

## Outside Counsel

## Expert Analysis

# SEC Action to Enforce Subpoena: New Front in Investigating Chinese Companies

On Sept. 8, 2011, the Securities and Exchange Commission (SEC) filed with the U.S. District Court for the District of Columbia an application for an order to show cause why the Shanghai-based accounting firm Deloitte Touche Tohmatsu CPA Ltd. (DTT) should not be ordered to comply with a subpoena the SEC issued several months earlier.<sup>1</sup> The SEC's subpoena had followed DTT's May 2011 resignation as the auditor for Longtop Financial Technologies Limited, a China-based software company with shares listed on the New York Stock Exchange. DTT had resigned after finding evidence of potential fraud and accounting irregularities at Longtop. In negotiations with the SEC over the subpoena, DTT's counsel took the position that Chinese "state secrets" and privacy laws precluded DTT from complying with it.

The SEC's court action seeking compliance with the DTT subpoena marks the latest development in its ongoing efforts to respond to the growing allegations of accounting and other fraud at U.S.-listed Chinese companies, many of which were listed through so-called "reverse merger" transactions, where private Chinese companies merged with U.S.-listed shell companies. The SEC's need for court intervention in its efforts to enforce a subpoena—something that the SEC rarely has had to do—exemplifies the challenges it faces in investigating U.S.-listed Chinese companies, and the manner in which its application gets resolved will have broader implications on how it and other regulators can obtain documents and information from Chinese and other foreign companies generally.

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### History

On May 23, 2011, Longtop filed a Form 6-K announcing DTT's resignation as the company's independent auditor. In its letter of resignation, DTT explained that it had uncovered "a number of very serious defects" in Longtop's finances, including evidence of potentially false bank records and unreported borrowings.<sup>2</sup> On May 27, 2011, the SEC issued an administrative subpoena seeking DTT's documents relating to its role as Longtop's auditor.

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On July 8, 2011, DTT's counsel sent a letter to the SEC stating that DTT would not be able to comply with the subpoena. First, DTT expressed its view that, because the subpoena sought "audit work papers" from a "foreign public accounting firm" (the subject of a specific provision of the Dodd-Frank Act addressing the production of audit papers of foreign public accounting firms), DTT could not be required to produce documents that pre-dated the July 21, 2010, Dodd-Frank enactment date.

Second, DTT argued that it could not produce the responsive documents because doing so would risk violating Chinese "state secrets"

laws, "archives" laws, privacy laws, and laws governing conduct of accountants, and therefore would expose DTT and its employees to civil and criminal penalties, including potentially lengthy prison terms. DTT's counsel noted that it had sought approval from the Chinese Securities Regulatory Commission (CSRC), but that the CSRC had refused to give its approval.

On Sept. 8, 2011, unable to obtain compliance from DTT, and presumably without real prospects of cooperation from Chinese regulators, the SEC filed its application for an order to show cause why DTT should not be directed to comply with the subpoena. In its application, the SEC challenged DTT's claim that Dodd-Frank's requirement relating to foreign public accounting firms somehow limited the SEC's ability to obtain documents that pre-dated the act's enactment. Also, assuming (without conceding) that Chinese law precluded the production in the United States of documents sought, the SEC argued that DTT nonetheless should be required to comply with the subpoena.

Presenting the relevant legal standard as one requiring the balancing of various factors including the competing interests of the nations whose laws are in conflict, extent and nature of the hardship on the party whose compliance is sought, the extent to which compliance would require actions be taken in the territory of the other nation, the nationality of the party, the importance of the matter in which the information is sought, and alternative means for obtaining the subpoenaed information, the SEC argued that all these factors weighed in favor of requiring DTT's compliance with the subpoena.

DTT initially did not file a response to the application or have its counsel enter an appearance on its behalf. At a hearing on Oct. 7, 2011 (where it appeared from the transcript that DTT's U.S. counsel was present in the gallery without making a formal appearance), the court noted that the SEC had not yet served DTT with the application

for an order to show cause. Before addressing the merits of the SEC's application, the court directed the SEC to submit supplemental briefing on the issue of whether the court had authority to issue the proposed order to show cause in the absence of service. The court stayed consideration of the merits of the application in the interim.

Following the SEC's submission of the supplemental brief, the court issued an opinion on Jan. 4, 2012, finding that service of the application was not a prerequisite to the issuance of an order to show cause, and scheduled a show-cause hearing for Feb. 1, 2012.

### Focus on Chinese Companies

The SEC's investigation of Longtop and its difficulty in enforcing the DTT subpoena arose in the context of the SEC's increased focus on Chinese companies, a focus that has accompanied the recent increase in the number of U.S.-listed Chinese companies, many through reverse merger transactions. According to the Public Company Accounting Oversight Board, between January 2007 and March 2010, 215 Chinese companies listed on U.S. stock exchanges, and Chinese companies made up approximately 26 percent of all reverse mergers and approximately 13 percent of all IPOs during that period.<sup>3</sup> This surge in listings has come with a rise in allegations of securities fraud and accounting irregularities, leading to calls for assurances that the SEC was taking adequate steps to protect U.S. investors in these newly listed Chinese companies.

