The Impact of Chinese State Secrecy Laws’ on Foreign-Listed Companies

By Liza Mark

Foreign listed China-based companies and multinationals with significant operations in China should take note of the conflict involving the audit work papers underlying the financial statements of China-based companies listed overseas and China’s State Secrecy Laws. As a result of the Chinese units of the Big Four accounting firms refusing to provide audit work papers for fear of violating China’s State Secrecy Laws, a U.S. Securities and Exchange Commission (“SEC”) administrative law judge issued an order suspending the Chinese units of the Big Four accounting firms from auditing U.S.-traded companies for six months on Jan. 23, 2014. On May 23, 2014, a Hong Kong Court of First Instance rejected Ernst & Young’s argument that China’s State Secrecy Laws prevented it from handing over information to the Hong Kong’s Securities and Futures Commission (“SFC”) and ordered that they do so. Both of these judgments are being appealed. The resolution of this question of regulatory access to China-based entities that tap the U.S. or HK capital markets will have an impact on the numerous China-based public companies listed in the U.S. and the HK markets and global multi-nationals that have significant operations in China.

The evolution of this conflict is described in the timelines below.

- Sept. 8, 2011 — SEC filed a subpoena enforcement action (the “Deloitte Enforcement”) against Deloitte Touche Tohmatsu CPA Ltd. (“Deloitte”) related to their 1

1 Big Four accounting firms refer to four biggest international accounting firms, i.e. PricewaterhouseCoopers, Deloitte Touche Tohmatsu, KPMG and Ernst & Young.


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work on the audit of the financial statements of Longtop Financial Technologies Limited ("Longtop").

Aug. 27, 2012 — Hong Kong’s SFC sued Ernst & Young’s Hong Kong branch, ("EY") demanding that EY hand over certain audit workpapers of Standard Water Limited, a China-based company that had attempted to list on the Hong Kong Stock Exchange.

Sept. 21, 2012 — The China Securities Regulatory Commission ("CSRC"), the Ministry of Finance of China ("MOF") and the Public Company Accounting Oversight Board of the United States ("PCAOB") reached a preliminary agreement regarding the handling of audit data. This preliminary agreement would allow PCAOB to have periodic observational visits to China, but no permission to conduct on-site inspections of Chinese audit firms who audit U.S. public companies.

Dec. 4, 2012 — The SEC brought an administrative proceeding against the Chinese branches of the Big Four accounting firms as well as BDO International, Ltd. ("BDO") for their refusal to turn over audit workpapers related to ongoing SEC investigations or enforcement actions of China-based companies listed in the U.S.

May 7, 2013 — The CSRC, MOF and PCAOB signed a Memorandum of Understanding on Enforcement Cooperation ("MOU"). This MOU set up a preliminary mechanism for exchanging documents and information between the parties during enforcement situations. According to the MOU, audit workpapers held by audit firms can be provided to the PCAOB and shared with the SEC as long as PCAOB first requests assistance from MOF and CSRC and followed certain procedures. However, routine inspections of audit firms by PCAOB in China are not covered by this MOU.

Jan. 23, 2014 — Pursuant to the Dec. 4, 2012 administrative proceeding, an SEC administrative law judge issued an order suspending the Chinese units of the Big Four accounting firms for six months ("Suspension Order"). The Big Four accounting firms appealed.

Jan. 27, 2014 — The SEC dismissed the Deloitte Enforcement against Deloitte for their failure to surrender audit workpapers and other documents related to SEC’s investigation into Deloitte’s former audit client, China-based Longtop.


May 9, 2014 — The SEC granted the Big Four accounting firms’ petition for review of the Suspension Order, together with a leave to adduce additional evidence.

May 23, 2014 — A Hong Kong Court of First Instance rejected EY’s argument that China’s State Secrecy Laws prevented it from handing over information to the SFC and ordered that they do so.

July 1, 2014 — The SEC barred EFP Rotenberg LLP, a New York accounting firm, and its partners from auditing U.S. traded companies based in China. This appears to be the first time the SEC has imposed such a targeted ban, specifically aimed at the auditing of Chinese companies.

U.S. In 2007, reverse mergers became popular among Chinese companies as a short-cut to become a listed public company in the U.S. From 2007 to 2010, 159 China-based companies listed in U.S. through the reverse merger process. Many of these companies ran into trouble, particularly regarding their financial reporting. A wave of auditor resignations, civil lawsuits and allegations of fraudulent accounting practices by short-sellers ensued. This prompted the SEC to set up a Cross-Border Working Group in 2010 and a Financial Reporting and Audit Task Force in July 2013 to focus on foreign issuers. During this period, both the SEC and the PCAOB experienced significant difficulties in inspecting relevant audit workpapers from China-based issuers and they sought assistance from the Chinese regulators, the MOF and the CSRC, with little success.

