

For Discussion

**Bills Committee on
Financial Reporting Council Bill**

**Component One
Establishment of the Financial Reporting Council**

PURPOSE

In response to Members' requests at the first Bills Committee's meeting held on 19 July 2005, the Administration has undertaken to provide, before the deliberation of each major component¹ of the Financial Reporting Council Bill (the Bill), a paper to set out the major proposals for that component. In relation to component one, this paper aims to –

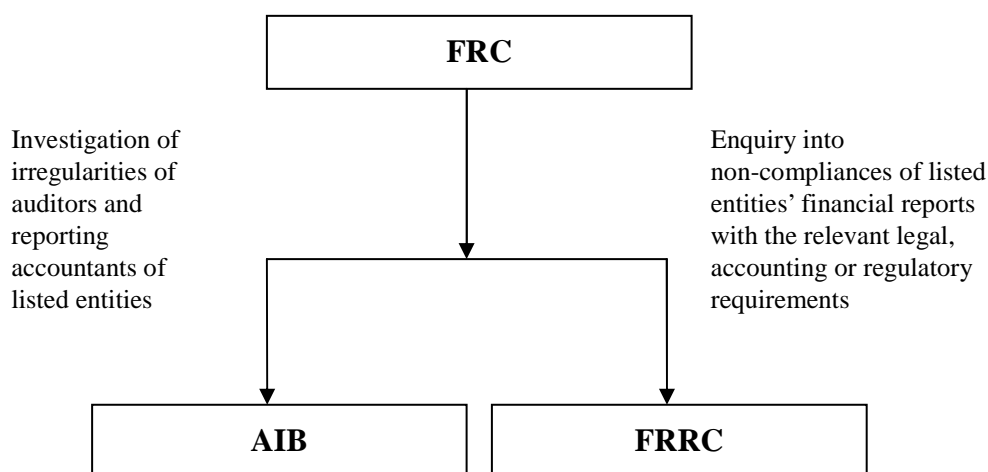
- (a) outline the major proposals contained in **Parts 1 and 2** of and **Schedules 2 and 3** to the Bill regarding the establishment of the Financial Reporting Council (FRC). These relevant provisions seek to provide for the (i) **legal status**; (ii) **composition**; (iii) **functions and powers**; and (iv) **checks and balances** of the FRC; and
- (b) set out the responses of the Administration to the salient comments on these issues as discussed at the second Bills Committee's meeting held on 27 September 2005 or as reflected in the deputations' submissions².

¹ For the grouping of components, please refer to the Administration's paper entitled "Proposed work plan" (LegCo Paper No. CB(1)2288/04-05(35)) as discussed by the Bills Committee at its meeting held on 27 September 2005.

² Please refer to the Administration's note entitled "Administration's Responses to the Submissions made to the Bills Committee" (LegCo Paper No. CB(1)2368/04-05(02)) for the detailed responses.

LEGAL STATUS OF THE FRC

2. **Clause 6** of the Bill establishes the FRC which is to be a body corporate. We consider it appropriate to set up an **independent statutory body** and set out, in statute, the powers, as well as the checks and balances, of the FRC. Institutionally, the FRC will oversee both the Audit Investigation Board (AIB) and the Financial Reporting Review Committee(s) (FRRC), as illustrated in the following diagram -



3. The Administration notes that the proposed establishment of the FRC has received wide support as revealed in many deputations' submissions³ to the Bills Committee. However, we are also aware of a few submissions expressing reservation on the need to establish this proposed statutory body. There are also suggestions on whether it would be desirable to house the relevant functions of the proposed FRC in the Hong Kong Institute of Certified Public Accountants (HKICPA) or the Securities and Futures Commission (SFC) instead. In response, the Administration's position is as follows -

³ These include the **accountancy professional bodies** (namely, the HKICPA, CPA Australia, Chartered Institute of Management Accountants – Hong Kong Division (CIMA), National Institute of Accountants of Australia – China Branch (NIAA), Association of Chartered Certified Accountants – Hong Kong (ACCA)); **chambers of commerce and listed companies** (namely, the British Chamber of Commerce, Chamber of Hong Kong Listed Companies); **other professional and advisory bodies** (namely, the Standing Committee on Company Law Reform, Law Society of Hong Kong, Hong Kong Institute of Chartered Secretaries); as well as some other firms and professionals.

