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By email (hytchiu@legco.gov.hk)

26 June 2018

Clerk to Bills Committee
(Attn.: Mr Hugo Chiu)
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr Chiu,

Bills Committee on Financial Reporting Council (Amendment) Bill 2018

Follow-up to meeting on 5 June 2018

I refer to your email dated 7 June 2018. The Administration's responses are set out in **Annex** for your follow-up action.

Yours sincerely,

(Billy AU)
for Secretary for Financial Services and the Treasury

c.c.
Financial Reporting Council (Attn: Ms Florence Wong)
Department of Justice (Attn: Ms Mabel Cheung
Ms Carmen Chan)

Annex

Bills Committee on Financial Reporting Council (Amendment) Bill 2018 ("the Bill")

Response to Matters Raised by Members at the Meeting on 5 June 2018

Pecuniary penalty to be imposed by the Financial Reporting Council ("FRC") (Item 1 of the list of follow-up actions)

Under the current regime, the maximum disciplinary pecuniary penalty provided in the Professional Accountants Ordinance (Cap.50) is $500,000. There have long been views in the community that the penalty level is not sufficient to ensure a proportionate disciplinary sanction for misconduct, thus undermining the effectiveness of disciplinary sanction. The International Monetary Fund has also criticised the situation in its last review of Hong Kong's securities market under the Financial Sector Assessment Programme, as it considered that the sanctions under the current regime were very limited and recommended that the future independent auditor oversight body should be given strong enforcement power. Hence, the level of pecuniary penalty should reflect the severity of the non-compliance and our proposal has taken into full consideration the views of various stakeholders. We have also made reference to the practices of other Hong Kong financial regulatory regimes and the auditor regulatory regimes of some overseas jurisdictions (such as the US and the UK) in devising the proposal in the Bill.

2. In addition, the Bill provides that the FRC must issue guidelines on the imposition of pecuniary penalty to indicate the manner in which it exercises its power to order a public interest entity ("PIE") auditor to pay a pecuniary penalty, and to have regard to the issued guidelines when exercising such power. The FRC is committed to issuing the guidelines as soon as practicable after the Bill is enacted and certainly prior to the commencement date proposed in the Bill, i.e. 1 August 2019. In gist, the FRC must have regard to the principles of fairness and proportionality when determining the pecuniary penalty to be imposed in individual cases. The guidelines will include the factors which will be considered by the FRC including that the pecuniary penalty should not have the likely effect of putting a firm or individual in financial jeopardy. The FRC will devise details of the guidelines in due course and engage relevant stakeholders throughout the process. In view of the Bills Committee's concern regarding the guidelines, the FRC has prepared a response setting out the principles it would adhere to when devising the guidelines, and the response was submitted to the Bills Committee on 6 April 2018 (LC Paper No. CB(1)771/17-18(02)).

Financial arrangement of the post-reform FRC (Item 2 of the list of follow-up actions)

3. Further to our response submitted to the Bills Committee on 16 March 2018 (LC Paper No. CB(1)687/17-18(02)) which provides a breakdown of the estimated annual operating expenses of the post-reform FRC, additional information on the underlying assumptions of the estimates is set out in the table below —

<table>
<tr><th>Expenditure Items</th><th>Amount
(at 2016 price level)</th><th>Remarks</th></tr>
<tr><td colspan="3">Staff Costs</td></tr>
<tr><td>1. Top Management Team (including the Chief Executive Officer and other Executive Directors)</td><td>$14 million[1]</td><td rowspan="7">The number of staff of the post-reform FRC is expected to be around 70, which is about three times of the existing FRC. The majority of the staff will be professional executives responsible for the inspection, investigation and disciplinary functions in respect of PIE auditors, as well as carrying out professional independent oversight over the HKICPA's regulatory functions under the new regime. The remaining staff will be responsible for administration and clerical/ secretarial matters of the operation of the FRC.

We envisage that there will be four to five levels of the professional executives within the FRC, namely (on a descending order of rank), Executive Director, Senior Director/Director, Associate Director and Manager.

