

For discussion

**Bills Committee on
Financial Reporting Council Bill**

**Follow-up actions arising
from the meeting held on 20 December 2005**

PURPOSE

At the meeting held on 20 December 2005, the Bills Committee deliberated, among other things, the Administration's paper entitled "Component Three: Financial Reporting Review Panel and Financial Reporting Review Committees" (LC Paper No. CB(1)420/05-06(02)). This paper sets out the Administration's responses to the follow-up action arising from the meeting.

ORGANIZATIONAL STRUCTURE OF A FINANCIAL REPORTING REVIEW COMMITTEE

2. Noting that **clause 40(1)(b)** of the Financial Reporting Council Bill (the Bill) provides that the Financial Reporting Council (FRC) may appoint a Financial Reporting Review Committee (FRRC) to enquire into a relevant non-compliance of a listed entity's financial report, some Members of and the legal adviser to the Bills Committee invited the Administration to elaborate on the following matters -

- (a) the arrangement and criteria under which the FRC would appoint the members of a FRRC;
- (b) whether the FRC's power of appointing a FRRC and its members should be non-delegable;

- (c) whether and how the appointment of a member of a FRRC could be revoked, and the circumstances under which such a power could be exercised;
- (d) whether a change in the membership of a FRRC would affect the legal status and put evidence collected prior to the change subject to legal challenge, and whether the continued operation of a FRRC despite the change in the membership would breach the rules of natural justice;
- (e) whether the parties concerned would be informed of the change in the membership of a FRRC;
- (f) in the event that a member of a FRRC was conflicted out in the course of an enquiry, whether the FRRC with the participation of less than five members would meet the requirement of **clause 41(1)** that a Committee should consist of at least five members; and whether a new member would be appointed or a new Committee formed under such a circumstance;
- (g) the application of section 51 of the Interpretation and General Clauses Ordinance (Cap. 1) in case of any vacancy in the membership of a FRRC; and
- (h) the quorum for a meeting of a FRRC.

3. Regarding paragraph 2(a), **clause 40(1)(b)** provides that the FRC may appoint a FRRC in accordance with **clause 41(1)** to enquire into a relevant non-compliance of a financial report in relation to a listed entity. **Clause 41(1)** provides that a FRRC is to consist of at least five members of the Financial Reporting Review Panel (FRRP)¹ and that one of the members is to be a Panel Convenor who is to be the Chairman of the Committee. Since the FRC is to appoint a FRRC to enquire into a particular non-compliance, the power conferred under **clause 40(1)(b)** must be exercisable to fulfill this purpose. In exercising this power, the

¹ Under **clause 39(1)**, the Chief Executive shall, in consultation with the FRC, appoint the FRRP of at least 20 persons, whom the Chief Executive considers suitable for appointment under **clause 40(1)(b)** as members of a FRRC.

FRC must act reasonably and in good faith and on lawful and relevant grounds of public interests. We envisage that the FRC will have to consider, among other things, the background and expertise of FRRP members, who shall not face a conflict of interest situation in that particular case, in making the appointment. In this light, we consider that there is no need to provide for the appointment arrangements (including the administrative procedures) and the criteria in the Bill. In this regard, section 182 of the Securities and Futures Ordinance² (SFO, Cap. 571) may provide a point of reference, as it does not contain any detailed requirements governing the arrangements or criteria under which the Securities and Futures Commission (SFC) appoints one or more persons to investigate cases concerning market misconduct either.

4. Regarding paragraph 2(b), **clause 11(2)** provides that the FRC shall not delegate any of its functions under, among other clauses, **Part 4** of the Bill. Hence, the FRC's power of appointing a FRRC and the Committee's members under **clause 40(1)(b)** (being within **Part 4** of the Bill) is non-delegable.

