

ACCESSING FOREIGN AUDIT WORK PAPERS AND THE CONFLICTING NON-U.S. LAWS DEFENSE: A RECENT CASE STUDY

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Recently, an SEC administrative judge suspended the Big Four accounting firms’ China affiliates from practicing before the SEC for six months, citing the firms’ refusal to turn over audit work papers requested by the SEC. This decision has since sparked a debate over the SEC’s authority to access foreign audit work papers when those documents are stored in jurisdictions that restrict or prohibit their transfer without authorities’ prior approval.

In this Note, I trace the legislative history defining the SEC’s ever-expanding power to access foreign audit work papers with a focus on section 106(e) of the Sarbanes-Oxley Act of 2002. I also map out the development of the violation of non-U.S. laws defense that accounting firms frequently assert to counter the SEC’s document requests. Against this background, I will argue that the administrative law judge’s interpretation of section 106(e) is seriously flawed. It may lead to untenable results that could be contrary to Congress’s intent and are certainly against the purposes of the SEC’s own disciplinary proceedings. Drawing upon the federal courts’ long-time jurisprudence in handling extraterritorial discovery disputes in civil litigations, I propose an alternative analytical framework that embraces a “good faith” defense to balance the SEC’s need to access foreign audit work papers with a foreign country’s authority to regulate its accounting profession.

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INTRODUCTION

The Securities and Exchange Commission (SEC) has long considered accessing audit work papers to be vital to its effective enforcement of the federal securities law.¹ The acceleration of globalization, however, has complicated the task.² U.S. firms have increasingly expanded their overseas operations, while foreign entities have looked to the U.S. capital market to raise funds.³ These two trends have gener-

1. See Edward F. Greene et al., *Problems of Enforcement in the Multinational Securities Market*, 9 U. PA. J. INT'L BUS. L. 325, 338 (1987) ("In connection with its investigation . . . the SEC will wish to examine . . . the work papers of the foreign accountant."). At one time, Mr. Greene was the SEC's general counsel. *Id.* at 325 n.**; see also David M. Stuart & Charles F. Wright, *The Sarbanes-Oxley Act: Advancing the SEC's Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations*, 2002 COLUM. BUS. L. REV. 749, 751 (2002) ("With the recent increase in investigations by the Division of Enforcement of the SEC into accounting fraud, it is now more important than ever that the SEC have full and ready access to documents created by auditors.") (internal citation omitted). Mr. Stuart and Mr. Wright were senior counsel at the SEC. *Id.* at 749, nn.*-**. Recently, a former Director of the SEC's Division of Enforcement remarked that "[o]nly with access to work papers of . . . public accounting firms can the SEC test the quality of the underlying audits and protect investors from the dangers of accounting fraud." Press Release, U.S. Secs. & Exch. Comm'n, SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents (Dec. 3, 2012), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486452#.U1g8fsZtdz8>. For a discussion on the Big Four's business development in China, see Paul L. Gillis, *Big Four in China: Hegemony and Counter-Hegemony in the Development of the Accounting Profession in China* (June 2011) (unpublished Ph.D. thesis, Macquarie University), available at <http://www.paulgillis.org/big-four-in-china-non-offse.pdf>.

2. Richard H. Walker, Dir., Div. of Enforcement, Sec. & Exch. Comm'n, Remarks Before the AICPA National Conference on Current SEC Developments (Dec. 5, 2000), available at <http://www.sec.gov/news/speech/spch447.htm>.

3. *Id.*

ated valuable business opportunities for foreign accounting firms,⁴ but they have also created significant legal obstacles for the SEC as it tries to get its hands on the audit work papers that are stored in foreign jurisdictions where the foreign accounting firms operate.

The most formidable legal obstacle is conflicting non-U.S. laws. A foreign jurisdiction may restrict or even prohibit the transfer of certain audit work papers out of the jurisdiction with various civil or criminal liabilities that will attach if an accounting firm violates the restriction or prohibition.⁵ This gives foreign accounting firms a perfect legal argument to contest an SEC subpoena or document request, that complying with the request or subpoena will force them to violate a foreign law. Recognizing this problem, Congress passed laws designed to enhance the SEC's capacity to obtain foreign audit work papers. Among them is section 106(e) of the Sarbanes-Oxley Act, which explicitly authorizes the SEC to initiate disciplinary proceedings against those foreign accounting firms that willfully refuse to turn over audit work papers to the SEC.⁶

Interpreting section 106(e) has become a focal issue in the recent saga between the SEC and the China affiliates of the Big Four⁷ accounting firms (Big Four's China affiliates).⁸ The SEC requested from them audit work papers pertaining to certain issuers that were under investigation.⁹ The accounting firms refused on the ground that Chinese law prohibited them from doing so.¹⁰ A disciplinary proceeding ensued, with parties heatedly disputing (1) whether the accounting firms' refusal was "willful" and (2) whether a "conflicting non-U.S. laws defense" was still viable under section 106(e).¹¹ An administrative law judge (ALJ) sided with the SEC and suspended the accounting firms from practicing before the SEC for six months.¹²

4. Stuart & Wright, *supra* note 1, at 760–61.

5. See, e.g., *infra* Part I.D.2 (discussing the possibility that audit work papers could involve state secrets under Chinese law). According to Chinese Criminal Law, an accountant disseminating state secrets to a foreign organization could be imprisoned for life. Xing Fa (刑法) [Criminal Law] (promulgated by the Nat'l People's Cong., July 1, 1979, effective July 1, 1979), art. 111 (China), available at http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384075.htm.

6. Sarbanes-Oxley Act of 2002 § 106(e), 15 U.S.C. § 7216 (2012).

7. The Big Four accounting firms are PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young, and KPMG. *Who Are the Big Four Accounting Firms?*, BIG 4 ACCOUNTING FIRMS, <http://www.big4accountingfirms.org> (last visited April 10, 2014).

8. See *infra* Part II.B.

9. See *infra* Part II.B.

10. *Infra* Part II.B.

11. *Infra* Part II.B.

12. *Infra* Part II.B.

This Note will use the ALJ's decision as a case study to examine the proper interpretation of section 106(e) in light of the historical development of the SEC's power to access foreign audit work papers. I will argue that the ALJ's interpretation, which will necessarily lead to a suspension of an accounting firm whenever the firm refuses to turn over audit work papers, is not built on a solid statutory basis, could run afoul of Congress's legislative intent, and is contrary to the purposes of the SEC disciplinary proceedings. I will then propose an alternative analytical framework that draws upon federal courts' experience in handling extraterritorial discovery disputes in general civil litigations. That framework will pivot on a conception of good faith that embraces the conflicting non-U.S. laws defense.

The Note is presented in three parts. Part I traces the legislative initiatives that gradually increased the SEC's ability to access foreign audit work papers. It also provides a detailed account of the conflicting non-U.S. laws defense, focusing on accounting firms operating in the European Union and China. Part II lays out the background of the saga between the SEC and the Big Four's China affiliates, and explains the ALJ's decision and his interpretation of section 106(e). Part III offers a critique of the ALJ's decision and proposes an alternative analytical framework. It ends with an application of the proposed framework to the Big Four's China affiliates case.

I.

THE SEC'S ACCESS TO FOREIGN AUDIT WORK PAPERS

A. *The Statutory Authority to Access Foreign Audit Work Papers Before 2002*

For years, the SEC has struggled to obtain audit work papers prepared by foreign accounting firms that provide service either to U.S. issuers' foreign operations or to foreign issuers.¹³ Because these work

13. Walker, *supra* note 2 (acknowledging the "difficulty" the SEC "has encountered in obtaining foreign audit workpapers"); *see also* Greene, *supra* note 1, at 338 ("Typically . . . the foreign accountant will [not] be willing to cooperate and the SEC will be forced to compel production of documents and testimony."); Linda Chatman Thomsen & Donna Norman, *Sarbanes-Oxley Turns Six: An Enforcement Perspective*, 3 J. BUS. & TECH. L. 393, 396 n.24 (2008) ("Foreign audit work papers traditionally have been beyond the reach of the Commission unless they were produced by a U.S. issuer."). Ms. Thomsen was the Director of SEC's Division of Enforcement. Thomsen & Norman, *supra*, at 393 n.*. "Issuer" in this context is generally understood to be any person whose securities are registered under section 12 of the Exchange Act, who is required to file reports pursuant to section 15(d) of the Exchange Act, or who files or has filed a registration statement that has not yet become effective under the Securities Act and that it has not withdrawn. *See, e.g.*, 15 U.S.C. § 78j-1(f) (2012) (defining "issuer" for purposes of the section titled "audit requirements").

papers are, for the most part, located in the foreign jurisdictions where the foreign accounting firms operate, the SEC's subpoenas to produce them have frequently met with formidable resistance, not only from the foreign accounting firms involved but also from foreign governments that are particularly sensitive to protecting their sovereignty.¹⁴ To the SEC, the issue has a "long and frustrating history."¹⁵ The problem has since been exacerbated by the acceleration of American business's globalization and the increasing interest of foreign businesses in seeking to raise capital in the United States.¹⁶ These trends, coupled with the rise in financial fraud, have made the access to foreign audit working papers a necessity for the SEC to combat fraud: audit work papers tend to act as the most organized roadmap to complex transactions, and contain information that does not exist in a company's own books and records.¹⁷

Before 2002, however, the SEC did not have meaningful enforcement tools. Although both the Securities Exchange Act of 1934 and the Securities Act of 1933 authorize the SEC to "administer oaths and affirmations, subpoena witnesses . . . and *require the production* of any books, papers . . . which the Commission deems relevant . . . to the inquiry,"¹⁸ that authority is arguably limited by the language that follows: "[P]roduction of any such records may be required from *any place in the United States* or any State at any designated place of hearing."¹⁹ Indeed, case law that interprets these two provisions generally takes the position that the SEC's subpoena power to compel production of documents stops at the U.S. border.²⁰

14. See, e.g., *infra* Part II.A.

15. Walker, *supra* note 2.

16. Walker, *supra* note 2.

17. Stuart & Wright, *supra* note 1, at 751–52.

18. 15 U.S.C. §§ 77s(c), 78u(b) (2012) (emphasis added).

19. Walker, *supra* note 2 § 78u(b) (emphasis added); see also Walker, *supra* note 2 § 77s(c) ("[P]roduction of such documentary evidence may be required from *any place in the United States* or any Territory at any designated place of hearing.") (emphasis added).

20. U.S. Secs. & Exch. Comm'n v. Minas de Artemisa, S.A., 150 F.2d 215, 218 (9th Cir. 1945) (holding that while the SEC had broad authority under the Securities Act to compel production of documents, service of SEC subpoenas is limited to the territorial boundaries of the United States). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contains a provision that specifically authorizes the SEC to request audit work papers from foreign accounting firms. See Pub. L. No. 111-203, § 106, 124 Stat. 1376, 1859–60 (2010) (codified as amended at 15 U.S.C. § 7216 (2012)). This provision may lend further support to the argument that the subpoena power does not extend beyond the U.S. border. On the other hand, the SEC recently used the subpoena power under the Securities Act and the Exchange Act to compel the production of audit work papers prepared by Deloitte's China affiliate. See Application for, Order to Show Cause and for Order Requiring Compliance with a Sub-

That interpretation has created a significant legal hurdle for the SEC in obtaining foreign audit work papers. The major players in the field, namely the Big Four accounting firms, are organized in a manner that allows them to easily take advantage of the territorial limit of the SEC's subpoena power. They hold themselves out as membership organizations which are structured as legally separate entities with no cross-ownership interest or cross-management responsibilities.²¹ Thus, whenever the SEC would request foreign audit work papers from the U.S. offices of these firms, they would argue that they lacked custody or control over such documents,²² while the foreign offices that stored these documents were arguably beyond the SEC's reach.²³

B. *The Sarbanes-Oxley Act ("SOX") and Section 106*

In the wake of massive accounting fraud uncovered in the early 2000s, Congress responded by passing SOX in 2002.²⁴ Three provisions in SOX directly address the SEC's lack of access to foreign audit work papers. First, section 102 requires foreign accounting firms that "prepare or issue, or . . . participate in the preparation or issuance of, any audit report with respect to any issuer" to register with the Public Company Accounting Oversight Board ("PCAOB"), an independent regulatory agency created by SOX to oversee the public accounting profession.²⁵ The registration, in turn, triggers section 105, which grants the PCAOB authority to obtain "audit work papers" from a "registered public accounting firm . . . wherever domiciled" and allows it to make the audit work papers so obtained "available to the

poena, SEC v. Deloitte Touche Tohmatsu CPA Ltd., 940 F. Supp. 2d 10 (D.D.C. 2013). Because the court granted the parties' joint motion to dismiss without prejudice, it did not decide the issue of whether the SEC had the statutory authority to subpoena foreign accounting firms. *Id.*

21. Ethan S. Burger, *Regulating Large International Accounting Firms: Should the Scope of Liability for Outside Accountants Be Expanded to Strengthen Corporate Governance and Lessen the Risk of Securities Law Violations?*, 28 *HAMLIN L. REV.* 1, 6–7 (2004).

