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We hope that you find this edition informative and we welcome your comments and suggestions for future topics.

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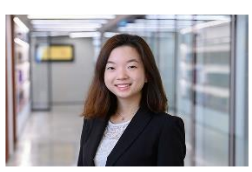

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Court of Appeal Ruled Overseas Merger Exempt from Hong Kong Stamp Duty

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The Court of Appeal recently handed down its judgment in **Nomura Funds Ireland Plc v The Collector of Stamp Revenue** *[2021] HKCA 1040* and held that the vesting of Hong Kong stock in a merger by way of universal succession[1] does not give rise to stamp duty under Hong Kong law. Prior to the judgment, the applicability of stamp duty in overseas mergers of companies holding Hong Kong stock was not statutorily codified. The present case is the first time a judicial authority in Hong Kong has confirmed such a position.

Background of the Case

The present case concerns a dispute arising from the merger of two funds in the Nomura group (the "**Merger**").

Nomura Funds Ireland Plc, the appellant, is an investment company incorporated in Ireland, structured as an umbrella fund consisting of different sub-funds. The appellant is authorised by the Central Bank of Ireland as an Undertaking for Collective Investment in Transferrable Securities ("**UCITS**") pursuant to a directive published by the European Union. Nomura Funds Ireland – China Fund ("**Receiving Sub-Fund**") is one of the sub-funds of the appellant.

Nomura Funds ("**Nomura Luxembourg**") was another investment company incorporated in Luxembourg, which was also a UCITS, with Nomura Funds – China Opportunities ("**Merging Sub-Fund**") as its sole sub-fund. The assets in the Merging Sub-Fund consisted entirely of securities listed on the Hong Kong Stock Exchange ("**HK Securities**").

The appellant and Nomura Luxembourg proposed to merge the Receiving Sub-Fund and the Merging Sub-Fund in accordance with the Luxembourg law relating to UCITS ("**Luxembourg UCITS Law**") and based on the following draft key terms set out in a written instrument titled "Common Merger Proposal" ("**CMP**"):

- the Merger would be made in accordance with the relevant articles of the Luxembourg UCITS Law;
- on the effective date of the Merger, the Merging Sub-Fund would transfer all its assets and liabilities to the Receiving Sub-Fund as a contribution in specie, in exchange for shares in the Receiving Sub-Fund to be issued to the sole shareholder of the Merging Sub-Fund, namely, Samba Capital and Investment Management Company, a company incorporated in Saudi Arabia; and
- the shares of the Merging Sub-Fund would be cancelled and Nomura Luxembourg would cease to exist.

According to Luxembourg UCITS Law, where the merging UCITS is established in Luxembourg, its merger with another UCITS is subject to the prior approval by the Luxembourg Commission for the Supervision of the Financial Sector ("**CSSF**") which will determine if the draft CMP prepared by both parties to the merger meets the prescribed statutory conditions.

In March 2015, the CSSF notified Nomura Luxembourg that it had no objection to the Merger. The Merger proceeded to take place in April 2015 and subsequently the assets of the Merging Sub-Fund, i.e. the HK Securities, were transferred to the Receiving Sub-Fund. Nomura Luxembourg was later deregistered in May 2015.

The Dispute in the Present Case

The HK Securities were Hong Kong stock within the meaning of Section 2 of the Stamp Duty Ordinance (Chapter 117 of the laws of Hong Kong) ("**SDO**"), and the transfer of any beneficial

[1] The doctrine of universal succession originates from Roman law. In brief, the doctrine of universal succession provides that where the law of incorporation recognises a succession of corporate personality from one corporate entity to another, then the law of the forum will recognise both the changed status of the company, and the fact that the successor will inherit all rights and liabilities of its predecessor. Since the doctrine was not in dispute in the present case, we will not further examine it in this Bulletin.

interest in Hong Kong stock is chargeable to stamp duty under Section 4 and Head 2(3) of the First Schedule to the SDO. The substantive issue in dispute was whether the Merger constituted a "transfer" of beneficial interest in Hong Kong stock within the meaning of the SDO.