5. Regarding paragraph 2(c), section 42(a) of Cap. 1³ provides that, where any Ordinance confers a power upon any person to make any appointment, then the person is also empowered to remove any person appointed in exercise of such power. In exercising the power of removal, the FRC must act reasonably and in good faith and on lawful and relevant grounds of public interests. The application of section 42(a) of Cap. 1 to the appointment of the FRRC members has not been excluded by any contrary intention appearing from the Bill⁴. As such, the Bill needs not expressly provide for the removal of a FRRC member.

² See **Annex**.

³ See **Annex**.

⁴ Section 2(1) of Cap. 1 provides that, save where the contrary intention appears either from Cap. 1 or from the context of any other Ordinance or instrument, the provisions of Cap. 1 shall apply to any other Ordinance in force.

6. Regarding paragraph 2(d), we do not believe that a change in the membership of a FRRC during an enquiry will affect a FRRC's legal status and thus, the legality of evidence collected by it. After the FRC has appointed a FRRC under **clause 40(1)(b)**, the FRC may appoint replacement members under **section 3 of Schedule 6**. The Bill envisages that after a FRRC has been appointed, it is possible for its members to be changed without dissolving the FRRC itself⁵. Further, it should be stressed that a FRRC is to enquire into non-compliances of a listed entity's financial report and is *not a tribunal with sanctioning power*. While a FRRC has to act fairly in conducting investigations/enquiries, considerable latitude is allowed as to its procedures⁶. For example, it does not appear to us that a change in the membership of a FRRC (due to, for example, the death of one of its members) during the course of an enquiry will by itself constitute a breach of natural justice.

7. Regarding paragraph 2(e), the Bill does not prohibit the FRC or a FRRC from informing concerned parties of the change in the membership of the FRRC if it sees fit. That said, in light of some Members' concerns, we are considering adding such a requirement to enhance the transparency of the operations of the FRRC, and will revisit this issue during the clause-by-clause scrutiny of the Bill.

8. Regarding paragraph 2(f), since pursuant to **clause 39(1)** the FRRP is to comprise at least 20 persons, we envisage that the FRC will *in the first place* appoint suitable candidates from the FRRP to a FRRC which is to consist of at least five members of the FRRP. As we explain in paragraph 3 above, in making the appointment, the FRC will take into

⁵ We have also considered the Court of Appeal's decision in Chao Pak Ki & Another v Hong Kong Society of Accountants [2005] CACV 12/2005. It concerns a disciplinary committee under the Professional Accountants Ordinance (Cap. 50) that determines whether a complaint referred to it has been proved and has power to impose disciplinary orders. On the other hand, a FRRC enquires into a relevant non-compliance of financial reports, reports its findings to the FRC but has no power to impose sanctions. Despite the difference in the nature of work, both the disciplinary committee and a FRCC have to reach a conclusion in the case referred to it. In that case, the disciplinary committee was constituted before any of its members were appointed by the Chairman of the Committee. The issue on appeal was that if one member of a committee stepped down, whether the Chairman had power to appoint a replacement member. The Court of Appeal agreed that a disciplinary committee, once constituted, remained constituted and that the Chairman of the Committee had power to appoint a replacement member to discharge the committee's statutory obligations.

⁶ Wade and Forsyth, *Administrative Law*, 9th edition, p. 548.

account all relevant considerations including the need to avoid any appointed members from facing a conflict of interest situation. In the less likely situation where the question of conflict of interest arises after the appointment has been made, the FRC may revoke the appointment of the concerned member of the FRRC as explained in paragraph 5 above. Whatever the case, if the number of members of a FRRC falls short of five members as required under **clause 41(1)**, the FRC may pursuant to **section 3 of Schedule 6** appoint a new member to fill the vacant membership.

9. Regarding paragraph 2(g), section 51(a) of Cap. 1⁷ provides that, where any committee is established by or under any Ordinance, the powers of such committee shall not be affected by any vacancy in the membership thereof. The application of section 51(a) of Cap. 1 to the FRRC has not been excluded by any contrary intention from the Bill. In this light, we see no need to add a new provision in the Bill governing this.