The Big Four accounting firms refused to turn over audit workpapers, despite being required to under the Sarbanes-Oxley Act of 2002 ("SOX"), claiming that doing so would violate the China’s State Secrecy Laws. This conflict ultimately led to the suspension ruling for a period of six months under the SEC administrative law proceeding against the Big Four accounting firms and BDO in January 2014 and the Big Four accounting firm and BDO appealed. Suspending an accounting firm for six months means that they cannot perform audit work on any U.S.-listed entities. That would leave an estimated 200+ China-based entities without an audit firm and may impact how U.S.-listed multinationals with significant operations in China conduct their global audits.

Hong Kong. As compared to the U.S., many more China-based companies are listed on the Hong Kong Stock Exchange. Therefore, it is not surprising that the SFC encountered the same difficulties as the SEC when trying to exert similar regulatory oversight on the financial reporting of the China-based companies listed in Hong Kong. The SFC also resorted to litigation after multiple unsuccessful requests for information. On Aug. 27, 2012, the SFC filed suit against EY to compel it to produce certain accounting workpapers and records of Standard Water, a company that attempted to list in Hong Kong. EY argued that they were prevented from turning over such accounting workpapers due to China’s State Secrecy Laws.

The surprising thing was that the SFC had requested the assistance of CSRC to obtain all audit workpapers pursuant to the “Memorandum on Regulatory Cooperation”, dated June 19, 1993, between inter alia SFC and CSRC as well as the International Organization of Secu-

6 See MOU, article IV (b) (ii).
ritories Commission Multilateral Memorandum of Understanding, to which both the SFC and CSRC are signatories. CSRC made the request to the China associate firm of EY and they still refused to provide the requested documents on the grounds of its duty of confidentiality and CSRC’s lack of jurisdiction over Standard Water. More interestingly, this litigation revealed certain informal instructions CSRC appears to have given to China based audit firms, where they clearly instruct these firms that if any foreign regulator requests to review the audit workpapers and documents relating to a Chinese company, such materials must be acquired through the cooperation with the CSRC. This lawsuit was deemed as a test for how far China’s State Secrecy Laws can shield disclosure of sensitive corporate matters in Hong Kong. On May 23, 2014, the Hong Kong Court of First Instance rejected EY’s arguments that they cannot provide the materials due to prohibition under the China’s State Secrecy Laws and held that EY shall hand over the audit workpapers related to Standard Water to SFC. EY subsequently appealed this ruling.

**China.** State Secrecy is not a new concept in China. The main basis for secrecy prohibitions for audit workpapers rests with the *Archives Law of the People’s Republic of China*, effective on July 5, 1996; the *Laws of the People’s Republic of China on Guarding State Secrets*, effective October 1, 2010 and the *Provisions of the China Securities Regulatory Commission, the State Secrecy Bureau and the State Archives Administration on Strengthening Confidentiality and Archives Administration Relating to Overseas Issuance and Listing of Securities*, effective October 20, 2009. However, the control of audit workpapers seemed to have progressively tightened after the various reporting difficulties, auditor resignations and civil lawsuits prompted by the reverse merger wave of China-based companies in the U.S. from 2007 to 2010.

The MOF promulgated the *Interim Provisions on the Cross-border Implementation of Audit Business by Accounting Firms (Draft for Comments)* for public comments on Apr. 21, 2014. The MOF Interim Provisions focus on domestic and overseas accounting firms that provide audit services for domestic China-based enterprises that list overseas, either during initial public offerings or periodic reporting after the IPO. According to these provisions, international accounting firms are barred from sending their staff to audit China-based companies under temporary practice licenses. Instead, they are required to team up with local accounting firms (one of the top 100 mainland accounting firms ranked by the Chinese Institute of Certified Public Accountant) and have the local accounting firm conduct the audit work within China. The provisions also clearly note that under this type of arrangement, the international accounting firm will issue the audit report and bear all liabilities for such audit report. In addition, the provisions reinforce the requirement that all accountants must strictly follow the China’s State Secrecy Laws and cannot pass on any information to overseas regulators or stock exchanges.

### I. State Secrets Under Chinese Laws

The *People’s Republic of China on Guarding State Secrets* (“State Secrets Law”) was revised and promulgated on Apr. 29, 2010 and effective October 1, 2010. According to this revised State Secrets Law, “State Secrets” are matters that, if divulged, would harm state security and national interests in the fields of political affairs, economy, national defense and diplomacy. Six detailed categories of state-secrets-related matters are listed, including secret matters concerning (1) major policy decisions on state affairs; (2) armed forces and national defense; (3) diplomatic activities; (4) economic and social development; (5) science and technology; and (6) activities for safeguarding national security and the investigation of criminal offences. The secret matters of a political party that satisfy the description of the preceding paragraphs (1) to (6) shall also be deemed as State Secrets. However, the definition of what constitutes “State Secrets” remain very vague. What constitutes harm is undefined and the types of information that would qualify as state secrets remain unclear.

