

**JULY 2012**

**CONSULTATION PAPER  
ON THE REGULATION OF SPONSORS**

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**JOINT RESPONSE FROM  
CLIFFORD CHANCE  
AND  
DAVIS POLK & WARDWELL  
ON BEHALF OF A GROUP OF  
FINANCIAL INSTITUTIONS**

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**CLIFFORD CHANCE**

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## Executive Summary

Set out below is a summary of our key responses to the consultation paper. We have made our best efforts to reason each observation and/or suggestion as fully as possible. Please note that this summary *must not* be read in isolation, but in the context of our full submissions in the following sections of this paper.

Consultation question	Text of consultation question	Summary of our response	Page(s)
1	Do you agree a sponsor should have a sound understanding of a listing applicant for which it acts?	Generally agree, but "sound understanding" must be read in the context of what can reasonably be achieved, particularly given the collaborative nature of the listing process.	15
2	Do you agree that a sponsor should advise and guide a listing applicant and its directors as to their responsibilities under the Listing Rules and other applicable regulatory requirements and take all reasonable steps to ensure that at all stages of the listing application process they understand and meet these responsibilities?	Generally agree to duty to advise and guide; <b>Disagree</b> with duty to take all reasonable steps to ensure the listing applicant and its directors understand and meet their regulatory duties	17
3	Do you agree that a sponsor should provide appropriate advice and recommendations to a listing applicant on any material deficiencies identified in relation to its operations and structure, procedures and systems, or its directors and key senior managers and ensure that any material deficiencies are remedied prior to the submission of a listing application?	<b>Strongly disagree</b>	21
4	Do you agree that before submitting a listing application a sponsor should complete all reasonable due diligence on the listing applicant save only any matters that by their nature can only be dealt with at a later date?	<b>Disagree</b> unless more practical guidance is provided on the meaning of "all reasonable due diligence"	23

5	Do you agree that before submitting a listing application a sponsor should come to a reasonable opinion that the information in the Application Proof is substantially complete?	Generally agree if more guidance is given on the meaning of "substantially complete"	26
6	Do you agree that before submitting a listing application a sponsor should come to a reasonable opinion that the applicant has complied with all applicable listing conditions (except to the extent that waivers from compliance have been applied for), has established adequate systems and procedures and the directors have the necessary experience, qualifications and competence?	<b>Disagree</b>	28
7	Do you agree that a sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration of the application as described in paragraph 57 above are disclosed to the regulators when submitting a listing application?	Generally agree, but with reservations about the drafting	29
8	Do you agree that a sponsor, after reasonable due diligence, should ensure that at the time of issue a listing document contains sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the financial condition and profitability of the listing applicant?	Generally agree except the "duty to ensure"	29
9	Do you agree that a sponsor, after reasonable due diligence, should have reasonable grounds to believe and does believe that at the time of issue of a listing document the information in the non-expert sections is true, accurate and complete in all material respects and that there are no material omissions?	Generally agree except the requirement for "complete" information	30

10	Do you agree that at the time of issue of a listing document a sponsor should be in a position to demonstrate that it is reasonable for it to rely on the expert sections of the listing document?	<b>Disagree</b>	32
11	Do you agree that the sponsor should take these steps in connection with an expert report? Are the steps set out in paragraph 17.6(g) of the draft Provisions sufficient and appropriate?	Pending clarifications by the SFC, concerned with certain provisions in this paragraph and <b>strongly disagree</b> with any wording that could potentially impose a duty to audit or replicate third party professionals' work except in respect of "red flag" issues	36-37
N/A	Proposed Paragraphs 17.6(e)-(f)	Concerned with much of the drafting of these provisions, except in relation to Paragraphs 17.6(e)(iii), 17.6(e)(v) and 17.6(f)(i)	37-39
12	Do you agree that a sponsor cannot delegate responsibility for due diligence?	<b>Disagree</b>	40
13	Are the steps we propose a sponsor should take when seeking assistance from a third party in its due diligence work sufficient and appropriate?	Generally agree, assuming the new rules will replace the existing ones	41
14	Do you agree that a sponsor should reasonably satisfy itself that all information provided to the Stock Exchange and the SFC during the listing application process is accurate, complete and not misleading and, if it becomes aware that the information provided does not meet this requirement, the sponsor should inform them promptly?	Generally agree subject to drafting changes	44
15	Do you agree that a sponsor should deal with all enquiries raised by the regulators in a cooperative, truthful and prompt manner?	Generally agree	44

16	Do you agree that a sponsor should disclose to the Stock Exchange in a timely manner any material information relating to a listing applicant or listing application of which it becomes aware which concerns non-compliance with the Listing Rules or other applicable legal or regulatory requirements?	Generally agree subject to drafting changes	45
17	Do you agree that if a sponsor ceases to act for a listing applicant during the listing application process, it is required to inform the Stock Exchange in a timely manner of the reasons for ceasing to act?	<b>Strongly disagree</b>	47
18	Do you agree that the Application Proof submitted with a listing application should be made publically available when the application is made?	<b>Strongly disagree</b> and would urge the SFC to consider our practical suggestions if a decision is made to adopt the proposal	72
19	Do you agree that a sponsor's records should be sufficient to demonstrate that the sponsor has complied with all applicable legal and regulatory requirements and in particular compliance with the Provisions?	<b>Disagree</b> with prescriptive nature of proposed amendments	50
20	Do you agree that a complete set of sponsor's records in connection with a listing transaction should be retained in Hong Kong for at least seven years after completion or termination of the transaction?	<b>Disagree</b>	52-53
21	Do you agree that before accepting any appointment as a sponsor, a firm should ensure that, taking into account of other commitments, it has sufficient staff with appropriate levels of knowledge, skills and experience to devote to the assignment throughout the period of the assignment?	Agree	56

22	Do you agree that the provisions of the Sponsor Guidelines concerning the Transaction Team should be transferred to the Code of Conduct?	Agree	57
23	Do you agree that a sponsor should maintain effective systems and procedures to ensure that an appropriate due diligence plan is formulated, updated as necessary and implemented in respect of each assignment and there are clear and effective reporting lines to ensure that key issues are escalated to Management for deliberation?	Generally agree except the definition of "Management" and the reference to "clear and effective reporting lines"	42
24	Do you agree that a sponsor's Management is obliged to adequately supervise the performance of due diligence including but not limited to the key issues discussed in paragraph 97?	<b>Disagree</b> except to the extent already provided for in current rules	56
25	Which, if any, of the proposals in paragraph 103 would achieve the objectives of enlarging the category of individuals qualified to act as Principals, whilst not affecting the overall quality of sponsor work?	Support proposals to expand eligibility criteria and have made suggestions	60-61
	Do you have any alternative suggestions to address the issues?		
26	Do you agree that there should only be one sponsor on each engagement?	The group's views are split – no member is in favour of limiting the number of sponsors to one; some members are supportive of a cap of a small number on each deal; others believe there should be no cap at all; the SFC is invited to consider the underlying issues further	76
27	If more than one sponsor is allowed, do you agree that they should all be required to meet the Listing Rules independence requirements?	<b>Disagree</b>	77

28	Do you agree that if more than one sponsor is appointed each sponsor's responsibilities should remain unaffected and that each sponsor should comply with all the expectations of a sponsor?	Agree that each sponsor is responsible fully for its own compliance obligations but <b>strongly disagree</b> with joint and several responsibility	78
29	Do you agree that the provisions of the CFA Code relating to the management of a public offer should be transferred to the Code of Conduct?	Agree	47
30	Do you agree that the obligation in the CFA Code relating to the provision of information to analysts should be transferred to the Code of Conduct?	Agree	43
31	Do you agree the Provisions should equally apply to a listing agent appointed for the listing of a REIT?	Agree	43
32	Do you agree that it should be made clear that sponsors are liable for untrue statements (including material omissions) in a prospectus?	<b>Strongly disagree</b>	92
33	Do you have any views on the proposed definition of "sponsor"?	Agree in principle with the SFC's definition	92

## **Introduction**

This submission is made on behalf of a group of 23 financial institutions, listed in Appendix 1, in response to the SFC's Consultation Paper dated May 2012.

### **General observations**

We very much welcome the opportunity to participate in a review of the regulation of the listing application process in Hong Kong, including the role of sponsors.

As the Consultation Paper states, initial public offers ("IPOs") have been a major component of Hong Kong's overall development as a leading international financial centre. It is hoped that IPOs will continue for the foreseeable future to be a major component of Hong Kong's economic success, its continued development and the prosperity of its people.

It is in everybody's interests, including the financial industry, to get the model for Hong Kong IPOs as right as possible.

In preparing this response, we have sought to look objectively at the issues, and ask the question, what model for the regulation of IPOs, is in the best interest of all concerned, in particular investors and Hong Kong.

We are pleased to confirm that in respect of a significant number of the proposals and questions set out in the Consultation Paper, we are in broad agreement with the SFC. However, we would like to engage the SFC, and other stakeholders, in a constructive debate about some of the proposals, about which we do have concerns. We are concerned that the proposals in question, however well-intentioned, may cause real harm to the Hong Kong market, without achieving any meaningful positive benefit. The SFC needs to look at ensuring that the Hong Kong market continues to be attractive to issuers, and that we do not end up with (i) long, overblown due diligence processes that focus on form over substance or result in check-the-box exercises that do not advance a deeper understanding of the significant issues, or (ii) complex, long prospectuses containing immaterial information that make it less likely that the prospectus will be read or understood by investors, in contrast to overseas trends towards more relevant and concise offering documents. Wherever appropriate we have put forward alternative proposals to the issues raised.

Understandably, given the role of the SFC as the regulator of Type 6 licensees, the paper focuses almost entirely on the regulation of sponsors. However, we do think this is an opportunity to look at the regulatory framework and day-to-day practices involved in Hong Kong IPOs more broadly. We consider that adopting a broader approach – preferably involving multi-partite discussion between stakeholders and the different regulatory authorities with an interest in IPO activity – will maximize

the prospects of developing a model which meets the common goal that everyone shares, namely to inform and thereby help protect investors in IPOs.

In this response to the Consultation Paper, you will find that we have effectively sought to address three topics:-

- (1) the conceptual framework for regulation of Hong Kong IPOs;
- (2) the role of the different participants in Hong Kong IPOs; and
- (3) desired changes to current regulation and practice.

**(1) Conceptual framework for regulation**

We consider that the conceptual framework for regulation of Hong Kong IPOs rests on three fundamental principles.

Firstly, the listing process is fundamentally a collaborative process involving not only the sponsors, but also the directors and management of the listing applicant, reporting accountants, legal counsel, internal controls consultants, valuers and other experts. Of course, it also involves the regulators, who guide and collaborate in the vetting process.

Secondly, Hong Kong has operated, and thrived, on the basis of a principles-based disclosure model, not a prescriptive, merits-based approach to listing. We believe this consistently-adopted approach has been a significant contributor to the Hong Kong market's success, backed of course by a strong rule of law.

Thirdly, the directors and management of the listing applicant perform the key role and take primary responsibility for information in the listing document. The SFC recognizes this explicitly in the Consultation Paper.

We firmly believe that this framework should remain in place for the foreseeable future, backed, as it is in Hong Kong by a strong rule of law. We should not, without very good reason, move further towards a merits-based approach to regulation of IPOs. If we do move in such a direction, we need to recognize the root of the reasons for doing so and any new regulation should be appropriately focused and thoroughly assessed.

Within a collaboratively-driven, disclosure-based framework, in which necessarily primary responsibility for disclosure rests with the directors and management of the listing applicant, over-regulation of the sponsors as "gatekeepers" risks distorting the process, resulting in unintended consequences, and ultimately Hong Kong's attractiveness as a listing venue may be harmed. The description "gatekeepers" is used consistently to describe the role of sponsors in the Consultation Paper. However, it is very important to have a clear understanding of what "gatekeeping"

should mean in the context of Hong Kong's regulatory framework. Our thematic concern about many of the proposals is that, firstly, they would push sponsors a considerable distance towards being identified as having primary responsibility for, and liability in respect of, all of the work that goes into an IPO; secondly, they are not consistent with the collaborative nature of the IPO application process; and thirdly, they tend to exacerbate the imbalance of power between the listing applicant and the sponsors, from which many practical problems are derived, as we will examine more closely in this paper.

Examples of proposals in our first category of concerns are: (i) enhanced obligations to review, verify and be responsible for experts' work; (ii) the introduction of new obligation to identify and ensure rectification of deficiencies in systems and controls of listing applicants, not just related to regulatory requirements, but also all business and operational risk and control; (iii) removal of the sponsor's ability under appropriate circumstances and with proper supervision to delegate due diligence responsibility to third parties; and (iv) creating statutory prospectus liability for sponsors for untrue statements in prospectuses.

## **(2) Role of the different participants in Hong Kong IPOs**

The proposals described in (i) and (iii) above also fall into our second category of concerns as does the absence of any consideration of what parallel regulatory and enforcement changes might usefully be focused on other participants – management, accountants and lawyers in particular, as well as the other experts involved. Sponsors are securities markets professionals and are not qualified to advise on accounting, legal, internal control, market research, industry reviews or indeed specialist, technical matters. We have identified the risk in some of the proposals that whilst sponsors may be required to do substantially more work in reviewing and verifying the work of, for example, the reporting accountants, the accountants may not be required, in parallel to co-operate with the sponsors to the extent that is necessary actually to perform their proposed new duties. Similarly, as regards to enhancement of enforcement against, and potential liability of, sponsors, we would ask the SFC to consider carefully whether, if the proposals focus almost exclusively on enhancing the liability of sponsors, the risk is that the directors and management of the listing applicants may perceive themselves under less pressure than at present, which might, in the worst-case scenario, actually drive the opposite behaviour to that sought. The SFC might also consider whether this may be exacerbated where, as is normally the case, the directors and management of the listing applicants are located offshore, so that Hong Kong regulated sponsors are seen as the easy target by investors and regulators alike.

We would very much welcome an ongoing dialogue with the SFC and other stakeholders about the balance between on the one hand the benefits of enhanced regulation, particularly requirements which move us towards a merits-based approach, and on the other hand the potential risk of harm to the attractiveness of Hong Kong as a regulatory regime and its attractiveness for listings.

We believe some of the general statements made in the Consultation Paper (about the quality of our industry's work and the quality of IPO documents) may be based in part on extreme or rare examples that paint the entire industry with engaging in such behavior on a systematic basis. However, rather than take exception with each of these statements or examples at length, we have focused on the specific proposals and language to look forward constructively on how these proposals would affect the industry and Hong Kong IPO process and to assist the SFC to identify a workable, balanced model, which reflects properly the collaborative nature of the listing process.