- (a) **The proposal of establishing an investigatory body independent of the professional accountancy bodies was originated by the HKICPA in 2003, with a view to addressing the issue that greater degree of independence is required for investigation of auditing irregularities in relation to listed entities.** Consistent with the international trend towards greater independence in the oversight of auditors, this proposal was made in the context of the notable corporate failures (for example, Enron and Worldcom) in other parts of the world over the past years which highlighted the need to enhance public confidence in the auditing profession and the effectiveness, transparency and accountability of the regulatory regime. In view of the wide support we received during the two public consultations in September 2003 and February 2005, we consider the current proposal, i.e. to establish the FRC as a new statutory body, justified;
- (b) **We do not consider it appropriate to put the proposed FRC under the SFC.** Unlike the situation in Australia and the United States but similar to that in the United Kingdom, a certified public accountant in Hong Kong does not need to be registered with a securities regulator before becoming a company auditor. In this connection, although the SFC possesses powers to investigate market misconduct and licensed securities and futures intermediaries, the HKICPA has pointed out that it is not within the functions of the SFC under section 5 of the Securities and Futures Ordinance (SFO, Cap. 571) to investigate the conduct of certified public accountants in respect of suspected breaches of accounting and/or professional standards; and
- (c) **Overall, the proposed establishment of the FRC will further help enhance the regulation of auditors and the quality of financial reporting of listed entities.** The proposal is necessary as it has a significant bearing on enhancing Hong Kong's corporate governance regime and investor confidence.

COMPOSITION OF THE FRC

Overview

4. **Clause 7** of the Bill sets out the composition of the FRC, which is to consist of not more than 11 members, namely -

- (a) One ex officio member from Government, i.e. the Registrar of Companies or his representative;
- (b) The Chief Executive Officer (CEO) of the FRC, as an ex officio member;
- (c) Three members, each nominated by the SFC, the Hong Kong Exchanges and Clearing Limited (HKEx) and the HKICPA; and
- (d) At least four and not more than six other appointed members.

5. In gist, the members of the FRC assume the **overseeing** role over the investigations carried out by the AIB and enquiries by the FRRC. **Clause 7(4)** provides for the appointment of the Chairman of the FRC who shall be one of the appointed members of the FRC. As a good corporate governance measure and following the general practice of many statutory bodies, we propose that the Chairman, who will be non-executive, shall be supported by a CEO. **Clause 8** provides for the appointment of a CEO of the FRC, who is the administrative head of the FRC and is responsible, subject to the FRC's direction, for administering the affairs of the FRC. We propose that the Chairman, CEO and all other members of the FRC (save the ex officio member from Government) should be appointed by the Chief Executive (CE).

6. **Clause 7(2)** provides that the majority of FRC members must be "**lay persons**"⁴ (i.e. non-accountants). **Clause 7(4)** provides

⁴ **Clause 2(1)** defines a "*lay person*" to mean a person who is not a certified public accountant within the meaning of the Professional Accountants Ordinance (PAO, Cap. 50) or a member of an accountancy body that is a member of the International Federation of Accountants. This definition is modelled on section 2(1) of the PAO.

that the Chairman of the FRC shall be appointed from among the appointed members of the FRC who are lay persons. We consider that the appointment of lay members (including the Chairman) to the FRC will help ensure the independence of the new body from the accountancy profession. With the commencement of the Professional Accountants (Amendment) Ordinance 2004⁵, the majority of an Investigation Committee of the HKICPA are also lay persons.

7. In respect of the qualifications and backgrounds of the FRC members, **it is the Administration's intention to establish an independent FRC with a wide and balanced composition.** The CE would consider appointment of candidates from different backgrounds and disciplines (such as those with experience in accounting, auditing, finance, banking, law, business administration, etc.), so that the FRC could discharge its functions as well as oversee the work of the AIB and FRRC effectively. That said, **we do not propose to set out in detail the qualification requirements of the appointed members in the Bill**, so as to facilitate the CE in appointing the best available candidates in the light of actual circumstances. This proposed arrangement is consistent with the Professional Accountants (Amendment) Ordinance 2004, which prescribes no detailed qualification requirements as regards the appointment of lay members to the Council, Disciplinary and Investigation Panels of the HKICPA.

