香港會計師公會
HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

Our Ref.: C/CGC, M22865

17 October 2003

Mr. Edward Lau,
Secretary, Standing Committee on
Company Law Reform,
Companies Registry,
Queensway Government Offices (High Block),
15th floor, 66 Queensway,
Hong Kong.

Dear Mr. Lau,

Corporate Governance Review by the
Standing Committee on Company Law Reform
A Consultation Paper on Proposals made in Phase II of the Review

The Hong Kong Society of Accountants ("the Society") is pleased to provide its comments, attached at Annexes A and B, on the consultation paper issued by the Standing Committee on Company Law Reform ("SCCLR") in relation to Phase II of its Corporate Governance Review.

We deal with the issues relating to corporate reporting, which have auditing and accounting implications, in Part A of Annex A and other issues in Part B. The separate paper at Annex B relates to the specific issue of auditors' liability (Chapter 5, paragraphs 22.44 – 22.52 of the consultation paper). We have no strong view on those matters not addressed in either of the annexes.

Alignment of Companies Ordinance and Listing Rules or Statutory Backing for the Listing Rules

As regards the general approach to the issues covered in the consultation paper, while we have indicated support in principle for a number of the proposals in the consultation paper that are based on Listing Rule requirements, this is subject to our overall view that it would be preferable to give broader statutory backing to the Listing Rules, rather than incorporating corresponding provisions in the Companies Ordinance ("CO") in a more piecemeal way. If there were to be widely-held support for statutory backing, then, in our view it would be more appropriate to adopt this position as the starting point and consider how statutory backing could best be implemented – for example, which elements, if any, should be incorporated into primary legislation, which in subsidiary, which should be reflected in rules, etc. We note that this subject is touched on in the "Consultation Paper on Proposals to Enhance the Regulation of Listing" issued recently by the Financial Services and the Treasury Bureau. In the course of considering implementation, thought would also need to be given to the question of unlisted public companies and how some of the more fundamental requirements could also be applied to such companies.

Among the reasons for our favouring the approach of statutory backing are the following:

(a) as a matter of principle, we believe that it is better to reserve the CO, as far as possible, for matters that are applicable to all companies, rather than adding to the number of provisions that are applicable only to listed/public companies or only to private companies;

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(b) we believe that legislating on specific provisions could result in the CO becoming out of step with the Listing Rules within a relatively short space of time, given that the Rules are generally more amenable to change and may, in practice, need to be changed in response to developments in the market, both locally and internationally; and

(c) we are also not clear as to how a set of expanded provisions on corporate governance matters, in the main body of CO, which would be applicable primarily to listed and public companies, would be enforced – whether, for example, there would be more than one enforcement agency and overlapping responsibilities.

Proportionate Liability

The Society remains very concerned about the considerable unfairness to professionals in Hong Kong generally, which often arises as a result of application of the current system of joint and several liability. It believes that a good case has been made for the introduction of a form of proportionate liability to address these concerns. We would suggest that the focus on auditors' liability in the consultation paper is overly narrow and runs the risk of clouding the more fundamental issue, which applies to all professionals. A number of significant jurisdictions have already introduced or are now committed to the introduction of a system of proportionate liability, most notably Australia. We note that the Australian Government published on 8 October 2003 the CLERP (Audit Reform and Corporate Disclosure) Bill 2003, which will amend the relevant legislation to ensure that proportionate liability applies to damages for economic loss for misleading or deceptive conduct. It is the Society's view that the Government of the HKSAR should take steps to introduce a well-thought-out system of proportionate liability to avert the possibility of a very damaging professional crisis, which would not be in the public interest and would be damaging to Hong Kong's position as a major regional financial centre.

We hope that you find our comments to be useful and constructive. If you have any questions on them, please contact Peter Tisman, Deputy Director (Business and Practice) at the Society in the first instance.

Yours sincerely,

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
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Enc.

ANNEX A

Comments from the Hong Kong Society of Accountants in response to the Standing Committee on Company Law Reform's Consultation Paper in Phase II of its Corporate Governance Review

Part A – Issues with accounting and/or auditing implications (other than the issue of auditors' liability)

CHAPTER 5 - CORPORATE REPORTING

Section 22 - The Responsibilities, Liabilities and Independence of External Auditors

We agree with the Standing Committee on Company Law Reform (SCCLR)'s proposals with respect to the following areas:

- Auditors' Function and Auditing Standards (paragraphs 22.06 – 22.13)
- Auditors' Remuneration (paragraphs 22.14 – 22.15)
- Outgoing Auditors (paragraphs 22.19 – 22.20)
- Auditors' Independence (paragraphs 22.21 – 22.29)
- Rotation of Audit Firms (paragraphs 22.30 – 22.33)
- Auditors' Duties (paragraphs 22.36 – 22.43)

Auditors' Access to Information (paragraphs 22.16 – 22.18)

We agree with the proposal that the present requirement under section 141(5) of the Companies Ordinance ("CO") on directors and officers of the company to provide such information and explanations as the auditors think necessary and the corresponding criminal sanctions should be extended to bring employees of the company within its scope.

Nevertheless, we have concern about the proposal to introduce a wider duty on (a) directors as well as (b) directors or auditors of a subsidiary undertaking of a company to volunteer information to the auditors of the company [holding company] where the normal standards of directors' or auditors' care and skill would require them to recognise that such information is needed; and that criminal sanctions should be applied to breaches of this wider duty only where the director or auditor knows that the information concerned is material to the audit [of the holding company].

Auditors of a subsidiary undertaking

We do not support the proposal to impose a duty on the auditors of a subsidiary undertaking to volunteer information to the auditors of the holding company for the following reasons:

(i) The rationale and justification for such a proposal for Hong Kong have not been fully discussed in the Phase II Corporate Governance Review consultation paper other than the understanding that there is a similar proposal in the United Kingdom ("UK").

(ii) The proposal has been drafted in such a way that it contains elements of uncertainty and ambiguity which may cause practical difficulties for the auditors of a subsidiary undertaking to comply. It is unclear as to the intended threshold of the criteria of *"where the normal standards of auditors' care and skill require them to recognise that such information is needed"* and *"information material to the audit [of the holding company]"*.

(iii) In performing an audit of the subsidiary undertaking, the auditors would consider materiality at the subsidiary undertaking level, and not the holding company or the group level. Such materiality level may not be appropriate for the audit of the holding company or group

accounts and therefore it would be impossible for the auditors of a subsidiary undertaking to determine what is considered material to the audit of the holding company or the group.

(iv) In a large group of companies with different levels of holding companies, an auditor of a subsidiary undertaking may in practice have difficulty in establishing all the holding companies and their auditors.