10. Regarding paragraph 2(h), **section 1(2) of Schedule 6** to the Bill provides that the procedure for convening meetings of a FRRC and for the conduct of business at those meeting is, subject to any direction of the FRC, to be determined by the Committee. **Since a FRRC is tasked to enquire into but not to adjudicate a case**, we do not see the need to rigidly provide in the Bill for the quorum for a meeting of the Committee. For reference, there is also no provision in the Professional Accountants Ordinance (Cap. 50) to prescribe the quorum requirement for the meeting of an Investigation Committee.

JURISDICTION OF A FRRC

11. Noting that a FRRC will enquire into the relevant non-compliances of a listed entity's "relevant financial report" as defined in **Part 1 of Schedule 1** to the Bill, some Members of the Bills Committee invited the Administration to consider whether certain "special notices", "special reports", "managerial accounts" and "directors'

⁷ See **Annex**.

report” published by a listed entity should be included in the proposed jurisdiction of the FRRC.

12. In formulating the jurisdiction of the FRRC, we have been guided by the principle that we should include those more important financial reports of a listed entity on which the investing public relies to appraise the financial position of the entity. Accordingly, we have included the **periodic accounts or financial statements and a “specified report”⁸ required for a “listing document”⁹** issued and published by a listed entity for the purposes of the relevant provisions under the CO, the relevant code issued by the SFC or Listing Rules, as the case may be.

13. We note that, under the Listing Rules, listed entities may need to publish certain announcements or issue circulars to shareholders as and when there are prescribed share transactions, discloseable transactions, major transactions, very substantial disposal or acquisition, or reverse takeover, etc. In such cases, the listed entity is required under the Listing Rules to notify the Stock Exchange which will comment on such draft special announcements or circulars prior to the announcement¹⁰. Although such announcements or circulars may reveal certain financial information, they do not fall within the definition of “*relevant financial reports*” under **Part 1 of Schedule 1**, as we consider that we should adopt a focused approach in prescribing the remit of the FRRC, at least at the start-up stage of the FRC.

14. In addition, the financial information contained in the directors’

⁸ Pursuant to **clause 2(1)**, “*specified report*” refers to any financial report specified in Part II of the Third Schedule to the Companies Ordinance (CO, Cap. 32) that is required under section 38 or 342 of the CO to be set out in a prospectus of a company; or in relation to a “*listing document*” other than a prospectus, any report on the relevant financial information on the entity, or a business or undertaking to be acquired or disposed of by the entity, that is required for inclusion in the listing document issued for the purposes of the relevant code published by the SFC or the Listing Rules.

⁹ Pursuant to **clause 2(1)**, “*listing document*”, in essence, means a prospectus within the meaning of the CO, or a document issued for the purposes of the Listing Rules, that offers any securities issued by a corporation or interests in a collective investment scheme to the public for subscription or acquisition.

¹⁰ Under the Listing Rules, some of these announcements or circulars, as the case may require, may present certain unaudited managerial accounts, while some may need to enclose any prescribed financial statements prepared, reviewed or audited by auditors or reporting accountants.

report, such as the amount, if any, to be transferred to the reserves, significant changes to fixed assets and issue of debentures, are already set out in full detail in the financial statements (which are already under the jurisdiction of a FRRC) within the same annual report¹¹. In this case, to avoid duplication, it is not necessary to put the financial information included in the directors' report subject to enquiries by the FRRC. Moreover, we do not consider that the remit of a FRRC should be further extended to cover the directors' report, which, by its very nature covers issues which are not only concerned with financial reporting.

15. It should also be noted that the present proposed scope of the jurisdiction of the FRRC has been agreed by the great majority of the respondents who commented on this issue during the consultation undertaken by the Administration in February 2005¹². Nevertheless, we envisage that, in the future, the relevant parties, including the FRC, will review the jurisdiction of the FRRC in the light of actual experience. In this connection, **clause 60(1)** proposes to empower the Secretary for Financial Services and the Treasury to amend **Schedule 1** to the Bill by notice published in the Gazette.