22. Stuart & Wright, *supra* note 1, at 759–60.

23. *See Deloitte*, 940 F.Supp. 2d at 14.

24. Jonathan Shirley, *International Law and the Ramifications of the Sarbanes-Oxley Act of 2002*, 27 *B.C. INT'L & COMP. L. REV.* 501, 502–05 (2004).

25. *See Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750–53 (codified at 15 U.S.C. § 7211 (2012)). The PCAOB is comprised of five members appointed by the SEC after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of Treasury. *Id.* § 101(e). One of its functions is to conduct investigations and disciplinary proceedings of public accounting firms. *Id.* § 101(c).

Commission.”²⁶ Third, section 106 creates a “deemed consent” regime where any “foreign public accounting firm” that “issues an opinion or otherwise performs material services upon which a registered public accounting firm relies” is deemed to have consented to (1) “produce its audit workpapers for the Board or the Commission” upon request and (2) “be subject to the jurisdiction” of a U.S. court for purposes of enforcing such request.²⁷ Together, these three provisions intend to cover both the situation where a foreign accounting firm prepares or issues an audit report for a foreign issuer and the situation where a foreign accounting firm helps its U.S. offices in preparing an audit report for a U.S. issuer.²⁸

On its face, SOX solved the problem created by the uncertainty of the territorial limit of the SEC subpoena power: the SEC can issue a section 106 request in lieu of a subpoena.²⁹ One might predict that with added weapons in its arsenal, the SEC would aggressively go after foreign accounting firms.³⁰ Such predictions, however, never came true. From 2002 to 2010, the SEC never brought any judicial or administrative enforcement action under section 106 against any foreign accounting firms, despite these firms’ continued resistance to producing requested audit papers.³¹ Neither has the PCAOB sanctioned a foreign accounting firm for its failure to produce audit work papers upon request.³² The added authority by SOX, with respect to accessing foreign audit work papers, seems to have become a paper tiger.

26. *Id.* § 105(b)(2)(B), 116 Stat. 745, 760 (codified as 15 U.S.C. § 7215(b)(2)(B) (2012)). There are, however, limitations on how much the PCAOB can share audit work papers with the SEC. Section 105(b)(5)(A) of SOX provides that “documents . . . received by . . . the Board . . . shall be confidential and privileged as an evidentiary matter . . . in any proceeding . . . and shall be exempt from disclosure . . . unless and until presented in connection with a public proceeding[.]” *Id.* § 105(b)(5)(A), 116 Stat. 745, 761 (codified at 15 U.S.C. § 7215(b)(5)(A) (2012)).

27. *Id.* § 106(b), 116 Stat. 745, 765 (codified with some differences in language at 15 U.S.C. § 7216(b) (2012)).

28. Stuart & Wright, *supra* note 1, at 750, 755–56, 774 (describing the circumstances under which a foreign accounting firm provides audit service to issuers).

29. *Stuart & Wright* at 774–76.

30. *Supra* note 1, at 751, 791.

31. I used WestlawNext and LexisNexis to search SEC actions that cited section 106. It resulted in only two cases, both of which are related to the most recent SEC enforcement actions against the Big Four’s China affiliates. *See* SEC v. Deloitte Touche Tohmatsu CPA Ltd., 940 F. Supp. 2d 10 (D.D.C. 2013); SEC v. Deloitte Touche Tohmatsu CPA Ltd., 928 F. Supp. 2d 43 (D.D.C. 2013).

32. I used WestlawNext and LexisNexis to search actions that cited section 105 brought by the PCAOB against a foreign accounting firm. It similarly produced no relevant results.

Two factors may have contributed to the PCAOB's reluctance to use section 105 and the SEC's reluctance to use section 106(e). First, the statute itself contains ambiguous language that could be construed in favor of the foreign accounting firms. Significantly, the deemed consent regime applies only if a foreign accounting firm either "issues an opinion" or "performs material service." When a Big Four's foreign affiliate does not issue opinions but only assists its U.S. counterpart, disputes could arise as to whether the service performed by the foreign affiliate is "material." Although the law is quite settled on the meaning of materiality for disclosure in financial statements,³³ it is unclear whether that interpretation of materiality applies to audit services. Suppose a Big Four's foreign affiliate provides audit services to a U.S. issuer's foreign operation that constitutes only a very small portion of the U.S. issuer's total revenue or total assets; it would not be a far stretch for a court to hold such services as immaterial.³⁴ With its limited enforcement resources, the SEC might want to avoid a court battle that could create an unfavorable precedent.

A second factor is that foreign accounting firms and, to a large extent the foreign governments behind them, successfully raised the issue of conflicting non-U.S. laws and the concern for intrusion on a foreign sovereignty. On this issue, foreign accounting firms have found sympathetic ears at PCAOB, and possibly at the SEC, too. Shortly after the passage of SOX, for example, the European Union ("EU") launched a lobbying campaign directly targeting a proposed

33. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (holding that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"); see also *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (adopting the *TSC Industries* standard of materiality for "the §10(b) and Rule 10b-5 context"). The Supreme Court has cautioned that the determination of materiality requires "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him." *TSC Indus., Inc.*, 426 U.S. at 450. The SEC has developed guidance to help accounting firms determine the circumstances under which an omission or misstatement in an issuer's financial statements would be considered material. See SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999) (to be codified at 17 C.F.R. pt. 211).

34. Cf. *In re Duke Energy Corp. Sec. Litig.*, 282 F. Supp. 2d 158, 160–61 (S.D.N.Y. 2003) (holding a 0.3% percent overstatement of revenues over a two-year period immaterial); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1426–27 (3d Cir. 1997) (holding a 0.2% understatement of a company's costs of goods sold immaterial); *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 547 (8th Cir. 1997) (holding a two percent overstatement of a company's assets immaterial). *But see Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 717–23 (2d Cir. 2011) (warning that materiality analysis is both quantitative and qualitative, and reversing a district court's finding of immateriality because it solely relied on quantitative measures).

rule implementing the section 102 registration requirement. In a letter addressed to the chairman of PCAOB, the EU warned that the registration would “cause serious conflicts of law with existing EU and national laws,” and requested “full exemption” for EU audit firms from registration.³⁵ Although the EU did not get exactly what it wanted, its effort paid off. In its final registration rule, PCAOB adopted a “Conflicting Non-U.S. Laws” exception that allows a foreign accounting firm both to register with PCAOB and simultaneously to decline to sign a standard consent (which is part of the registration form) to “comply with any request for . . . production of documents.”³⁶

The Big Four accounting firms quickly took advantage of this new rule: none of their EU affiliates signed the standard consent in their registration forms, citing conflicting EU laws as an excuse for their inability to fully comply with PCAOB’s document production request.³⁷ Although PCAOB made it clear that the exception “does not apply to potential conflicts of law that may arise subsequent to registration,”³⁸ it still undercuts the section 105 authority, since registered

35. Letter from Frits Bolkestein, Member, European Comm’n, to Charles M. Niemeier, Chairman, Pub. Co. Accounting Oversight Bd. (Apr. 11, 2013) [hereinafter EU Letter], available at http://pcaobus.org/Rules/Rulemaking/Docket%20001/042_European_Union.pdf. The EU feared the legal consequences of registration, particularly the consequence of granting the PCAOB authority to access EU accounting firms’ audit work papers and the possibility of those documents being shared with the SEC. *Id.*

36. See PUB. CO. ACCOUNTING OVERSIGHT BD., BYLAWS AND RULES Rule 2105 (2014), available at <http://pcaobus.org/Rules/PCAOBRules/Documents/All.pdf> [hereinafter BYLAWS AND RULES]; see also Pub. Co. Accounting Oversight Bd., FORM 1—APPLICATION FOR REGISTRATION, item 8.1, available at <http://pcaobus.org/Registration/Documents/Form1Sample.pdf>. Rule 2105(a) provides that an applicant for registration may withhold information “when submission of such information would cause the applicant to violate a non-U.S. law if that information were submitted to the Board.” BYLAWS AND RULES *supra*, Rule 2105(a). In a subsequent FAQ, the PCAOB suggested that an applicant’s refusal to sign the standard consent would not be treated as an incomplete application if the refusal were due to conflicting non-U.S. laws. To qualify under rule 2105(a), an applicant must, among other things, submit a legal opinion concluding that submitting information would cause the applicant to violate non-U.S. law. *Frequently Asked Questions Regarding Issues Relating to Non-U.S. Accounting Firms*, PUB. CO. ACCOUNTING OVERSIGHT BD. (July 21, 2014), http://pcaobus.org/Registration/Information/Pages/Non_US_Registration_FAQ.aspx.

37. The registration forms of these accounting firms are available on the PCAOB website. *Registered Firms* Pub. Co. Accounting Oversight Bd., <http://pcaobus.org/Registration/Firms/Pages/RegisteredFirms.aspx> (last visited Dec. 22, 2014). I searched the European affiliates of PricewaterhouseCoopers, Deloitte, KPMG, and Ernst & Young. None of them signed the standard consent in their registration forms.

38. Pub. Co. Accounting Oversight Bd. Release No. 2004-005 at A2-16 (June 9, 2004), available at http://pcaobus.org/Rules/Rulemaking/Docket013/2004-06-09_Release_2004-005.pdf.

foreign accounting firms that did not sign the standard consent could later rely on the absence of consent to defend against PCAOB's request for audit working papers.³⁹

The issue of conflicting non-U.S. laws rattled the SEC as well. In a letter addressing the SEC's Secretary, the EU voiced its strong opposition to "the SEC's desire for access to foreign auditor's working papers."⁴⁰ The letter even posed a situation "whereby EU or Member State authorities would have direct regulatory access to working papers of U.S. audit firms auditing subsidiaries of EU groups located in the United States" and asked whether this would be "acceptable" to the SEC.⁴¹ The SEC seemed to have gotten the message. In remarks made in London, the Director of the Office of International Affairs reiterated the SEC's section 106 authority.⁴² But he also recognized the issue of conflicting non-U.S. laws and emphasized that "assistance of [the SEC's] counterparts" was "necessary" to "vindicate [the SEC's] legitimate interest."⁴³ He even implicitly suggested that section 106, a "national mandate[] superimposed upon global markets," could be a "springboard for regulatory cooperation."⁴⁴ In other words, section 106 might have served as a carrot to lure foreign governments into signing information-sharing agreements with the SEC, as opposed to a stick.⁴⁵

39. The accounting firms in the China affiliate case argued this point. BDO China Dahua CPA Co. Admin. Proc. Rulings Release No. 763, at *2 n.4 (ALJ Apr. 30, 2013) (order on motions for summary disposition as to certain threshold issues), *available at* <https://www.sec.gov/alj/aljdec/2014/id553ce.pdf>.

40. Comments on Retention of Records Relevant to Audits and Reviews from Alexander Schaub, Director-General, European Comm'n, to Jonathan G. Katz, Sec'y, SEC (Dec. 20, 2002).

41. *Id.*

42. Ethiopis Tafara, Acting Dir., Office of Int'l Affairs, SEC, Address at the Annual Conference of the Institute of Chartered Accountants of England & Wales: U.S. Perspective on Accountancy Regulation and Reforms (July 8, 2003), *available at* <http://www.sec.gov/news/speech/spch070803et.htm>.