(v) The proposal shifts the onus of disclosure from the current reactive obligation on auditors of a subsidiary undertaking to respond to auditors of the holding company enquiries to a pro-active one to volunteer information. This may result in an extension of the scope of the audit carried out by auditors of the subsidiary undertaking with cost implications. We suggest that the proposal should be subject to a further "cost and benefit" analysis.

(vi) We consider that the auditors of the holding company at present already have an effective channel to receive material information on a subsidiary undertaking through any qualifications/modifications in the audit report of the subsidiary undertaking; and the extant HKSA Statement of Auditing Standards (SAS) 510 "Principal Auditors and Other Auditors" already requires co-operation between auditors.

Paragraph 19 of SAS 510 already sets out the basic principles and essential procedures such that the subsidiary auditors, knowing the context in which the principal auditors will use their work, should co-operate, subject to the necessary consent of the client, with the principal auditors. In principle, the subsidiary auditors would therefore be prepared to co-operate with the principal auditors and make available such information as the principal auditors may require in order to discharge their duties as auditors of the financial statements audited by them. In addition, paragraph 25 of SAS 510 provides guidance such that if in carrying out their audit procedures the subsidiary auditors identify matters which they consider likely to be relevant to the principal auditors' work, they would normally consider the most appropriate means of bringing the matter to the attention of the principal auditors. This may be achieved through the subsidiary auditors' direct communication with the principal auditors, providing consent is granted by the subsidiary's management.

In view of the above, we therefore consider that the current requirements are adequate and recommend that further research should be carried out before reaching a conclusion on the proposal to widen the duty of the auditors of a subsidiary undertaking. We believe that it would be more appropriate, if considered necessary, to expand the guidance in the HKSA's Professional Standards instead of introducing legislation to widen the duty of the auditors of a subsidiary undertaking.

Directors of a company

We support the concept to widen the duty of the directors of a company to volunteer information to the auditors of the company subject to clarification of certain ambiguities, such as the meaning of "*where the normal standards of directors' care and skill require them to recognise that such information is needed*". In respect of the definition of "normal standards of care and skill", clarification is required as to whether it would mean that a single standard would apply to all directors of the company, or a different standard for each individual director with reference to his/her education and training background, working experience, professional qualifications, etc. If the latter, it would mean too much a pressure on the professionally trained directors as the normal standards of care and skill expected of them may be higher.

Directors of a subsidiary undertaking

We question the rationale and justification of requiring directors of a subsidiary undertaking to volunteer information to the auditors of the holding company, given that such directors would also be facing the same problem as auditors of a subsidiary undertaking in determining the materiality level of the holding company or the group level in order to carry out a meaningful reporting.

Rotation of Audit Partners (paragraphs 22.34 – 22.35)

We note that it is not clear in the Phase II Corporate Governance Review consultation paper as to whether the proposal with respect to rotation of audit partners is applicable to only listed entities or to all companies in general. We are of the view that extending the requirement to require rotation of audit partners in the audit of private companies would be going too far, since there is no public interest involved and the issues of perception surrounding independence also centres on listed companies. In addition, given the fact that the international references quoted in the consultation paper, i.e. the Sarbanes-Oxley Act (2002) and the IFAC (International Federation of Accountants) Code of Ethics for Professional Accountants are directed at the audit of listed companies, we would take it that the SCCLR's proposal on rotation of audit partners is also intended to be applicable only to the audit of listed entities.

With respect to the proposal itself, we have the following comments:

(i) We recognise that the use of the same lead engagement partner on an audit over a prolonged period may create a familiarity threat. Under the IFAC Code of Ethics for Professional Accountants (paragraph 8.151), auditors of listed entities are required to apply the evaluation process and implement safeguards to reduce the threat to their independence to an acceptable level. The suggested safeguards are:

- rotation of the lead engagement partner after a predefined period (no longer than 7 years);
- a partner rotating after a predefined period should not resume the lead engagement partner role until a further period of time has elapsed (not less than 2 years).

(ii) Although rotation of the lead engagement partner may, on the one hand, help to reduce any perceived threat to independence, there could, on the other hand, be adverse consequences. The efficiency and effectiveness of the audit may be affected, particularly in the case of complex corporations, where the acquisition of specialist knowledge may be beneficial in understanding and reporting on the business. Under the circumstances, we would suggest that the current requirements under the IFAC Code of Ethics may be a more appropriate starting point for Hong Kong (i.e. a rotation period of no more than 7 years). The situation could be subject to review in 2 - 3 years' time to see if it is necessary to shorten the maximum period to 5 years or some other duration.

(iii) The proposed "time-out" period of five years is considered too long. A shorter period is considered to be more appropriate given that a period of five years could prove challenging, not only for small and medium-sized firms, but also for larger firms in the case of audits of specialised industries. Accordingly, we recommend that a "time-out" period of not less than two years, as recommended in the IFAC Code of Ethics for Professional Accountants, should be adopted.

(iv) We support the SCCLR's recommendation of a detailed review of the final rules of the Sarbanes-Oxley model with regard to other partners to determine their relevance and applicability in Hong Kong.

Auditors' Liability (paragraphs 22.44 - 22.52)

Our views on the issue of auditors' liability are contained in Annex B of this submission.

Part B – Comments on non-accounting/auditing issues

CHAPTER 3 – DIRECTORS

Section 7 – Directors' Duties

We would like to reiterate our view with respect to a similar proposal made in Phase I of the SCCLR's Corporate Governance Review. We believe that Hong Kong should aim to underline and entrench its position as one of the world's centres of finance and commerce and, as such, it should be seen to be maintaining a high benchmark in terms of corporate governance standards. We consider that this purpose would be better served by including in the CO a broad statement of general principles in relation to directors' duties and standard of care and skill in the performance of their functions and exercise of their powers, rather than adopting non-statutory guidelines as proposed.

We consider that a statutory enactment would serve the following purposes:

- create more certainty as to the basic expectations in relation to directors' duties;
- give more weight to the principles;
- remind directors of the existence of the legal requirement to exercise fiduciary duties and an appropriate standard of skill and care;
- facilitate monitoring and enforcement by minority shareholders.

We accept that it would not be possible for all directors' duties to be encapsulated in the statute and that any codified statement of directors' duties would not be exhaustive, nevertheless an express provision to this effect could be added in the CO. Furthermore, it would seem to us that the statutory and non-statutory approaches need not be mutually exclusive, and that any statutory statement of the basic duties could be supplemented by a more extensive set of non-statutory principles.

