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

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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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2. Id.
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

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\(^{4}\) Id.
\(^{5}\) Id.
\(^{9}\) Id.
\(^{10}\) Id.
\(^{11}\) Id.
Brazil in third with thirty-five companies. 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. On the Hong Kong market, Chinese companies constitute a much higher proportion. Throughout the years since the very first listing of a Chinese state-owned-enterprise (SOE) in the 1990s, 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. Chinese companies also have the most sought after stocks and contribute 79.6 percent of the total turnover value. 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. 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. The conduct of auditors themselves is thus held to their professional standards. The auditing standards in the United States have a long history of development, beginning in the 1900s. In 1917, the American Institute of Certified Public Accountants (AICPA) first formed a special committee for

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12. Id.
17. Id.
19. See id.
20. See id.
establishing auditing standards. In 1978, this became the Auditing Standards Board. For a long time, the auditing profession was professionally regulated internally by their industry association.

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. In the same year, another one of Andersen’s clients, WorldCom, collapsed in yet another accounting scandal, again sending shockwaves through the financial market. 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. The firm Arthur Andersen itself was closed down. 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.

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. 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. 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.” 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.
The PCAOB consists of five board members appointed by the Securities and Exchange Commission (SEC), after consultation with the Fed and the Treasury. The board members typically have backgrounds as leading accounting firm partners, legal scholars, or lawyers with public administration experience. Furthermore, a maximum of two members may have worked or may be currently working as accountants. 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. The oversight responsibility over the PCAOB lies with the SEC, which reviews and approves its rules, standards, and annual budget. The SEC also reviews any disciplinary action taken by the PCAOB and may make modifications to a decision to sanction. 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. 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. 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. Moreover, each registered accounting firm must file an annual report with the PCAOB. 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. The PCAOB states that when considering the application, it considers

36. Id. § 101(e)(2).
37. Bylaws and Rules of the PCAOB §§ 2(2202), 7(1100) (Public Company Accounting Oversight Board 2016).
39. Id. § 107(c).
40. Id. § 102(a).
41. PCAOB, Bylaws and Rules of the PCAOB § 2(2100).
42. Id.
43. Id. § 2(2200).
if the firm has violated any rules or regulations, or if it failed to provide complete and accurate information.\textsuperscript{45}

Upon registration, registered accounting firms are then statutorily required to be periodically inspected by the PCAOB.\textsuperscript{46} The ongoing essential function of the PCAOB is to undertake these regular inspections in order to assess compliance with auditing standards.\textsuperscript{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.\textsuperscript{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.\textsuperscript{49} During the inspection, the PCAOB team inspects documentation, interviews personnel, and reviews the firm’s internal control policy.\textsuperscript{50} The Rules of the PCAOB are drafted widely enough to include the possibility to conduct a “surprise inspection” if necessary.\textsuperscript{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.\textsuperscript{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.\textsuperscript{53} The consequences of any enforcement action resulting from an investigation will also be felt extraterritorially by an overseas firm.\textsuperscript{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.\textsuperscript{55} The same occurred to a Brazilian branch of Deloitte, which was fined $8 million USD...
by the PCAOB and ordered to retain a 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

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\(^{58}\) 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... ").


\(^{63}\) Id. § 102(e).
PCAOB’s monitoring functions. But these overarching powers, backed by sanctions, are problematic when placed alongside the local laws in a foreign jurisdiction. A case-in-point is the conflict with the secrecy laws in France, upon which a number of Continental European countries are modeled. The French Penal Code prohibits the disclosure of secret information entrusted to persons during the course of their profession, which includes auditors. 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. Contravention of this French law that protects professional privilege is punishable by imprisonment of up to one year. 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. In 2005, it initiated the inspection of foreign accounting firms, but this was not an easy task due to logistical and jurisdictional hurdles. 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. When the deadline for the first inspection was nearing, the PCAOB had 129 foreign firms—nearly half of the total number