43. *Id.*

44. *Id.*

45. The SEC's enforcement action against the Big Four's China affiliates, to be discussed in Part II, could be an example of how the SEC uses section 106 to induce cooperation from foreign regulators. Before the SEC initiated the enforcement action, the Chinese regulator rebuked the SEC's cooperation request and was not interested in negotiating a framework through which a mechanism for transfer of audit work papers could be established. It even issued a letter in 2011, reiterating its position that accounting firms operating in China "must comply with the relevant Chinese laws" and that "those who provide audit archives and other documents overseas without authorization and in violation of the law shall be subject to legal liabilities." Decl. of James V. Feinerman at 15-16, *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, 940 F. Supp. 2d 10 (D.D.C. 2013). After the section 106(e) action was initiated, however, the Chinese regulator "spelled out a new procedure for screening [audit] work papers for state

C. *Dodd-Frank Act of 2010 and Section 106(e)*

The reluctance of the SEC and PCAOB to fully utilize the newly granted authorities emboldened foreign accounting firms. They continued to ignore the SEC's request for audit work papers. Testifying before Congress in 2010, the SEC's then-Chief Accountant listed the EU, Switzerland and China as foreign jurisdictions where "access to . . . audit work papers . . . has been hindered."⁴⁶

The landscape, however, might have shifted after the passage of the sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").⁴⁷ A little known section⁴⁸ embedded in the Dodd-Frank Act amended section 106 and brought two significant changes designed to enhance the SEC's ability to obtain foreign audit work papers. First, the deemed-consent regime was refined as an affirmative obligation, and the covered foreign accounting firms go beyond those that perform "material service" upon which a U.S. accounting firm relies. As a result, any foreign accounting firm that "issues an audit report, performs audit work, or conducts interim reviews," regardless of the materiality of such services or whether a U.S. accounting firm relies on such service, "shall produce the audit work papers" upon the SEC's or PCAOB's request.⁴⁹ This amendment

secrets," under which it would determine whether an SEC request is appropriate and if so, it would ask Chinese accounting firms to search for state secrets in the audit work papers, redact those state secrets, and submit the redacted papers for review. The Chinese regulator would then process the papers and coordinate with the SEC. BDO China Dahua CPA Co., Initial Decision (Public), Admin. Proc. Rulings Release No. 553, 2014 WL 242879, at *19 (ALJ Jan. 22, 2014) [hereinafter *BDO China Initial Decision*]. The Chinese Securities Regulatory Commission had since used the procedure and furnished some requested audit work papers to the SEC even before the ALJ rendered his ruling. *Id.* at *30, 38. The PCAOB might have held the same view. In the Adopting Release, the PCAOB states its continuous belief that "most conflicts of law can be resolved through an approach in which the Board works in the first instance with the non-U.S. regulator or through the use of special procedures such as voluntary consents and waivers." Pub. Co. Accounting Oversight Bd. Release No. 2004-005, at A2-17 (June 9, 2004), available at http://pcaobus.org/Rules/Rulemaking/Docket013/2004-06-09_Release_2004-005.pdf.

46. *Accounting and Auditing Standards: Pending Proposals and Emerging Issues: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 106 (2010) (written testimony of James L. Kroeker, Chief Accountant, SEC).

47. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

48. *Id.* § 106 (codified as amended at 15 U.S.C. § 7216 (2012)) (titled "Expansion of Audit Information to be Produced and Exchanged"). No debate was conducted on this provision, and the legislative record is devoid of any meaningful explanation as to why the provision was there.

49. 15 U.S.C. § 7216(b) (2012) (emphasis added).

apparently eliminated the uncertainty arising from the term “material service” in the original section 106.

A more powerful change came from an added provision: section 106(e). In the past, whenever an SEC subpoena met with a snub from a foreign accounting firm, enforcing the subpoena in federal courts was the only explicit statutory remedy available to the SEC. Section 106(e), titled “Sanctions,” gives the SEC another statutory remedy. It provides that “a willful refusal to comply, in whole or in part, with any request” made by the SEC or PCAOB under section 106—which of course includes requests for audit work papers—“shall be deemed a *violation* of the [SOX].”⁵⁰ Read alone, the provision does not seem noteworthy. However, rule 102(e) of the SEC’s Rules of Practice allows the SEC to “temporarily or permanently” deny any person’s privilege to appear or practice before the SEC upon a finding that the person “*willfully violated* . . . federal securities laws,” which encompasses SOX.⁵¹ Thus, when read through the lens of rule 102(e), section 106(e) essentially grants the SEC authority to strip foreign accounting firms of their ability to provide any audit service to U.S. issuers or foreign issuers should they refuse to cooperate. The SEC can temporarily or permanently bar foreign accounting firms from issuing audit reports filed with the SEC or from playing any role in the preparation or furnishing of an audit report filed with the SEC.⁵² Thus, a section 106(e) enforcement action, by virtue of rule 102(e) proceedings, could permanently cut off a foreign accounting firm’s lifeline, thereby forcing it to cave to the SEC’s document request.

While the Dodd-Frank Act further increased the SEC’s ability to access foreign audit papers, it did not and could not eliminate the issue of conflicting non-U.S. laws. Indeed, conflicting non-U.S. laws arguably became foreign accounting firms’ last legal resort, since the Dodd-Frank Act fixed the ambiguities embedded in the original section 106. I will turn next to these laws, examine what they are, and explain why they pose the single most difficult legal obstacle to the SEC’s enforcement of section 106.

50. *Id.* § 7216(e).

51. 17 C.F.R. § 201.102(e)(1)(iii) (2001). SOX codified this preexisting rule at 15 U.S.C. § 78d-3(a)(3). Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 602, 116 Stat. 745, 794.

52. 17 C.F.R. § 201.102(f) (2013) (defining “practice” as, among others, “[t]he preparation of any statement, opinion or other paper by any . . . accountant . . . filed with the Commission in any registration statement, notification, application, report or other document with the consent of such . . . accountant”).

D. *Conflicting Non-U.S. Laws*

Because audit work papers contain non-public and sometimes very sensitive information that could implicate a country's national interest and its authority in regulating the accounting profession, countries tend to exercise control over whether and when such information can be shared with a foreign regulatory agency. The control generally takes two forms: blocking statutes and secrecy statutes. A blocking statute generally prohibits the sharing of audit work papers with a foreign regulatory agency, usually for the purpose of protecting a country's judicial sovereignty.⁵³ A secrecy statute, on the other hand, generally requires a domestic accounting firm to get approval from a domestic authority before it can disclose certain information contained in audit work papers.⁵⁴ This Note focuses on the EU's and China's blocking and secrecy statutes because these two jurisdictions have been identified by the SEC as high priority for the need to access audit work papers.

1. *European Union*

Before 2006, the EU did not have a unified position on how to handle transfer of audit work papers to a non-EU country. The issue was largely left to the member states that have their own blocking

53. French law, for example, makes it a crime "for anyone to request, look for, or transmit in writing, orally or in any other form, any document or information in economic, commercial, industrial, financial or technical fields for the purpose of gathering evidence in view of foreign civil or administrative proceeding or in the framework of said proceedings." *Trueposition, Inc. v. LM Ericsson Tel. Co.*, No. 11-4574, 2012 WL 707012, at *3 (E.D. Pa. Mar. 6, 2012); see also Diana Lloyd Muse, Note, *Discovery in France and the Hague Convention: The Search for a French Connection*, 64 N.Y.U. L. REV. 1073, 1073-78 (1989) (reviewing the historical, social, and cultural context of the French blocking statute). As of 1986, at least fifteen nations had adopted laws expressly designed to counter efforts by United States courts to secure production of documents situated outside the United States. RESTATEMENT (THIRD) OF U.S. FOREIGN RELATIONS LAW § 442, reporters' note 1 (1986).

54. The Cayman Islands are an example. The Cayman Confidential Relationships (Preservation) Law provides:

Whenever a person intends or is required to give in evidence in, or in connection with, any proceeding being tried, inquired into or determined by any court, tribunal or other authority (whether within or without the Islands) any confidential information within the meaning of this Law, he shall before so doing apply for directions and any adjournment necessary for that purpose may be granted.

Cayman Confidential Relationships (Preservation) Law § 4(1) (2009), available at http://www.gazettes.gov.ky/sites/default/files/gazette-supplements/Gs332009_web.pdf. Confidential information, under the statute, is broadly defined to include any information "concerning any property which the recipient thereof is not, otherwise than in the normal course of business, authorised by the principal to divulge." *Id.* § 2.

statutes and professional secrecy laws.⁵⁵ In 2006, the European Parliament adopted Directive 2006/43/EC, which for the first time laid out a two-track framework that EU member states must transpose into their own legal system whenever they transfer audit work papers outside the EU.⁵⁶ Under the Directive, inter-governmental transfer is the preferred track. A foreign authority can send a request directly to a member state's authority.⁵⁷ The request must, among other things, explain the justifications for the transfer.⁵⁸ The member state's accounting firms then send the requested audit work papers to its home country authority, which can then transfer the documents if it has already had a reciprocal arrangement with the requesting foreign authority.⁵⁹ Most importantly, the member state can reject the foreign authority's request (1) if providing the audit work paper "would adversely affect the *sovereignty, security, or public order* of the Community or of the requested Member State;" (2) if judicial proceedings have already been initiated in the requested member state "in respect of the same actions and against the same persons;" or (3) if the transfer would violate EU-wide data protection laws.⁶⁰

The private-governmental track is discouraged, as it will be allowed only in "exceptional cases."⁶¹ Under this track, a foreign authority can directly request audit work papers from an accounting firm operating in a member state. However, the foreign authority must notify the member state of the request in advance.⁶² A transfer will be allowed by a member state only if, among other things, (1) it will not "conflict with" the accounting firm's home country obligations and (2) a reciprocal arrangement has been established between the member

55. In the letter addressed to the Chairman of the PCAOB, the EU provided examples of member states' blocking and professional secrecy statutes. EU Letter, *supra* note 35, at 6–7. Member states mentioned in the letter include Denmark, Sweden, Germany, France, and Finland. *Id.* In addition, the EU has an EU-wide data protection law that prohibits transfer of personal data to countries outside the EU that do not provide adequate data protection as mandated by the Directive. Directive 95/46/EC, of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, 1995 O.J. (L 281) 31–50. The United States is such a country. EU Letter, *supra* note 35, at 1.

56. Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on Statutory Audits of Annual Accounts and Consolidated Accounts, Amending Council Directive 78/660/EEC and 83/349/EEC, and Repealing Council Directive 84/253/EEC, 2006 O.J. (L 157) 87.

57. *Id.* art. 47(2), 2006 O.J. (L 157) at 105.

58. *Id.* art. 47(2)(a), 2006 O.J. (L 157) at 105.

59. *Id.* art. 47(1)(d), 2006 O.J. (L 157) at 105.

60. *Id.* art. 47(1)(e), (2)(d), 2006 O.J. (L 157) at 105–06 (emphasis added).

61. *Id.* art. 47(4), 2006 O.J. (L 157) at 106.

62. *Id.*

state and the foreign authority.⁶³ Thus, even with the private-governmental track, a member state's blessing is required before a foreign authority can lay its hands on the audit work papers.

As of September 2010, all EU member states have fully transposed the Directive.⁶⁴ The United Kingdom,⁶⁵ for instance, completed the transposition in 2010. It followed the Directive's two-track system whereby a foreign authority can request audit work papers either from the U.K. Secretary of State or from a U.K. accounting firm.⁶⁶ Under either track, however, the Secretary of State retains the final word since his or her approval is a prerequisite for the transfer.⁶⁷ The statute authorizes the Secretary of State to refuse or direct an accounting firm to refuse a request when there is concern for "sovereignty, security or public order" or there is a pending parallel proceeding, the same grounds as those listed in the Directive.⁶⁸ The statute does not define "sovereignty, security, or public order," leaving the Secretary of State wide latitude to exercise discretion.

2. *China*

China did not and still does not have a statute that specifically addresses transfer of audit work papers to a foreign authority. Audit

63. *Id.*

64. EUROPEAN COMM'N, SCOREBOARD ON THE TRANSPOSITION OF THE STATUTORY AUDIT DIRECTIVE (2006/43/EC) (2010), http://ec.europa.eu/internal_market/auditing/docs/dir/01_09_10_scoreboard_en.pdf. Each member state's transposition measure is also accessible online. EUROPEAN COMM'N, NATIONAL TRANSPOSITION MEASURES FOR DIRECTIVE 2006/43/EC, http://ec.europa.eu/internal_market/auditing/directives/transpo_en.htm (last visited Jan. 6, 2014). Under EU law, a directive becomes effective only if it is incorporated into national law by member states. It does, however, place an obligation on each member state to ensure that a particular aim is achieved by a particular date, leaving member states to decide on the exact implementation details. *See* KAREN DAVIES, UNDERSTANDING EUROPEAN UNION LAW 56–57 (5th ed. 2013).

65. I chose the U.K. based on my knowledge of English. Other member states' transposition measures are available online at http://ec.europa.eu/finance/auditing/directives/transpo_en.htm.

66. Companies Act, 2006, c. 6, § 1253D(1) (U.K.). It is worth noting that section 1253D(1)(c) permits a U.K. accounting firm to transfer audit work papers to a foreign authority for the purposes of investigating an auditor or an audit firm. *Id.* §§ 1253D(1)(c), 1253DC. One of the conditions for the transfer is that the foreign authority must have entered into a reciprocal working arrangement with the U.K. Secretary of State through which the Secretary of State may direct the accounting firm to refuse the foreign authority's request. *Id.* §§ 1253DC, 1253E, sch. 10, para. 16AB(5).

67. *Id.* §§ 1253DA, 1253DB.