ENQUIRY POWERS OF A FRRC

16. With respect to the enquiry powers of a FRRC under **clauses 43 and 45**, some Members invited the Administration to consider -

- (a) specifying how to reconcile the information-gathering requirement under **clause 43(1)** with the situation where the relevant records or documents do not belong to the persons concerned, or where the persons concerned are restricted to disclose the records or documents by any statutory or

¹¹ A directors' report will be attached to the accounts or financial statements set out in an annual report of the corporation.

¹² It may be useful to refer to the experience of the Financial Reporting Review Panel which was established in the United Kingdom (UK) in 1990. Previously it was only tasked to review annual accounts prepared under the UK Companies Act 1985. It was only in 2004 that legislative amendments were introduced to empower the Panel to keep under review **annual and interim accounts** and **financial information within a prospectus** that are produced by issuers of listed securities and **are required to comply with the relevant accounting requirements imposed by the listing rules**.

contractual requirements; and

- (b) setting out the criteria which may constitute a “reasonable excuse” referred to in **clause 45**.

17. Regarding paragraph 16(a), **clause 43(1)** requires the listed entity and other relevant persons to produce any record or document, or give any information or explanation, for the purposes of the enquiry by a FRRC. We agree with Members that difficulties may arise where a person may run the risk of breaching the obligations under any contractual or statutory requirements and incur liability by reason only of the compliance with the requirement given by a FRRC pursuant to **clause 43(1)**. In this regard, we agree to consider proposing a Committee Stage Amendment to include an additional immunity clause under **clause 53** to the effect that a person who complies with a requirement under any provision of this Ordinance shall not incur any civil liability to any person by reason only of that compliance. A similar provision is found in section 380(3) of the SFO¹³.

18. Regarding paragraph 16(b), **clause 45** empowers a FRRC to apply to the Court for an inquiry of any failure to comply, without reasonable excuse, with an information-gathering requirement imposed on a person under **clause 43**. The Administration considers that it should be best for the Court to decide on whether the failure is justified by a reasonable ground and whether the compliance should be enforced, and that it is neither necessary nor desirable to attempt to define what constitutes a “reasonable excuse” in the Bill.

Financial Services and the Treasury Bureau
January 2006

¹³ See **Annex**.

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▼ Chapter: 571	Title: SECURITIES AND FUTURES ORDINANCE	Gazette Number: L.N. 12 of 2003
Section: 182	Heading: Investigations	Version Date: 01/04/2003

Division 3-Powers of investigations

(1) Where-

- (a) the Commission has reasonable cause to believe that an offence under any of the relevant provisions may have been committed;
- (b) the Commission has reasonable cause to believe that a person may have engaged in defalcation, fraud, misfeasance or other misconduct in connection with-
- (i) dealing in any securities or futures contract or trading in any leveraged foreign exchange contract;
 - (ii) the management of investment in any securities, futures contract or leveraged foreign exchange contract;
 - (iii) offering or making any leveraged foreign exchange contract or collective investment scheme;
 - (iv) giving advice in relation to the allotment of securities, or the acquisition or disposal of, or investment in, any securities, futures contract, leveraged foreign exchange contract, or an interest in any securities, futures contract, leveraged foreign exchange contract or collective investment scheme; or
 - (v) any transaction involving securities margin financing;
- (c) the Commission has reasonable cause to believe that market misconduct may have taken place;
- (d) the Commission has reasonable cause to believe that the manner in which a person has engaged or is engaging in any of the activities referred to in paragraph (b)(i) to (v) is not in the interest of the investing public or in the public interest;
- (e) the Commission-
- (i) for the purpose of considering whether to exercise any power under section 194 or 196, has reason to inquire whether any person is or was at any time guilty of misconduct, or is not a fit and proper person, as described in section 194(1) or (2) or 196(1) or (2); or
 - (ii) for the purpose of assisting the Monetary Authority to consider whether to exercise any power under section 58A or 71C of the Banking Ordinance (Cap 155), has reason to inquire whether any person-
 - (A) is or was at any time guilty of misconduct, or is not or has ceased to be a fit and proper person, as described in section 58A(1) of that Ordinance; or