64. Id.
67. CODE PENAL [C. PEN.] [PENAL CODE] art. 226-13 (Fr.).
68. C. PEN. art. 226-14 (Fr.).
69. C. PEN. art. 226-13 (Fr.).
71. See Goelzer, supra note 65.
72. BYLAWS AND RULES OF THE PCAOB § 4(4003b).
of foreign firms—still pending inspection. Only Canada onboarded immediately and signed the cooperation agreement. Among those who refused inspections were registered accounting firms from seventeen jurisdictions, including China, the United Kingdom, France, Germany, Luxembourg, Korea, and more. 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.

The noncooperation of foreign accounting firms and regulators largely attributed to the delay. 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. The regulatory bodies of the various European jurisdictions were among the most vocal critics. 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. 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. 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, and that the only practicable solution moving forward is mutual

73. Schnare Press Release, supra note 70.
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].
77. Id.
78. Id.
80. Id.
81. Id. at 4.
recognition and full reliance on foreign national oversight bodies. 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. 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.”

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. 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. 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. 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. 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.
a foreign oversight entity to qualify for full reliance. The statement includes up to twenty-three detailed essential criteria listed under five general principles. Succinctly, the foreign oversight body has to be transparent, independent, and perform its work with adequacy and integrity. 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. 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.

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. 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. In 2005, Canada also became the first jurisdiction to sign a cooperative agreement with the United States. 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. Presently, twenty-four audit regulatory bodies have signed formal cooperative arrangements with the PCAOB. 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). Currently, there are about 1,790 auditing firms registered with

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.
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

course of inspection;\textsuperscript{110} Brazil provides a good example of this method.\textsuperscript{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.\textsuperscript{112} In general, the PCAOB now reports no major obstacles in fulfilling its inspection function, with the notable exception of China.\textsuperscript{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."\textsuperscript{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.\textsuperscript{115} The plan stated that the government would provide "political protection," entry barrier, and various government support to the largest firms.\textsuperscript{116} In this policy statement, it also explicitly asked companies that are listed in foreign markets, especially SOEs, to

\begin{itemize}
\item \textsuperscript{110} Schnare Press Release, \textit{supra} note 70, at 5.
\item \textsuperscript{112} Anna Alon et al., \textit{Dynamics and Limits of Regulatory Privatization: Reorganizing Audit Oversight in Russia}, 40(8) \textit{ORG. STUD.} 1217, 1217-19 (2019).
\item \textsuperscript{113} Auditing firms in Hong Kong are also not adequately inspected, to the extent where their audits involve Chinese companies. \textit{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 \textit{Public Companies}].
\item \textsuperscript{115} \textit{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).
\item \textsuperscript{116} Guanyu Jiakuai Fazhan Woguo Zhuce Kuaijishe Hangye de Ruogan Yijian (关于加快发展我国注册会计师行业的若干意见) \textit{[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).
\end{itemize}
preferentially choose those accounting firms that are beneficial "to protecting the safety of national economic information." \footnote{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.\footnote{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.\footnote{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.\footnote{120} The scheme obliged the Big Four firms to restructure their offices in China if they were to remain in the market.\footnote{121} These measures are viewed as politically motivated.\footnote{122} Further, the managing partner must be a Chinese national.\footnote{123} Within five years the number of "foreign partners" as well as their asset proportions were reduced to a flat 20 percent.\footnote{124} At the time of the scheme, none of the managing partners of the Big Four firm in China were locals, hence these requirement effective 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.\footnote{125} The duty of monitoring accounting firms is borne by both the CSRC and the Ministry of Finance.\footnote{126} The two agencies are both direct subordinates of the State Council of