### **(3) Desired changes to current regulation and practice**

It seems to us that a significant part of the SFC's concern is in fact about the day-to-day operation of the listing application process, in particular the completeness of first drafts of prospectuses filed with the regulators, and the completeness of the underlying due diligence and analysis to support the first draft. We have noted the SFC's frank statements (both in the Consultation Paper, and made publicly during the consultation period) that it considers there have been too many cases where the first draft, and the corresponding due diligence, is of sub-optimal quality. We certainly wish to address these concerns and make sure they are eliminated. Our concern, though, is that some of the proposals in the Consultation Paper may not be workable, and in particular may have unintended, undesirable consequences. Examples include: (i) the proposal that the first draft prospectus (but not subsequent drafts and not the regulators comments) would be publicly disclosed at the time of filing; (ii) the requirement for completion of all material due diligence before the first draft prospectus is filed, in contrast to the industry's view that the process is most effectively treated as an ongoing process, with some due diligence appropriately completed only after filing; and (iii) the very onerous proposed new record-keeping requirements. The industry certainly wants to find a model that works well for due diligence and prospectus vetting. The industry group has its own concerns to some extent about the approach adopted for vetting taken by the regulators, which is addressed in some detail in this paper. The industry group very much welcomes the opportunity to discuss this further and is hopeful that a mutually acceptable operating model can be agreed and developed to benefit all of Hong Kong's stakeholders.

Finally we would note that, broadly, the Consultation Paper divides into two main categories of recommendations. Firstly, "operational" proposals, largely intended to be reflected in significant additions to the Code of Conduct for Persons Licensed by or Registered with the SFC ("SFC Code of Conduct"). Secondly, the discussion about prospectus liability. We believe that, in the near term, the primary focus of the SFC, and other relevant, regulatory agencies, should be on ensuring that the operational proposals are made as effective as possible. Such changes can be brought in without the need to amend primary legislation. They should have much

more immediate impact than legislative changes which are likely to take some time to be enacted and even after that it would likely take several years for any claim based on statutory liability to find its way to the courts. We would strongly recommend that the SFC defer consideration of all aspects of prospectus liability to a separate consultation exercise, as in fact appears to be at least partly envisaged at the end of the Consultation Paper.

### **Reading this response**

This introduction sets out our thematic concerns in quite high-level terms. We trust that the detailed responses which follow will identify the concerns more concretely. We should add that we have listed our responses to questions in order of what we see as themes, rather than strictly in the numerical order presented in the consultation paper. Hopefully, the logic will be clear. We have addressed all of the questions and proposals.

We would welcome the opportunity to engage with the SFC and others, in further discussion to identify and implement the best possible approach for Hong Kong. In some respects, we would welcome further guidance and clarification from the SFC than is set out in the Consultation Paper. It seems to us that the SFC could go further in applying and delineating materiality tests, particularly as it impacts on the content of prospectuses. There is also very little if any guidance or directional material addressed to others involved, in particular, of course, the directors (including proposed directors) and management of the listing applicants. Investor education is also important, to ensure that in a disclosure-based regime, it is understood that sometimes listed companies can fail, without implying any fault on the part of the sponsor.

We also think that a very useful aspect that can and should be discussed in much more detail than appears in the paper is the question of international cross-market analysis of the regulatory framework. This is touched on only lightly in the Consultation Paper. A concern is that, if the proposals set out in the Consultation Paper are adopted in full (something which we do not consider to be desirable), Hong Kong would find itself at the far-end of the spectrum in terms of regulatory requirements, which could damage Hong Kong's attractiveness as an international capital market destination. Some of the regulatory enhancements are supported in the paper by the fact that similar requirements exist in other markets. However, they may be inapposite to a disclosure-based approach such as in Hong Kong. Adopting requirements from other markets in a selective fashion also disregards the fact that the Hong Kong market may be fundamentally different from the markets from which some of the proposals are copied. We shall touch on these in key respects in this response. We have decided, however, not to set out a full-blown multi-jurisdictional analysis of all issues in this response, because we consider it would be much more productive to discuss only those aspects where the SFC's proposals would appear to be out of line with international practice and/or risk making Hong Kong less attractive/competitive as a venue for IPOs .

This is an extremely valuable opportunity, and we are pleased that the SFC has initiated the consultation process.

## **Part 1: The role of the sponsor in the collaborative listing process**

### **General comments (paragraphs 1 – 8)**

We welcome the SFC's initiative to review and align the relevant provisions so that the sponsor's roles and responsibilities are set out, where practicable, in a single document. The approach set out in paragraphs 40 to 44 of the Consultation Paper is generally acceptable to us.

We strongly agree with the statement in paragraph 4 on page 2 of the Consultation Paper, that "an IPO is the culmination of an intensive and collaborative process, with the directors performing a key role and taking primary responsibility for information in the listing document".

In our view, the collaborative nature of the listing process is central to any regulatory philosophy of sponsor's work in Hong Kong. Whatever detailed responsibilities the SFC, as statutory regulator of the securities industry, may decide to regulate under the theme of "sponsor's work", it must be fully aware of the fact that the subject matter of its effort in this respect is by its very nature the fruits of months or even years of team work among a number of parties. The approach that the SFC has repeatedly stated in the Consultation Paper, that the sponsors are treated, and will be regulated, as "gatekeepers" of the listing process, must be read in this context.

In particular, we stress that the primary responsibility for accuracy of disclosure in the Hong Kong listing process lies with the listing applicant, its directors and management. As stated in the Joint Response on Behalf of a Group of 14 Investment Banks in relation to the 2003 Consultation Paper on the Regulation of Sponsors and Independent Advisers ("Joint Response"):

"Issuers and their directors must be held *primarily to account* if there has been any failure to ensure adequate and proper disclosure to investors or for other corporate misconduct."

This is acknowledged in paragraph 2 of the Consultation Paper where the SFC reiterates that "... the directors of a company are primarily responsible to investors to ensure that they are fully informed; directors have the deepest knowledge of the business and its prospects and are best placed to ensure that disclosure is accurate and meaningful". In the same vein, the Listing Rules state that the listing applicant's directors must collectively and individually take responsibility for the listing document<sup>1</sup>.

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<sup>1</sup> Listing Rule 11.12 and paragraph 2 of Appendix 1 Part A

### **Understanding the applicant (paragraph 45)**

We agree with the SFC that a sponsor should have a sound understanding of the listing applicant, including the elements stated in Question 1. We take this as an "enhanced version" of the basic know-your-client requirement for a licensed financial intermediary with the attendant responsibility to make reasonable efforts to ascertain all the relevant facts, including interviewing the appropriate persons and asking pertinent questions in this regard.

We would emphasize, however, that regulations couched in aspirational terms tend to provide limited guidance in practice. The due diligence conducted by a sponsor on the listing applicant, directors and other relevant parties must be considered in light of what is reasonable under constantly evolving circumstances, having regard to the nature and background of the specific listing applicant. The question is to what extent the sponsor, within the practical constraints of an actual transaction, may be required to "leave no stone unturned". We cannot avoid the perennial question of what is reasonable and practicably feasible for a sponsor attempting to verify the background of a listing applicant. The question has been especially acute in recent times with most Hong Kong IPOs involving companies that operate in countries where the political and legal infrastructure, including access to information, and transparency of governmental and quasi-governmental procedures, may be vastly different from what we take for granted in Hong Kong.

In addition, some issues such as outright fraud and commercial failure are beyond the customary parameters of due diligence. We must stress that some failures are concealed and are incapable of being identified, prevented or cured by the due diligence process. Obviously, the financial or general "success" of a company as a listed entity can never be guaranteed by adequate pre-listing due diligence. The concept of sponsors as "gatekeepers" must be tempered by clear-headed considerations of the types of issues any "gatekeeper" can reasonably keep outside the gate. It would not be helpful for public investors to have blind faith in the gatekeeping process. They should be fully aware of its limits, as well as the crucial balance between preventive measures and after-the-event enforcement. We echo the Joint Response that "the regulators should enhance investors' risk awareness that there is no 'guaranteed' investment in the stock markets".

The duty to have a sound understanding of the listing applicant must also be considered within the collaborative framework of the IPO process. Clearly, even if sponsors are willing and able to devote a huge amount of effort and expense on specific due diligence issues, they cannot be expected to have full access to, or know about the existence of, all relevant records (e.g. the reporting accountants' working papers).

In addition, in most relevant SFC enforcement cases in the past, problems have tended to arise from directors' and management's wrongdoing or accounting

failures (including fraud), which in reality may be impossible to uncover by due diligence.

We believe, therefore, that the key idea behind the "sound understanding" concept should be the sponsor (a) exercising a reasonable level of care and diligence that would be commensurate with its status as a licensed organization and in the specific circumstances of a listing applicant, with the attendant professionalism and commitment of material resources, and (b) employing the "professional scepticism" required in Practice Note 21 of the Listing Rules to find out as much as it reasonably can about the listing applicant.

***Q1: Do you agree a sponsor should have a sound understanding of a listing applicant for which it acts?***

***Response:*** Subject to the observations above, we agree with this requirement.

#### **Providing advice and guidance to the applicant (paragraph 46)**

SFC regulation<sup>2</sup> currently requires the adviser to use all reasonable efforts to ensure that its client understands the relevant regulatory requirements and their implications at all stages of a transaction. We believe the ambit of the current requirement is reasonable and appropriate and where fraud and serious misconduct have been alleged, the SFC should already have the necessary enforcement tools to address the issues.

We do not have strong objections to the restated requirement in the *first half* of the proposed new Paragraph 17.3(b)(i) to advise and guide a listing applicant and its directors as to their responsibilities under the Listing Rules and other applicable regulatory requirements. However, noting that "other applicable regulatory requirements" is very broad, we would emphasize that the obligation must be performed in conjunction with other professional advisers such as legal advisers and accountants. In particular, where the applicant has cross-jurisdictional operations that fall outside the sponsor's reasonable sphere of competence (or where relevant, professional qualifications), the sponsor will necessarily have to rely on the knowledge of local professional advisers to assist in the due diligence process.

We note that in the UK, the relevant requirement<sup>3</sup> is for the sponsor to guide the listing applicant in understanding and meeting its responsibilities *under the listing rules, disclosure rules and transparency rules* only. We are not aware of any equivalent requirement for a sponsor in Australia or the U.S., and an issue

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<sup>2</sup> Paragraph 6.3 of Corporate Finance Adviser Code of Conduct ("CFA Code")

<sup>3</sup> LR 8.3.1R

manager's obligations in Singapore do not appear to extend to guiding the listing applicant and its directors as to their legal or regulatory responsibilities.

Apart from the above, the proposed new Paragraph 17.3(b) seeks to impose three additional elements to the current requirements to advise and guide the listing applicant, namely:

- (a) to take all reasonable steps to ensure that at all stages of the listing application process the applicant and its directors understand and meet their responsibilities under the Listing Rules and other applicable regulatory requirements<sup>4</sup>;
- (b) to provide advice and recommendations to the applicant on any material deficiencies in its operations and structure, procedures and systems, or its directors and key senior managers<sup>5</sup>; and
- (c) to ensure that any material deficiencies are remedied prior to the submission of a listing application<sup>6</sup>.

Taking these elements in order:

We disagree with (a) above, as it significantly expands the current provision by requiring the sponsor to "ensure" that the directors understand and to *meet* the relevant requirements. The word "ensure" effectively makes the sponsor a guarantor that such requirements will be met and this is much too high a standard. Sponsors can take actions to identify and escalate issues of non-compliance, but imposing a positive "duty to ensure" appears excessive to us. If a listing applicant or its directors should choose to disregard the sponsor's advice and guidance, notwithstanding that the sponsor has clearly explained to them their responsibilities and the applicant and its directors have fully understood the same, we contend that the applicant and its directors, rather than the sponsor, should be held responsible for their compliance failure.

Comparing the position in other advanced markets:

- In the U.S. (where the "sponsor" concept does not exist), underwriters do not typically provide formal advice on ongoing compliance obligations which are

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<sup>4</sup> proposed new Paragraph 17.3(b)(i) of the SFC Code of Conduct

<sup>5</sup> proposed new Paragraph 17.3(b)(ii) (first four lines) of the SFC Code of Conduct

<sup>6</sup> proposed new Paragraph 17.3(b)(ii) (last two lines) of the SFC Code of Conduct

extensive and demanding. Listing applicants usually turn to their legal counsel to seek advice on ongoing compliance matters.

- In Australia, there is no statutory or listing rule requirement for the lead manager (whose appointment is not mandatory) to advise and/or ensure the listing applicant complies with all its obligations, although it is usual for the lead manager while assisting in the listing process to provide certain aspects of compliance guidance to the listing applicant in conjunction with the listing applicant's legal advisers and/or accountants.
- In Singapore, the requirement<sup>7</sup> is for the issue manager to be satisfied (amongst other things) that the listing applicant is set up sufficiently to comply with the continuing listing requirements and that its directors appreciate the nature of their responsibilities and can be expected to honour their obligations under the Listing Manual.
- In the UK, the requirement<sup>8</sup> is for the sponsor to guide the listing applicant in understanding and meeting its responsibilities under the listing rules, the disclosure rules and the transparency rules only and there is no requirement to ensure the directors meet their responsibilities.

***Q2: Do you agree that a sponsor should advise and guide a listing applicant and its directors as to their responsibilities under the Listing Rules and other applicable regulatory requirements and take all reasonable steps to ensure that at all stages of the listing application process they understand and meet these responsibilities?***

***Response:*** We do not have strong objections to the duty to "advise and guide a listing applicant and its directors as to their responsibilities under the Listing Rules and other applicable regulatory requirements", provided that the advice and guidance is to be given in conjunction with other advisers such as legal advisers and accountants where appropriate.

We do not agree with the duty to "take all reasonable steps to ensure that at all stages of the listing application process they understand and meet these responsibilities", as a "duty to ensure" would effectively make the sponsor a guarantor of such responsibilities being understood and met by the directors, which is too onerous a standard and is beyond the requirements of any advanced jurisdictions of which we are aware.

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<sup>7</sup> Rule 112(1) Listing Manual

<sup>8</sup> LR8.3.1R

We also strongly disagree with (b) above (the requirement to provide advice and recommendations on material deficiencies in the applicant's operations and structure, procedures and systems). The current comparable Listing Rule<sup>9</sup> requires the sponsor to check and confirm that the applicant has established "procedures, systems and controls (including accounting and management systems) which are adequate having regard to the obligations of the new applicant and its directors to comply with the [Listing Rules] and other relevant legal and regulatory requirements and which are sufficient to enable the new applicant's directors to make a proper assessment of the financial position and prospects of the new applicant and its subsidiaries". This duty focuses on what systems and procedures must be in place for the listing applicant to be able to comply with applicable laws and regulations on an ongoing basis – the emphasis is on the ability of the applicant to function as a listed company (whether or not it is a commercially successful business). This current provision already places considerable responsibility on sponsors, beyond the requirements of any advanced jurisdiction of which we are aware.

In contrast, the proposed wording requires the sponsor to advise on "any material deficiencies in [the applicant's] operations and structure, procedures and systems". This proposed requirement goes far beyond a sponsor's reasonable role as a securities markets specialist. Obviously, the sponsor firm, being a securities advisory intermediary, would not and cannot be expected to have the expertise to advise a commercial enterprise on all aspects of its "operations and structure". For example, paragraph (b) above could be construed to mean that the sponsor has to take primary responsibility for advising the applicant on all of the applicant's procedures and systems, potentially including specialist areas such as IT, intellectual property, human resources and environmental protection issues. This would essentially turn the sponsor into a business and/or management consultant to the listing applicant, which is not a reasonable proposal and is beyond the normal expertise of a sponsor.