(B) is or was at any time guilty of misconduct, or should cease to be regarded as a fit and proper person, as described in section 71C(4) of that Ordinance;

(f) the Commission has reason to inquire whether any of the conditions imposed in respect of an authorization under section 104 or 105 are being complied with; or

(g) a matter in respect of the investigation of which the Commission decides to provide assistance under section 186 is, in the opinion of the Commission, of a nature similar to the matter described in paragraph (a), (b), (c), (d), (e) or (f) as that which the Commission has reasonable cause to believe or has reason to inquire (as the case may be),

the Commission may in writing direct one or more of its employees or, with the consent of the Financial Secretary, appoint one or more other persons, to investigate any of the matters referred to in paragraphs (a) to (g).

(2) The costs and expenses incurred by an investigator, other than an employee of the Commission, are to be paid out of moneys provided by the Legislative Council.

(3) The Commission shall furnish an investigator with a copy of his direction or appointment (as the case may be), and the investigator, before first imposing any requirement on a person under section 183(1), (2) or (3), shall produce a copy of the direction or appointment (as the case may be) to that person for inspection.

(4) Before the Commission directs any of its employees, or appoints any person-

(a) to investigate any matter under subsection (1)(e)(i), to the extent that the investigation is for the purpose of considering whether to exercise any power under section 196; or

(b) to investigate any matter under subsection (1)(e)(ii),

the Commission shall consult the Monetary Authority.

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Chapter:	1	Title:	INTERPRETATION AND GENERAL CLAUSES ORDINANCE	Gazette Number:	
Section:	42	Heading:	Power to appoint includes power to suspend, dismiss, re-appoint, etc.	Version Date:	30/06/1997

Where any Ordinance confers a power or imposes a duty upon any person to make any appointment or to constitute or establish any board, tribunal, commission, committee or similar body, then the person having such power or duty shall also have the power-

- (a) to remove, suspend, dismiss or revoke the appointment of, and to re-appoint or reinstate, any person appointed in exercise of such power or duty;
- (b) to revoke the appointment, constitution or establishment of, or to dissolve, any board, tribunal, commission, committee or similar body appointed, constituted or established, in exercise of such power or duty, and to re-appoint, re-constitute or re-establish the same; and
- (c) to specify the period for which any person appointed in exercise of such power or duty shall hold such appointment:

Provided that where the power or duty of such person so to act is only exercisable upon the recommendation, or is subject to the approval or consent, of some other person, then such power shall only be exercisable upon such recommendation or subject to such approval or consent.

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Chapter:	1	Title:	INTERPRETATION AND GENERAL CLAUSES ORDINANCE	Gazette Number:	
Section:	51	Heading:	Powers of board, etc. not affected by vacancy	Version Date:	30/06/1997

Where any board, tribunal, commission, committee or similar body is established by or under any Ordinance, the powers of such board, tribunal, commission, committee or similar body shall not be affected by-

- (a) any vacancy in the membership thereof;
- (b) any defect in the appointment or qualification of a person purporting to be a member thereof; or
- (c) any minor irregularity in the convening of any meeting thereof.

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Chapter: 571 Title: SECURITIES AND FUTURES ORDINANCE Gazette Number: L.N. 12 of 2003
Section: 380 Heading: **Immunity** Version Date: 01/04/2003

(3) A person who complies with a requirement made under any provision of this Ordinance shall not incur any civil liability, whether arising in contract, tort, defamation, equity or otherwise, to any person by reason only of that compliance.