\footnote{117. Id. at 4(2).}
\footnote{118. See generally Zhongwa Hezuo Kuaijishi Shiwusu 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.}
\footnote{119. See generally id.}
\footnote{120. Id.}
\footnote{121. Id.}
\footnote{122. See Alexa Melsaac, 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].}
\footnote{123. Zhongwa Hezuo Kuaijishi Shiwusu Bentubua Zhuanzhi Fangan, supra note 118, at art. 11.}
\footnote{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).}
\footnote{126. See Zhonghua Renmin Gongheguo Caizhengbu Zhuyuan 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/bzbn/ [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/newssite/kjb/ [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


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 Xiangguangurenmin dabeihui Changwuweiyaunhui Baogaoqupiao FaxINGZBUCeGaIeGaIYougangzuoqingkuang (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工作情况) [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 Jiaandu 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/zjhxwfb/xwdd/202010/t20201016_384469.html [https://perma.cc/6ZSY-9SQ4] (last visited Dec. 9, 2020).


133. Zhongguo Jiameihui (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%BC%9A#:text=%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%BC%9A#.
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. They conduct their work through their provincial branch office, often through cooperation with the Chinese Institute of Certified Public Accountants (CICPA). The Ministry of Finance has a wider scope of monitoring, and most are on the local accounting firms and companies. In the last available annual review of 2017, they conducted enforcement action on seventeen accounting firms and seventy-four companies. When a problem is detected in a qualified accounting firm, the Ministry of Finance and CSRC will form a joint team to conduct inspection. The two agencies may jointly order sanctions, for example to suspend the license of an accounting firm to conduct further business with listed companies. It should be noted that the combined number of enforcement actions on accounting firms and companies in 2017 was seventeen and seventy-four, respectively.
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. 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. There are multiple pieces of legislation and administrative circulars governing different subject areas that are relevant. These start with the general provision for the confidentiality duty of accountants. Then for audits of listed companies, there are specific prohibitions for transferring documents to overseas parties. 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. Anyone who contravenes can be fined up to five million yuan, have its business permit revoked, or be prohibited from providing relevant services. The responsible person in charge and other directly liable persons may be criminally prosecuted. 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. Local entities or individuals are in turn prohibited from providing documents or materials relating to securities business to any overseas regulators.


141. Guozhai Chengxiaoantuan Chengyuanzige Shenpi Banfa, supra note 139.


143. See id.


145. See id.


147. Id. at art. 180.

148. Id. at art. 214.

149. Id. at art. 177.

150. See Zhonghua Renmin Gonghexue 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. Yet, there are a lot of ambiguities both in the substance of state secrets and the procedure of determining what constitutes state secrets. 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." 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. 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.

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. 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

151. Id.
152. Huang, supra note 15.
154. See, e.g., Liu Mou 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 Dionzi Youxiangongsi Mingshi Panjueshu (赵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 Pangjushu (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.
secrets protection agencies, from various levels, should appraise the information. 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. If prosecuted, the punishment that the law sets down is harsh. 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.

A relevant securities regulation that directly links the handling of audit documents to the State Secret Law is the CSRC Circular No. 29, which is also referenced by the Ministry of Finance’s Interim Provisions released to accounting firms. 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[,]” 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.” Circular No. 29 also specifies the requirement for accessing documents for purposes of foreign monitoring. Where overseas securities regulatory authorities conduct inspections on companies listed overseas, which may involve documents that contain state secrets, the listed company

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.
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.\textsuperscript{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.\textsuperscript{167} The emphasis is on maintaining ample control within China’s national border.\textsuperscript{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.\textsuperscript{169} Audit firms therefore need to obtain the necessary approval in order to minimize their own legal risks.\textsuperscript{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.\textsuperscript{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.\textsuperscript{172} In any

\textsuperscript{166.} Id.
\textsuperscript{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).
\textsuperscript{168.} See sources cited supra note 167.
\textsuperscript{169.} Id.
\textsuperscript{170.} See Zhongguo Zhengjianhui Guanyu Bufen Kuaijishi Shiwusuo Xiangjingwai Tigong Shenji Gongzuo Digao Deng Dangan Wenjian De Fuhan, supra note 167, at 6.
\textsuperscript{171.} Id. at 2.
case, their significant assets, or earnings, are located within China and they are grouped together by the market as "China Concepts Stock" (CCS). 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. 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.