The range of salaries for each professional executive will depend on his/her personal experience and capability.</td></tr>
<tr><td>2. Investigation</td><td>$15 million</td></tr>
<tr><td>3. Inspection</td><td>$15 million</td></tr>
<tr><td>4. Discipline</td><td>$9 million</td></tr>
<tr><td>5. Oversight of the Hong Kong Institute of Certified Public Accountants ("HKICPA")'s regulatory functions in respect of PIE auditors, recognition of overseas auditors as PIE auditors and international relations</td><td>$3 million</td></tr>
<tr><td>6. Administration (including finance, public relations, human resources, information technology, general administration, secretarial services, etc.)</td><td>$9 million</td></tr>
<tr><td>7. Other staff-related expenses (including mandatory provident fund contribution, insurance, staff recruitment, staff training and development, etc.)</td><td>$6 million</td></tr>
</table>

[1] The total staff cost of the FRC for the Chief Executive Officer and the Deputy Chief Executive Officer was $6.5 million in 2016.

Non-staff Costs		
8. Rent for accommodation	$8 million[2]	The reference for the estimate was the level of rents for Grade A commercial buildings in Kowloon Bay/Kwun Tong in 2016, inclusive of all miscellaneous fees (e.g. rates, Government rent, management fees, utilities, etc.) (i.e. around $50 per square feet).
9. Other expenses (including corporate communication, legal and professional services, conference and duty visits, telecommunication, printing and stationery, depreciation, contingency, etc.)	$11 million	The proportion of non-staff costs accounted for 14% of the total recurrent expenditure of the existing FRC in 2016. Therefore, we consider the estimated amount of $11 million (around 12% of the total operating costs) for other operating costs of the post-reform FRC to be reasonable and justified.
Total	**~ $90 million[3]**	

Access to audit working papers of recognised PIE auditors kept in the Mainland (Item 3 of the list of follow-up actions)

4. The globalisation of financial markets and the increase in cross-border investment activities have led to an international trend which calls for enhanced collaboration between local and overseas financial regulators. In this regard, the FRC has been reaching out to and engaging relevant regulators in other jurisdictions.

5. Over the years, the FRC has maintained good communication with the Ministry of Finance ("MoF") on cross-boundary regulatory co-operation matters. The two bodies have been discussing a cooperation agreement on access to audit working papers kept in the Mainland. The MoF recognises the importance of allowing access by the FRC to relevant audit working papers and is considering suitable measures on cross-boundary cooperation in this area. We understand that the discussion has been making good progress and the discussion topics include the FRC's future roles under the new auditor regulatory regime. In order to enable the post-reform FRC to effectively carry out its statutory duties, the FRC

[2] At present, the office accommodation of the FRC is provided by the Companies Registry at a rental value of $1 per annum. The present provision is around 4,000 sq ft. at the Queensway Government Offices.
[3] The FRC's budget in 2016 was about $30 million.

has agreed with the MoF that the cooperation agreement will cover the FRC's regulatory functions under the new regime, namely, inspection, investigation and discipline.

6. The discussion between the MoF and the FRC will continue with a view to concluding the agreement as soon as possible. Prior to the conclusion of the agreement, the FRC will not request audit firms to produce the relevant audit working papers kept in the Mainland. The Government will closely monitor the development and maintain liaison with all relevant stakeholders.

Composition of the FRC (Items 4 and 5 of the list of follow-up actions)

The chairmanship of the FRC

7. The Government considers that the future FRC chairperson should be a non-executive director. Firstly, the chairperson should focus on matters relating to the overall direction, policies and strategies of the FRC, as well as assessing the effectiveness and efficiency of the FRC in discharging its statutory duties, having regard to the international and local developments and practices. The chairperson should not be pre-occupied by day-to-day executive responsibilities. Moreover, the chairperson should be independent from the executive arm so as to enhance the internal checks and balances mechanism, e.g. it would facilitate the implementation of the Chinese Wall policy that the executives who have participated in the investigation/inspection or disciplinary processes of a case would not take part in making a disciplinary decision of the case.

