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Against the Chinese wall: the US government's limited investigative reach

By Winston Y. Chan and Susannah Stroud Wright

It has been widely reported that the investigative might and scrutiny of the Securities and Exchange Commission (SEC) and the Department of Justice are focused on China-based companies and on western companies' business activities in China. Indeed, the SEC has gone so far as to establish a task force dedicated to examining possible accounting or other fraud committed by Chinese companies publicly listed in the United States by means of reverse mergers, and the SEC's head of enforcement announced in September 2011 that the task force's efforts are in parallel to criminal investigations by the Justice Department. Moreover, since 2002, about one-fifth of all actions by the SEC and Justice Department under the Foreign Corrupt Practices Act (FCPA) have involved allegations of unlawful business conduct in China.

Yet in house and outside counsel whose clients are or will be caught in the government's cross hairs may want to take note: When it comes to accessing documents and witnesses — the bread and butter of any investigation — the SEC and Justice Department have limited investigative reach as to China. Because these agencies have no subpoena power abroad, U.S. regulators and prosecutors must enlist the assistance of foreign authorities in order to obtain foreign documents or information from foreign witnesses. Bilateral agreements ordinarily govern the requests for such assistance, but those currently in force between the United States and China are aged and toothless.

For example, since 1994 there has been a memorandum of understanding (MOU) between the SEC and China Securities Regulatory Commission that declares the signatories' mutual "intent to provide each other assistance in obtaining information and evidence to facilitate the enforcement of their respective laws relating to securities matters." Similarly, in 2001, the United States and China entered into a mutual legal assistance agreement (MLAA) for the purpose of "provid[ing] mutual assistance in investigations, in prosecutions, and in proceedings related to criminal matters."

Yet, for all of the optimism of the MOU and MLAA, neither sets forth any actual mechanism for obtaining assistance. SEC enforcement attorneys and prosecutors for the Justice Department thus are, and always have been, without an established framework to access documents and witnesses located in China, in contrast to what exists with respect to investigations involving other countries. Nor has the Justice Department made any effort since 2001 overtly to build upon the MLAA in order to buttress its ability to investigate criminal conduct in China.

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As for the SEC, in 2006, it and the China Securities Regulatory Commission announced a mutual intention to increase their "cooperation and collaboration" efforts, and in July 2011 (five years later) officials from the SEC and Public Company Accounting Oversight Board (PCAOB) met with officials from the Commission and China's Ministry of Finance to discuss the feasibility of granting the PCAOB the ability to conduct field inspections in China of U.S.-listed companies. Most commentators observed that the meeting appeared to be unsuccessful and that any agreement on this topic likely would not be reached, in much the same way that the Commission has in the past opposed PCAOB inspections of China-based accounting firms as an affront to Chinese sovereignty.

In the absence of formalized procedures implementing the announced ideals of bilateral cooperation between the United States and China as to foreign evidence, the SEC and Justice Department are left with the traditional poles of evidence gathering — a request for voluntary disclosure or, if the company has some presence in the United States, a subpoena. If the company is listed in the United States, the SEC may also seek to enforce records-related terms in the governing listing agreement. Practically speaking, however, the SEC and Justice Department are likely to approach China-based companies in the first instance with voluntary disclosure requests, and companies that have received or will receive such requests may wish to take into account the following considerations:

First, the government's requests for voluntary disclosure lack teeth in the absence of any meaningful connection between the company and the United States. Orders of contempt and default judgments cannot be enforced in China, and Chinese-based assets cannot be seized. There is no extradition treaty between China and the United States, and U.S. prosecutors cannot apply

Winston Y. Chan *is of counsel in the San Francisco office of Gibson, Dunn & Crutcher LLP, where he focuses on white-collar criminal defense, securities and antitrust enforcement, and conducting internal investigations. He is a former prosecutor.*

Susannah Stroud Wright, *a former prosecutor, is a senior associate in the Palo Alto office of Gibson, Dunn & Crutcher LLP, where she focuses on white-collar criminal defense, internal corporate investigations and complex consumer class actions.*

for or execute search warrants in China. Accordingly, the companies most incentivized to voluntarily disclose evidence to the SEC and Justice Department are Chinese companies with material business operations in the United States, or at least aspirations for having as much.

Second, any disclosure of documents or information located in China must comport with China's state secrecy laws, which broadly define the scope of "state secrets" to include matters involving economic interests and technology. Indeed, the MOU expressly provides that any assistance requested by the SEC can be denied "[w]here the provision of assistance would be contrary to the public interest of [China]," and the MLAA permits denials of Justice Department requests for assistance where "the execution of the request would prejudice the sovereignty, security, public order (ordre publique), important public policy or other essential interests of [China]."

Third, when weighing whether or not to provide the SEC or Justice Department with documents or witnesses unearthed in China pursuant to an internal investigation, companies should be cognizant of the real likelihood that the government might not have the ability to access that same information independently. In such a circumstance, companies may want in advance to negotiate for the possibility of greater cooperation credit than is given in the normal course. More robust cooperation credit might also apply when companies voluntarily provide routine public or third-party records that fall outside of the government's reach, but are nonetheless significant building blocks of an enforcement attorney's or prosecutor's investigation — bank or brokerage statements of Chinese accounts, for example.

Fourth, if a company is faced in the United States with a government investigation and concurrent civil lawsuits, the latter should be handled with the awareness that any document provided to civil plaintiffs will thereby become subject to the subpoena power of the SEC and Justice Department, irrespective of any protective order. As such, strategic decisions should be made on all fronts by all counsel acting in concert.

Despite all of the recent attention focused on the government's apparent crackdown on China-based companies and on western companies' business activities in China, the reality may be that the SEC and Justice Department will seek to rely in large measure on the targets of that crackdown to provide most if not all of the evidence against themselves. In house and outside counsel advising such companies should pause to recognize that the scales are not as tipped in favor of the government's investigators, particularly for those China-based companies with no meaningful business activity in the United States.