The characteristics of Chinese companies that sought listing in the United States varied at different stages. 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. 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). This was against the backdrop of a rapid phrase of "Reform and Opening Up" in China. The Chinese government encouraged its largest enterprises to benefit from the foreign capital and governance standards that its own domestic market lacked. 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. The companies that arrived at these times were generally still the most well-established companies. Some of the pioneering tech companies of China also began listing in the United States at this time, such as Baidu which was

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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.otcmarkets.com/corporate-services/company-directory [https://perma.cc/ECY8-NERB] (last visited Dec. 13, 2020).


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].


181. Id.

listed on Nasdaq in 2005. 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.

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. These companies were much smaller in size and were often privately owned. 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. 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. 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. 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. 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. 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. 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.

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

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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.
Concepts Stock began to emerge. Ernst & Young was named in two class-action lawsuits over its work on the Chinese company, Sino-Forest, which eventually went bankrupt. KPMG was also implicated by possible irregularities in the audit of China Forestry, leading to a suspension of its shares. Following the auditing scandals of these Chinese companies, the PCAOB began its action to inspect the auditing firms. These registered Chinese auditing firms had never been inspected at that time. 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. 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. 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. As the firms refused the requests to provide working papers, the SEC and the PCAOB found their ability to overseer the financial reporting of Chinese companies seriously limited.

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

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].
198. See id.
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. Deloitte then discovered the fraud, which involved the company forging the entire bank balance, and resigned from acting as the company’s auditor. As the SEC began investigating the auditor, the company was eventually delisted. In the Deloitte investigation, the company refused the PCAOB’s request to provide documentation. 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. The SEC then sued Deloitte in May 2012.

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. The accounting firms refused to cooperate and all followed Deloitte’s argument in their own challenges. 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. 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. 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.

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


204. Id. at 1.

205. Id.

206. See generally id. at 2.


211. GILLIS, supra note 208.


215. BDO China Dahua CPA Co. Ltd. et al., supra note 213.
2012 to discuss the problem of document access. Then, a CSRC delegation went to Washington in November 2012, although there was still no change in position. 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. 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. These lawsuits, and their eventual settlement, set the stage for U.S. and Chinese regulators to come to an agreement.

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. 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. 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. In the first dialogue meeting, the issue of PCAOB's inspections was already included on the agenda. Then in the third round of meetings, in 2011, both sides agreed to make joint efforts to accelerate reaching agreement on the issue. That same year, the Sino-U.S. Symposium on Audit Oversight was held in Beijing, although in

221. See Lynch, supra note 218.
222. Gillis, supra note 208, at 157.
223. Id.
224. Id.
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
instances of CSRC providing access since the signing of the MoU, as well as one joint inspection at a registered audit firm. It is unclear how many requests were made over the same period, but the PCAOB was certainly dissatisfied. 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. According to the PCAOB, the position of the Chinese authorities was the obstacle to inspection. 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.” 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. 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.

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. One of the


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

237. Id.

238. Public Companies, supra note 113.


most high-profile cases was Luckin Coffee, a private company in China seeking to challenge Starbucks. Since early 2020, rumors in the market had pointed to the company’s fraudulent financials. 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. Luckin’s auditor was an associated firm of EY in China. Although the firm was registered with the PCAOB, it has never been subject to inspection. 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.