Whilst the duties to check the applicant's procedures and systems (to the extent that such systems relate to Hong Kong regulatory compliance by the applicant as a listed company) and the experience, qualifications and competence of the directors have some basis in the current Listing Rules, we cannot see any basis for requiring sponsors to provide the same advice in relation to "operations and structures", nor in relation to "key senior managers".

In our view, the proposal to advise and recommend on material deficiencies in relation to directors and key senior managers is highly problematic. Each director is required<sup>10</sup> to satisfy the Stock Exchange that he has the character, experience,

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<sup>9</sup> Listing Rule 3A.15(5)

<sup>10</sup> Listing Rule 3.09

integrity and competence commensurate with his role as a listed company director. In addition, sponsors must have reasonable grounds to believe that the directors collectively have the experience, qualifications and competence to manage the listing applicant's business and comply with the Listing Rules<sup>11</sup>. We believe this is an appropriate and sufficient standard. An additional requirement for sponsors to advise and recommend on "material deficiencies identified in relation to ... directors and key senior managers" and to ensure such deficiencies are remedied before the A1 submission is neither appropriate nor realistic, particularly as it is not clear what "deficiencies" in relation to a *person* may refer to in practice.

The proposed provision goes on to state that the sponsor must not only provide advice and recommendations, but also "ensure" that material deficiencies are remedied. This amounts to making the sponsor a kind of guarantor for the listing applicant's operations and structure, systems and procedures, as well as directors and senior management, which is not practicable.

We see a danger in both paragraphs (b) and (c) above (paragraph (c) will be discussed below) that, by codifying duties to advise the listing applicant on material deficiencies in systems and procedures and to ensure such deficiencies are remedied, the unintended consequence will flow that the applicant and investors will subsequently have a cause of action against the sponsor (on "legitimate expectation" or similar grounds) for any alleged failure to perform such duties, if it results in a loss to these parties. This can impose a duty of care (of probably a tortious nature) owed by the sponsor to these parties, which would be severely detrimental to Hong Kong's attractiveness, compared with other advanced markets of the world, as an international financial centre. As set out below in our review of advanced markets, we are not aware of a comparable jurisdiction with standards giving rise to the same level of legal exposure for sponsors. In addition, we must not have a regulatory framework where the listing applicant's directors can blame the sponsor for their own failures in preparing and taking responsibility for the prospectus.

We strongly disagree with (c) above (the requirement to remedy any material deficiencies prior to the A1 submission) for the following reasons:

- the term "material deficiencies" is too wide and must be limited to deficiencies in those compliance systems and procedures which would materially affect the listing applicant's ability to comply with the Listing Rules and other applicable securities laws and regulations and which would materially affect the ability of the applicant's directors to make a proper assessment of the financial position and prospects of the applicant and its subsidiaries, not just general "deficiencies" in operations and structures

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<sup>11</sup> Listing Rules Appendix 19 Paragraph (b)(vi)

- not all "material deficiencies" are capable of remedy (or even discovery)
- requiring all "material deficiencies" to be remedied prior to the listing application essentially means listing applicants must spend significant amounts of time and cost on adjusting their systems and practices long before there is any certainty of listing – this will likely have a severe chilling effect on the willingness of potential applicants to choose Hong Kong as their listing venue
- in the case of material deficiencies that must be rectified by implementing new procedures or policies, proving that such procedures or policies are effective will take time – requiring the deficiencies to be "remedied" instead of implementing procedures and policies to remedy them would not be practicable prior to A1 submission
- where a "material deficiency" is incapable of remedy, the disclosure-based philosophy of IPO regulation puts the focus on adequately disclosing it to potential investors who will be expected to take it into account as part of their investment decision; it would be an overreach for regulation to attempt to provide a "fail-safe" position for investors by *eliminating* deficiencies
- if a "material deficiency" is identified and relevant recommendations are made, and yet the deficiency subsists (either because it is by its nature incapable of being remedied, or because the listing applicant's management is unable or unwilling to remedy it), the key questions for the regulators (and the sponsors) should then be:
  - can this deficiency be sufficiently addressed by appropriate disclosure?
  - does this deficiency go to the listing applicant's suitability for listing?

In a case where the above are the key issues to be resolved, it will be too simplistic to pin the liability onto the sponsor. Indeed, this approach potentially makes sponsors a kind of guarantor for the viability of the listing applicant, which goes against the entire disclosure-based philosophy behind IPO regulation in Hong Kong. Unintended and far-reaching consequences may flow from this radical change.

In the end, if the question as to suitability for listing is answered in the negative, the simple solution must be for the regulator to reject the listing application outright. Provided that the sponsor has not failed to perform its duties in (a) above, there should be no ground for attaching liability to it under the current disclosure-based philosophy of listing regulation. We strongly disagree with imposing (c) as an additional requirement.

Taking note of other advanced markets:

- In the U.S., the focus is on disclosure and the underwriters would endeavour to meet as many of the mandatory disclosure requirements as possible before submitting a first draft registration statement with the Securities and Futures Commission (the "SEC") for review. While underwriters will carry out a number of due diligence steps including investigations into the listing applicant's fundamental compliance issues, there is no requirement for them to *resolve* such issues before submission of documents to the SEC.
- In Australia, the obligation is on the listing applicant, not the sponsor, to resolve before the listing application fundamental compliance issues relating to the listing applicant.
- In Singapore, there is only a market practice for the issue manager to consult the SGX-ST on fundamental compliance issues such as interested person transactions, conflicts of interest and negative working capital prior to making the listing application.
- In the UK, the sponsor must submit to the Financial Services Authority (the "FSA") a letter setting out how the listing applicant satisfies, or *will at the time of the IPO* satisfy, the listing rule requirements no later than the time of submitting the first draft of the applicant's prospectus. Confirmation in relation to internal systems and controls is contained in the sponsor's declaration provided at the time of the listing application (which takes place once the applicant's prospectus has been approved by the FSA). The other confirmations in such declaration do not specifically cover the credentials of directors but due diligence on this will be covered through checking the disclosure in the applicant's prospectus as required under relevant rules. In our understanding, the market practice is that the sponsor receives a long form comfort letter from the reporting accountants to support the sponsor's confirmations.

In practice, the proposed requirements in (a) – (c) above are likely to lead to an inordinate number of pre-A1 enquiries by listing applicants and their advisers resulting from a desire to "pre-empt all possible issues". We believe this is not healthy for the market, and will also put enormous strain on the regulators.

***Q3: Do you agree that a sponsor should provide appropriate advice and recommendations to a listing applicant on any material deficiencies identified in relation to its operations and structure, procedures and systems, or its directors and key senior managers and ensure that any material deficiencies are remedied prior to the submission of a listing application?***

***Response:*** Based on the reasons set out above, we strongly disagree with these requirements.

### **Expected status before filing listing application**

**A. Completion of (substantially) all reasonable due diligence (paragraphs 47 – 52)**

We are of the view that the sponsor should have completed substantive due diligence at an early stage. Currently, based on the experience and professional judgment of the sponsor involved, there is already an implied understanding that it has gathered a substantial amount of information about the listing applicant, and will not ask the regulators to open a file unless it genuinely believes that the applicant has a reasonable chance of securing the necessary listing approval and waivers from the regulators. This, we believe, is inherent in the overall requirement for licensed intermediaries to act with integrity and reasonable diligence.

However, we are concerned about the SFC's stipulated level of due diligence. The sub-heading above Paragraph 47 and the heading of the proposed Paragraph 17.4(a) both refer to "completion of reasonable due diligence"; Paragraph 48 refers to "substantially complete" due diligence; while in Paragraph 52 and the text of Paragraph 17.4(a), the requirement is to complete "all reasonable due diligence" save any matters that by their nature can only be dealt with at a later date. It would obviously be impracticable to demand completion of "all" due diligence before A1 submission.

In this connection, we invite the SFC to take into account the fact that the A1 submission does not in any way put a moratorium on the listing applicant's business operations. The applicant will continue to conduct its business and its outlook will continue to evolve throughout the listing process. Furthermore, a requirement for the sponsor to "complete" all reasonable due diligence at a particular stage is, essentially, also a requirement for all the other professional advisers to "complete" their part of the work, which may not be possible in real terms – in particular, the reporting accountants will be engaged on an ongoing basis with the listing applicant (typically without the presence of sponsors) regarding the financial aspects of the business.

Turning to the fundamental reasons for conducting due diligence: traditionally, due diligence is inseparable from the disclosure exercise and the purpose of due diligence is to ensure that disclosure is fair, reasonable and not misleading. The SFC's proposal appears to be expanding the due diligence concept so that "adequacy" is no longer linked to the disclosure document but will be evolved into a standalone exercise carried out to safeguard something much wider than fairness of disclosure – potentially the commercial soundness of the applicant's business. We are very concerned about this approach, as there is a risk of indirectly introducing elements of a merits-based regime to Hong Kong, which will have wider repercussions for the attractiveness of Hong Kong as an IPO venue.

In our view, the key is to *identify* key due diligence issues as early as possible and if required, bring them to the regulators' attention. We are therefore concerned with the use of the word "complete" in relation to reasonable due diligence.

We believe the proposed requirement would not be helpful without more detailed SFC guidance on the meaning of "all reasonable" due diligence – particularly as to what needs to be done by what time. In particular, any requirement for a "reasonable" level of due diligence to be completed by the time of the listing application must refer to "reasonableness" as determined at such time. In providing such guidance, we urge the SFC to be mindful of the fact that each case must turn on its own facts and without such guidance, we are concerned that an expectation gap may exist between what the sponsor deems appropriate and practicable at the time of conducting an overall due diligence exercise and what might be seen as appropriate *in hindsight* after a specific issue has arisen.

***Q4: Do you agree that before submitting a listing application a sponsor should complete all reasonable due diligence on the listing applicant save only any matters that by their nature can only be dealt with at a later date?***

***Response:*** Based on the above reasons, we do not agree with this requirement unless the SFC provides more detailed guidance as to what "all reasonable due diligence" means and what the sponsor would be expected to have achieved by what time.

***B. Listing document (paragraph 53)***

There appears to be a mismatch between the expectations of the regulators, the sponsors and listing applicants as to what stage the first draft of the applicant's prospectus should have reached by the time of A1 submission.

Currently, the Listing Rules<sup>12</sup> provide that at the time of the first submission of the Form A1 listing application, the applicant's prospectus should be an advanced proof, and that if the Stock Exchange considers that the draft prospectus is not in an advanced form, it will not commence its review and will return all documents to the sponsor. The proposed Paragraph 17.4(b) in the SFC Code of Conduct requires that before submitting a listing application, a sponsor should come to "a reasonable opinion that the information in the Application Proof is substantially complete".

Juxtaposed, the proposed new rule adds to the existing requirement in two key ways:

- the current standard of "advanced proof" will be replaced (presumably meant to be enhanced) by the concept of "substantially complete"; and
- a positive duty will be imposed on a sponsor to form the relevant reasonable opinion.

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<sup>12</sup> Listing Rule 9.03(3)

In our view, neither of these two aspects stand up to close scrutiny. Firstly, neither "advanced proof" nor "substantially complete" is defined. Whether something is "substantially complete" may not be clear. For example, would the disclosure be treated as not being substantially complete if some of the board members have not yet been appointed and therefore their biographies are not yet included in the draft prospectus at the time of A1 application? By way of another example, the disclosure at the A1 stage in the "use of proceeds" section will only reflect management's current thinking about the financial needs of the group. Modifications (often considerable) could be necessary and normal in the interval between A1 submission and listing, as a result of changing conditions and even management's further thoughts about strategies and plans as a result of discussions with the sponsors during the listing application process. To what extent would sections such as these need to be "complete" in light of the proposed new rule?

In our view, the SFC's apparent insistence on "completeness" rather than application of a materiality concept to an applicant's prospectus disclosure is a cause for concern. As we will discuss below in relation to "complete" disclosure in Question 14, the concern is that in practice, a demand for a "complete" picture of anything is generally not realistic. In Hong Kong, prospectuses are already significantly longer than in other jurisdictions and, in practice, additional disclosure (including repetitions of the same statement in different parts of the prospectus) is often demanded by the regulators. We fear that a requirement for "completeness" will only induce practitioners to lengthen the disclosure indiscriminately to avoid liability – not just for material omissions but *any* omissions. This is obviously not healthy for the market.

In our experience, the current "advanced proof" regime under the Listing Rules appears to be an appropriate standard. In so far as the regulators consider that the existing "advanced proof" concept has failed to fend off excessively immature cases, we cannot see what, if any, change could be expected by replacing the existing concept (in which conceivably a degree of understanding has developed by market usage, albeit limited) with the proposed one. We submit that the exercise will not change the practical situation very much, although we would not have strong objections to the proposal if the SFC provides more detailed guidance on the meaning of "substantially complete". Equally important, the standard can only work without confusion if the SFC and the Stock Exchange are in full coordination and take a consistent and transparent approach in its application.

As for the proposed sponsor's duty to form a reasonable opinion of the "substantial completeness" of the draft prospectus, the key practical difference is that, where an applicant's prospectus is deemed by the regulators as not being substantially complete, the sponsor will be technically in breach of a regulatory duty and, in theory at least, be exposed to disciplinary action. In our view, this is unnecessary and inappropriate. A premature application should and will be returned by the regulators. If the inadequacies are only discovered after vetting has commenced,

the regulators can choose to suspend vetting until the inadequacies are fixed. In so far as the sponsors have been "delinquent" (and arguably, wasted the regulators' resources), it is adequately covered in the overall requirement for all licensed intermediaries to act with due skill, care and diligence, in the best interests of its clients and the integrity of the market<sup>13</sup>. To the extent that submitting a premature listing application is due to incompetence or lack of integrity, this is adequately covered in existing general principles<sup>14</sup>.

In relation to the heavy volume of amendments that are sometimes seen to be made to the A1 proof prospectus, we believe the appropriate view may be that the prospectus has simply failed to meet the current "advanced proof" standard. We believe one of the reasons why the standard of an "advanced proof" prospectus has generally deteriorated in recent years may be the regulators' exercising their powers to refuse to accept an A1 application too infrequently, even where the draft prospectus is below acceptable standards. This may have encouraged some listing applicants to put pressure on sponsors to be more aggressive on filing timelines and less concerned about the quality of the A1 draft prospectus. We note from the Stock Exchange's public records that, between January 2009 and 29 June 2012, out of a total of 649 listing applications received (for the Main Board and Growth Enterprise Market combined), only 11 applications were rejected<sup>15</sup>. We could not identify any statistics regarding the Stock Exchange's refusal to accept an A1 application for vetting.

This is despite the Stock Exchange's stated determination to return a listing application if the prospectus is not in an advanced state<sup>16</sup>. By acting more firmly on this, the regulators may be able to give a stronger message to issuers and sponsors alike of the seriousness with which the regulators take this issue of good first filings.

Depending on the circumstances, the regulators may consider imposing a practical deterrent, such as returning a blatantly premature listing application and declining to commence the vetting process, or suspending vetting until the problems have been appropriately addressed. In appropriate cases, the regulators may impose a cooling-off period before an application may be re-submitted, which in our view would be an effective deterrent.

