that it was prohibited by Swiss

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[11] The baselessness of the Division's proffered construction of "willful refusal" is made clear by its implications. It would *require* foreign accounting firms to commit crimes abroad in order to comply with Section 106, and the firms could be banned from practicing before the Commission if they refused to do so. At the same time, however, a conviction for committing those same crimes abroad could potentially serve as the basis for suspension under Rule 102(e)(2). 17 C.F.R. § 201.102(e)(2) (providing that an entity that is convicted of a "felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing" before the SEC, without express limitation concerning the jurisdiction in which the conviction must be entered).

law, the Commission sanctioned and suspended the broker under 15 U.S.C. § 78o(b)(4)(D), which covers *both* "willful violations" of, and the inability to comply with Rule 17a-4(j). Rel. No. 34-29243 (S.E.C. May 29, 1991). Congress could have used § 78o(b)(4)(D) and Rule 17a-4(j) as a model for § 7216, but did not. Instead, Congress included the requirement that only a "*willful refusal*" to produce documents violates the federal securities laws. This legislative choice must be given proper effect.

Indeed, the Supreme Court's decision in *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005), directs that the term "willful refusal" be construed in precisely this manner. There, the government's central argument was that the word "corruptly" in the witness tampering statute, 18 U.S.C. § 1512(b), should be given the same meaning it has traditionally been given in the obstruction statute, 18 U.S.C. § 1503. Despite the similarity in context and the centuries of obstruction precedent supporting the government's view, the Supreme Court dismissed the argument in a terse footnote because in § 1512, unlike § 1503, the word "corruptly" is modified by "knowingly." 544 U.S. at 706 n.9. The Court concluded that the extra word rendered any statutory analogies "inexact," *id.*, and that it was required to reject the government's construction because the term "corruptly" would do "no limiting work whatsoever." *Id.* at 705 n.9, 707.

As in *Arthur Andersen*, both "willful" and "refusal" must be given meaning. The simplest and most sensible way to do so is by construing the terms to require consciousness of wrongdoing or a lack of good faith. Indeed, the only time the Supreme Court has ever been confronted with a statute in which it found that "willful" modified "refusal," it gave meaning to each word and construed the phrase to require a lack of good faith. *Metro. Edison Co.*, 304 U.S. at 387 ("The qualification that the refusal must be 'willful' fully protects one whose refusal is made in good faith and upon grounds which entitle him to the judgment of the court before

obedience is compelled."). So too here: the Division cannot satisfy the "willful refusal" standard without establishing that Respondents did not act in good faith.

2. The SEC's Interpretation of "Willful Refusal" Violates the Principle of Prescriptive Comity

The SEC's interpretation of "willful refusal" should be rejected for the further reason that it is inconsistent with the longstanding principle of prescriptive comity. The Supreme Court has directed that under this principle, any statutory ambiguity must be resolved in a way that "avoid[s] unreasonable interference with the sovereign authority of other nations." *See Empagran*, 542 U.S. at 164 ("This rule of statutory construction cautions courts to assume that legislators take account of the legitimate sovereign interests of other nations when they write American laws."); *see also, e.g., Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 817 (1993) (Scalia, J., dissenting) (explaining that the principle of "prescriptive comity" is "the respect sovereign nations afford each other by limiting the reach of their laws," which is "exercised by legislatures when they enact laws, and courts assume it has been exercised when they come to interpreting the scope of laws their legislatures have enacted").

The principle of prescriptive comity does not permit a construction of "willful refusal" that would make good faith efforts by a foreign accounting firm to comply with the laws of its home country (and refuse to commit a crime there) illegal under U.S. law. To avoid such "unreasonable interference" with foreign law—as the Supreme Court requires—the term "willful refusal" must at least be construed to require the Division to prove that Respondents were not acting in good faith. Indeed, there is a longstanding line of federal court decisions that takes precisely this approach. These cases have held that, primarily due to concerns about international comity, the imposition of severe sanctions on a foreign party that cannot produce documents in U.S. litigation because of foreign legal prohibitions should be limited to instances

in which the party did not act in good faith.[12] This principle is also set forth in the Restatement (Third) of Foreign Relations Laws of the United States, § 442(2)(b) (1987), which provides that "a court *or agency* should not ordinarily impose sanctions of contempt, dismissal or default on a party that has failed to comply with the order for production [due to foreign law prohibitions], except in cases of deliberate concealment or removal of information or of a failure to make a good faith effort...." (emphasis added). Here, prescriptive comity similarly requires a construction of "willful refusal" in which the Division must prove that the Respondents were not acting in good faith before sanctions can be imposed.

The legislative history of Section 106 comports with prescriptive comity's "assum[ption] that legislators take account of the legitimate sovereign interests of other nations when they write American laws." *Empagran*, 542 U.S. at 164. Before Dodd-Frank's enactment, Commission representatives informed Congress on multiple occasions of the sensitive issues of international comity that can arise in this context, including the obstacles faced by foreign accounting firms in producing documents directly to the SEC as well as the SEC's own efforts to coordinate with foreign regulators on these issues.[13] Dodd-Frank's

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[12] *See, e.g.*, *Societe Internationale*, 357 U.S. 197 (sanction of dismissal not appropriate where foreign party had acted in good faith but was unable to comply with document demands); *In re Sealed Case*, 825 F.2d 494, 488-89 (1987) (overturning a contempt order for refusal to produce documents to a grand jury on the grounds that compliance would violate the foreign bank secrecy laws, in part because the district court "specifically found that the [subject of the contempt order] had acted in good faith throughout these proceedings"); *Cochran Consulting, Inc. v. Uwatec USA, Inc.*, 102 F.3d 1224, 1226-27 (Fed. Cir. 1996) ("to avoid sanctions, the party that is unable to comply with a valid discovery request must have acted in good faith" and not colluded with a foreign government in "courting [the] legal impediments" (quotation and citation omitted)); *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111, 114 (S.D.N.Y. 1981) ("[T]he good faith of the party resisting discovery is a key factor in the decision whether to impose sanctions when foreign law prohibits the requested disclosure.").

