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The U.S.-China Audit Oversight Dispute: Causes, Solutions, and Implications for Hong Kong

ROBIN HUI HUANG*

The audit oversight regime in the United States demands inspection and investigative power on all audit firms that provide service to listed companies, including foreign audit firms.¹ This is not a new requirement but has been in place since the enactment of Sarbanes-Oxley Act of 2002.² The extraterritorial power granted by the act is often in conflict with laws and sovereignty of foreign jurisdictions. Demanding foreign audit firms to turn over documentation produced during the auditing process can put the firms into the vortex of this conflict, as domestic law in foreign jurisdictions may forbid them to do so. This conflict of law has now grown into one of the most serious disputes between U.S. and Chinese regulators, due to the cross-listing of many Chinese issuers (known as Chinese Concept Stocks) on the U.S. stock market.³ In order to properly understand the conflict and the rationale of all sides, this article will retrace the United States' Public Company Accounting Oversight Board regime (PCAOB) from its creation, particularly in relation to its extraterritorial oversight power and international inspection practice. Over the years, the U.S. watchdog has resolved the foreign oversight issue with most jurisdictions, but the conflict with China has only escalated. The audit oversight regime of China and its restriction on audit working papers from outside access will then be reviewed.

Throughout the years of unresolved audit oversight issues with China, multiple Chinese stocks listed in the United States have collapsed, often

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1. See generally Sarbanes-Oxley Act of 2002 Pub. L. No. 111-203, 124 Stat. 745 (2002).

2. *Id.*

3. See, e.g., Sofia Horta e Costa, *Two Accounting Scandals in China in One Week Burn Investors*, BLOOMBERG (April 8, 2020, 3:13 AM), <https://www.bloomberg.com/news/articles/2020-04-08/two-accounting-scandals-in-one-week-burn-investors-in-china-inc> [https://perma.cc/F36Q-6R77].

because of fraudulent accounting practices.⁴ The failure of these Chinese companies resulted in great losses for U.S. investors, the very thing the PCAOB is meant to prevent.⁵ From lawsuits with Chinese auditing firms, to a relatively calm midpoint in 2013 when a Memorandum of Understanding was signed, by 2020 the U.S. regulators have lost their patience with the obstacles China places in their audit document inspections. The United States recently issued perhaps its sternest warning that may point towards a potential consequence of all Chinese companies being delisted.⁶ While the U.S.-China dispute continues to escalate, the same audit oversight issues with Hong Kong seem to have subsided. The Hong Kong market is actually expecting more Initial Public Offerings (IPOs) of Chinese companies, including those that will be “coming back” from U.S. listings.⁷ It is crucial to understand the rationale of the Chinese reaction towards the U.S. regulators’ demand throughout the years. Revelation from the lawsuits against audit firms and companies in the United States and Hong Kong will shed light on how the conflict of law comes down to today’s most significant confrontation. Lastly, alternative policy options at this juncture and how regulators can act to refine policy to accommodate the reality of these Chinese companies will bring about critical impact on the integrity and performance of the U.S. and Hong Kong stock markets, as well as on the bilateral relationship between the United States and China.

The handling of cross-border audit oversight is a significant issue as financial markets trend towards more cross-listing and interconnection.⁸ The U.S. financial market is highly internationalized, and there are indeed a large number of foreign companies listed or cross-listed on the U.S. exchanges.⁹ As of the first quarter of 2020, of the more than 2,400 public companies on the NYSE, 507 are non-U.S. companies.¹⁰ They come from forty-six countries and make up around 20 percent of all listed companies.¹¹ The largest source of foreign companies on NYSE is Canada with its 135 companies, followed by China ranking second with eighty companies, and

4. *Id.*

5. *Id.*

6. See Benjamin Bain & David Westin, *SEC Chief Backs Bill to Delist China Firms Barring Audit Reviews*, BLOOMBERG (June 2, 2020, 10:50 AM), <https://www.bloomberg.com/news/articles/2020-06-02/sec-chief-backs-bill-to-delist-china-firms-barring-audit-reviews> [https://perma.cc/8NBJ-P7ZF].

7. Kari Soo Lindberg, *Flood of China Mega Listings Will Tighten Hong Kong Liquidity*, BLOOMBERG, (May 21, 2020, 10:17 PM), <https://www.bloomberg.com/news/articles/2020-05-21/landing-mega-china-ipos-will-shake-up-hong-kong-s-interest-rates> [https://perma.cc/R5AY-KJTJ].

8. *Current List of All Non-U.S. Issuers 507 NYSE and NYSE American-Listed Non-U.S. Issuers from 46 Countries (as of April 30, 2020)*, NYSE (Apr. 30, 2020), <https://www.nyse.com/publicdocs/nyse/data/CurListofallStocks.pdf> [https://perma.cc/9Z79-BH64].

9. *Id.*

10. *Id.*

11. *Id.*

Brazil in third with thirty-five companies.¹² There are also around 180 Chinese companies of various sizes on Nasdaq, including three heavy-sized companies being constituent stocks of the Nasdaq 100 Index.¹³ On the Hong Kong market, Chinese companies constitute a much higher proportion.¹⁴ Throughout the years since the very first listing of a Chinese state-owned-enterprise (SOE) in the 1990s,¹⁵ the listing of Chinese companies in Hong Kong has grown at a rapid rate and now constitutes 67.5 percent of the market capitalization of the Hong Kong stock exchange.¹⁶ Chinese companies also have the most sought after stocks and contribute 79.6 percent of the total turnover value.¹⁷ With the prevalence of listing and trading across jurisdictions, especially that of the mega economies of the United States and China, the oversight of these lists and trades becomes an ever more critical task.

I. The Audit Oversight Regime in the United States and its Extraterritorial Application

A. THE SARBANES-OXLEY ACT AND THE PCAOB OVERSIGHT REGIME

Listed companies are required to periodically report their financial statements so that investors can obtain timely and crucial information about the companies.¹⁸ Independent examination of financial records and financial statements by auditing firms is, therefore, an indispensable part of this process to ensure that such information is fair and accurate and conforms to the law and generally accepted accounting principles.¹⁹ The conduct of auditors themselves is thus held to their professional standards.²⁰ The auditing standards in the United States have a long history of development, beginning in the 1900s.²¹ In 1917, the American Institute of Certified Public Accountants (AICPA) first formed a special committee for

12. *Id.*

13. These statistics are out of a total of around 3,300 companies listed on Nasdaq, as of June 30, 2020. *Quotes for NASDAQ-100 Index*, NASDAQ, <https://www.nasdaq.com/market-activity/quotes/nasdaq-ndx-index> [<https://perma.cc/D77W-DD6D>] (last visited Dec. 8, 2020).

14. *HKEX Fact Book 2019*, HKEX (Mar. 24, 2020), https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/HKEX-Fact-Book/HKEX-Fact-Book-2019/FB_2019.pdf [<https://perma.cc/27YC-RBAG>].

15. Robin Hui Huang, *Yiguoliangzhibeijing xia de xianggang yu neidi zhengquan jianguan bezuo tizhi* (一国两制背景下的香港与内地证券监管合作体制) [*The Prospect and Evolution of Securities Regulatory Cooperation between Hong Kong and Mainland China Under the 'One Country, Two Systems' Arrangement*], 5 *比较法研究* [J. COMPAR. L.] 12 (2017).

16. *HKEX Fact Book 2019*, *supra* note 14.

17. *Id.*

18. Securities Exchange Act of 1934, 15 U.S.C. § 78(m) (2020).

19. *See id.*

20. *See id.*

21. *Accounting Research Guide*, GEO. L. (June 23, 2020), <https://guides.ll.georgetown.edu/accounting/auditing-standards> [<https://perma.cc/CN5G-WWFF>].

establishing auditing standards.²² In 1978, this became the Auditing Standards Board.²³ For a long time, the auditing profession was professionally regulated internally by their industry association.²⁴

That self-regulated auditor oversight landscape was drastically changed following the Enron scandal. In March 2002, Arthur Andersen, an auditor for an energy company, was charged in a criminal proceeding with obstruction of justice, which included the shredding of documents related to an audit.²⁵ In the same year, another one of Andersen's clients, WorldCom, collapsed in yet another accounting scandal, again sending shockwaves through the financial market.²⁶ Enron's value fell from a high of around \$90 USD per share down to less than \$1 USD, and it became the largest corporate bankruptcy in history at the time, until WorldCom broke the same record.²⁷ The firm Arthur Andersen itself was closed down.²⁸ The failures of Enron and WorldCom demonstrated to lawmakers that auditors' self-regulation was not working. The U.S. Congress concluded that the system of oversight by the profession itself was no longer sufficient, and substantial changes had to be made.²⁹

Hence in June 2002, the U.S. Congress passed the Sarbanes-Oxley Act which created the PCAOB as an independent nonprofit body to oversee the audits of public companies.³⁰ The Sarbanes-Oxley Act also included wide-ranging measures to mandate higher corporate responsibility standards, enhance financial disclosure requirements, increase punishment towards white-collar crime, and create new corporate fraud crimes.³¹ The U.S. Congress made the PCAOB's core mission to "protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."³² For the first time in U.S. history, the auditors of public companies were put under independent and external oversight, which was likely also a first for jurisdictions around the world.³³

22. *Id.*

23. *Id.*

24. *Id.*

25. *United States v. Arthur Andersen, LLP*, 374 F.3d 281, 286–87 (5th Cir. 2004).

26. George J. Benston, *The Quality of Corporate Financial Statements and Their Auditors Before and After Enron*, POL'Y ANALYSIS: CATO PROJECT ON CORP. GOVERNANCE, AUDIT & TAX REFORM No. 497, 12 (Nov. 6, 2003), <https://www.cato.org/sites/cato.org/files/pubs/pdf/pa497.pdf> [<https://perma.cc/7HR3-YSVF>].

27. *Id.*

28. *Id.* at 15.

29. Sarbanes-Oxley Act of 2002, § 101(a), 15 U.S.C. §7211(a) (2020).

30. *Id.*

31. *Id.*

32. *Id.*

33. *About the PCAOB*, PCAOB (Sept. 30, 2020), <https://pcaobus.org/About> [<https://perma.cc/F6ZV-UBUG>]; Paul Lanois, *The Legacy of the Sarbanes-Oxley Act, 15 Years On*, CLS BLUE SKY BLOG (Feb. 9, 2017), <https://clsbluesky.law.columbia.edu/2017/02/09/the-legacy-of-the-sarbanes-oxley-act-15-years-on/> [<https://perma.cc/4DTU-5UF7>].

The PCAOB consists of five board members appointed by the Securities and Exchange Commission (SEC) after consultation with the Fed and the Treasury.³⁴ The board members typically have backgrounds as leading accounting firm partners, legal scholars, or lawyers with public administration experience.³⁵ Furthermore, a maximum of two members may have worked or may be currently working as accountants.³⁶ PCAOB's funding comes from fees allocated to issuers, brokers, and dealers, plus an annual fee paid by registered accounting firms to cover the costs of reviewing audit reports.³⁷ The oversight responsibility over the PCAOB lies with the SEC, which reviews and approves its rules, standards, and annual budget.³⁸ The SEC also reviews any disciplinary action taken by the PCAOB and may make modifications to a decision to sanction.³⁹ The PCAOB's oversight regime is proactive and robust, and it plays a vital monitoring role in the capital markets by overseeing the audits of U.S. listed companies.

B. STATUTORY POWER OF THE PCAOB IN CONDUCTING FOREIGN AUDIT INSPECTIONS

The first obligation for auditors of U.S. listed companies is that they must register with the PCAOB and come under its jurisdiction.⁴⁰ It is unlawful for any person that is not a registered accounting firm to prepare or issue audit reports for any U.S. listed companies.⁴¹ Hence, every accounting firm, domestic or foreign, that prepares an audit report for a company, or plays a substantial role in the preparation, must be registered.⁴² Moreover, each registered accounting firm must file an annual report with the PCAOB.⁴³ The registration requirement itself was not a particular hurdle for foreign parties until it later restricted accounting firms from certain overseas jurisdictions. Registration is done electronically on a standard form with information such as contact information, offices, license numbers, and so on.⁴⁴ The PCAOB states that when considering the application, it considers

34. Sarbanes-Oxley Act of 2002, § 101(e)(1), (4), 15 U.S.C. §7211(a) (2020).

35. *Former Chairmen and Board Members*, PCAOB, <https://pcaobus.org/about/the-board/former-chairmen-and-board-members> [<https://perma.cc/ZR9Z-XL6S>] (last visited Dec. 12, 2020).

36. *Id.* § 101(e)(2).

37. BYLAWS AND RULES OF THE PCAOB §§ 2(2202), 7(7100) (Public Company Accounting Oversight Board 2016).

38. Sarbanes-Oxley Act of 2002, 101(h), 109(b), 15 U.S.C. §7211(a) (2020).

39. *Id.* § 107(c).

40. *Id.* § 102(a).

41. PCAOB, BYLAWS AND RULES OF THE PCAOB § 2(2100).

42. *Id.*

43. *Id.* § 2(2200).

44. PCAOB, SAMPLE FORM, FORM 1: APPLICATION FOR REGISTRATION (2020), <https://pcaobus.org/Registration/Pages/registration-process.aspx> [<https://perma.cc/8JYK-YR37>] (last visited Dec. 8, 2020).

if the firm has violated any rules or regulations, or if it failed to provide complete and accurate information.⁴⁵

Upon registration, registered accounting firms are then statutorily required to be periodically inspected by the PCAOB.⁴⁶ The ongoing essential function of the PCAOB is to undertake these regular inspections in order to assess compliance with auditing standards.⁴⁷ All audit firms with more than 100 issuer clients need to be annually inspected, and firms that provide audit reports for fewer clients are inspected at least triennially.⁴⁸ The particular sets of audits to be reviewed in each firm are selected on a risk-based fashion, focusing on those that have heightened risks of misstatement in financial statements.⁴⁹ During the inspection, the PCAOB team inspects documentation, interviews personnel, and reviews the firm's internal control policy.⁵⁰ The Rules of the PCAOB are drafted widely enough to include the possibility to conduct a "surprise inspection" if necessary.⁵¹ The outcomes of the inspections are publicly disclosed in an individual report for each firm, and in the case of deficiencies, the report may lead to a reprimand or enforcement action on the accounting firms.⁵²

These requirements are the same for both domestic and foreign accounting firms. The Sarbanes-Oxley Act states that any foreign accounting firm that prepares an audit report for a U.S. listed company will be subject to regulators' oversight and enforcement "in the same manner and to the same extent" as an accounting firm that is established domestically.⁵³ The consequences of any enforcement action resulting from an investigation will also be felt extraterritorially by an overseas firm.⁵⁴ For example, a Canada-based accounting firm that audited a Canadian mining company was found with deficiencies in its practices and was fined, ordered to conduct training, and ordered to submit a written report to the PCAOB.⁵⁵ The same occurred to a Brazilian branch of Deloitte, which was fined \$8 million USD

45. Press Release, PCAOB, Frequently Asked Questions Regarding Registration with the Board, Release No. 2003-001F (Dec. 4, 2017), https://pcaobus.org/Registration/Information/Documents/Registration_FAQ.pdf [<https://perma.cc/8ETU-2QYE>].

46. Sarbanes-Oxley Act of 2002, § 104(a), 15 U.S.C. §7211(a) (2020).

47. *Id.*

48. *Id.* § 104(b)(1).

49. *PCAOB Inspection Procedures: What Does the PCAOB Inspect and How Are Inspections Conducted?*, PCAOB, <https://pcaobus.org/Inspections/Pages/PCAOB-inspection-procedures-what-does-PCAOB-inspect-how-inspections-conducted.aspx> [<https://perma.cc/2VCV-PH4H>] (last visited Oct. 28, 2020) [hereinafter *PCAOB Inspection Procedures*].

50. *Id.*

51. Ernst & Young LLP Response to PCAOB, Comment Letter on Proposed Rule on Inspections of Registered Public Accounting Firms, PCAOB (Aug. 18, 2003), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket_006/010_ernst_and_young_llp.pdf?sfvrsn=C86269f9_0 [<https://perma.cc/U83P-WP7X>] (noted by the comment from accounting firms during the PCAOB rulemaking).

52. *PCAOB Inspection Procedures*, *supra* note 49.

53. Sarbanes-Oxley Act of 2002, § 106(a)(1), 15 U.S.C. §7211(a) (2020).

54. *Id.*

55. Deloitte LLP, PCAOB Release No. 105-2018-020 12-13 (Oct. 16, 2018).

by the PCAOB and ordered to retain an third-party independent monitor to review the firm's practice.⁵⁶

Central to the audit working paper dispute is the power under section 106 of the Sarbanes-Oxley Act. This grants the PCAOB power to demand a registered accounting firm to produce audit working papers for inspection upon request.⁵⁷ Even if a foreign accounting firm does not issue audit reports, the PCAOB can determine that it nonetheless plays a substantial role in the preparation of the report and needs to be subjected to the same registration and inspection requirement.⁵⁸ The crucial parts of section 106 are two deeming provisions. The first states that if a foreign accounting firm provides services for a PCAOB-registered accounting firm and issues an opinion that forms part of any audit report, the PCAOB will consider the foreign firm to have consented to the production of its working papers for PCAOB inspection, and the firm will be subject to U.S. jurisdiction for court-ordered enforcement of any request for the production of working papers.⁵⁹ At the same time, the second states that if a U.S. accounting firm engages the service of a foreign accounting firm in preparation of any audit report, the U.S. firm will be deemed to have consented to supplying audit working papers produced in the work of that foreign firm, and further, deemed to have secured agreement of the foreign firm to produce the document as a condition of relying on the work of that foreign firm.⁶⁰ The accounting firms themselves are constantly reminded of this obligation, as they must affirm their consent to comply with this requirement every year in their annual filing to the PCAOB.⁶¹

Read together, these provisions mean that an accounting firm that performs an audit for an overseas company has the obligation to produce documents for inspection.⁶² For the failure to comply with the request for documents, the SEC may bring court proceedings for the mandatory supply of information, injunctions, cease-and-desists, and more.⁶³ According to the Sarbanes-Oxley Act, being overseas does not prohibit the company from falling within PCAOB's oversight, and it is the responsibility of the accounting firms that provide services to U.S. listed companies, regardless of their geographical locations, to make sure they are in compliance with the

56. Deloitte Touche Tohmatsu Auditores Independentes, PCAOB Release No. 105-2016-0311 (Dec. 5, 2016).

57. Sarbanes-Oxley Act of 2002, § 106, 15 U.S.C. §7211(a) (2020).

58. *Id.*

59. *Id.* § 106(b)(1).

60. *Id.* § 106(b)(2).

61. PCAOB, PCAOB ANNUAL REPORT FORM 2, pt. 9, item 9.1(b) (Nov. 10, 2020), https://pcaobus.org/about/rules-rulemaking/rules/form_2 [<https://perma.cc/LAT6-VJMM>] (affirming that the registered firm has “secured from each of its associated persons. . . consents to cooperate in and comply with any request for testimony or the production of documents made by the Board. . .”).

