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12 September 2005

Ms Connie Szeto
for Clerk to Bills Committee
Legislative Council
Hong Kong Special Administrative Region
of the People's Republic of China
Legislative Council Building
8 Jackson Road, Central
Hong Kong

By post and by fax 2869 6794

Dear Ms Szeto,

Submission of views relating to the Financial Reporting Council Bill

Thank you for your letter of 26 July 2005 requesting views from the SFC's Investor Education Advisory Committee, the SFC's Public Shareholders Group and the SFC's staff, on the Financial Reporting Council Bill (the Bill) and in particular, on the following two issues:

- (a) Whether the function of the Financial Reporting Council (FRC) would overlap with the function of the SFC in investigating accounting irregularities of listed entities; and
- (b) Whether the function of the FRC should be purely investigatory as proposed by the Administration.

The SFC's Investor Education Advisory Committee and Public Shareholders Group held respective meetings on 29 and 30 August 2005 to discuss the Bill.

Members of the two committees raised the following points at the meetings. As no votes were taken at these meetings the following comments do not necessarily represent the unanimous views of the respective committees' members.

Views of members of the SFC's Investor Education Advisory Committee

- (a) A member expressed concern on the clarity of the Bill in defining the role of the FRC in relation to the Audit Investigation Board, in particular the extent to which the FRC conducts its investigation and how much evidence it would gather. The member stated that it is very clear that the police's role is to collect sufficient evidence for the Department of Justice to prosecute; and that the FRC should have a similar role of obtaining sufficient evidence to support a successful disciplinary case.

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- (b) A member expressed concern regarding the sanctions available to the Hong Kong Institute of Certified Public Accountants (HKICPA), that these would not be sufficient to deter serious wrongdoings. The current Bill anticipates that the FRC would refer the relevant investigation/enquiry report to a “specified body” for disciplinary action, further investigation or any other actions. In certain cases, the FRC would refer a case of auditors’ irregularities to the HKICPA for disciplinary proceedings. The maximum sanctions that the HKICPA could impose are a fine of HK\$500,000 and/or order that the name of the professional accountant be removed from the register permanently. The member was concerned that the current level of fine would not be sufficient to deter serious wrongdoings, and hence would render the FRC a toothless tiger.

Views of members of the SFC’s Public Shareholders Group

General view

- (a) A member was of the view that the budget of the FRC was small as compared to budgets of similar bodies overseas. He commented that the US Public Company Accounting Oversight Board (US PCAOB) has a annual budget of over US\$100m (about HK\$780m) while the UK Financial Reporting Council (UK FRC) has an annual budget of £12m (about HK\$180m). Hong Kong’s budget represented about 1/78 of the US PCAOB and 1/18 of the UK FRC. He also commented that the FRC funding represents only a tiny fraction of the market capitalization of listed companies in Hong Kong (much smaller than the comparable fraction in the USA and the UK). In order for the FRC to achieve its objectives, it should be better funded.

The member further advised that both PCAOB and UK FRC’s funding comes from levies on companies based on their market capitalization. He suggested the Administration should consider adopting a similar basis of funding for the FRC.

A member asked how the FRC budget compared to that of the HKICPA; would it represent an increase over the resources made available by the HKICPA at present to conduct inspections of auditors.

Whether the function of the FRC would overlap with the function of the SFC in investigating accounting irregularities of listed entities

- (b) Members were of the view that because the proposed function of the AIB is actually a part of the current functions of the HKICPA, there is no change from the current situation in terms of overlapping of functions with the SFC. Members were pleased to see that the

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current bill promotes two-way sharing of information between the FRC and the SFC which is an improvement from the current one-way flow of information from the SFC to the HKICPA only.

Members generally felt that the SFC and the FRC would need to co-ordinate their work as there would be occasions where the SFC and the FRC were each interested in different aspects of the same particular matter.

Whether the function of the FRC should be purely investigatory as proposed by the Administration

- (c) Members asked whether all cases referred by the FRC to the HKICPA would be taken up by the HKICPA. The SFC staff responded that the Bill does not oblige the HKICPA to take disciplinary action for all cases referred to it by the FRC.