[13] For example, the SEC Chief Accountant specifically testified that "[a]ccess to non-U.S. firms and their audit work papers, particularly in the European Union, Switzerland, and *China*, has been hindered due to the PCAOB's lack of explicit legal authority to share information with its foreign counterparts and other issues related to the coordination of inspections with local authorities and the resolution of potential conflicts of law." U.S. House Committee on Financial Services, Testimony Concerning Accounting and

amendments to Sarbanes-Oxley were primarily intended to support the SEC's and PCAOB's efforts to foster cooperative arrangements with foreign regulators while paying due respect to the challenges facing foreign accounting firms. *See, e.g.*, 15 U.S.C. § 7216(f) (establishing "alternate means" for foreign accounting firm to satisfy obligations through production to foreign counterpart of SEC); *id.* § 7215(b)(5)(C) (authorizing PCAOB to share inspection information with foreign regulators).[14] The legislative history contains no hint that Congress intended at the same time to violate the principle of prescriptive comity and *disrupt* these same cooperative efforts by making it illegal for foreign accounting firms to comply in good faith with the laws of their home countries. The term "willful refusal" therefore must be interpreted in a manner consistent with prescriptive comity and the known impediments potentially arising under foreign laws, as reflected in Section 106's legislative history. Viewed in that context, "willful refusal" means a refusal to provide documents that is not done in good faith—it does not punish a foreign firm's good faith efforts to comply with foreign laws and sovereignty.

Auditing Standards: Pending Proposals and Emerging Issues, James L. Kroeker, Chief Accountant, SEC (May 21, 2010) (emphasis added); *see also* U.S. Senate Banking Subcommittee on Security and International Trade and Finance, Testimony Concerning Continuing Oversight on International Cooperation to Modernize Financial Regulation, Commissioner Kathleen L. Casey, SEC (Jul. 20, 2010) ("[c]ertain provisions of the Dodd-Frank bill will facilitate supervisory cooperation between U.S. authorities and our foreign counterparts…").

[14] In discussing Section 105(b)(5)(C), the Senate Report described the significant number of registered accounting firms located in non-U.S. jurisdictions and noted that "[i]n conducting inspections abroad, the Board has sought to coordinate and cooperate with local authorities…." Senate Report, 111-176, at 152-53 (Apr. 30, 2010). The Senate Report explained that this new provision was included because the PCAOB had reported that efforts to obtain inspection information through cooperative sharing arrangements was hindered by the fact that the PCAOB, for its part, did not have authority to share its own inspection information with foreign regulators, and the Senate wanted to support these efforts by the PCAOB. *Id.*

B. "Willful Refusal" Is Not Satisfied Where Respondents are Unable to Comply Without Violating China Law

Even if the Division were correct (which it is not) that the term "willful refusal" requires nothing more than a conscious decision not to produce the requested documents, it is well-settled that the good faith inability to comply with document demands due to foreign law precludes sanctions in U.S. court. Thus, even under its own proffered standard, the Division cannot prevail here.

In *Societe Internationale*, the Supreme Court reversed a district court's dismissal of the plaintiff's case under Federal Rule of Civil Procedure 37 as a sanction for failing to disclose bank records that "would violate Swiss penal laws." 357 U.S. at 200. The Court stated that "Rule 37 should not be construed to authorize dismissal . . . when it has been established that failure to comply has been due to *inability*, and *not to willfulness*, bad faith, or any fault of petitioner." *Id.* at 212 (emphasis added); *see id.* 211 ("The findings below, and what has been shown as to petitioner's extensive efforts at compliance, compel the conclusion on this record that petitioner's failure to satisfy fully the requirements of this production order was due to *inability* fostered neither by its own conduct nor by circumstances within its control." (emphasis added)).[15] The Supreme Court thus made clear that the good faith inability to comply with document demands without violating foreign law is distinct from—and does not constitute—mere willfulness.

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[15] *See also United States v. Wendy*, 575 F.2d 1025, 1030 (2d Cir. 1978) ("A long recognized defense [to contempt charges] is the cited individual's inability to comply with the court's order."); *Smith v. O'Neill*, No. 99-00547 (ESH/DAR), 2001 U.S. Dist. LEXIS 12575, at *13-14 (D.D.C. Aug. 3, 2001) ("'[N]oncompliance with discovery orders is considered willful when the court's orders have been clear, when the party has understood them, and when the party's non-compliance *is not due to factors beyond the party's control.*'")(emphasis added) (citation omitted)); *see also United States v. Maccado*, 225 F. 3d 766, 772 (D.C. Cir. 2000) ("[a] good faith effort to comply with the order is a defense" to criminal contempt).

A number of subsequent cases have followed suit. *See, e.g.*, *Cochran Consulting, Inc.*, 102 F.3d at 1232 (where Swiss law prohibited disclosure, it was "necessary to consider whether [defendant's] failure to comply was 'due to inability, and not to willfulness, bad faith, or any fault of the petitioner.'" (citation omitted)); *In re Westinghouse Elec. Corp. Uranium Contracts Litig.*, 563 F.2d 992, 994 (10th Cir. 1977) (same regarding Canadian law); *Shcherbakovskiy v. Da Capo Al Fine, Ltd.*, 490 F.3d 130, 139 (2d Cir. 2007) ("the inquiry into *Russian law* ... will inform a finding as to appellant's *willfulness*, or lack thereof, in *refusing* to produce the documents.") (emphasis added). Indeed, in the context of civil litigation, a number of courts have recognized that "[l]egal and practical inability to obtain the requested documents ..., including by reason of foreign law, may place the documents beyond the control of the party who has been served with the Rule 34 request." *See, e.g.*, *Tiffany (NJ) LLC v. Qi*, 276 F.R.D. 143, 148 (S.D.N.Y. 2011) (quotation and citations omitted). Such an approach is also consistent with the longstanding principle that for a party to act "willfully," it must act "without justifiable excuse." Black's Law Dictionary 1434 (5th ed. 1979); *see also Bryan v. United States*, 524 U.S. 184, 192 n.12 (1998) ("willful" means, among other things, "without justifiable excuse" (quotation and citation omitted)). As recognized in *Societe Internationale* and its progeny, a foreign party's good faith inability to produce documents without violating the law of its home country is undoubtedly a "justifiable excuse" that precludes a finding of willfulness. Thus, at minimum and even under the Division's proffered construction, Respondents cannot be found to have "willfully refused" if they are constrained by foreign law and have acted in good faith.

IV. THE DIVISION CANNOT PROVE THAT RESPONDENTS WILLFULLY REFUSED TO COMPLY WITH THE SECTION 106 REQUESTS

A. The Division Cannot Establish Respondents' Lack of Good Faith

The Division cannot establish a "willful refusal" here because Respondents have acted in the good faith (and reasonable) belief that they are prohibited by China law and the express directives of their China regulators from producing the requested documents directly to the SEC, and nonetheless have made extensive efforts to facilitate production of the documents to the Staff. Respondents are simply caught between the conflicting laws and demands of two competing sovereigns. Respondents' refusal to commit a crime—or otherwise violate China law and the express directives of Respondents' China regulators—by producing documents directly to the SEC does not constitute a "willful refusal" under Section 106.