Section 8 – Voting by Directors in relation to Directors' Self-dealing

We support the proposed legislative amendments in relation to improving the general legal position on self-dealing by directors, as set out in paragraph 8.06 of the Phase II Corporate Governance Review consultation paper ("consultation paper"), which should be applicable to all listed and unlisted public companies in Hong Kong.

Section 9 – Shareholders' Approval for Connected Transactions of Significance involving Directors

We support the proposed legislative amendments with respect to shareholders' approval for significant transactions involving directors, as set out in paragraphs 9.09 – 9.11 of the consultation paper, which should apply to listed and unlisted public companies in Hong Kong.

As regards the de minimus thresholds for connected transactions to be incorporated into law, we are of the view that these thresholds should be consistent with those in the Listing Rules in order to avoid confusion. As regards the specifics, in our submission to the Stock Exchange's *Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues* (January 2002), we expressed reservations about the way in which the proposed "total assets" test and "turnover" test would work in practice. We were of the view that the existing thresholds for notifiable transactions and connected party transactions should be retained. (See Appendix A.)

Section 10 - Transactions between Directors or Connected Parties with an Associated Company

We agree with the extension of the Listing Rules requirements relating to connected party transactions to an associated company, as well as the proposed legislative amendments with respect to transactions between directors or connected parties with an associated company, as set out in paragraphs 10.22 of the consultation paper, which should apply to listed and unlisted public companies in Hong Kong.

As regards the definition of "associated company", in order to avoid confusion, we consider that there should be one definition in the context of both the Companies Ordinance and the accounting standard.

In our submission on the proposals made in Phase I of the Corporate Governance Review, we drew attention to paragraph 2 of Statement of Standard Accounting Practice (SSAP) 10 "Accounting for investments in associates", which defines an "associate" as an enterprise in which the investor has significant influence and which is neither a subsidiary or a joint venture of the investor. "Significant influence" is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies.

Due to difference in the nature of "subsidiary" and "associate", we consider that it is not appropriate to adopt the UK Companies Act definition of "subsidiary", for the purpose of consolidating accounts, which uses the "dominant influence" test of control, and apply it to associates in the context of connected transactions. The concept of "significant influence" used in SSAP 10 to define associate is considered to be more appropriate. In addition, as SSAP 10 is in conformity with the relevant International Accounting Standard, the SSAP definition of "associate" is therefore already accepted internationally.

Section 11 – The Roles and Functions of the Chairman and Chief Executive Officer

We agree that it is sufficient to recommend separation of the roles and functions of the chairman and chief executive as a best practice. We also agree that this is an issue relevant only to listed companies and, therefore, that it would be sufficient to introduce appropriate provisions in the Listing Rules and the Code of Best Practice.

Section 12 - Board Procedures

We note that a number of the proposals in relation to strengthening board procedures set out in this section are in line with recommendations made by the Society in our corporate governance publications. We support the suggestion that the various proposals be incorporated into the Code of Best Practice of the Listing Rules and, in addition, consider that further guidance should be provided on the following matters:

a. *Access to the Company Secretary* (paragraph 12.19)

   "*The company secretary should work closely with the chairman in advising directors of their duties and responsibilities under applicable rules and regulations*"

   Noting that there is also a recommendation for separation of the roles and functions of the chairman and CEO in section 11, paragraph 11.04, we think that it would be helpful to the implementation of the proposal if guidance were to be provided on the chairman's role.

b. *Relationship of Board to Management* (paragraphs 12.22 and 12.23)

   "*There should be guidelines on the relationship between the company's board of directors and the company's management*"

While the fundamental relationship between the board and management may be clear, in practice, it is sometimes difficult to clearly distinguish the roles of the two. It would be helpful, therefore, if some sample/model guidelines could be provided for reference.

Section 13 - Audit, Nomination and Remuneration Committees

We support most of the proposals in relation to audit, nomination and remuneration committees set out in paragraph 13.46, except that we believe item (c), i.e. that "a retired partner of the firm auditing the company's accounts should be prohibited absolutely from acting as the chairman or member of an audit committee", to be overly restrictive.

A retired partner of the relevant audit firm could be in a position to make a very positive contribution to the work of the company's audit committee, provided his independence is not open to question. In order to address the question of independence, we consider that a "sanitisation" period of say, 2 – 3 years, will be sufficient in most cases. So as to further strengthen the perception of independence, a further pre-condition could be added, requiring any retired partner sitting on the audit committee to have no financial interest in the audit firm.

Section 14 - The Structure of the Board and the Role of Non-executive Directors

We support the proposals with respect to the structure of the board and the role of non-executive directors, as set out in paragraphs 14.44 & 14.45 of the consultation paper.

Section 15 - Directors' Qualifications and Training

Whilst we agree that it is not practical or desirable to make directors' training and qualifications mandatory at this stage, we consider that it should be a medium-term goal to make directors more professional in their approach and that the situation should be reviewed in a few years' time. It is important, for example, that directors keep up with changes in company law.

Section 16 - Directors' Remuneration

We support the proposal to require listed companies to disclose individual director's remuneration packages by name in their annual financial statements, including full details of all elements. We would also propose that such details should be further analysed into performance and non-performance based.

Although we do not see a great demand for extending the above proposal to private companies, we would have no strong objection to such an extension. We would however suggest that the minimum threshold for shareholders to be able to direct disclosure should be raised from not less than 5% to not less than 10% of the nominal issued share capital of the company (paragraph 16.23(b) of the consultation paper).

We consider that there should also be specific disclosures on key aspects of a company's remuneration policy. Otherwise, disclosure of individual director's package would not be meaningful. With regard to the key issues to be covered in a general policy statement on directors' remuneration, we suggest that reference could be made to the UK Greenbury Report on "Directors' Remuneration" published in July 1995. The Greenbury recommendation of key issues to be covered in a general policy statement on directors' remuneration have been set out in the HKSA guide on recommendations for enhanced transparency and accountability of directors' remuneration, published in 1999 (extract at Appendix B).

We support the proposals with respect to the disclosure of directors' share options (paragraph 16.23(d) of the consultation paper).

If companies are required to disclose key aspects of their remuneration policy, then we would go along with the introduction in Hong Kong of requirements along the lines of the UK's Directors' Remuneration Regulations 2002 (paragraph 16.25 of the consultation paper). However, if there is no requirement to disclose information about remuneration policy, then the question of shareholders' approval of remuneration reports should be revisited at a later time.