68. *Id.* §§ 1253DA(4), 1253DB(5), 1253E(7); Directive 2006/43/EC, *supra* note 56, art. 36(4), 2006 O.J. (L 157) at 101.

work papers, however, are arguably subject to the State Secrecy Law, which was passed in 1989 and amended in 2010.⁶⁹

The State Secrecy Law is notorious for its open-ended language and lack of clarification.⁷⁰ It casts a wide net on what constitutes a “state secret”: virtually any matter “related to state security and national interests” that is “entrusted to a limited number of people for a given period of time” is a state secret.⁷¹ Although the statute goes on to provide a list of major state secret matters, which includes “activities related to foreign countries” and “national economic and social development,” there is a catch-all provision that authorizes agencies administering the protection of state secrets to identify matters not listed in the statute as state secrets.⁷²

Under the implementing regulation, the State Secrets Bureau (SSB) is responsible for designing national policy on protection of state secrets, while central government agencies may separately or jointly with the SSB identify matters that are “within their respective administrative areas” as state secrets.⁷³ Since the Ministry of Finance (MOF) and the Chinese Securities Regulatory Commission (CSRC) share authority to regulate the accounting profession,⁷⁴ by virtue of the implementing regulation they can issue agency rules on whether audit work papers are state secrets.

The CSRC exercised this prerogative in 2009 when it issued an agency rule jointly with the SSB.⁷⁵ The rule creates two obligations

69. See CONG.-EXEC. COMM’N ON CHINA, NATIONAL PEOPLE’S CONGRESS STANDING COMMITTEE ISSUES REVISED STATED SECRETS LAW (2010), available at <http://www.cecc.gov/pages/virtualAcad/index.phpd?showsingle=140456>.

70. HUMAN RIGHTS IN CHINA, STATE SECRETS: CHINA’S LEGAL LABYRINTH 5–23 (2007), available at http://www.hrichina.org/sites/default/files/PDFs/State-Secrets-Report/HRIC_StateSecrets-Report.pdf.

71. Baoshou Guojia Mimi Fa (保守国家秘密法) [Law on the Protection of State Secrets] (promulgated by the Standing Comm. Nat’l People’s Cong., Sept. 5, 1988, amended April 29, 2010, effective Oct. 1, 2010), art. 2 (China).

72. *Id.* art. 9.

73. Baoshou Guojia Mimifa Shishi Tiaoli (保守国家秘密法实施条例) [Regulations on the Implementation of the Law on Guarding State Secrets] (promulgated by the State Council, Jan. 17, 2014, effective Mar. 1, 2014) arts. 2, 3 (China), available at <http://www.big5.hrichina.org/en/implementation-regulations/2014-regulations-implementation-law-peoples-republic-china-guarding-state>.

74. Declaration of Professor Xin Tang at 5, SEC v. Deloitte Touche Tohmatsu CPA Ltd., 940 F. Supp. 2d 10 (D.D.C. 2013).

75. Guanyu Jiaqiang Zai Jingwai Faxing Zhengquan Yu Shangshi Xiangguan Baomi He Dang’an Guanli Gongzuo De Guiding (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的规定) [Provisions on Strengthening Confidentiality and Archives Administration in Overseas Issuance and Listing of Securities] (promulgated by the China Sec. Regulatory Comm’n, State Secrecy Bureau, and State Archives Admin., Oct. 20, 2009) (China) [hereinafter No-

for accounting firms with respect to transfer of audit work papers. First, audit work papers that “involve any state secrets” cannot be transmitted outside China without the approval of “relevant in-charge authorities.”⁷⁶ Second, accounting firms must report “any matter involving state secrets” to “in-charge authorities . . . for approval” when “overseas securities regulatory authorities . . . propose to conduct off-site inspection.”⁷⁷ The rule ends by reminding accounting firms of the liabilities, including criminal ones, they may incur if they violate the rule.⁷⁸ It does not, however, identify the “in-charge authorities,” nor does it explain the circumstances under which audit work papers would “involve any state secrets.”⁷⁹

3. *Conclusions*

With the government functioning as a gatekeeper in both the EU and China, the SEC could face formidable legal challenges when attempting to access foreign audit work papers. The EU, on the one hand, at least established a clear mechanism through which the SEC’s request presumably would not be refused,⁸⁰ though the ambiguity surrounding the terms “sovereignty, security, or public order” does create uncertainties. China, on the other hand, does not have such a clear mechanism. The SEC may get lost while navigating the Chinese bureaucracy, not knowing which agency is the authority “in-charge.” On top of that is the broadly defined “state secret,” which arguably could cover any information contained in audit work papers,⁸¹ and the arbitrary manner in which the State Secrets Law has been enforced.⁸² In

tice 29], *available at* <http://lawprofessors.typepad.com/files/doc-29-from-tang-xin-declaration-1.pdf>.

76. *Id.* art. 6.

77. *Id.* art. 8.

78. *Id.* art. 9.

79. *Id.*

80. Paragraph 28 of the Preamble of Directive 2006/43/EC recognizes that “[t]he complexity of international group audits requires good cooperation,” therefore, “Member States should . . . ensure that competent authorities of third countries can have access to audit working papers and other documents through the national competent authorities.” Directive 2006/43/EC, *supra* note 56, at 91.

81. One federal judge commented that China’s State Secrets Law has “broad sweep and can preclude disclosure of a host of nebulously defined categories of information.” *Munoz v. China Expert Tech., Inc.*, No. 07 Civ. 10531, 2011 WL 5346323, at *1 (S.D.N.Y. Nov. 7, 2011).

82. Sigrid Ursula Jernudd, Note, *China, State Secrets, and the Case of Xue Feng: The Implications for International Trade*, 12 CHI. J. INT’L L. 309, 322–23 (2011) (discussing the Xue Feng prosecution for violating the State Secrets Law as a result of selling oil and gas information that was subsequently deemed a state secret).

light of China's tradition of jealously guarding its sovereignty,⁸³ chances are that the SEC would clash more frequently with the Chinese authorities than with its European counterparts, putting Chinese accounting firms in an awkward position.

II.

THE SEC AND THE BIG FOUR'S CHINA AFFILIATES: BACKGROUND

The ever-increasing number of China-based companies listed in the U.S. stock market makes it imperative for the SEC to access audit work papers prepared by Chinese accounting firms when these companies show financial irregularities. The experience the SEC has had in dealing with China's State Secrecy Law, however, is nothing but frustration. This, coupled with the Big Four's China affiliates' refusal to cooperate with the SEC's section 106 requests, resulted in the first-ever section 106(e) enforcement action.⁸⁴ The SEC brought the case against Big Four's China affiliates in an administrative proceeding, and an ALJ issued a decision on January 22, 2014. This Part examines the events leading up to the enforcement action and explains the ALJ decision in detail, which lays the groundwork for an alternative analytical framework to address issues presented by conflicting non-U.S. laws.

A. *The SEC's Recent "China Problem"*

It is not a coincidence that the SEC flexed its section 106 muscle against the Big Four's China affiliates. Between 2007 and 2010, the U.S. capital market saw an insurgence of Chinese companies raising capital through a reverse merger.⁸⁵ Under this model, a Chinese pri-

83. Jacques deLisle, *China's Approach to International Law: A Historical Perspective*, 94 AM. SOC'Y INT'L L. PROC. 267, 272-74 (2000) (noting China's "[e]xtremely robust notions of state sovereignty" as part of its views of international law even in the post-Mao era).

84. In 2011, the SEC also asked a federal district court to enforce a subpoena issued to Deloitte's China affiliate by invoking its subpoena power under the Securities Act and the Exchange Act. Application for Order to Show Cause and for Order Requiring Compliance with a Subpoena, SEC v. Deloitte Touche Tohmatsu CPA Ltd., 940 F. Supp. 2d 10 (D.D.C. 2013). Because that case does not involve section 106(e), I will examine it only to the extent necessary.

85. See PUB. CO. ACCOUNTABILITY OVERSIGHT BD., ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION: JANUARY 1, 2007 THROUGH MARCH 31, 2010, at 3 (2011), available at http://pcaobus.org/research/documents/chinese_reverse_merger_research_note.pdf (concluding that Chinese reverse mergers account for twenty-six percent of the total reverse merger transactions from January 1, 2007 to March 31, 2010).

vate company merges into a shell entity that is an existing public company, thereby becoming listed without having to go through the rigorous IPO process.⁸⁶ Although the practice has since been clamped down on by the New York Stock Exchange and NASDAQ,⁸⁷ those Chinese companies that had gained access to the U.S. capital market through this model started to show irregularities in their financial reporting, such as restatements of past years' financial statements or resignations of auditors.⁸⁸ These irregularities caused the companies' stock to plunge, costing U.S. investors billions of dollars on paper and resulting in numerous shareholder lawsuits.⁸⁹

These developments naturally drew the attention of the SEC.⁹⁰ As part of the SEC's investigations of these companies, it sought to review audit work papers, some of which were prepared by the Big Four's China affiliates and stored in China where these companies conducted their substantial operations.⁹¹ Predictably, the Big Four's China affiliates refused to turn over those documents, citing the potential risks of violating the State Secrets Law.⁹² The SEC then tried another route: it contacted the CSRC and sought its help.

86. Qingxiu Bu, *The Chinese Reverse Merger Companies (RMCs) Reassessed: Promising But Challenging*, 12 J. INT'L BUS. & L. 17, 18 (2013).

87. Michael Rapoport, *How the Big Four Audit Firms' Chinese Units Ended Up in Hot Water*, WALL ST. J. BLOG (Jan. 22, 2014, 6:06 PM), <http://blogs.wsj.com/moneybeat/2014/01/22/how-the-big-four-audit-firms-chinese-units-ended-up-in-court>; see also Stanley Lubman, *Unpacking the Law Around the Chinese Reverse Takeover Mess*, WALL ST. J. BLOG (Jan. 24, 2012, 3:21 PM), <http://blogs.wsj.com/chinarealtime/2012/01/24/unpacking-the-law-around-the-chinese-reverse-takeover-mess/> (noting that the SEC has approved rules that require reverse merger companies to file audited financial statements covering a full fiscal year commencing after the filing of specified initial documentation before they can be listed); Jonathan P. Rochwarger & Joel L. Rubenstein, *SEC Approves More Rigorous Listing Requirements of the Major U.S. Stock Exchanges for Reverse Merger Companies*, NAT'L L. REV. (Nov. 29, 2011), <http://www.natlawreview.com/article/sec-approves-more-rigorous-listing-requirements-major-us-stock-exchanges-reverse-merger-comp>.

88. Azam Ahmed, *Chinese Reverse-Merger Companies Draw Lawsuits*, N.Y. TIMES (July 25, 2011), <http://dealbook.nytimes.com/2011/07/26/chinese-reverse-merger-companies-draw-lawsuits>.

89. Bu, *supra* note 86, at 22–23; see also Azam Ahmed, *Chinese Stocks Plummet on News of Justice Department Inquiry*, N.Y. TIMES (Sept. 29, 2011), <http://dealbook.nytimes.com/2011/09/29/chinese-stocks-plummet-on-news-of-justice-department-inquiry>.

90. Rapoport, *supra* note 87.

91. Rapoport, *supra* note 87; see also Bu, *supra* note 86, at 21–22 (noting that the operating part of the reverse merger Chinese companies and the U.S.-listed part are technically two separate legal entities, with the Chinese-owned part carrying out substantial business operations).

92. Rapoport, *supra* note 87.

At the time, the SEC and the CSRC had a Memorandum of Understanding (“MOU”) in place that provided a framework for cooperation.⁹³ The MOU spells out the SEC and the CSRC’s “intent to provide each other assistance in obtaining information and evidence to facilitate the enforcement of their respective laws,” but provides that such assistance must “be consistent with the domestic laws of the respective States,” and may be “denied” if it “would be contrary to the [State’s] public interest.”⁹⁴ The MOU does not specifically mention transfer of audit work papers, thereby leaving open the scope of assistance to each side’s interpretation.

The vague language and China’s stubbornness in insisting on protecting its sovereignty⁹⁵ turned the 1994 MOU into a piece of useless paper; since 2009, the SEC has sent twenty-one requests to the CSRC for assistance in connection with sixteen separate investigations and has had over thirty communications with the CSRC, but has received no assistance or response.⁹⁶ Meanwhile, the mentality of those who run the SEC since the financial crisis and the discovery of the Madoff Ponzi scheme shifted to tough enforcement,⁹⁷ suggesting that inside the agency, concerns about failure to act gradually came to outweigh concerns for the international implications of a particular enforcement action. As the SEC’s frustration with both the Chinese government and the Big Four’s China affiliates grew, it seemed to be only a matter of time before the agency would run out of patience. Indeed, when Congress was debating the Dodd-Frank bill, Congressman Kanjorski (D–Pa.), who introduced the section 106 amendment, asked the SEC’s then-Chief Accountant whether he had anything in

93. Memorandum of Understanding Between the United States Securities and Exchange Commission and the China Securities Regulation Commission Regarding Cooperation, Consultation, and the Provision of Technical Assistance, SEC Release No. IS-662, 56 SEC Docket 1717, 1994 WL 163-73 (Apr. 28, 1994) available at https://www.sec.gov/about/offices/oia/oia_bilateral/china.pdf.