For the SFC's reference, we attach in Appendix 2 to this paper a sample letter from the SEC declining to perform detailed examination of a registration statement or

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<sup>13</sup> GP1 of the SFC Code of Conduct

<sup>14</sup> Paragraph 3 of the CFA Code

<sup>15</sup> source: HKEX website

<sup>16</sup> HKEX News Release "Update on IPO Vetting Initiatives", 2 June 2003

issue any comments due to material deficiencies. In this example, the SEC suggested that the issuer either makes substantive amendments to correct the deficiencies or withdraws the filing. This is a clear and strong message to the issuer that the listing application will not proceed without major improvements.

***Q5: Do you agree that before submitting a listing application a sponsor should come to a reasonable opinion that the information in the Application Proof is substantially complete?***

***Response:*** We believe this amendment is unnecessary, as the current rules already require the listing application to be accompanied by an advanced proof of the prospectus. We believe appropriate safeguards are already in place. However, we would not have strong objections to the proposed amendment if the SFC provides more detailed guidance on the meaning of "substantially complete".

***C. Listing applicant (paragraphs 54 – 56)***

We have compared the proposed Paragraph 17.4(c) in the SFC Code of Conduct with the relevant Listing Rule requirement<sup>17</sup>. In substance, the proposed change is that the sponsor would be required to come to a reasonable opinion on the three specified matters (namely, the applicant's compliance with applicable rules and regulations; its having established adequate systems and procedures; and the directors having relevant experience, qualifications and competence) before submitting the A1 application, instead of before the issue of the listing document.

This is in line with the SFC's effort to push more of the diligence work to before the A1 application. In reality, under the existing rules, the regulators have and always will have the power and discretion to return an incomplete or premature listing application. The key change is that by putting a positive obligation for the sponsor to form the relevant opinion before the A1 submission, a premature case will immediately result in a regulatory breach by the sponsor and expose the sponsor to disciplinary action.

If the proposal is adopted, timing of the sponsor's declaration on the listing applicant's compliance status and systems and controls will be significantly moved forward. In terms of the current practice on internal controls review (being part of standard sponsor's due diligence process) the internal controls consultant is engaged before A1 submission and the preliminary report issued prior to the A1 submission will identify key issues for rectification. Some requirements, such as board committees, cannot in practice be fully met before all directors are on board which can normally only happen some time after A1 submission process (it being often not possible for independent non-executive directors to be persuaded to sign up to the position before the company has submitted its listing application). Other

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<sup>17</sup> Listing Rule 3A.15(5) – (6)

issues, such as quality control procedures, internal practice manuals and IT systems, where relevant, are currently identified before the time of A1 submission and rectified during the time leading up to the Listing Committee hearing. These issues are typically remedied within a short period of time, but in practice *after* the A1 submission when there is more certainty of the listing going ahead. In fact, the Listing Division and the Listing Committee of the Stock Exchange do sometimes impose additional requirements during the vetting and approval process, e.g. requiring the listing applicant to appoint additional independent non-executive directors, or prescribing the composition of certain board committees.

Accelerating the entire process to the time before the listing application is made is likely to cause considerable problems for potential listing applicants, as they are being asked to expend a significant amount of time and resources before it has any prospect of being listed in Hong Kong. In some cases, certain arrangements put in place by a listing applicant (e.g. business arrangements with connected persons which may have an impact on the listing applicant's independence under the Listing Rules) may need to be unwound because of comments from the Listing Division or the Listing Committee, which will increase the burden on the listing applicant. We believe acceleration of internal systems compliance will be detrimental to the attractiveness of Hong Kong as a market for potential listing applicants.

In practice, listing applicants would usually not be willing to introduce wholesale changes to their day-to-day operations (e.g. setting up procedures for identifying connected persons and tracking connected transactions, introducing or amending internal practice manuals, incorporating international anti-monopoly or anti-corruption standards, or revising approval processes) until later on in the listing process, when there is more certainty of a listing. In some cases, the listing applicant may not even have the relevant resources at the outset (e.g. a company secretary with the relevant qualifications and internal accounting professionals). We are concerned that requiring such arrangements to be in place before the A1 submission is likely to cause substantial difficulties to most potential listing applicants. Admittedly, listing applicants should be committed to becoming a public company and prepared to meet the public disclosure standards. However, in reality, requiring these applicants to spend significant amounts of time and cost on adjusting their systems and practices long before there is any certainty of listing will likely have a severe chilling effect on the willingness of potential applicants to choose Hong Kong as their listing venue.

The requirement for listing applicants to have established adequate compliance systems and procedures before the A1 application substantially prolongs the pre-A1 preparation time and therefore the overall timetable (from the listing applicant's perspective), potentially making Hong Kong a "difficult market" for listing applicants. In addition, some of the listing conditions can only be satisfied during the listing application process. For example, financial information may have to be updated during the listing process. It is also normal for the listing suitability of the listing applicant (bearing in mind that this is also a listing condition) to be

fleshed out during the process. It is not always realistic to require full compliance with each detailed listing condition prior to A1 filing.

Although we have no objections in principle to the regulators encouraging more due diligence work to be done at the front-end of the listing process, we believe the proposed Paragraph 17.4(c) is unnecessary and inappropriate, and may result in a chilling effect on potential listing applicants choosing Hong Kong as a listing destination.

***Q6: Do you agree that before submitting a listing application a sponsor should come to a reasonable opinion that the applicant has complied with all applicable listing conditions (except to the extent that waivers from compliance have been applied for), has established adequate systems and procedures and the directors have the necessary experience, qualifications and competence?***

***Response:*** For the reasons stated above, we disagree with this amendment. The current Listing Rule requirement gives public investors adequate protection. Moving the timing for the sponsor to form the relevant opinion to the time of A1 filing would have a significant impact on the market, particularly on prospective listing applicants as they will have to expend a considerable amount of time and resources before there is any prospect of a successful listing.

***D. Notification of all material issues identified (paragraphs 57 – 58)***

In so far as any material and fundamental issues of the nature described in the Consultation Paper have been identified prior to submitting the A1 application, we agree that they should be communicated to the regulators without delay. We agree in principle to the underlying spirit of this proposal.

However, we have some residual concerns about the rule<sup>18</sup> if the intention is to hold the sponsor liable for failing to disclose material issues relating to the broad concepts of "listing suitability" and "public interest". Using an example to illustrate our concern: where historical records have been identified in relation to a director which do not fall strictly within the relevant disclosure requirement<sup>19</sup>, the sponsor may believe that the matter is not reasonably necessary for the consideration of "whether a listing applicant is suitable for listing and whether the listing of the applicant's securities is contrary to the interest of the investor public or to the public interest", whilst market regulators may take a very different approach.

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<sup>18</sup> proposed new Paragraph 17.4(d) of the SFC Code of Conduct

<sup>19</sup> Listing Rule 13.51(2)

We are reassured by the fact that the requirement is subject to the reasonable opinion of the sponsor, but would welcome any additional guidance the SFC may see fit to give.

***Q7: Do you agree that a sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration of the application as described in paragraph 57 above are disclosed to the regulators when submitting a listing application?***

***Response:*** We are broadly comfortable with this requirement but have reservations about the drafting of this amendment, due to a concern that the sponsors and the regulators may have different interpretations as to what the sponsor should "reasonably" have seen as being necessary for the regulators' consideration of the listing application, particularly what factors may or may not be relevant to the evaluation of listing suitability or public interest.

### **Sponsor's responsibility for prospectus disclosure and due diligence**

#### ***A. Overall disclosure (paragraph 59)***

We have no objections in principle to the proposed Paragraph 17.5(a), except that we do not think it should be the sponsor's duty to "ensure" the facts stated in that provision. As noted in the discussions above for Questions 2 and 3 above, the word "ensure" potentially turns the sponsor into a guarantor of the relevant matters which is, in our view, impracticable. We submit that this requirement should be replaced with one to believe on reasonable grounds in the matters stated.

***Q8: Do you agree that a sponsor, after reasonable due diligence, should ensure that at the time of issue a listing document contains sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the financial condition and profitability of the listing applicant?***

***Response:*** We agree generally with this wording, except that the duty to "ensure" should be replaced by a requirement for the sponsor to believe on reasonable grounds in the stated matters.

#### ***B. Disclosure: non-expert sections (paragraphs 60 – 62)***

The proposed new Paragraph 17.5(b) covers the same ground as and is very similar to the existing Listing Rule requirement<sup>20</sup>. The key differences are:

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<sup>20</sup> Listing Rule 3A.15(4)

- the current rule requires checking that the information is true in all material respects (and any opinions and forward-looking statements are made after due and careful considerations and based on fair and reasonable assumptions); the new requirement is to check that the information is "true, accurate and complete in all material respects and not misleading or deceptive"
- the current rule requires confirmation that the non-expert sections do not omit material information; the new requirement refers to "no matters or facts the omission of which would make any information in [the non-expert sections] or any part of the listing document misleading"

We believe the proposed extensions are broadly reasonable, except for the requirement for "completeness". It is in practice very difficult, if not impossible, to prove the "completeness" of a disclosure document, even with the materiality qualification. It is essentially a requirement to be satisfied of the non-existence of additional relevant facts, which is beyond the reasonable capability of any investigator in a listing exercise. We would invite the SFC to give guidance as to what concerns it has as to the current "no material omissions" formulation, pending which we submit that the current wording is more appropriate.

***Q9: Do you agree that a sponsor, after reasonable due diligence, should have reasonable grounds to believe and does believe that at the time of issue of a listing document the information in the non-expert sections is true, accurate and complete in all material respects and that there are no material omissions?***

***Response:*** We agree generally with this amendment, provided that the requirement for information to be "complete in all material respects" is removed.

***C. Disclosure: expert sections and due diligence on expert's work (paragraphs 63 – 73)***

The SFC proposes to re-state the sponsor's responsibilities in respect of third party experts' work by inserting the new Paragraphs 17.5(c) and 17.6(g).

The proposed Paragraph 17.5(c) appears to beg the question: if all the requirements of Paragraph 17.6(g) (together with all such Listing Rules as are relevant) are complied with, will the sponsor be taken to be in a position to demonstrate that it is reasonable to rely on the expert sections? If not, what additional duties does the SFC expect the sponsor to perform to demonstrate such reasonableness?

The current requirement in the Listing Rules<sup>21</sup> is, in our view, fairly detailed, covering such aspects as verification of the factual information relied on by the expert; soundness of the bases and assumptions used by the expert; as well as the

<sup>21</sup> Listing Rule 3A.16 and Appendix 19 paragraph (c) (applied by Listing Rule 3A.13)

expert's qualifications, scope of work and independence. If the SFC's key concern is as summarized in paragraph 29 of the Consultation Paper – namely, "uncritical reliance on experts", it appears that a sponsor that has bona fide signed and issued the relevant declaration as required by the Listing Rules cannot be said to be guilty of "uncritical" reliance.

Generally, we have no objections to the principle that the sponsor should rely on the expert report only if it is reasonable in the circumstances for it to do so, and the SFC's effort to refine and enhance regulation in this respect. However, the new principle-based Paragraph 17.5(c) is a significant proposal as it puts the burden of proof on the sponsor to show reasonable reliance. We are concerned that the SFC's observations on the laws of other jurisdictions, used to support this proposal, appear to be incomplete:

- In the Consultation Paper, the SFC notes with approval the U.S. jurisprudence requiring an underwriter's reliance on expert reports to be reasonable in order for it to establish a defence to disclosure liability, including the duty to investigate the reliability of such expert statements where "red flags" are apparent in respect of those statements. We do not suggest here that such an approach is flawed or that a sponsor should be entitled to rely blindly or unreasonably on the reports of experts. However, the U.S. approach does not, in our opinion, support the imposition on the sponsor, as the SFC is proposing, of general, positive obligations to demonstrate, in respect of each expert or each item of expert information in any given transaction, the reasonableness of its reliance. We would remind the SFC that in the U.S., an underwriter is only required to make such a demonstration where the underwriter has been sued, has had specific complaints pleaded against it in respect of specific disclosure issues, and has elected to dispute such complaints. We can all agree that a sponsor's reliance must be reasonable, but it is a very different matter to require that such reasonableness be positively demonstrated in each case – particularly where no "red flags" are apparent.
- In our understanding, the Australian requirement to demonstrate reasonableness of reliance is, likewise, called into play *only if* the lead manager or underwriter is seeking to rely on the due diligence defence or reasonable reliance defence where the applicant's prospectus is found to have omitted material information or if a material statement is misleading or deceptive<sup>22</sup>.
- There is no requirement for the issue manager to be in a position to demonstrate reasonable reliance in Singapore (except where the issue manager is seeking to raise a defence against liability or misstatement<sup>23</sup>), although when the issue

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<sup>22</sup> s.733(1) Corporations Act

<sup>23</sup> under s.255(3) Securities and Futures Act

manager seeks to rely on experts in areas beyond its expertise, the issue manager (together with the listing applicant, its directors and management) would in practice satisfy itself that such reliance is reasonable in the circumstances<sup>24</sup>. The issue manager is not expected to ascertain the correctness of information prepared by a third party in the prospectus<sup>25</sup>.

- Nor is there any such requirement in the UK – where the sponsor seeks to raise a defence in relation to a provision<sup>26</sup> for civil liability for prospectus misstatements, the work it must have performed in relation to expert's work is couched in terms of the expert being properly qualified and experienced, the expert's terms of reference, scope of work and assumptions, and consistency between the factual information relied on by the expert and the sponsor's knowledge of such facts.

In our view, given the existence of Listing Rule 3A.16 as it may be amended by the new Paragraph 17.6(g) (see below), Paragraph 17.5(c) is not necessary from an investor's protection perspective.

We are gravely concerned by the SFC's attempt to make the sponsors responsible for confirming the experts' analyses and opinions. Sponsors are specialized financial intermediaries and it would be wholly unrealistic to expect them to provide such assurances.

We note in passing that where mistakes in the expert sections of a listing document is a result of misconduct or negligence of expert advisers, it would not be fair to impose liability on the sponsor instead of the expert. We will welcome an opportunity to discuss with the SFC issues relating to the actions that may be appropriately taken against expert advisers in such cases.

***Q10: Do you agree that at the time of issue of a listing document a sponsor should be in a position to demonstrate that it is reasonable for it to rely on the expert sections of the listing document?***

***Response:*** We do not agree with this amendment. Given the existing Listing Rule 3A.16 as it may be amended by the new Paragraph 17.6(g) (see below) and the absence of equivalent requirements in other major markets of the world, we do not see a persuasive case for putting an additional principle that seeks to put the evidential burden on the sponsor to show reasonableness of reliance.

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<sup>24</sup> General Principle 3 Singapore Investment Banking Association Guidelines ("SIBA Guidelines")

<sup>25</sup> Paragraph 3 in Section II, Recommended Procedures for SIBA Guidelines

<sup>26</sup> s.90(2) and Schedule 10 Financial Services and Markets Act ("FSMA")

We would like to invite the SFC to clarify whether Paragraph 17.6(g) will be an *addition* to the current Listing Rule requirements, or if the former will *replace* the latter. Obviously, it will not be appropriate to have two concurrent and partially overlapping sets of rules regulating the same aspect of sponsor's work.