Supplementary Provisions

8. **Schedules 2 and 3** to the Bill contain supplementary provisions relating to the FRC, as well as its members and CEO. The major provisions relating to the appointment of the FRC members are as follows -

- (a) **Tenure of the FRC members:** As set out in **section 2 of Schedule 2** and **section 1 of Schedule 3**, the appointed

⁵ The Professional Accountants (Amendment) Ordinance 2004, enacted by the Legislative Council in July 2004, introduced reforms concerning, among other things, the membership of the Council, Investigation Committees and Disciplinary Committees of the HKICPA. Pursuant to the section 10(2)(e) of the PAO, the CE may appoint 4 lay persons to the HKICPA's Council. Moreover, under sections 33(3)(b) and 42C(2)(b) of the PAO, the majority of a Disciplinary Committee and an Investigation Committee of the HKICPA now comprise lay persons respectively. The relevant provisions of the Amendment Ordinance have commenced operation since November 2004.

members and the CEO of the FRC are to be appointed for a term not exceeding three years, and are eligible for reappointment. We do not prescribe the maximum number of terms an appointed member may serve, because there is already a general guideline within the Administration that a non-official member of a statutory body should not serve more than six years in any one capacity. As for the CEO post, we consider that reappointment should be allowed, having considered the post-holder's experience and performance in administering the affairs of the FRC;

- (b) **Terms and conditions of appointment:** Section 4 of Schedule 2 and section 3 of Schedule 3 provide that the terms and conditions of the appointment of the appointed members and the CEO of the FRC are to be determined by the CE. In this regard, save the CEO of the FRC, all other members of the FRC (including the Chairman of the FRC) are expected to serve on a *pro bono* basis. For the remuneration of the CEO, it is expected to be determined by the CE after taking into account factors such as the prospective appointee's background, experience and performance, together with the pay trends and levels in comparable bodies;
- (c) **The acting arrangement:** Section 3 of Schedule 2 and section 2 of Schedule 3 prescribe the acting arrangements for the Chairman, the CEO and other members of the FRC. The CE may appoint a temporary Chairman, a temporary member or an acting CEO to act in the respective place during the absence or incapacity of the Chairman, a member or the CEO (as the case may be); and
- (d) **Removal of members:** Section 5 of Schedule 2 and section 4 of Schedule 3 respectively provide for removal of the appointed members and the CEO for reasons such as bankruptcy, incapacity caused by physical or mental illness, or conviction of an offence, which render them unable or unfit to perform their functions.

9. We consider that it should suffice for the Bill to set out the broad framework in respect of the operational structure of the FRC, leaving the FRC to decide the detailed procedures for itself. **Schedule 2** proposes the key provisions relating to the **convening and conduct of meetings**. Notably, under **section 6 of Schedule 2**, we propose that at least two-third of the members constitute the quorum of any meeting of the FRC. Every matter for decision at a meeting of the FRC is to be determined by a majority of the votes of the members of the FRC present, subject to a minimum threshold of four votes. The minimum threshold will ensure that all decisions of the FRC shall not be passed by a thin “minority” of members. Moreover, in case of an equality of votes, the Chairman has a casting vote, which shall not be counted for the purpose of satisfying the “four-vote” threshold. Alternatively, the FRC may transact business by circulation of papers, vide a written resolution approved by all the members of the FRC present in Hong Kong (being not less than the number required to constitute two thirds of the members of the FRC), in accordance with **section 7 of Schedule 2**.

FUNCTIONS OF THE FRC

General Functions

10. **Clause 9** sets out the following functions of the FRC –
- (a) to receive complaints concerning “relevant irregularities” and “relevant non-compliances”⁶ in relation to listed entities⁷;
 - (b) to investigate or enquire into, in response to a complaint or

⁶ “*Relevant irregularities*” are defined in **clause 4** to cover irregularities of (a) auditors in respect of the audit of accounts of a listed entity or (b) reporting accountants in respect of the preparation of financial reports for the purposes of a listing document. “*Relevant non-compliances*” are defined in **clause 5** to cover non-compliances of financial reports of a listed entity with relevant legal, accounting or regulatory requirements. The details of the scope of these two definitions will be discussed when the Bills Committee deliberates the operation of the AIB and a FRRC.