The appellant sought stamp duty relief from ad valorem stamp duty ("**AVSD**") under Section 27(5) of the SDO with regards to the vesting of HK Securities on the grounds that (i) there was no "transfer", but only "transmission" of the HK Securities, which was effected by operation of the Luxembourg UCITS Law, rather than by the CMP; and (ii) no beneficial interest in the HK Securities passed under the CMP as the vesting of HK Securities amounted to a "transmission" or "universal succession" under Luxembourg UCITS Law. Therefore, the CMP should not be a "stampable" instrument under Head 2(3) of the First Schedule to the SDO. The appellant's view was supported by two Luxembourg legal opinions ("**Luxembourg Legal Opinions**") and the same were submitted to the Collector of the Stamp Revenue (the "**Collector**").

The Collector disagreed with the appellant and held that the CMP was chargeable to AVSD because (i) the Merger operated as a voluntary disposition inter vivos; and (ii) the CMP was made for the purpose of effecting a transaction whereby the beneficial interest in the HK Securities passed.

The District Court Decision

The appellant appealed to the District Court, which upheld the Collector's position on the grounds that (i) the CMP stated that the transfer of the assets and labilities to the Receiving Sub-Fund was to be done "in accordance with" (in contrast to "by operation of") Luxembourg UCITS Law; (ii) the distinction between "transfer" (by voluntary acts) and "transmission" (by operation of law), if any, and in other contexts (e.g. companies law), is wholly irrelevant to the present case, and in particular, the Collector agreed that "transfer" for the purposes of Head 2(3) of the First Schedule to the SDO should be construed with its natural and ordinary meaning, i.e. "one parting with something to another"; and (iii) the Luxembourg Legal Opinions were inconsistent with each other and the second Legal Opinion lacked legal analysis and was not supported by the plain reading of the statutory provisions of the Luxembourg UCITS Law. Hence, the CMP should be chargeable to stamp duty.

The Court of Appeal Decision

The Court of Appeal overturned the District Court decision and ruled in favour of the appellant. The Court of Appeal held that the CMP is not itself a stampable instrument and there was no change in beneficial ownership of the HK Securities. The Court of Appeal set out in the judgment each of the grounds of appeal raised by the appellant, and in summary:

Grounds 1 & 2: Did the District Court err in law by rejecting the Luxembourg Legal Opinions? Alternatively, did the District Court err in law by interpolating its own interpretation of Luxembourg UCITS Law?

The Court of Appeal was of the view that the Luxembourg Legal Opinions were not inconsistent with each other and that the District Court erred for not accepting the Opinions. In fact, the Court of Appeal held that the Luxembourg lawyers provided clear and cogent reasons in support of their view that the vesting of the HK Securities in the Receiving Sub-Fund was effected through the operation of transmission by law but not by the CMP.

Ground 3: Did the District Court err in law by finding there was no material distinction to be drawn between a "transfer" and a "transmission" in the context of the charge to AVSD?

Given the reasoning set out above, the Court of Appeal found that it was not necessary to deal with this Ground 3. Nevertheless, for the sake of completeness, the Court provided its view that the Merger met the essential criteria of a universal succession by law despite the word "transmission" not being mentioned in the relevant articles of the Luxembourg UCITS Law. It was clear to the Court that the vesting of the HK Securities in the Receiving Sub-Fund was by way of universal succession and as such was not subject to stamp duty under the SDO.

Ground 4: If there had been a "transfer" of the HK Securities, would the said "transfer"

be exempt under Section 27(5) of the SDO by virtue of being a transfer under which no beneficial interest passes?

Given the above conclusions, the Court of Appeal found that it was unnecessary to consider this Ground.

No interest on Refund of Stamp Duty

Another interesting point to note from the present case is that after the Court of Appeal ordered the Collector to refund the full amount of the stamp duty paid by the appellant, the appellant sought interest on the refund of the duty paid at the rate of 8% per annum, accruing from the date of its payment to the Collector, based on (i) common law restitution that the Collector was unjustly enriched with the benefit and use of the paid stamp duty proceeds; and (ii) Section 49 of the District Court Ordinance (Chapter 336 of the laws of Hong Kong), pursuant to which the District Court may order simple interest on the debt or damages in respect of which a judgment is given by Court at the rate as it thinks fit.