CHAPTER 4 - SHAREHOLDERS

Section 17 - Self-dealing by Controlling Shareholders

We support the proposal set out in paragraph 17.11 of the consultation paper to incorporate the following changes into the law:

(i) connected transactions must be disclosed and subject to a disinterested shareholders' vote;

(ii) the definition of a "connected person" in relation to controlling shareholder; and

(iii) the rule should be subject to certain exceptions and other de minimis exceptions, along the lines of those adopted in respect of director-related transactions. As regards the appropriate thresholds for the de minimis exceptions and the assets thresholds for a disinterested shareholders' vote to be incorporated into law, we are of the view that these thresholds should be consistent with those in the Listing Rules in order to avoid confusion. We suggest incorporating them in rules or subsidiary legislation, which would be easier to amend, rather than primary legislation.

We also support the proposal that voting on connected transactions must take place on a poll (paragraph 17.13 of the consultation paper).

Although the Listing Rules have not set out the criteria for the Stock Exchange to grant a waiver to connected party transaction requirements, we note that the Stock Exchange would usually exercise its discretion to grant such a waiver for expediency or for a series of continuous transactions. We consider that the waiver is a useful tool. If the other requirements relating to connected party transactions are incorporated in the CO but the waiver is omitted, this would appear to have the effect that the Stock Exchange would not be able to exercise a discretion in the case of Hong Kong-incorporated listed companies, which would be anomalous. This highlights one of the problems of trying to incorporate specific aspects of the Listing Rules into law. The Listing Rules are able to provide for a degree of flexibility that it is difficult, and probably not desirable, to replicate in the law. This is one reason for our holding the view, stated in the covering letter and elsewhere in this submission, that it would be preferable in principle to give some form of statutory backing to the Listing Rules rather than seeking to incorporate particular elements of the Rules into the CO.

Notwithstanding the above views, we consider that the criteria for granting a waiver, whether the waiver is to be introduced into the law or to be remained part of the Listing Rules, should be more clearly spelt out.

To digress briefly from the issues raised in the consultation paper, we are of the view that one of the fundamental problems with the existing system of corporate governance checks and balances is that independent non-executive directors (INEDs) are beholden to controlling shareholders for their position on the board. This makes it inherently more difficult for them to be completely disinterested in relation, for example, to connected transactions. We would suggest therefore that the position of INEDs, including measures that could be taken, through the law or otherwise, to further support and protect their function, as well as related issues, such as their remuneration, should also be examined.

Section 18 - Substantial Transactions

It is noted that in certain other jurisdictions, requirements to obtain prior shareholders' approval or to disclose before certain (non-connected) transactions are permitted apply to e.g. undertakings, property or assets generally, rather than being restricted to fixed assets as in the CO; and that the specification of the quantitative thresholds in most jurisdictions are found in listing rules. It is also noted that the term "fixed asset" is not defined in section 155A of the CO.

We consider that the Listing Rules' requirements in relation to "major transactions", i.e. any acquisition/realisation of assets (not limited to fixed assets) by a listed issuer or any of its subsidiaries, the value of which is in excess of the specified quantitative thresholds, are relatively onerous and should not be incorporated into law by bringing section 155A into line with it; similarly to e.g. UK and Australia, it is sufficient for listed companies to be bound by relevant requirements under the Listing Rules.

Section 155A may be seen as a basic minimum requirement and, therefore, it would be reasonable to transfer this provision, modified as may be necessary (e.g. to remove any obvious anomalies) from the main body of the CO into Table A in the First Schedule of the CO, to become applicable to all local companies unless specifically excluded.

Section 19 - Variation of Class Rights

We would agree with the SCCLR's proposal not to recommend legislative changes in this area of the law.

Section 20 - The Suitability of Judicial Control, Multiplicity of Provisions and Class Votes

(a) <u>On class composition</u> (paragraphs 20.08 - 20.17, paragraph 20.36(a)) -

We consider that the question concerning minority rights is complex and that a balance has to be struck between the ability of minority shareholders to exercise their rights and the ability of directors to conduct the business free from undue interference from minority shareholders. Minority shareholders should only be able to exercise their rights where e.g. the affairs of the company are conducted in a manner unfairly prejudicial to the interests of shareholders generally or some part thereof.

We consider that it is not necessary for the definition of class to be defined so as to allow minority shareholders to have a greater say in a proposed scheme of arrangement, for instance, by having separate class meetings for minority shareholders on the basis of their interest rather than legal rights. In any case, the court could order a separate meeting if it considered that the interests of minority shareholders were so dissimilar to those of the controlling shareholder.

(b) <u>On the multiplicity of provisions</u> (paragraphs 20.18 - 20.34, paragraph 20.36(b)) -

We note that there are areas of possible overlap between section 166 of the CO, which provides for schemes of arrangement; section 58, which provides for a statutory scheme for companies to reduce share capital with court and shareholder approval; and section 168, which allows a company that has acceptance amounting to 90% in value of the shares for which an offer is received, to compulsorily acquire the shares of dissenting minorities in an amalgamation or a merger. Nevertheless, we consider that these provisions serve different purposes and that the flexibility currently available under the provisions should be preserved as far as possible.

(c) On the suitability of judicial control (paragraphs 20.35 & 20.36(c)) -

We consider that judicial control, which is based on the common law system of precedents, generally provides a reasonable degree of certainty and predictability. Alternatives by way of e.g. administrative control by regulators would not necessarily offer more certainty, and arbitration would not necessarily reduce costs. Whilst the judicial system would be improved by e.g. simplifying the procedures and reducing the costs involved, there is no substitute for judicial control in terms of the impartiality and independence that it offers and is perceived to offer.

Section 21 - Company General Meetings

Our comments on the proposals in relation to company general meetings are as follows:

Contents of Notice (paragraphs 21.28 - 21.33)

We note that at common law, the information contained in or with the notice must be sufficient to allow a member to determine whether or not to attend the meeting. If the material facts are not disclosed in the notice calling the meeting, any resolution passed will be invalidated at the instance of a member who did not attend.

We have no objection to the basic principle of requiring minimum information to be given in the meeting notices regarding the proposed resolutions, provided the information required to be given is reasonable, such as the examples given in paragraph 21.28, i.e. the text of the resolution, a brief explanation of the reasons behind any proposed resolution, including relevant biographical details of a director proposed for (re-)election, material interests of directors or major shareholders, etc.

Agenda of Annual General Meeting (AGM) (paragraphs 21.34 - 21.38)

We consider that relevant part of section 141(2) of the CO, which requires the auditor's report to be read before the company in general meeting, should be retained unless the members present dispense with that requirement. Not only is the requirement to read out the auditor's report at the meeting useful in ensuring that the auditors attend general meetings, but it also helps to focus shareholders/investors' attention on the report, which is especially important in the case of qualified reports.