62. Sarbanes-Oxley Act of 2002, § 106(b)(1)–(2), 15 U.S.C. §7211(a) (2020).

63. *Id.* § 102(e).

PCAOB's monitoring functions.⁶⁴ But these overarching powers, backed by sanctions, are problematic when placed alongside the local laws in a foreign jurisdiction.⁶⁵ A case-in-point is the conflict with the secrecy laws in France, upon which a number of Continental European countries are modeled.⁶⁶ The French Penal Code prohibits the disclosure of secret information entrusted to persons during the course of their profession, which includes auditors.⁶⁷ There is an exception to this non-disclosure when disclosure of secret information is required by law, but this is still references local law, not foreign law.⁶⁸ Contravention of this French law that protects professional privilege is punishable by imprisonment of up to one year.⁶⁹ Local laws like this put the internationally oriented Sarbanes-Oxley Act at odds with many foreign jurisdictions, and the ensuing conflict of law created some discontent in the early years of PCAOB's foreign audit inspection.

C. PRACTICE OF PCAOB'S FOREIGN AUDIT INSPECTION SINCE 2005

The PCAOB began the regular cycle of inspections of U.S. accounting firms soon after its establishment. In the first cycle, the PCAOB conducted 982 such inspections and completed annual inspections on the largest U.S. domestic firms.⁷⁰ In 2005, it initiated the inspection of foreign accounting firms, but this was not an easy task due to logistical and jurisdictional hurdles.⁷¹ As mentioned, the PCAOB needs to inspect the smaller registered accounting firms at least once within the three-year period of the firm's issuance of its audit report.⁷² When the deadline for the first inspection was nearing, the PCAOB had 129 foreign firms—nearly half of the total number

64. *Id.*

65. Daniel L. Goelzer, PCAOB Board Member, Baker & McKenzie International Law Lecture at Georgetown Law School (Apr. 19, 2004) in *The PCAOB and the Oversight of Non-U.S. Auditors*, PCAOB (Apr. 19, 2004), https://pcaobus.org/News/Speech/Pages/04192004_GoelzerOversightNonUSAuditors.aspx [<https://perma.cc/PN2C-7GG4>].

66. Adel I. Abdullin & Stanislav A. Shardin, *Protection of Personal Data in France: Problems Implementing a Pan-European Approach*, V. 8 No. 5 PERIÓDICO DO NÚCLEO DE ESTUDOS E PESQUISAS SOBRE GÊNERO E DIREITO CENTRO DE CIÊNCIAS JURÍDICAS - UNIVERSIDADE FEDERAL DA PARAÍBA [J. CTR. FOR STUD. & RSCH. ON GENDER & L. CTR. FOR LEGAL SCIS. - FED. UNIV. PARAÍBA] 540, 544-45 (2019), <https://periodicos.ufpb.br/index.php/ged/article/download/48773/28252/> [<https://perma.cc/V2DZ-HDS4>].

67. CODE PÉNAL [C. PÉN.] [PENAL CODE] art. 226-13 (Fr.).

68. C. PÉN. art. 226-14 (Fr.).

69. C. PÉN. art. 226-13 (Fr.).

70. Press Release, Rhonda Schnare, Dir. Int'l Affs., PCAOB, Final Rule Concerning the Timing of Certain Inspections of Non-U.S. Firms, PCAOB Release No. 2009-003 (June 25, 2009), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket_027/2009-06-25_release_no_2009-003.pdf?sfvrsn=61e7cb9b_0 [<https://perma.cc/6KC8-ZAYZ>] [hereinafter Schnare Press Release].

71. See Goelzer, *supra* note 65.

72. BYLAWS AND RULES OF THE PCAOB § 4(4003b).

of foreign firms—still pending inspection.⁷³ Only Canada onboarded immediately and signed the cooperation agreement.⁷⁴ Among those who refused inspections were registered accounting firms from seventeen jurisdictions, including China, the United Kingdom, France, Germany, Luxembourg, Korea, and more.⁷⁵ Thus, the PCAOB had to issue an extension of the time for inspection, with a set timeline to inspect all of these audit firms by the end of 2012.⁷⁶

The noncooperation of foreign accounting firms and regulators largely attributed to the delay.⁷⁷ Foreign regulators and professional bodies of various jurisdictions actively responded to this delay, noting that the denied inspections were largely due to either restrictions under local laws or objections based on national sovereignty.⁷⁸ The regulatory bodies of the various European jurisdictions were among the most vocal critics.⁷⁹ The European association for public accountants commented that the PCAOB's rule essentially forced non-U.S. firms to choose between violating either their home country laws or the PCAOB regulations.⁸⁰ They suggested that a potential violation of law by accounting firms in such circumstances calls into question the integrity of the PCAOB's policy and that such a policy failed to represent public interest, contrary to the intention of Sarbanes-Oxley Act.⁸¹ The French body of statutory auditors stated that the audit firms cannot be considered responsible for any delay or hindrance; rather, the legal conflict with the strong French professional Secrecy laws triggered any delay,⁸² and that the only practicable solution moving forward is mutual

73. Schnare Press Release, *supra* note 70.

74. Letter from Gordon Thiessen, Chair, Canadian Pub. Accountability Bd., Response to PCAOB Rulemaking Docket Matter No. 001 (Mar. 28, 2003), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket_001/010_cpab_canada.pdf?sfvrsn=be6e2c72_0 [<https://perma.cc/4LAK-LASE>].

75. *Updated Information on PCAOB International Inspections*, PCAOB (Dec. 31, 2010), https://pcaobus.org/International/Inspections/Pages/122010_UpdatedInformation.aspx [<https://perma.cc/2SN5-F7YB>].

76. Press Release, PCAOB, PCAOB Adopts and Proposes Rule Amendments on the Timing of Certain Non-U.S. Inspections and Seeks Comment on Related Issues (Dec. 4, 2008), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-adopts-and-proposes-rule-amendments-on-the-timing-of-certain-non-u-s-inspections-and-seeks-comment-on-related-issues_7 [<https://perma.cc/V32K-CG56>].

77. *Id.*

78. *Id.*

79. *See, e.g.*, Letter from Hans van Damme, FEE President, to J. Gordon Seymour, Off. of the Sec'y, PCAOB, re: FEE Comments on PCAOB Release No. 2008-007 (Jan. 27, 2009), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket_027/001_fee.pdf?sfvrsn=9010629_0 [<https://perma.cc/WF7M-MYGL>].

80. *Id.*

81. *Id.* at 4.

82. Letter from Vincent Baillot, President, Compagnie Nationale des Commissaires aux Comptes, to J. Gordon Seymour, Off. Sec'y, PCAOB, on Request for public comment on proposed amendment to Rule 4003 (Feb. 2, 2009), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket_027/013_cncc.pdf?sfvrsn=601ca18d_0 [<https://perma.cc/LK5M-FQ3H>].

recognition and full reliance on foreign national oversight bodies.⁸³ The China Securities Regulatory Commission (CSRC) also wrote a letter to the PCAOB, criticizing the latter's "attempts to take actions on a unilateral basis," and stating that they strongly oppose any inspection on Chinese firms before a consensus is reached.⁸⁴ The position of the CSRC, as stated in the letter, was that the oversight of Chinese accounting firms should fully rely upon the work of the CSRC itself, and that cross-border inspection must "abide by the principles of respecting mutual sovereignty and cooperating as equals."⁸⁵

As the United States was the first to establish such an independent audit oversight body conferred with far-reaching power, conflict and objections from foreign jurisdictions were understandable. While the foreign regulators stood by their own national laws and doubted the United States' proclaimed extraterritorial jurisdiction, the U.S. regulators and investors were equally skeptical of the auditing quality and oversight standards of external bodies, especially in light of the circumstances of the Enron failure.⁸⁶ In fact, congressional inquiry into the collapse uncovered that Enron itself once evaluated how much influence it could have by "donating" to the International Accounting Standards Committee, a standard setting forum.⁸⁷ One board member of the PCAOB commented that there were important differences between the board's inspection and that of other regulators, and that few other countries spent as much on enforcement of financial reporting and auditing as the United States did.⁸⁸ For the PCAOB, its mandate and longstanding initiative was to promote mutual cooperation between regulators, to the extent that it can fully rely on the monitoring work of foreign regulators.⁸⁹ A 2007 policy statement drafted the criteria for

83. *Id.*

84. Letter from Dr. Tong Daochi, Dir.-Gen., Dep't of Internal Affs., to SEC, on PCAOB Notice of Filing of Proposed Amendment to board Rules Relating to Inspection, File No. PCAOB-2008-06 (May 15, 2009), <https://www.sec.gov/comments/pcaob-2008-06/pcaob200806-1.pdf> [<https://perma.cc/5JVJ-WNL5>].

85. *Id.*

86. Empirical research at the time pointed to lower quality in financial reporting in other jurisdictions, for example China. See Robert McGee & Xiaoli Yuan, *Corporate Governance and the Timeliness of Financial Reporting: An Empirical Study of the People's Republic of China* (Fla. Int'l Univ., Working Paper May 2008).

87. Charles Niemeier, PCAOB Bd. Member, Keynote Address at New York State Society of CPAs/FAE Conference (Sept. 10, 2008), in *Keynote Address on Recent International Initiatives, 2008 Sarbanes-Oxley, SEC and PCAOB Conference*, PCAOB (Sept. 10, 2008), https://pcaobus.org/News/Speech/Pages/09102008_NiemeierNYSSCPAFAEConference.aspx [<https://perma.cc/SN78-ADXX>].

88. Charles Niemeier, PCAOB Bd. Member, PCAOB Open Board Meeting (Dec. 5, 2007), in *Statement on Consideration of Proposing Release of Full Reliance Policy Statement*, PCAOB (Dec. 5, 2007), https://pcaobus.org/News/Speech/Pages/12052007_Niemeier.aspx [<https://perma.cc/5VFL-UDSL>].

89. See BYLAWS AND RULES OF THE PCAOB §3(4012) (Aug. 30, 2004).

a foreign oversight entity to qualify for full reliance.⁹⁰ The statement includes up to twenty-three detailed essential criteria listed under five general principles.⁹¹ Succinctly, the foreign oversight body has to be transparent, independent, and perform its work with adequacy and integrity.⁹² The entity must have adequate funding and a sufficient number of staff relevant to the market size, and the source of funding must not be subject to interference or undue influence by external parties.⁹³ If it is to be relied upon, the foreign oversight body must also exhibit a good record of historical performance in both investigation and enforcement.⁹⁴

Perhaps due to the PCAOB's insistence to assert jurisdiction and common standards, almost all advanced or emerging market countries have, over time, established independent oversight bodies of their own. In response, the International Forum of Independent Audit Regulators (IFIAR) formed to coordinate these independent audit regulators and help the PCAOB come into cooperative agreements with its national counterparts.⁹⁵ Canada was one of the earliest adopters of such an independent oversight body through its creation of the Canadian Public Accountability Board in early June 2002, just one month after the passage of the Sarbanes-Oxley Act.⁹⁶ In 2005, Canada also became the first jurisdiction to sign a cooperative agreement with the United States.⁹⁷ The next major jurisdictions to come into agreement with the PCAOB were the United Kingdom, Switzerland, and Japan in 2011, followed by France and other European countries from 2013 onwards.⁹⁸ Presently, twenty-four audit regulatory bodies have signed formal cooperative arrangements with the PCAOB.⁹⁹ While the negotiation process between the regulators is not disclosed, one can assume that the jurisdictions that have signed cooperative agreements have fulfilled the criteria listed by the PCAOB in its 2007 policy statement (i.e. have an adequately funded independent audit oversight body with a good track record).¹⁰⁰ Currently, there are about 1,790 auditing firms registered with

90. See Press Release, PCAOB, Request for Pub. Comment on Proposed Policy Statement: Guidance Regarding Implementation of PCAOB Rule 4012, Release No. 2007-011 (Dec. 5, 2007), https://pcaobus.org/Inspections/Documents/2007_12-05_release_2007-011.pdf [<https://perma.cc/T4BT-4A4W>] [hereinafter PCAOB Release No. 2007-011].

91. *Id.* at 3.

92. *Id.*

93. *Id.* at A1-11.

94. *Id.* at A1-16.

95. China's regulator is not a member of IFIAR. China does not have a separate body for audit oversight, as will be introduced in the next part. See *Member Directory*, IFIAR, <https://www.ifiar.org/members/member-directory/> [<https://perma.cc/URV2-FAZC>] (last visited Nov. 5, 2020).

96. Letter from Gordon Thiessen to David Brown, *supra* note 74.

97. See *PCAOB Cooperative Agreements with Non-U.S. Regulators*, PCAOB, <https://pcaobus.org/International/Pages/RegulatoryCooperation.aspx> [<https://perma.cc/BXH7-RPXU>] (last visited Dec. 9, 2020).

98. *Id.*

99. The latest agreement was signed in 2018 with Austria. See *id.*

100. See Niemeier, *supra* note 88.

the PCAOB.¹⁰¹ Approximately 50.5% of firms are located within the United States, while the remainder (850 firms) are located abroad.¹⁰² In a given year, the PCAOB inspection team conducts over 200 inspections globally.¹⁰³

There are now three possible modes for the PCAOB to conduct foreign inspections. First, the PCAOB and local regulators can administer joint inspections, and Canada provides a good example of this collaborative mode.¹⁰⁴ Often, this option occurs when a cooperative agreement is in place. The PCAOB coordinates with a local regulatory body to form a joint team, and together they conduct an on-site inspection on the accounting firm working to meet the requirements that constitute a satisfactory inspection for both regulating agencies.¹⁰⁵ Second, the PCAOB can rely, to a varying degree, on the inspection work performed by a foreign regulator, evaluating the work on a sliding scale of reliance that takes into account the rigor and independence of the foreign regulator.¹⁰⁶ Under the rules, a non-U.S. firm that is subject to PCAOB's inspection can request the PCAOB to rely on a local inspection to an appropriate extent,¹⁰⁷ which can comprise up to a "full-reliance," meaning that the PCAOB would not need to send their own investigatory team.¹⁰⁸ This request for a local inspection is set out in the aforementioned 2007 policy statement, but in the years following the statement's release, there has been no further indication of this reliance policy at work. On the contrary, the reliance trends in the opposite direction, with the Financial Reporting Council of the United Kingdom describing that it now "relies to a significant degree on the work of the [PCAOB]."¹⁰⁹ Third, an overseas inspection may be conducted solely by the PCAOB's team, especially where there is no formal reliance agreement in place. This does not necessarily mean that the PCAOB will face resistance to the inspection, and local regulators may sit in as observers during the

101. PUB. CO. ACCT. OVERSIGHT BD. [PCAOB], ANNUAL REPORT (2019), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/annual-reports/2019-pcaob-annual-report.pdf?sfvrsn=3d0b243_2 [<https://perma.cc/7GXP-4WAC>].

102. *Registered Firms*, PCAOB, <https://pcaobus.org/oversight/registration/registered-firms> [<https://perma.cc/E9ZA-JPPG>] (last visited Dec. 9, 2020).

103. Mark Maurer, *U.S. Audit Watchdog Overhauls Inspection Plan to Assess Virus Impact*, WALL ST. J. (Aug. 12, 2020, 3:10 PM), <https://www.wsj.com/articles/u-s-audit-watchdog-overhauls-inspection-plan-to-assess-virus-impact-11597259445> [<https://perma.cc/2HLQ-MAVC>].

104. See, e.g., *Reports for Audits Conducted in Accordance with Both Canadian Auditing Standards and the Standards of the Public Company Accounting Oversight Board (United States)*, CHARTERED PRO. ACCTS. CAN. (Dec. 2017), <https://www.cpacanada.ca/-/media/site/business-and-accounting-resources/docs/g10481-rg-audit-assurance-alert-combined-cas-pcaob-reports-january-2018.pdf?la=en&hash=62533402A0B94C654571B2D1B7DFA53FF6DB7384> [<https://perma.cc/JG3H-L589>].

105. PCAOB Release No. 2007-011, *supra* note 90, at A1-10.

106. Niemeier, *supra* note 88, at 1.

107. BYLAWS AND RULES OF THE PCAOB § 4(4011) (2014).

108. BYLAWS AND RULES OF THE PCAOB § 3(4012) (Aug. 30, 2004).

109. *Consultation Document: Monitoring the Work of Third Country Auditors*, FIN. REPORTING COUNCIL [FRC] (Mar. 2012), <https://www.frc.org.uk/getattachment/af821d86-7dc9-4d9f-b096-c664f8da3c55/-;.aspx> [<https://perma.cc/BSV2-YVDC>].

course of inspection;¹¹⁰ Brazil provides a good example of this method.¹¹¹ A local regulator may also put no restrictions at all. Russia's regulator had not made any comment on PCAOB's consultation and inspection in Russia had been proceeding smoothly since the beginning on the basis of PCAOB conducting their own inspection.¹¹² In general, the PCAOB now reports no major obstacles in fulfilling its inspection function, with the notable exception of China.¹¹³

II. China's Audit Oversight Regime and Restriction to Foreign Access

A. ACCOUNTING PROFESSION AND OVERSIGHT IN CHINA

The development of the auditing standards in China, and of the whole accounting industry, followed a very different path. While the auditing standard and oversight regime of the United States developed over a century, in China the accounting industry was built into its present form within twenty years. It is often said with a political undertone that the accounting profession of the United States has been developed "from the bottom up," whereas the Chinese counterpart was created "from the top down."¹¹⁴ For instance, in 2009, the Chinese State Council published a plan for the accounting industry to establish a tier structure of "10-200-7000" firms according to their sizes.¹¹⁵ The plan stated that the government would provide "political protection," entry barrier, and various government support to the largest firms.¹¹⁶ In this policy statement, it also explicitly asked companies that are listed in foreign markets, especially SOEs, to

110. Schnare Press Release, *supra* note 70, at 5.

111. See Lewis Ferguson, PCAOB Bd. Member, Speech at 6th Annual Conferência Brasileira de Contabilidade e Auditoria Independente (Jun. 13, 2016) in *Global Developments in Audit Oversight*, PCAOB (June 13, 2016), https://pcaobus.org/news-events/speeches/speech-detail/global-developments-in-audit-oversight_618 [<https://perma.cc/EQF3-G2ML>].

112. Anna Alon et al., *Dynamics and Limits of Regulatory Privatization: Reorganizing Audit Oversight in Russia*, 40(8) ORG. STUD. 1217, 1217-19 (2019).

113. Auditing firms in Hong Kong are also not adequately inspected, to the extent where their audits involve Chinese companies. See *Public Companies That Are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions Where the PCAOB Is Denied Access to Conduct Inspections*, PCAOB, <https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx> [<https://perma.cc/FM8E-N54G>] (last visited Dec. 9, 2020) [hereinafter *Public Companies*].

114. Shuwen Deng & Richard Macve, *How China Has Built an Accounting and Auditing Profession with Potential Global Impact* (Working Paper Jan. 15, 2018), <https://ssrn.com/abstract=3102253> [<https://perma.cc/SM25-MMME>].

115. *Id.* ("10-200-7000" means that the Chinese State Council planned the industry to have ten large accounting firm, 200 medium-sized firms, and 7000 small firms).