1. Respondents Cannot Produce the Requested Documents Without Violating China Law and Facing Severe Sanctions

Respondents are unable to comply with the Division's requests for direct production without violating China law and the express directives of their primary regulators, and exposing Respondents to the serious risk of severe sanctions in China. The CSRC and MoF have repeatedly directed Respondents—orally and in writing—not to produce the very documents requested by the Division in its Section 106 Requests. Tang Decl. ¶¶ 22, 25-26, 36; Declaration of James Feinerman ('Feinerman Decl.") ¶ 36 [redacted] These directives carry the full force of China law, and are based on, *inter alia*, the CSRC's authority concerning cross-border regulation and enforcement. Feinerman Decl. ¶¶ 36-45; Tang Decl. 43-48. Violation of these directives alone (independent of any other implicated China laws) would

subject Respondents to severe penalties including suspension of their business or dissolution altogether. Tang Decl. ¶¶ 68-79. With their very existence at stake, no reasonable China-based accounting firm would produce documents directly to the SEC in the face of such instructions.

The specific directives of Respondents' China regulators derive from a clear line of established China law imposing strict controls on the dissemination of commercially confidential or state sensitive information. These laws independently prohibit Respondents from producing audit workpapers to the SEC without appropriate regulatory approval.

- Article 25 of the State Secrets Law prohibits any "'organization or individual . . . [from] carrying or transmitting items containing state secrets out of mainland China without the approval of relevant authorities.'" Tang Decl. ¶ 54.

- Audit workpapers are considered "archives" under the PRC Archives Law and thus are prohibited from being transferred overseas without permission from the State Archives Administration ("SAA") and CSRC. *Id.* ¶¶ 59-60.

- Regulation 29 was jointly promulgated by the CSRC, State Secrecy Bureau ("SSB"), and SAA to govern the dissemination of audit workpapers and other documents abroad. It requires the China-based firms to obtain the approval of a number of regulatory authorities (including the CSRC, SSB and SAA before transmitting such documents to overseas securities regulatory authorities. Respondents' Exh. 296, Art. 6, 8 (Provisions on Strengthening Confidentiality and Archives Administration of Overseas Issuance and Listing of Securities ("Regulation 29") (Oct. 20, 2009)); Tang Decl. ¶ 41.

- Chinese law imposes a special "obligation" on accountants "to keep confidential their clients' trade secrets that they come to know in carrying out their business." PRC CPA Law, Art. 19 Respondents' Exh. 289 (Law of the People's Republic of China on Certified Public Accountants – Articles 5, 19 & 42); Tang Decl. ¶¶ 64-65. Article 253(A) of the PRC Criminal Law prohibits employees of any China entities from "illegally providing citizens' personal information obtained during the course of performing duties or providing services." Respondents' Exh. 286 (Criminal Law of the People's Republic of China – Articles 111, 219, 220, 253(a) & 398); Tang Decl. ¶¶ 66-67.

As with the directives, sanctions for violating these laws are severe. Accounting firms that violate these laws could be suspended from practice, have their licenses revoked, or face dissolution. Tang Decl. ¶¶ 68-79. Individual violators face the loss of their ability to practice their profession and, for certain violations, imprisonment. *Id.*

Whatever it now may argue, the SEC's own statements and actions over the course of the past several years confirm the conclusion that Respondents are prohibited by China law from producing documents directly to the SEC. As discussed above, the SEC nor the PCAOB never questioned, at the time or for years thereafter, the China law opinions accompanying Respondents' PCAOB registrations that China law prevents them from providing "full cooperation" with overseas document requests. As recently as December 3, 2012, the Division acknowledged in the *Longtop* action that Chinese law and directives prohibit Respondents' production of documents. *See* SEC's Reply Memorandum in Support of Its Application for Order Requiring Compliance with Subpoena at 3, DTTC Proceeding (D.D.C. Dec. 3, 2012) (stating that the SEC "does not contend—particularly in light of statements by the CSRC since the filing of this action—that DTTC bears no risk in complying with the Subpoena."; *see also id.* at 12 ("the SEC does not contend that DTTC bears no risk in complying with the Subpoena. . . ."); *id.* at 16 n.8 ("[W]e do not dispute that some sanctions could be imposed upon DTTC . . . .").

These statements about China law are consistent with views expressed by SEC and PCAOB leadership. In a 2012 speech, PCAOB board member Lewis Ferguson explained unequivocally that "[u]nder Chinese law, it is illegal to remove audit work papers from China." Respondents' Exh. 258 (PCAOB Speaker L. Ferguson Speech at California State University 11th Annual SEC Financial Reporting Conference (Sept. 21, 2012)). Similarly, former SEC Chairman Schapiro explained to Congress in 2011 that China views the SEC's efforts to obtain "direct access to witnesses and information" as "a possible violation of sovereignty and/or national interest," and that, "[i]n such cases" the SEC will "generally work with the jurisdiction's home regulator to pursue our enforcement aims." Respondents' Exh. 241, 6-7 (Letter and attachments from SEC Chairman M. Schapiro to Chairman P. McHenry (House Subcommittee

on TARP, Financial Services, and Bailouts of Public and Private Programs - Committee on Oversight and Government Reform) (Apr. 27, 2011).

Nor can the SEC's current suggestion that Respondents are free to produce the requested documents directly to the SEC be reconciled with (1) its purported "twenty-three (23) separate formal requests for assistance to the CSRC," SEC's Renewed Memorandum of Points and Authorities in Support of Its Application for Order Requiring Compliance with a Subpoena ("Renewed Mem.") at 3, *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 11 Misc. 512 (D.D.C. May 1, 2013), (2) the SEC's continued and ongoing negotiations with the CSRC concerning audit workpaper access, and (3) the substantial communications dating back to 2011 in which the SEC has explicitly or implicitly recognized the CSRC's authority in this area and the necessity of obtaining the workpapers in a regulator-to-regulator manner. *See, e.g.*, Tang Decl. ¶ 49; Respondents' Exh. 418, ¶¶ 12-14 (Second Declaration of A. Arevalo, filed in SEC v. Deloitte Touche Tohmatsu CPA Ltd., No. 11 Misc. 512 (D.D.C.) (Apr. 29, 2013)); Respondents' Exh. 183, ¶¶ 37, 39-42, 52 (First Declaration of Alberto Arevalo, filed in *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 11-0512 (D.D.C.) (May 1, 2013));