⁷ **Clause 3** defines “*listed entity*” to mean a listed corporation or a listed collective investment scheme.

otherwise, such relevant irregularities and relevant non-compliances⁸;

- (c) with respect to each investigation or enquiry, to decide on and carry out the appropriate action in accordance with the Ordinance;
- (d) to approve and oversee the policies and activities of the AIB, a FRRC and any committee established by the FRC;
- (e) to refer to a specified body, or provide assistance to a specified body on the body's investigation or enquiry into or dealing with, any case or complaint concerning a relevant irregularity or a relevant non-compliance; and
- (f) to perform such other functions as are imposed on the FRC under the Ordinance or any other Ordinance.

11. We will discuss the investigation and enquiry powers of the FRC in detail when the Bills Committee deliberates the provisions of the Bill in relation to the operation of the AIB and a FRRC. It may, however, be pointed out here that, pursuant to **clause 9(b) or (c)**, the FRC may initiate an investigation or enquiry in response to complaints *or otherwise*. Therefore, a complaint is not a precondition for the FRC to initiate an investigation or enquiry. We consider that it is best for the FRC, as an independent investigation body, to decide its enforcement approach (i.e. whether it will adopt a proactive or reactive approach), having regard to the caseload, resources and other relevant considerations, and subject to the thresholds that restrict the initiation of the investigation or enquiry powers under clause 23 or 40 (as the case may be).

Referral of Cases or Provision of Assistance to Specified Body

12. As mentioned in paragraph 10(e) above, the FRC may refer a case or provide assistance to a “specified body”. **Clause 2(1)** defines a

⁸ Regarding the question of whether the FRC should be purely investigatory, please refer to the Administration's paper entitled “Functions of the Financial Reporting Council” (LegCo Paper No. [CB\(1\)2288/04-05\(34\)](#)).

“*specified body*” to mean a “*specified authority*” or a “*specified enforcement agency*”. “*Specified enforcement agency*” is defined to cover an exhaustive list of named agencies⁹; whereas the definition of “*specified authority*” has not named any authority but is to mean an authority, regulatory organization, or an accountancy body which is not a “*specified enforcement agency*” and is in Hong Kong or elsewhere. The definition of “*specified authority*” is intended to cover a body to which the FRC sees fit to refer cases or provide assistance but the name of which is yet to be identified until an actual case arise. In this connection, **clause 12**, which is modelled on section 186 of the SFO, prescribes a set of conditions governing the referral or provision of assistance to a “*specified authority*”. In this regard, the FRC has to be satisfied itself that¹⁰ -

- (a) the referral, or the provision of assistance, will enable or assist the specified authority to perform its functions;
- (b) it is not contrary to the interest of the investing public¹¹ or to the public interest that the case or complaint should be referred or the assistance should be provided¹²;
- (c) where the “*specified authority*” is an authority or regulatory organization in Hong Kong or elsewhere, the authority (i) performs an investigatory or enquiry function similar to that of the FRC; or (ii) regulates, supervises or investigates

⁹ “*Specified enforcement agency*” is defined in **clause 2(1)** to mean the Commissioner of Police of Hong Kong, Commissioner of the Independent Commission Against Corruption, HKICPA, SFC, HKEx, Registrar of Companies, Monetary Authority, Insurance Authority, Commissioner of Inland Revenue, Official Receiver, Mandatory Provident Fund Schemes Authority, or the Market Misconduct Tribunal.

¹⁰ Conditions (a) and (b) also apply to the disclosure of information to a “*specified enforcement agency*”, by virtue of **clause 51(4)** of the Bill. Clauses (c) to (e) are additional conditions, as safeguards, applying to the referral or provision of assistance to a “*specified authority*”.

¹¹ **Clause 2(3)** provides that a reference to the interest of the investing public in the Bill does not include any interest the taking into consideration of which is or is likely to be contrary to the public interest.

