

The SFC signs a tri-partite MOU on audit working papers with the MOF and CSRC

July 2019

Introduction

Corporate fraud and misfeasance has been one of the enforcement priorities of the Securities and Futures Commission (SFC) in recent years. Audit working papers (AWPs) are vital to the SFC's work in this area as they shed light on how the business or affairs of a listed company were conducted and may also constitute crucial evidence in subsequent legal proceedings. In line with this regulatory focus, the SFC entered into a Memorandum of Understanding (MoU) with the Ministry of Finance of the People's Republic of China (MOF), and the China Securities Regulatory Commission (CSRC) on 3 July 2019 which facilitates the SFC's obtaining of AWP kept in the Mainland in respect of Hong Kong listed companies.

The SFC's need to access AWP held in the Mainland

As of December 2018, 50% of companies listed on the Hong Kong Stock Exchange (the Exchange) were Mainland-based companies, with the same accounting for nearly 70% of the market capitalisation on the Exchange. Seamless and timely access to AWP concerning these companies is therefore important to the SFC in performing its statutory function of regulating the securities market in Hong Kong.

The SFC is empowered by statutes to demand production of AWP from Hong Kong registered

CPA firms who are in possession of them. It can also seek investigative assistance from its Mainland counterpart, the CSRC, under bilateral and multilateral cooperative arrangements. Nevertheless, it is not necessarily an easy task for the SFC to gain access to AWP kept in the Mainland if their transmission to overseas is subject to the state secrecy laws and regulations, or if the reporting accountants resist disclosure, citing the prohibitions under the state secrecy laws and regulations as a reasonable excuse for not complying with the production notices.

The SFC was engaged in a 5-year legal battle with Ernst & Young (EY) in respect of the production of AWP. EY was appointed as reporting accountant and independent auditor in the listing of Standard Water Limited in Hong Kong back in 2009. It engaged Ernst & Young Hua Ming LLP (HM), a separate legal entity established by a joint venture between EY and Hua Ming Certified Public Accountants in Mainland China, to conduct the on-site field work. The SFC commenced an investigation in 2010 after EY resigned as reporting accountant and Standard Water withdrew the listing application. The AWP generated and kept by HM in the Mainland became the subject of a number of the SFC's production notices. They became the heart of the legal battle when EY did not comply with the notices¹.

¹ The proceedings were brought by the SFC in 2012 under s185 of the Securities and Futures Ordinance which empowered the Court of First Instance to (i) inquire into the circumstances of EY's non-compliance with the SFC's

production notices; and (ii) give an order to compel disclosure by EY where there was no reasonable excuse for EY's non-compliance.

EY claimed that it had a reasonable excuse for not providing the AWP in responding to the SFC's notices, in that there were legal impediments to transmitting the AWP created during overseas listing out of Mainland China, which included (i) the State Secrets Law, (ii) Law on Certified Public Accountants, (iii) the Archives Law, and (iv) the Regulation on Strengthening Confidentiality and Archives Administration relating to Overseas Issuance and Listing of Securities jointly promulgated by the CSRC, National Administration for Protection of State Secrets, and the State Archives Bureau. The Court of First Instance held that none of the laws and regulations cited imposed a blanket prohibition on the cross-border transmission of AWP. The issue was whether the AWP contained any state secret or commercial secret, which was fact-sensitive, and EY failed to demonstrate so. On the basis that EY had the presently enforceable right over the AWP, the Court ordered EY to comply with the production notices. The SFC eventually got hold of the accounting records 5 years after it issued the first production notice².

Scope of the tri-partite MoU and implications

The tri-partite MoU should smoothen the process by which the SFC obtains AWP held in the Mainland and reduce the need for it to resort to Court proceedings to obtain these documents.

Under the MoU, the SFC can, in an investigation in respect of a Hong Kong listed Mainland company and its related entities or persons, make requests to the MOF and CSRC to access AWP concerning these entities prepared by Hong Kong accounting firms but kept in the Mainland. The MOF and the

CSRC will provide the fullest assistance in response to the SFC's requests.

Prior to the MoU, Hong Kong accounting firms may find themselves in a difficult position when they receive a production notice for AWP concerning their Mainland listed clients. They may be caught between handing over the AWP to the SFC and falling foul of the state secrecy laws and regulations, and not producing the AWP and falling foul of the local securities laws which could subject them to court proceedings. In deciding whether to hand over the AWP, Hong Kong accounting firms would need to make judgment calls on whether the AWP requested contain state secrets or commercial secrets, which are not easy decisions to make. The tri-partite MoU would also have the effect of easing the difficulties faced by the accounting firms in Hong Kong by providing for mechanisms and procedures through which conflicting obligations surrounding state secrets protection and ensuring the integrity of the Hong Kong securities market can be resolved at the level of regulators.

Other MoUs concerning AWP

In the same vein as the tri-partite MoU, the Supervision and Evaluation Bureau (SEB) of the MOF and the Financial Reporting Council (FRC), the accounting regulator in Hong Kong, signed a separate MoU on 22 May 2019 (FRC MoU). Under the FRC MoU the FRC will be able to make requests to the SEB for assistance in gaining access to AWP of Hong Kong accounting firms located in the Mainland.

Prior to that, The International Organisation of Securities Commissions, an international body which brings together the securities regulators around the world, approved the Enhanced

² EY filed a Notice of Appeal against the order made by the Court of First Instance. It discontinued the appeal after it produced the specified accounting records to the SFC.

Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (EMMOU) in March 2017. Under the EMMOU, securities regulators can obtain and share AWP in combating financial misconduct.

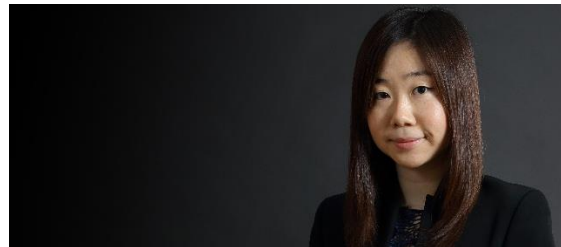
Conclusion

The MoU, being the first tri-partite MoU signed by the SFC with two Mainland regulators at the same

time, was described by Ashley Alder, the SFC's Chief Executive Officer, as a significant milestone to enhance cooperation with the Mainland counterparts in order to combat instances of misconduct amongst Mainland-based Hong Kong listed companies. With the fullest assistance from the Mainland regulators, the SFC should be able to detect and tackle cases of suspected corporate fraud and misfeasance involving Mainland companies more efficiently.



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