The Court of Appeal rejected the appellant's request and agreed with the Collector's view that the appellant should not be entitled to interest on the refund as the statutory appeal regime under the SDO was not intended to award interest on any refunds for any payer of stamp duty who successfully challenged the Collector's assessment on appeal. In the present case, Section 14 of the SDO provided for the statutory regime under which a stamp duty payer can appeal against the Collector's assessment. The Court of Appeal was of the view that Section 14 of the SDO was intended by the legislature to provide an exhaustive appeal scheme setting forth the circumstances and terms under which payments of stamp duty wrongly assessed may be recovered. The Court of Appeal noted that the legislature, as a matter of policy, had balanced the need to have the stamp duty paid to the public purse first despite an ongoing appeal with the prejudice that may be suffered by any payer of stamp duty in the event that it is successful in its appeal. Accordingly, it could not be the intention of the legislature to allow for interest to be payable on any such recovered amounts.

Key Takeaway

This case has set a legal precedent in Hong Kong on the stamp duty implications arising from an overseas merger. The case also confirms that "transfers" of Hong Kong stock by way of universal succession (i.e. the surviving entity inherits all assets and liabilities of the absorbed entity by operation of law, such that upon merger, the former would be treated as good as the latter in law) should not give rise to any charge to stamp duty. Although the underlying assets being "transferred" in the present case were Hong Kong stock, it is expected that the same principle will also apply to immovable properties situated in Hong Kong.

Start-ups: Practical Tips on Fundraising

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When raising funds for your company, there are certain steps that you can take both before and during the fundraising exercise in order to smooth the process. This article provides some general and practical guidance to start-up companies looking to raise funds as well as a brief overview of the key legal documents that you will likely encounter.

Be prepared

Before embarking on a fundraising round, it is important to get your ducks in a row. As part of your preparations, you should have ready some basic core materials that any potential investor will typically expect to see during the due diligence stage such as:

- products and/or services;
- historic performance data;
- the actual new product / invention;
- financial statements and recent management accounts of the company;
- biographies and credentials of key persons (including shareholders and directors) and employees involved in the company and an organisation chart; and
- information and documents relating to the company's cap table, existing assets and liabilities, incorporation and corporate structure (including group chart).

Having a set of well-prepared core documents at the outset can help you in making a good first impression on investors and by expediting the due diligence process (more on this below).

Term sheet

A term sheet (also known as a letter of intent (LOI), memorandum of understanding (MOU) or heads of terms) is by no means mandatory (some just go straight to drafting the final contracts), but it does feature regularly in transactions as a means of recording the principal terms on which the investor(s) will, subject to the satisfaction of any mutually agreed conditions, invest in the target company.

Generally term sheets are not binding on the parties except for certain provisions such as confidentiality and the governing law clause. Nevertheless, it is an important document because it sets the basis and tone for the negotiation and drafting of the definitive transaction documents and, once signed, the investor(s) may be reluctant to deviate from the agreed terms. Therefore, you should consider having a lawyer review your term sheet before signing it. In addition, you should also pay attention to any exclusivity clauses which could restrict your ability to approach or otherwise deal with other potential investors.

Due diligence

Due diligence is the process by which a third party investor obtains information and documents about a target company (including financial and legal information and documents). Seasoned investors will usually kick-start the process by sending their preferred form of due diligence questionnaire to the company's management and/or representatives who must then provide the requested information and documents in the agreed manner and, if applicable, by the agreed deadline. Generally speaking, the due diligence process becomes lengthier and more complex with the maturity of a start-up company. In contrast, due diligence should be a relatively straight-forward exercise with younger start-up companies.

As mentioned above, advance preparation of core documents can greatly assist in expediting the due diligence process. Insofar as the legal due diligence is concerned, a start-up company which is incorporated in Hong Kong should be prepared to provide the following corporate information and documents when requested by an investor:

- certificate of incorporation;
- certificate of change of name;
- business registration certificate;
- articles of association;
- copy of the shareholders' agreement relating to the company (if any);
- copies of the company's registers of members, directors and transfers;

- copies of all documents filed at the Companies Registry in respect of the company since the date of incorporation (or in respect of a period specified by the investor);
- complete set of executed documents relating to previous financing rounds and share cap table (if any);
- copies of all convertible notes / bonds, options, warrants and other securities convertible into shares that have been issued by the company;
- copies of all loan / facility agreements, security, guarantee and finance documents;
- copies of employment contracts of key employees and option schemes and benefits (if any);
- copies of all material contracts of the company (e.g. client contracts and supply contracts);
- documents relating to any premises owned and/or leased by the company;
- documents relating to intellectual property owned and/or used by the company including licences and evidence of registration; and
- information regarding any pending or threatened litigation, arbitration or other proceedings involving or affecting the company or any of its assets.