It is noted that at present, Regulation 54 of Table A indicates certain general business of an AGM (paragraph 21.35 of the consultation paper). We consider that it is sufficient to include relevant provisions in Table A and that this practice should continue.

Members' Resolution (paragraphs 21.39 – 21.48)

We agree with the SCCLR that shareholders' resolutions and related information should be circulated at the expense of the company if they meet certain criteria, e.g. timing, length, minimum threshold requirements. We do not support the concept of deposit system as an alternative approach to dealing with members' resolutions, as it appears to be over-complex.

As regards the right of shareholders to nominate directors for election at general meetings, we consider that there should not be any limit on the number of such nominations, and that criteria for nomination should be set out in order to prevent abuses, e.g. a shareholder might bombard the meeting with nominations in order to obstruct the proceedings. As regards the percentage of shareholding requirement for such nominations, we consider that it would need to be sufficiently low to encourage genuine nominations, and high enough to prevent abuse.

Voting on a Show of Hands (paragraphs 21.60 - 21.64)

We consider that voting on connected party transactions and contentious issues should be conducted by a poll, whereas uncontroversial resolutions or non-contentious matters could be dealt with more expeditiously by show of hands. Rather than to rule out voting by a show of hands, a better approach may be to consider lowering the existing criteria (e.g. the threshold requirement) for shareholders to demand a poll and also to issue guidance to the chairman as to situations in which a poll should normally be conducted.

Absentee and Electronic Voting (paragraphs 21.65 - 21.72)

We support, in principle, absentee voting and electronic voting. Nevertheless, there would need to be an effective monitoring and verification process to ensure security and authenticity in relation to such votes.

One proxy for each shareholding (paragraphs 21.73 - 21.79)

We support, in principle, the idea of multiple proxies on the basis that owners should be enfranchised, provided that there is some mechanism in place to prevent abuse.

Proxies to vote on a show of hands (paragraphs 21.80 - 21.83)

We agree with permitting proxies to vote on a show of hands.

Proxy Solicitation (paragraphs 21.84 - 21.87)

We consider that proxy solicitation should be regulated to deter abuse.

Delivery of Proxy by Electronic Means (paragraphs 21.88 - 21.94)

We support, in principle, the inclusion of specific provision for the delivery of proxies by electronic means. Nevertheless, as with electronic voting, there would need to be a strong monitoring process to address the security and authenticity concerns.

A Proxy to Vote on Poll according to their Terms (paragraphs 21.95 - 21.98)

Our initial view is that, in principle, we would support the introduction of such a requirement. However, it appears that not much information is available about the background to this suggestion and therefore some further consideration may need to be given to, for example, possible exceptional circumstances.

Disclosure of Proxy Voting Information (paragraphs 21.99 - 21.103)

Purely from the perspective of greater transparency, the chairman of the meeting should disclose to the meeting before the voting, the number of proxies held by the company and the voting instructions (if any) thereunder. On the other hand, there is a risk that prior disclosure of such information may influence the vote. As such, we would suggest making prior disclosure a best practice in normal circumstances rather than a mandatory requirement.

Inspection of Proxy Document (paragraphs 21.104 - 21.107)

We support the proposal that shareholders should be able to inspect votes, but the inspection should be made after the meeting so as not to disrupt the proceedings.

CHAPTER 6 - CORPORATE REGULATION

Statutory backing for the Listing Rules

It is noted that many of the SCCLR's proposals in the Phase II Corporate Governance Review consultation paper appear to be aimed at aligning the CO with the Listing Rules. For various reasons, referred to in the covering letter to this submission, we consider that, in principle, a better approach would be to give statutory backing to, and strengthen enforcement of, the Listing Rules, rather than to try to align various requirements in the CO with the Listing Rules on a more ad hoc basis.

Generally, we are not in favour of expanding the category of provision in the CO that are applicable to only certain types of companies, this will make it more complex when one of the main aims of the 1997 consultancy was to simplify the legislation. As far as possible, the CO should be used to establish minimum requirements applicable to all companies.

Secondly, as the Listing Rules are more amenable to change, notwithstanding the need for proper consultation, it is more efficient to respond to changes in market situation both locally and internationally through the Listing Rules. If requirements based on the Listing Rules are incorporated in the CO, either the legislation could quickly become out of step again, particularly where thresholds, asset tests, etc. are concerned, or necessary changes to the Rules may need to be delayed pending the introduction of related legislative changes. Furthermore the fundamental differences in the nature of the approval processes for the Rules and the legislation mean that, in practice, it may not always be possible to keep the two in alignment in future.

Thirdly, we are also not clear as to how an expanded set of provisions in the CO on corporate governance issues, applicable primarily to listed and public companies, would be enforced – whether, for example, there would be more than one regulatory and overlapping responsibilities.

Under the circumstances, giving some form of statutory backing and strengthening of the enforcement of the Listing Rules is considered to be a more appropriate approach. We appreciate, however, that even this approach will not be without its difficulties and will require careful thought to be given to the mechanics and the detailed implementation of such an arrangement, including the possible application of similar requirements to unlisted public companies in some cases.

The regulation of unlisted companies

We have no strong view on the question of whether the regulation of unlisted companies should be improved at the present time. To a large extent this is a question of public perception and whether there is a public demand for a more proactive enforcement, or at least a stronger capacity to respond to complaints. It is noted that in relation to specific areas of the law, in particular filing defaults, the Companies Registry is already adopting a more rigorous approach. Given the need to find a source of funding to strengthen the enforcement capability and the lack of clear-cut evidence of major problems in this area, it might be better to review this subject one or two years down the road. For the present time, we believe that, as long as there are adequate legislative provisions to protect the interest of minority shareholders, enabling them to raise concerns and, where necessary, take legal action and seek remedies, this is sufficient.

ANNEX B

Comments on issues of professional liability in response to paragraph 22.52 of the SCCLR's Consultation Paper in Phase II of its Corporate Governance Review

This paper supplements the submission made on behalf of the Hong Kong Society of Accountants ("HKSA") dated 16 April 2002 entitled "Proposal for an equitable system of liability". That submission recommended amendments to the existing system of joint and several liability in Hong Kong by the introduction of a modified system of proportionate liability in certain cases. The submission was sent in the first instance to the Financial Services Branch of the Government of the Hong Kong SAR ("FSB"). In May 2003, the HKSA was informed by the FSB that the Standing Committee on Company Law Reform ("SCCLR") had agreed to study the issue of auditor's liabilities.