94. *Id.* ¶¶ 2, 4.

95. Lubman, *supra* note 87.

96. Securities and Exchange Commission’s Reply Memorandum in Support of Its Application for Order Requiring Compliance with Subpoena at 21–22, *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, 940 F. Supp. 2d 10 (D.D.C. 2013); see also Christopher M. Matthews, *SEC Details Friction with Chinese Counterpart over Audits*, WALL ST. J. BLOG (Dec. 4, 2012, 6:40 PM), <http://blogs.wsj.com/corruption-currents/2012/12/04/sec-details-friction-with-chinese-counterpart-over-audits/>.

97. Robert Khuzami, Dir., Div. of Enforcement, Secs. & Exch. Comm’n, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), available at <https://www.sec.gov/news/speech/2009/spch080509rk.htm>.

mind to “fix the China problem.”⁹⁸ The Chief Accountant responded, “The House regulatory reform bill on section 106 of Sarbanes-Oxley that would give us greater ability to subpoena work papers from foreign audit firms . . . would be of assistance.”⁹⁹

B. Section 106(e) Enforcement Action and the ALJ’s Ruling

When the non-enforcement efforts to access audit work papers proved to be fruitless, the SEC, starting in 2011, began to send the Big Four’s China affiliates section 106 requests and issued subpoenas. Again, the Big Four’s China affiliates declined to comply. In 2012, the SEC initiated its first section 106(e) administrative proceedings, seeking to permanently bar the Big Four’s China affiliates from practicing before the SEC because of their failure to comply with the section 106 request.¹⁰⁰

The parties did not seriously dispute that the Big Four’s China affiliates failed to comply with the SEC’s request,¹⁰¹ so the issue quickly turned to whether the failure was “willful,” which is the prerequisite to trigger rule 102(e) disciplinary proceedings. Under section 106(e), only a “willful refusal to comply” with a section 106 request is a violation of securities law.¹⁰² The accounting firms took the position that “willful” required proof of bad faith, while the SEC maintained that as long as the refusal was “intentional,” that is, a deliberate choice not to comply, it was “willful.”¹⁰³

In a 112-page ruling, the ALJ sided with the SEC. Noting that “willful” is not defined in the statute and concluding that the meaning of the term is “not plain,” the ALJ engaged in a structural analysis of

98. *Accounting and Auditing Standards: Pending Proposals and Emerging Issues: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 23 (2010).

99. *Id.* at 24.

100. The SEC also sought to enforce the subpoena in federal courts. The case was dismissed. *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, 940 F. Supp. 2d 10 (D.D.C. 2013).

101. The accounting firms argued, among other things, that section 106(b)(1) is applicable only in circumstances in which a foreign accounting firm prepared or furnished an audit report. Since they only conducted audit work but did not issue or prepare any audit report, the SEC lacked authority to compel document production under section 106(b)(1). The ALJ easily rejected this argument, pointing to section 106(b)(1)’s language, which covers any “foreign public accounting firm” that “performs audit work.” *BDO China Dahua CPA Co.*, Admin. Proc. Rulings Release No. 763, at *13–14 (ALJ Apr. 30, 2013) (order on motions for summary disposition as to certain threshold issues), available at <https://www.sec.gov/alj/aljdec/2014/id553ce.pdf>.

102. See *supra* text accompanying note 50.

103. *BDO China Initial Decision*, *supra* note 45, at *64.

the provision.¹⁰⁴ Section 106(e) is “not consistent with the usual statutory format” of securities statutes under which “willful” is “an element of a particular administrative sanction,” the ALJ wrote.¹⁰⁵ Rather, “willful” in section 106(e) is “an element of the unlawful conduct.”¹⁰⁶ That unusualness, however, does not warrant treating the term differently from how it is commonly interpreted in civil securities law cases, namely, “intentionally committing the act which constitutes the violation” regardless of the actor’s subjective motive.¹⁰⁷

To support this holding, the ALJ cited two other SOX provisions that also contain the word “willful.” One is section 105(c)(7), which makes it unlawful for any person barred or suspended from association with a registered public accounting firm “willfully to become or remain associated with” such a firm.¹⁰⁸ The ALJ reasoned that interpreting “willfully” to require something more than a deliberate act would defeat the purpose of this provision, since “the whole point of an associational bar is to prevent barred persons from associating” again with a registered public accounting firm.¹⁰⁹ The other provision is section 107(d)(3), which authorizes the SEC to remove a PCAOB board member upon a finding that the member “has willfully violated” securities law or “has willfully abused” his authority.¹¹⁰ Finding this language similar to an Exchange Act provision that authorizes the SEC to censure or deny the privilege to practice before it to any person who “willfully violated” securities law, the ALJ concluded that it should have the same meaning as in civil securities law cases.¹¹¹ Since “willful” in these two SOX provisions means “intentional” conduct, so does the “willful” in section 106(e), according to the ALJ. After all, “a term appearing in several places in a statutory text is generally read the same way each time it appears.”¹¹²

Having found that the Big Four’s China affiliates willfully refused to comply with the SEC’s section 106 request, thereby violating section 106(e), the ALJ turned to sanctions. Interestingly, the ALJ

104. *BDO China Initial Decision*, *supra* note 45, at *66.

105. *BDO China Initial Decision*, *supra* note 45, at *67–68.

106. *BDO China Initial Decision*, *supra* note 45.

107. *BDO China Initial Decision*, *supra* note 45, at *67–69 (citation omitted).

108. *BDO China Initial Decision*, *supra* note 45, at *69 (citing 15 U.S.C. § 7215(c)(7)(A) (2012)).

109. *BDO China Initial Decision*, *supra* note 45.

110. *BDO China Initial Decision*, *supra* note 45, (citing 15 U.S.C. § 7217(d)(3) (2012)).

111. *BDO China Initial Decision*, *supra* note 45, *68–69 (referring to 15 U.S.C. § 78d-3 (2012), which codifies rule 102(e)).

112. *BDO China Initial Decision*, *supra* note 45, at *71.

opted to consider the accounting firms' subjective motive at this stage, though he is not required to do so.¹¹³

Without deciding the merits of whether China's State Secrets Law in fact precluded the accounting firms from furnishing the requested audit work papers, as the firms claimed, the ALJ lashed out at them:

The evidence demonstrates unequivocally that Respondents did know that they might face a bar, first when they registered with the [PCAOB] . . . and second when they filed their Sarbanes-Oxley 106 agent designation with the [SEC], which has the authority to impose a practice bar. Given the rarity of [sanction] proceedings for . . . failure to cooperate, it would not have been irrational for Respondents to take a calculated risk, as they did here Respondents could have stopped auditing U.S. issuers after Dodd-Frank was enacted, but they did not.

I have little sympathy for Respondents [K]nowing that if called upon to cooperate in a[n SEC] investigation into their business, they must necessarily fail to fully cooperate and might thereby violate the law . . . they [still] invested money and effort in building up their accounting business. Such behavior does not demonstrate good faith, indeed, quite the opposite—it demonstrates gall.¹¹⁴

Not surprisingly, the ALJ imposed heavy sanctions: he barred the Big Four's China affiliates from practicing before the SEC for six months.¹¹⁵ The ruling sent a shock wave through the industry,¹¹⁶ and as of late 2014, the accounting firms were appealing the decision.¹¹⁷

113. *BDO China Initial Decision*, *supra* note 45, at *78. Under case law, the SEC only needs to consider whether a particular sanction is in the public interest. *See Altman v. SEC*, 666 F.3d 1322, 1329 (D.C. Cir. 2011). Although the ALJ concluded that sanctioning the Big Four's China affiliates was in the public interest, he nevertheless continued to discuss the accounting firms' subjective motives, stating that "good faith or lack thereof . . . is relevant to evaluating the appropriate sanction." *BDO China Initial Decision*, *supra* note 45, at *78–80.

114. *BDO China Initial Decision*, *supra* note 45, at *79.

115. *BDO China Initial Decision*, *supra* note 45, at *82–85. Rule 410 of SEC's Rules of Practice permits a losing party to appeal the ALJ's decision to the Commission upon a filing of petition for review. 17 C.F.R. § 201.410 (2013). If a party again loses before the Commission, it can petition the U.S. Court of Appeals for the D.C. Circuit to review the Commission's order. *See* 15 U.S.C. § 78y(a)(1) (2012).

116. Michael Rapoport, *What's Next for Big Four Audit Firms in China?*, WALL ST. J. BLOG (Jan. 23, 2014, 3:41 PM), <http://blogs.wsj.com/moneybeat/2014/01/23/whats-next-for-big-four-audit-firms-in-china/>; *SEC's Charges Against China-Based Accounting Firms Have Broad Implications*, ROPES & GRAY LLP (Dec. 5, 2012), <http://www.ropesgray.com/~media/Files/alerts/2012/12/secs-charges-against-china-based-accounting-firms-have-broad-implications.pdf>.

117. Michael Rapoport, *China Units of Big-Four Firms Appeal Audit Ban*, WALL ST. J., Feb. 12, 2014, <http://online.wsj.com/news/articles/SB100014240527023037043045>

III.

PROPOSED ALTERNATIVE FRAMEWORK: THE “GOOD FAITH” DEFENSE

In this Part, I argue that although the accounting firms may deserve some sanction in this case, the ALJ’s interpretation of section 106(e)’s “willful” does not have solid statutory basis. Combined with the ALJ’s narrow understanding of the “good faith” defense, the interpretation will have broad, adverse ramifications, may lead to untenable results that could be contrary to the legislative intent, and are certainly contrary to the purposes of rule 102(e) proceedings. Drawing upon federal courts’ long-time jurisprudence in handling extraterritorial discovery disputes in civil litigations, I will then propose an alternative analytical framework that embraces a “good faith” defense to balance the interests of the SEC’s need to access foreign audit work papers with a foreign country’s authority to regulate its accounting profession.

A. *Critique of the ALJ’s Interpretation of “Willful” and “Good Faith”*

Even from the perspective of pure structural analysis of a statutory provision, the ALJ’s equation of “willful” in section 106(e) with “intentional conduct” is not necessarily built on solid grounds. As numerous courts and commentators have observed, the term “willful” is a “word of many meanings,” and “its construction [is] often . . . influenced by its context.”¹¹⁸ This contextual approach has been recognized and consistently deployed by courts. For example, “willful” is used to describe the intent required for both civil and criminal violations of the Exchange Act;¹¹⁹ but courts have generally held that “willful,” as used in the criminal provisions of the federal securities

79379410335942436. The SEC is appealing as well, on the ground that the sanctions are too lenient: the accounting firms should be permanently barred. *Id.* As of the time of this writing, both sides are in the process of negotiating settlements. Michael Rapoport, *Big Four Audit Firms in China in Settlement Talks with SEC Enforcers*, WALL ST. J., June 2, 2014, <http://online.wsj.com/articles/big-four-audit-firms-in-china-in-settlement-talks-with-sec-enforcers-1401752112>; Michael Rapoport, *SEC, Big Four Chinese Affiliates Make Progress in Talks over Documents*, WALL ST. J., Oct. 22, 2014, <http://online.wsj.com/articles/sec-big-four-chinese-affiliates-make-progress-in-talks-over-documents-1414012408>.

118. *Spies v. United States*, 317 U.S. 492, 497 (1943); *see also Ratzlaf v. United States*, 510 U.S. 135, 141 (1994).

119. *Compare* Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) (2012) (“willfully” as an element required for criminal liability), *with* Securities Exchange Act of 1934 § 15(b)(4), 15 U.S.C. § 78o(b)(4) (2012) (“willfully” as an element required for civil sanction).

law, demands a higher level of intent than that demanded in civil and administrative proceedings.¹²⁰

The same approach should be applied to civil provisions as well. It is true that as a general proposition, “willful” as used in civil provisions of federal securities law means “no more than that the person charged with the duty knows what he is doing.”¹²¹ This seems to suggest that “willful” in section 106(e), a civil provision, should be no different. But all of the cases that adopted the general proposition interpreted “willful” as an element of the administrative sanction,¹²² while section 106(e) is one of those rare civil provisions in which “willful” is an element of the violation.¹²³ Since courts have not had an opportunity to expound such provisions,¹²⁴ the contextual approach would caution against any direct transplantation of what courts have said about “willful” when it is an element of the administrative sanction into section 106(e), where it is an element of the violation.