116. *Guanyu Jiakuai Fazhan Woguo Zhubu Kuaijishi Hangye de Ruogan Yijian* (关于加快发展我国注册会计师行业的若干意见) [*Opinion on Accelerating the Development of Our Country's CPA Industry*], Guowu Yuan Bangong Ting (国务院办公厅) [Office of the State Council] no. 56, 2009, at 2(3).

preferentially choose those accounting firms that are beneficial “to protecting the safety of national economic information.”¹¹⁷

China has aggressively mandated the localization of accounting firms. The Ministry of Finance issued a detailed scheme in 2012 that targeted the Big Four accounting firms.¹¹⁸ The scheme pointed at the larger proportion of foreign partners versus Chinese partners in and criticized the firms for not releasing board-level control from the Chinese partners.¹¹⁹ It implied that KPMG, PricewaterhouseCoopers (PwC), and Ernst & Young (EY) had too large a proportion of foreign partners at 70 percent, 61 percent, and 55 percent respectively.¹²⁰ The scheme obliged the Big Four firms to restructure their offices in China if they were to remain in the market.¹²¹ These measures are viewed as politically motivated.¹²² Further, the managing partner must be a Chinese national.¹²³ Within five years the number of “foreign partners” as well as their asset proportions were reduced to a flat 20 percent.¹²⁴ At the time of the scheme, none of the managing partners of the Big Four firm in China were locals, hence these requirement effectively ousted all four managing partners.

In terms of the institutions for audit oversight, China has not set up a separate body specifically for this function.¹²⁵ The duty of monitoring accounting firms is borne by both the CSRC and the Ministry of Finance.¹²⁶ The two agencies are both direct subordinates of the State Council of

117. *Id.* at 4(2).

118. See generally *Zhongwa Hezuo Kuaijishi Shiwusuo Bentubua Zhuanzhi Fangan* (中外合作会计师事务所本土化转制方案) [*Scheme for the Localization Restructuring of Chinese-Foreign Cooperative Accounting Firms*], Guowu Yuan Bangong Ting (国务院办公厅) [Office of the State Council] no. 8, 2012.

119. See generally *id.*

120. *Id.*

121. *Id.*

122. See Alexa McIsaac, *An Examination of Localization Success Factors of Chinese Big Four Accounting Firms*, DIG. COMMENTS (Apr. 2013), https://digitalcommons.bryant.edu/cgi/viewcontent.cgi?article=1001&context=honors_modern [<https://perma.cc/4J3T-W7BY>].

123. *Zhongwa Hezuo Kuaijishi Shiwusuo Bentubua Zhuanzhi Fangan*, *supra* note 118, at art. 11.

124. *Id.* at art. 6(3) (despite the emphasis on localization and local partners’ control, the restructure plan promulgated by the Ministry of Finance required the post-restructure firm to maintain the original foreign firm names).

125. See *China*, INT’L FED. ACCTS. (Aug. 2020), <https://www.ifac.org/about-ifac/membership/country/china> [<https://perma.cc/C3LV-ATFC>].

126. See *Zhonghua Renmin Gongheguo Caizhengbu Zbuyao Zhineng* (中华人民共和国财政部主要职能) [Responsibilities of Ministry of Fin, of the PRC], ZHONGHUO RENMIN GONGHEGUO CAIZHENGBU (中华人民共和国财政部) [MINISTRY FIN. PRC], <http://www.mof.gov.cn/znjg/bbzn/> [<https://perma.cc/WUV4-3VQA>] (last visited Dec. 9, 2020); see *Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Huijibu* (中国证券监督管理委员会会计部) [Accounting Dep’t of China Sec. Reg. Comm’n], ZHONGGUO ZHENGQUAN JIANDU GUANLI WEIYUANHUI (中国证券监督管理委员会) [CHINA SEC. REG. COMM’N], <http://www.csrc.gov.cn/pub/newsite/kjbj/> [<https://perma.cc/48TR-QHQ4>] (last visited Dec. 9, 2020).

China.¹²⁷ The CSRC focuses on the auditing of listed companies and their financial reporting, which is central to the audit dispute between the United States and China.¹²⁸ Almost the entire budget of the CSRC comes from direct government funding, with 0.71% from “other income.”¹²⁹ The Accounting Department (Chief Accountant Office) within the CSRC performs the function of monitoring the accounting firms that qualify for auditing listed companies, and annually it inspects 5 percent of the qualified accounting firms randomly.¹³⁰ Such qualified accounting firms are a category of their own.¹³¹ As of 2019, forty auditing firms are qualified for auditing listed company, and that translates to two of these qualified auditing firms being inspected every year.¹³² At the same time, the Accounting Department of CSRC is also responsible for other tasks such as advising on accounting matters in the CSRC’s investigation, administering the charging and taxation policies of securities market, and handling the budgeting and auditing of the CSRC.¹³³

127. See *Guowuyuan Zuzhi Jigou* (国务院组织机构) [*Internal Org. of the State Council of PRC*], ZHONGGUO RENMIN GONGHEGUO ZHONGYANGRENMINZHENGFU (中华人民共和国中央人民政府) [PRC Gov’t], <http://www.gov.cn/guowuyuan/zuzhi.htm> [https://perma.cc/4JWJ-J7AS] (last visited Dec. 9, 2020).

128. See *Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Huijibu* (中国证券监督管理委员会会计部) [*Accounting Dep’t of China Sec. Reg. Comm’n*], ZHONGGUO ZHENGQUAN JIANDU GUANLI WEIYUANHUI (中国证券监督管理委员会) [CHINA SEC. REG. COMM’N], <http://www.csrc.gov.cn/pub/newsite/kjb/> [https://perma.cc/3YX6-BZYL] (last visited Dec. 9, 2020).

129. *China Securities Regulatory Commission 2020 Departmental CSRC, Budget*, CSRC, <http://www.csrc.gov.cn/pub/zjhpublic/G00306213/202006/W020200611635297504738.pdf> [https://perma.cc/RTY2-G66W] (last visited Dec. 9, 2020).

130. *Zhongguo Zhengjianhui Suiji Chouchashixiang Qingdan* (中国证监会随机抽查事项清单) [*The Accounting Dep’t Inspection List*], ZHONGGUO ZHENGQUAN JIANDU GUANLI WEIYUANHUI (中国证券监督管理委员会) [CHINA SEC. REG. COMM’N], <http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201511/P020151113518850155088.pdf> [https://perma.cc/DZH6-AYCT] (last visited Dec. 9, 2020).

131. See *id.* The qualification to audit listed company has been an approval-based system. As of August 24, 2020, this will be changed into a registration-based system, and the number of firms is expected to increase. See *Yihuiman Zhuyi Shouguowuyuan Weituo Xiangguanguorenmin daibiao dahui Changwuweiyuanhui Baogaogupiao Faxingzhucegaige Youguangongzuoqingkuang* (易会满主席受国务院委托向全国人民代表大会常务委员会报告股票发行注册制改革有关情况) [*Chairman Yi HuiMan Entrusted by the*

State Council to Report to the Standing Committee of the National Representative Conference Report on the Work Related to the Reform of the Registration System for Stock Issuance], ZHONGGUO ZHENGQUAN JIANDUGUANLI WEIYUANHUI (中国证券监督管理委员会) [CHINA SEC. REG. COMM’N], http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/202010/t20201016_384469.html [https://perma.cc/6ZSY-9SQ4] (last visited Dec. 9, 2020).

132. Wu Tong, *40jia Zhengquanzhigebuijishi Shiwusuo Beigongbuchufajichuliqingkuang* (家证券资格会计师事务所公布被处罚及处理情况) [*Punishment and Handling of Forty Listed Accounting Firms*], WEMP (Oct. 18, 2020, 11:15 AM), https://wemp.app/posts/fa64c2f4-5749-427d-92d3-468b681d19bc?utm_source=bottom-latest-posts [https://perma.cc/7KJ6-A3XS].

133. *Zhongguo Jianshenghui* (中国证监会) [*Accounting Department of China*], MBAWIKI, <https://wiki.mbalib.com/wiki/%E4%B8%AD%E5%9B%BD%E8%AF%81%E7%9B%91%E4%BC%9A#:~:text=%E4%B8%AD%E5%9B%BD%E8%AF%81%E7%9B%91%E4>

The Ministry of Finance has the role of monitoring and inspecting all accounting firms in the country, regardless of whether the firm is qualified for an auditing listed company.¹³⁴ They conduct their work through their provincial branch office, often through cooperation with the Chinese Institute of Certified Public Accountants (CICPA).¹³⁵ The Ministry of Finance has a wider scope of monitoring, and most are on the local accounting firms and companies.¹³⁶ In the last available annual review of 2017, they conducted enforcement action on seventeen accounting firms and seventy-four companies.¹³⁷ In the same year, they also randomly inspected six accounting firms that are qualified for providing services to listed companies.¹³⁸ When a problem is detected in a qualified accounting firm, the Ministry of Finance and CSRC will form a joint team to conduct inspection.¹³⁹ The two agencies may jointly order sanctions, for example to suspend the license of an accounting firm to conduct further business with listed companies.¹⁴⁰ It should be noted that the combined number of

%BC%9A%E7%9A%84%E5%B7%A5%E4%BD%9C%E8%81%8C%E8%B4%A3,-%E4%BE%9D%E6%8D%AE%E6%9C%89%E5%85%B3%E6%B3%95%E5%BE%8B&text=%EF%BC%88%E4%B8%80%EF%BC%89%E7%A0%94%E7%A9%B6%E5%92%8C%E6%8B%9F%E5%AE%9A%E8%AF%81%E5%88%B8,%E7%9B%91%E4%BA%8B%E4%BC%9A%E7%9A%84%E6%97%A5%E5%B8%B8%E7%AE%A1%E7%90%86%E5%B7%A5%E4%BD%9C%E3%80%82 [https://perma.cc/L5ST-WM67] (last visited Dec. 9, 2020).

134. *Id.*

135. *Caizhengbu Bangongting Guanyu Yinfa Jiaqiang Zhuce Kuaijishi Hangye Lianhe Jianguan Ruogan Cuoshi De Tong Zhi*

(财政部办公厅关于印发加强注册会计师行业联合监管若干措施的通知) [*Notice by the General Office of the Ministry of Finance of Issuing the Certain Measures for Strengthening the Joint Supervision of the Certified Public Accountants Industry*], CAIJINGBU GONGBANTING (财经部办公厅) [GEN. OFF. MINISTRY FIN.] no. 10 (Apr. 22, 2020), http://www.gov.cn/zhengce/zhengceku/2020-04/30/content_5507755.htm [https://perma.cc/2ZWB-KY4A].

136. See *Zhonghuarenmin Gongheguo Caizhengbu Zhuyao Zhineng*

(中华人民共和国财政部主要职能) [*Responsibilities of Ministry of Fin. of the PRC*], ZHONGHUARENMIN GONGHEGUO CAIZHENGBU (中华人民共和国财政部) [MINISTRY FIN. PRC], <http://www.mof.gov.cn/zjnj/bbzn/> [https://perma.cc/9RBD-E64Y] (last visited Dec. 9, 2020).

137. *2017 Nian Caizhengbu Kuaiji Jiandu Jiancha Chuli Qingkuang*

(年财政部会计监督检查处理情况) [*2017 Report of the Ministry of Finance Inspection and Enforcement Actions on Auditors*], CAIJINGBU GONGBANTING (财经部办公厅) [GEN. OFF. MINISTRY FIN.] no. 39, (2018).

138. *Kuaiji Xinxi Zhiliang Jiancha Gonggao Di Sanshijiu Hao*

(会计信息质量检查公告第三十九号) [*Announcement of the Accounting Information Quality Inspection of the Ministry of Finance of the People's Republic of China*], CAIJINGBU GONGBANTING (财经部办公厅) [GEN. OFF. MINISTRY FIN.] no. 39 (Oct. 18, 2018), <http://www.shanghaiinvest.com/cn/viewfile.php?id=13270> [https://perma.cc/7SV9-UPDF].

139. *Guozhai Chengxiaotuan Chengyuanzige Shenpi Banfa* (国债承销团成员资格审批办法) [*Measures for the Examination and Approval of Membership of National Bond Underwriting Syndicate*], CAIJINGBU (财经部) [MINISTRY FIN.] no. 39 (May 7, 2006), http://www.gov.cn/flfg/2007-03/05/content_541551.htm [https://perma.cc/CG7H-9MH9].

140. *Caizhengbu Guanyu Xingai Kuaijishi Shiweisuo Zhiyexuke he Jiandu Guanlibanfa* (财政部关于修改《会计师事务所执业许可和监督管理办法》等2部部门规章的决定) [*The*

inspections done by the CSRC and Ministry of Finance is still markedly less than the U.S. counterpart's annual inspection on all the larger firms.¹⁴¹ It can be said that the mechanism of monitoring audit work on a listed company is still under development and is not yet emphasized by the Chinese regulators.

B. CHINA'S LAW ON RESTRICTION TO ACCESS TO AUDIT DOCUMENTS

With regard to the access of auditing documents, the law in China is very stringent.¹⁴² There are multiple pieces of legislation and administrative circulars governing different subject areas that are relevant.¹⁴³ These start with the general provision for the confidentiality duty of accountants.¹⁴⁴ Then for audits of listed companies, there are specific prohibitions for transferring documents to overseas parties.¹⁴⁵ The Securities Law of 2019 states that a securities service institution (that includes audit firms, law firms, etc.) shall properly preserve clients' documents, verification materials, working papers, and may not divulge such material.¹⁴⁶ Anyone who contravenes can be fined up to five million yuan, have its business permit revoked, or be prohibited from providing relevant services.¹⁴⁷ The responsible person in charge and other directly liable persons may be criminally prosecuted.¹⁴⁸ Furthermore, an expressed ban in the Securities Law prohibits overseas securities regulators, such as the SEC, from conducting any investigation, evidence collection or other activities within China.¹⁴⁹ Local entities or individuals are in turn prohibited from providing documents or materials relating to securities business to any overseas regulators.¹⁵⁰

Ministry of Finance on the Revision of the "Accounting Firm License and Supervision Management Measures, etc." 2 Decisions of Ministry Regulations], CAIJINGBU (财经部) [MINISTRY FIN.] no. 97 (2019).

141. *Guozhai Chengxiaotuan Chengyuanzige Shenpi Banfa*, *supra* note 139.

142. See *What Is the Difference Between Western and China's Accounting Standards*, LEHMAN, LEE & XU, <http://www.lehmanlaw.com/resource-centre/faqs/accounting-and-auditing/what-is-the-difference-between-western-and-chinas-accounting-standards.html> [<https://perma.cc/U2FZ-2BMR>] (last visited Dec. 9, 2020).

143. See *id.*

144. *Zhonghua Renmin Gongheguo Zhuce Kuaijishi Fa* (中华人民共和国注册会计师法) [Certified Public Accountants Law of the People's Republic of China], (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 13, 1993, amended 2014), art. 19 (China).

145. See *id.*

146. *Zhonghua Renmin Gongheguo Zhengquan Fa* (中华人民共和国证券法) [Securities Law of the People's Republic of China], (promulgated Dec. 28, 2019, implemented Mar. 1, 2020), art. 162 (China).

147. *Id.* at art. 180.

148. *Id.* at art. 214.

149. *Id.* at art. 177.

150. See *Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa* (中华人民共和国保守国家秘密法) [Law of the People's Republic of China on Guarding State

Central to the dispute to access audit document is the law regarding state secrets. The State Secrets Law of 2010 prohibits transferring overseas any document or other item containing state secret.¹⁵¹ Yet, there are a lot of ambiguities both in the substance of state secrets and the procedure of determining what constitutes state secrets.¹⁵² The law encompasses a wide range of matters that may be classified as state secrets, with one of the categories termed as “secret matters in national economic and social development.”¹⁵³ The range of information that were put forward as state secrets by litigants in the Chinese court is wide, including payment information of social security fees, financial information of a company that contracted with military, transaction information of property and land relating to certain government agencies, or any documents that were created as an extension of some other classified documents.¹⁵⁴ While not all cases were substantiated by the court, the range of information that may be suggested as state secrets signify a considerable litigation risk faced by auditing firms if they are to hand over their audit information to an overseas party.¹⁵⁵

State Secrets Law also contains a catchall provision, where even if information is not marked as classified, but if one “should have known” it concerns national security and national interest, one would still be prosecuted in the same manner.¹⁵⁶ Another extra complexity in the law is that during the court process, the question of what constitutes a state secret and the level of secrecy is considered in order to identify which of the state

Secrets], (promulgated by the Standing Comm. of the Nat’l People’s Cong., Apr. 29, 2010, effective Oct. 1, 2010), art. 26.

151. *Id.*

152. Huang, *supra* note 15.

153. Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa, *supra* note 150, at art. 9.

154. *See, e.g.*, Liumou Yu Nanjingshi Renliziyuan he Shehuibaozhangju Xingzhengfuyi Xingzheng Panjueshu (刘某与南京市人力资源和社会保障局行政复议行政判决书) [Liu Mou and Nanjing Municipal Human Resources and Social Security Bureau, Nanjing Municipal People’s Government Administrative Supervision, Administrative Reconsideration and Administrative Judgment of the First Instance], CLI.C.78071137 Lawinfochina (Railway Transport Court of Nanjing 2019); *see* Zhaomou Wangmou yu Jiangsu Baoke Dianzi Youxiangongsi Mingshi Panjueshu (赵某、王某与江苏宝科电子有限公司民事判决书) [First-Instance Civil Judgment on Disputes between Zhao and Wang and Shareholders of Jiangsu Baoke Electronics Co Ltd on the Right to Know], CLI.C.94846250 Lawinfochina (Court of Yangzhou Economic Zone 2018); Huangmou deng yu Ziranziyuanbu deng Xingxigongkai Xingzheng Pangjueshu (黄某等与自然资源部等信息公开行政判决书) [Administrative Judgment of Beijing No.3], CLI.C.97328639 Lawinfochina (Court of Tongzhou District 2019); *see* Shanghai Jingxie Gongsi Su Jiandeshi Qita Xinxi Gongkaian (上海经协公司诉建德市政府其他信息公开案) [Shanghai Economic Association Company v. Jiande Municipal Government Other Information Disclosure Case], CLI.C.861533 Lawinfochina (Higher People’s Court of Zhejiang 2012).