In this proceeding, the Division ignores these earlier statements and argues that there is enough ambiguity under China law to enable the Respondents to produce the documents and ignore the resulting peril to them. To support its "ambiguity theory," the SEC relies solely on a U.S. academic (Professor Donald C. Clarke), who attempts to parse the language of the various directives and Chinese laws to identify ambiguity that theoretically might have been exploited by

Respondents to produce documents directly to the SEC. In particular, Prof. Clarke reads the directives as merely requiring China-based audit firms to comply with pre-existing law, none of which (according to Clarke) prohibit production of the audit workpapers. But Prof. Clarke's contentions are unsustainable. There is nothing unclear about the written directives from the CSRC. They are unequivocal that "foreign regulatory agencies" seeking the production of audit workpapers from China must "resolve such matters through joint consultations using regulatory cooperation mechanisms with the Chinese regulatory agencies," and firms that produce documents to foreign regulators "without authorization" will be "held legally responsible ...." Respondents' Exh. 20 (Department of Accounting Correspondence [2011] No. 437 from the China Securities Regulatory Commission to Accounting Firms Concerned (official document in Chinese and unofficial translation in English (Oct. 26, 2011)). To the extent the directives refer back to pre-existing law, such provisions also prohibit the production of audit workpapers without approval. As Professor Clarke acknowledges, China law defines audit workpapers as "archives,"[16] and thus requires China firms to obtain government permission before producing such "archives" to foreign regulators. *See* Tang Decl. ¶ 60. Here, the CSRC has directed Respondents *not* to produce the requested workpapers. Accordingly, Respondents' direct production to the SEC would plainly violate China law independent of the CSRC's express directives. Tang Decl. ¶ 11.

Further, even if the written directives were ambiguous (they are not), the CSRC's oral directives to Respondents were not (an issue about which Clarke does not opine). And in any event, Professor Clarke's hyper-technical approach to construing the directives is entirely inconsistent with the manner in which China law is properly construed and understood. The

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16 Clarke Decl. ¶ 14.

"cultural and legal assumption" in China is that "any action of an entity that is subject to a comprehensive regulatory regime is not allowed unless specifically authorized." Feinerman Decl. ¶¶ 7, 41. In this environment, "no responsible company operating in China would attempt to take advantage of statutory or legal uncertainty and take an action that may be deemed illegal or viewed unfavorably by the government such that it could result in regulatory or other government repercussions." *Id.* ¶ 43. As such, the directives are properly understood as prohibiting direct production of audit workpapers to foreign regulators, and the violation of such directives would result in severe punishment. Tang Decl. ¶¶ 11-12, 37, 43-79. Moreover, as the CSRC, MoF, and other China governmental agencies generally have broad power to regulate, restrict, and punish conduct within their purview, the absence of an earlier express prohibition does not equate to consent to produce documents from the Chinese government. Feinerman Decl. ¶¶ 7, 41. In light of the express prohibition by the CSRC, China clarified its interpretation of China law, which is that it prohibits Respondents from producing documents directly to the SEC. Prof. Clarke's interpretation of China law—contrary to the China government's view of its own law—deserves no weight.

The SEC also argues that Respondents could interpret the China state secrets laws narrowly to circumvent the China prohibition on direct production. However, in China, the definition of a "state secret" is very broad, and ultimately must be evaluated in accordance with the directive and under the control of the Chinese government. *See* Tang Decl. ¶¶ 40, 57. While Respondents themselves must defer to the Chinese government concerning what constitutes "state secrets," Professor Tang—a Chinese law professor—has explained that, based on their clients' business, it is "very likely" that Respondents' audit workpapers would be deemed to contain state secrets and their production would therefore violate the applicable law. *See, e.g.*,

Tang. Decl. ¶¶ 52, 57. In light of the potential criminal liability, Professor Clarke's suggestion that the firms simply rely on their audit clients' determination of what documents constitute state secrets—and not consult the CSRC—is exceedingly unreasonable. *See* Clarke Decl. ¶¶ 25, 27. And, at the present time, Respondents are unable to obtain guidance directly from the SSB because the CSRC has asserted jurisdiction here in light of the cross-border nature of the requested production, and accordingly the SSB has directed Respondents' requests to the CSRC. Any production by Respondents would thus "very likely" violate China's state secrets laws and expose Respondents to the severe risk of criminal liability.

In any event, in light of the above, Respondents have undoubtedly acted in the good faith (and reasonable) belief that they are prohibited by China law and the express directives of their China regulators. That alone precludes a finding of "willful refusal," and the Division is therefore unable to meet its burden under Section 106.

2. Respondents Are Unable to Produce the Documents And Have Acted in Good Faith

In the face of these serious prohibitions under China law, Respondents have acted with good faith, and have taken steps to cooperate with the SEC and facilitate the production of the requested documents.

a. Respondents Disclosed the China Law Prohibitions When Registering with the PCAOB

When Respondents registered with the PCAOB nearly a decade ago, each of them clearly identified the potential limits on their ability to cooperate with documents requests from U.S. regulators.[17] This position was based on advice from qualified legal counsel, which itself was included in their PCAOB registration applications, and was consistent with well-known

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17 *See, supra*, note 7 and corresponding text.

legal restrictions in other countries. It was also consistent with the registration rules the PCAOB had developed for foreign public accounting firms, which the SEC itself "applauded" for not "subjecting foreign firms to unnecessary burdens or conflicting requirements." Exchange Act Release No. 48,180.

Well aware of these Chinese legal restrictions, the PCAOB and SEC were fully authorized to deny Respondents' applications, but instead permitted registration based on the "expectation that any potential obstacles to inspections would be resolved through cooperative efforts with foreign regulators." *See* PCAOB, *PCAOB Issues Release on Consideration of Registration Applications from Firms in Non-U.S. Jurisdictions Where There are Unresolved Obstacles to Inspections*, (Oct. 7, 2010), http://pcaobus.org/News/Releases/Pages/10072010_InternationalObstacles.aspx; *see also* PCAOB Release No. 2010-007 at 2 (Oct. 7, 2010) ("This practice was rooted in a belief that the PCAOB and authorities in those jurisdictions would, working cooperatively, overcome any obstacles to registered firms' compliance with PCAOB inspection demands for documents and information, and would do so without undue delay relative to the inspection schedule mandated by the Act."). Presumably, Respondents were permitted to register because of a desire to provide Chinese companies with access to the U.S. capital markets, and to ensure that both Chinese issuers and U.S. multinational companies with substantial operations in China would be audited by highly qualified accounting firms. Indeed, if the PCAOB had not approved the registration of firms that—like Respondents—faced foreign law restrictions on their ability to produce documents, the result would have been scope limitations in the audit reports of multi-national corporations whose foreign operations required foreign auditors to assume a "substantial role" in

their audits. Accordingly, those multi-nationals would not have been able to comply with SEC filing rules.