The ALJ seems to have recognized this, as he devoted significant efforts to highlight the fact that “willful” in section 106(e) is an element of the violation.¹²⁵ He also deliberately chose not to give much weight to the general definition of “willful,” but relied on two SOX provisions that also contain the word “willful” in an attempt to contextualize section 106(e)’s “willful.”¹²⁶ These two provisions, however, arguably undercut his conclusion rather than support it. The first provision, as explained, authorizes the SEC to remove a PCAOB Board member upon a finding that the member “has willfully violated” se-

120. *See, e.g.,* United States v. O’Hagan, 521 U.S. 642, 666 (1997) (stating that a criminal violation of federal securities law requires that an individual have undertaken the proscribed act with a “culpable intent”).

121. *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *see also* Joan McPhee, “Willfulness” Under the Federal Securities Laws and Intent-Based Defenses to Federal Securities Prosecutions, ROPES & GRAY LLP, available at http://www.ropesgray.com/files/Publication/cd588b54-a9b6-428b-969a-9e35d87251e0/Presentation/PublicationAttachment/feb3138-00da-4652-98e6-9f1e4f828c7a/Article_2001_Willfulness_McPhee.pdf (“In the civil arena, the term ‘willfully’ has typically been understood to mean simply that the act constituting the violation was undertaken voluntarily and intentionally . . .”).

122. *Wonsover*, 205 F.3d at 414; *see also* *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949); *Geahart & Otis, Inc. v. SEC*, 348 F.2d 798, 802–03 (D.C. Cir. 1965); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965).

123. The other provision is section 105(c)(7) of SOX. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 105(c)(7), 116 Stat. 745, 763–64 (2002) (codified at 15 U.S.C. § 7215(c)(7) (2012)).

124. I searched cases that cited section 105(c)(7) in WestlawNext and LexisNexis. I did not find any case citing this provision, either by federal courts or by the SEC.

125. *BDI China Initial Decision*, *supra* note 45, at *66–69.

126. *BDI China Initial Decision*, *supra* note 45, at *69.

curities law or “has willfully abused” his authority.¹²⁷ The structure of such a provision is exactly the same as those civil provisions in which “willful” is an element of administrative sanction: only when a PCAOB Board member’s violation of securities law or abuse of authority is “willful” will he or she be removed from office. Since “willful” in this provision is not an element of the violation, it offers little guidance as to how the term should be interpreted in section 106(e). The other provision relied upon by the ALJ makes it unlawful for any person barred from associating with a registered public accounting firm “willfully to become or remain associated with” a registered public accounting firm.¹²⁸ Although the ALJ might be correct that “willful,” an element of the violation in this provision, should mean “intentional” conduct, he reached this conclusion precisely by using the contextual approach, namely, examining this provision’s underlying purpose.¹²⁹ By the same token, the ALJ should have used the contextual approach in interpreting section 106(e)’s “willful.” Thus, even if “willful” in the associational bar provision means intentional conduct, it does not necessarily lend support to the proposition that “willful” in section 106(e) means the same thing. The underlying purposes of these two provisions could be different and a separate contextual analysis should be performed for the purposes of section 106(e).

To be sure, section 106(e) reflects Congress’s resolve to strengthen the SEC’s ability in accessing foreign audit work papers.¹³⁰ But Congress may have intended the word “willful” in section 106(e) to be a check on the SEC’s deployment of a section 106 request. Although committee reports, conference reports, and congressional testimonies shed little light on why the word “willful” was in section

127. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 107(d)(3), 116 Stat. 745, 767–68 (codified at 15 U.S.C. § 7217(d)(3) (2012)); *BDO China Initial Decision*, *supra* note 45, at *69.

128. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 105(c)(7), 116 Stat. 745, 763–64 (codified at 15 U.S.C. § 7215(c)(7) (2012)).

129. *BDO China Initial Decision*, *supra* note 45, at *68–69. As the ALJ explained, “[T]he whole point of an associational bar is to prevent barred persons from associating with a registered public accounting firm . . . [and] it would be nonsensical for ‘willfully’ . . . to mean something other than . . . ‘intentionally committing the act.’” *Id.* at *69.

130. The title of the subsection is “*Increasing Regulatory Enforcement and Remedies.*” Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929J, 124 Stat. 1376, 185960 (2010) (emphasis added). When the same provision was introduced in the Senate, its sponsor stated that one of the purposes of the provision was to “modern[ize] [the SEC’s] ability to obtain critical information.” 156 CONG. REC. S2644 (daily ed. Apr. 26, 2010) (statement of Sen. John Francis Reed); *see also* Modernizing and Strengthening Investor Protection Act of 2010, S. 3258, 111th Cong. § 4(e)(3), at 34–36.

106(e), the legislative history might suggest that Congress did not want the SEC's section 106 request to be unrestrained.

Section 106 first showed up in a bill introduced by Congressman Kanjorski (D–Pa.) on October 15, 2009.¹³¹ It was then rolled over into H.R. 4173,¹³² the bill that was eventually passed by the House,¹³³ and became the Dodd-Frank Act.¹³⁴ Section 106(e) or its equivalent was found in both bills,¹³⁵ but H.R. 4173 added a new provision, not seen in Congressman Kanjorski's bill, immediately after section 106(e). The provision, under the title "Other Means of Satisfying Production Obligations," provides that "[n]otwithstanding any other provision of this section, the staff of the Commission . . . may allow foreign public accounting firms . . . to meet production obligations under this section [through] alternate means, such as through foreign counterparts of the Commission."¹³⁶ This provision had been intact since its introduction and was codified into section 106(f) of SOX.¹³⁷

Although legislative materials did not explain the addition of section 106(f) as the Dodd-Frank bill travelled through the House, it was possible that Congress did not view a section 106 request as the sole means of obtaining documents from a foreign accounting firm. Rather, Congress may have envisioned cooperation with foreign regulatory authorities as an alternative that could be utilized by the SEC under certain circumstances.¹³⁸ Thus, "willful" in section 106(e) arguably should be interpreted in a manner that at least preserves the SEC's incentive to utilize section 106(f).¹³⁹

131. Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 603, at 137 (as introduced by Rep. Paul E. Kanjorski, Oct. 15, 2009).

132. *Additional Reforms to the Securities Investor Protection Act: Hearing Before the Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 1 (2009) (statement of Rep. Paul E. Kanjorski, Chairman, Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters.).

133. H.R. 4173, 111th Cong. § 7603 (as passed by House, Dec. 11, 2009).

134. Dodd-Frank Act § 929J.

135. *Compare* Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 603 (as introduced by Rep. Paul E. Kanjorski, Oct. 15, 2009), *with* H.R. 4173, 111th Cong. § 7603 (as passed by House, Dec. 11, 2009).

136. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7603 (as introduced by Rep. Barney Frank, Dec. 2, 2009).

137. Dodd-Frank Wall Street Reform and Consumer Protection Act § 929J, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

138. One could certainly speculate whether section 106(f) was meant to address the concern that a section 106 request might intrude on a foreign country's sovereignty, especially when there were conflicting non-U.S. laws. Unfortunately, I have not been able to uncover a clear clue in the legislative record as to whether this is what Congress intended.

139. The statutory interpretation canon "*verba cum effectu sunt accipienda*" would caution against an interpretation that causes another provision to have no conse-

Under the ALJ's interpretation, however, section 106(f) probably will end up being a meaningless provision. Imagine a British accounting firm that performs audit work for a British issuer with business operations in the U.K. The SEC wants to access audit work papers pertaining to the issuer. It could either send a section 106 request to the accounting firm or contact the British government for help. Applying the ALJ's logic, any refusal from the accounting firm, which is intentional conduct, will automatically subject the firm to rule 102(e) disciplinary proceedings. Should this be the case, the SEC would have every incentive to send the section 106 request rather than going through the government-to-government channel. What's worse, since the British accounting firm is aware of the possibility that the British Secretary of State may disapprove a transfer of audit work papers to the SEC,¹⁴⁰ yet it chooses to continue performing its business, the firm shows a lack of good faith, which would warrant at least a temporary suspension.¹⁴¹ Indeed, it is difficult to construct a scenario in which the firm would be able to show good faith (as defined by the ALJ). Audit work must be performed for the foreign issuer,¹⁴² and yet any such business operation in a foreign jurisdiction with existing laws that could block the transfer of audit work papers is conclusive evidence of bad faith. Thus, under the ALJ's interpretation, a refusal of a section 106 request will *always* lead to suspension of the accounting firm, with the possibility that the firm would be permanently barred from practicing before the SEC. This effectively rules out the conflicting non-U.S. laws defense, giving the SEC "self-proclaimed license to charge" and suspend foreign accounting firms "whenever it pleases, constrained only by its own discretion."¹⁴³ With such a nuclear option

quence. See ANTONIN SCALIA & BRYAN A. GARNER, *READING LAW: THE INTERPRETATION OF LEGAL TEXTS* 174–79 (2012).

140. See *supra* notes 67–68 and accompanying text.

141. See *supra* notes 114–15 and accompanying text.

142. Federal securities laws require that an issuer have an independent auditor to issue audit opinions. 15 U.S.C. § 78m(a) (2012) (mandating that issuers file information required by the SEC); 17 C.F.R. § 210.2-02 (2013) (requiring issuers' financial statements to be accompanied by audit opinions issued by independent auditors); Sec. & Exch. Comm'n, Form 20-F, Item 8.A, *available at* <http://www.sec.gov/about/forms/form20-f.pdf> (requiring foreign private issuers to file audited financial statements in their registration statements or annual reports). In addition, section 404(b) of SOX requires an auditor to attest to management's assessment of internal controls. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404(b), 116 Stat. 745, 789 (codified at 15 U.S.C. § 7262(b) (2012)).

143. *Checkosky v. SEC*, 139 F.3d 221, 225 (D.C. Cir. 1998). In *Checkosky*, the SEC was criticized for failing to articulate an intelligible standard for "improper professional conduct" under rule 102(e)(1)(iii). *Id.* at 224–26. The court noted that such failure would allow the SEC to charge and prove improper professional conduct

at hand, the SEC has virtually no incentive to utilize section 106(f) even when a foreign jurisdiction has a blocking or secrecy statute. Forcing a foreign accounting firm to pressure the foreign government by sending the firm a section 106 request will probably be more effective than initiating direct talks with the foreign government.¹⁴⁴

Apart from probably rendering section 106(f) meaningless, the ALJ's interpretation could undermine the international cooperation regime the SEC has worked for years to build. Over the years, the SEC has signed enforcement Memoranda of Understanding ("MOUs") with more than twenty foreign counterparts,¹⁴⁵ and through these MOUs the SEC sends out over 600 requests annually for assistance to foreign regulators.¹⁴⁶ Though empirical evidence of the MOUs' effectiveness is lacking, the fact that the SEC continues to promote such MOUs and that such requests typically are not denied serves as testimony to its success.¹⁴⁷ Indeed, on its website, the SEC has listed notable enforcement cases that are the fruits of assistance provided by foreign regulators.¹⁴⁸

One of the underpinnings of such MOUs is the SEC's respect for foreign sovereignty. In virtually all enforcement MOUs, there is a clause that permits a foreign regulator to deny an assistance request if it would require the foreign regulator to "act in a manner that would violate the laws of the [foreign country]" or if accommodating the request would be contrary to the foreign country's "public interest" or "national security."¹⁴⁹

"whenever it pleases." *Id.* at 225. The same could be said here, since the standard articulated by the ALJ would give the SEC unbounded discretion to suspend foreign accounting firms' privilege to practice before the SEC.

144. There is speculation that forcing the Big Four's China affiliates to pressure the Chinese government is one of the reasons that motivated the SEC to initiate the administrative proceeding. ROPES & GRAY LLP, *supra* note 116; *see also supra* notes 121–24 and accompanying text.

145. *See Cooperative Arrangements with Foreign Regulators*, U.S. SECS. & EXCH. COMM'N, http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml#enforce (last updated Feb. 26, 2015).

146. U.S. SECS. & EXCH. COMM'N, FY 2015 ANNUAL PERFORMANCE PLAN 33 (2013), *available at* <http://www.sec.gov/about/reports/sec-fy2015-annual-performance-plan.pdf>.

147. Eduard H. Cadmus, Note, *Revisiting the SEC's Memoranda of Understanding: a Fresh Look*, 33 FORDHAM INT'L L.J. 1800, 1854–55 (2010).

148. SECS. & EXCH. COMM'N, *supra* note 145.

149. *See, e.g.*, Memorandum of Understanding on Consultation, Technical Assistance and Mutual Assistance for the Exchange of Information, U.S.–Arg., art. III, § 2(4), Dec. 9, 1991, *available at* http://www.sec.gov/about/offices/oia/oia_bilateral/argentina.pdf. Enforcement MOUs with other foreign regulators contain a similar provision; *see also* Cadmus, *supra* note 147, at 1843–44.

