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ERNST & YOUNG DISCONTINUES APPEAL OVER PRODUCING CHINESE AUDIT WORKING PAPERS TO SFC

Introduction

Ernst & Young (**EY**) has discontinued its appeal against the May 2014 order of Hong Kong's Court of First Instance requiring it to hand over to the Securities and Futures Commission (the **SFC**) audit working papers related to the failed listing application of Mainland-incorporated Standard Water Limited (**Standard Water**). EY was engaged as the reporting accountant and auditor on the listing application, although the audit field work was conducted by its Mainland joint venture partner, Ernst & Young Hua Ming (**EYHM**).

According to the SFC's notice of the discontinuation,¹ the audit working papers originally requested by the SFC have now been produced by EY rendering academic the issue on which EY appealed the court order to produce the documents – that the court had been wrong in finding that China's State secrets laws did not prevent it from producing the documents.

Although the SFC appears to have won for now, the procedures to be followed by Hong Kong audit firms when faced with a request to produce Chinese accounting records to the regulators remain unclear. The latest Interim Provisions on Accounting Firms' Provision of Auditing Services for the Overseas Listing of Enterprises in Chinese Mainland, which came into effect on 1 July 2015, reiterate that the accounting records (including audit working papers) of Mainland companies may be subject to claims of state secrecy under Chinese laws and cannot be taken out of the Mainland without the relevant authorities' prior consent.

¹ SFC. "EY's Appeal over Audit Working Papers Discontinued". 23 July 2015. Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR79>.

In the EY case, however, the PRC law experts failed to agree on who the "relevant authorities" were and guidance on this would be useful. The new provisions also specify that where an offshore judicial or regulatory authority requires access to Chinese accounting records, access should be sought in accordance with the agreement between the Mainland regulatory authorities and those of the offshore jurisdiction, a position potentially at odds with the SFC's statement and the finding of the court in the EY case that primary responsibility for obtaining clearance lies with the offshore audit firm.

Background

The SFC sought access to the audit working papers under section 183 of the Securities and Futures Ordinance (**SFO**) which obliges a person to produce to the SFC any records or documents specified by the SFC in relation to an investigation into whether any offence or market misconduct has been committed. Since section 183 does not have extraterritorial effect, the SFC's proceedings to compel production of the audit working papers related only to EY's obligation to produce the documents: no notices were issued to EYHM and no action was taken by the SFC to compel EYHM to produce the documents.

EY's case, in summary, was that:

- the audit working papers were produced by EYHM and were kept at its offices in Beijing. Since EYHM is a separate legal entity and property in the papers resided in EYHM, EY had no rights over the papers;

- China laws restrict the cross-border transmission of audit working papers and prohibit their direct production to overseas regulators;
- The same China laws prevented EY from handing over certain hard drives it held in Hong Kong;
- The appropriate channel for the SFC to obtain EYHM's papers was through the China Securities Regulatory Commission (the **CSRC**) with whom it has a cooperation mechanism for mutual assistance.

The court determined that the audit working papers were in EY's possession since it had an enforceable legal right to demand their production from EYHM which acted as its agent in conducting audit work in relation to Standard Water. Further, EYHM could not rely on its duty of confidentiality to Standard Water to resist such production.

The court dismissed EY's argument that China State secrets laws prevented the transmission of the documents to Hong Kong as "a complete red herring". The regulation on which EY's claim was based is the Regulation on Strengthening Confidentiality and Archives Administration Relating to Overseas Issuance and Listing of Securities (Circular [2009] No. 29 of 20 October 2009) (**Regulation 29**), jointly promulgated by the CSRC, the National Administration for Protection of State Secrets and the State Archives Bureau to govern the preservation of records and documents generated during the offshore listing of Chinese companies. Both PRC law experts opined that Regulation 29 does not impose a *blanket* prohibition on the cross-border transmission of audit working papers to overseas regulatory authorities: transmission is allowed if prior approval from the relevant government departments is obtained. The issue of whether audit working papers contain State or commercial secrets is fact-sensitive and depends on the contents of the papers in question. Since the audit working papers were not produced to the court, EY did not establish that they in fact constituted state or commercial secrets.

On the issue of whose responsibility it is to seek clearance from the CSRC to allow audit working papers to be produced to a party outside the Mainland, both PRC law experts agreed that either EY or EYHM were primarily responsible.

The judgement in the case is available on the website of the Hong Kong Judiciary (www.judiciary.gov.hk).²

The Implications and New Rules Effective 1 July 2015

² The Securities and Futures Commission v. Ernst & Young, HCMP1818/2012. Available at http://legalref.judiciary.gov.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=93214&QS=%2B&TP=JU.

In its notice of the discontinuation,³ the SFC reminded Hong Kong auditors of their obligation to comply with SFC requests for audit working papers, including those held by their Mainland affiliates, made under the SFO. The SFC further stipulates that where documents or records requested by the SFC are held in China by the Mainland affiliates or agents of Hong Kong auditors, the responsibility for seeking clearance from the Mainland authorities to produce the documents to the SFC lies with the auditor.

The SFC also thanked and acknowledged the CSRC for its assistance in the matter which some have suggested implies that the CSRC may have lent a hand in ensuring that the SFC obtained the papers.

Hong Kong auditors also need to be aware of new rules, the Interim Provisions on Accounting Firms' Provision of Auditing Services for the Overseas Listing of Enterprises in Chinese Mainland (the **Interim Provisions**) that came into effect on 1 July 2015. Article 11 of the Interim Provisions requires both Mainland companies and overseas audit firms (including Hong Kong firms) to strictly comply with the provisions of Regulation 29 which stipulates that accounting records of Chinese companies may be subject to claims of state secrecy under Chinese law and the prior consent of the relevant Mainland authorities is required before they can be taken out of the Mainland.

Article 12 of the Interim Provisions stipulates that where the listing of a Mainland company becomes the subject of a legal action or other matter and an overseas judicial or regulatory authority requires access to the audit working papers in respect of that company, or where an overseas regulatory authority requires access to the audit working papers for a Mainland company, access should be sought in accordance with the relevant supervision agreement entered into between the regulatory authorities of Mainland China and the relevant overseas jurisdiction. This appears to be at odds with the SFC's statement in its latest notice that primary responsibility for obtaining clearance lies with the offshore audit firm, not the SFC.

For further information on the Interim Provisions, please see our newsletter "Hong Kong Accountants' Exemption from Restrictions on Foreign Accountants Auditing Chinese Companies Listing Offshore".⁴

³ See Note 2 above.

⁴ Charltons. "Hong Kong Accountants' Exemption from Restrictions on Foreign Accountants Auditing Chinese Companies Listing Offshore". July 2015. <http://www.charltonslaw.com/hong-kong-accountants-exemption-from-restrictions-on-foreign-accountants-auditing-chinese-companies-listing-offshore/>

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