

II. REPORT

The date of First Reading of the Bill is 24 January 2018. Members may refer to the Legislative Council ("LegCo") Brief (File Ref.: ACCT/2/1/2C) issued by the Financial Services and the Treasury Bureau dated 17 January 2018 for further details.

Object of the Bill

2. The Bill seeks to amend the Financial Reporting Council Ordinance (Cap. 588) to:

- (a) enhance the independence of the regulatory regime for auditors of listed entities ("ALEs");
- (b) regulate ALEs through registration, recognition, inspection, investigation and disciplinary sanction;
- (c) provide for a review and appeal mechanism regarding decisions made against ALEs;
- (d) provide for the new composition and functions of the Financial Reporting Council ("FRC");
- (e) provide for levies payable to FRC; and
- (f) provide for transitional and related matters.

Background

3. At present, FRC established under Cap. 588 is independent of the audit profession. FRC's functions include conducting investigations into possible auditing and reporting irregularities of ALEs. According to paragraphs 3 to 7 of the LegCo Brief, it has become the international standard and practice in recent years that regulatory regimes for auditors of public interest entities ("PIEs") should be independent of the audit profession and be subject to independent oversight by bodies acting in the public interests. As the regulatory regime in Hong Kong has been considered as self-regulatory, Hong Kong is not able to be represented on the International Forum of Independent Audit Regulators. Further, the International Monetary Fund ("IMF") conducted a review of the Hong Kong regulatory regime against the

principles of securities regulation introduced by the International Organisation of Securities Commissions in 2014 and has made certain recommendations. The Administration considers it necessary to reform the existing auditor regulatory regime in the light of IMF's recommendations and to bring the regime in line with the latest international standard and practice.

Key provisions of the Bill

4. The Bill introduces a new regulatory regime for PIE auditors with FRC acting as the independent audit oversight body responsible for the inspection, investigation and disciplinary matters with regard to PIE auditors. PIE is defined in the proposed section 3 of Cap. 588 to mean (a) a listed corporation the listed securities of which comprise at least shares or stocks; or (b) a listed collective investment scheme. The key features of the new regulatory regime are summarized in the ensuing paragraphs.

Registration and recognition of PIE auditors

5. At present, Cap. 588 does not provide for registration and recognition for PIE auditors. The Bill seeks to add a new Part 3 to Cap. 588 to provide for the registration of local auditors as PIE auditors by the Council of the Hong Kong Institute of Certified Public Accountants ("HKICPA") and recognition of overseas auditors or certain Mainland auditors as PIE auditors by FRC. A person who undertakes or carries out any PIE engagement specified in the new Schedule 1A to Cap. 588¹ commits an offence if the person is not a registered or recognized PIE auditor. The offence is punishable, on conviction on indictment, to a fine of \$1,000,000 and to imprisonment for two years and, for a continuing offence, to a further fine of \$20,000 for each day during which the offence continues; and on summary conviction, to a fine of \$100,000 and to imprisonment for six months, and for a continuing offence, to a further fine of \$2,000 for each day during which the offence continues.

Inspection, investigation, disciplinary matters and sanctions

6. The Bill seeks to add a new Part 3A to Cap. 588 to provide that FRC may direct inspections in relation to PIE engagements completed by PIE auditors as to whether the provisions of Cap. 588 or a professional standard have been complied with. The Bill also seeks to provide for the circumstances

¹ PIE engagements are specified in the new Schedule 1A to include the preparation of an auditor's report in relation to annual accounts required to be prepared under the Listing Rules.

under which FRC may direct an investigation. Such circumstances include where FRC has reasonable cause to believe that a PIE auditor has carried out a PIE engagement in a way that is not in the interest of the investing public or in the public interest.² The Bill also seeks to add a new Part 3B to Cap. 588 to provide for disciplinary matters for misconduct by PIE auditors and the sanctions that may be imposed by FRC.

Review and appeal against decisions of HKICPA Council and FRC

7. The Bill seeks to add a new Part 3C to Cap. 588 to provide for a review and appeal mechanism regarding decisions on PIE auditors by HKICPA Council and FRC. The new Part 3C of and Schedule 4A to Cap. 588 provide for the establishment of the Public Interest Entities Auditors Review Tribunal ("PIEART"). Its jurisdiction includes reviewing decisions on the refusal of registration or recognition of PIE auditors, and sanctions imposed on PIE auditors for misconduct. A party who is dissatisfied with a determination made by PIEART may, with leave, appeal to the Court of Appeal.

8. Other proposals in the Bill are summarized in the following paragraphs.

New composition and functions of FRC

9. At present, FRC members must include the Registrar of Companies (or his representative), and members nominated by HKICPA, the Securities and Futures Commission ("SFC") and the Hong Kong Exchanges and Clearing Limited ("HKEX") respectively. Clause 9 of the Bill seeks to repeal these requirements and empower the Chief Executive to appoint all FRC members. The Bill also seeks to amend section 9 of Cap. 588 to provide, among other things, for FRC's functions under the new regime to regulate PIE auditors through the proposed registration and recognition system, and through inspection, investigation and disciplinary sanction and to oversee HKICPA's performance of certain functions in respect of PIE auditors. The Bill also seeks to provide additional powers for FRC to perform its functions under the new regime.

Levies

10. At present, FRC is funded through an ad hoc agreement between HKICPA, SFC, HKEX and the Companies Registry Trading Fund. The Bill proposes that FRC would be funded by three new levies on securities

² See the proposed section 23(1)(a) of Cap. 588.

transaction, PIEs and PIE auditors. According to paragraph 25 of the LegCo Brief, the levies would ensure stability of funding support to FRC and it would be collected in accordance with the principle that FRC should be operationally and financially independent of the Government and the "user pay" principle.

Transitional arrangements and related amendments

11. The Bill also seeks to provide for transitional arrangements for auditors who have undertaken engagements in the nature of PIE engagements and for investigations initiated before the commencement of the provisions introduced by the Bill and make related amendments.

Commencement

12. The Bill, if passed, will come into operation on 1 August 2019.

Public Consultation

13. According to paragraph 32 of the LegCo Brief, the Administration conducted a three-month public consultation exercise from June to September 2014 to solicit views on the proposal to introduce an independent oversight regime for the regulation of PIE auditors. An overwhelming majority of the respondents were supportive of the objective and direction of the reform. The consultation conclusions were published in June 2015.

Consultation with LegCo Panel

14. According to the Clerk to the Panel on Financial Affairs, the Panel discussed the reform proposals to improve the regulatory regime for ALEs on 7 July 2014. The Government briefed the Panel on the results of the public consultation on the reform proposals on 6 July 2015. Panel members raised concerns and enquiries on a number of issues at the two meetings, including the reasons for subjecting only ALEs instead of the entire audit profession to the reform; whether the proposed expansion of the regulatory remit of the FRC would lead to over-concentration of powers of FRC; the measures to ensure fairness and due process of FRC in exercising its powers over PIEs, including the need to separate FRC's investigation and disciplinary mechanisms; the proposed level of pecuniary penalty on listed entity auditors and registration of listed entity auditors.

Conclusion

15. LSD is scrutinizing the legal and drafting aspects of the Bill. A further report will be made, if necessary. As the Bill seeks to introduce a new regime for regulating PIE auditors and reform the composition of FRC, Members may wish to form a Bills Committee to study the Bill in detail.

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