

ClientAlert

White Collar Practice

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Federal Court Sides With SEC, Orders Hearing on SEC's Subpoena to Deloitte

SEC Targets Chinese Issuers and Auditors, Deregisters Longtop

On January 4, 2012, a magistrate judge granted the request of the US Securities and Exchange Commission ("SEC") for a hearing to decide whether to order the Shanghai office of Deloitte Touche Tohmatsu CPA Ltd. ("Deloitte Shanghai") to produce documents related to its work as the outside auditor of Longtop Financial Technologies, Ltd ("Longtop" or the "Company"). This proceeding will decide important issues bearing on the SEC's ongoing enforcement action against Longtop, a publicly traded Chinese company. The magistrate judge's decision closely follows the SEC's deregistration of Longtop on December 14, 2011 for failing to file required annual reports and audited financial statements with the SEC. Longtop's securities are now substantially worthless.

The hearing will also highlight tensions between the SEC and Chinese issuer and auditor regulators who have failed to reach a written agreement on mutual assistance in securities investigations and supervision of audit firms despite talks during the summer of 2011. This sets the stage for either resolution of those tensions through negotiation or increased conflict between the two regulatory systems with unknown consequences for issuers and auditors in both capital markets.

Increased regulatory resources, enhanced financial penalties, demands by Congress for SEC and PCAOB action, aggressive steps by the SEC to move against registrants, involvement of the US Department of Justice ("DOJ"), and tensions between US and Chinese regulators all contribute to substantial enforcement risks for US-listed Chinese companies and their outside auditors. Chinese companies and their auditors should take immediate steps to mitigate these risks and to avoid or manage SEC and DOJ investigations.

SEC Moves on Several Fronts Against Listed Chinese Companies and Their Auditors

Longtop is a Chinese company publicly traded in the United States offering software, consulting and financial support services that is based in the Cayman Islands with its principal offices in Hong Kong and Mainland China. On May 22, 2011, Longtop's independent auditor, Deloitte Shanghai, issued a written statement that its prior audit reports could no longer be relied upon and resigned. In its resignation, Deloitte Shanghai cited Section 10A of the Exchange Act of 1934, alleging potential improper conduct affecting financial statements. Deloitte Shanghai is registered with the PCAOB.



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The SEC's financial fraud investigation of Longtop commenced soon thereafter.¹ The American Depository Shares shares of Longtop were then delisted from the New York Stock Exchange ("NYSE") on August 29, 2011.²

SEC Subpoenas Deloitte Shanghai's Longtop Work Papers

When Deloitte Shanghai resigned, the SEC served an investigative subpoena on the auditor through counsel on May 27, 2011, seeking production of the Longtop audit work papers. The SEC subpoena focused on assertions of fraud in the Section 10A resignation letter. When Deloitte Shanghai did not comply, the SEC brought a subpoena enforcement action in US District Court for the District of Columbia on September 8, 2011, asking the court to order Deloitte Shanghai to produce the subpoenaed documents.

Without conceding that it was subject to US jurisdiction, Deloitte Shanghai challenged the SEC's subpoena, justifying its nonproduction by invoking China's state secrecy laws and opposition by Chinese regulators to production of Longtop's financial documents to foreign regulatory authorities. The SEC's victory Wednesday essentially forces Deloitte Shanghai either to appear at the hearing, conceding jurisdiction, or to risk default. As a PCAOB Standing Advisory Group member observed, "Deloitte China's right to audit US-listed companies, including subsidiaries of US MNCs [multinational companies], is at stake."³

SEC Administrative Action Against Longtop

After Deloitte Shanghai resisted production of subpoenaed documents and the Company did not cooperate with the SEC investigation, the SEC's Enforcement Division initiated administrative proceedings against Longtop on November 10, 2011 for its failure to file annual reports and audited financial statements. Only 33 days later, Longtop's registration was revoked. This speedy action reflects the SEC's determination to obtain compliance from registrants, particularly where the auditors have not assisted the SEC in the underlying investigation. As support for its decision, the administrative judge referenced the auditors' statements in its resignation of May 22, 2011 that effectively stripped Longtop's financials from its annual reports.

Continuing Regulatory Investigations and Tensions Between SEC and Chinese Regulators

More SEC investigations of Chinese publicly traded companies and their auditors are expected. Independently, the SEC Chairman recently asked Congress for authorization to impose enhanced financial penalties of up to US\$1 million for individuals and US\$10 million for entities for each violation.⁴ In addition, the SEC Enforcement Director recently revealed that DOJ is also conducting criminal investigations of certain Chinese issuers allegedly involved in financial fraud.⁵

At the same time, the PCAOB may initiate proceedings to deregister China-based independent auditors in connection with ongoing SEC enforcement investigations of issuers. This will likely prompt a strong response from Chinese authorities. Indeed, Chinese regulators have already laid the groundwork for reciprocal sanctions. Last fall, the Chinese Ministry of Finance and Securities Regulatory Commission demanded that Big Four accounting firms review and report whether any financial information from Chinese publicly traded companies or US-based Chinese subsidiaries has been shared with the SEC without the consent of Chinese authorities.

Against this backdrop, public companies, particularly those based in China, and their auditors must exercise cautious awareness of the SEC's rigorous standards for auditing, internal controls and financial reporting.⁶ In the absence of bilateral agreements on mutual assistance in securities investigations, tension between US securities regulators and their Chinese counterparts is likely to continue. Meanwhile, the SEC continues to target Chinese companies suspected of financial fraud and to initiate deregistration proceedings similar to those initiated against Longtop.