155. *See id.*

156. Zhonghua Renmin Gongheguo Baoshou Guojia Mimi Fa

(中华人民共和国保守国家秘密法) [Law of the People’s Republic of China on Guarding State Secrets], (promulgated by the Standing Comm. of the Nat’l People’s Cong., Apr. 29, 2010, effective Oct. 1, 2010), art. 5.

secrets protection agencies, from various levels, should appraise the information.¹⁵⁷ This means that a piece of information can be retroactively recognized as a state secret after the matter goes into court. It may not be conclusively ascertained whether a particular document contains state secrets or not until consultation with the relevant government agency.¹⁵⁸ If prosecuted, the punishment that the law sets down is harsh.¹⁵⁹ According to a judicial interpretation issued by the Supreme People's Court, which has the highest authority in case handling, any person who unlawfully supplies "three or more items" of state secrets abroad is regarded as acting in an "especially serious circumstance," and shall be sentenced to imprisonment for a minimum of ten years.¹⁶⁰

A relevant securities regulation that directly links the handling of audit documents to the State Secret Law is the CSRC Circular No. 29,¹⁶¹ which is also referenced by the Ministry of Finance's Interim Provisions released to accounting firms.¹⁶² Circular No. 29 states that "any archives, including working papers, which are created in mainland China . . . in the course of any overseas issuance and listing of the securities, shall be stored in mainland China[.]"¹⁶³ and that if the documents involve any state secrets, national security, or other substantial interests of the state, then prior approval is required from competent authorities before such working papers can be transferred to any "overseas institutions or individuals through any means."¹⁶⁴ Circular No. 29 also specifies the requirement for accessing documents for purposes of foreign monitoring.¹⁶⁵ Where overseas securities regulatory authorities conduct inspections on companies listed overseas, which may involve documents that contain state secrets, the listed company

157. Zuigao Renmin Fayuan Guanyu Shenli Wei Jingwai Qiequ, Citan, Shoumai, Feifa Tigong Guojia Mimi, Qingbao Anjian Juti Yingyong Falü Ruogan Wenti De Jieshi (最高人民法院关于审理为境外窃取、刺探、收买、非法提供国家秘密、情报案件具体应用法律若干问题的解释) [Supreme People's Court Interpretation of Certain Issues Regarding Application of State Secrets Law] (promulgated by the Sup. People's Ct., Nov. 20, 2000, effective Jan. 22, 2001), at art. 7.

158. *Id.*

159. *See id.* at art. 2.

160. *See id.* at art. 2 §2.

161. Guanyu Jiaqiang Zaijingwai Faxing Zhengquan Yu Shangshi Xiangguan Baomi He Dangan Guanli Gongzuo (关于加强在境外发行证券与上市相关保密和档案管理工作) [The Regulation on Strengthening Confidentiality and Archives Administration Relating to Overseas Issuance and Listing of Securities] (promulgated by the China Securities Regulatory Commission, Nov 20, 2009), No. 29, at art. 3.

162. Huijishi Shiwusuo Congshi Zhongguo Neidi Qiye Jingwai Shangshi Shenji Yewu Zanzing Guiding (会计师事务所从事中国内地企业境外上市审计业务暂行规定) [Interim Provisions on Accounting Firms' Provision of Auditing Services for the Overseas Listing of Enterprises in Chinese Mainland] (promulgated by the Ministry of Finance, May 26, 2015, effective Jul. 1, 2015), art. 12.

163. Guanyu Jiaqiang Zaijingwai Faxing Zhengquan Yu Shangshi Xiangguan Baomi He Dangan Guanli Gongzuo, *supra* note 161, at § 6.

164. *Id.*

165. *Id.* at 8.

or the auditing firm should report as such to the authorities to obtain approval, and then to the department that is responsible for managing the state secret.¹⁶⁶ In short, the regulations from the CSRC and the Ministry of Finance reiterate and again remind the auditing firms of the overhanging legal restrictions set out in the State Secret Law.

The above rules and regulations regarding audit documents all set out that approval from competent agencies is required prior to any foreign inspection.¹⁶⁷ The emphasis is on maintaining ample control within China's national border.¹⁶⁸ As the net of what could constitute state secrets is wide and ambiguous, and as a lot of sectors in China have a strong state-owned presence, the possibility for a company's information to involve state secrets is not neglectable.¹⁶⁹ Audit firms therefore need to obtain the necessary approval in order to minimize their own legal risks.¹⁷⁰ In practice, however, there is a sizeable administrative hurdle for any accounting firm seeking to obtain the necessary clearance. For instance, it is difficult to tell which governmental department is to be regarded as the "competent agency," as it depends on the specific information under concern, and more than one government agency may be involved.¹⁷¹ In any case, the channel for such process is not clearly specified.

III. Dispute over Access to Chinese Audit Documents in the United States

A. CHINESE COMPANIES LISTING IN THE U.S. MARKETS

The two jurisdictions collided as Chinese companies started to arrive to the U.S. market. These Chinese companies may not have actually been incorporated in China, and may instead have their places of incorporation in the British Virgin Islands, Cayman Islands, or other jurisdictions.¹⁷² In any

166. *Id.*

167. In fact, the CSRC has also issued a letter of notice to some accounting firms to stress that audit working papers should not be provided to overseas entities without the CSRC's prior approval. See Zhongguo Zhengjianhui Guanyu Bufen Kuaijishi Shiwusuo Xiangjingwai Tigong Shenji Gongzuo Digao Deng Dangan Wenjian De Fuhan

(中国证监会关于部分会计师事务所向境外提供审计工作底稿等档案文件的复函) [Reply of the China Securities Regulatory Commission on the Provision of Audit Work Papers and Other Archive Documents by Some Accounting Firms Overseas] (on file with the author) (This letter is internal and has not been made public). See also Online Interview with an Anonymous Academic (July 19, 2020) (on file with author); Online Interview with an Accountant Who Has Seen the Letter (July 20, 2020) (on file with author).

168. See sources cited *supra* note 167.

169. *Id.*

170. See Zhongguo Zhengjianhui Guanyu Bufen Kuaijishi Shiwusuo Xiangjingwai Tigong Shenji Gongzuo Digao Deng Dangan Wenjian De Fuhan, *supra* note 167, at 6.

171. *Id.* at 2.

172. *How China Supercharged the Offshore Market in Cayman and British Virgin Islands*, WALKERS GLOB. (Dec. 2016), https://www.walkersglobal.com/images/Publications/Articles/2016/12.2016_Global_Turnaround_asia.pdf [<https://perma.cc/6R7R-4T44>].

case, their significant assets, or earnings, are located within China and they are grouped together by the market as “China Concepts Stock” (CCS).¹⁷³ The companies listed in the United States are required to comply with the reporting and monitoring standards of the United States, and the auditors providing services to them need to be registered with the PCAOB and are required to be inspected.¹⁷⁴ As of now, the majority of CCS companies are listed on the Nasdaq in the range of around 180 companies, many of which are tech companies or smaller sized companies, with the larger companies mostly found on the NYSE.¹⁷⁵

The characteristics of Chinese companies that sought listing in the United States varied at different stages.¹⁷⁶ The earliest ones arrived in the 1990s, when the largest Chinese companies sought not only to broaden their shareholder base and increase liquidity, but also to tap into the more prudent corporate governance requirement of the U.S. exchanges.¹⁷⁷ In 1993, Sinopec Shanghai Petrochemical was the first Chinese company to stage an Initial Public Offering (IPO) in the form of American Depository Receipts (ADR).¹⁷⁸ This was against the backdrop of a rapid phrase of “Reform and Opening Up” in China.¹⁷⁹ The Chinese government encouraged its largest enterprises to benefit from the foreign capital and governance standards that its own domestic market lacked.¹⁸⁰ The “second wave” of Chinese companies seeking listings in the United States occurred around the 2000s and was comprised of a further stream of state-owned enterprises.¹⁸¹ The companies that arrived at these times were generally still the most well-established companies.¹⁸² Some of the pioneering tech companies of China also began listing in the United States at this time, such as Baidu which was

173. See generally *Chinese Companies Listed on Major U.S. Stock Exchanges* U.S.-CHINA ECON. SEC. REVIEW COMM’N. (Oct. 2, 2020), https://www.uscc.gov/sites/default/files/2020-10/Chinese_Companies_on_US_Stock_Exchanges_10-2020.pdf [https://perma.cc/EX5B-NL4V].

174. See *id.* at 1.

175. There are around eighty Chinese companies on NYSE, and also some companies traded in the Over-the-Counter (OTC) market. See generally *id.* See also *Company Directory*, OTC MKTS., <https://www.otcmarts.com/corporate-services/company-directory> [https://perma.cc/ECY8-NERB] (last visited Dec. 13, 2020).

176. See generally U.S.-CHINA ECON. & SEC. REV. COMM’N, 113TH CONG., 1ST SESS., USCC 2013 ANNUAL REPORT (Comm. Print 2013).

177. *Id.* at 4.

178. *Id.* at 135.

179. See *id.* at 35. See generally Yonglong Lu et al., *Forty Years of Reform and Opening Up: China’s Progress Toward a Sustainable Path*, 5 SCI. ADVANCES 8 (Aug. 7, 2019), <https://advances.sciencemag.org/content/5/8/eaau9413/tab-pdf> [https://perma.cc/86J7-9Y43].

180. David Cogman & Gordon Orr, *How They Fell: The Collapse of Chinese Cross-Border Listings*, MCKINSEY & CO., 2 (Dec. 1, 2013), <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-they-fell-the-collapse-of-chinese-cross-border-listings> [https://perma.cc/74PQ-WDBL].

181. *Id.*

182. See generally *Chinese Companies Listed on Major U.S. Stock Exchanges*, *supra* note 173, at 3–15. (illustrating the IPO dates for Chinese companies listed on the major U.S. stock exchanges).

listed on Nasdaq in 2005.¹⁸³ The U.S. markets were ideal for these companies because of the readily available capital, as well as the markets' experience with technology startup listings.¹⁸⁴

The third wave of listings, in the late 2000s to early 2010s, saw a much quicker surge in the number of companies getting into the U.S. markets.¹⁸⁵ These companies were much smaller in size and were often privately owned.¹⁸⁶ A major motivation behind their listing in the United States was that they were often unable to compete for either bank capital or IPO in their own domestic market.¹⁸⁷ China's regulation of securities offerings has long been a merits-based system under which the issuer needs to go through a merit review process, conducted by the CSRC, for pre-approval of securities offerings, in addition to the usual requirements of adequate information disclosure.¹⁸⁸ It was not easy for privately owned issuers to get approval because the listing capacity of the Chinese market was quite limited and the CSRC also gave listing preference to state-owned enterprises.¹⁸⁹ Further, compared to the IPO market in China, the U.S. market has some important advantages for the Chinese issuer, including but not limited to: access to international capital, good liquidity powered by global institutional investors, and strong reputational effects.¹⁹⁰ Around the period of the third wave of listings, the U.S. investment banks and other service firms had established themselves and formed their business connections in China.¹⁹¹ These factors made it ripe for the listing surge of these smaller companies into the U.S. market. But due to the weaker corporate governance, a lack of corporate regulatory oversight, and the underdeveloped standards for accounting practices, it is hardly surprising that these companies would cause disproportional trouble as they failed.¹⁹² It is estimated that, by the end of the collapse in value for China Concept Stocks, these companies would represent less than one percent of the total value of all U.S.-listed Chinese companies.¹⁹³

B. SEC'S LAWSUITS AGAINST CHINESE BRANCH OF BIG FOUR ACCOUNTING FIRMS

Beginning in the 2010s, just as the PCAOB was stepping up its foreign inspection regime, a series of auditing scandals involving these China

183. Cogman & Orr, *supra* note 180, at 2.

184. *Id.* at 3.

185. *Id.*

186. *Id.*

187. *Id.*

188. ROBIN HUI HUANG, SECURITIES AND CAPITAL MARKETS LAW IN CHINA 55–56 (2014).

189. *Id.*

190. *Id.*

191. See Cogman & Orr, *supra* note 180, at 3.

192. See *id.*; see also USCC 2013 ANNUAL REPORT, *supra* note 176, at 134.

193. Cogman & Orr, *supra* note 180, at 3.

Concepts Stock began to emerge.¹⁹⁴ Ernst & Young was named in two class-action lawsuits over its work on the Chinese company, Sino-Forest, which eventually went bankrupt.¹⁹⁵ KPMG was also implicated by possible irregularities in the audit of China Forestry, leading to a suspension of its shares.¹⁹⁶ Following the auditing scandals of these Chinese companies, the PCAOB began its action to inspect the auditing firms.¹⁹⁷ These registered Chinese auditing firms had never been inspected at that time.¹⁹⁸ As mentioned above, under the Sarbanes-Oxley Act, a foreign accounting firm is also obliged to produce the audit working papers related to any audit work upon request.¹⁹⁹ But when the PCAOB used its Section 106 powers to request production of audit working papers, the auditing firms all refused to comply, reasoning that it might be a violation of Chinese laws to do so.²⁰⁰ The Chinese laws governing the protection of state secrets were quoted by the accounting firms to justify their restriction on foreign access to the Chinese companies' books, records, and audit working papers.²⁰¹ As the firms refused the requests to provide working papers, the SEC and the PCAOB found their ability to oversee the financial reporting of Chinese companies seriously limited.²⁰²

A series of lawsuits over access to audit documents started with Deloitte's member firm in China, which was the auditor for Longtop Financial.²⁰³

194. See sources cited *infra* notes 195 & 196.

195. Sino-Forest was a private company and not a SOE, despite its name containing "Sino." In its books it had forests that did not actually exist. Eventually Sino-Forest would bankrupt in 2012, with damages awarded to plaintiff in civil lawsuits for up to \$7.6 billion USD. Ernst & Young would have to pay up to \$125 million USD to settle. See Peter Koven & Barbara Shecter, *OSC Accuses Ernst & Young as Firm Settles Sino-Forest Class Action Suit*, FIN. POST (Dec. 3, 2012), <https://financialpost.com/news/fp-street/osc-accuses-ernst-young-of-insufficient-audits-of-sino-forest> [<https://perma.cc/RYQ9-EDPG>].

196. China Forestry had its turnover overstated by at least 92 percent, and its plantation assets overstated by at least 87 percent. China Forestry was a private company incorporated in Caymans Islands. REUTERS, *FACTBOX- China's Corporate History Rocked by Accounting Scandals*, THOMSON REUTERS FOUND. NEWS (Jun. 20, 2011, 5:52 AM), <https://news.trust.org/item/20110620055200-vltc5/> [<https://perma.cc/WU8J-899S>].

197. See William D. Duhnke, *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally – Discussion of Current Information Access Challenges with Respect to U.S.-Listed Companies with Significant Operations in China*, PUB. CO. ACCT. OVERSIGHT BD. (Dec. 7, 2018), <https://pcaobus.org/News/Speech/Pages/statement-vital-role-audit-quality-regulatory-access-audit-information-internationally.aspx> [<https://perma.cc/X6PW-CAYE>].

198. See *id.*

199. Sarbanes-Oxley Act, 15 U.S.C. § 7216 (2002).

200. BDO China Dahua CPA Co. Ltd., et al, Securities Act Release No. 74217, Admin. Proc. File Nos. 3-14872, 3-15116, at 8, 11, 14, 16 (U.S. Sec. Exch. Comm'n. Feb. 6, 2015) (corrected order on the basis of offers of settlement).

201. *Id.* at 22.

202. See Duhnke, *supra* note 197, at 5.

203. Longtop was a Chinese software company and was listed on the NYSE from 2007. Its profit and bank balance were forged with some help from the bank's staff. The fraud was only discovered following repeated challenges and a physical visit to the bank by Deloitte. See

Deloitte had signed off six previous audit reports for Longtop when a research firm in 2011 alleged that the company's profit margin was unreasonably high.²⁰⁴ Deloitte then discovered the fraud, which involved the company forging the entire bank balance, and resigned from acting as the company's auditor.²⁰⁵ As the SEC began investigating the auditor, the company was eventually delisted.²⁰⁶ In the Deloitte investigation, the company refused the PCAOB's request to provide documentation.²⁰⁷ The argument put forward by Deloitte was that if they were to comply with the PCAOB's request, they would have to violate the Chinese law and the firm and its partners would be subject to punishment in China.²⁰⁸ The SEC then sued Deloitte in May 2012.²⁰⁹

In the same year, the SEC requested documents from all the other Big Four firms, as part of the SEC's investigations into the wrongdoings of nine more China-based companies.²¹⁰ The accounting firms refused to cooperate and all followed Deloitte's argument in their own challenges.²¹¹ Then, in December, the U.S. regulators stepped up their effort to sue all the Big Four audit firms, plus one other major U.S. firm.²¹² The proceedings were against the Chinese affiliates of each of the Big Four firms, as the SEC sought a court order to compel the firms to provide the requested auditing information.²¹³ If a court order is issued to compel a party to provide documents and they still refuse to do so, the partners of those firms may face a large fine, or imprisonment, for being in contempt of court.²¹⁴

While these cases were ongoing, the SEC and CSRC were in constant negotiation.²¹⁵ First, SEC Chairman Mary Schapiro visited Beijing in July

generally Floyd Norris, *The Audacity of Chinese Frauds*, N.Y. TIMES (May 26, 2011), <https://www.nytimes.com/2011/05/27/business/27norris.html> [<https://perma.cc/D4VE-DKRX>].

204. *Id.* at 1.

205. *Id.*

206. *See generally id.* at 2.

207. Press Release, SEC, SEC Charges Deloitte & Touche in Shanghai with Violating U.S. Securities Law in Refusal to Produce Documents, Release No. 2012-87 (May 9, 2012), <https://www.sec.gov/news/press-release/2012-2012-87htm> [<https://perma.cc/QM8Q-EA35>].

208. PAUL GILLIS, *THE BIG FOUR AND THE DEVELOPMENT OF THE ACCOUNTING PROFESSION IN CHINA* 150 (2014).

209. SEC Press Release No. 2012-87, *supra* note 207.

210. Press Release, SEC, SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents, Release No. 2012-249 (Dec. 3, 2012), <https://www.sec.gov/news/press-release/2012-2012-249htm> [<https://perma.cc/RC46-Z8BQ>].

211. GILLIS, *supra* note 208.

212. SEC Press Release No. 2012-249, *supra* note 210.

213. BDO China Dahua CPA Co. Ltd. et al., Securities Act Release No. 68335, Admin. Proc. File Nos. 3-15116, at 3 (U.S. Sec. Exch. Comm'n. Dec. 3, 2012) (order instituting administrative proceedings).

214. 18 U.S.C. § 401 (1948).

215. BDO China Dahua CPA Co. Ltd. et al., *supra* note 213.

2012 to discuss the problem of document access.²¹⁶ Then, a CSRC delegation went to Washington in November 2012, although there was still no change in position.²¹⁷ It was not until shortly before the scheduled public hearing of the Longtop case that the CSRC informed the SEC that they would be turning over the audit working papers.²¹⁸ This dramatic episode eventually concluded with the cooperation of Chinese authorities, such that these accounting firms at last all turned over the working papers to the SEC.²¹⁹ These lawsuits, and their eventual settlement, set the stage for U.S. and Chinese regulators to come to an agreement.²²⁰

C. CHINA-U.S. MOU AND POST-2013 DEVELOPMENT

Following heated disputes and court actions, authorities in the United States and China came to an agreement in 2013.²²¹ This was the result of a long series of high-level bilateral discussion and was only made possible under a period of a general good relationship between the United States and China.²²² The issue was raised as early as 2009, when the two countries established a bilateral Strategic and Economic Dialogue during the Obama and Hu Jintao presidency.²²³ In the first dialogue meeting, the issue of PCAOB's inspections was already included on the agenda.²²⁴ Then in the third round of meetings, in 2011, both sides agreed to make joint efforts to accelerate reaching agreement on the issue.²²⁵ That same year, the Sino-U.S. Symposium on Audit Oversight was held in Beijing, although in

216. See Xijua, *Chinese Vice Premier Meets SEC Chair*, PEOPLE CHINA (Jul. 3, 2012), <http://en.people.cn/90883/7863478.html> [<https://perma.cc/4XNF-MHGZ>].