The above list is not exhaustive and will be tailored to suit the circumstances including the potential investment amount, the sector in which your start-up company operates, and the maturity of your start-up company.

After you have responded to the investor's due diligence questionnaire, you may receive further rounds of follow-up questions and requests. You should answer them honestly and avoid withholding information for fear of scaring off the potential investor. Most issues are capable of being resolved or managed from a risk allocation perspective. For more complex requests concerning legal issues and documentation, a lawyer can assist you.

Involving a lawyer in the legal due diligence process is helpful when it eventually comes to negotiating the representations and warranties to be given by the company and/or the founders to the investor.

The transaction documents

If you have cleared the due diligence stage, the next step is to negotiate, agree and execute the transaction documents. Each round of investment is usually labelled as a 'Series' (such as a Series A Investment) with the earliest rounds being labelled as 'Seed Round(s)'. Institutional investors will usually invest in the equity of your start-up company (though there are different types of investment), which means that such institutional investors will become shareholders of your start-up company. In an equity investment involving a subscription for shares, the transaction documents will generally include a subscription agreement, a shareholders' agreement (or, as the case may be, an amended shareholders' agreement) and amended articles of association.

A subscription agreement, as the name suggests, is the contract that governs the terms for subscribing for new shares that will be issued by the start-up company. Such an agreement would contain key terms for the subscription such as subscription price and the number of shares that will be subscribed. A subscription agreement will also set out representations and warranties about the start-up company and, where relevant, its subsidiaries. Contractual warranties are statements made by a person (whether that person be a founder, the start-up company, or the relevant subsidiary) in favour of an investor (or the investors) about the conditions of the relevant company to which the warranties relate. The main purpose and effect of such warranties is to impose legal liability upon the warrantor making such statements and to provide the investor with a remedy if the statements made about the relevant company prove to be incorrect, and the value of the start-up company thereby reduced (i.e. where the investor suffers a loss). As an investor will have direct recourse against the person who gives the warranties, it is not uncommon to request a subsidiary of the start-up company, that owns the relevant assets and operates the actual business, to be a party to the subscription agreement and to give warranties.

The shareholder rights of an institutional investor are usually different from (and usually better than) that of a founder. For instance, an institutional investor may request that certain critical matters (commonly known as reserve matters) can only be carried out with the consent of such investor. An investor may also ask for liquidation preference where their rights to a distribution of assets of the company will rank ahead of an ordinary shareholder (e.g. the founder). Different shareholder rights can be distinguished by different 'classes' of shares. Usually institutional investors' shares that have better rights are called 'Preferred Shares'. The rights of the shareholders are usually set out in the articles of the start-up company and the shareholders' agreement. The model articles that are prescribed to a Hong Kong company at its incorporation do not provide for a separate class of shares, and would need to be amended in order to accommodate an investor's request for different class rights. It is also important to amend the articles so that they are consistent with the terms of the shareholders' agreement. A failure to do so may cast doubt on the enforceability of a specific right or obligation to the extent that there exists any inconsistency.

A lawyer can guide you through the entire fundraising process and advise you on the legal risks and implications of the terms of your transaction. For more information on fundraising and how MinterEllison LLP can assist you, please contact George Tong or Caroline De Souza.

Exclusive Jurisdiction Clause in Favour of Foreign Courts Can be Overridden

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The Court of First Instance ("**CFI**") has recently decided in the case of *Quaestus Capital Pte Ltd v Everton Associates Limited and another* [2021] HKCFI 1367 on an interlocutory challenge to the Hong Kong courts' jurisdiction by a securities brokerage firm involved in a "non-recourse" loan scheme. The brokerage firm relied on an exclusive jurisdiction clause in favour of London courts in the relevant brokerage agreement to seek to set aside an order for serving the writ out of the jurisdiction pursuant to Order 11 of the Rules of the High Court.

The CFI ruled that notwithstanding the existence of the exclusive jurisdiction clause, which was wide enough to cover the borrower's claims, there was strong cause to allow the proceedings to continue against the brokerage firm in Hong Kong.