How to Reduce Risks of SEC Investigations and Respond Effectively to SEC Inquiries

Compliance and Corporate Governance Improvements for Issuers

The SEC's aggressive investigation of Longtop is only one of some reportedly 55 to 60 open Enforcement Division financial fraud investigations of Chinese companies listed on US exchanges. Approximately 300 Chinese companies are publicly traded in the US. At least 159 entered US capital markets through reverse mergers since 2007.⁷ More than two dozen listed Chinese companies trading in the US have announced auditor resignations or accounting issues since March 2011.

The most effective “defense” for Chinese issuers facing SEC scrutiny is to undertake affirmative steps to ensure the reliability of financial statements and to prevent fraud. Companies intending to continue as SEC registrants should:

- improve internal controls and accounting systems
- adopt robust compliance programs, along with training
- implement strong anticorruption codes and policies
- strengthen corporate governance
- strengthen effective working relationships with independent auditors.

If the SEC does initiate an investigation, as part of its process the SEC (and in some cases the DOJ) will review controls, corporate compliance programs and the effectiveness of so-called “gatekeeper” functions to determine whether existing policies and procedures are meaningful or whether they are simply “window dressing.”

The “gatekeeper” functions are designed to ensure reliable financial statements. They include an effective Audit Committee whose members have financial expertise, independent registered auditors, a chief compliance officer who reports to the Audit Committee, management focused on accountability and fiduciary obligations, and expert external legal counsel.

The Auditors’ Dilemma

As long as US and Chinese securities regulators continue to spar over coordination, supervision and enforcement, registered auditors of China-based issuers also face adverse consequences from SEC and PCAOB enforcement initiatives. After Wednesday’s federal court ruling, additional SEC subpoenas for auditor work papers related to Chinese issuers are likely to follow.

Unlike an individual Chinese corporation, which may choose to de-list and eventually exit the US capital markets, registered auditors may be serving numerous corporate clients with operations in China and elsewhere in Asia. PCAOB deregistration will terminate the provision of such audit services by a registered audit firm. Moreover, cooperation among US and foreign regulators and auditor supervisory bodies presents additional risks of parallel enforcement actions in other capital markets.

Finally, if plaintiffs initiate litigation against Chinese issuers in the United States, auditors may be the only parties with accessible valuable assets in the event of judgments. Recognizing this vulnerability, US shareholders who have already filed class actions or other proceedings against the China-based issuers have also named the outside auditors. Given their unique position, auditors of listed Chinese companies should carefully assess and identify fraud risks and, as the PCAOB recently instructed, apply professional skepticism in gathering and evaluating audit evidence.⁸

1. Revocation of Longtop’s registration was based on failure to file period reports under Section 13(a) and Rule 13a-1 thereunder of the Exchange Act of 1934, not on financial fraud.
2. The SEC then approved new NYSE and Nasdaq rules to toughen standards for reverse-merger companies, such as Longtop, after issuing an investor bulletin warning investors about reverse-merger companies. SEC Approves New Rules to Toughen Listing Standards for Reverse-Merger Companies, *SEC Press Release* 2011-235 (Nov. 9, 2011), <http://www.sec.gov/news/press/2011/2011-235.htm>; *Investor Bulletin: Reverse Mergers*, (June 2011), <http://www.sec.gov/investor/alerts/reversemergers.pdf>.
3. Paul Gillis, “Deloitte loses a round against the SEC,” CHINA ACCOUNTING BLOG (Jan. 5, 2011), <http://www.chinaaccountingblog.com/weblog/deloitte-loses-a-round.html>.
4. See Chairman Mary Schapiro’s letter to US Senators Jack Reed and Mike Crapo (Nov. 28, 2011), <http://www.scribd.com/doc/74820022/Mary-Schapiro-s-Letter-to-Senator-Jack-Reed>.
5. Andrea Shalal-Esa and Sarah N. Lynch, “Exclusive: Justice Department probing Chinese accounting,” REUTERS.COM (Sept. 29, 2011), <http://www.reuters.com/article/2011/09/29/us-china-usa-accounting-idUSTRE78S3QM20110929>.
6. Two US Senators wrote separately to the respective Chairpersons of the SEC and the PCAOB, demanding regulatory action against Chinese issuers and/or their auditors. “Schumer to US Audit Watchdog: To Protect US Investors, Bar Chinese Accounting Firms that Resist Oversight” (Nov. 22, 2011), <http://schumer.senate.gov/record.cfm?id=334966&>; Casey Calls on SEC To Investigate China’s Access to US Capital Markets – Illegal Activity Puts US Jobs, Investors at Risk (Dec. 15, 2011), <http://casey.senate.gov/newsroom/press/release/?id=d68f7294-a40f-47e9-9d70-abbbeb7208d4>.
7. “Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010,” PCAOB Research Note #2011-P1 (March 14, 2011), http://pcaobus.org/Research/Documents/Chinese_Reverse_Merger_Research_Note.pdf.
8. “Audit Risks in Certain Emerging Markets,” *PCAOB Staff Audit Practice Alert No. 8* (Oct. 3, 2011), http://pcaobus.org/Standards/QandA/2011-10-03_APA_8.pdf.

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