217. Paul Gillis, *Tong Daochi on Audit Cooperation*, CHINA ACCT. BLOG (Dec. 11, 2012, 12:15 AM), <https://www.chinaaccountingblog.com/weblog/tong-daochi-on-audit-cooper.html> [<https://perma.cc/6XUN-B9C4>].

218. Sarah N. Lynch, *SEC, Deloitte Resolve Dispute Over Longtop Audit Work Papers*, REUTERS (Jan. 27 2014, 4:30 PM), <https://www.reuters.com/article/court-sec-deloitte-idCNL2N0L11PX20140127> [<https://perma.cc/C78V-69A6>].

219. See *id.*; see also Press Release, SEC, SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents, Release No. 2015-25 (Feb. 26, 2015), <https://www.sec.gov/news/pressrelease/2015-25.html> [<https://perma.cc/EY44-F4Q9>].

220. SEC Press Release No. 2015-25, *supra* note 219.

221. See Lynch, *supra* note 218.

222. GILLIS, *supra* note 208, at 157.

223. *Id.*

224. *Id.*

225. Wang Qishan, Vice Premier of China, Remarks at the Opening Session of the U.S.-China Strategic and Economic Dialogue (May 9, 2011), in *Remarks at the Opening Session of the U.S.-China Strategic & Economic Dialogue*, U.S. DEP'T STATE (Jan. 20, 2017), <https://2009-2017.state.gov/secretary/20092013clinton/rm/2011/05/162881.htm> [<https://perma.cc/RG9C-KAU7>].

another two rounds of dialogue the audit issue was not seen moving forward.²²⁶

Finally on May 10, 2013, the PCAOB, the CSRC, and the Chinese Ministry of Finance signed a Memorandum of Understanding on Enforcement Cooperation (2013 China-U.S. MoU), establishing a cooperative framework between the two sides for the production and exchange of audit documents.²²⁷ The 2013 China-U.S. MoU serves to provide a mechanism for the parties to request and receive, from each other, assistance in obtaining information.²²⁸ According to Article IV of the 2013 China-U.S. MoU, the assistance available under the MoU is to provide “information and documents held in the files of the Requested Party,” and such information may include “documents sufficient to identify all audit review or other professional services” as well as “audit working papers or other documents held by audit firms.”²²⁹ Under the provision of the MoU, the PCAOB can request financial records in relation to an investigation and may pass those documents to the SEC, after Chinese regulators approve that giving the financial records would not violate their local laws.²³⁰ Information received through the MoU may be used solely for the purpose of conducting administrative enforcement proceedings and investigations, including the imposition of sanctions on audit firms based in China.²³¹ The MoU provided four grounds to deny a request: (i) where providing documents is contrary to a party’s domestic law, (ii) where the request is not made in accordance with provisions of the MoU, (iii) on grounds of public interest or essential national interest, and (iv) where the request lacks sufficient specificity.²³² The MoU defines investigations narrowly as inquiries into the actions or omissions of audit firms only, which does not include investigations into issues arising from the companies the firms audited.²³³

The signing of the MoU, with its stated content of mutual assistance, seems to represent a first step into further cooperation between the two sides. But despite significant time and resources being spent in negotiating the MoU, there have been many difficulties in actually gaining access to necessary auditing records.²³⁴ In fact, it seems that there were only four such

226. See *Sino-U.S. Audit Oversight Cooperation Faces Difficulties*, XINHUA NEWS AGENCY (Aug. 10, 2011), http://www.china.org.cn/business/2011-08/10/content_23183587.htm [<https://perma.cc/EMV8-9RVP>].

227. News Release, PCAOB, PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators, (May 24, 2013), https://pcaobus.org/News/Releases/Pages/05202013_ChinaMOU.aspx [<https://perma.cc/DEN6-69VW>].

228. *Id.*

229. Memorandum of Understanding on Enforcement Cooperation, China-U.S., Art. 4, May 5, 2013, <https://justthenews.com/sites/default/files/2020-05/PCAOB-ChinaMay2013Memo.pdf> [<https://perma.cc/7RBF-UGSZ>] [hereinafter 2013 China-US MoU].

230. *Id.* at Art. IX (c).

231. *Id.* at Art. VII(a)(ii).

232. *Id.* at Art. III(b).

233. *Id.* at Art. II.

234. See Duhnke, *supra* note 197, at 5.

instances of CSRC providing access since the signing of the MoU, as well as one joint inspection at a registered audit firm.²³⁵ It is unclear how many requests were made over the same period, but the PCAOB was certainly dissatisfied.²³⁶ In a subsequent policy paper, the PCAOB plainly stated that it was being prevented from inspecting the audit work and practices of accounting firms in China, and also of audit firms in Hong Kong, to the extent their clients had operations in China.²³⁷ According to the PCAOB, the position of the Chinese authorities was the obstacle to inspection.²³⁸ In the PCAOB's own words, "since signing the MoU in 2013, Chinese cooperation has not been sufficient for the PCAOB to obtain timely access to relevant documents and testimony necessary to carry out our mission . . . nor have consultations undertaken through the MoU resulted in improvements."²³⁹ It is peculiar why the signing of the MoU, despite the original showing of good will from both sides, ended up not improving the situation. Later rounds of dialogue have also not further advanced the cooperation.²⁴⁰ It could be that the two sides indeed had different interpretations of what they had originally agreed to do in the first place. The SEC and the PCAOB might have expected that their Chinese counterpart would provide access to audit documents, on par with other jurisdictions. Yet, the CSRC, following the black letter on the MoU, may have only intended to allow for discretionary access on a case-by-case basis. In any case, the PCAOB now publishes a list of companies with which it faces obstacles in inspecting the principal auditor's work, and these companies are overwhelmingly either Chinese or from Hong Kong.²⁴¹

In 2020, serious accounting frauds perpetuated by Chinese companies were exposed again, and, again, this was followed by a crash of their share prices amid the market slump of the COVID-19 pandemic.²⁴² One of the

235. Press Release, Zhongguo zhengjian hui (中国证监会) [China Securities Regulatory Commission], Zhongguo zhengjian hui youguan fuze ren da jizhe wen (中国证监会有关负责人答记者问) [Relevant Person in Charge of China Securities Regulatory Commission Answered Reporters' Questions], (Apr. 27, 2020), http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/202004/t20200427_374552.html [<https://perma.cc/FEV5-7526>] [hereinafter CSRC Apr. 27, 2020 Press Release].

236. See Duhnke, *supra* note 197, at 5.

237. *Id.*

238. *Public Companies*, *supra* note 113.

239. *China-Related Access Challenges*, PCAOB, <https://pcaobus.org/International/Pages/China-Related-Access-Challenges.aspx> [<https://perma.cc/33VU-P488>] (last visited Dec. 10, 2020).

240. See Press Release, U.S. Dep't Treasury, 2016 U.S.-China Strategic and Economic Dialogue Joint U.S.-China Fact Sheet – Economic Track, (July 6, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0484.aspx> [<https://perma.cc/H26F-4NYD>] (illustrating that very much of what has been previously agreed to has not been implemented despite reiterated commitment).

241. *Public Companies*, *supra* note 113.

242. See, e.g., Jennifer Wang, *China's Luckin Coffee Founder Is \$1 Billion Poorer After Company Announces Fraud Investigation*, FORBES (Apr. 20, 2020, 7:00 AM), <https://www.forbes.com/sites/jenniferwang/2020/04/30/chinas-luckin-coffee-founder-is-1-billion-poorer-after-company-announces-fraud-investigation/#616fb41a5bfe> [<https://perma.cc/X5PC-QF76>].

most high-profile cases was Luckin Coffee, a private company in China seeking to challenge Starbucks.²⁴³ Since early 2020, rumors in the market had pointed to the company's fraudulent financials.²⁴⁴ When the company announced that its internal audit had confirmed the allegations of fabricated sales figures, U.S. investors suffered great losses as Luckin's share value sunk in one day from \$26.2 USD to \$6.4 USD, a decrease from its all-time peak of \$50 USD only three months before.²⁴⁵ Luckin's auditor was an associated firm of EY in China.²⁴⁶ Although the firm was registered with the PCAOB, it has never been subject to inspection.²⁴⁷ Since 2010, the PCAOB has stopped new firms from registering if they come from a jurisdiction which the PCAOB cannot oversee, but this remains inadequate as accounting firms registered prior to that ban are still allowed.²⁴⁸

The SEC quickly made a strongly worded statement criticizing the quality of financial information and disclosure from China.²⁴⁹ In response, the CSRC said in a press conference that they have always taken a positive attitude towards cross-border regulatory cooperation and supported overseas securities regulators in investigating and dealing with the financial fraud of listed companies within their jurisdiction.²⁵⁰ The CSRC cited an example of cooperation in 2016 and 2017, where the Chinese regulator assisted its U.S. counterpart in the inspection of three U.S.-listed companies.²⁵¹ Yet, in any case, by early 2020 the U.S. regulator has become more assertive in its disappointment with the negotiation process.²⁵² It is even reported that the U.S. administration is planning to terminate the 2013 China-U.S. MoU.²⁵³ The SEC has already made some moves in the direction of barring Chinese

243. *Id.*

244. *Id.*

245. *Id.*

246. Jing Yang, *Ernst & Young Say It Isn't Responsible for Luckin Coffee's Accounting Misconduct*, WALL ST. J. (July 16, 2020, 10: 18 AM), <https://www.wsj.com/articles/ernst-young-says-it-isnt-responsible-for-luckin-coffees-accounting-misconduct-11594909084> [https://perma.cc/SBS8-NNQV].

247. Jeffery P. Mahoney, *Inspection of PCAOB-Registered Chinese Auditor*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 17, 2020), <https://corpgov.law.harvard.edu/2020/04/17/inspection-of-pcaob-registered-chinese-auditor/> [https://perma.cc/K9N3-T8ND].

248. *Id.*

249. See Public Statement, Jay Clayton et al., SEC Chairman, Emerging Market Investment Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies Are Limited (Apr. 21, 2020), <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting> [https://perma.cc/6KPE-JZB5].

250. CSRC Apr. 27, 2020 Press Release, *supra* note 235.

251. *Id.*

252. See Jay Clayton et al., *supra* note 249.

253. Humerya Pamuk & Alexandra Alper, *Exclusive: Trump Administration to Soon End Audit Deal Underpinning Chinese Listings in U.S-Official*, REUTERS (Jul. 14, 2020), <https://www.reuters.com/article/us-usa-china-stocks-exclusive/exclusive-trump-administration-to-soon-end-audit-deal-underpinning-chinese-listings-in-u-s-official-idUSKCN24E2XW> [https://web.archive.org/web/20201115161028/https://www.reuters.com/article/us-usa-china-stocks-exclusive/exclusive-trump-administration-to-soon-end-audit-deal-underpinning-chinese-listings-in-u-s-official-idUSKCN24E2XW].

companies.²⁵⁴ Citing the PCAOB's difficulty in inspection, the rules of Nasdaq changed so that it may "deny initial or continued listing" or to "apply addition[al] and more stringent criteria" to a listing applicant, based on the qualifications of the applicant's auditor.²⁵⁵ As such, Nasdaq now has the mandate to bar new listings, based on the audit oversight obstacle, and even halt the trading of existing Chinese stocks.²⁵⁶

The U.S. Senate followed up on the issue and passed the "Holding Foreign Companies Accountable Act" by unanimous consent in May 2020.²⁵⁷ As an amendment to the Sarbanes-Oxley Act, this short bill—around 1,000 words—was especially tailored for China.²⁵⁸ If passed, it will require a listed company to disclose whether it employed a foreign accounting firm that the PCAOB is unable to inspect or investigate because of a position taken by a foreign authority²⁵⁹ (i.e. the CSRC).²⁶⁰ If so, the company will need to establish to the SEC that it is not owned or controlled by a foreign government.²⁶¹ In any case, if such listed companies remain on the SEC's list for three years, the proposed Act will direct the SEC to prohibit the company's stock from trading on any national exchange, or through the over-the-counter market.²⁶² In addition to the disclosure about auditing by uninspected foreign accounting firms, any such company must also disclose the percentage of shares owned by government entities, whether government entities have a controlling financial interest, the name of each official of the Chinese Communist Party who is a member of the board, and whether the company's articles of incorporation contain any charter of the Chinese Communist Party.²⁶³

On June 4, 2020, the U.S. President, Donald Trump, issued a Memorandum on Protecting United States Investors from Significant Risks

254. See generally Press Release, SEC, Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of Proposed Rule Change to Amend IM-5101-1 (Use of Discretionary Authority) to Deny Listing or Continued Listing or to Apply Additional and More Stringent Criteria to an Applicant or Listed Company Based on Considerations Related to the Company's Auditor or When a Company's Business Is Principally Administered in a Jurisdiction That Is a Restrictive Market, Release No. 34-88987 (June 2, 2020), at 1, <https://www.sec.gov/rules/sro/nasdaq/2020/34-88987.pdf> [<https://perma.cc/ZGT4-LCH5>].

255. *Id.* at 6.

256. *Id.* at 2, 6, 8–9; see generally Holding Foreign Companies Accountable Act, Pub. L. No. 166-222 (2020) (codified as amended at 15 U.S.C. § 7214).

257. Holding Foreign Companies Accountable Act, Pub. L. No. 166-222 (2020) (codified as amended at 15 U.S.C. § 7214). The U.S. House of Representatives also included provisions, which are substantially similar to the Holding Foreign Companies Accountable Act, in the National Defense Authorization Act.

258. Securities Exchange Act Release No. 34-88987, *supra* note 254, at 4-5.

259. Holding Foreign Companies Accountable Act, Pub. L. No. 166-222 (2020) (codified as amended at 15 U.S.C. § 7214).

260. *Id.*

261. *Id.*

262. *Id.*

263. *Id.*

from Chinese Companies.²⁶⁴ This set up a President's Working Group on Financial Markets (PWG),²⁶⁵ which is chaired by the Secretary of the Treasury and includes the key financial regulators such as the Chairman of the Federal Reserve and the Chairman of the SEC.²⁶⁶ On July 24, 2020, the PWG released a report, titled "Report on Protecting United States Investors from Significant Risks from Chinese Companies" (PWG Report), examining certain risks to investors of Chinese companies listed in the United States due to the PCAOB's lack of access to the work of such companies' auditors, as well as setting out five categories of detailed recommendations for increasing investor protection: (1) enhanced listing standards for access to audit work papers; (2) enhanced issuer disclosures; (3) enhanced fund disclosures; (4) greater due diligence of indexes and index providers; and (5) guidance for investment advisers.²⁶⁷ These recommendations will be mainly implemented by the SEC with a transitional period until January 1, 2022 for the enhanced listing standards.²⁶⁸

Finally, on December 2, 2020, the United States House of Representatives also passed the Holding Foreign Companies Accountable Act.²⁶⁹ Again, this passing was in unanimous vote, after the Senate passed the bill by another unanimous voice vote in May 2020, which indicates bipartisan support and broad consensus on a hardline stance against Chinese companies.²⁷⁰ Finally, on December 18, 2020, the U.S. President Donald Trump signed the bill into a formal law.²⁷¹

In anticipation of this legislation, some Chinese companies, such as Alibaba and NetEase, have already pursued secondary listings in Hong Kong as a hedge against the potential loss of access to the U.S. stock markets.²⁷² As the legislation grants a grace period of three years,²⁷³ more Chinese

264. Memorandum from Donald Trump, President of U.S., on Protecting United States Investors from Significant Risks from Chinese Companies (June 4, 2020), <https://www.whitehouse.gov/presidential-actions/memorandum-protecting-united-states-investors-significant-risks-chinese-companies/> [https://perma.cc/6Y7F-WCTE].

265. *Id.* at § 2.

266. *Id.*

267. PRESIDENT'S WORKING GRP. ON FIN. MKTS., REPORT ON PROTECTING UNITED STATES INVESTORS FROM SIGNIFICANT RISKS FROM CHINESE COMPANIES (July 20, 2020), at 3-4.

268. *Id.* at 3, 9.

269. Holding Foreign Companies Accountable Act, Pub. L. No. 166-222 (2020) (codified as amended at 15 U.S.C. § 7214).

270. Timothy Blakely et al., *Holding Foreign Companies Accountable Act Expected to Make U.S. Exchanges Less Hospitable to Chinese Companies*, J.D. SUPRA (Dec. 8, 2020), <https://www.jdsupra.com/legalnews/holding-foreign-companies-accountable-89903/>.

271. Thomas G. Appleman et al., *Holding Foreign Companies Accountable Act Signed into Law*, NAT'L L. REV. (Dec. 30, 2020), <https://www.natlawreview.com/article/holding-foreign-companies-accountable-act-signed-law> [https://perma.cc/9H2K-NFJ9].

272. Blakely et al., *supra* note 270.

273. Holding Foreign Companies Accountable Act, Pub. L. No. 166-222 (2020) (codified as amended at 15 U.S.C. § 7214).

companies may follow suit. Hence, the next part will turn to the issue of access to Chinese audit documents in Hong Kong.

IV. Dispute over Access to Chinese Audit Documents in Hong Kong

A. ACCESS DISPUTE IN HONG KONG: SFC v. EY

The conflict concerning access to audit working papers has also led to the Hong Kong regulator pursuing one of the Big Four firms in the court, much like the litigations initiated by SEC.²⁷⁴ In an examination of the example of Hong Kong's court case, the access dispute was not due to audit oversight but from an investigation of Hong Kong's securities regulator, the Securities and Futures Commission (SFC).²⁷⁵ At that point in time, around the 2010s, the accounting profession was largely self-regulated.²⁷⁶ In 2010, the dispute over access to audit working papers arose when the SFC exercised its power to investigate a fraudulent listing application.²⁷⁷ Under Section 183 of Hong Kong's Securities and Futures Ordinance (SFO),²⁷⁸ when the SFC has reasonable cause to believe that a party has in their possession "any record or document which contains information relevant to an investigation," the party must produce to the SFC any specified record or document.²⁷⁹ Furthermore, failure to comply with this section without reasonable excuse constitutes a criminal offense.²⁸⁰

In 2010, in an investigation on a listing applicant, the SFC requested that EY provide documents and information relevant to its initial assessment of whether there was any implication of false accounting on its client company's listing application.²⁸¹ While the listing application was still pending, EY resigned as the accountant and stated that there were inconsistencies in the accounting records.²⁸² The SFC followed up with an investigation and issued up to eight request notices to EY, who refused them all.²⁸³ In May 2010, the SFC requested the assistance of the CSRC to obtain the working papers in relation to the audit of the company, pursuant to the Memorandum on Regulatory Cooperation (MORC) dated June 19, 1993, between the SFC and the CSRC as well as IOSCO Multilateral

274. *Sec. & Futures Comm'n v. Ernst & Young*, (2014) 1818 H.C.M.P. 4, 4–5 (C.F.I.) (H.K.).