Background

The borrower of the "non-recourse" loan was a private equity firm incorporated in Singapore which wished to obtain funds to finance its business operations. By 'non-recourse', it meant that the lender shall only look to the collateral security for repayment of the loan, and may not make any further claim against the borrower in case of a default.

Through an intermediary, the borrower was introduced to the lender, and entered into an "equity collateralised non-recourse non-title transfer term loan" by using the shares ("**Shares**") in China Metal Resources Utilization Limited (a company listed on the Stock Exchange of Hong Kong) held by the borrower as collateral.

On 21 April 2020, the borrower and the lender entered into a loan agreement and a pledge agreement. The borrower was required by the agreements to transfer the Shares as collateral into a brokerage account, which was specified in the loan agreement as Look's Securities Limited ("**Look's**"), a brokerage firm in Hong Kong nominated by the lender. The borrower, lender and Look's entered into a collateral management agreement which governed the custodian arrangements of the collateral. All agreements entered into were governed by Hong Kong law and provided for the non-exclusive jurisdiction for the Hong Kong courts. The agreements also made clear that there would be no change in beneficial ownership of the collateral except upon occurrence of an event of default.

On 1 June 2020, pursuant to the loan agreement, the borrower deposited 94 million Shares with Look's. A few days later, the lender stated that there would be delay in the funding due to bank compliance issues, and requested the borrower to open an account with another brokerage, Axis Capital Markets Limited ("**Axis**"), where the lender had the funds immediately available. The borrower agreed and opened an account with Axis. In doing so, the borrower entered into a brokerage account control agreement ("**Axis Agreement**") with the lender and Axis. The Axis Agreement contained an English choice of law clause and an exclusive jurisdiction clause in favour of courts in London.

However, even though no money was ultimately advanced by the lender to the borrower pursuant to the loan agreement, it transpired that the Shares were disposed of, without the borrower's knowledge, through a hypothecation agreement entered into between the lender and a third party.

The borrower's case was that the lender, Axis and the third parties involved in the disposing of the Shares were all part of a fraudulent scheme.

The exclusive jurisdiction clause

The Axis Agreement provided that:-

"*Consent to Jurisdiction; Venue; Jury Trial Waiver. Each of the parties hereto hereby consents to the exclusive jurisdiction of the courts sitting in London, England, as well as to the jurisdiction of all courts from which an appeal may be taken from the aforesaid courts, for the purpose of any suit, action or other proceedings by any party to this* [Axis Agreement]*, arising out of or related in any way to this* [Axis Agreement]*, or any related document. Each of the parties hereto hereby irrevocably and unconditionally waives any defense of any inconvenient forum to the maintenance of any action or proceedings in any such court, any objection to venue with respect to any such action or proceeding and any right of* *jurisdiction on account of the place of residence or domicile of any party hereto.*"

The borrower's argument that the Hong Kong courts ought to have jurisdiction to adjudicate the disputes involving Axis was threefold:-

(i) The borrower's claims did not fall within the scope of the exclusive jurisdiction clause as its claims were formulated on the basis that the Axis Agreement did not represent a genuine transaction but was an instrument used in the fraud, and did not arise out of and did not relate to the Axis Agreement. Instead, its claims arose out of and were related to the fraudulent scheme in which Axis was involved.

(ii) The exclusive jurisdiction clause in the Axis Agreement was part of the fraudulent scheme and therefore null and void.

(iii) Even if the exclusive jurisdiction clause was valid, there was strong cause for the borrower to be allowed to continue its action against Axis in Hong Kong.

CFI's ruling

The CFI held that the exclusive jurisdiction clause was drafted widely, and there was a presumption that the parties likely intended that any dispute arising out of the relationship they have entered into, whether arising in contract, tort or some other cause of action, would be decided by the courts in London. The borrower's claim against Axis, whether for fraud or knowing receipt, arose out of Axis' custody of the Shares which came about as a direct result of the Axis Agreement and their subsequent disposition. As such, the borrower's claims were subject to the exclusive jurisdiction clause.

