US AND CHINA ENSNARED IN REGULATORY COLD WAR

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US regulators have been pushing for a deal that would allow them to inspect the work of auditors based in China. Prompted by rising investor concerns in the US over the allegations of accounting fraud at dozens of Chinese companies listed on US exchanges, US regulators went a step further and sought documents from Chinese auditors related to investigations of nine of these companies. China, citing sovereign issues, denied US authorities access to the audit documents and has resisted joint inspections of China-based audit firms. In the contentious back and forth, China instructed the Big Four auditors to hand over control of their Chinese operations to local partners by the end of 2012 and to put a Chinese citizen at the top within three years.

Officials from the US Securities and Exchange Commission ("SEC") and Public Company Accounting Oversight Board ("PCAOB") have been negotiating a deal with their counterparts in Beijing since 2007. The talks with China's finance ministry and the China Securities Regulatory Commission center on proposals to allow PCAOB inspectors into the country to review auditing firms as required under the Sarbanes-Oxley law. Approximately 110 auditing firms based in China and Hong Kong are registered with the PCAOB.

The SEC met the China regulator to discuss enforcement investigations. Accounting controversies at Chinese companies listed in the US have raised concerns over diminished appetite among US investors to back small to midsize China groups that are trying to raise capital to expand their businesses. As a result of the ensuing investigations, the US exchanges have halted trading on dozens of these China-based companies, resulting in billions of dollars of losses. The SEC has attempted to investigate alleged fraud at some Chinese companies and has filed several lawsuits, but they have been unable to get information from the China-based firms that audit many of these companies, including Chinese affiliates of the Big Four—Deloitte Touche Tohmatsu, PricewaterhouseCoopers, Ernst & Young and KPMG.

In response to the pressure exerted by US authorities, China announced in May 2012 that it wants local control of Chinese audit firm operations by the end of 2012. Effective January 1, 2013, anyone wishing to become a certified public accountant in China will need to take and pass the CPA exam in Mandarin. China's Ministry of Finance directed that no more than 40% of partners at China's Big Four affiliates can have gained their qualification as a certified public accountant from overseas. That number can't exceed 20% by the end of 2017, according to the guidelines.

The new rules, which apply to both partners and managing partners, will give local partners a majority of votes in the new partnership the firms are forming and effective control. Foreigners were brought in to help build China's accounting business more than 20 years ago, and the accounting giants may struggle to find enough local employees with the necessary experience to run their operations. By some estimates, more than 90% of the senior positions are now held by non-Chinese.

The Finance Ministry's move complicates efforts to reassure investors that auditing problems of recent years, in which instances of fraud and misrepresentation went undetected, are under control. That could be particularly true if the new rules result in a forced pace of promotion for local partners and if the experienced foreign employees necessary to help train the firms' rapidly expanding workforces are sent home.

In response, the SEC brought an administrative proceeding on December 3, 2012 against five accounting firms, alleging they refused to hand over documents sought in investigations of alleged accounting frauds at nine Chinese companies. The international accounting firms, for their part, say compliance with SEC demands would mean breaking Chinese law. The stakes are high. If an administrative law judge rules in its favor, the SEC action could lead to the Big Four's Chinese affiliates being barred from auditing US-traded companies—something that could complicate the audits of multinational companies doing business in China. The regulatory moves also stand to heighten a US-

China confrontation over how much US officials can do to ensure that Chinese audit firms adhere to US regulatory standards.

The regulatory stalemate has accelerated the pace at which Chinese companies are “going dark” and withdrawing from US exchanges. Many of these companies are seeking listing status on Hong Kong’s Hang Seng stock market. Moreover, the impasse diminishes the competitiveness of the US markets as other companies seek to raise capital elsewhere.