¹² Pursuant to **clause 12(3)**, in forming an opinion on the conditions (a) and (b), for the purposes of the provision of assistance to a specified authority, the FRC shall take into account whether the specified authority will pay to the FRC any of the costs and expenses incurred in providing the assistance and whether the specified authority will be able and willing to provide reciprocal assistance. This is modelled on section 186(4) of the SFO.

accountants; banking, insurance, or other financial services; or the affairs of corporations;

- (d) the specified authority is subject to adequate secrecy provisions; and
- (e) the case or complaint is referred, or the assistance is provided, with a view to the specified authority's performance of any of its regulatory, supervisory, investigatory or disciplinary function or otherwise for the purpose of such function.

13. **Clause 12(6)** provides that, where the FRC is satisfied that a specified authority has met the relevant criteria, the FRC shall as soon as practicable cause the name of the authority to be published in the Gazette. This is modelled on section 186(5) of the SFO, and is intended to enhance the transparency of such referral or provision of assistance.

14. Moreover, **clause 12(7)** is modelled on section 186(6) of the SFO with a view to prohibiting the FRC from referring any information or evidence, which is provided by a person to the FRC in the course of investigation or enquiry and might tend to incriminate himself, to a specified authority in a jurisdiction outside Hong Kong for use in criminal proceedings against the person in that jurisdiction¹³.

Other general powers

15. **Clause 10** sets out the general powers of the FRC. **Clause 10(1)** provides that the FRC may do all such things as are necessary for, or incidental or conducive to, the performance of its functions. Apart from this, the FRC may employ persons or appoint persons as consultants, agents or advisers to assist the FRC to perform its functions (c.f. **clauses 10(2)(a) and (b)**). The FRC may also enter into a memorandum of understanding with another party pursuant to **clause 10(2)(d)**. We envisage that the FRC may, if necessary, enter into such memoranda with

¹³ This is consistent with Article 14(3)(g) of the International Covenant on Civil and Political Rights (replicated in Article 11(2)(g) of the Hong Kong Bill of Rights) which provides that a person shall not be compelled to testify against himself or to confess guilt, in the determination of any criminal charge against him.

the HKICPA, other financial services regulators or law enforcement agencies to set out, for example, the interface of the work of the FRC with that of the other party, with a view to facilitating cooperation.

16. **Clause 11** deals with the delegation of functions or powers of the FRC. Furthermore, **clause 13** empowers the FRC to issue non-statutory guidelines, which are not inconsistent with the Ordinance, indicating the manner in which the FRC will perform its functions or providing guidance on the operation of any provision of the Ordinance. We envisage that these guidelines may cover issues such as the procedures for handling complaints, with a view to enhancing the transparency of the FRC's operations.

CHECKS AND BALANCES

17. We consider that there should be an effective mechanism whereby the FRC is accountable for its work and is subject to adequate checks and balances. Nonetheless, at the same time, the FRC should be able to exercise its powers in an effective way without undue hindrance. Consequently, we have exercised due care in prescribing the checks and balances which correspond to the powers vested in this new investigatory body.

18. With the objectives set out in paragraph 17 above in mind, and after making reference to the arrangements of other statutory bodies such as the SFC and the recently established Hong Kong Deposit Protection Board¹⁴, we propose to put in place in the Bill a range of checks and balances including -

- (a) **Composition of the FRC** – As mentioned in paragraphs 4 to 6 above, other than the ex officio member from Government, all members of the FRC (including the Chairman and the CEO) shall be appointed by the CE. The lay majority of the Council also help ensure the independence of the FRC from the accountancy profession;

¹⁴ The Hong Kong Deposit Protection Board is established pursuant to the Deposit Protection Scheme Ordinance (DPSO, Cap. 581) enacted by the Legislative Council in May 2004.

- (b) **Directions of the CE** – **Clause 14** provides that the CE may, after consultation with the Chairman of the FRC, and on being satisfied that it is in the public interest to do so, give the FRC written directions as he thinks fit with respect to the performance of any of its functions. This proposed reserve power is a tool of last resort for the Government, through the CE, to implement the necessary remedial measures in the most pressing and extreme circumstances. The provision is necessary to enable the Administration to continue to account to the Legislative Council and the public for effective regulation of the auditing profession¹⁵;
- (c) **FRC to furnish information** – **Clause 15** provides that the FRC shall, when required by Secretary for Financial Services and the Treasury (SFST), furnish to him such information as he specifies, on the principles, practices and policy that it is pursuing or adopting in performing its functions or exercising its powers as well as the reasons therefor;
- (d) **FRC's budget** – **Clause 17** provides that the annual estimates of the income and expenditure of the FRC shall be subject to the approval of SFST;
- (e) **Audit by the Director of Audit** – **Clause 19** provides that the Director of Audit shall be the auditor of the FRC. He is entitled to have access to the books of account and records of the FRC and to require such information and explanation as he considers necessary to perform his functions. In each financial year, the Director of Audit shall prepare a report on the audit of the financial statements of the FRC;
- (f) **Annual Report** – **Clause 20** provides that the FRC shall submit to SFST, on an annual basis, a report on the activities