In June 2003, the SCCLR issued a consultation paper on proposals made in phase II of the review entitled "Corporate Governance Review". At paragraphs 22.44 to 22.52, the SCCLR considered a number of issues arising under the heading "Auditor's Liabilities". The SCCLR was unable to reach a conclusion on this issue and invited comments on the overall issue of auditor's liability with particular reference to the desirability or otherwise of proportionate liability and proposals made by the Company Law Reform Steering Group ("CLRSG") in the United Kingdom. This paper is submitted in response to the SCCLR's invitation.

Introduction

It is important to bear in mind that the HKSA's original submission was not intended to be limited to the position of auditors, let alone accountants. The HKSA believes that the issue is of much wider importance to professionals generally. For the reasons set out in the original submission, the HKSA believes that the current system of joint and several liability can give rise to considerable unfairness particularly where plaintiffs in claims for economic loss arising from negligent misrepresentation target defendants with "deep pockets" rather than those primarily to blame for the loss suffered. Whilst the HKSA welcomes consideration of the issue of auditor's liability in its widest sense by the SCCLR, it maintains that a broader debate is still necessary in relation to the fundamental fairness of joint and several liability particularly in respect of actions in tort to recover economic loss based on negligent misrepresentation.

This paper will start with an update on the various issues raised in the HKSA's original submission by reference to recent important developments around the world particularly in relation to auditor's liabilities although the issues impact all professionals, especially those known to carry professional indemnity insurance. It will then address the arguments raised in paragraph 22.50 of the SCCLR's paper against the question of both proportionate liability and the ability of an auditor to cap its liability in respect of claims. The paper will then set out the HKSA's arguments in support of repeal of section 165 of the Companies Ordinance in as far as it prohibits an auditor from limiting liability in respect of audit work. Finally the paper will summarize the HKSA's views as to why it remains appropriate to amend the current system of joint and several liability.

Recent developments

Perhaps the most startling development since the HKSA's submission was originally sent to the FSB has been the collapse worldwide of the firm of Arthur Andersen & Co ("AA") largely as the result of its ill-fated involvement with Enron. AA was previously one of the so-called "Big 5" global accounting firms. Whilst it is not appropriate for the HKSA to comment on the reasons for the demise of AA, the fact that a leading global brand disappeared from the worldwide business community so swiftly is a clear indication of the risks which all professionals face.

The SCCLR paper refers in paragraph 22.02 to the recent Scottish decision in the case of *Royal Bank of Scotland v Bannerman Johnstone Maclay and others*. Although the case was decided on assumed facts on an application by the defendant auditor to strike out the claims for failing to disclose a reasonable cause of action, the impact of the decision is that an auditor might owe duties of care to third parties if it knew, or ought to have known, that they would rely on the audited accounts and the auditor did not disclaim liability to such third party. In that case it was held that a duty might be owed even though no allegation had been made that there had been direct contact between the auditor and the plaintiff bank. The suggestion by the court that the auditor could have disclaimed liability in such circumstances may therefore have been impractical.

As the SCCLR paper comments, the potential exposure of an auditor is now very great. It is precisely this type of unexpected decision which causes the greatest concern to all professionals. Whilst it is at least possible to adopt appropriate risk management techniques to reduce or avoid potential liability as far as possible, that process is thrown into disarray when decisions are made which effectively extend the duties of care owed to a completely new category of persons.

Another good example of the potential exposure faced by auditors is the recent English Court of Appeal decision in the case of *Equitable Life Assurance Society v Ernst & Young*. In that case, Equitable claimed damages of some £2.6 billion from E&Y for negligence in their conduct of the audit of its statutory accounts for the financial years ended 31 December 1997, 1998 and 1999. The judge at first instance had struck out the majority of Equitable's claims on a summary judgment application on the basis that they had no reasonable prospect of success particularly in respect of the losses claimed. The Court of Appeal substantially allowed Equitable's appeals. Whilst it expressed sympathy for E&Y's complaint that the sheer size of Equitable's claims represented an unwarranted burden for a litigant to have to bear in the circumstances, it did not see that it could reach a decision on the material available that particular heads of claim could not succeed for more than a given amount. The Court indicated that there might be other procedural opportunities for E&Y to capitalize on their scepticism about the size of Equitable's claims but it was not appropriate to adopt the course which the judge at first instance took.

It appears that the Court of Appeal was reluctant to decide on a summary basis claims involving developing areas of the law (which effectively includes most significant professional indemnity claims) nor did it consider it appropriate to decide summarily a case where there were some disputes of fact without giving the parties an opportunity to test the evidence on cross-examination. Accordingly, it appears that E&Y will be put to the considerable cost and uncertainty of having to defend a very significant litigation. This again epitomises the significant difficulties which professionals face in defending claims, particularly where the basis or amount of the claim is potentially dubious.

The HKSA, however, has noted the judgment of Mr. Justice Evans-Lombe in the first part of the litigation commenced by Barings against their former auditors. The judgment primarily related to the claim of Baring Futures (Singapore) Limited ("BFSL") against Deloitte & Touche (Singapore) ("D&T") for failing to detect the losses arising from Nick Leeson's trading. The claim against D&T was for some £150 million. Whilst the judge found that D&T had been negligent, he made a number of findings going to reduce their liability to the Plaintiff.

The *Barings* decision appears to stand on its own facts predominantly as a result of the very high levels of fault by Barings management and staff found by the trial judge and attributed to BFSL. The trial judge applied the significant findings of fault to hold that any damages should be significantly reduced by reason of BFSL's contributory negligence and to say that D&T should bear no liability for all losses incurred after a certain date when head office management inexplicably started to fund trades entered into by Nick Leeson without seeking an explanation of what the money was for.

In assessing contributory negligence, the trial judge held that there were a number of distinct periods between the date on which D&T's liability commenced and the date on which management's failings were so serious that they eclipsed the causative effect of any breach of duty on the part of D&T so as to become the effective cause of the losses suffered thereafter. For the first period, the judge held that

management's failings should reduce any damages by 50%. For the second period, the reduction was 60% and for the third period it was 80%. The judge went on to apply reductions in respect of the final period in case he was wrong in finding that management's failings had from that date become the effective cause of the losses suffered. For this final period, the judge applied reductions of 90% and 95%.