The CFI rejected the contention that since "fraud unravels everything", the exclusive jurisdiction clause contained in the Axis Agreement would therefore be null and void. The CFI applied the doctrine of separability with respect to jurisdiction clauses, which would be viewed as a distinct agreement and can thus only be avoided on grounds which relate directly to the jurisdiction clause. In the absence of any suggestion that the borrower was not aware of the jurisdiction clause or was specifically misled into agreeing to give the English courts exclusive jurisdiction, the exclusive jurisdiction clause was not excluded from application to a dispute involving claims that the agreement as a whole is vitiated (e.g. by fraud).

Having decided that the exclusive jurisdiction clause was applicable, the CFI was nonetheless satisfied that there was strong cause for not giving effect to the clause and exercised its discretion to refuse an order to set aside the service of the writ out of jurisdiction.

In allowing proceedings to be continued against Axis in Hong Kong, the CFI's main consideration appeared to be to avoid multiplicity of proceedings. Given the fact that jurisdiction clauses in the loan agreement and pledge agreement between the borrower and the lender provided for the Hong Kong courts to have jurisdiction, and the jurisdiction clause in the Axis Agreement provided for the London courts to have jurisdiction, there would necessarily be two sets of proceedings, one in London and another in Hong Kong, if the borrower could not proceed with its claim against Axis in Hong Kong. The learned judge found it necessary to avoid a 'disastrous' situation where there are separate actions in different jurisdictions culminating in two separate trials and two judgments by two different tribunals, each based on incomplete materials, with a real risk of inconsistent findings.

Nevertheless, the learned judge left it open for Axis to claim damages for any loss it suffers as a result of the borrower's breach of the exclusive jurisdiction clause (e.g. any additional expense incurred in having to litigate in Hong Kong as compared to London).

Takeaway

If contracting parties have agreed that a foreign court should have exclusive jurisdiction over disputes arising out of the contract, the court will ordinarily enforce the agreement by staying proceedings in Hong Kong. Nevertheless, the court has a discretion to refuse to stay proceedings brought in breach of such agreement if there is "strong cause" for doing so.

In the present case, the CFI was satisfied that the claimant has demonstrated that there was a "strong cause" for allowing proceedings to continue in Hong Kong in spite of an exclusive jurisdiction clause in favour of London courts, by reason of multiple parties being involved in a dispute arising out of the same facts, the fact that part of the dispute would be litigated in the Hong Kong courts, and there being a real risk that multiplicity of proceedings would give rise to inconsistent findings of facts by different tribunals.

One further point to note – in the present case, even though the borrower successfully resisted the jurisdictional challenge, the CFI refused to make any order as to costs due to material non-disclosure on the part of the borrower in its *ex parte* application to serve its writ of summons out of the jurisdiction. The learned judge criticised the borrower for not making any reference in its affidavit in support to the need to show strong cause or strong reasons why the Hong Kong court should assume jurisdiction despite the exclusive jurisdiction clause in favour of London, and that no attempt was made to demonstrate such strong cause. This omission was exacerbated by the fact that Axis had already referred to principles surrounding exclusive foreign jurisdiction clauses in earlier interlocutory applications. It is therefore important to bear in mind the duty of full and frank disclosure in making *ex parte* applications for service out of the jurisdiction.

Further Accouting Reform: the Financial Reporting Council (Amendment) Bill 2021

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On 16 July 2021, the Financial Reporting Council (Amendment) Bill 2021 (the "**Bill**") was gazetted. The Bill aims to further develop the Financial Reporting Council ("**FRC**") into a fully-fledged independent regulatory and oversight body for the accounting profession. It seeks to amend the Financial Reporting Council Ordinance (Cap. 588) ("**FRCO**") to, *inter alia*, enhance the independence of the regulatory regime for accounting professionals; to regulate accounting professionals through registration, issuing practising certificates, inspection, investigation and disciplinary sanction; to rename the FRC; and to provide for the new functions of the FRC[2].

Background

At present, the Hong Kong Institute of Certified Public Accountants (the "**HKICPA**") is vested with certain regulatory powers in respect of certified public accountants ("**CPAs**") and practice units[3] which include *among other things*, issuance of practising certificates, registration, investigation and discipline over the same under the Professional Accountants Ordinance (Cap. 50) ("**PAO**"); whereas the FRC is responsible for regulating auditors of Public Interest Entities ("**PIE**")[4] and exercises powers of inspection, investigation and discipline over PIE auditors and their responsible persons in relation to their engagements for listed entitles under the FRCO.