As proposed, the two sets of rules cover much the same ground, but with significant and in our view unhelpfully onerous differences. For example:

- the two regimes are broadly identical in terms of the sponsor's checks of the expert's qualifications and experience, scope of work and independence
- for factual information not independently verified but relied on by the expert, the Listing Rule requires the sponsor to confirm that the facts are true in all material respects and does not omit any material information – this we believe is already highly demanding, being basically a requirement that the sponsor verifies any information which the expert does not; Paragraph 17.6(g) specifies two completely different tasks: (a) checking consistency with the sponsor's own knowledge of the facts and (b) making independent inquiries or assessments of such facts
- the Listing Rule<sup>27</sup> goes on to define "factual information", which is not provided in the proposed Paragraph 17.6(g)
- under the Listing Rule<sup>28</sup>, the sponsor should ensure the bases and assumptions adopted by the expert are "fair, reasonable and complete"; under Paragraph 17.6(g) the new test is "fair and reasonable"
- the Listing Rule requires the sponsor to ensure the expert is sufficiently resourced to give the relevant opinion; Paragraph 17.6(g) is silent on this point
- the Listing Rule requires the sponsor to ensure that the prospectus fairly represents the view of the expert and contains a fair copy of or extract from the expert's report (this is broadly similar to the requirements of the Companies Ordinance<sup>29</sup>); Paragraph 17.6(g) is silent on this point

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<sup>27</sup> Rule 3A.16(1)(a) – (c)

<sup>28</sup> Rule 3A.16(2)

<sup>29</sup> Under s.40(2)(d)(ii), a defence is raised against civil liability for a misstatement in a prospectus if the defendant proves, in relation to an expert statement or expert report, that the report fairly represented the statement or was a correct and fair copy or extract from the report.

We assume for the time being that Paragraph 17.6(g) will *replace*, and not be super-imposed on, the existing Listing Rule requirements. On this basis, we would make an important observation that the proposed language imposing a duty on the sponsors to make independent inquiries or assessments of the facts relied on by the expert appears extremely burdensome. While we understand that the SFC does not expect sponsors to "audit the auditors" (or other relevant experts), the language of the draft rules are very broad and the practical parameters are very hard to draw. This broad drafting gives us concern, as it could impose a duty on the sponsor to conduct a forensic study of the expert's work, which, as we trust the SFC agrees, would be wholly unrealistic and directly at odds with its long-established approach reflected in the notes to Paragraph 5.5(b) of the CFA Code. Such an approach also risks disincentivizing the experts, in particular the reporting accountants, from ensuring that all aspects of their work are reasonable.

If the intention is not to have such a broad auditing duty but to make the sponsor focus and follow up on "red flag" issues, we strongly urge the SFC to spell this out in the rules. Specifically, we are:

- (a) comfortable with Paragraph 17.6(g)(i);
- (b) concerned with Paragraph 17.6(g)(ii) generally which goes well beyond and is directly at odds with the practice reflected in the notes to Paragraph 5.5(b) of the CFA Code and in particular the proposal that the sponsor must review relevant accounting systems and controls – the obligations regarding accounting policies, review of accounting systems and controls etc. should be limited to where the sponsor is reasonably put on enquiry about the sufficiency of the expert's work; or if the sponsor has reasons to be aware of discrepancies between the financial disclosure and actual business performance and other operating aspects; or if the sponsor is reasonably put on enquiry regarding the veracity of management discussion and analysis in light of the general due diligence picture it has formed so far into the process;
- (c) concerned with Paragraph 17.6(g)(iii) which also goes beyond the practice reflected in the notes to Paragraph 5.5(b) of the CFA Code – similar to (ii) above, the obligation to work with the valuer regarding valuation methodologies should be triggered only if the sponsor is reasonably put on alert regarding the quality or adequacy of the valuer's work;
- (d) concerned with the scope of Paragraph 17.6(g)(iv) – this should not cover "all factual information on which an expert relies", as this is not quantifiable or even ascertainable in reality; the obligation to ensure consistency should be triggered only when a reasonable sponsor would have been alerted to any actual or potential inconsistencies;

- (e) concerned with the scope of Paragraph 17.6(g)(v) – this should be amended to apply only to material factual information that is contained in the expert report or has been specifically brought to the attention of the sponsor by the expert, and only to the extent that it is reasonably practicable<sup>30</sup>;
- (f) concerned with the scope of Paragraph 17.6(g)(vi) – the duty to corroborate should arise only where a reasonable sponsor would be put on enquiry and the potential inconsistency is material in light of the general import of the expert report; and
- (g) generally comfortable with Paragraph 17.6(g)(vii), provided the discrepancies or irregularities are made subject to a materiality qualification.

We would like to point out that, in practice, in its position as an independent professional adviser, the reporting accountant/auditor does not and cannot give the sponsors full access to relevant records and proceedings. The sponsor does not have actual control over the auditor's performance of its professional duties. Access to meetings between the auditor and the listing applicant is typically limited and there is usually no access at all to the auditor's working papers. We respectfully submit that the SFC should explore into better coordination with other industry regulators (such as the Hong Kong Institute of Certified Public Accountants and the Financial Reporting Council) for concerted enforcement efforts, instead of putting responsibilities on the sponsor that are unrealistic.

In addition, we strongly believe that in terms of the due diligence the sponsor should perform on other expert parties' work, Hong Kong should adopt an *objective* test and not a subjective one. In other words, it is question of what a *reasonably competent* sponsor would have concluded, rather than having to look case by case at the skills and knowledge of the individual sponsor concerned. To demand otherwise would make compliance too difficult and impracticable, with sponsors having to go to considerable lengths to trawl through their informally held information about the listing applicant, their industry, their markets, and so on. The problem would be particularly acute for a financial conglomerate the corporate finance division of which may be involved in a number of transactions and may have "access" (in an imputed sense) to information in other departments and

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<sup>30</sup> To illustrate this, consider a case where the reporting accountant relies on the management's representation that all sales invoices are genuine. The accountant may only verify a portion of such invoices by confirming directly with the customers. It would be wholly unrealistic to require the sponsor to make independent enquiries to verify the accuracy of the statement, as that would require a separate checking the full set of invoices. This is impracticable in terms of cost and timing, and more importantly, unrealistic because accountants do not typically share that much detailed information with the sponsors. Add to this the regulatory requirements to keep books and records of the exercise and the whole regime becomes extremely onerous.

functions and even other jurisdictions across the globe, which information may be subject to regulatory and/or contractual confidentiality requirements. We believe imposing a subjective test of reasonableness would make the rule difficult to comply with or to enforce.

We would urge the SFC to take into account equivalent requirements in advanced markets of the world. In particular we note that:

- In the UK, there is no positive obligation for the sponsor to check the work of a third party expert. Where the sponsor is seeking to raise the due diligence defence against a claim under Section 90 FSMA, the checks are focused on competence and consent of the expert in relation to the statement, as well as its qualifications and experience.
- In Australia, the lead manager or underwriter has no responsibility to ensure the accuracy or reliability of information prepared by a third party expert included in the prospectus. "Reasonable reliance" comes into play only if the lead manager is facing a lawsuit and is seeking to raise the relevant defence.
- In Singapore, the duties of the issue manager regarding a third party expert's work extend only to the qualifications, experience and capacity of the expert to perform the relevant work, and the expert's independence and suitability, taking into account its track record<sup>31</sup>.
- In the U.S., underwriters do not have statutory or regulatory responsibilities in respect of information prepared by third party experts in the prospectus. An underwriter has to prove the absence of any reasonable belief that any expertised statement is untrue or contains a material omission only if it is facing a lawsuit and is seeking to raise the due diligence defence<sup>32</sup>.

***Q11: Do you agree that the sponsor should take these steps in connection with an expert report? Are the steps set out in paragraph 17.6(g) of the draft Provisions sufficient and appropriate?***

***Response:*** We cannot give a complete response at this stage, pending clarification by the SFC on what (if any) additional duties, apart from Paragraph 17.6(g) and relevant Listing Rules, the SFC expects the sponsor to perform to satisfy the duty to demonstrate reasonableness, as proposed in Paragraph 17.5(c). We strongly urge the SFC to publish a draft of the "final rule" (fully aligned with the comparable Listing Rules) so the market can have a complete picture of the regulations before expressing its opinion on the proposed amendment.

<sup>31</sup> Paragraph 3 Section II SIBA Guidelines

<sup>32</sup> s.11(b) Securities Act

At this stage, assuming that the proposed new rules will replace the current ones, our key comments are:

- (a) we are concerned with the proposed amendments in Paragraph 17.6(g), except sub-paragraphs (i) and (vii) (provided (vii) is augmented by a materiality qualification in respect of discrepancies or irregularities);
- (b) we do not agree with the scope of sub-paragraph (v) unless it is amended to apply only to material factual information that is contained in the expert report or has been specifically brought to the attention of the sponsor by the expert, and only to the extent that it is reasonably practicable;
- (c) we are strongly against any attempt to impose upon the sponsor a duty to audit, conduct a forensic investigation of, or replicate other professional parties' work – this would be impracticable, as well as directly at odds with the notes to Paragraph 5.5(b) of the CFA Code – and would urge the SFC to spell out the "red flag" concept in the drafting of Paragraph 17.6(g) as we have suggested above; and
- (d) for the sponsor's due diligence on other expert parties' work, Hong Kong should adopt an *objective* test and not a subjective one.

#### ***D. Independent due diligence steps and interview practices***

The SFC has put two entirely new sections in the indicative draft Paragraph 17.6(e) and (f) with no attendant consultation questions in the text of the Consultation Paper. Noting that there is no existing equivalent to these detailed requirements, we studied them in some detail and our initial views are as follows:

- Paragraph 17.6(e)(i) – We agree that only "material" records and documents are specifically required to be checked, but we are very concerned that there is no mention of such documents being reasonably obtainable by the sponsor (with the assistance of the listing applicant or otherwise). In our view, the sponsor clearly cannot be expected to check *all* records of the company in existence, nor would it be practicable for it to check the records (tax certificates, invoices and bank statements being cogent examples) that are likely to form the information underlying the audit process. Please see our discussion on Question 11 above regarding our serious reservations about "second guessing" the auditor or reporting accountant (unless the sponsor is reasonably put on enquiry).
- Paragraph 17.6(e)(ii) – This requirement is too broad in our view. Not all issues require corroboration by third party enquiries and we do not believe the SFC intends to make the sponsor verify each and every factual statement with enquiries, unless there are circumstances that would put a reasonable sponsor on enquiry – i.e. a "red flag" exists. We believe there should be an "as

reasonably required" qualification. We also suggest that such reasonableness must be determined at the time of making the enquiry and in the relevant circumstances.

- Paragraph 17.6(e)(iii) – We are generally comfortable with this provision.
- Paragraph 17.6(e)(iv) – Similar to Paragraph 17.6(e)(ii), we believe the obligation to obtain written confirmations cannot extend to all matters, but only to any "red flag" issues that would be apparent to a reasonable sponsor. The obligation to obtain written confirmations must also be qualified by reasonable practicality and materiality.
- Paragraph 17.6(e)(v) – We are generally comfortable with this provision, subject to our views below regarding the interview steps proposed by the SFC in Paragraph 17.6(f).
- Paragraph 17.6(e)(vi) – Similar to Paragraphs 17.6(e)(ii) and (iv), we believe these obligations cannot extend to all matters, but only to any "red flag" issues that would be apparent to a reasonable sponsor. Otherwise, we are generally comfortable with this provision as regards public filings and databases, external confirmations and third-party data about competitors, subject to these requirements being qualified by "so far as practicably obtainable" and "where circumstances reasonably require". In relation to the engagement of external agents to perform relevant checks, we believe this must be qualified by "where circumstances reasonably require". We would advise caution on this point, as engagement of external agents has cost implications that will likely be transferred to the listing applicant in practice, with attendant impact on the cost of the listing and hence the attractiveness of Hong Kong as a market.
- Paragraph 17.6(f) – We are concerned that the preamble to this paragraph appears to be couched in subjective and aspirational terms such as "effective and adequate" measures. We object strongly to the requirement to ensure that the "results" of the interviews are accurate, complete and reliable, the meaning of which is very uncertain to us. The requirement would be more acceptable if the word "result" is replaced by "records". However, minutes of meetings are by definition summaries of the proceedings only and therefore, the requirement should be revised to "reasonably accurate, complete and reliable in all material respects". As a general observation about third party interviews, we would like to remind the SFC that in a normal case, the third party cannot be informed about the intended listing.
- Paragraph 17.6(f)(i) – We are generally comfortable with this requirement.
- Paragraph 17.6(f)(ii) – Third party interviewees typically cannot be informed about the listing application at all because of Listing Rule confidentiality requirements and potential insider trading concerns (the latter in cases such as a

spin-off IPO or a secondary listing). Even if they were informed, third parties such as customers and suppliers typically do not have a "stake" in the listing and do not have any incentive to cooperate with the sponsor in carrying out due diligence. In many cases, the third parties are not even accessible to the sponsor without the help of the listing applicant. Noting the SFC's concern that the interviews are at risk of being manipulated by the applicant, we would suggest that the requirement should be changed to "with as little involvement of the listing applicant as reasonably practicable".

- Paragraph 17.6(f)(iii) – The sponsor will not be in a position to "ensure" the interviewee has appropriate authority and knowledge. We suggest this be replaced by "be reasonably satisfied".
- Paragraph 17.6(f)(iv) – We are concerned that the expressions "in-depth" and "adequate" and "satisfactory" are all subjective standards that are difficult to comply with. We agree generally to the requirement to follow up on incomplete and outstanding matters.
- Paragraph 17.6(f)(v) – As some irregularities may be incapable of resolution, we would suggest replacing the word "resolved" with "addressed".

***E. Reliance on non-expert third parties to conduct due diligence (paragraphs 74 – 76)***

In principle, we agree with the SFC that while professional advisers such as legal counsel are an integral part of the collaborative process of a listing application, the sponsor remains responsible for a reasonable allocation of work according to the professional competency of each party in the working team, as well as the overall quality of the due diligence conducted on the listing applicant.

Whilst we understand the risks of over-delegation of due diligence duties, a clear line should be drawn between "over-delegation" on the one hand, and on the other situations where sponsors are appropriately relying on experts on areas of their expertise, as well as having parties such as legal counsel help with coordinating among the group of sponsors and underwriters in the due diligence exercise.

In paragraphs 29 and 74 of the Consultation Paper, the SFC expresses its concern about "over-delegation" – not simply "delegation" – of due diligence responsibilities. In paragraph 76 of the Consultation Paper, the SFC acknowledges that in some circumstances it may be appropriate for a sponsor to seek assistance from a third party in the course of due diligence and again in that paragraph, the SFC recognizes that "legal counsel who are capital market specialists will often have developed general experience and expertise which can be brought to bear in collaboration with sponsors to assist in the due diligence exercise".