8. We have also made reference to local and overseas experience. The auditor regulatory bodies in major overseas jurisdictions (such as the UK Financial Reporting Council) are chaired by a non-executive director. Other financial regulators in Hong Kong (including the Securities and Futures Commission, the Mandatory Provident Fund Schemes Authority and the Insurance Authority) are also led by non-executive chairpersons.

Background of persons to be appointed as members of the FRC

9. The proposed section 7(4)(b) provides that some members of the FRC should be appointed because of their *knowledge* in accounting, auditing, finance, banking, law, administration or management (i.e. section 7(4)(b)(i)) or their professional or occupational *experience* (i.e. section 7(4)(b)(ii)). We consider that the provisions are appropriate to allow the Government to appoint suitable persons with the relevant knowledge or experience to the Council, including those who have profound knowledge in the fields but do not possess the relevant professional or occupational experience (e.g. academics). It is

also worth noting that section 4AA(3)(b) of the Insurance Ordinance (Cap.41) (as added by the Insurance Companies (Amendment) Ordinance 2015) also contains similar background requirements for persons to be appointed as members of the Insurance Authority.

The function and power of the FRC in overseeing the HKICPA's performance of functions relating to registered PIE auditors (Item 6 of the list of follow-up actions)

10. For the purpose of enabling the FRC to perform independent oversight of the HKICPA's regulatory functions (viz. registration of PIE auditors; establishing and maintaining the PIE auditors register; setting continuing profession development requirements for registered PIE auditors; and setting standards on professional ethics, auditing and assurance practices for registered PIE auditors) as stipulated in the proposed section 9(b), the proposed section 10(1A) provides for a light-handed oversight model by empowering the FRC to –

(a) request the HKICPA to provide relevant information and periodic reports on its performance of a specified function;

(b) conduct assessment on the HKICPA's performance of a specified function; and

(c) if satisfied that it is in the public interest to do so, give the HKICPA written directions on the performance of a specified function.

Our policy intention is that these are the specific powers that may be exercised by the FRC for overseeing the HKICPA's performance of specified functions in respect of PIE auditors as stipulated in the proposed section 9(b). It is also our policy intention that once a written direction is issued by the FRC to the HKICPA, the latter must comply with the direction for protecting the public interest. This is provided in the proposed section 10(1B). We are of the view that as a statutory professional body which shoulders some of the regulatory functions in the regime, the HKICPA will cooperate with the FRC if any such direction is issued. With this in mind, we consider that the scope of the proposed section 10(1B) is appropriate.

11. The oversight model proposed in the Bill was the outcome of the tripartite meetings between the Financial Services and the Treasury Bureau ("FSTB"), the FRC and the HKICPA, as reflected in the consultation paper in 2014 and supported by the overwhelming majority of respondents during the public consultation. The three parties have agreed that the framework of the oversight model should be provided in the legislation, whilst the operational details of the arrangement should be set out in a Memorandum of

Understanding ("MoU") to be agreed between the FRC and the HKICPA. After the Bills Committee has the opportunity to thoroughly discuss the key functions and arrangements of the FRC under the new regime, the FRC and the HKICPA will as soon as possible commence the discussion on the relevant MoU, which should cover various aspects including –

(a) the types of information the FRC may require the HKICPA to produce for the oversight function and the likely circumstances under which the FRC would exercise this power;

(b) the information to be included in the periodic reports of the HKICPA and the frequency of submitting the periodic reports by the HKICPA to the FRC;

(c) the scope, criteria, work flow and procedures of the assessment to be carried out by the FRC on the HKICPA; and

(d) the circumstances under which the FRC would issue written directions to the HKICPA and the relevant procedures involved.

FSTB will participate in the discussion between the FRC and the HKICPA on, amongst other things, the relevant MoU with a view to facilitating the early conclusion of the MoU (and certainly prior to the commencement date proposed in the Bill, i.e. 1 August 2019).

Financial Services and the Treasury Bureau
26 June 2018