The regulation of PIE auditors by the FRC was pursuant to a reform proposal introduced in 2018 to transfer such powers from the HKICPA to the FRC. The Government has been taking a step-by-step approach to achieve regulatory reform and indicated that further reform would be on the way. Against such background, the Bill has been introduced to transfer further powers currently exercised by the HKICPA to the FRC.

The Legislative Proposal

The key aspects of the proposal are summarised as follows:

(i) Renaming of the FRC

In view of the expansion of the scope of regulation beyond PIE auditors to cover all CPAs, the FRC will be renamed the "Accounting and Financial Reporting Council" ("**AFRC**") to more fully reflect its roles and functions after the reform[5]. Similarly, the current FRCO will be renamed the "Accounting and Financial Reporting Council Ordinance" ("**AFRCO**")[6].

(ii) Issue of practising certificates and registration

The Bill seeks to add a new Part 2A[7] to the FRCO which provides for the AFRC to exercise its new functions in relation to the issue of practising certificates to CPAs[8] and registration of CPA firms[9] and corporate practices[10]. It also provides for the AFRC to establish and maintain a register of CPAs (practising), CPA firms and corporate practices (i.e. practice units)[11].

In connection with the above functions, the proposed new Part 2A provides for the related offences which include pretending to be or practising as CPAs

[2] p. C4019 of the Bill.
[3] A practice unit means (a) a firm of CPA (practicing); (b) a CPA (practising); or (c) a corporate practice under section 2 of the Professional Accountants Ordinance (Cap. 50).
[4] Public Interest Entity means (a) a listed corporation (equity); or (b) a listed collective investment scheme (Section 3(1) of the Financial Reporting Council Ordinance (Cap. 588)).
[5] Clause 10 of the Bill.
[6] Clause 4 of the Bill.
[7] Clause 19 of the Bill.
[8] Division 1 of the new Part 2A (Clause 19 of the Bill).
[9] Division 2 of the new Part 2A (Clause 19 of the Bill).
[10] Division 3 of the new Part 2A (Clause 19 of the Bill); the AFRC will also be responsible for the registration of PIE auditors (Clause 20 of the Bill), whereas CPAs will continue to be dealt with by the HKICPA.
[11] Division 4 of the new Part 2A (Clause 19 of the Bill).

(practising)[12]; signing audit reports without practising certificates[13]; and advertising or representing as being qualified to practise[14] etc.

It should be noted that the HKICPA will continue to be responsible for registration of CPAs and to administer professional examinations, qualification and continuing professional development programmes, and the mutual or recognition agreements with accountancy bodies of other jurisdictions in relation to the registration of CPAs in Hong Kong, subject to the oversight of the AFRC.

(iii) Inspection, investigation and discipline

Pursuant to a proposed new Part 3AA[15] of the FRCO, the AFRC may appoint CPA inspectors to carry out inspections in relation to practice units for the purpose of determining whether a unit has observed, maintained or applied a professional standard. It also provides for the powers of the AFRC to conduct investigations in relation to professional persons[16]. In addition, the AFRC will be vested with disciplinary powers under the Bill in respect of professional persons. If a professional person commits any misconduct under the proposed new section 37AA of the AFRCO, the AFRC could then impose sanctions under the proposed new section 37CA of the AFRCO[17]. Sanctions include the following:

- public or private reprimand;
- a pecuniary penalty to the AFRC in a sum not exceeding HK$500,000;
- revocation or suspension of a person's registration for a period of time;
- cancellation of practising certificate; and
- non-issuance of practising certificate on a permanent basis or for a period of time.

It is worth noting that the scope of disciplinary powers on professional persons and the type and level of sanctions over them in case of non-compliance under the proposed regime will follow closely and remain comparable to those currently provided in the PAO[18].

(iv) Oversight of the HKICPA's statutory functions

The AFRC would oversee the HKICPA's performance of the following functions[19]:

(a) conducting examinations to ascertain whether persons are qualified for registration as CPAs, and dealing with applications and other matters relating to the registration of CPAs;

(b) arranging with accountancy bodies in places outside Hong Kong for the mutual or reciprocal recognition of accountants;

(c) setting continuing professional development requirements for CPAs;

(d) issuing or specifying standards on professional ethics, and accounting, auditing and assurance practices, for CPAs; and

(e) providing training for qualifying for registration as, and the continuing professional development of, CPAs.