The State Secrecy Administration Bureau (“SSSB”) and other administrative ministries or departments are authorized to promulgate detailed rules to further regulate state secrets protection in various industries. For example, SSSB and PRC Ministry of Land and Resources jointly promulgated rules concerning the protection of secret geological materials. With regard to the state secrets in overseas issuance and listing of securities, the CSRC, jointly with SSSB and the State Archives Administration (“SAA”), promulgated the *Provisions on Strengthening Confidentiality and Archives Administration of Overseas Issuance and Listing of Securities (“Provisions”)* on Oct. 20, 2009.

**Are Audit Workpapers State Secrets?** Certain information in audit workpapers falls into the category of State Secrets. However, it is quite obvious that not all information in audit workpapers would constitute “State Secrets.” According to the No. 2 *Chinese CPA Practice Guide — Audit Working Paper* issued by the Chinese Institute of Certified Public Accountant, audit workpapers include plenty of public information of the audited company, including but not limited to the enterprise approval certificate, business license, articles of association, minutes of the board of directors meeting etc., which obviously cannot be classified as State Secrets. In

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8. The Securities and Futures Commission v. Ernst & Young (A Final [2014] HKCFI 031; HCMPI1818/2012 (23 May 2014)).
10. See HK regulator files E&Y China secrecy test case, By Paul J Davies, [http://www.ft.com/intl/cms/s/0/13e9cd1c-f0ea-11e1-89b2-00144efebad0.html#axzz361METjS](http://www.ft.com/intl/cms/s/0/13e9cd1c-f0ea-11e1-89b2-00144efebad0.html#axzz361METjS).
14. Id.
17. No. 2 Chinese CPA Practice Guide — Audit Working Paper, article 2.61 and 2.64.
addition, Article 6 of the MOF Interim Provisions provides that, where the audit workpapers involve any State Secrets, state security or vital interests, such audit workpapers shall not be stored, processed or transferred in non-confidential computer information systems; said audit workpapers are forbidden from being carried, transported overseas or transferred to overseas institutions or individuals via any means without the approval of competent authorities. This implies that (1) only certain parts, not all, of the audit workpapers involve State Secrets and (2) theoretically, even the part containing State Secrets can be transferred overseas if appropriate governmental approval is granted.

**Legal Liability Related to State Secrets.** Any persons who disclose State Secrets may be subject to criminal or administrative liability. According to the PRC Criminal Law, whoever illegally provides State Secrets to an organization, institution or person outside of China shall be sentenced to ten years of imprisonment or life sentence, when circumstances are “especially serious”. If the circumstances are “extremely abominable”, such person may be sentenced to death and the property of such person could be confiscated.18 “Institutions or organizations outside the territory” include the branches (representative office) established within the territory of PRC by their parent organizations outside the territory of PRC while “individuals outside the territory” would include those persons with foreign nationality who reside in the PRC.19 The meaning of “extremely serious” or “extremely abominable” circumstances are not clearly defined.20 Thus, if any accountant or company officer, whether a PRC national or not, provides the audit workpapers involving State Secrets to the SEC, the SFC, U.S. courts or HK courts without obtaining the proper government approval, such behavior is likely to be defined as “illegally providing state secrets” and such accountant or company officer could be subject to criminal liability based on the seriousness. Administrative liability for persons illegally disclosing State Secrets is murkier than criminal law liability. According to China’s State Secrecy Laws, if the illegal disclosure of State Secrets does not constitute a criminal offense, the relevant secret-guarding administrative department shall urge the punishment from the organization where such persons worked.21 However, no measures have ever been issued for organizations to follow. It is precisely this lack of clarity on what constitutes a “State Secret,” combined with the potentially heavy criminal and administrative liability, and the various commentary from MOF and CSRC, indicating that audit workpapers are considered, partially at least, “State Secrets,” that puts the audit profession, China-based foreign listed companies and multi-nationals with significant operations in China, in a quandary.

**II. Steps to Take**

The murkiness of the legal limitations is a fact of life in China and the quandary of what to do with audit workpapers appears, in part, to be driven by political considerations. For now, a prudent course of action for foreign listed China-based companies and multi-nationals with significant operations in China should include:

- A company’s Audit Committee should be made aware of this situation and the potential consequences of being trapped between different regulators in the foreign listed jurisdiction and the Chinese regulators.
- A company should discuss this situation with their auditor and determine their position on the issue and work out potential contingency plans.
- A company should consider their internal auditing function and determine where audit data should be kept.
- A company should strengthen its internal policies regarding protection of audit data, particularly such data that may contain “State Secrets.”

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18 PRC Criminal Law, article 111 and article 113; and see Interpretations of the Supreme People’s Court on Several Issues Concerning Application of Law for Trial of Cases of Stealing, Spying, Buying or Unlawfully Supplying State Secrets or Intelligence for Entities outside the Territory of China, article 2.

19 See Rules For Implementation Of The State Security Law Of The People’s Republic Of China, article 3.

20 Id. Footnote 18.

21 See People’s Republic of China on Guarding State Secrets, article 48.