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Briefing note - Reissued 30 May 2014

Hong Kong Court orders Ernst and Young to hand over auditing records to Hong Kong regulator

In an unprecedented decision handed down on 22 May 2014, the Hong Kong Court of First Instance (CFI or, the court) has ordered the Hong Kong office of the global accounting firm, Ernst and Young (EY) to produce audit working papers and underlying accounting documents to the Securities and Futures Commission (SFC), related to work for its former client, the PRC-based water services company, Standard Water Limited (SW)[1]. Following SW's withdrawal of its Hong Kong listing application in 2010, the SFC launched an investigation in 2012. EY objected to production of its audit working papers related to SW, claiming that it would risk EY contravening PRC's State secrets laws. This is the first Hong Kong case under section 185 of the Securities and Futures Ordinance (SFO) where a court has been asked to inquire into a Hong Kong auditor's non-compliance with notices issued by the SFC.

Key issues

- First time Court uses discretionary power to compel production of auditor's records
- No blanket restriction prohibiting PRC-HK transmission of audit papers to HK regulator
- EY's Chinese affiliate, as EY's agent, had a duty to provide the records to EY

In a strongly worded judgment, the CFI held that in the absence of "an innocent explanation", EY did not have a "reasonable excuse" for not having produced the audit working papers sought by the SFC, said to be contained in hard drives and other material found to be in EY's possession in Hong Kong. The CFI regarded EY's objections to production based on PRC State Secrets laws as "a complete red herring". Further, EY would *not* be at risk, as it claimed, of being subject to criminal, administrative or civil liabilities (under PRC laws) if it was compelled by a Hong Kong court to produce the relevant audit records to the SFC.

The CFI also made it clear that EY 's obligations as a *Hong Kong firm* to produce the auditing records were a matter of *Hong Kong law* and there was no question of its Chinese affiliate, Ernst Young Hua Ming LLP (HM), being compelled by the SFC or by the Hong Kong court to directly produce to the SFC any of HM's audit working papers and documents situated in the PRC.

Although there have been separate US administrative proceedings taken by the US regulator, the Securities and Exchange Commission (SEC), against the Chinese affiliates of each of the Big Four accounting firms, with recommended sanctions imposed against the firms for failing to produce work papers to the US SEC, [2] Hong

[1] SFC v Ernst & Young (a firm), HCMP 1818/2012, unreported.

[2] http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486452

Kong's CFI made it clear that "no legitimate parallel" could be drawn between the US proceedings and the Hong Kong proceedings, mainly because the SFO provisions under which production was sought, do not have the same extraterritorial reach as the US Sarbanes- Oxley Act of 2002 and the US Securities Exchange Act, which require foreign public accounting firms to provide the US SEC upon request with audit work papers involving any company trading on US markets.

The Background and the Parties Involved

As a Hong Kong company, EY is subject to Hong Kong laws including the SFO. Its PRC-based unit, HM, is a special joint partnership regulated by the Chinese Institute of Certified Public Accountants, under the jurisdiction of the China Securities Regulatory Commissions (CSRC) and is subject to the laws of the PRC. HM is a "private company" and not a PRC-State-owned enterprise.

In 2009, SW engaged EY as its reporting accountant and independent auditor for the purpose of SW's intended IPO launch in Hong Kong and subsequent listing on the Hong Kong Stock Exchange (HKEx). EY engaged HM to undertake audit work on SW.

SW made a formal listing application to the HKEx on 9 November 2009 but only a few months later, EY resigned from its engagement with SW citing inconsistencies in documentation which meant that EY could no longer act as auditors for SW. Less than nine days later, SW withdrew its HKEx listing application.

On 29 March 2010, the SFC requested EY to provide documents and information relevant to the SFC's initial assessment of whether there was any implication of false accounting on SW's part. EY replied that it could not voluntarily provide the SFC with the information sought and did not comply.

SFC proceedings in Hong Kong against EY

Between April 2010 and October 2011, the SFC issued nine SFO statutory notices ("section 185 notices")[3] to EY. EY failed to comply with each notice, citing legal impediments under PRC State secrets laws as the reason. In August 2012, the SFC commenced proceedings against EY for failing to produce the specified accounting records, invoking section 185 SFO[4], which empowered the CFI to inquire into the circumstances of EY's non-compliance and to make discretionary orders to compel production as the CFI saw fit.

SFC's case before the Hong Kong CFI

Among other things, the SFC's stance before the CFI was that:

- EY had in its "possession" the audit working papers and records, whether in HK or in the PRC;
- EY must have known why it resigned from its engagement with SW and the details of any document inconsistencies provided by SW to the HKEx;

[3] Section 185(1) Securities & Futures Ordinance (SFO) Cap. 571 provides the SFC with an alternative means of enforcing compliance with its information gathering powers under ss. 179,180, 181 and 183 SFO, in addition to criminal prosecution. Under s. 185, if a person subject to a requirement under one of the information gathering powers fails to comply, the SFC can apply to the CFI for an order. The CFI under s. 185 SFO can make an inquiry, and, if no reasonable excuse for non-compliance is disclosed, the CFI can order the person/company to comply with the requirement to produce.

[4] Sections 183-185 SFO.

- If the audit working papers and other documents required under the section 185 notices were contained in any of the hard drives[5] in EY's possession, EY had not demonstrated any valid restriction under PRC laws which would prevent it from disclosing them *in Hong Kong* to the SFC;
- Regarding the PRC laws upon which EY relied, there is no blanket prohibition on transmission, EY could have sought permission to disclose the information under PRC law but chose not to do so.