The judge also considered the power of the court to grant relief pursuant to the Singapore equivalent of section 358 of the Companies Ordinance. That provision allows a court hearing an action for negligence, default, breach of duty or breach of trust against a company's auditor or officer to grant relief either wholly or partly from liability where it appears that the defendant acted honestly and reasonably and that he should fairly be excused for the negligence, default, breach of duty or breach of trust having regard to all the circumstances of the case. The judge found that an auditor, even though negligent, may have acted reasonably for the purposes of the relevant statutory provision provided it acted in good faith and the negligence was technical or minor in character. D&T only invoked the section in relation to two issues on the quantification of damage. The judge found that if the other arguments in relation to those particular items of damage were not sufficient to relieve D&T of liability for them, they should be relieved under the statutory provision. The judge's approach may suggest that the courts could use the statutory provision to try to soften the effect of the rules on causation and loss having regard to the overall economic outcome for the interested parties. This development could be significant given the frequent disproportion between the damages that may flow from an error and the size of the fee in respect of the work concerned.

The most significant recent developments are perhaps to be found in Australia where there has been serious market failure in the professional indemnity insurance market leading to a significant risk that services will be carried out by uninsured persons such that there will be no one to sue for damages in the event of negligence causing economic loss. The crisis has arisen as a result of a significant contraction in the number of insurers offering professional indemnity insurance, vast premium increases and significant reductions in the extent of cover provided as a result of additional policy exclusions and increases in applicable conditions and self-insured retentions. The difficulties in obtaining insurance, at least at affordable levels, are said to result in consumers being denied access to appropriate professional services, losing the ability to obtain compensation where appropriate and perhaps being unaware that services might be provided by professionals who are not accredited or insured and not subject to professional standards. On 6 August 2003 one of a series of joint ministerial meetings was held to discuss the issues arising from the crisis and consider ways in which it might be resolved. At that meeting, Commonwealth, State and Territory ministers endorsed a national scheme for Professional Standards Legislation ("PSL") for economic loss in conjunction with a commitment to implement proportionate liability across Australia.

PSL is intended to protect consumers by making it mandatory for professionals to carry professional indemnity insurance and to partake in risk management schemes but permitting safety ceilings or caps on claims. The representative association of a group or profession will prepare and submit a scheme for the scrutiny and approval of the Professional Standards Council ("PSC"). The scheme must include a range of risk management and other obligations on the members of the group or profession in exchange for a cap on the civil liability of those members which is set out in the scheme. Once approved by the PSC, the scheme is submitted to the relevant minister for final approval. Once final approval is granted, it will apply to all members of the group or profession represented by the association with only limited exceptions. The cap on liability will be set high enough to cover all consumer claims and most corporate claims for economic loss but should eliminate the risk of catastrophic claims. The intention is that once nationally consistent legislation is in place for PSL, professional indemnity insurance will become more widely available at affordable prices again.

The ministers also endorsed a national model for proportionate liability so that the courts, in considering the liability of a defendant, will also have regard to the responsibility of any potential defendant not a party to the proceedings. The model will require defendants to notify a plaintiff in writing of the identity and alleged role of any other potential defendants of whom they are aware. Defendants who fail to comply with this provision will be at risk of being ordered to pay costs. Proportionate liability has already been introduced in certain states within Australia such as New

South Wales and Victoria and the impetus now appears to be on achieving consistency across Australia. The important thing to recognize is that both of the major elements of the proposal are being pursued together rather than separately or as alternatives.

The Australian Government published on 8 October 2003 the CLERP (Audit Reform and Corporate Disclosure) Bill 2003 <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=700> which will amend the relevant legislation to ensure that proportionate liability applies to damages for economic loss for misleading or deceptive conduct.

The conclusion to be drawn from these recent developments is that all professionals, including auditors, remain exposed to significant potential liability which is all too often exacerbated by the effect of the principle of joint and several liability. Whilst the decision in the *Barings* litigation suggests the position may not be as bad as some suggest, it remains a decision at first instance decided on its own particular facts. It is not known whether the decision will be subject to appeal. The fact specific nature of the decision can be tested against the fact that previously it had generally been accepted that the maximum reduction that might be ordered in respect of contributory negligence would be of the order of 30%. Further the relief granted under the Singapore equivalent of section 358 of the Companies Ordinance has generally been believed to be of no application since it was considered very difficult for a court to find an auditor's actions to be reasonable if the court had already held that he was negligent or otherwise in breach of duty and therefore had not exercised reasonable skill and care.

The HKSA welcomes the initiatives taken by the Australian government to address the problem by the introduction of PSL which involves caps on liability together with, rather than as an alternative to, a system of proportionate liability. Whilst the catalyst for the changes in Australia is unfortunate, the fact that they have become necessary shows that complacency should be avoided and brave action should be taken sooner rather than later.

HKSA's comments on the arguments against proportionate liability and capping

Set out below are the HKSA's comments on the different arguments identified in paragraph 22.50 of the SCCLR paper.

1. **The first argument identified is that it would be difficult to limit a defendant's liability to a particular percentage of the damages without having all involved persons before the court. This argument is premised on the basis that each tortfeasor will be liable for the whole loss suffered.** It is this premise which the HKSA believes should be challenged. Whilst the HKSA accepts that this is the law as it stands, its primary contention is that the effect of this law, particularly in claims for economic loss, is unfair and inequitable. This is particularly the case where the "deep pocket" defendant is only peripherally responsible for the loss claimed. In any event, courts frequently find themselves in situations where findings of fact have to be made or inferences have to be drawn on the basis of incomplete information. Where for instance a claim is brought against a defendant auditor by a company in liquidation, invariably a number of relevant witnesses will not be called by the liquidators whether as a result of their own choice or as a result of circumstance. The HKSA contends that the situation would be little different were the court to be called upon to decide on proportionate liability in the absence of other potentially responsible parties. In any event, the difficulty could be reduced by introduction of a requirement on the defendant to notify a plaintiff in writing the identity and alleged role of any other potential defendants of whom they are aware at an early stage of proceedings or even before proceedings are commenced.

2. **The second argument raised is that an auditor should be able to limit its liability either contractually or by incorporation as a limited liability company.** The HKSA certainly welcomes the recommendations of the CLRSG to the effect that the UK equivalent of section 165 of the Companies Ordinance should be amended to enable an auditor to limit its liability contractually with the company and in tort with third parties. To date, no amendment to the UK company legislation has been enacted and, unless and until section 165 were to be amended,

this argument should be given little weight. In any event, the HKSA believes that the ability to cap liability should go hand in hand with proportionate liability as has been proposed in Australia.

An audit firm is already allowed to incorporate as a limited liability company in Hong Kong. To date, not many practices have taken up this opportunity. In any event, the HKSA does not believe that the ability to incorporate has any bearing on the issue of joint and several liability and the significant potential exposures arising therefrom. The size and number of claims made will not be affected by the way in which audit firms choose to structure themselves.