The ALJ's interpretation of section 106 threatens to undercut this foundation. First, it is ironic that the SEC would allow a foreign regulator to use conflicting non-U.S. laws as a legitimate excuse in declining the SEC's request for audit work papers but would punish an accounting firm operating in that foreign jurisdiction for raising the same excuse. There does not seem to be any justification for such a double standard. Second, and more importantly, the SEC could circumvent the MOUs' requirement to respect foreign laws by simply sending a section 106 request to foreign accounting firms. The foreign accounting firm, faced with a near-certain suspension if it refuses the section 106 request, will probably have no choice but to comply with the request. In doing so, the accounting firm would either disregard the conflicting non-U.S. law or, more likely, pressure the foreign regulator to permit the transfer of audit work papers to the SEC. Given that foreign blocking or secrecy statutes usually contain vague words such as "public order" or "national interest,"¹⁵⁰ a foreign regulator might bend those words in a manner that it would not had the SEC sent an assistance request directly to the foreign regulator. And even if the foreign regulator withstands the pressure from accounting firms, it probably will not appreciate the SEC's tactics that indirectly encroach upon a foreign sovereign's independent decision-making authority. As a result, foreign regulators would be less willing to facilitate assistance to the SEC despite the existence of MOUs that have proved to be indispensable parts of the SEC's enforcement apparatus.

Finally, the ALJ's interpretation is inconsistent with the purposes of rule 102(e) proceedings. Rule 102(e) has been understood to be remedial and not punitive.¹⁵¹ As federal courts have pronounced, the SEC in adopting rule 102(e) did not intend to add an "additional weapon" to its "enforcement arsenal," but rather meant for the provision to be "an attempt . . . to protect the integrity of its own processes"¹⁵² and an attempt to safeguard "the confidence of the investing public in the integrity of the financial reporting process."¹⁵³ The SEC itself agreed with this characterization. For example, in explaining an amendment to the rule in 1998, the SEC stated that rule 102(e) "protects the integrity of the Commission's processes" by "seek[ing] to assure that professionals who prepare filings made with

150. See *supra* notes 60, 71–72 and accompanying text.

151. See, e.g., *McCurdy v. SEC*, 396 F.3d 1258, 1264–65 (D.C. Cir. 2005) (recognizing that "[t]he Commission may impose sanctions [under rule 102(e)] for a remedial purpose, but not for punishment").

152. *Touche Ross & Co. v. SEC*, 609 F.2d 570, 579, 582 (2d Cir. 1979).

153. *Marrie v. SEC*, 374 F.3d 1196, 1200 (D.C. Cir. 2004).

the Commission have the competence to prepare filings that comply with applicable requirements.”¹⁵⁴ In a recent opinion, the SEC further elaborated that rule 102(e) ensures that professionals “perform their tasks diligently.”¹⁵⁵ Thus, the SEC has suspended accountants who demonstrated incompetence by failing to perform audits in accordance with the Generally Accepted Auditing Standard¹⁵⁶ and attorneys who have acted unethically while representing their clients before the SEC.¹⁵⁷

It is difficult to imagine how an accounting firm’s refusal to turn over audit work papers implicates the firm’s competence. The only plausible rationale to initiate rule 102(e) proceedings, therefore, is to ensure that the accounting firm diligently performs its task and that the integrity of the financial reporting process is protected. The ALJ’s interpretation of “willful” and “good faith,” however, is hardly consistent with this rationale. Recall the British accounting firm hypothetical.¹⁵⁸ Further assume that the firm, upon receiving the SEC’s section 106 request, immediately sends the requested audit work papers to the British Secretary of State and actively seeks his or her approval to transfer them. The Secretary, after due consideration, denies the application in writing, leaving the accounting firm no choice but to refuse the SEC’s request. As explained, this will automatically lead to the firm being suspended if the SEC initiates a rule 102(e) proceeding. But how will this encourage other British accounting firms to diligently perform their tasks? The firm has diligently exhausted all available means to comply with the SEC’s request. Nor will the suspension protect the integrity of financial reporting. U.K. accounting firms will have to refuse section 106 requests as long as the British Secretary of State prohibits them from turning over the requested documents. Without qualified accounting firms performing audit work for the British issuer, the issuer’s financial statements will be left unaudited. This hardly enhances the integrity of financial reporting, even letting alone the fact that an issuer without an independent auditor could be delisted from the U.S. capital market.¹⁵⁹

154. Amendment to Rule 102(e) of the Commission’s Rules of Practice, 63 Fed. Reg. 57,164, 57,170 n.70 (Oct. 26, 1998) (codified as amended at 17 C.F.R. § 201.102(e) (1999)).

155. Steven Altman, Exchange Act Release No. 63306, 2010 WL 5092725, at *16 (Nov. 10, 2010), *aff’d*, Altman v. SEC, 666 F.3d 1322 (D.C. Cir. 2011).

156. *See, e.g.*, McCurdy, 396 F.3d at 1264–65.

157. *See, e.g.*, Steven Altman, 2010 WL 5092725, at *16.

158. *See supra* Part III.A.

159. *See supra* note 142 and accompanying text.

To sum up, construing section 106(e)'s "willful" as "intentional conduct" does not have a solid statutory basis and deviates from the settled contextual interpretation approach. Together with the definition of "good faith" that effectively excludes the conflicting non-U.S. laws defense, this could upset Congress's intent when it enacted section 106(f) and also is contrary to the announced purposes of rule 102(e) proceedings. The ALJ's interpretation, therefore, should be replaced by an alternative analytical framework that would exonerate a foreign accounting firm from charged section 106(e) violations when a conflicting non-U.S. law prevents the firm from accommodating an SEC section 106 request.

B. An Alternative Analytical Framework that Builds In the Good Faith Defense

An alternative analytical framework can be achieved by construing "willful" as "not acting in good faith." This construction would build in a conflicting non-U.S. laws defense and could avoid the problems discussed earlier.¹⁶⁰ In addition, it is also perfectly consistent with the contextual interpretation approach courts have long endorsed whenever they are called upon to construe "willful" in a particular statutory provision.¹⁶¹ The issue remains, however, as to what constitutes "good faith" in the context of transferring audit work papers, and the federal securities laws offer little guidance.

Fortunately, I do not need to write on a clean slate. In the context of extraterritorial discovery disputes in civil litigation, where party A seeks the production of documents located in a foreign country from party B (or a non-party), federal courts have examined the circumstances under which party B (or the non-party) demonstrated good faith or the lack thereof when it raised the issue of conflicting non-U.S. laws.¹⁶² The concept was developed from the Supreme Court's seminal case *Societe Internationale pour Participations Industrielles*

160. See *supra* Part III.A.

161. See, e.g., *supra* note 118–20 and accompanying text.

162. It should be noted that good faith is not the sole factor a court will consider when deciding whether to credit a party's conflicting non-U.S. laws defense. Courts have used the factors listed in the section 442 of the Restatement (Third) of the Foreign Relations Law (formerly section 40 of the Restatement (Second) of the Foreign Relations Law) along with good faith factor. See Keith Y. Cohan, Note, *The Need for a Refined Balancing Approach When American Discovery Orders Demand the Violation of Foreign Law*, 87 TEX. L. REV. 1009, 1016–20 (2009). But see Lenore B. Browne, Note, *Extraterritorial Discovery: An Analysis Based on Good Faith*, 83 COLUM. L. REV. 1320, 1345–50 (1983) (arguing that good faith should be the sole factor a court should consider to determine whether to credit a conflicting non-U.S. laws defense).

et Commerciales, S.A. v. Rogers.¹⁶³ In this case, a Swiss holding company sued the United States to recover property seized during World War II, contending that the seizure was improper.¹⁶⁴ The district court ordered the plaintiff to produce concededly relevant documents held by its Swiss banker.¹⁶⁵ The Swiss Federal Attorney, however, confiscated those documents after determining that turning them over would violate Swiss banking law relating to the secrecy of banking records and penal law prohibiting economic espionage.¹⁶⁶ Unable to produce the documents, the plaintiff raised the conflicting non-U.S. law defense, arguing that disclosure would lead to the imposition of criminal sanctions.¹⁶⁷

A unanimous Supreme Court reversed the lower court's dismissal of the suit after finding that the plaintiff had demonstrated "good faith." Resting heavily on the fact that the plaintiff had sought waiver from the Swiss government and had actively worked on a plan "designed to achieve maximum compliance with the production order,"¹⁶⁸ the Court held that the plaintiff had "attempted all which a reasonable man would have undertaken in the circumstances"¹⁶⁹ and acted in good faith.¹⁷⁰ According to the Court, "[i]t is hardly debatable that fear of criminal prosecution constitutes a weighty excuse for nonproduction, and this excuse is not weakened because the laws preventing compliance are those of a foreign sovereign."¹⁷¹

Although *Societe Internationale* suggests that affirmative endeavor is a factor to be considered in ascertaining a party's good faith,¹⁷² it is not clear whether this is the *only* factor. This is because the parties in *Societe Internationale* did not dispute the substance of Swiss banking and penal law.¹⁷³ The Court, therefore, did not address the question of whether compliance with the U.S. discovery order would in fact have resulted in the Swiss company's violation of Swiss law. In addition, the Court in dictum suggested two other dimensions

163. 357 U.S. 197, 201 (1958).

164. *Id.* at 198–99.

165. *Id.* at 200.

166. *Id.*

167. *Id.* at 199–201.

168. *Id.* at 203.

169. *Id.* at 201, 209.

170. *Id.* at 208–09.

171. *Id.* at 211.

172. *Id.* at 202–03, 211 (crediting petitioner's "extensive efforts at compliance" with a production order); see also Note, *Limitations on the Federal Judicial Power to Compel Acts Violating Foreign Law*, 63 COLUM. L. REV. 1441, 1462 (1963) (discussing the good faith effort required by *Societe Internationale*).

173. *Societe Internationale*, 357 U.S. at 201–02, 204.

of good faith. The Court noted first that no evidence could prove that the plaintiff and the Swiss government colluded in the confiscation of the documents.¹⁷⁴ It further cautioned that if the plaintiff “deliberately courted legal impediments to production,” the result could be different.¹⁷⁵ The Court did not, however, elaborate what circumstances would warrant a finding of a “deliberately courted legal impediment.”

Subsequent lower courts’ decisions have offered some clarification.¹⁷⁶ First, they have confirmed that affirmative efforts are a prerequisite to a finding of good faith. Such efforts include investigating whether the requested documents fall under the purview of conflicting non-U.S. laws and actively seeking exemptions from the laws’ applications. For example, in *In re Westinghouse Electric Corp.*, a third party to a litigation, subpoenaed to produce certain documents held in Canada, argued that compliance with the subpoena would violate Canadian laws.¹⁷⁷ The party had sent a “lengthy formal request” to the Canadian authorities asking that it be exempted from the Canadian laws and that it be permitted to produce the documents in question.¹⁷⁸ It also “made diligent effort” to disclose materials not subject to the Canadian laws.¹⁷⁹ Relying on these facts, the Tenth Circuit held that the party acted in good faith.¹⁸⁰ Likewise, in *United States v. First National Bank of Chicago*, the Seventh Circuit suggested that a finding of good faith would hinge on whether a party asserting the conflicting non-U.S. laws defense had made reasonable efforts to explore a limited exception under Greek law and seek the Greek authorities’ permission to produce relevant documents.¹⁸¹

By contrast, in *Ohio v. Arthur Andersen & Co.*, the Tenth Circuit concluded that Arthur Andersen’s assertion that Swiss law precluded discovery was unsubstantiated because the company did not even investigate the content of the requested documents to confirm whether

174. *Id.* at 201.

175. *Id.* at 208–09.

176. *Societe Internationale* is the Supreme Court’s only pronouncement on the issue.

177. *In re Westinghouse Elec. Corp. Uranium Contracts Litig.*, 563 F.2d 992, 994–95 (10th Cir. 1977).

178. *Id.* at 995. The Canadian government denied this request. *Id.*

179. *Id.* at 998.

180. *Id. But see* *Linde v. Arab Bank, PLC*, 269 F.R.D. 186, 199 (E.D.N.Y. 2010) (noting that a waiver request that mischaracterized the status of a lawsuit does not support a finding of good faith); *Remington Prods., Inc. v. N. Am. Philips Corp.*, 107 F.R.D. 642, 653 (D. Conn. 1985) (a waiver request that argued against exemption supports a finding of bad faith).