Respondents followed the rules that the SEC and PCAOB established, shared the U.S. regulators' expectation that "obstacles to limitation" would be "resolved through cooperative efforts with foreign regulators," and served as an important component of the SEC's effort to open the U.S. capital markets to China issuers while attempting to protect U.S. investors. Indeed, in most of the underlying investigations here, Respondents were responsible for identifying any potential fraud and bringing it to the SEC's attention. To now suggest that such conduct constitutes "bad faith" is simply not true.

b. Respondents Have Worked Diligently to Facilitate Production of the Requested Documents

When the SEC issued the Section 106 Requests here, Respondents have worked diligently to cooperate with the SEC and facilitate the production of the requested documents. When the CSRC asked DTTC, on behalf of a "foreign regulator," to produce audit workpapers in July 2010, DTTC made a full production to the CSRC in just over two weeks. *See* Respondents' Exhs. 115, 116 (Letter from DTTC to CSRC regarding "[Client A] - Request by SEC for audit working papers" (Chinese and English versions) (Aug. 10, 2011)); *see also* Respondents' Exh. 92 (Letter from DTTC to CSRC regarding "[R]eporting and seeking direction regarding the request by the U.S. Securities and Exchange Commission ("SEC") for access to our working papers related to audits of [Client A] (Apr. 8, 2011)). Since then, Respondents have engaged in numerous discussions with the CSRC and MoF about the SEC's requests for documents, with the purpose of seeking permission to produce the requested documents or otherwise facilitating a production by the CSRC to the SEC. Respondents even sought to produce certain types of documents directly to the SEC, but were instructed that the production of *any* documents must be

made through the CSRC. Some of the Respondents also attempted to liaise directly with the SSB, but were re-directed to the CSRC. As time passed, Respondents repeatedly worked to facilitate a CSRC production to the SEC. These efforts were in part responsible for the CSRC's offer of production to the SEC in April 2012, which the SEC rejected. There is nothing more that Respondents could reasonably do to produce the documents in this context. Far from lacking good faith, Respondents have taken every reasonable step to facilitate production, but have been instructed not to produce the documents to the SEC, and are thus, unfortunately, trapped in the middle of an international dispute between the CSRC and SEC.

Notwithstanding these efforts, the Division has suggested that Respondents were never under any obligation to seek approval from the CSRC to produce the documents in the first place, and therefore seeking such permission from the CSRC is evidence of bad faith. But Respondents' communications with their primary regulators in China cannot constitute bad faith. First, these communications were appropriate and required under applicable law. Article 179 of the Securities Law, Respondents' Exh. 291, vests the CSRC has authority over cross-border supervision and regulation issues, and Regulation 29, Respondents' Exh. 296, specifically requires China-based audit firms to obtain the CSRC's approval before producing documents to foreign regulators. Second, the Division's position ignores that the SEC itself was in contact with the CSRC concerning the production of the DTTC Client A audit workpapers long *before* any of the Respondents ever sought guidance from their China regulators. As such, the SEC itself—and not the Respondents—put the CSRC on notice about the SEC's efforts to obtain audit workpapers from China-based firms. When DTTC received the SEC's Section 106 Request for DTTC Client A workpapers, it was only natural that it would contact the CSRC, both because of applicable law *and* the fact that it had produced the very same documents to the CSRC less than

one year earlier. Indeed, the SEC knew about and *encouraged* DTTC to contact the CSRC regarding the production of documents. Third, under the general legal and regulatory environment in China, "no responsible audit firm operating in China would produce documents from China to a foreign regulator without first alerting its regulator." Feinerman Decl. ¶ 44. In doing so here, "Respondents acted reasonably, responsibly, and consistent with and as required by Chinese law in alerting the CSRC," and "had [they] not alerted the CSRC and simply produced the documents directly to the SEC they would have violated PRC law." *Id.* These is simply no basis for holding that Respondents' efforts to obtain guidance from the CSRC constitutes bad faith.

At bottom, the position of the Division and its China law expert to the contrary boils down to the following: if Respondents had only sneaked the workpapers out of China without alerting the Chinese authorities, the Chinese authorities would have never known Respondents were violating China law and sovereignty, and the instant impasse would not exist. To suggest *that* was the proper course is absurd. Indeed, it is inconceivable that the SEC would support such an approach if the shoe were on the other foot. The SEC's assertion that Respondents should have surreptitiously removed the documents from China—violating China laws and practices—does not satisfy the SEC's burden of showing Respondents' lack of good faith in willfully refusing to produce the documents.

B. The Underlying Section 106 Requests Are Unenforceable Under Principles of International Comity

The Division is also unable to establish that Respondents "willfully refused" to comply with the Section 106 Requests because those requests themselves are not enforceable under established principles of international comity. The Division has apparently disavowed any attempt in this proceeding to "seek the production of any documents relating to any of the

relevant requests from any of the audit firms."[18] But that does not alter the fact that if the Section 106 Requests are unenforceable—and therefore Respondents would not be required to comply with them—then there is no basis for concluding that Respondents "willfully refused" under Section 106.

Here, as discussed in Section A.1., it is clear that the Section 106 Requests would require Respondents (China-based audit firms) to violate Chinese law on Chinese soil, defy the direct orders of several Chinese governmental entities, and subject themselves and their personnel to potentially severe sanctions, including dissolution, revocation of their licenses, and imprisonment. The enforceability of document demands in such circumstances depends on a number of factors derived from the Restatement of Law of Foreign Relations and principles of international comity. *See, e.g.*, *United States v. First Nat'l Bank of Chi.*, 699 F.2d 341, 345 (7th Cir. 1983). These factors include: "(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 another 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." Renewed Mem. at 30.[19] Here, these factors must be applied in a

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[18] SEC's Memorandum of Points and Authorities Opposing Motion to Extend Stay ("SEC's Opp. to Mot. to Extend Stay"), at 6, *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 11 Misc. 512 (D.D.C.) (D.D.C. Jan. 24, 2013); *see id.* at 7 ("No production of documents is sought in [the previous DTTC 102(e)] proceeding."); *id.* at 18 ("[T]he Division does not seek to compel the production of documents in [this] proceeding.")

