Service on Counsel: Does SEC Have New Methods for Reaching PRC Companies?

A Washington, D.C., federal judge may have given the Securities and Exchange Commission a new tool to extend its reach to companies based in the People's Republic of China. Magistrate Judge Deborah Robinson recently ordered Shanghai-based auditors Deloitte Touche Tohmatsu CPA Ltd. (DTT) to appear in court and "show cause" why the firm should not be required to comply with an SEC subpoena seeking documents related to DTT's former client, Longtop Financial Technologies Limited, a U.S. public company also based in the PRC and currently under SEC investigation for fraud. While the court's Jan. 4, 2012, order does not compel DTT to produce the documents, but rather to appear in court on the issue, the decision is significant because the SEC had not served DTT directly with either the original subpoena or the order to show cause papers. Instead, the SEC attempted to serve DTT's U.S.-based counsel. Magistrate Judge Robinson upheld service of the order to show cause on DTT's counsel – who had neither responded to the SEC's application nor appeared at the hearing – and now DTT must appear and explain to the court why it should not have to respond to the subpoena.

Longtop, a financial services software company, relied upon audit reports prepared by DTT in its registration with the SEC for its 2007 initial public offering. Following industry analyst reports alleging that Longtop's financial statements were fraudulent, DTT resigned its role as the company's auditors, citing specific and serious issues, including recently identified falsity of the Longtop's financial records in relation to cash at bank and loan balances (and possibly in sales revenue), deliberate interference by members of Longtop management in DTT's audit process and the unlawful detention of DTT's audit files. The SEC opened a formal investigation and attempted to subpoena documents from DTT by serving the subpoena on the firm's U.S. counsel at the time, who reportedly confirmed his authority to accept service of the subpoena. According to the SEC, DTT does not contest the service of the subpoena. After requesting an extension of time to respond to the subpoena, DTT objected to the production on technical grounds relating to the effective date of the Dodd-Frank Act and asserted that production of documents could subject DTT to sanctions under PRC law. DTT communicated its objections to the SEC through new U.S. counsel. Thereafter, the SEC applied for the order to show cause, seeking enforcement of the subpoena. At the specific request of Magistrate Judge Robinson, the SEC submitted additional authority in support of its arguments that the court could require DTT to show cause, even where it had not been served with the motion and had not responded or appeared at the hearing, and that, under the Federal Rules of Civil Procedure, service on U.S. counsel constituted good service and the court should authorize it.

Magistrate Judge Robinson accepted the SEC's argument that the issue of service was essentially moot because the agency could have proceeded ex parte and held that service of the order to show cause on DTT was not a prerequisite to enforcement of the order. While the court could have rested its decision there, it went on to consider and accept the SEC's other arguments in support of the order to show cause. The SEC asserted that the Federal Rules allowed the court to order service outside the United States by any means that does not violate an international agreement, that service on DTT's counsel violated no international agreement and so the court should authorize it. It also argued that service on counsel is good and sufficient, citing cases in which the court had authorized service on counsel,

even – in at least two cases – where counsel had disclaimed authority to accept service. While the Magistrate Judge Robinson did not comment on whether counsel's authority to accept service was important, she did agree with the SEC that, given DTT's unquestionable familiarity with the matter, it would suffer no prejudice from a failure to serve the order. Specifically, the court noted that counsel for the SEC had had numerous conversations with DTT's counsel, had advised him of the filing of the application to show cause and to enforce the subpoena and sent him copies of the filings by email, and that DTT's counsel had been seated in the gallery of the courtroom during a status conference.

The significance of the court's decision remains unclear – both for DTT and other PRC-based entities. What is more clear, however, is that the SEC is being aggressive in trying to circumvent the roadblocks it faces regarding serving process on PRC nationals, and its contention that providing actual notice to a PRC-based company through service on US-based counsel is sufficient, even where counsel has not been authorized to accept service, impacts the ability of PRC-based entities, and their counsel, to respond. This case is not the first time the SEC has sought to circumvent the difficulty serving subpoenas on PRC nationals by attempting to serve counsel – and in at least two cases without even inquiring whether counsel was authorized to accept service. In the context of a subpoena, these attempts to serve counsel present an extremely difficult "catch-22." When the SEC staff makes a seemingly routine inquiry as to whether counsel represents a client, the usual and reasonable answer is "yes" – an answer that now might be met with an attempt to serve counsel with a subpoena for a client's documents or testimony. A "no" answer, however, may mean that, should the SEC succeed in serving the subpoena, counsel may have lost the ability to protect fully the client's interests. And if, as DTT did, the witness resists enforcement of the subpoena, the SEC may seek to enforce the subpoena by order to show cause. While an SEC investigation is not usually public, disclosure of an investigation often has a negative impact and forcing the SEC to seek compliance through an order to show cause proceeding may make an otherwise a nonpublic investigation public. This puts both respondents and their counsel in a predictably uncomfortable space – between a rock and hard place.

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