

AUDIT FIRM ORDERED TO DISCLOSE PRC WORKING PAPERS TO SFC DESPITE PRC "STATE SECRETS LAW" CONCERNS

On 23 May 2014, the Securities and Futures Commission of Hong Kong ("SFC") successfully obtained an order from the High Court of Hong Kong¹ requiring Ernst & Young Hong Kong ("E&Y") to produce all audit working papers prepared in connection with its audit of Standard Water Limited ("**Standard Water**"), despite concerns raised by E&Y that: (i) disclosing such information would result in E&Y breaching numerous PRC laws, including the State Secrets law²; and (ii) in any event, E&Y had no right to possession of the relevant documents, the audit having been conducted by Ernst & Young Hua Ming LLP ("**HM**"), a sino-foreign cooperative joint venture between Hua Ming Certified Public Accountants and E&Y in China.

Background

Standard Water was incorporated in the Cayman Islands and registered as a non-Hong Kong company under Part XI of the Companies Ordinance (Cap. 32). Its two main operating subsidiaries engaged in the business of water supply and waste water treatment in the PRC. In 2009, Standard Water applied to list on the main board of the Stock Exchange of Hong Kong Limited. E&Y was engaged as reporting accounting and independent auditor for that purpose.

In March 2010, while the listing application was still pending, E&Y resigned from its role as reporting accounting and independent auditor with immediate effect, citing "*inconsistencies in documentation*" which led them to conclude they could no longer act. In light of E&Y's resignation, in April 2010 the SFC issued a direction to investigate whether any market misconduct had been committed, or misleading information disclosed, in connection with the listing application.

¹ The Securities and Futures Commission v Ernst & Young (a firm) (unreported, HCMP 1818/2012, 23rd May 2014, per Hon Ng J.)

² The Law on Guarding State Secrets.

Throughout the SFC's inquiries E&Y refused to provide copies of the working papers or details of individuals at the firm who could assist in SFC's inquiries.

E&Y's Response

E&Y refused to provide the SFC with the audit working papers on the grounds that:

- E&Y had no legal rights over the working papers because all on-site field work had been conducted by HM's audit team in Beijing, all working papers were generated and kept in Beijing and property in the working papers resided with HM, a separate legal entity;
- PRC laws restricted the cross-border transmission of audit working papers and the production of the same to foreign regulators; and
- the appropriate channel for the SFC to obtain copies of the audit working papers would be through the China Securities Regulatory Commission ("**CSRC**") in the PRC.

The High Court's Decision

The High Court found that:

- E&Y had an enforceable legal right to demand the production of the audit working papers from its PRC branch, HM, and, as a matter of PRC law, HM had a duty to provide all such papers to E&Y. Further, HM could not rely on a duty of confidentiality towards the Company to resist producing the working papers to E&Y. Accordingly, the working papers were considered to be in the possession of E&Y;
- There was no blanket prohibition under PRC law which prevented HM providing the working papers to E&Y in Hong Kong for disclosure to the SFC, nor was there any real risk that E&Y would be subject to criminal, administrative or civil liabilities if compelled by the Court to produce the papers to the SFC; and

- If the Court was wrong, and prior approval from the relevant authorities was required prior to sending the documents to Hong Kong, either E&Y or HM was the entity with primary responsibility for seeking all such necessary approvals. The SFC was clearly not in a position to do so for the simple reason that it did not possess the working papers and was unaware of the content of the papers.

The Evidence

The Court made a number of findings about the evidence presented by E&Y , in particular that:

- As the audit working papers were not disclosed in the proceedings, neither the expert witnesses nor the Court were able to review them and therefore no evidence was produced to support the claim that they could not be disclosed to SFC;
- It failed to call the Partners directly involved in the audit, instead calling a witness with no personal involvement in the matter and who was unable to answer questions put to him in cross-examination;
- Its disclosure that the firm held hard drives and servers containing potentially relevant information in Hong Kong should have been more timely; and
- It had failed to disclose documents evidencing the relationship between E&Y Hong Kong and HM in PRC.

On the question of PRC law, the Court concluded the State Secrets Law does not impose a blanket prohibition on the transmission of the audit working papers out of the PRC, but only documents containing state secrets are prohibited, in which case their transfer out of the PRC will require approval from the appropriate PRC authorities. There was no evidence presented to the Court that any of the audit working papers contained PRC state secrets or even commercial secrets. In addition, the Court found that it was inherently improbable that E&Y, as the reporting accountant of the Company, did not possess any audit working papers in Hong Kong, particularly given its need to comply with the HKICPA Guidelines.

Key Lesson

Case strategy, for example choice of witnesses and timing of disclosure, impacts credibility and can cause firms to lose ground where cooperation might otherwise have led to more goodwill with the Court. It will also impact on the approach of the SFC. The SFC's Guidance Note on Cooperation provides that a failure to cooperate with the SFC might be considered an aggravating factor in assessing the appropriate disciplinary sanction to be imposed if such non-cooperation amounts to obstruction or falls short of the standard of conduct expected of a fit and proper person.

Conclusions

The orders obtained by the SFC will be seen as a victory for regulators and investors against the backdrop of rising concerns as to the accountability of Chinese businesses seeking to raise capital in foreign jurisdictions such as Hong Kong, Singapore and the US. It continues the trend of disclosure following the (long awaited) resolution of the regulatory skirmish between the US Securities and Exchange Commission and Deloitte Touche Tohmatsu's Chinese operations in connection with the disclosure of audit working papers relating to the US-listed Longtop Financial Technologies Ltd. From a public policy perspective this is an unsurprising result.

But what does the decision mean for clients?

- The decision highlights the conundrum faced by firms working across borders. On the one hand, firms have legitimate concerns that the transmission of documents outside of the PRC may be in breach of PRC laws, yet on the other they may have legal and professional obligations in Hong Kong (or for that matter Singapore or US). The temptation may be to revisit relationships with PRC operations to ensure that no obligation arises to transmit documents offshore, yet consideration must also be given to whether such controls would result in any breaches of legal/regulatory obligations in Hong Kong in any event.

- Leaving that issue aside, the decision makes it clear that neither regulators nor the courts are willing to accept 'blanket' objections to the disclosure of documents held in the PRC on the basis that they contain state secrets or confidential/commercial secrets. They are looking to the applicants to demonstrate that in relying on this ground of non-disclosure, they have already conducted a thorough review of the documents in hand and assessed whether or not there is some risk that the documents do contain information that is prohibited from disclosure under PRC law.
- In future, clients will need to conduct an internal review of all documents in order to determine which, if any, may contain state or commercial secrets. This will also include a determination as to whether or not approval for their disclosure from the relevant PRC authorities should be obtained. Practically, it would be difficult for a regulator or a court to require the disclosure of documents in the face of advice from a relevant PRC authority that they should not be disclosed.
- Finally, in any dispute with regulators over the disclosure of documents held in the PRC (or elsewhere), it will be imperative to ensure that evidence is submitted from witnesses with actual knowledge of the matter in question so that there is strong independent evidence in support of the position that disclosure is prohibited under PRC or other legal regime.

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