[19] Restatement (Third) of Foreign Relations Law of the U.S. § 442(1)(c) (1987); *see also In re Westinghouse Elec. Corp. Uranium Contracts Litig.*, 563 F.2d at 997; *Minpeco, S.A. v. ContiCommodity Servs., Inc.*, 116 F.R.D. 517, 522 (S.D.N.Y. 1987); Restatement (Second) of Foreign Relations Law of the U.S. § 40 (1965); *cf. Societe Nationale Industrielle Aerospatiale v. U.S. Dist. Court*, 482 U.S. 522, 544 n.28 (1987) (recognizing a draft of what is now § 442 of the Restatement (Third) of Foreign Relations Law of the United States as "relevant to any comity analysis").

manner consistent with the D.C. Circuit's strong reluctance to order a violation of foreign law on foreign soil. *In re Sealed Case*, 825 F.2d 494, 498 (D.C. Cir. 1987) ("[I]t causes . . . considerable discomfort to think that a court of law should order a violation of law, particularly on the territory of the sovereign whose law is in question."). It is clear that the balance of these factors—and the D.C. Circuit's instructions—preclude enforcement of the Section 106 Requests.

Alternate Means. In this case, the most significant factor in the analysis is the SEC's ability to "obtain the subpoenaed information through alternative means": a production from the CSRC. *Richmark Corp. v. Timber Falling Consultants*, 959 F.2d 1468, 1475 (9th Cir. 1992) ("If the information sought can easily be obtained elsewhere, there is little or no reason to require a party to violate foreign law."); *In re Sealed Case*, 825 F.2d at 499 (noting that it is "relevant to our conclusion that the grand jury is not left empty-handed by today's decision"). In seeking to press forward in this action, the Division has long contended that its "negotiations with the CSRC ha[d] ended unsuccessfully," and that the "SEC Staff ha[d] concluded that the CSRC is not a viable gateway for the production of audit workpapers from China." Mot. to Consolidate at 4. But it is now clear that the SEC has at least two viable avenues for obtaining the documents at issue here. First, in declarations filed in the *Longtop* matter as well as documents produced in this proceeding, the Division has revealed that the CSRC is "in the process of developing new procedures intended to facilitate the production of audit workpapers," which would allow for the production of the type of documents sought here, and that "former OIA Director Ethiopis Tafara [has] had several communications with the CSRC about these purported new potential procedures." *See* Respondents' Exh. 418, ¶¶ 12-14 (Second Declaration of A. Arevalo, filed in *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 11 Misc. 512 (D.D.C.) (Apr. 29, 2013)). In late March, the CSRC told the SEC that it "would start the new procedures with regard to the SEC's

prior requests for Longtop-related documents." *Id.* ¶ 14. In short, the negotiations between the SEC and CSRC give every indication of bearing fruit, and an order compelling the violation of foreign law would not be appropriate in that context.

Second, the PCAOB's recently announced MOU with the CSRC and MOF requires those agencies to provide each other assistance in obtaining audit workpapers and other audit documents, which can be used in "enforcement proceedings," "any investigation," or "any other purpose permitted or required by ... authorizing statute, regulations or rules." Respondents' Exh. 274, Art. VII (Memorandum of Understanding on Enforcement Cooperation between the PCAOB and the CSRC and the Ministry of Finance of China (May 10, 2013)). Critically, the MOU expressly provides that the PCAOB may "share such information" *with the SEC*—without seeking the Chinese agencies' consent or approval to do so. *Id.* Arts. VII, IX(b), (c); *see also* 15 U.S.C. § 7215(b)(5)(B). These two recently emerging alternate means would obviate the need to order Respondents to violate China law, and thus weigh heavily in favor of non-enforceability.

Indeed, requiring the SEC to pursue these viable alternate means of production before sanctioning Respondents is entirely consistent with the Congressional intent underlying Section 106. That provision was specifically enacted to provide the SEC with a mechanism to seek audit workpapers and related documents from foreign public accounting firms, and evidences Congress's sensitivities to the exact scenario here. Section 106(f) specifically provides that "[n]otwithstanding any other provisions of this section, the staff of the Commission or the Board may allow a foreign public accounting firm ... to meet production obligations ... through alternate means, *such as through foreign counterparts* of the Commission or the Board." 15 U.S.C. § 7216(f) (emphasis added). The SEC now asks this Court to disregard the possible

availability of alternate means altogether and instead sanction Respondents for obeying China law. Such a request is plainly inconsistent with the Congressional intent in this area.

Hardship of Compliance. As discussed in Section A.1, if Respondents were to violate China law and produce the documents directly to the SEC, they would be subject to severe sanctions in China. Violating the express directives from the CSRC and MOF could subject Respondents to suspension from conducting business or even dissolution altogether. These are extraordinarily severe sanctions that threaten the very existence of the firms. And if Respondents were to produce state secrets to the SEC, they would be subject to criminal penalties, and their personnel would be subject to imprisonment. These are not hypothetical risks: China vigorously defends its sovereign interests in state secrets, archives, and other protected information. Here, producing the requested documents in defiance of the CSRC's explicit instructions not to do so—and in the context of ongoing sovereign-to-sovereign negotiations—would put Respondents squarely in the cross-hairs of their local regulator. It is unrealistic to suggest that Respondents would not be subject to harsh sanctions in such circumstances. Critically, Respondents are third parties here, and risk of such a hardship "'should be imposed on a nonparty . . . only in extreme circumstances." *Tiffany (NJ) LLC*, 276 F.R.D. at 158 (quotation and citation omitted). Accordingly, this factor also weighs against enforceability.

Respective Sovereign Interests. The enforceability of the Section 106 Requests also depends on the "interests of each nation in requiring or prohibiting disclosure, and determine whether disclosure would affect important substantive policies or interests of either" the United States or China. *Richmark*, 959 F.2d at 1476 (quotation and citation omitted). In conducting that assessment, the D.C. Circuit has admonished that courts should not "'sit in judgment on the acts

of the government of another done within its own territory.'" *In re Sealed Case*, 825 F.2d at 498 (quoting *Underhill v. Hernandez*, 168 U.S. 250, 252 (1897)). Here, the Section 106 Requests implicate China's longstanding and fundamental interests in protecting information concerning its national security and economic interests and businesses controlled or invested in by the government, and maintaining the legitimacy of its laws regarding state secrets, archives, and privacy. *See* Feinerman Decl. ¶¶ 7, 30, 32. Like numerous other countries, China views an overseas regulator's attempt to compel the production of audit workpapers prepared and located in China as an intrusion on its territorial sovereignty and core interests, and has therefore chosen to channel all foreign securities regulators' requests for documents in China through the CSRC. *See* Feinerman Decl. ¶¶ 30-34. Enforcement of the Section 106 Requests would thus directly offend these core interests.