(v) Review and appeal mechanism

At present, an independent review tribunal, the Public Interest Entities Auditors Review Tribunal (the "**Tribunal**"), has been established

12 Division 5 of the new Part 2A.
13 Ibid.
14 Ibid.
15 Clause 42 of the Bill.
16 "Professional person" is proposed to mean (a) a CPA; or (a) practice unit under Clause 5(21) of the Bill.
17 Clause 64 of the Bill.
18 Section 35 of the Professional Accountants Ordinance (Cap. 50).
19 Clause 12(4) of the Bill.

under section 37N of the FRCO with jurisdiction to review the HKICPA's decisions in relation to the registration of local PIE auditors and the FRC's decisions regarding the recognition of overseas PIE auditors and discipline of all PIE auditors. The Bill seeks to expand the Tribunal's jurisdiction to review all decisions in relation to the issue of practising certificates, registration of CPA firms and corporate practices and disciplinary actions against CPAs and practice units made by the AFRC. In light of the expanding functions of the Tribunal, it is proposed to be named as "Accounting and Financial Reporting Review Tribunal"[20].

Under the current FRCO, if a party to a review is dissatisfied with a determination of the review made by the Tribunal, the party may appeal to the Court of Appeal and leave is required for such an appeal[21]. The Bill does not seek to amend such an appeal mechanism and thus the position remains the same under the proposed AFRCO.

(vi) A proposed new advisory committee

The Bill seeks to provide for the establishment of a new advisory committee to advise the AFRC on matters of policy regarding any of its regulatory objectives and functions.

(vii) Transitional arrangements

The Bill introduces a new provision to provide for the power of the Secretary for Financial Services and the Treasury to make transitional and saving provisions consequent on the enactment of the AFRCO by way of regulation for matters including pending applications for registration of practice units and the issue of practising certificates before the HKICPA under the PAO. Such regulation would be subsidiary legislation subject to scrutiny by way of negative vetting of the Legislative Council.

It is proposed that all registration applications approved by the HKICPA before the commencement of the new regime will remain valid, whereas outstanding applications will be transferred to the AFRC for processing upon commencement of the new regime. For ongoing practice reviews, investigations and disciplinary cases of the HKICPA which have not been completed on the commencement date of the new regime will continue to be conducted under the PAO mechanism. The result of such practice reviews or investigation under the transitional arrangement will then be referred to the AFRC for follow-up action[22].

Legislative Timetable

The Bill received its First Reading at the Legislative Council meeting on 21 July 2021 and a Bills Committee was formed on 23 July 2021. At the time of writing, the Second Reading debate of the Bill has not resumed and will take place on a date to be notified.

Potential reduction in compliance costs and independent regulation of accountants

According to the Government, one of the justifications for the Bill is to ensure more efficient use of resources and reduce compliance burden as presently, individual practice units and CPAs with both PIE engagements and all other engagements would be subject to separate inspections by the FRC and the HKICPA, which may lead to extra compliance burden for the entities concerned. However, on the other hand, there are also concerns about the potential increase in compliance costs and burden for non-PIE auditors and CPAs under the proposed regime.

The Government also suggests that the reform would make our regulatory regime of the accounting profession more in line with the international standard and practice by vesting the regulatory powers with a regulatory body

[20] Clause 75(2) of the Bill.

[21] Sections 37ZF and 37ZG of the FRCO.

[22] Legislative Council Brief dated 14 July 2021, paragraphs 17-19

independent from the trade to ensure impartiality, and to reinforce our status as an international financial centre and business hub. In this regard, the HKICPA accepts that a common feature found in other jurisdictions is independent regulation of PIE auditors, though there is no one approach as such. According to the HKICPA, regulatory models for the whole of the accounting profession differs between jurisdictions and such differences reflect the different natures and structures of the profession across different jurisdictions.

Conclusion

As mentioned above, the Bill is a more extensive reform of the regulation of the accounting profession as a whole than the previous one which was concerned with PIE auditors only and would involve a wider range of stakeholders. As with any other reforms, in light of the various concerns of the stakeholders, it is believed that more extensive consultations would likely enhance the effectiveness of the reform.

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