275. *Id.* at 18.

276. James Brackens, *The Value of Self-Regulation and the Tools that Help Drive It*, AICPA, (Jan. 3, 2014), <https://blog.aicpa.org/2014/01/the-value-of-self-regulation-and-the-tools-that-help-drive-it.html#sthash.o8n1WtvO.dpbs> [<https://perma.cc/Y38G-6BHD>].

277. *Sec. & Futures Comm'n*, 1818 H.C.M.P. at 8.

278. Securities and Futures Ordinances, (2020) Cap. 571, § 183(1) (H.K.).

279. *Can SFC Demand Documents Across the Border?*, ONC LAWS., (2014), http://www.onc.hk/en_US/can-sfc-demand-documents-across-the-border/ [<https://perma.cc/M3VK-U3NJ>].

280. *Id.*; see also Securities and Futures Ordinances, *supra* note 278 at §184(1).

281. *Sec. & Futures Comm'n*, 1818 H.C.M.P. at 8.

282. *Id.* at 7.

283. *Id.* at 10, 12.

Memorandum of Understanding (MMU).²⁸⁴ The CSRC then made a request, to the mainland audit counterpart that worked for EY, for the audit working papers.²⁸⁵ But the mainland firm also refused the CSRC's request, claiming that it needed to keep confidentiality to its client and that CSRC lacked the jurisdiction to monitor the audit work because the client company was listed in Hong Kong.²⁸⁶ After these futile attempts to request documentation from EY, the SFC sought an order from the court in 2012.²⁸⁷ In the trial, *inter alia*, EY alleged that it could not produce the records or papers as they contained state secrets, as found in Circular No. 29, and that the mechanism of clearance required reporting to the Mainland authorities to obtain approval.²⁸⁸ This mechanism also became a point of contention in the trial, with EY arguing that the SFC should be the requesting party to initiate the request to the CSRC, not the auditing firm (although the SFC did also request the CSRC in this case).²⁸⁹

The Hong Kong court gave its judgment in 2014, ordering EY to produce the accounting records.²⁹⁰ None of EY's arguments were sustained.²⁹¹ The court held that whether the working papers contained state secrets was fact-sensitive and EY had not proven the existence of any state secret in the papers.²⁹² The court also held that since the regulator did not have access to the document in the first place, and hence could not have known if it contained relevant protected material, it was unreasonable to require overseas regulatory bodies to initiate discussion with the CSRC in the first instance.²⁹³ In the case, EY sidestepped the issue of whether the documents contained state secrets and did not provide any evidence on it.²⁹⁴ Later, it further surfaced that the firm had the information locally in Hong Kong from the beginning.²⁹⁵

B. CHINA-HONG KONG MOU AND SUBSEQUENT DEVELOPMENT

The aftermath of the EY case led Mainland and Hong Kong to begin negotiations to cooperate on the issue.²⁹⁶ In May 2019, the Ministry of

284. *Id.* at 11.

285. *Id.*

286. *Id.*

287. *Id.* at 4.

288. *Id.* at 9. See also China Securities Regulatory Commission, *Provisions on Strengthening Confidentiality and Archives Administration Relating to Overseas Issuance and Listing of Securities*, 2009, at art. 8.

289. *Sec. & Futures Comm'n*, 1818 H.C.M.P. at 20.

290. *Id.* at 86–88.

291. *Id.*

292. *Id.* at 49.

293. *Id.* at 19, 56.

294. *Id.* at 47.

295. *Id.* at 87.

296. Press Release, FRC, The Supervision and Evaluation Bureau of the Ministry of Finance and the Financial Reporting Council of the Hong Kong Special Administrative Region Sign a Memorandum of Understanding to Promote Cross-Boundary Cooperation and Enhance Audit

Finance and Hong Kong's newly reformed Financial Reporting Council (FRC) signed a Memorandum of Understanding (2019 FRC MoU).²⁹⁷ The FRC is the regulator for auditors of listed companies and is vested with direct powers of inspection, investigation, and discipline concerning the auditors.²⁹⁸ The FRC was first established in 2007, but at that time, its mandate was limited to only initiating investigation after non-compliance or misconduct had occurred.²⁹⁹ It was not until 2019 that the FRC transformed into a fully independent body of audit oversight.³⁰⁰ Similar to the PCAOB, the FRC has the power to conduct an annual inspection on Hong Kong's accounting firms, including fieldwork and examination on any record or document related to the auditing process.³⁰¹ The board of the FRC is formed by the CEO (appointed by the Chief Executive of Hong Kong), three members (each appointed by the Hong Kong Stock Exchange, the Hong Kong Institute of CPA (HKICPA), and the SFC), plus the Registrar of Companies.³⁰² The Companies Registry Trading Fund (CRTF), the Hong Kong Institute of Certified Public Accountants (HKICPA), the SFC, and the Hong Kong Exchanges and Clearing Limited (HKEX) jointly contributed to funding of the FRC in equal amounts and stated that the funding was "unconditional and non-refundable."³⁰³

The inspection function of the FRC directly touches upon the document access restriction found in the Chinese law, but, of course, this is already dealt with in the 2019 FRC MoU.³⁰⁴ In addition to the fact that FRC requires a review of those audit papers, in order to perform proper monitoring, this MoU is a direct consequence of the cross-border audit paper dispute between the SFC and EY.³⁰⁵ Given the parallel timing of the signing of this MoU and the reforming of the FRC regime itself, it seems that the two are the result of each other, as the FRC could not properly function without access to all the audit documentation on Chinese companies listed in Hong Kong.³⁰⁶ Under the MoU, the FRC is able to request the Ministry of Finance for assistance to obtain access to the audit working papers in the Mainland, in order to conduct its inspections and

Quality, (May 22, 2019), https://www.frc.org.hk/en-us/FRC_PressRelease/en-us_Press%20release_FINAL_Eng.pdf [<https://perma.cc/LBG9-2MW5>].

297. *Id.*

298. Kelvin Wong, *Chairman's Message*, FIN. REPORTING COUNCIL (2019), <https://www.frc.org.hk/en-us/about-the-frc/chairman-message> [<https://perma.cc/84HB-3L2C>].

299. *Progress Report on the Work of the Financial Reporting Council*, LEGIS. COUNCIL PANEL ON FIN. AFFS. (May 4, 2020), https://www.frc.org.hk/en-us/Documents/LegCo_FA_Panel_2020/FRC_Panel_Papers_2020_Eng_issued.pdf [<https://perma.cc/RJL6-4LSR>].

300. *Id.*

301. China-Related Access Challenges, *supra* note 239.

302. FINANCIAL REPORTING COUNCIL (FRC), ANNUAL REPORT, (2019) at 35.

303. *Id.* at 69.

304. FRC 2019 ANNUAL REPORT, *supra* note 298, at 5.

305. *See generally* FRC Press Release May 22, 2019, *supra* note 296.

306. FRC 2019 ANNUAL REPORT, *supra* note 302, at 30.

investigations.³⁰⁷ Months after the audit regulators signed the agreement, a similar agreement for securities investigation concerning audit working papers was signed by the SFC, the CSRC, and the Ministry of Finance (2019 SFC MoU).³⁰⁸ Under this agreement, the SFC can also request from the Mainland authorities audit working papers kept in mainland China, and the Ministry of Finance and the CSRC have agreed to provide full assistance.³⁰⁹ This is similar to the FRC's MoU, but applicable in a securities law enforcement scenario.³¹⁰

The above two MoUs have the effect of changing the process from the position in the CSRC's Circular 29.³¹¹ Before the signing of the two MoUs, the operation of Circular 29 and other relevant regulations was that if an accounting firm was requested to produce audit working documents, they would need to consider whether the documents requested contain state secrets and request approval by themselves.³¹² They may find themselves in a difficult position, as such a decision is not easy to make, and such clearance is not easy to obtain.³¹³ The two MoUs put the power and standing of requesting the handover of audit documents in the hands of the respective regulators rather than the accounting firms.³¹⁴ Instead of asking the audit firms to do their own assessment and applications, the investigating regulator will make the request on their own based on the MoUs.³¹⁵ With cooperation from the Chinese regulators, the FRC and SFC expect the inspection and enforcement operation of the on Hong Kong market to be properly conducted.³¹⁶ In the first year of the MoU operation, the FRC reported that they are investigating forty-three ongoing cases and that they have "started a dialogue with the Ministry of Finance to kick off the mechanism."³¹⁷ It is unclear yet if any account record has been transferred through the MoU since the signing, but it can be expected that similar

307. See FRC Press Release May 22, 2019, *supra* note 296, at 1–2; see also FRC 2019 ANNUAL REPORT, *supra* note 302, at 30.

308. *Signing of Tri-Partite MoU by Ministry of Finance*, CHINA SECS. REGUL. COMM'N (Apr. 7, 2019), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201907/t20190704_358775.html [<https://perma.cc/E4XL-H4AE>].

309. See William Hallett et al., *Hong Kong: SFC, CSRC and MOF Sign Tripartite MOU on Access to Audit Working Papers Kept in Mainland China*, HERBERT SMITH FREEHILLS (July 30, 2019), <https://www.mondaq.com/hongkong/white-collar-crime-anti-corruption-fraud/826410/sfc-csrc-and-mof-sign-tripartite-mou-on-access-to-audit-working-papers-kept-in-mainland-china> [<https://perma.cc/DVH5-TH2E>].

310. See generally *id.*

311. Richard Ma & Zheng Zha, *China: Implementation of the MOU Entered into Between U.S. PCAOB and Chinese Regulators*, MONDAQ (May 7, 2014), <https://www.mondaq.com/china/compliance/311948/implementation-of-the-mou-entered-into-between-us-pcaob-and-chinese-regulators> [<https://perma.cc/6WBN-QEXJ>].

312. PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 267, at 39.

313. See *id.* at 36.

314. *Id.*, at 7.

315. *Id.* at 11.

316. *Id.* at 16.

317. FRC 2019 ANNUAL REPORT, *supra* note 302, at 51.

dispute with accounting firms will not arise again. Up to this point, further audit document access disputes and worry of adequate audit oversight have not arisen. On the contrary, the Hong Kong market is actively promoting to welcome more Chinese companies to stage IPOs or to do second listings.³¹⁸

V. A High-Stakes Game of Chicken: The Way Forward

In one sense, the Sino-U.S. audit oversight dispute sets up a high-stakes game of chicken. As the Holding Foreign Companies Accountable Act has a three-year transitional period clause, it is anyone's guess what may happen eventually. It is unclear whether China will modify its behavior, or the United States will carry through with its threats. But one thing is clear that it is important for both sides to better understand each other and on that basis, find the best way forward.

A. CHINA'S POSITION AND RATIONALE IN THE DISPUTE TO DOCUMENT ACCESS

To find the next step ahead, the rationale of the Chinese position needs to be examined. The above-mentioned disputes with United States and Hong Kong regulators can provide some helpful starting points. One reason for the reservation of the Chinese authorities is the stated policy objective to protect state secrets and sensitive information.³¹⁹ But there does not seem to be a fundamental and concrete issue about the involvement of state secrets in all the disputes.³²⁰ No party has actually relied on the point that there were state secrets present in the audit working papers, nor submitted any proof of it. It is rather safe to assume that there are no state secrets present. After all, the companies investigated in the various account frauds are not utility companies, high tech companies, nor state-owned companies. Their sizes are also not too significant to affect the local economy at large. Therefore, it is more probable that information and documents from these companies contain no sensitive state secrets. The fact that throughout years of trial, nothing was substantiated on the point of actually containing state secrets illustrate this point, and in all of court cases the audit documents were eventually passed to the overseas regulators.

A second reason for the seemingly uncooperative stance of Chinese authorities may be due to the technical difficulty faced by the Chinese accounting firms and regulators. As mentioned before, while it is clear either the CSRC or the Ministry of Finance is responsible for dealing with

318. Press Release, EY, IPOs Continue to Grow in Mainland China and Hong Kong Despite the Outbreak of COVID-19, (June 23, 2020), https://www.ey.com/en_cn/news/2020/06/ipo-continue-to-grow-in-mainland-china-and-hong-kong-despite-the-outbreak-of-covid-19 [<https://perma.cc/7D54-TCX4>].

319. Jerry C. Ling, *Traps for the Unwary in Disputes Involving China*, JONES DAY (Aug. 2012), <https://www.jonesday.com/en/insights/2012/08/traps-for-the-unwary-in-disputes-involving-china> [<https://perma.cc/KD85-ZSSJ>].

320. *Id.*

external regulators, it is less clear which government agencies in China are responsible for what state secrets, and even less clear what is to be regarded as state secret in the first place. When it comes to potential state secrets, there is a tangled web of bureaucratic that is not easy to take down, and certain matters are simply beyond the reach of the CSRC and the Ministry of Finance. Apart from the CSRC and the Ministry of Finance, other relevant governing agencies in this area include, but are not limited to, the State-owned Assets Supervision and Administration Commission, the Ministry of Justice, the Ministry of Public Security, the Ministry of State Security, the General Political Department (Liaison Bureau) of the People's Liberation Army, the Joint General Staff (Intelligence Department) of the People's Liberation Army, and even the Council of State Security with the President and the Premier as its Chairman and Vice-Chairman.³²¹

Another technical difficulty for the CSRC is that, as noted in *SFC v. EY* earlier, the CSRC may lack the jurisdiction to monitor the audit work in relation to the companies listed in overseas markets.³²² As a regulator for the Chinese markets, the CSRC's approval is needed for overseas listings only if the company is incorporated in China.³²³ In practice, however, many overseas-listed Chinese companies, most of them being private companies such as Luckin Coffee, are actually incorporated in offshore centres, notably the Cayman Islands.³²⁴ These companies do not need to obtain approval from the CSRC for their overseas listings, and the CSRC has no jurisdiction or responsibility in relation to them.³²⁵ In such a case, the CSRC has no mandate to inspect these companies and their audit firms.³²⁶

There is also an issue of reciprocity. While the 2013 China-U.S. MoU envisioned a "reciprocal" mutual assistance for each other's jurisdiction, one fact is that, at present, there are no foreign companies listed on the Chinese market whereas a large number of China-based companies listed on foreign markets, particularly the U.S. market.³²⁷ Hence, there is a serious imbalance

321. Interview with Anonymous CSRC Official, in Beijing, China (Oct. 24, 2019); William Hallatt & Emily Lam, *Introduction of New PRC Regulations Reiterating Rules on State Secrets Post SFC v. EY Judgment*, HERBERT SMITH FREEHILLS, (Sept. 25, 2015), <https://www.lexology.com/library/detail.aspx?g=A6fab557-dcbc-4e1e-b3d2-eedb68400186> [<https://perma.cc/YUE8-EBBY>].

322. *SFC Wins Hong Kong Case Against EY for Audit Failure*, ASIAN EXTRACTOR: UNEARTHING ACCT. FRAUD ASIA (July 21, 2015), <https://asianextractor.com/2015/07/31/sfc-wins-hong-kong-case-against-ey-for-audit-failure-in-standard-water-limited-as-the-accounting-firm-finally-handed-over-the-audit-papers-held-by-its-mainland-affiliate-ey-hua-ming-eyhm/> [<https://perma.cc/MBL8-KAGU>].

323. CHINA SECS. REGUL. COMM'N, *China's Securities and Futures Markets*, 1, 7 (Feb. 2007), http://www.csrc.gov.cn/pub/csrc_en/about/annual/200812/P020090225529643752895.pdf [<https://perma.cc/5EVR-5FP3>].

324. Wang, *supra* note 242.

325. Interview with an Anonymous Academic, in Beijing, China (Oct. 25, 2019) (on file with author); *id.*

326. PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 267, at 2.

327. Timothy Webster, *Paper Compliance: How China Implements WTO Decisions*, 35 MICH. J. INT'L L. 525, 536 (2014).

between inbound and outbound regulatory assistance requests. The CSRC signed the IOSCO Multilateral Memorandum of Understanding from 2007 and promised to provide international assistance relating to investigations in securities misconduct.³²⁸ As shown in Table 1 below, since then, the number of assistance requests received has been consistently multiple times larger than the number of requests sent outward.³²⁹ As such, the CSRC may find themselves drawn in request on assistance to investigate companies listed overseas, which they may not have most of their stalk on. They might rather need to focus their non-abundant resources and efforts on companies listed on the Chinese domestic market. Indeed, resource constraints are a universal problem faced by regulatory bodies worldwide,³³⁰ but this problem is particularly severe for the CSRC.³³¹

328. See *Signatories to Appendix A and Appendix B List*, NAT'L ORG. SECS. COMM'NS., <https://www.iosco.org/about/?subSection=MMou&subSection1=signatories> [<https://perma.cc/MF7W-R6RT>] (last visited Dec. 12, 2020). See also IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2002), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD386.pdf> [<https://perma.cc/C25C-2XK7>].

329. CHINA SECS. REG. COMM'N, 2018 Annual Report 74 (Oct. 21, 2019), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201910/P020191021577549600990.pdf [<https://perma.cc/7CWW-5TPW>]; CHINA SECS. REG. COMM'N, 2017 Annual Report 55 (Oct. 21, 2019), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201910/P020191021577183357334.pdf [<https://perma.cc/WD4R-KQ63>]; CHINA SECS. REG. COMM'N, 2016 Annual Report 52 (Oct. 21, 2019), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201910/P020191021576941951705.pdf [<https://perma.cc/A2QJ-7TTB>]; CHINA SECS. REG. COMM'N, 2015 Annual Report 47 (Oct. 21, 2019), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201910/P020191021576744925476.pdf [<https://perma.cc/KY46-ST72>]; CHINA SECS. REG. COMM'N, 2014 Annual Report 58 (June 12, 2015), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201506/P020150612564204379767.pdf [<https://perma.cc/K7H5-N4FN>]; CHINA SECS. REG. COMM'N, 2013 Annual Report 73 (July 1, 2014), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201407/P020140701435306564563.pdf [<https://perma.cc/27US-SS7S>]; CHINA SECS. REG. COMM'N, 2012 Annual Report 63–64 (July 16, 2013), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201307/P020130716403852654782.pdf [<https://perma.cc/3YJV-9HSU>]; CHINA SECS. REG. COMM'N, 2011 Annual Report 50 (May 15, 2012), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201205/P020120515677609374835.pdf [<https://perma.cc/BW4T-9DP6>]; CHINA SECS. REG. COMM'N, 2010 Annual Report 58 (July 10, 2011), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201203/P020120315575855936801.pdf [<https://perma.cc/AAB7-PTF2>]; CHINA SECS. REG. COMM'N, 2009 Annual Report 62 (Nov. 5, 2010), http://www.csrc.gov.cn/pub/csrc_en/about/annual/201011/P020101105493830315968.pdf [<https://perma.cc/BYC2-4V6Y>]; CHINA SECS. REG. COMM'N, 2008 Annual Report 45 (July 1, 2009), http://www.csrc.gov.cn/pub/csrc_en/about/annual/200907/P02009070149662500834.pdf [<https://perma.cc/YG8A-E5ZH>].

330. Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resources-Based Evidence*, 93 J. FIN. ECON. 207 (2009).

331. HUANG, *supra* note 188, at 38–39. Indeed, due to the low salary level, the CSRC has difficulties in retaining good staff. *Id.*

Table 1: Figures of International Assistance by CSRC, 2008-2018³³²

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Number of Requests Received	141	64	49	86	54	90	97	130	174	39	52
Number of Requests Sent	15	11	1	5	3	6	13	30	37	-	12

Overall, although not insurmountable, these technical issues probably contributed to the CSRC's reluctance to promise full-fledged cooperation. For these reasons, while the SEC and the PCAOB view the record of regulatory cooperation under the 2013 China-U.S. MoU as grossly unsatisfactory, the CSRC considers it "effective," stating that it has led to some concrete achievements and would pave the way for broader and deeper cooperation in the future.³³³

What could be further lacking is the political will. From a political angle, China's overall policy objective has always been maintaining national control on matters within its border.³³⁴ Chinese authorities' articulated the preference to keep national control through the writing of legislation and its industrial policy towards the accounting profession.³³⁵ Coming from this politically-oriented standpoint, it could be hard to persuade the Chinese authorities to share their monitoring power.³³⁶ That is what happened to the negotiation with U.S. Regulators despite having signed the 2013 China-U.S. MoU.³³⁷ Chinese authorities have made this point clear early on in their comment submitted to the PCAOB that the "fundamental challenge" of FCAOB's attempt to take action on a "unilateral basis."³³⁸ It further states that "cross-border inspection must abide by the principles of respecting mutual sovereignty and cooperating as equals."³³⁹ In the end, China may want the United States to recognize China's own audit oversight regime

332. The figures are obtained from the annual reports of the CSRC. The number of requests sent in 2017 is not revealed by the CSRC. See sources cited *supra* note 328.

333. Press Release, CSRC, Officials from Relevant Departments of the CSRC Answered Reporter Questions, (Apr. 27, 2020), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/202004/t20200427_374553.html [<https://perma.cc/4BQS-M3JW>].

334. Shigeo Kobayashi et al., *The "Three Reforms" in China: Progress and Outlook*, 45 JAPAN RSCH. INST. RSCH. J. (1999).

335. Wei Lu et al., *Governmental Influences in the Development of Chinese Accounting During the Modern Era*, 19 ACCT., BUS. & FIN. HIST. 305 (2009).

336. *Id.*

337. CSRC Apr. 27, 2020 Press Release, *supra* note 235.

338. Letter from Dr. Tong Daochi PCAOB-2008-06, *supra* note 84.

339. *Id.*

instead of having to collaborate or letting U.S. inspector onshore.³⁴⁰ This would make it much like the EU-China arrangement.³⁴¹ The European Union recognized China's audit oversight regime so that the countries can rely on each other's oversight regime to inspect audits.³⁴² But these concessions will need a level of mutual trust and understanding between the two sides, which it is now seriously short of.³⁴³ This lack of trust is understandable; after all, many Chinese Concept Stocks have already failed due to accounting fraud and not to mention the series of other acute disputes between China and the United States outside of the financial sphere.³⁴⁴

Finally, there is also a need to look at these audit firms' critical role and actions within these disputes.³⁴⁵ In all of these disputes concerning access to the audit firms' working document, the reader should note that they originated from the firms' refusal to turn in their work as required.³⁴⁶ Although the reason cited by them was that Chinese regulators might not allow such to happen, these audit firms themselves are often first and foremost the target under investigation, and they have an inherent interest themselves in not letting the watchdog get a hold of their proven faulty works.³⁴⁷ It is also apparent that these audit firms did not try to get the necessary approval on their own initiative.³⁴⁸ All they have done was to cite the Chinese legal restrictions.³⁴⁹ Considering this factor, the Chinese regulator may have been a shield inadvertently being used by these accounting firms to shield themselves from the stricter overseas regulators.³⁵⁰ Note that in the Hong Kong *EY* case, when the CSRC request documents from the accounting firm, it also refused.³⁵¹ Again, the fact that

340. GILLIS, *supra* note 208, at 160.

341. Chris Devonshire-Ellis, *EU's Court of Auditors Complains About China's Belt Road MoU Deals & Lack of Strategic Intelligence – But There Are Solutions*, SILK ROAD BRIEFING (Sept. 11, 2020), <https://www.silkroadbriefing.com/news/2020/09/11/eus-court-of-auditors-complains-about-chinas-belt-road-mou-deals-lack-of-strategic-intelligence-but-there-are-solutions/> [<https://perma.cc/K6ZZ-K8TR>].

342. Council Directive 2006/43/EC, 2006 O.J. (L 157). Commission Implementing Decision (EU) 2019/1874, 2019 O.J. (L 289) (EC). It is worth noting that there are currently no European companies listed on China markets.

343. Silvia Amaro, *Trade, Human Rights and Climate: Disagreements Dominate EU-China Summit*, CNBC (Sept. 14, 2020, 8:16 PM), <https://www.cnbc.com/2020/09/14/eu-china-relations-put-to-the-test-in-virtual-summit.html> [<https://perma.cc/KZD2-YGUT>].

344. Francine McKenna, *After China Fraud Boom, Nasdaq Steps up Scrutiny of Shady Listings*, MKT. WATCH (June 20, 2016 11:10 AM), <https://www.marketwatch.com/story/after-china-fraud-boom-nasdaq-steps-up-scrutiny-of-shady-listings-2016-06-20> [<https://perma.cc/NNF7-XGZ4>].

345. Elizabeth P. Gray & Jessica L. Matelis, *PCAOB Foreign Inspections – A Chinese Conundrum*, 44 REV. SEC. & COMMODITIES REGUL. 145 (2011).

346. *Id.*

347. *Id.*

348. *Id.*

349. *Id.*

350. *Id.*

351. See discussion *supra* Section IV.A.

in the end, all these documents were signals that there is no inherent reason why the Chinese regulator would stop them from transferring in the first place.³⁵² As such, a better path would be to avoid getting the auditing firms directly involved in the cross-border legal conflict, which is exactly what the 2019 FRC MoU and the 2019 SFC MoU seek to achieve.³⁵³

B. POLICY OPTIONS AND IMPLICATIONS

As of the time of writing, negotiation between the U.S. and Chinese regulators, if any, is in a stalemate.³⁵⁴ The confidence in the market has shaken, and some Chinese companies have begun their flee from the U.S. market.³⁵⁵ Some U.S. investors have suffered tremendous losses from fraudulent corporate and accounting practices.³⁵⁶ For the most serious counter-measure to this ultimate failure of prudent cross-border regulatory oversight, the Holding Foreign Companies Accountable Act has opened up a possibility that all Chinese companies currently trading in the United States may be delisted.³⁵⁷

This is undoubtedly the most draconian approach.³⁵⁸ But if the reason behind forcefully exercising audit oversight was to achieve the policy objective of protecting investors' interest, then the potential consequence of delisting Chinese companies is probably doing the exact opposite.³⁵⁹ First of all, this is hugely disruptive to the overall market.³⁶⁰ China is now the third-largest source of foreign companies listed in the United States, and the market capitalization involved is gigantic.³⁶¹ At the moment, the Chinese companies in question are worth a combined USD \$2 trillion, representing a non-trivial share of U.S. equity markets.³⁶²

352. Raymond Tran, *Comply at Your Own Risk: Reconciling the Tension Between Western Due Diligence Practices and Chinese State Secrets Law*, 25 CAL. INT'L L. J. 45, 46 (2017).

353. *Id.*

354. Jaclyn Jaeger, *Luckin Coffee, iQIYI Fraud Allegations Point to a Wider China Problem*, COMPLIANCE WEEK (Apr. 9, 2020, 1:24 PM), <https://www.complianceweek.com/accounting-and-auditing/luckin-coffee-iqiyi-fraud-allegations-point-to-wider-china-problem/28735.article> [<https://perma.cc/EYC2-9APA>].

355. Jakub Jakóbcowski, *A Stalemate in the US-China Trade Negotiations: The Tariff War and Technology*, OSRODEK STUDIÓW WSCHODNICH (May 28, 2019), <https://www.osw.waw.pl/en/publikacje/osw-commentary/2019-05-28/a-stalemate-us-china-trade-negotiations-tariff-war-and> [<https://perma.cc/E4MQ-WTXP>].

356. *Id.*

357. *Id.*

358. Kenneth Rapoza, *Why 200 Chinese Companies May Soon Delist from the U.S. Stock Exchange*, FORBES (Aug. 19, 2020, 11:25 AM), <https://www.forbes.com/sites/kenrapoza/2020/08/19/why-200-chinese-companies-may-soon-delist-from-the-us-stock-exchange/?sh=79cb08aa3fe7> [<https://perma.cc/3QYT-97SP>].

359. *Id.*

360. *Id.*

361. *Id.*

362. *Exchange-traded Fiends: Boiling Point*, THE ECONOMIST (Dec. 5, 2020), <https://www.economist.com/business/2020/12/03/congress-wants-to-boot-chinese-firms-from-american-exchanges> [<https://perma.cc/NS9A-4HAA>].

Secondly, in a wave of hasty delisting, the buyout price of these companies is sure to shrink, and that would open up a valuation trap such that the controlling shareholders or founders of these Chinese companies can delist or privatize the stock at a huge discount.³⁶³ Then it can be re-listed elsewhere at a premium, resulting in great losses for U.S. investors.³⁶⁴ This is exactly what happened to several Chinese stocks such as Qihoo, which after delisting from the United States, re-listed in Shanghai at nearly seven times higher valuation after just eighteen months.³⁶⁵

Thirdly, there are, of course, well-functioning and profitable Chinese companies in the U.S. market.³⁶⁶ Although there are some bad apples, the Chinese companies listed in the U.S. market have been well-behaving and profitable as a group. It is reported that the S&P/BNY Mellon China Select ADR Index has performed significantly better than the S&P 500 Index since November 2019.³⁶⁷ There would still be demand from investors to invest in these companies after they are delisted, but would then be placed on an overseas national exchange.³⁶⁸ Using the same standard to delist all Chinese companies from the U.S. exchanges may not only affect the U.S. market, but also deprive U.S. investors of the easy opportunity to buy China Concept Stocks.

On the other side, the Holding Foreign Companies Accountable Act can put very significant pressure on China to force it to seriously reconsider its position on the audit oversight dispute. The Chinese securities market has undergone impressive growth in the past three decades, but still have many problems which prevent it from meeting the fundraising and listing needs of all Chinese companies.³⁶⁹ As noted earlier, the China-Concept Stocks are huge in terms of market capitalization, and it would be extremely difficult, or close to impossible, for the Chinese securities market to take all of them in quick succession. Further, for many Chinese companies, they would prefer to be listed in the United States to get various benefits, such as access to international investors, global reputational effects, sounder regulatory

363. Thomas Kirchner, *Forced Chinese ADR De-Listings Will Harm Americans the Most*, REAL CLEAR MKTS. (Aug. 11, 2020), https://www.realclearmarkets.com/articles/2020/08/11/forced_chinese_adr_de-listings_will_harm_americans_the_most_501465.html [https://perma.cc/G7YJ-2HDX].

364. Jens Hansen & Fredrik Öqvist, *Why Do U.S.-Listed Chinese Firms Go Private?* 9 (Working Paper, Aug. 18, 2015), <http://ssrn.com/abstract=2186683> [https://perma.cc/CEJ7-L2MU].

365. *Id.*; Jesse Fried & Matthew J. Schoenfeld, *Delisting Chinese Companies Plays Straight into Their Hands*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 9, 2020), <https://corpgov.law.harvard.edu/2020/06/09/delisting-chinese-firms-a-cure-likely-worse-than-the-disease/> [https://perma.cc/Z82Z-83TY].

366. Yen Nee Lee, *Think Tank Explains Why It's 'Pointless' to Delist Chinese Companies from U.S. Stock Markets*, CNBC (July 3, 2020, 3:06 AM), <https://www.cnbc.com/2020/07/03/pointless-to-delist-chinese-companies-from-us-stock-markets-piie-says.html> [https://perma.cc/PLG4-8XDC].

367. *Exchange-traded Fiends: Boiling Point*, *supra* note 358.

368. *Id.*

369. ROBIN HUI HUANG, *Securities and Capital Markets Law in China* 35-42 (UK, Oxford University Press, 2014).

environment, and better valuation. Indeed, the opening-up policy has brought huge benefits to the Chinese economy in general, and it would deal a huge blow to China if it were to be denied access to the U.S. market.

That said, however, it is unclear whether China will bow to the pressure to accommodate the U.S. request in full. Apart from the economic considerations noted above, there are also complex political factors that determine the extent to which China will make concessions. As a party state, China's decision-making process can be more susceptible to the whims of certain important individuals, while at the same time, as a socialist country, may be more heavily influenced by populism such as anti-U.S. nationalism. These political factors have become even more difficult to judge due to the implications of the ongoing COVID-19 pandemic.

Hence, the ideal solution for the United States and China is to come into cooperative arrangements, as it did resolve the early differences between the United States and other countries.³⁷⁰ From the previous experience of the objections from various European countries, it is only usual for a jurisdiction to reject extraterritorial oversight by another.³⁷¹ Such conflict of law may only be resolved by mutual recognition of audit oversight regime, as the United States and the European countries did after a few years of negotiation.³⁷² The European Union and China have come to an agreement with each other, and this is the goal of China with regard to its relationship with the United States.³⁷³

In fact, following the recent Luckin scandal, the CSRC has indicated its intention to work out a new plan to have joint inspection with the PCAOB in April 2020.³⁷⁴ But the fact that regulators from the two sides stop short of carrying further joint inspection since 2016-2017, may signal that the trial joint inspection was unsuccessful as far as the PCAOB is concerned, probably because of access to documents or personnel, even on the ground.³⁷⁵ The PCAOB is obligated to issue a firm inspection report after each inspection, but the PCAOB never issues a report from that trial.³⁷⁶ Further, on August 8, 2020, the CSRC claimed to have sent to the PCAOB an updated proposal for strengthening regulatory cooperation four days before but did not reveal the proposal's details.³⁷⁷ Again, the PCAOB seems

370. Vivian Ni, *China and U.S. Seek Closer Cooperation on Audit Oversight*, CHINA BRIEFING, (Aug. 25, 2011), <https://www.china-briefing.com/news/china-and-u-s-seek-closer-cooperation-on-audit-oversight/> [<https://perma.cc/V2S6-7K9H>].

371. François Goderment & Abigél Vasselier, *China at the Gates: A New Power Audit of EU-China Relations*, EUR. COUNCIL ON FOREIGN RELS., (Dec. 1, 2017), https://ecfr.eu/publication/china_eu_power_audit7242 [<https://perma.cc/HAN6-RZDJ>].

372. *Id.*

373. *Id.*

374. *Id.*

375. CSRC Apr. 27, 2020 Press Release, *supra* note 235.

376. Jaeger, *supra* note 350.

377. Press Release, CSRC, Zhengjian hui youguan bumen fuzhe ren jiu meiguo zongtong jinrong shichang gongzuo zu fabu "guanyu baohu meiguo touzi zhe fangfan zhongguo gongsi zhongda fengxian de baogao" shiyi da jizhe wen

to have little interest in it.³⁷⁸ Plainly, the two sides lack a sufficient level of mutual trust and have expectations too far apart.³⁷⁹

One obstacle to any agreement between the two sides may be the actual accounting practice standard in China.³⁸⁰ Considering the development of the accounting industry in China, as compared to other jurisdictions, China's development is uniquely late and rapid.³⁸¹ Another obstacle is China's audit oversight regime.³⁸² From PCAOB's 2007 policy paper, it is clear that one of the most emphasized criteria for reliance on a foreign regulator, besides a high standard of performance, is for it to have a high level of independence, in terms of both its operation, personnel makeup and source of funding.³⁸³ Since China has not set up a specific agency for audit oversight but instead spread the function among different departments within the government, notably the Ministry of Finance and the CSRC, China's regime is currently unlike most of the world's jurisdictions and certainty not in the preference for the PCAOB.³⁸⁴ Yet another issue may be about the mutual trust of the two sides, which unfortunately is at a recent low point.³⁸⁵ In fact, the assertion from the United States that China evades

(证监会有关部门负责人就美国总统金融市场工作组发布《关于保护美国投资者防范中国公司重大风险的报告》事宜答记者问) [The Heads of Relevant Departments of the Securities Regulatory Commission Answered Reporters' Questions on the Issue of the "Report on Protecting U.S. Investors from Major Risks of Chinese Companies" Issued by the U.S. President's Financial Market Working Group] (Aug. 8, 2020), http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/202008/t20200808_381339.html [https://perma.cc/M6SW-9ZCT].

378. The PCAOB Chairman commented that the proposal has substantial defects. According to Mr. Fang Xinghai, the Vice-Chairman of the CSRC, the proposal may give the PCAOB access to the audit work papers of all Chinese companies listed in the United States, including SOEs, but certain information may need to be edited for national security reasons. *Zhongguo biaooshi yuan peihei meiguo jiejue qiye shenji fenqi xu zhijie xieshang* (中国表示愿配合美国解决企业审计分歧 吁直接) [*China Expresses Willingness to Cooperate with the United States to Resolve Corporate Audit Differences, Calls for Direct Consultation*], LIANTIE ZAOBAO (Aug. 27, 2020, 8:47 AM), <https://www.zaobao.com/realtime/china/story20200827-1080107> [https://perma.cc/9HY3-4Y6C].

379. CSRC Press Release (Aug. 8, 2020), *supra* note 377.

380. Dezen Shira et al., *Chinese Accounting Standards: A Primer for Foreign Investors*, CHINA BRIEFING (Oct. 8, 2018), <https://www.china-briefing.com/news/chinese-accounting-standards/> [https://perma.cc/PD6A-J822].

381. *Id.*

382. *Id.*

383. PCAOB Release No. 2007-011, *supra* note 90.

384. Ma & Zha, *supra* note 311.

385. In this regard, on the contrary, with the new passing by the National People's Congress Standing Committee of a National Security Law in Hong Kong, the political trust of the two sides is arguably enhanced, so that Chinese authorities may be more inclined to cooperate in providing access to audit documents and to handle state secrets with more flexibility. Matt Levine, *Money Stuff: The U.S. Doesn't Trust China Audits*, BLOOMBERG (Aug. 7, 2020, 11:59 AM), <https://www.bloomberg.com/news/newsletters/2020-08-07/money-stuff-the-u-s-doesn-t-trust-china-audits> [https://perma.cc/D6JD-ERTV].

their commitment is not unique to the ineffective 2013 China-U.S. MoU.³⁸⁶ A report from the U.S.-China Economic and Security Review Commission suggested that Chinese companies often operate in the United States as though behind a firewall, using legal barriers and a multilayered corporate structure that keeps them immune from the jurisdiction of the U.S. courts.³⁸⁷ Although there are a number of conventions and agreements in place, the report is of the view that “China interprets its obligations . . . in a manner that effectively protects Chinese firms from U.S. litigation.”³⁸⁸ Therefore, it seems that from both a technical standpoint and a political standpoint, a cooperative agreement is far in sight, and multiple middle steps need to be taken.³⁸⁹

While it is tough for the United States and China to enter into an agreement, could Hong Kong’s FRC serve as a proxy?³⁹⁰ While China’s audit practice standard is still developing, and that there is no independent body set up for audit oversight, this is not the case in Hong Kong.³⁹¹ Since 2019, Hong Kong has reformed its FRC into an independent audit regulator to monitor all accounting firms in the territory with high level of independence.³⁹² A lot of audit works performed by Hong Kong accounting firms concerns Chinese companies and their operations in the mainland, and the oversight of these Chinese audits are covered by the 2019 FRC H.K. agreement.³⁹³ Given Hong Kong’s adequate oversight regime and FRC’s independent nature, it is possible for Hong Kong to negotiate with the PCAOB to join its cooperative framework.³⁹⁴ If Chinese companies listed in the United States are to be audited by Hong Kong’s accounting firms, and

386. John Solomon, *China Is Cheating on Obama-era Stock Market Deal, Trump Urged to Intervene*, JUST THE NEWS (May 19, 2020, 11:40 AM), <https://justthenews.com/government/white-house/china-isnt-complying-obama-era-stock-market-deal-trump-urged-intervene> [<https://perma.cc/5C8Q-7B2G>].