Given the above, with which we are in agreement, we are slightly surprised by the statement in the proposed Paragraph 17.6(h) that "a sponsor cannot delegate responsibility for due diligence". We believe the mischief that the regulators are trying to prevent is abrogation, not delegation, of responsibilities. Delegation in itself should not cause major problems provided all the safeguards are in place – e.g. initial overall planning, reasonable division of tasks, continuing control and supervision. In reality, the difference between seeking "assistance" from an outside professional and "delegating" something to it is often illusory. We do not think it would be helpful to put too fine a point upon the use of such fluid terms. Rather, the emphasis should be on whether delegation (or obtaining assistance) is reasonable in the surrounding circumstances and whether, due to lack of the attendant checks and balances, delegation of responsibilities has become abrogation of responsibilities.

We do not agree with the SFC's statement in Paragraph 75 of the Consultation Paper, that "a [Rule 10b-5 disclosure letter] might ... give rise to concerns that a sponsor has over-relied on legal counsel during the due diligence process, and as a result has not met its obligations to conduct reasonable due diligence". We do not see any link between the level of due diligence performed by a sponsor and the fact that it requests the disclosure letter from legal counsel. In Hong Kong IPO practice, the disclosure letter is typically obtained from U.S. counsel in relation to the international offering circular but that does not mean that because the letter exists, sponsors do less than is required either under Practice Note 21 of the Listing Rules or to raise the relevant legal defences under U.S. law. We would invite the SFC to consider further the true purpose of the Rule 10b-5 disclosure letter.

In any event, the SFC clearly envisages in the new Paragraph 17.6(h) the delegation of (or enlisting assistance in) certain discrete tasks and outlines key checks to ensure delegation would not be excessive. For example, we believe it is acceptable practice to engage experts with appropriate qualifications in the relevant profession or industry sector to conduct specific aspects of technical due diligence.

***Q12: Do you agree that a sponsor cannot delegate responsibility for due diligence?***

***Response:*** We do not believe inserting this general statement in the new Paragraph 17.6(h) is helpful. "Delegation" of individual tasks in the due diligence exercise would not in itself be problematic if the sponsor retains overall control and exercises close supervision. In any event, the SFC clearly envisages the delegation of (or enlisting assistance in) certain discrete tasks. We believe sufficient guidance is given in Paragraph 17.6(h) without the overall statement against delegation.

The SFC's proposed Paragraph 17.6(h)(i)-(iv) sets out a list of things which the sponsor should do regarding the work of non-expert third parties. While we have no objections in principle to a list of key steps (which although not exhaustive, could be a useful aide memoire for the sponsor), we note the potentially confusing

overlaps and discrepancies between this rule and the existing requirement in the Listing Rules<sup>33</sup>, for example:

- the existing requirement states a general duty for the sponsor to satisfy itself that it is reasonable to rely on the information or advice provided by the third party professional (echoing the proposed Paragraph 17.5(c) for expert work); there is no equivalent in the proposed SFC amendments
- the proposed Paragraph 17.6(h) requires the sponsor to determine the scope and extent of tasks to be performed; the existing rule requires the sponsor additionally to inquire into the methodology proposed to be used by the professional
- the existing rule requires the sponsor to ensure consistency between the professional's report and other information known to the sponsor; the proposed Paragraph 17.6(h) is silent on this

Same as for Questions 10-11 above, we can only assume that the new Paragraph 17.6(h) will *replace*, and not be added onto, the existing Listing Rule. We would strongly urge the SFC to clarify and streamline the regulations.

Echoing our comments in relation to Questions 10-11 above, we would caution against any attempt to impose a duty on the sponsor which is equivalent to requiring it to duplicate the work of the professional, or to conduct a forensic examination of the such work.

***Q13: Are the steps we propose a sponsor should take when seeking assistance from a third party in its due diligence work sufficient and appropriate?***

***Response:*** We cannot give complete comments at this stage, pending clarification by the SFC as to how the proposed steps will interact with the existing Listing Rule requirements. We strongly urge the SFC to publish a draft of the "final rule" (fully aligned with the comparable Listing Rules) for public consultation so the market can have a complete picture of the regulations before expressing its opinion on the proposed amendment.

Assuming that the proposed new rules will replace the current ones, we have no major objections to the proposed new provisions, but we would caution against any attempt to impose a duty on the sponsor which is equivalent to requiring it to duplicate the work of the professional, or to conduct a forensic examination of the such work.

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<sup>33</sup> Paragraph 5 of Practice Note 21

***F. Due diligence plan (paragraph 96)***

The proposed new Paragraph 17.9(c) and (d) is an expansion and enhancement of the equivalent existing SFC requirement<sup>34</sup>. We do not have major objections to this except as follows:

- (a) We believe the current definition of "Management" (covering the board of directors, managing directors, CEO, Responsible Officers and other senior management personnel) is too wide and will cause practical problems, particularly for international financial conglomerates whose directors and Responsible Officers may very well be based outside Hong Kong and may not typically be involved directly in the day-to-day operations of the Hong Kong IPO practice.
- (b) We believe it is not helpful in new Paragraph 17.9(d) to refer to "clear and effective reporting lines". The spirit of the requirement is that there should be within the organization appropriate channels for issues to be escalated to the appropriate level of management, but at the same time allowing a certain degree of flexibility to be maintained within the organization, instead of insisting on rigid hierarchical structures.

The question of the extent to which "Management" should be required to assume full responsibility and supervision over sponsor's work is discussed in more detail in "Sponsor's internal management – C. Management oversight" below.

***Q23: Do you agree that a sponsor should maintain effective systems and procedures to ensure that an appropriate due diligence plan is formulated, updated as necessary and implemented in respect of each assignment and there are clear and effective reporting lines to ensure that key issues are escalated to Management for deliberation?***

***Response:*** We agree with this amendment generally, except that (a) the requirement to escalate key issues to "Management" as currently defined is in our view excessive and impracticable. Please refer to our response to Question 24 for our concern as to requiring the most senior management of a financial institution to participate in day-to-day sponsor's work; and (b) there is no need to refer to "clear and effective" reporting lines as long as key issues are being escalated to an appropriate level of management.

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<sup>34</sup> Part I, Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC ("Internal Control Guidelines")

**G. Information provided to analysts in new listings (paragraph 113)**

We agree in principle to the proposed Paragraph 17.7(d).

**Q30: Do you agree that the obligation in the CFA Code relating to the provision of information to analysts should be transferred to the Code of Conduct?**

**Response:** We agree with this.

**H. Scope of Provisions (paragraph 114)**

We agree in principle to the proposal to apply the relevant provisions to the listing agent of a Real Estate Investment Trust ("REIT").

**Q31: Do you agree the Provisions should equally apply to a listing agent appointed for the listing of a REIT?**

**Response:** We agree with this.

**Communication with the regulators (paragraphs 77 – 83)**

Comparing the proposed Paragraph 17.7(a) – (b) and the current Listing Rule requirement<sup>35</sup>, we again see two overlapping but differently-worded rules regulating the same area. Chiefly, the sponsor's responsibility under the existing provision is to ensure that all information provided to the Stock Exchange is "true in all material respects and does not omit any material information", while under the new rule the information must be "accurate, complete and not misleading".

This discrepancy is unnecessary and potentially confusing. We would urge the SFC to merge or streamline these requirements so that there is only one rule regulating this area. For our part, we would invite the SFC to explain specifically the reason for adding the word "misleading" on top of the words "accurate and complete". If something is both accurate and complete, we do not see how it could nevertheless be characterized as "misleading". We also note that the Consultation Paper itself, when one looks at the section on prospectus liability, uses the phrase "accurate and complete". See for example paragraph 117 of the Consultation Paper – "It is axiomatic that accurate and complete disclosure in a prospectus is fundamental for investor protection".

We also object to the word "complete" in the proposed provision. A representation that any information is "complete" is essentially an assurance of the non-existence of additional relevant information, which is too high a standard. We believe this should be replaced with the concept of "no material omissions".

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<sup>35</sup> Listing Rule 3A.04

The current Listing Rule requirement is to ensure truthfulness of all information provided "in all material respects". This should be carried over into the proposed Paragraph 17.7(a).

It would also be helpful for the Stock Exchange and the SFC to clarify the communication lines, as the SFC is not generally available in practice for consultation during an IPO exercise (except as regards a REIT listing, where the SFC is the primary regulator vetting the listing application).

***Q14: Do you agree that a sponsor should reasonably satisfy itself that all information provided to the Stock Exchange and the SFC during the listing application process is accurate, complete and not misleading and, if it becomes aware that the information provided does not meet this requirement, the sponsor should inform them promptly?***

***Response:*** We agree with this amendment, subject to (a) replacing "accurate, complete and not misleading" with "accurate and not misleading in all material respects, and does not contain any material omission", and (b) streamlining of the new and existing requirements.

We agree in principle to the proposed Paragraph 17.7(b), which requires sponsors to deal with regulators' enquiries in a cooperative, truthful and prompt manner.

***Q15: Do you agree that a sponsor should deal with all enquiries raised by the regulators in a cooperative, truthful and prompt manner?***

***Response:*** We agree generally with this amendment.

As for the proposed Paragraph 17.7(c), we have no objections in principle subject to the following:

- (a) Only material non-compliance should be subject to the reporting requirement. It is doubtful whether it would be a good use of the regulators' resources to deal with all reports of non-compliance even if they are wholly insignificant in amount or in relation to the listing applicant's business operations or financial position.
- (b) We also query whether the duty to report non-compliance "in a timely manner under the circumstances" would prejudice the applicant's chances of rectifying the problem before the matter is escalated to regulators. We submit that such a reporting obligation should arise only after the sponsor has had reasonable time to notify the listing applicant and for the latter to rectify the non-compliance. In other words, an exception should be made to the reporting requirement where efforts are being made in good faith to rectify the matter.

- (c) The reference to "other applicable legal or regulatory requirements" is too wide and should be limited to legal or regulatory requirements that are relevant to the status of the listing applicant in relation to the listing.

In relation to our position in (a) and (c) above, we note that in the UK<sup>36</sup>, the sponsor's obligation is to disclose to the FSA any material information relating to the sponsor or to the listing applicant of which it has knowledge which concerns non-compliance with the listing rules or disclosure rules and transparency rules only, without any reference to "other applicable legal or regulatory requirements". There is no specific duty to report non-compliance in the U.S., Australia or Singapore.

***Q16: Do you agree that a sponsor should disclose to the Stock Exchange in a timely manner any material information relating to a listing applicant or listing application of which it becomes aware which concerns non-compliance with the Listing Rules or other applicable legal or regulatory requirements?***

***Response:*** We agree with this amendment, subject to (a) adding "material" before "non-compliance"; (b) giving the listing applicant reasonable time to rectify the non-compliance before the reporting obligation is triggered and (c) limiting "other applicable legal or regulatory requirements" in the manner stated above.

As for the proposed Paragraph 17.7(d), we take strong exception to the proposal for the sponsor to disclose the reason for cessation to act. The basic duty to protect client confidentiality is the first obvious hurdle we see. Even assuming for the time being that the SFC will provide an appropriate safe harbour, the sponsor may remain exposed on a contractual basis to the listing applicant for breaching confidentiality.

In practice, a sponsor may cease to act for an applicant for various reasons (including purely commercial or economic reasons). Requiring the sponsor to disclose the reason may have negative unintended consequences. Below are two purely hypothetical examples to illustrate the potential difficulties:

***Scenario 1:*** Half-way through the listing process, Sponsor A uncovers a major due diligence issue (e.g. certain members of the senior management of the applicant have triad connections) and decides to resign. It notifies the Stock Exchange of such details as it has discovered about this issue and the process is stalled. A year later, the listing applicant engages another firm, Sponsor B. Will the Stock Exchange disclose the information given by Sponsor A to Sponsor B? Assuming Sponsor B does its own due diligence and reaches a different conclusion from Sponsor A, will the regulators take Sponsor A's view of the matter, or Sponsor B's?

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<sup>36</sup> LR8.3.5A R

**Scenario 2:** Sponsors A and B are acting as joint sponsors in an IPO. Halfway through the listing process, Sponsor A has a dispute with the applicant in relation to fees and there are a number of loose ends in the due diligence process that Sponsor A is no longer willing to tie up in light of the dispute. It decides to resign. In the notification to the regulators it specifically highlights the difficult issues encountered in its due diligence process. Will the Stock Exchange (a) notify Sponsor B of Sponsor A's allegations and (b) require Sponsor B to refute such allegations before allowing the listing application to go ahead?

It appears to us that the proposed requirement suffers from a major defect, that the SFC does not specify what the regulators will do with the information given to it by the resigning sponsor. Will the information be disclosed to or be verified against other sponsors in the same transaction and/or the listing applicant? How do the regulators propose to use the information? Without clarification of these key issues, a straightforward whistle-blowing obligation is both unfeasible and unfair on all parties concerned.

A decision to cease to act as sponsor may also be based on unproven suspicions of wrongdoings which, if published to a third party, may have legal consequences to the sponsor (e.g. exposure to defamation suits). The SFC's proposal for a positive obligation to disclose the reasons will call for legal protection for sponsors, which, in our view, may necessitate statutory amendment. This is an additional reason for our strong objection to the proposed wording.

We are not aware of an equivalent requirement in other major markets of the world. We note also that other professional advisers (e.g. reporting accountants and lawyers) are not under any similar reporting obligations under their professional rules of conduct when they cease to be involved in an IPO. Given the collaborative nature of the IPO process, we are not convinced that the sponsors should be in a significantly different position from other advisers as regards such a reporting requirement.

We observe that under GL7-09 issued by the Stock Exchange, upon the re-filing of an A1 application where the original sponsors have been terminated and replacement sponsors appointed, the latter must provide the Stock Exchange with the reasons and circumstances of the original sponsors' ceasing to act, a clearance letter from the original sponsors (only if such letter is available), and any matters that the replacement sponsors consider necessary to be brought to the Stock Exchange's attention. We believe this is the appropriate approach, as it focuses the minds of the replacement sponsors to conduct due diligence regarding the circumstances surrounding the termination of the original sponsors.

For the above reasons, we are strongly against this proposed requirement.

***Q17: Do you agree that if a sponsor ceases to act for a listing applicant during the listing application process, it is required to inform the Stock Exchange in a timely manner of the reasons for ceasing to act?***

***Response:*** We strongly disagree with this amendment. We strongly urge the SFC to consider removing this proposal, or revising it and further consulting on the revised version.

## **Sponsor's internal management**

### ***A. Overall Manager of a Public Offer (paragraph 112)***

The SFC proposes to transplant from the CFA Code to the SFC Code of Conduct the specific duties and obligations on the part of sponsors to act as the overall manager of the public offer process and ensure sufficient arrangements are in place so that the public offer is conducted in an orderly and fair manner<sup>37</sup>. It appears that the proposed language for Paragraph 17.10 of the SFC Code of Conduct is substantially the same as the existing CFA Code and the proposed changes in language are not material. We agree with the proposal.