3. **The third argument raised is that the directors would be responsible for the balance of the damages awarded in respect of such liability if an auditor were able to limit its contractual liability.** This argument is not fully understood. The reality is that the day-to-day management of a company's affairs is the responsibility of its directors and officers. A number of the recommendations in the SCCLR paper quite appropriately address the duties that directors owe in the exercise of their functions and how such directors should be educated as to their responsibilities. The directors and officers know far more about the company and its affairs given their role in management than can be expected of an auditor whose function is to report the financial position as at a certain date. It seems entirely appropriate that the directors and officers should be liable for losses which the company might have suffered as a result of their negligently made management decisions. The HKSA believes that the apportionment of liability through the system of proportionate liability is fair and equitable in this respect. Further, management can purchase directors' and officers' liability insurance in order to protect themselves against any increased risk of liability.

4. **The fourth argument is that the ability to limit liability for negligence should apply to all professions, including directors. The argument goes on that an auditor should not be given favourable treatment.** The HKSA entirely agrees with this point which is why it has been pressing for a wider review of the system of joint and several liability. That said, the HKSA submits that an auditor is in fact in a different position, given its regulatory role, which is not akin to the roles of other professionals. This has been recognized in paragraph 22.51. Consideration of the position of an auditor alone, however, is potentially misleading and may give rise to potentially irrelevant arguments and other considerations. As mentioned in the introduction to this paper, the main focus of the HKSA's submission is the review of the appropriate system of liability for the benefit of all professionals. The Australian government response has been to address the issue in a far broader context by application to all professions and other groups. The HKSA urges the HKSAR government to follow suit.

5. **The fifth argument is that proportionate liability is not the same as contributory negligence since in the former case the court may be required to rule in the absence of some relevant party whereas in the latter case the court has the benefit of hearing the arguments of the opposing parties.** The HKSA recognizes that a court will hear evidence from the plaintiff before deciding whether it has been contributorily negligent and, if so, to what extent. A court, however, is frequently required to reach decisions at a trial without having access to all potential witnesses and all the best evidence. This is the reality of all litigation, especially particularly significant and complex litigation. If it were not the case, the litigation process would in all probability become unworkable in practice. It is the HKSA's view therefore that this concern is far greater in theory than it would be in practice especially if a defendant were required as part of its defence to identify the alleged role of any other potential defendants of whom it is aware.

6. **The last argument raised is that it may not be a practical or realistic proposition for a plaintiff to pursue all other parties under a proportionate liability scheme. The example is given of a company which has gone into liquidation.** The HKSA recognizes that this may present a practical problem for a plaintiff in certain circumstances but it is no different to the situation where a plaintiff suffers loss as a result of breach of duty by a single defendant which is insolvent by the time that litigation is commenced. When a plaintiff is harmed by joint

tortfeasors, however, he receives an advantage, the logic of which is difficult to justify at least in the context of the type of claims which form the focus of this paper. The justification for imposing an inequitable financial burden on a defendant whose contribution to the loss suffered may have been relatively slight is unclear and in the HKSA's view not made out. In cases of economic loss, which often involve commercial entities used to taking risks, there does not appear to be a justification for relieving the plaintiff of a financial burden at the expense of a defendant. The equitable solution is for the contribution of each of the parties to be assessed according to their relative blameworthiness. This may mean that a plaintiff does not recover in full in certain circumstances but at least it will be able to make some recovery. At least the solvent defendant will not have had to bear an unfair share of the total loss suffered.

Section 165 of the Companies Ordinance

The HKSA would welcome the repeal of section 165 of the Companies Ordinance to the extent that it prohibits an auditor from limiting his liability in respect of audit work. The recommendations of the CLRSG in this respect are particularly helpful. The position of the company and its shareholders will not be prejudiced as a result provided that it is a condition that the limit on liability should be approved by the company at the AGM.

The HKSA believes that the position in respect of third parties is more difficult. As there is no privity of contract between an auditor and third party, the effectiveness of any cap on liability as far as claims by third parties are concerned must remain open to doubt.

The decision in *Bannerman* highlights a problem. In that case there was no direct contact between the auditor and the plaintiff bank but the court still found it arguable that the auditor might owe the bank a duty of care. The HKSA has issued a Professional Risk Management Bulletin providing guidance to auditors on appropriate action which they may wish to take to help protect themselves against exposure to third party claims to assist them in managing the risk of inadvertently assuming a duty of care to third parties in relation to their audit reports. The Institute of Chartered Accountants in England & Wales ("ICAEW") has also issued a Technical Release following the *Bannerman* decision with guidance on the same subject. The effectiveness of what has been recommended by the HKSA and the ICAEW, however, has not yet been tested by the courts.

The repeal of the relevant part of section 165 of the Companies Ordinance will therefore be beneficial but in the HKSA's view cannot be the total answer by reason of the continuing uncertainties for an auditor's liability that exist particularly in respect of claims by third parties.

The case for proportionate liability

The HKSA is encouraged by the consultation process being undertaken by the SCCLR but suggests that the breadth of the issues on which comments have been invited is too narrow. The HKSA firmly believes that there is a danger in seeking to review issues on a piecemeal basis in a restricted context since this can give rise to further unfairness and inequalities between different groups or professions. This is borne out by the arguments against capping liability and proportionate liability set out in paragraph 22.50 of the SCCLR paper. The HKSA maintains that the case has been made out that the system of joint and several liability operates unfairly, particularly in the professional indemnity arena, and that a case has been made out for the introduction of a system of proportionate liability. The real issue is where the boundaries of such a system should lie.

The HKSA is encouraged to note the wide-ranging reforms proposed by the Australian government in order to address the professional indemnity crisis there. The proposals extend to all professionals and have been taken in the name of consumer protection which the HKSA recognizes is essential. The proposals call into question the perceived wisdom that the principle of joint and several liability should be sacred in order to protect a plaintiff's position. That requirement no longer appears justified particularly in respect of claims by commercial entities for economic loss against a negligent professional.

Neither the Australian government nor the HKSA is suggesting that the principle of joint and several liability should be abolished in its entirety. What is more important is to establish an equitable system of liability particularly in respect of claims for economic loss where the potential damages can be so significant. The claim by *Equitable* is a case in point.

It is far better to address the issue responsibly now rather than be forced to introduce changes hastily in response to a similar crisis to that faced in Australia. A number of jurisdictions such as Canada, certain States in the USA, Ireland, Bermuda and now Australia have "bitten the bullet" as far as proportionate liability is concerned and the HKSA believes that it is appropriate for the HKSAR Government to do so too for the reasons outlined in this paper and its earlier submission.

Hong Kong Society of Accountants
October 2003