In an April 27, 2011, letter to the Congressional Committee on Oversight and Government Reform, SEC Chairwoman Mary Schapiro addressed these concerns, emphasizing the steps the SEC had taken to protect investors from potential securities and accounting fraud at U.S.-listed Chinese companies. Specifically, in the summer of 2010, the SEC launched "a proactive risk-based inquiry" into U.S. audit firms with a significant number of "domestic issuer clients with primarily foreign operations, including in the PRC." Following those inquiries, more than 24 Chinese companies filed Form 8-Ks disclosing auditor resignations and accounting problems, with trading in a number of those companies being suspended and registrations of several companies being revoked. In the letter, Ms. Schapiro also acknowledged the challenges the SEC faced, borne out later in the Longtop investigation, in obtaining information and documents from Chinese companies, noting that the Chinese regulators tend to "view such direct efforts [to obtain information from Chinese companies] as a possible violation of sovereignty and/or national interest."<sup>4</sup>

In June 2011, the SEC issued an investor bulletin explaining reverse merger transactions and specifically warning of the risks associated with investments in them, including their frequent reliance on smaller accounting firms and the potential "lack of history of compliance with United States securities laws and accounting rules."<sup>5</sup> Although the bulletin did not focus exclusively on China, all six of the enforcement actions it listed as examples of accounting problems arising in the context of reverse mergers involved Chinese companies.

### Implications

The SEC's Longtop investigation and its attempts to enforce the DTT subpoena raise a number of issues, the resolution of which could have wider implications for the SEC's ongoing efforts to investigate U.S.-listed Chinese companies, as well as potentially how the SEC and other U.S. regulators deal with overseas companies and documents more generally.

The fact the SEC has had to seek judicial intervention to enforce the DTT subpoena itself is noteworthy. An informal survey of federal dockets shows that in the past five years, the SEC made applications for subpoena compliance by order to show cause on fewer than 20 occa-

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sions, among the countless subpoenas it must have issued during that period. Ordinarily, SEC subpoenas get complied with, without the need for judicial intervention, and where subpoenas seek documents maintained abroad, the SEC often has been able to reach some accommodation with the subpoena recipient or gain cooperation from overseas regulators.

The SEC's difficulties in obtaining the documents it needs in its Longtop investigation may foreshadow challenges the SEC will face in its ongoing efforts to investigate other U.S.-listed Chinese companies. It also has revealed some of the shortcomings of the existing framework for international cooperation among securities regulators. Both the SEC and the CSRC are signatories (along with 77 other foreign regulators) to the 2002 Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (Multilateral MOU), Section 6(b) of which pro-

vides that "no domestic secrecy or blocking laws or regulations should prevent the collection or provision of the information" to the requesting overseas agency.

Moreover, the SEC and CSRC executed a bilateral memorandum of understanding in 1994, as well as a 2002 Terms of Reference for Cooperation and Collaboration, making commitments to cooperate and collaborate in investigations. But the Longtop case makes apparent that ultimately, the SEC can do little to enforce these cooperation obligations. The memoranda of understanding themselves make clear that they "are not intended to create legally binding obligations or supersede domestic laws."<sup>6</sup>

The difficulties the SEC has had in simply trying to get the merits of its court application addressed—complicated by challenges of serving an overseas entity—underscores the obstacles it and other regulators can face in obtaining information from overseas, and from China in particular. While the court ultimately issued the order to show cause, without requiring prior service of the application, it did so more than six months after the SEC originally issued the DTT subpoena and nearly four months after the order to show cause application was made.

It will be worth following how the court ultimately decides the SEC's application, specifically, whether the court requires DTT to comply with the subpoena despite its concerns about violating Chinese law and the CSRC's refusal to approve of any production. The decision will have implications on the SEC's and other U.S. regulators' ongoing ability to obtain documents and information from China, as well as potentially other foreign jurisdictions.



1. *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, 1:11-mc-00512 (D.D.C.).

2. DTT's resignation letter and certain letters between DTT's counsel and the SEC discussed and cited below are attached to the SEC's application for an order to show cause, available on the court docket.

3. The Public Company Accounting Oversight Board, Activity Summary and Audit Implications for Reverse Mergers Involving Chinese Companies from the China Region: Jan. 1, 2007 through March 31, 2010, available at [http://pcaobus.org/Research/Documents/Chinese\\_Reverse\\_Merger\\_Research\\_Note.pdf](http://pcaobus.org/Research/Documents/Chinese_Reverse_Merger_Research_Note.pdf).

4. April 27, 2011 Letter from Mary L. Schapiro to Patrick T. McHenry, available at <http://s.wsj.net/public/resources/documents/BARRONS-SEC-050411.pdf>.

5. SEC Office of Investor Education and Advocacy, Investor Bulletin: Reverse Mergers (June 2011), available at <http://www.sec.gov/investor/alerts/reversemergers.pdf>.

6. Multilateral MOU, Section 6(a). The three memoranda of understanding referenced here can be found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf> (Multilateral MOU), [http://www.sec.gov/about/offices/oia/oia\\_bilateral/china.pdf](http://www.sec.gov/about/offices/oia/oia_bilateral/china.pdf) (1994 Memorandum of Understanding), and [http://www.sec.gov/about/offices/oia/oia\\_bilateral/chinator.pdf](http://www.sec.gov/about/offices/oia/oia_bilateral/chinator.pdf) (2002 Terms of Reference).