At the same time, it must also be recognized that, for a number of reasons, the SEC's interests in the documents at issue are not as significant. Notably, the Division has repeatedly disavowed any effort to "seek the production of any documents" in this proceeding. SEC's Opp. to Mot. to Extend Stay, at 6. It has forgone its statutory right to seek enforcement of the Section 106 Requests in court, and it has not even asked for the CSRC's assistance in obtaining the documents requested by eight of the ten Section 106 Requests. All of these actions belie any substantial interest in the requested documents themselves.[20] Respondents are witnesses whose documents may provide further evidence, but the SEC has other evidence and means of addressing the possible wrongful acts of others. Thus, the SEC's interests in Respondents documents is further removed than China's direct interest in regulating the firms within its

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[20] For these same reasons, the factor addressing "the importance to the investigation or litigation of the documents or other information requested," *Richmark*, 959 F.2d at 1475 (quotation and citation omitted), cuts decisively against enforcement.

borders and the flow of commercial and state secrets. As such, consideration of the sovereigns' respective interests weighs against enforcing the Section 106 Requests.

Location of Information and Parties. U.S. courts are disinclined to order compliance with a subpoena when the respondent is not a U.S. citizen and the information originated and is not located in the United States. *Richmark*, 959 F.2d at 1475. Indeed, the D.C. Circuit has explicitly acknowledged its substantial reservations about requiring a foreign entity to violate another country's laws in the territory of that state. *In re Sealed Case*, 825 F.2d at 498. Here, Respondents are China-based firms with no offices in the United States, and all of their personnel are located in China. All of the audit work was performed in China, and all of the documents sought by the SEC were prepared and are currently maintained in China. Thus, an order compelling compliance here would operate entirely outside the United States.

Taken together, these factors weigh heavily against enforcement. Accordingly, the Section 106 Requests are not enforceable and Respondents therefore cannot "willfully refuse" to comply with them.

C. Respondents' Objectively Reasonable Understanding of Their Obligations Under Section 106 Precludes a Finding of Willfulness

Even if it were *now* determined that the Section 106 Requests were valid and enforceable (despite the considerations set forth above), sanctions predicated on a "willful refusal" would be precluded by the Supreme Court's decision in *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47 (2007). Prior to this case of first impression, the Respondents reasonably interpreted their obligations under China and U.S. laws—with the assistance of qualified legal counsel. That objectively reasonable understanding cannot be punished, even if later clarified as incorrect under U.S. laws.

In *Safeco*, the Court considered the meaning of the term "willfully" in a civil penalty provision of the Fair Credit Reporting Act ("FCRA"). According to that provision, "[a]ny person who willfully fails to comply with any requirement imposed under" the FCRA "is liable" for various monetary awards. *See* 15 U.S.C. § 1681n. The Court concluded that although Safeco had indisputably failed to comply with a "requirement imposed under this title," Safeco was nonetheless absolved from liability because its violations were not done "willfully." In reaching that conclusion, the Court explained that a party does not "willfully" violate a statute if its conduct was based on an "objectively reasonable" interpretation of its legal obligations—even if that interpretation turns out to be mistaken. *Safeco*, 551 U.S. at 69-70 & n.20. Because Safeco's violations stemmed from an objectively reasonable (albeit erroneous) interpretation of its notice obligations, its failure to comply with those requirements was not "willful." When explaining why Safeco's mistaken interpretation was objectively reasonable, the Court emphasized that at the time Safeco committed the violations, "no court of appeals had spoken on the issue, and no authoritative guidance [had] yet to come from the [the governing agency]." *Id.* at 70; *see id.* at 70 n.20 (explaining that when "the statutory text and relevant court and agency guidance allow for more than one reasonable interpretation"—as was the case in *Safeco*—"it would defy history and current thinking to treat a defendant who merely adopts one such interpretation as a [willful] violator").

As in *Safeco*, Respondents' obligations to comply with the Section 106 Requests were ambiguous—and certainly subject to "more than on reasonable interpretation"—at the time they purportedly "willfully refused" to comply. The enforceability of document demands that require the recipient to violate foreign law on foreign soil is subject to a complex and fact-specific multi-factor test. In the D.C. Circuit, the possibility that such requests are unenforceable under

international comity factors is particularly heightened. *In re Sealed Case*, 825 F.2d at 498. Here, the Division has made no effort to enforce any of the Section 106 Requests, despite the provision of Section 106(b)(1)(B). Instead, the Division has sought to sanction Respondents even while acknowledging that the document requests at issue may not be enforceable at all in federal court, because ordering compliance with them would potentially expose Respondents to "severe sanction in China."[21]

Thus, even assuming the correctness of the Division's position, at the time the Respondents did not comply with the Section 106 Requests, the question whether they had an enforceable obligation to do so was very much unresolved. Regardless whether—as a procedural matter—the Division was required to enforce the Section 106 Requests in federal court before initiating the instant proceeding, it remains that the Division's approach left open several "reasonable interpretation[s]" of Respondents' obligations. Importantly, because the alleged "willful refusals" occurred before the issuance of the OIP, that objective ambiguity is not cured simply by a decision in these proceedings that the Section 106 Requests are enforceable. Under *Safeco*, such legal uncertainty precludes a finding of willfulness as a matter of law.[22]

V. THE SEC'S ATTEMPT TO SANCTION RESPONDENTS IS AN ARBITRARY AND CAPRICIOUS DEPARTURE FROM PRIOR POLICY

Even if the Division were able to satisfy the "willful refusal" standard under Section 106 (and it cannot), the imposition of sanctions under Rule 102(e) would be impermissibly

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[21] *In the Matter of Deloitte Touche Tohmatsu CPA Ltd*, A.P. 3-14872, Division of Enforcement's Memorandum of Law in Opposition to DTTC's Motion to Dismiss ("Opp."), at 8 n.1; *see also* Speech by PCAOB Member Lewis Ferguson, Investor Protection through Audit Oversight (Sept. 21, 2012), *available at* http://pcaobus.org/News/Speech/Pages/ 09212012_FergusonCalState.aspx ("[u]nder Chinese law, it is illegal to remove audit workpapers from China.").