***Q29: Do you agree that the provisions of the CFA Code relating to the management of a public offer should be transferred to the Code of Conduct?***

***If not, why not?***

***Response:*** We agree.

### ***B. Proper records (paragraphs 86 to 90)***

The SFC proposes to introduce into the SFC Code of Conduct a provision that a sponsor's records should (a) require a sponsor to maintain adequate records relating to the sponsor's work and (b) those records should be sufficient to demonstrate that the sponsor has complied with all applicable legal and regulatory requirements, including in particular the matters specified in the proposed new provision.

There are two new aspects to this. Firstly, rather than simply referring to maintaining proper books and records and a proper trail of work<sup>38</sup>, the proposed new provision (intended to be Paragraph 17.8 of the SFC Code of Conduct) would state that a sponsor should maintain adequate records so as to demonstrate to the SFC its compliance with "*all applicable legal and regulatory requirements*". Secondly, and this is not apparent from the body of the Consultation Paper, one has

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<sup>37</sup> Paragraphs 5.3 and 5.4 of the CFA Code.

<sup>38</sup> Paragraph 2.3 of the CFA Code.

to look at the specific proposed new language for the SFC Code of Conduct. Unlike the existing provision, namely Paragraph 2.3 of the CFA Code, which is drafted in general terms only (i.e. a sponsor should maintain proper books and records and be able to provide a proper trail of work done), the proposed new provision is lengthy and highly prescriptive. Such onerous and prescriptive record-keeping requirements arguably go beyond the equivalent record-keeping requirements for any other profession, including accountants (auditors) and solicitors. The requirements would only tend to encourage a checklist mentality as opposed to a more meaningful approach to record-keeping for the benefits of the investing public.

We assume, although this should be made clear by express language, that the reference to all applicable legal and regulatory requirements is intended to be limited to the obligations of the sponsor in connection with each public offering. Our concern is that the reference to "all" such requirements is too broad. It may push sponsors towards adopting the stance that they will document compliance minutiae. The concern is first that such an approach to documentation will slow down the listing process appreciably, and add to its cost, without any discernible benefit in providing protection to investors. Secondly, it will actually distract representatives of sponsors from focusing on the key material matters of substance which need to be dealt with during the course of a listing application.

At the very least it would appear preferable to change the language to *"all material legal and regulatory requirements applicable to its work as a sponsor in respect of listing applications"*.

On its face, the proposed new provision appears only to cover five main areas of the sponsor's work. However, when one looks at the other proposed new provisions in the SFC Code of Conduct to which it cross-refers (Paragraphs 17.3, 17.4, 17.5, 17.6(h) and 17.9(e)) and also the scope of each of the five areas described, it would appear that the requirement will, in practice, mean that sponsors must create a full audit trail of substantially all aspects of their work. This proposition risks being wholly impracticable and, as we have already said, potentially very distracting from the real work in analyzing material issues that need to be the key focus.

Moreover, sub-paragraph 17.8(a)(iii) would require documentation of all internal discussions relating to the sponsor's advice to a listing applicant (Paragraph 17.3), work required before submitting a listing application (Paragraph 17.4) and disclosure in the offering document (Paragraph 17.5). This is reinforced and extended still further by sub-paragraph 17.8(a)(iv). Sub-paragraph 17.8(a)(iv) would require documentation of internal discussions and actions taken in respect of all significant matters arising in the course of the listing application, and regardless of whether or not the relevant matters end up being disclosed in the final listing document.

In addition, sub-paragraph 17.8(a)(v) would require documentation of the activities of "Management", which is intended to be defined very broadly, using the same definition as appears in the current Sponsor Guidelines, introduced in 2007, i.e. including the sponsor firm's Board of Directors, Managing Director, Chief Executive Officer, Responsible Officers, Executive Officers, and other senior management personnel<sup>39</sup>. Please see our comments on this definition in the section on "Management Oversight" below. The activities of Management to be documented include: (i) supervising the acceptance of the mandate; (ii) monitoring implementation of the due diligence plan; (iii) ensuring sufficient and appropriate persons are assigned to the work ; (iv) reviewing the standard and extent of the due diligence work and the performance of the Principals and the Transaction Team, as well as (v) resolving suspicious circumstances, difficult or sensitive issues, conflicting information and material non-compliance. These prescribed activities of Management appear to be largely new. We address them below.

We are very concerned that the proposal is unduly prescriptive, heavy-handed, and impracticable to comply with fully. Most importantly, it would actually likely to have a deleterious effect on the quality of sponsor's work, in focusing efficiently and effectively on addressing the key issues in each listing application.

Further, we refer to the separate proposals to the effect that sponsors will not be permitted to delegate responsibility for due diligence and the new significantly more onerous requirements for sponsors to closely review and be satisfied as to the adequacy of experts' work. In view of these separate proposals, in practice the requirements would appear to necessitate sponsors obtaining and retaining copies of the experts' working papers. This may simply not be feasible. As we have noted in our response to Question 11, access to experts' working papers is at best very restricted and at worst, impossible to obtain.

At the very least we would like to see more qualifications introduced to the language in the proposed new provision so that only materially important documentation needs to be retained. In our view, at the very least, proper materiality qualifications should be introduced into each sub-paragraph (i) through to (vi). The materiality qualifications should, in our view, be two-fold. Firstly, to restrict the need for full documentation to material issues arising during the IPO application process. Secondly, so far as emails, oral advice and discussions are concerned, to make it clear that not all such records need to be generated (in the case of notes of advice and discussions) or retained. It should only be material items of documentation that need to be retained and only material advice and discussions need to be documented.

Preferably: (i) the current formulation of the obligation to keep records would be maintained; (ii) the SFC could continue to provide guidance as to what types of

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<sup>39</sup> proposed new Paragraph 17.12 (Glossary) of the SFC Code of Conduct

issues should be documented and, (iii) instead of a general over-tightening of the formal regulation, problems would be addressed by the SFC requiring those sponsors which have consistently defaulted in record-keeping to provide direct, specific undertakings to the SFC.

Frankly, we are also concerned that the approach proposed is going to contribute materially to the role of a sponsor becoming significantly less attractive to those financial institutions which the Hong Kong market would be best served seeing continue to play an active role as sponsors. This is because the proposed new record-keeping obligations can be seen as going beyond what is necessary to allow the SFC properly to review the work of sponsors, but actually exposing sponsors to litigation claims and very extensive discovery requests, including pre-action requests.

***Q19: Do you agree that a sponsor's records should be sufficient to demonstrate that the sponsor has complied with all applicable legal and regulatory requirements and in particular compliance with the Provisions?***

***If not, why not?***

***Response:*** We agree that a sponsor's records should be sufficient to demonstrate material compliance with legal and regulatory requirements applicable to the sponsor in connection with each listing application. We are concerned that the approach proposed for the new record-keeping obligation is overly prescriptive and risks being impracticable, unnecessarily burdensome and ultimately an unhelpful distraction from the sponsor's focus on the key issues to be addressed during listing applications. We would prefer to see more general language retained with continued specific guidance being issued by the SFC from time to time and with "repeat offenders" becoming the subject of a requirement to give specific undertakings to the SFC.

Paragraph 90 of the Consultation Paper proposes that a complete set of a sponsor's records in connection with a listing transaction should be retained in Hong Kong for at least seven years after completion or termination of the transaction.

There are two elements to this proposal. Firstly, it appears to be intended to apply not just to listing applications which are successful but also to those which have lapsed or are withdrawn. Secondly, a seven-year retention period is proposed.

We assume that a significant reason why the seven-year limitation period is proposed is the current limitation period for common law claims for negligence (six years). So part of the intention appears to be assist potential claimants against sponsors.

We assume that the intention is to retain the original records.

Retention of complete, original records for seven years brings with it significant cost and infrastructure. In this context, it is worth bearing in mind the challenges involved in retaining all records in a retrievable form, including all e-mails written or received by every member of the transaction team, particularly where individuals may well leave a financial institution.

It seems to us that there is no sound reason to require records to be kept for seven years in respect of listing applications which are terminated.

Even in the case of successful listing applications, if there is a material problem with the listing application, one would expect that to surface, if not within the first 12 months of listing, then certainly within the first two years after the listing. We would be surprised if there were circumstances in which it would be necessary or appropriate for the SFC to commence an investigation or audit of a listing application more than two years after the listing occurred or was withdrawn.

We also bear in mind that the SFC has effective power to direct that, in appropriate circumstances, a sponsor must retain its records for as long as the SFC considers appropriate.

We are not aware of other jurisdictions where there is a retention period as long as seven years.

In all the circumstances, we are in favour of a retention period for sponsor's records in Hong Kong (but see below as to location of the records) in connection with a listing transaction for three years<sup>40</sup> after completion or termination of the transaction, or in respect of individual transactions, for such longer period as, in appropriate circumstances, the SFC may direct.

In addition, it may be counter-productive and commercially prohibitive to require a complete set of sponsor's records in connection with a listing transaction to be retained in Hong Kong. By way of illustration, emails of major corporate and financial institutions are generally archived and stored in back-up servers overseas, so long as such emails can be readily retrievable and searchable, there is no discernible benefit in requiring sponsors to maintain the emails relating to a particular listing transaction as part of the deal file in Hong Kong.

We should also add that where sponsor work relates to overseas issuers, as it frequently does, companies may be required by local regulations or local state secrecy laws to ensure that certain original documents are kept at the issuer's place of incorporation and cannot be kept by the sponsor in Hong Kong. Requiring all

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<sup>40</sup> Two years to allow for a problem to surface and then a year for the SFC's investigation to come to the attention of the sponsor.

original records to be kept in Hong Kong at all times would be too burdensome as a practical matter.

We note in particular that the proposed record-keeping requirement would be difficult, if not impossible, to comply with in relation to some PRC issuers. There is a CSRC regulation issued in 2009 ("关于加强在境外发行证券与上市相关保密和档案管理工作的规定") that all original working paper formed within the PRC must be kept in the PRC ("六、在境外发行证券与上市过程中,提供相关证券服务的证券公司、证券服务机构在境内形成的工作底稿等档案应当存放在境内"). This requirement appears to conflict directly with the SFC's proposal that all original records must be kept in Hong Kong. Further clarification is required as to the scope of this proposal e.g. whether copy records would be sufficient where originals cannot be retained in Hong Kong or so long as the records are capable of being produced to the Hong Kong regulators upon request then it will not be necessary for the records to be retained in Hong Kong.

In terms of other concerns, we note that a fundamental theme running through both the Consultation Paper and this response is that the listing process is a collaborative process. It involves reporting accountants, lawyers and others who play an important role throughout the listing application, including of course the listing applicant's own representatives. In our experience, it quite often proves to be the case that, when the SFC investigates listing work, it becomes apparent that documentation held by lawyers, accountants or others is significant, in helping to show that in fact the sponsor adequately discharged its duties or even to show that responsibility for problems that arose rested not with the sponsor but with other parties involved. We have already brought up in our response to Question 11 above and recommend again here, that the SFC adopt a collaborative approach with the regulators of other industries, e.g. the Hong Kong Institute of Certified Public Accountants and The Law Society of Hong Kong, to ensure that a consistent approach to record-keeping is adopted for all parties involved in any transaction.

***Q20: Do you agree that a complete set of sponsor's records in connection with a listing transaction should be retained in Hong Kong for at least seven years after completion or termination of the transaction?***

***If not, why not?***

***Response:*** No. For the reasons set out above, we are in favour of a retention period for sponsor's records in Hong Kong or elsewhere in connection with a listing transaction for three years after completion or termination of the transaction, or in respect of individual transactions, for such longer period as, in appropriate circumstances, the SFC may direct. We consider that a three-year period is generally going to be sufficient and there are significant administrative burdens in maintaining such records for longer periods, such as seven years. We recommend that the SFC adopt a collaborative approach with the regulators of other industries, e.g. the Hong Kong Institute of Certified Public Accountants and The Law Society

of Hong Kong, to ensure that a consistent approach to record-keeping is adopted for all parties involved in any transaction.

### ***C. Management oversight (paragraphs 97 to 99)***

The SFC proposes that the SFC Code of Conduct will include an obligation on "Management" (as proposed to be defined by the SFC) to (a) assume full responsibility for the sponsor's operation and (b) supervise key issues<sup>41</sup>. These key issues to be supervised by "Management" are proposed to be described as including, but not being limited to: (a) accepting the mandate as a sponsor; (b) monitoring the implementation of the due diligence plan; (c) ensuring that sufficient persons with appropriate levels of knowledge, skills and experience are devoted to each assignment over the period of the assignment; (d) reviewing the standard and extent of due diligence work, and the performance of the Principals and the Transaction Team; and (e) resolving suspicious circumstances, difficult or sensitive issues, conflicting information and material non-compliance.

It is important to look at the detail of the proposed definitions of "Management", "Principals" and "Transaction Team".

We have already set out the definition of "Management" above in our commentary dealing with record-keeping. It is worth repeating it. It is intended to be defined very broadly, as it is currently in the existing Sponsor Guidelines, introduced in 2007, to include the sponsor firm's Board of Directors, Managing Director, Chief Executive Officer, Responsible Officers, Executive Officers, and other senior management personnel.

"Principal" is proposed to be defined as "a Responsible Officer or Executive Officer that is appointed by the sponsor firm to be in charge of the supervision of the Transaction Team for a listing assignment. This is effectively the same definition as currently provided for in the existing Sponsor Guidelines.

The "Transaction Team" is proposed to be defined as the staff appointed by the sponsor firm to carry out a listing assignment. This does not appear to be controversial.

We recognize that sponsors are, and have been for a long time, subject to the Internal Control Guidelines. The Internal Control Guidelines have been in force, and have remained unchanged, since 2003. We believe these guidelines have been regarded as effective, and as the appropriate way in which to codify general management responsibilities, outside of the specific statutory provisions imposing management responsibilities and liabilities. Broadly speaking, the specific statutory provisions take two forms: first, the provisions providing for the licensing

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<sup>41</sup> proposed new Paragraph 17.9(e) of the SFC Code of Conduct

or registration, and responsibilities, of responsible officers and executive officers; secondly, provisions dealing with responsibilities and liabilities arising from a failure to put in place and maintain effective systems and controls to ensure compliance with the Securities and Futures Ordinance ("SFO"), most notably Parts XIII and XIV concerned with market misconduct.

The Internal Control Guidelines already provide for the following: (a) management assumes full responsibility for the firm's operations; (b) management and supervisory functions must be performed by qualified and experienced individuals and (c) management ensures that management and supervisory functions are performed by qualified and experienced individuals.

Accordingly, whilst it is not clear to us why this needs to be repeated in the SFC Code of Conduct when it is already in the Internal Control Guidelines and then repeated in the Sponsor Guidelines, we do not have a strong objection to a statement appearing in the SFC Code of Conduct to the effect that Management of a sponsor must assume full responsibility for the sponsor's operations. Similarly, we have no strong objection to the SFC Code of Conduct stating that it is Management's responsibility to *supervise* the process of ensuring that sufficient persons with appropriate levels of knowledge, skills and experience are devoted to each assignment over the period of the assignment, because this is already stated in the Sponsor Guidelines.