The SEC quickly made a strongly worded statement criticizing the quality of financial information and disclosure from China. 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. 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. Yet, in any case, by early 2020 the U.S. regulator has become more assertive in its disappointment with the negotiation process. It is even reported that the U.S. administration is planning to terminate the 2013 China-U.S. MoU. The SEC has already made some moves in the direction of barring Chinese

243. Id.

244. Id.

245. Id.


248. Id.


251. Id.

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

companies.\textsuperscript{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 additional and more stringent criteria” to a listing applicant, based on the qualifications of the applicant’s auditor.\textsuperscript{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.\textsuperscript{256}

The U.S. Senate followed up on the issue and passed the “Holding Foreign Companies Accountable Act” by unanimous consent in May 2020.\textsuperscript{257} As an amendment to the Sarbanes-Oxley Act, this short bill—around 1,000 words—was especially tailored for China.\textsuperscript{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 authority\textsuperscript{259} (i.e. the CSRC).\textsuperscript{260} If so, the company will need to establish to the SEC that it is not owned or controlled by a foreign government.\textsuperscript{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.\textsuperscript{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.\textsuperscript{263}

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

\begin{footnotesize}
\textsuperscript{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].

\textsuperscript{255} Id. at 6.

\textsuperscript{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).

\textsuperscript{257} Id.


\textsuperscript{260} Id.

\textsuperscript{261} Id.

\textsuperscript{262} Id.

\textsuperscript{263} Id.
\end{footnotesize}
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

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.
272. Blakely et al., supra note 270.
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. 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). At that point in time, around the 2010s, the accounting profession was largely self-regulated. In 2010, the dispute over access to audit working papers arose when the SFC exercised its power to investigate a fraudulent listing application. Under Section 183 of Hong Kong’s Securities and Futures Ordinance (SFO), 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. Furthermore, failure to comply with this section without reasonable excuse constitutes a criminal offense.

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. While the listing application was still pending, EY resigned as the accountant and stated that there were inconsistencies in the accounting records. The SFC followed up with an investigation and issued up to eight request notices to EY, who refused them all. 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
Memorandum of Understanding (MMU). The CSRC then made a request, to the mainland audit counterpart that worked for EY, for the audit working papers. 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. After these futile attempts to request documentation from EY, the SFC sought an order from the court in 2012. 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. 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).

The Hong Kong court gave its judgment in 2014, ordering EY to produce the accounting records. None of EY's arguments were sustained. The court held that whether the working papers contained state secrets was factsensitive and EY had not proven the existence of any state secret in the papers. 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. In the case, EY sidestepped the issue of whether the documents contained state secrets and did not provide any evidence on it. Later, it further surfaced that the firm had the information locally in Hong Kong from the beginning.

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. 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.
Finance and Hong Kong's newly reformed Financial Reporting Council (FRC) signed a Memorandum of Understanding (2019 FRC MoU). The FRC is the regulator for auditors of listed companies and is vested with direct powers of inspection, investigation, and discipline concerning the auditors. 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. It was not until 2019 that the FRC transformed into a fully independent body of audit oversight. 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. 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. 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."

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. 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. 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. 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

297. Id.
300. Id.
301. China-Related Access Challenges, supra note 239.
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.
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.
310. See generally id.
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
[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

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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].


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


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. 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. 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, but this problem is particularly severe for the CSRC.


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, 2008-2018

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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.

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. Chinese authorities’ articulated the preference to keep national control through the writing of legislation and its industrial policy towards the accounting profession. Coming from this politically-oriented standpoint, it could be hard to persuade the Chinese authorities to share their monitoring power. That is what happened to the negotiation with U.S. Regulators despite having signed the 2013 China-U.S. MoU. 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.” It further states that “cross-border inspection must abide by the principles of respecting mutual sovereignty and cooperating as equals.” In the end, China may want the United States to recognize China’s own audit oversight regime.
instead of having to collaborate or letting U.S. inspector onshore. This would make it much like the EU-China arrangement. The European Union recognized China's audit oversight regime so that the countries can rely on each other's oversight regime to inspect audits. But these concessions will need a level of mutual trust and understanding between the two sides, which is now seriously short of. 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.