EY's case before the Hong Kong CFI

- EY did not challenge the validity of the section 185 notices, claiming that it had already provided all documents it had in hand;
- Whilst the other documents and records which might contain material potentially responsive to the section 185 notices (said to be contained in hard drives and IT servers held by EY) were, in its possession, it said that its Chinese affiliate, HM, asserted a proprietary interest in the hard drives, said to have been passed over to EY erroneously, and that HM had expressly forbidden EY from disclosing potentially relevant documents;
- EY claimed that PRC laws did not permit cross-border transmission of audit working papers and prohibited direct production of them to overseas (i.e. HK) regulators and so EY did not have a right to force HM to hand them over;
- Handing the hard drives over to the SFC may involve breaching PRC laws and put EY and/or its partners at risk of exposure to criminal or administrative sanctions by the PRC;
- The proper channel for the SFC to get the hard drives was for the SFC to apply to the PRC regulator. [6]

The CFI's findings against EY

The CFI found that EY's main factual witness was not "entirely reliable" and no weight could be placed on his evidence. The witness did not have sufficient knowledge of EY's engagement of HM or of the reasons for EY's resignation as auditor immediately prior to SW's withdrawal of its proposed HKEx IPO listing application. The CFI commented that there was considerable force in the SFC's argument that EY was trying to provide "as little information as possible to the SFC and the court during the proceedings".

It was common ground among the PRC legal experts called by both parties that the relationship between EY and its Chinese affiliate HM was akin to that of "principal and agent", governed by PRC law[7]. It was also agreed that there *no blanket restriction* prohibiting PRC-HK cross-border transmission of audit working papers to overseas regulatory authorities. This meant that since HM had acted as EY's agent in carrying out field audit work of SW, HM had a *duty to produce* to EY all the books, records and documents, and *EY, as principal* was entitled to have *continued access* to and make copies of HM's records even after termination of their contractual engagement. Under HK law, the CFI held that the legal position was the same: HM, as agent, must hand over

[5] "Hard drives" in the CFI judgment and in this briefing refer to not only the hard drives disclosed by EY in evidence but all hard drives and IT servers mentioned by it during the case.

[6] The CFI noted that the SFC had already requested assistance of the CSRC, for all working papers in relation to HM's audit of SW, however the CSRC was unable to obtain the papers because HM disputed the CSRC's jurisdiction over HM: para.210 , ibid f.n. 1.

[7] Referred to as "agency of entrustment" under PRC law: paras. 122-130, ibid f.n. 1.

on demand the audit working papers to EY, its principal.

Both sides' experts accepted that whether the audit working papers were in fact "PRC State secrets" depended entirely on the contents. As neither expert had seen HM's audit working papers, nor was there any evidence before the court that HM or anyone else suspected that the papers *might* contain PRC State secrets, the CFI found that there was "no way in which EY could establish that the audit working papers contained State secrets or commercial secrets under PRC laws which would preclude their transmission from the PRC to Hong Kong".

EY also unsuccessfully argued that it should be the SFC, not EY, who should apply to the PRC securities regulator, CSRC, for prior approvals, if necessary, for release of HM's audit working papers, under PRC law.

EY also claimed that HM's sending of the hard drives to HK was "unlawful" according to PRC law. The CFI, noting that EY had chosen "not to fully explain" exactly how it was that the hard drives were sent to Hong Kong "unlawfully", said it was not satisfied that EY, HM and/or their partners would be exposed to any risk of criminal prosecution or administrative penalties in the PRC if the hard drives were disclosed.

Therefore, the CFI was therefore unable to conclude that the hard drives contained "PRC State secrets" or that their disclosure to the SFC would be a crime against PRC interests. It followed that EY did not have a "reasonable excuse" under section 185 of the SFO for not having produced or producing the HK hard drive materials to the SFC.

The CFI's conclusion

EY failed to demonstrate that its Chinese affiliate's audit papers contained PRC State secrets or that they should be kept confidential, and failed to establish that there were any PRC legal impediments prohibiting transmission of the audit working papers from the PRC to Hong Kong.

The CFI stated that "in the absence of an innocent explanation", EY had had "deliberately withheld" from the SFC information in its knowledge which would have been responsive to at least three of the section 185 notices. It was also "inherently improbable" that EY did not have in its Hong Kong files records over and above what it had already provided to the SFC in relation to its engagement of HM and of its decision to resign shortly before SW's withdrawal of its public listing application to the HKEx. The CFI therefore issued an order to EY to comply with the section 185 notices within 28 days, or such other time period as may be agreed between the SFC and EY.

Implications of the CFI's judgment

As noted, this is the first Hong Kong case brought by the SFC under section 185 of the SFO in relation to a Hong Kong auditor's non-compliance with notices issued by the SFC. Strongly worded criticism was levelled by the court at EY's intransigent position in refusing to comply with the notices. Indemnity costs were also awarded against EY.

In a cautionary warning for senior management in other accounting firms, all reasonable steps should be taken to comply with an SFC notice to produce. The regulator has demonstrated its intolerance to non-compliance, or what it perceives as something less than full compliance, with a number of challenges in other cases before the Court. Hefty fines have been imposed in past cases for non-compliance with section 185 SFO notices, ranging from fines to custodial sentences.

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