Members advised that they would feel more comfortable if the FRC also has a disciplinary function because it is more likely that the FRC would initiate disciplinary proceedings in respect of its investigations. Members are concerned that if the investigation function and disciplinary function are housed in different bodies, there is a danger that disciplinary cases will not proceed after referral. If the FRC budget is a concern, members considered that the required funding could come from the HKICPA as that part of its current function would be transferred to the FRC.

(By way of background, members were concerned about the transparency and efficiency of disciplinary cases handled by the HKICPA. Members commented that past significant corporate failures such as the Guangan case, which happened in 1997, were not yet concluded by the HKICPA. Members also considered that the sanctions available to the HKICPA were not adequate to serve the FRC purpose.)

Other comments

- (d) A member suggested that the law be changed to allow findings of the FRC and findings of the disciplinary actions of the HKICPA to be used by investors in their civil actions for damages. The member was of the view that such a provision is important because this would greatly reduce the cost of shareholders actions. Greater threat of civil actions by shareholders would encourage higher standards of audit work.
- (e) Members asked whether there would be whistleblower protection provisions in the Bill. Members were of the view that whistleblower protection is important for staff of audit

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firms and staff of the listed companies. Members commented that it was Enron's staff who reported the management's wrongdoings.

Views of the SFC's staff

Whether the function of the FRC would overlap with the function of the SFC in investigating accounting irregularities of listed entities

- (a) We do not anticipate that there will be undue overlap between the FRC's investigations and the SFC's own investigations. When the FRC is investigating the work of auditors, the FRC and the SFC may well both be looking at issues arising from the same events concerning corporations. However, the FRC will be looking for evidence of auditor malpractice, particularly whether the audit work was sufficient and whether appropriate judgments were made, whereas the SFC will be looking for evidence of corporate fraud or misconduct, breach of Listing Rules or market misconduct. There will be good reasons for the two bodies to co-ordinate such actions but this is provided for in the Bill.
- (b) When the FRC is investigating compliance with disclosure obligations under Listing Rules or accounting standards, the SFC may well have complementary concerns as to whether disclosure is misleading and it will be necessary to ensure co-ordination. It will be especially necessary where the FRC investigations could lead to the SFC considering action against the persons responsible for disclosure.
- (c) Overall whilst we recognise the need for co-operation between the SFC and the FRC we do not consider that there will be duplication of effort, wastage of resources and delays in taking action against the parties involved. We note that the FRC will also need to co-ordinate with other regulatory bodies and government agencies in their investigations.

Whether the function of the FRC should be purely investigatory as proposed by the Administration

- (d) The SFC staff has no view on whether the FRC should have purely an investigative role or whether it should take on some of the prosecution work of the HKICPA. We note it is not uncommon, nor prohibited by law, for regulatory bodies to perform both investigatory and disciplinary roles and, albeit less common, criminal prosecutorial roles. For example, most securities regulators around the world have the power to both investigate and bring civil proceedings. Most also conduct their own disciplinary proceedings. Some, such as the UK Financial Services Authority (FSA), Australian Securities and Investments Commission

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(ASIC) and the SFC itself, can also bring criminal proceedings, although usually of the summary variety only.

- (e) Whether the roles should be separated is therefore a policy question. What appears more essential is to avoid prejudgement of proceedings and that is usually done by ensuring that those who establish the evidence of a breach through investigation do not play a part in making a decision on the breach. This is because biased or apparently biased proceedings could be struck down as procedurally flawed or stayed permanently by the courts. For example, with regard to the SFC's disciplinary proceedings, at the end of an investigation, evidence of an alleged breach is passed to a separate group of staff who decide whether there is enough evidence to start disciplinary cases and conduct the proceedings together with an ultimate decision maker. The same situation prevails with other securities regulators such as the Securities and Exchange Commission in the USA, the FSA and ASIC, though their specific arrangements differ.
- (f) As the FRC budget will not provide more than a small staff, it seems impossible for the FRC to ensure sufficient separation of roles of its staff necessary to provide appropriate safeguards of the rights of those involved in disciplinary proceedings. This would suggest that, unless the FRC budget were increased significantly, practical as much as policy reasons restrict the FRC to an investigatory role.

We would be delighted to provide further information or elaboration on these points, if this would be of assistance to the Bills Committee.

Yours sincerely,

Peter Au-Yang