Finally, there is also a need to look at these audit firms' critical role and actions within these disputes. 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. 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. It is also apparent that these audit firms did not try to get the necessary approval on their own initiative. All they have done was to cite the Chinese legal restrictions. 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. Note that in the Hong Kong EY case, when the CSRC request documents from the accounting firm, it also refused. Again, the fact that

340. Gillis, supra note 208, at 160.
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. 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.

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. The confidence in the market has shaken, and some Chinese companies have begun their flee from the U.S. market. Some U.S. investors have suffered tremendous losses from fraudulent corporate and accounting practices. 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.

This is undoubtedly the most draconian approach. 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. First of all, this is hugely disruptive to the overall market. China is now the third-largest source of foreign companies listed in the United States, and the market capitalization involved is gigantic. 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.

353. Id.
356. Id.
357. Id.
359. Id.
360. Id.
361. Id.
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. Then it can be re-listed elsewhere at a premium, resulting in great losses for U.S. investors. 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.

Thirdly, there are, of course, well-functioning and profitable Chinese companies in the U.S. market. 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. 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. 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. 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

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368. Id.
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. From the previous experience of the objections from various European countries, it is only usual for a jurisdiction to reject extraterritorial oversight by another. 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. 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.

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. 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. The PCAOB is obligated to issue a firm inspection report after each inspection, but the PCAOB never issues a report from that trial. 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. Again, the PCAOB seems

372. Id.
373. Id.
374. Id.
377. Press Release, CSRC, Zhengjian hui youguan bumen fuze ren jiu meigu zongtong jinrong shichang gongzu zu fabu “guanyu baohu meiguo touzi zhe fangfan zhongguo gongsi zhongda fengxian de baogao” shiyi da jizhe wen
to have little interest in it.\textsuperscript{378} Plainly, the two sides lack a sufficient level of mutual trust and have expectations too far apart.\textsuperscript{379}

One obstacle to any agreement between the two sides may be the actual accounting practice standard in China.\textsuperscript{380} Considering the development of the accounting industry in China, as compared to other jurisdictions, China's development is uniquely late and rapid.\textsuperscript{381} Another obstacle is China's audit oversight regime.\textsuperscript{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.\textsuperscript{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.\textsuperscript{384} Yet another issue may be about the mutual trust of the two sides, which unfortunately is at a recent low point.\textsuperscript{385} In fact, the assertion from the United States that China evades


\footnotesize{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. \textit{Zhongguo biaoshi yuan peihe 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 否直接) [\textit{China Expresses Willingness to Cooperate with the United States to Resolve Corporate Audit Differences, Calls for Direct Consultation}], \textit{Lianhe Zaobao} (Aug. 27, 2020, 8:47 AM), https://www.zaobao.com/realtime/china/story20200827-1080107 [https://perma.cc/9HY3-4Y6C].}

\footnotesize{379. CSRC Press Release (Aug. 8, 2020), \textit{supra} note 377.}


\footnotesize{381. \textit{Id.}}

\footnotesize{382. \textit{Id.}}

\footnotesize{383. PCAOB Release No. 2007-011, \textit{supra} note 90.}

\footnotesize{384. Ma & Zha, \textit{supra} note 311.}

\footnotesize{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, \textit{Money Stuff: The U.S. Doesn't Trust China Audits}, \textit{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. 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. 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.” 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.

While it is tough for the United States and China to enter into an agreement, could Hong Kong’s FRC serve as a proxy? 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. 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. 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. 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.

388. Id.
389. Id.
391. Id.
392. Id.
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

396. See discussion supra Section IV.A.
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. This approach is fairly pragmatic and did successfully resolve the matter and allowed the party to obtain access to audit documents. 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. 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. 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. 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.

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.
410. Jakóbowski, supra note 351.
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.
416. ROBIN HUI HUANG, SECURITIES AND CAPITAL MARKETS LAW IN CHINA 82–96 (2014).
419. Clayton, supra note 409.
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. Alan 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://
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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