[22] Even apart from the enforceability of the requests themselves, Respondents' obligations under Section 106 (including the contours of the "willful refusal" standard itself) were sufficiently unclear at the time of their alleged violations that a finding of willfulness is not permissible under *Safeco*.

arbitrary and capricious under the Administrative Procedures Act ("APA") for two independent reasons.

First, agency action is "arbitrary and capricious" when it is "internally inconsistent and inadequately explained." *Gen. Chem. Corp. v. United States*, 817 F.2d 844, 857 (D.C. Cir. 1987). Here, in the first and only case of its kind, the Commission has instituted these proceedings to sanction (and potentially ban from practice) foreign audit firms that are prohibited from producing documents directly to the SEC, while permitting initial public offerings by foreign issuers that are audited by these very same firms. For many years, the SEC has permitted initial public offerings by foreign private issuers that are audited by these Respondents, *knowing* that Respondents have said they will be unable to produce documents except in accordance with Chinese law. Most recently, the Commission approved an initial public offering *this year* by Beijing-based company LightInTheBox Holding Co., Ltd. ("LightInTheBox") months after initiating the omnibus proceeding, and approximately one year after initiating the DTTC Proceeding. Similarly, in late 2012, the Commission approved an initial public offering by China-based gaming company YY, Inc., well after the initiation of the DTTC Proceeding and having served Wells Notices on all of the Respondents. LightInTheBox and YY, Inc.'s financial statements are audited by certain of the Respondents. The Commission has offered no explanation for why Respondents' inability to produce documents directly to the SEC purportedly endangers the "Commission's processes" to the point that a ban from practice might be appropriate, but at the same time initial public offerings by companies audited by the Respondents should be approved. This inconsistency not only renders the Commission's attempt to sanction Respondents arbitrary and capricious, it also belies the Division's assertion that

Respondents' inability to produce documents to the SEC is a significant obstacle to investor protection.

Second, when an agency departs from a prior practice or policy, it generally "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 of course the agency must show that there are good reasons for the new policy." *Id.* The pursuit of sanctions under Rule 102(e) constitutes a significant shift in Commission practice—a change that has yet to be acknowledged, let alone reasonably explained. Until the initiation of these proceedings, the Commission's consistent position and practice has been that foreign public accounting firms would not be forced to violate the laws of their home country in order to comply with an SEC document demand. Indeed, for decades, in recognition of the conflicts between United States law and the law of other jurisdictions, the SEC has not put individual firms in the middle of these disputes, but has embarked on a consistent policy of negotiating MOUs directly with foreign regulators. This includes dozens of MOUs with individual regulators and a multilateral enforcement MOU that includes over fifty foreign regulators, including the CSRC.

Shortly after the enactment of SOX, then-SEC Chairman Harvey Pitt reaffirmed this approach, stating that the SEC needed to "accommodate the home country requirements and regulatory approaches of the home jurisdiction of our foreign registrants and potential registrants." Harvey L. Pitt, SEC Chairman, *Remarks at the* Financial Times' *Conference on Regulation and Integration of the International Capital Markets* (Oct. 8, 2002), *available at* http://www.sec.gov/news/speech/spch588.htm. And in July 2003, then-Acting Director of the Office of International Affairs Ethiopis Tafara stated that "we at the SEC recognize the

importance of balancing the interests of U.S. investors with the need for practical, measured solutions in the application of our rules to foreign actors. Accordingly, we will continue to establish high standards of investor protection, while striving to avoid unnecessary regulatory burdens, or subjecting foreign market participants to conflicts of law." Ethiopis Tafara, *Speech by SEC Staff: U.S. Perspective on Accountancy Regulation and Reforms* (July 8, 2003), *available at* http://www.sec.gov/news/speech/spch070803et.htm. Director Tafara acknowledged that "[i]t is certainly in no one's interest to put a foreign firm in a position where it must risk violation of its home country laws in order to do business in the United States . . . ." *Id.* As recently as 2011, then-Chairman Schapiro confirmed that when a foreign entity was prohibited from producing documents directly to foreign regulators, the SEC's policy was to "work with the jurisdiction's home regulator to pursue our enforcement aims." Respondents' Exh. 241, 6-7 (Letter and attachments from SEC Chairman M. Schapiro to Chairman P. McHenry (House Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs - Committee on Oversight and Government Reform) (Apr. 27, 2011)). Months later, that approach was abruptly abandoned by the SEC with the filing of the *Longtop* action and the institution of the DTTC Proceeding—without any explanation.

The PCAOB's own registration process has been consistent with the U.S. regulators' pronouncements about cooperation, and it has permitted numerous foreign audit firms from around the world to register despite declining to sign Exhibit 8.1 to its registration form—which called for consent to "cooperate in and comply with any request for . . . production of documents."—on the grounds that foreign law may prohibit them from doing so. As discussed *supra,* note 7, despite the PCAOB's effort in its reply letter to the Respondents to preserve—as a technical matter—its ability to take action against firms that did not produce documents, it has

persisted in its longstanding practice of seeking cooperative mechanisms for obtaining such documents. And in any event, that letter says nothing about the Commission's policies. The Commission had a longstanding *practice* of not imposing the sort of "between-a-rock-and-a-hard-place" dilemmas currently facing Respondents, and otherwise consistently indicated that it would not. The Division's decision to institute proceedings against Respondents marks a sharp and unexplained break from that past practice.

Without acknowledging a change in its position, the Division now seeks to sanction Respondents for refusing to violate the dictates of Chinese law. This unexplained inconsistency violates the hallmarks of reasoned decision-making. *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). The Commission remains free to issue regulations to address prospectively the issue, including by modifying the registration requirements for foreign public accounting firms. It has not done so, and instead seeks to change course in this proceedings without any reasoned decision-making process.

VI. SANCTIONS

As set forth above, DTTC does not believe there is any basis for the Commission to sanction Respondents. If Your Honor were to disagree, however, DTTC joins KPMG Huazhen's Pre-Hearing Brief, which fully address the potential sanctions issues, and adopts and incorporates by reference the arguments made therein.

VII. CONCLUSION

For the foregoing reasons, the Division is unable to prove that Respondents willfully refused to comply with the Section 106 Requests, and in any event, an attempt to sanction Respondents in these circumstances is impermissibly arbitrary and capricious.

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