387. Kevin Rosier, U.S.-CHINA ECON. AND SEC. REV. COMM’N, STAFF RSCH. REP., CHINA’S GREAT LEGAL FIREWALL: EXTRATERRITORIALITY OF CHINESE FIRMS IN THE UNITED STATES, 3 (May 5, 2015), https://www.uscc.gov/sites/default/files/Research/Extraterritoriality%20of%20Chinese%20Firms_Research%20Report_0.pdf [<https://perma.cc/V5DP-4AEX>].

388. *Id.*

389. *Id.*

390. Suneet Chatterjee & Umesh Desai, *Hong Kong Audit Regulation Bill Likely This Year: FRC CEO*, REUTERS (Sep. 26, 2017, 6:43 AM), <https://www.reuters.com/article/us-summit-regulation-frc/hong-kong-audit-regulation-bill-likely-this-year-frc-ceo-idUSKCN1C11EW> [<https://web.archive.org/web/20200914041231/https://www.reuters.com/article/us-summit-regulation-frc/hong-kong-audit-regulation-bill-likely-this-year-frc-ceo-idUSKCN1C11EW>].

391. *Id.*

392. *Id.*

393. *See supra* Section IV.B. *See also* Michael Cohn, *Hong Kong CPAs Sign Pact with U.K. Accounting Overseer*, ACCT. TODAY (Sept. 27, 2019, 4:57 PM), <https://www.accountingtoday.com/news/hong-kong-cpas-sign-pact-with-u-k-accounting-overseer> [<https://perma.cc/VZ7P-N883>].

394. *Hong Kong to Adopt Independent Audit Oversight Regime*, INT’L ACCT. BULL. (Jan. 23, 2018), <http://www.internationalaccountingbulletin.com/News/hong-kong-to-adopt-independent-audit-oversight-regime-6034501> [<https://perma.cc/U4BK-6EBJ>].

that the PCAOB can rely on Hong Kong's FRC for audit oversight with a cooperative agreement between them, this could potentially resolve the oversight dispute by having the Hong Kong's regulator to serve as a proxy for China. This route again would require a high level of trust between all regulators and governments of all sides to implement, and unfortunately, it is at a historic low point, given that the United States has recently revoked the special status accorded to Hong Kong SAR.³⁹⁵

Another possible solution is to sidestep the approval issue for state secrets in China and only to ask if there is any actual state secret involved in the audit documents. The case of *SFC v. EY* in Hong Kong is a good example in this regard.³⁹⁶ Singapore took this approach.³⁹⁷ Singapore is another jurisdiction that has a number of Chinese companies listed.³⁹⁸ There are sixteen companies listed under SGX's China Index, which indexed companies with at least 50 percent of its revenue or assets in China.³⁹⁹ In *BNY Corporate Trustee Services Ltd. v. Celestial Nutrifoods Ltd.*, a liquidator requested audit documents of a liquidated company's operation in China.⁴⁰⁰ The company and its auditor, PwC, resisted again on the same reasoning as the Hong Kong case, that China's state secret law prohibits it.⁴⁰¹ In both the first instance and the appeal court, this argument was not directly refuted, but the court held that PwC had not proved that it China would actually punish it if the audit documents are provided.⁴⁰² Unlike the cases in the United States, the CSRC did not appear to have intervened and provided the documents half-way through the trial.⁴⁰³ This may be due to the nature of the case being a dispute between two private parties.⁴⁰⁴ In the end, the court held that the auditors need to turn over documents in suitable situations.⁴⁰⁵ Since the accounting firm cannot provide evidence to prove their hypothetical argument that the Chinese law on state secrets *may* bar it from providing accounting documents, the issue of extraterritoriality was not touched by the court or by the Singaporean regulators.⁴⁰⁶ As such, the Chinese regulator was also not invoked, and they did not take active notice

395. Exec. Order No. 13936, 3 C.F.R. (2020).

396. See discussion *supra* Section IV.A.

397. *FTSE ST China Index's Three Largest Industrial Stocks*, SING. EXCH. (Oct. 21, 2020), <https://www.sgx.com/research-education/market-updates/20201021-ftse-st-china-indexs-three-largest-industrial-stocks> [<https://perma.cc/UHC4-MSTT>].

398. *Id.*

399. *Id.* See also *FTSE ST China Indices*, FTSE RUSSELL (Nov. 30, 2020), <https://research.ftserussell.com/Analytics/FactSheets/temp/4e32e204-23c4-4f95-afc6-77bb073d7c91.pdf> [<https://perma.cc/F75W-XCVH>].

400. *BNY Corporate Trustee Services Ltd v. Celestial Nutrifoods Ltd* [2014] SGHC 155.

401. *Id.*

402. *Id.*

403. *Id.*

404. *Id.*

405. *Id.*

406. *Id.*

of the dispute.⁴⁰⁷ This approach is fairly pragmatic and did successfully resolve the matter and allowed the party to obtain access to audit documents.⁴⁰⁸ It is probably an optimal solution for jurisdictions with limited exposure to Chinese companies, such as Singapore or the European Union, or jurisdictions that have not yet taken the jurisdictional issue directly against the Chinese regulators.⁴⁰⁹ But the U.S. and Hong Kong markets are much more exposed to Chinese companies to make this circumventing meaningful. They both need to regularly inspect audit working documents as part of their regulator's routine function.

If the United States and China do not take the above routes, they will remain in a prolonged stalemate, and regulators and investors would still have to deal with the fallout.⁴¹⁰ In any oversight and regulatory policy decision, there is a competitive balancing exercise involved. Whereas recently, the United States increases the harshness of both their rhetoric and rules towards Chinese companies, these companies are going to find the Hong Kong market more favorable.⁴¹¹ Chinese companies are going to gradually leave the U.S. market on their own initiative before the situation further escalate. It does not necessarily have to be a competition of rule relaxing, and in any case, the Hong Kong regulator has not and should not lessen the intensity of their oversight. There can be choices around what to emphasize on the regulatory menu based on actual risks. One possible initiative to properly handle these Chinese companies is to properly categorize them into different sizes and types and accord to them differential treatment. It should be noted that, throughout the years, those Chinese companies that are involved in fraudulent activities, or otherwise failed in the U.S. markets, are not those larger SOEs but the smaller private ones.⁴¹² The risk profiles of these smaller companies or new startups are vastly different from the much larger Chinese conglomerates. It is perhaps sensible to draw a line based on asset or revenue level and to put stricter scrutiny on the smaller tier. The larger tier could be allowed to remain on

407. *Id.*

408. *Id.*

409. Public Statement, Jay Clayton, SEC Chairman, et al., U.S. Sec. & Exch. Comm'n, Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China (Dec. 7, 2019), <https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other> [<https://perma.cc/S7YQ-PHDQ>].

410. Jakóbowksi, *supra* note 351.

411. Eamon Barrett, *Naomi Xu Elegant & Lucinda Shen, The U.S. clampdown on Chinese companies in unexpected windfall for Hong Kong*, FORTUNE (June 26, 2020, 5:35 AM), <https://fortune.com/2020/06/26/us-chinese-companies-secondary-listing-hong-kong/> [<https://perma.cc/3XCQ-5YRU>].

412. Masamichi Hoshi et al., *China Scrambles to Stem Manufacturing Exodus as 50 Companies Leave*, NIKKEI ASIA (July 18, 2019), <https://asia.nikkei.com/Spotlight/Most-read-in-2019/China-scrambles-to-stem-manufacturing-exodus-as-50-companies-leave> [<https://perma.cc/D5UU-D4PD>].

the U.S. market if they can provide certain undertaking as to the monitoring of their audit process. As for Hong Kong, if these smaller companies are going to de-list from the United States and then re-list in Hong Kong, they should also be put under tighter due diligence requirements.

Lastly, one area that is worthy of attention for the regulators of both the U.S. and Hong Kong market is the handling of further novel listing of Chinese companies.⁴¹³ Save from delisting existing companies, and the SEC can recommend barring any future listing if they come from a jurisdiction that does not comply with the PCAOB's requirement.⁴¹⁴ In both the United States and Hong Kong, there might be an issue with the listing process in that it could be relatively loose at times.⁴¹⁵ China itself has more rigid listing requirements and procedures in its domestic market.⁴¹⁶ This is in the first place one of the factors why many of China's largest companies choose to get listed overseas.⁴¹⁷ The more flexible listing requirement found in the U.S. and Hong Kong market has a certain corporate governance background of their own, and the auditing standards in their respective local markets are more established to begin with.⁴¹⁸ Yet, as the stock market allows cross-border listing, the same handling of listing may not be adequate, especially towards Chinese companies.⁴¹⁹ Hong Kong's regulator has in recent years realized the issue, and emphasized their oversight enforcement in the listing process, as a "front-loaded" approach,⁴²⁰ as the SFC sanctioned several investment banks in several high-profile cases of deficient due diligence process in the IPO of Chinese enterprises.⁴²¹

413. Fried & Schoenfeld, *supra* note 361.

414. *Id.*

415. Alexandra Alper, *U.S. Lawmaker Urges Trump Administration to Seek Tougher Rules on Chinese Companies*, NASDAQ (July 21, 2020, 6:34 PM), <https://www.nasdaq.com/articles/u.s.-law-maker-urges-trump-administration-to-seek-tougher-rules-for-chinese-companies-0> [<https://perma.cc/K57U-HH3J>].

416. ROBIN HUI HUANG, *SECURITIES AND CAPITAL MARKETS LAW IN CHINA* 82–96 (2014).

417. Li Wei, *China IPOs: Why Chinese Companies List Overseas*, CKGSB KNOWLEDGE (July 18, 2018) <https://knowledge.ckgsb.edu.cn/2018/07/30/infographics/china-ipos-chinese-companies-list-overseas/> [<https://perma.cc/3TLX-4ARE>].

418. Julia Fioretti & Ishika Mookerjee, *There's a Long Way to Go Before China Abandons US Listings*, ECON. TIMES (May 22, 2020, 8:57 AM), <https://economictimes.indiatimes.com/markets/stocks/news/theres-a-long-way-to-go-before-china-inc-abandons-us-listings/articleshow/75873140.cms> [<https://perma.cc/T2BX-NWNZ>].

419. Clayton, *supra* note 409.

420. Ashley Alder, Chief Executive Officer, Securities and Futures Commission, Speech at HKSI Institute Roundtable Luncheon Series (July 13, 2017) in *Front-loaded, Transparent and Direct: A New Approach to Regulation for Changing Markets*, SEC. & FUTURES COMM'N (July 13, 2017), https://www.sfc.hk/web/files/ER/PDF/Speeches/CEO%20speech%20at%20HKSI%20final_13%20Jul.pdf [<https://perma.cc/K6FX-LSJF>].

421. Including Morgan Stanley and Merrill Lynch in the IPO of Tianhe Chemicals Group, Citigroup in the IPO of Real Gold Mining, and several more. These IPO sponsors are fined and have their licenses suspended from the Hong Kong market. Alun John, *HK Suspends UBS Sponsor License, Fines It and Others \$100 Million for IPO Failures*, REUTERS (Mar. 14, 2019 4:07 AM), <https://www.reuters.com/article/us-hongkong-regulator-ubs-group/hk-suspends-ubs-sponsor-license-fines-it-and-others-100-million-for-ipo-failures-idUSKCN1QV12F> [<https://perma.cc/3TLX-4ARE>].

VI. Conclusion

The ongoing dispute between the United States and China on audit oversight has no clear resolution in sight. While it is unlikely that there would actually be a complete delisting of Chinese companies from the U.S. markets as a whole, as it is not beneficial in any way to all sides, there will likely be more restrictive measures for existing companies in the U.S. markets as well as new companies seeking to stage IPOs. Having reviewed the development of the PCAOB regime and its early dispute with jurisdictions other than China, notably the various European jurisdictions, can see that China is still at the very same place as those jurisdictions were in around the 2010s. They also contested the Sarbanes-Oxley Act's self-proclaimed extraterritorial jurisdiction and disallowed foreign audit inspection by the PCAOB. The reasons they cited were sovereignty issues and conflicts with local laws on state secret protection. China's domestic law has the same conflict with the Sarbanes-Oxley Act as those jurisdictions. Yet, since then all the major jurisdictions and the United States have come to a resolution, with the establishment of their own independent audit regulators and by entering into cooperative agreements with the PCAOB.

China has not established an independent audit regulator. On top of that, its law on state secrets is also much stricter than the other countries. Although China and the United States did sign a Memorandum of Understanding in 2013 as a first step of cooperation, any sign of mutual trust and assistance has evaporated by 2020 as a fresh wave of accounting scandals of Chinese Concept Stocks emerges. In examining the conduct of various parties in relevant court cases, we observe that the Chinese regulators are not inherently objected to cooperation and are not always against the sharing of audit documents. Combining with the review of Chinese local laws and its oversight regime, we suggest that there are multiple technical and political reasons for the CSRC's reluctance to offer full assistance to the PCAOB. The Chinese law on state secrets may be a hurdle for the CSRC itself, instead of its shield, as there are complicated administrative requirements to obtain proper state secret clearance. Then the CSRC may face resource issues due to more foreign requests for regulatory assistance compared with its requests for foreign regulatory assistance, stemming from the fact that there are many Chinese companies listed overseas while no foreign companies are listed in China.

Going forward, the ideal solution is for the two sides to come into a cooperative agreement, just as the United States and the European jurisdictions eventually did, but there are several obstacles. Besides that, the PCAOB may doubt the quality of work by its Chinese counterpart; another problem may lie with the structure of Chinese' oversight regime, which is not viewed as a separate and independent body like the PCAOB itself. We

suggest that one way could be for Hong Kong to act as a “proxy.” Hong Kong’s accounting firm can audit the Chinese companies listed in the United States, while Hong Kong’s independent FRC, which oversees the accounting firm, can negotiate with the PCAOB for recognition and enter into a cooperative agreement, hence satisfying PCAOB’s need for oversight. But it is also noted that in any possible resolution, be it a bilateral agreement or having Hong Kong as a middleman, a high level of political trust between all sides is needed, and that is one important direction that all sides need to work on.

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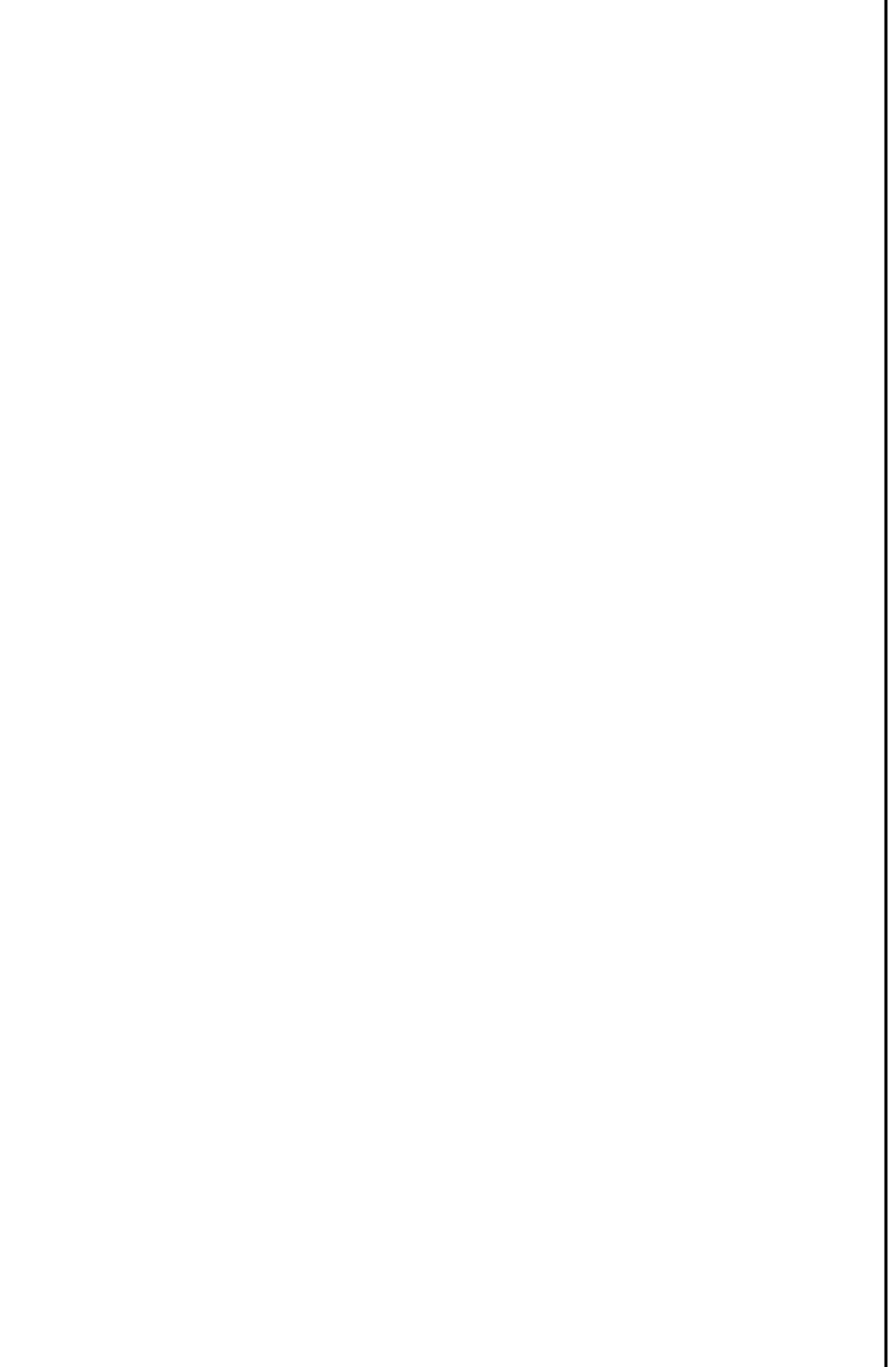
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