¹⁵ Similar provisions providing for this CE's reserve power are found in, for example, section 11 of the SFO, section 9 of the DPSO, and section 6E(3) of the Mandatory Provident Fund Schemes Ordinance (Cap. 485).

of the FRC, its financial statements and auditors' report. These reports and statements shall be laid before the Legislative Council; and

- (g) **Oversight by The Ombudsman** – Clause 76 includes an amendment to Schedule 1 to The Ombudsman Ordinance (Cap. 397) to the effect that complaints against the actions of the FRC may be lodged with the Office of The Ombudsman.

19. Furthermore, the FRC may be subject to a **judicial review** by the court in respect of the performance of the Council's functions or exercise of its powers. We also envisage that the FRC will consider putting in place a series of administrative measures to ensure proper control of its operation. These may include drawing up internal guidelines on the exercise of the Council's powers and memoranda of understanding on cooperation with other bodies.

Need for a Separate Appeal Tribunal?

20. We have given considerable thought to the need to set up an independent tribunal to hear appeals from any party aggrieved by the actions of the FRC. **The Administration's position is that it is not necessary to establish such an appeal tribunal, as the FRC's role is mainly confined to investigatory and enquiry work and the FRC is not vested with any disciplinary power to sanction any person or impose a penalty on its own.** In this regard, our legal adviser is of the view that the investigation/enquiry and the referral of cases to a specified body by the FRC are too remote from the determination of a civil right or obligation of the person to which the case or complaint relates¹⁶. As a benchmark comparison, there is no particular appeal mechanism against an investigation by the Investigation Committee of the HKICPA and the HKICPA Council's decision to refer a case to a Disciplinary Committee.

¹⁶ Article 14(1) of the International Covenant on Civil and Political Rights (replicated in Article 10 of the Hong Kong Bills of Rights) guarantees that everyone shall be entitled to a fair and public hearing by a competent, independent and impartial tribunal established by the law *in the determination of any criminal charge against him, or of his rights and obligations in a suit at law.*

21. Having said so, **any party aggrieved by the action of the FRC may apply to the court for a judicial review of the action concerned.** Moreover, both the disciplinary decisions under the PAO¹⁷ and Court's decisions regarding the revision of accounts under **clause 50** of the Bill are appealable. Coupled with other safeguards mentioned in paragraphs 18 and 19 above, we consider that there should be no need to establish a separate appeal tribunal for this purpose.

Financial Matters

22. We note that some Members of the Bills Committee and deputations have expressed views on the adequacy of the funding for the FRC, which is to be set out in a memorandum of understanding signed among the four funding parties (viz. the Companies Registry Trading Fund, HKICPA, SFC, HKEx). The Administration has been guided by the principles that it is necessary to maintain a lean structure for the FRC and that, at the same time, the funding arrangement should be adequate for the FRC to discharge its functions effectively. In response to the views expressed by the Bills Committee Members, the Administration has written to the HKICPA, SFC and HKEx to explore whether additional resources should be injected to the FRC.

23. As far as the Bill is concerned, **clause 16** provides that the FRC is exempt from taxation under the Inland Revenue Ordinance (Cap. 112). **Clause 18** requires the FRC to prepare a statement of accounts for the financial year. As mentioned in paragraphs 18(e) and (f) above, the Director of Audit shall be the auditor of the FRC and the financial statements of the FRC shall be laid before the Legislative Council.

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¹⁷ Under section 41(1)(b)(iii) of the PAO, a certified public accountant who is aggrieved by a disciplinary order made in respect of him by a Disciplinary Committee of the HKICPA under section 35(1) of the PAO may appeal to the Court of Appeal.