181. *United States v. First Nat’l Bank of Chi.*, 699 F.2d 341, 346 (7th Cir. 1983); *see also* *CFTC v. Lake Shore Asset Mgmt. Ltd.*, No. 07 C 3598, 2007 WL 2915647, at *14–15 (N.D. Ill. Oct. 4, 2007) (interpreting *First Bank of Chicago* as requiring a showing of an effort to seek a waiver if possible).

they were within the scope of the Swiss law.¹⁸² This formed the basis of the court's finding that Arthur Andersen acted in bad faith.¹⁸³

Second, lower courts have generally required that the party who is subject to a subpoena carry the burden of proof that conflicting non-U.S. laws prevent compliance with the subpoena. In *In re Sealed Case*, the D.C. Circuit dealt with a situation where a foreign country's banking secrecy law prohibited a third party to the litigation from producing certain documents.¹⁸⁴ Because the government had conceded that "it would be impossible for the [party] to comply with the . . . order without violating the laws of Country Y on Country Y's soil," the court accepted the party's good faith argument.¹⁸⁵ In so ruling, the court expressed its "considerable discomfort to think that a court of law should order a violation of law, particularly on the territory of the sovereign whose law is in question."¹⁸⁶

By contrast, the Second Circuit in *United States v. First National City Bank* rejected the requested party's good faith defense in part because it failed to prove that complying with the discovery order would necessarily lead to a violation of foreign law.¹⁸⁷ The court noted "a number of valid defenses" available to the requested party under German law, as well as and German courts' wide latitude in awarding damages "even in the face of liability."¹⁸⁸ Similarly, in *SEC v. Lines Overseas Management, Ltd.*, the court credited the government's evidence that "there is a foreign legal mechanism by which [the requested parties] can lawfully (within those [foreign] countries) comply with the U.S. subpoena" and was therefore unconvinced that enforcing the subpoena would subject the requested parties to liability in foreign courts.¹⁸⁹

Third, lower courts have found a lack of good faith when parties have taken advantage of the conflicting non-U.S. laws by intentionally hiding documents in those foreign jurisdictions. These cases seem to have built on *Societe Internationale's* dictum that actively courting legal impediments would result in a finding of bad faith.¹⁹⁰ For example, in *General Atomic Co. v. Exxon Nuclear Co.*, a U.S. plaintiff de-

182. *Ohio v. Arthur Andersen & Co.*, 570 F.2d 1370, 1373 (10th Cir. 1978).

183. *Id.* at 1373.

184. *In re Sealed Case*, 825 F.2d 494, 495 (D.C. Cir. 1987).

185. *Id.* at 498.

186. *Id.*

187. *United States v. First Nat'l City Bank*, 396 F.2d 897, 904-05 (2d Cir. 1968).

188. *Id.* at 905.

189. *SEC v. Lines Overseas Mgmt., Ltd.*, No. Civ. A. 04-302 RWR/AK, 2005 WL 3627141, at *10 (D.D.C. Jan. 7, 2005).

190. *See supra* text accompanying note 175.

liberately concealed documents in Canada knowing that the Canadian government would likely pass a law very soon prohibiting the release of those documents.¹⁹¹ The plaintiff sent two lawyers to Canada to conduct an inventory of documents and specifically instructed them “not to bring back any documents” to the U.S.¹⁹² After Canada passed the law, the plaintiff asserted the conflicting non-U.S. laws defense and even attempted to negotiate with the Canadian government for a waiver or relaxation of the Canadian law.¹⁹³ The court, however, was not appreciative of the plaintiff’s tactics. Finding that the plaintiff “followed a deliberate policy of storing . . . documents in Canada with the expectation that they would be unavailable for discovery in anticipated litigation in the United States,”¹⁹⁴ the court concluded that such conduct amounted to “courting legal impediments” and that the plaintiff acted in bad faith.¹⁹⁵

Drawing from the principles articulated by the cases above, I propose a three-step inquiry in the context of a section 106 request in order to determine whether an accounting firm’s refusal to comply with such a request is “willful.” As a preliminary matter, the SEC establishes a *prima facie* case of “willful” when the accounting firm fails to turn over the requested audit work papers. The accounting firm, however, can produce evidence to support its good faith compliance, while the ultimate burden of persuasion still lies with the SEC.¹⁹⁶

First, the foreign accounting firm can present evidence to show that compliance with the request would in fact result in a violation of foreign law. This includes evidence that the firm has made reasonable

191. *Gen. Atomic Co. v. Exxon Nuclear Co.*, 90 F.R.D. 290, 299–303 (S.D. Cal. 1981).

192. *Id.* at 301.

193. *Id.* at 294–95, 307.

194. *Id.* at 299.

195. *Id.* at 299, 302–03.

196. In administrative proceedings, the SEC always has the burden of proof, and the Supreme Court held in *Steadman v. SEC* that the standard of proof is “preponderance of the evidence.” 450 U.S. 91, 96 (1981). The SEC, however, has distinguished between the burden of persuasion and the burden of production. For example, in *Jay Houston Meadows*, the SEC held that requiring a broker-dealer to produce evidence in support of his innocence did not improperly shift the burden of proof to the broker-dealer when the SEC had made a *prima facie* case. See *Jay Houston Meadows*, Exchange Act Release No. 37156, 1996 WL 218638, at *6 & n.27 (May 1, 1996), *aff’d*, *Meadows v. SEC*, 119 F.3d 1219 (5th Cir. 1997); see also Philip A. Lehman, Exchange Act Release No. 309, 2006 WL 721579, at *6–7 (ALJ Mar. 20, 2006) (initial decision) (addressing the distinction between burden of proof and burden of production); Gerald James Stoiber, Exchange Act Release No. 39565, 1998 WL 23969, at *2 & n.4 (Jan. 22, 1998) (noting the distinction between burden of persuasion and burden of production).

efforts to determine that the requested documents indeed fall within the scope of the foreign law and that the foreign law prohibits their production. The SEC, on the other hand, can offer evidence that the foreign law provides valid defenses or escape clauses that would exonerate the accounting firm.

Second, if the foreign law is found to prevent compliance with the section 106 request, the accounting firm can present evidence that it has made affirmative steps to explore alternative methods. Such methods generally refer to seeking waivers or exemptions from foreign regulators, but a court should also consider whether the accounting firm has made available those materials that do not fall under the foreign law. In this regard, a court should closely scrutinize the content of the waiver request and should compare the accounting firm's conduct both before and after the initiation of rule 102(e) proceedings to determine whether the firm has made extensive efforts.

The third and final step of the inquiry is whether the accounting firm courted legal impediments to production, which could occur in two forms. One form is when the firm deliberately placed the requested documents in the foreign country with the knowledge that the foreign law would prevent the SEC's access to those documents in a later enforcement action. The other involves collusion between the accounting firm and a foreign government in enacting a law solely for the purposes of thwarting the SEC's section 106 request.¹⁹⁷ Barring a finding of courting legal impediments, a court should conclude that the accounting firm acts in good faith, and therefore that the refusal to turn over audit work papers is not "willful" under section 106(e).

Critics may argue that this alternative analytical framework will necessarily carve out certain audit work papers that are beyond the SEC's reach. Although this is a legitimate concern, it might be overstated. This rigorous three-step inquiry will likely weed out accounting firms' abusive use of the good faith defense. In the context of extraterritorial discovery disputes in civil litigations, courts have demonstrated their capability to discern when the defense was pretextual.¹⁹⁸ There is no reason to doubt that courts will be able to do the

197. Though no cases have actually found that such collusion would constitute bad faith, *Societe Internationale's* dictum suggested that it would. *Societe Internationale pour Participations Industrielles et Commerciales, S.A. v. Rgoers*, 357 U.S. 197, 201 (1958).

198. I have found only three cases in which courts have held that the requested party acted in good faith: *Societe Internationale*, *In re Westinghouse Litigation*, and *In re Sealed Cases*. See *supra* notes 168–70, 177–80, 184–86 and accompanying text.

same in the context of section 106 requests. Thus, the carve-out is likely to be narrow at its inception.

Perhaps the best way to illustrate the point is to apply this framework to the Big Four China affiliates case. The available record suggests that the Big Four's China affiliates at least failed the first two steps of the inquiry.¹⁹⁹ After they received section 106 requests, but before the SEC decided to initiate 102(e) proceedings, the accounting firms met with officials of the CSRC to seek their input²⁰⁰ and were told not to provide work papers that involved state secrets directly to the SEC.²⁰¹ None of them, however, asked the CSRC to respond to the SEC, or proposed to provide the requested audit work papers to the CSRC for purposes of determining whether they contained any state secrets.²⁰² Nor did they make efforts to ascertain whether the requested documents in fact involved any state secrets. Notice 29 and the CSRC's subsequent letter only prohibit the transfer of audit work papers that "involve state secrets."²⁰³ Good faith would require the accounting firms to invite the CSRC to examine those documents or to provide proper guidance so that an initial determination could be made as to which documents involve state secrets. Indeed, this is exactly what the accounting firms did after the SEC decided to initiate rule 102(e) proceedings. They immediately arranged a meeting with the CSRC, "urged the CSRC to respond as soon as possible," and "urged the CSRC to issue a 'notice' . . . as soon as possible" so that the firms could produce the requested audit work papers to the CSRC pursuant to the notice and then the CSRC could turn over those papers to the SEC.²⁰⁴ Deloitte China, using examples provided by the CSRC, even voluntarily started screening a client's audit work papers to redact information that constituted state secrets²⁰⁵ and admitted that only "a relatively small portion of the audit work papers contained state secrets."²⁰⁶ In addition, before the initiation of rule 102(e) proceedings, the firms simply relayed the CSRC's position to the SEC.²⁰⁷ They never actively sought exemption or waiver, or attempted to use proposed alternative mechanisms to achieve maximum compliance

199. Out of confidentiality concerns, the ALJ redacted certain sections of his decision. The complete decision, therefore, is not publicly available. *BDO China Initial Decision*, *supra* note 45, at *2–3.

200. *BDO China Initial Decision*, *supra* note 45, at *13, *27–28, *34–36, *44–45.

201. *BDO China Initial Decision*, *supra* note 45, at *13, *27–28, *34–36, *44–45.

202. *BDO China Initial Decision*, *supra* note 45, at *13, *27–28, *34–36, *44–45.

203. *See supra* note 76 and accompanying text.

204. *BDO China Initial Decision*, *supra* note 45, at *19.

205. *BDO China Initial Decision*, *supra* note 45, at *36.

206. *BDO China Initial Decision*, *supra* note 45, at *37.

207. *BDO China Initial Decision*, *supra* note 45, at *13, *27–28, *34–36, *44–45.

with the section 106 requests. This contrasted with what they did after the initiation of rule 102(e) proceedings,²⁰⁸ which further evidences their lack of good faith. Thus, under the alternative analytical framework, the Big Four's China affiliates' refusals to turn over the requested audit work papers probably will still be "willful" conduct that warrants discipline.

With respect to those audit work papers that are actually carved out, there is an alternative mechanism to address the risks associated with the SEC's inability to access them. One of the cornerstones of federal securities law is disclosure,²⁰⁹ and the SEC can amend Regulation S-K²¹⁰ to require issuers to disclose the fact that foreign accounting firms performing audit work for the issuer may, under certain circumstances, be unable to comply with an SEC section 106 request due to conflicting non-U.S. laws. Of course, the disclosure should be sufficiently detailed, and should include, but not be limited to, a description of the pertinent foreign laws at issue so that U.S. investors can appreciate the significance of the conflicts. Nevertheless, it is entirely doable and certainly is not as burdensome to issuers and foreign accounting firms as what would result from a suspension of the accounting firms.

CONCLUSION

Section 106(e) of SOX is a vital tool that Congress gave to the SEC to facilitate the agency's access to foreign audit work papers. While the SEC's interests in examining those documents should be adequately protected, so should those of the foreign countries that restrict the transfer of certain audit work papers out of their jurisdictions and those of the U.S. investors eager to invest in foreign entities with promising performance.²¹¹ The balance of these interests lies in the proper interpretation of the term "willful" in section 106(e). An alter-

208. *See supra* notes 204–07 and accompanying text.

209. *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 904 (5th Cir. 1977) ("The cornerstone of the regulatory structure envisaged by the authors of the Securities Act is disclosure.").

210. Regulation S-K, 17 C.F.R. pt. 229 (2014) (covering the form and content of, and requirements for, non-financial statements information under the federal securities law).

211. Should foreign accounting firms be suspended despite their good faith efforts to comply with the SEC's section 106 request, U.S. investors will lose the opportunity to invest in those highly profitable foreign entities. Recent enthusiasm toward the recent listing of Alibaba is illustrative of what could be at stake. *See* Chun Han Wong, *Alibaba IPO: A Hit Overseas, But Less Dazzling in China*, WALL ST. J., Sept. 19, 2014, <http://online.wsj.com/articles/alibaba-ipo-a-hit-overseas-but-mixed-feelings-in-china-1411124957>; Liz Hoffman, *Easier Rules Lure Foreign Firms to List in U.S.*,

native analytical framework that pivots on good faith and embraces the conflicting non-U.S. laws defense can achieve that balance. In this regard, the ALJ's decision in the Big Four's China affiliates case offers an opportunity for the SEC to re-examine the statutory scheme surrounding section 106(e) and the purposes of rule 102(e) proceedings. The SEC should grasp this opportunity and interpret "willful" in section 106(e) as "not acting in good faith."