The Sponsor Guidelines were introduced as recently as 1 January 2007, following the last consultation exercise regarding sponsors, and they form part of the SFC's Fit and Proper Guidelines. Whilst not having the force of law (in the same way that a Code of Conduct does not have the force of law) the Fit and Proper Guidelines have set out matters that the SFC will normally consider when assessing whether a person (corporate or individual) is fit and proper to be, or remain, licensed. So far as sponsors are concerned, specific guidelines are set out in Appendix 1 to the Fit and Proper Guidelines.

We also do not have any strong objection to a statement that Management is responsible for reviewing the performance of the Principals, which we believe is at least an implicit requirement in both the Internal Control Guidelines and the Sponsor Guidelines.

However, where we do have real concern is in respect of the suggestion, which appears to be clear from the SFC's proposal, that high-level management (including the Board of Directors and the CEO) must to some extent play an active role in looking, on an individual transaction-by-transaction basis, at: (i) the acceptance of the mandate; (ii) monitoring the implementation of the due diligence plan; (iii) reviewing the standard and extent of the due diligence work; (iv) the performance of the Transaction Team; and (v) resolving suspicious circumstances, difficult or sensitive issues, conflicting information and material non-compliance. We say this

is clear because paragraph 97 of the Consultation Paper states that Management must "[direct] the overall management of the transaction".

We believe that requiring the most senior management (who may well not be specialists in IPO work) of a sponsor firm to play an active role, albeit a supervisory role, in each listing transaction undertaken by the sponsor firm is an overreaction to the SFC's concerns about the quality of sponsor work. We believe it is inconsistent with the regulatory framework provided for by the SFO, as supplemented by the Sponsor Guidelines. The framework imposes transaction-by-transaction direct supervisory responsibility on the Principals, who must be Responsible Officers or Executive Officers, with all the regulatory responsibility and potential liability provided for under the SFO. We believe it is inconsistent with what is separately proposed by the SFC in terms of deepening the pool of available Principals. On the one hand the SFC appears to be open to deepening the pool of available Principals and maintaining the same existing framework which requires Principals to be Responsible Officer or Executive Officers. On the other hand, the message seems to be for Principals generally – "we no longer trust you generally to manage listing transactions effectively; we want the top senior management (including the Board of Directors and the CEO) to give substantive input and direct the overall management of each transaction".

We also note that, if Management in the context includes the Board of Directors or the CEO of a financial institution, those persons or, at least some of them, may not even have particular expertise in listing transactions in Hong Kong and may not even be located in Hong Kong.

We believe this is not workable, and not necessary. We adopt in their entirety the comments that were made in this respect in paragraph 4.2.3 of the joint Freshfields /Linklaters response dated 31 August 2005 to the then SFC consultation paper, starting with the words "*However, the Guidance seems to envisage that a wider group of persons should take responsibility for this ...*". It seems to us that those comments remain as relevant now as they were then. We note that in this respect the Consultation Paper, unlike in other places, does not really provide any detailed rationale for extending the role of senior management in this way. Paragraph 97 starts with a mere, bare assertion that "It is essential the Management has adequate oversight over the due diligence exercise".

In our view the appropriate approach is the existing one found in the current provisions of the Internal Control Guidelines and in the Sponsor Guidelines. In other words, senior management must ensure that there are adequate periodic reviews of individual transactions done, by the compliance function of the relevant firm in particular (which is required to maintain as much independence as possible from the front line personnel), as well as the internal audit function. The reviews should be appropriately detailed. The results should be reported in a timely and frank manner up to senior management. Senior management must then review the results in a timely and objective manner and take appropriate steps to address any

deficiencies in respect of the performance of individuals and in systems and controls.

We would accept that, for particularly difficult or sensitive issues that arise, or particularly serious instances of material non-compliance, those are matters which should be elevated on a timely basis to senior management, so that they can be addressed. However, we believe that this is already happening and does not need any significant change in regulation to ensure it continues to happen.

***Q24: Do you agree that a sponsor's Management is obliged to adequately supervise the performance of due diligence including but not limited to the key issues discussed in paragraph 97?***

***If not, why not?***

***Response:*** No. At least not beyond the extent that is already provided for in existing regulations, in particular the Sponsor's Guidelines. The definition of Management encompasses extremely senior management. As a general matter, save in very serious circumstances, one would not expect them to become involved in the day-to-day management and supervision of individual transactions. There should, however, be – as is required now – an effective process of review of the performance of the Transaction Teams, which should be elevated for an appropriate and timely review by senior management, with effective remedial action being taken whenever necessary.

***D. Sufficient resources (paragraphs 93 and 94)***

The SFC proposes that the SFC Code of Conduct will include an obligation on a firm to ensure that, before accepting any appointment as a sponsor, taking account of other commitments, it has sufficient staff with appropriate levels of knowledge, skills and experience to devote to the assignment throughout the period of the assignment.

We agree with this. It is a current requirement, at least implicit in the Internal Control Guidelines, provided for in general terms by the existing SFC Code of Conduct, General Principle 3 and explicitly provided for by the Sponsor Guidelines (see Paragraphs 1.1.2 and 1.1.3 in particular).

***Q21: Do you agree that before accepting any appointment as a sponsor, a firm should ensure that, taking into account of other commitments, it has sufficient staff with appropriate levels of knowledge, skills and experience to devote to the assignment throughout the period of the assignment?***

***If not, why not?***

***Response:*** We agree.

In paragraph 95 of the Consultation Paper, the SFC propose that the existing provisions in the Sponsor Guidelines<sup>42</sup> concerned with appointment of the Transaction Team, comprising corporate finance staff with at least one Principal, with appropriate skills and expertise, should be consolidated with the other code provisions relating to sponsor engagement, and moved to the SFC Code of Conduct. We generally agree with this.

***Q22: Do you agree that the provisions of the Sponsor Guidelines concerning the Transaction Team should be transferred to the Code of Conduct?***

***If not, why not?***

***Response:*** We generally agree with this.

#### ***E. Sponsor fees (paragraphs 98 and 99)***

In paragraphs 98 and 99 of the Consultation Paper, the SFC discusses the dual role of the sponsor as, typically, both sponsor and underwriter and the question of underwriters' fees, and expresses the clear view that there are likely to be problems, and in particular a disincentivization to do sponsor work properly, unless an appropriate portion of fees is designated as the sponsor fee, and also "no deal, no fee arrangements" are undesirable.

The SFC does not seek to introduce any regulatory changes in this respect. As a matter of principle, we agree that such changes may be inappropriate as they would conflict directly with the free market for capital markets transactional work in Hong Kong, and with the fundamental principles which underlie Hong Kong's dynamic economy.

We do not believe that the absence of a minimum fee structure for sponsor work has contributed or will contribute in future to lower than desirable standards of work. However, we do have a related concern that we are seeing sponsors' and underwriting fees increasingly being subject to considerable pressure by listing applicants. If the SFC over-regulates sponsors and their management, without being seen to adopt a proportionate and balanced approach (in particular an approach which recognizes both that the listing process is a collaborative process and that responsibility for mis-disclosure and other problems lies with the listing applicant's management), there is the prospect that this will tend to encourage those firms who are involved in significant underwriting activities, not to assume the sponsor role in an IPO. This may lead to more and more sponsor work being undertaken by boutique corporate finance houses, who, by definition, tend to be

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<sup>42</sup> Paragraphs 1.1.3, 1.1.6, 1.2.4 and 1.2.5 of the Sponsor Guidelines

smaller and have less of a range of specialists available to assist, than the large financial institutions.

We believe that for many of the proposals in the Consultation Paper to achieve the intended objectives, it is important for the SFC to appropriately empower the sponsors so as to mitigate the uncertainties faced by them when assuming the role, hence committing significant resources commensurate with the heightened responsibilities and liabilities. The sponsors should be protected from the fear that it may be economically penalized simply because it is trying to abide by the strict standards imposed by the proposals.

***F. Sponsor Principals (paragraphs 100 to 104)***

We welcome the SFC's willingness to explore ways to expand the pool of individuals who can qualify as Principals.

We certainly support proposals that the eligibility criteria be expanded by the SFC recognizing relevant experience obtained overseas in jurisdictions of comparable sophistication and that there be greater emphasis in appropriate cases on experience gained in the area of due diligence, again either in Hong Kong or elsewhere.

In particular, we would make the following suggestions:

- (a) The SFC should identify the relevant jurisdictions that it considers have "comparable or higher relevant legal and regulatory standards" than Hong Kong (e.g. the UK and the U.S.).
- (b) The majority of the financial institutions authorizing this response paper consider that it would be sufficient for at least one Principal to have local/ Hong Kong IPO experience, and for the other Principal(s) to have overseas experience only. Two members of the industry group considered that it was very important that all Sponsor Principals have local/ Hong Kong experience, bearing in mind the prescriptive nature of Hong Kong IPO due diligence requirements.
- (c) It would also be helpful to understand if the SFC intends to expand the definition of "corporate finance experience" and take into account experience gained in the area of due diligence in transactions which do not necessarily have an element of equity fund-raising by listed issuers, for instance, significant merger and acquisition transactions. The majority of the financial institutions authorizing this response paper support taking into account significant merger and acquisition transaction experience for the same reasons as identified under (b) above, two members of the group considered that merger and acquisition transaction experience should not be taken into account.

- (d) The Sponsor Guidelines currently require a track record of two "completed" IPO transactions in the immediately preceding five years. As a practical matter, in order to be able to count a transaction as a completed IPO transaction, the principal applicant must have remained employed by the same firm throughout the entire process of the relevant transaction, and the relevant transaction must have been successfully listed. This requirement for "completed" IPO transactions may become increasingly difficult to satisfy under the current market conditions, with (i) many IPO transactions being prolonged for two to three years before they reach the finish line, (ii) many IPO transactions having substantially completed the regulatory vetting process or even passed the listing hearing but nevertheless been pulled due to unfavorable market conditions; and (iii) frequent movement of individuals from one financial institution to another. We therefore suggest that the SFC considers relaxing the "completed" IPO transactions requirement to allow for experience gained in ongoing IPOs (or substantially completed IPOs) to also be considered. We believe this is an appropriate modification given current market conditions. During difficult markets it may not be possible for sponsor firms to identify two completed IPOs that an applicant has worked on (notwithstanding the five year look-back period). In this regard, the SFC should consider transactions which have passed Listing Committee Hearing or have obtained the Stock Exchange letter on "in principle approval of the listing application" as an appropriate juncture for determining whether relevant experience has been obtained from a transaction. This will allow an applicant to demonstrate his/her abilities regardless of market conditions (which are not within an applicant's control).
- (e) For sponsor firms similar to the group of financial institutions which authorized this response, the limitation on attributing experience obtained by multiple applicants to the same transaction creates another problematic issue. Frequently, different people from different teams (e.g. country coverage, industry sector coverage, corporate finance execution, etc.) may all have played a "substantial role" in the same transaction. It is unreasonable in the circumstances to place a cap on the number of people a firm may attribute to the same transaction (especially for complex listings). We would therefore suggest the SFC relaxes this requirement as part of its vetting process, or in the alternative provide guidance on the number of individuals that may be attributed to the same transaction. On a related note, it would be helpful if the SFC provides additional clarity on what it deems to be "substantial" involvement in a transaction.
- (f) In addition to written submissions, as part of the SFC's assessment process, consideration could be given to introducing a competence-based interview as an alternative (we take the view that it should not be mandatory, i.e., it can be waived if an applicant is able to satisfy the relevant experience requirements stipulated in the Sponsor Guidelines). We believe this is

helpful in several respects. The SFC will be given an opportunity to discuss any outstanding concerns about an application directly with the applicant. The relevant licensing team will also be able to assess first-hand whether an applicant has a clear understanding of the objectives, expectations and responsibilities of being a Principal. Importantly, an applicant will be given an opportunity to directly address and respond to any concerns immediately, which would help streamline and reduce the time required to process an application.

- (g) Further, we note that increasingly the SFC has been raising ad hoc comments/requirements that go beyond the eligibility criteria set out in the Sponsor Guidelines. It would be helpful if SFC can set out more comprehensive guidelines to streamline the application process. Guidance provided to sponsor firms on specific "bottleneck" issues which arise during the course of an application should be publicized (e.g. in the form of additional FAQs). This will increase transparency and provide sponsor firms with a better understanding of how such issues should be addressed as part of the application process.
- (h) In terms of addressing application delays, we would suggest the SFC introduces a performance pledge on the review of applications. This would assist sponsor firms in managing timing expectations, and also appropriately allocate resources and coverage to live transactions.

We would further like to note that expanding the eligibility criteria for Principals will not necessarily mean that standards are adversely impacted. Importing "international best practices" from suitable overseas applicants (and fostering the sharing of know-how obtained by such individuals from other jurisdictions in key areas such as due diligence etc.) may in fact raise overall due diligence and sponsor work standards in Hong Kong in the long-run, and improve the ability of firms to assign appropriate senior officers to supervise transactions. As a policy matter, the expansion of eligibility criteria for Principals is an important step forward in ensuring Hong Kong maintains its competitive edge in attracting listings from other international jurisdictions.

***Q25: Which, if any, of the proposals in paragraph 103 would achieve the objectives of enlarging the category of individuals qualified to act as Principals, whilst not affecting the overall quality of sponsor work?***

***Do you have any alternative suggestions to address the issues?***

***Response:*** We certainly support proposals that the eligibility criteria be expanded by the SFC recognizing relevant experience obtained overseas in jurisdictions of comparable sophistication and that there be greater emphasis in appropriate cases on experience gained in the area of due diligence, again either in Hong Kong or

elsewhere. We refer to the suggestions or alternatives as set out above for the SFC's consideration.

## **Part 2: Publication of the Application Proof (paragraphs 84 – 85)**

The SFC proposes that the Application Proof of an applicant's prospectus should be made publicly available on the Stock Exchange's website when the A1 listing application is made. Paragraph 84 of the Consultation Paper states the objectives for this as:

- to improve the quality of listing documents
- to enhance the efficiency of the listing process

We acknowledge that some benefits could be brought about by a public A1 filing system, such as better management of certain processes (e.g. cornerstone investment). Nevertheless, we have grave reservations about the proposal and fear that the cost entailed in this regime may outweigh its perceived benefits.

### **A. *Our concerns***

Set out below are some of our key concerns which we would invite the SFC to consider:

***Failure to protect investors*** – The SFC's primary consideration must always be the protection of investors. We will discuss below (under section B1: "Transparency of vetting and a meaningful disclosure system") our concerns with giving public investors a series of "snapshots" of the listing applicant at disjunctive points in time and potentially out of context.

We are also concerned that, in light of current practice that the sponsor and other syndicate roles are typically not settled early in the process, a new requirement to make A1 filings public may cause listing applicants to gravitate towards sponsors that are perceived as more likely to favour speedier A1 filing over meticulous and lengthy due diligence. This will clearly be counter-productive in terms of investor protection for the Hong Kong market in general.

***Consequences of public filing*** – Once a draft of the applicant's prospectus is made available to the public, an element of "public scrutiny" of the entire listing process will be inevitable. Commentators, journalists and even business competitors can react to the information via the media, private letters (including anonymous complaints) or other communications, and both the regulators and the IPO working party will be obliged to take these into account regardless of their bases and intent. The resultant inefficiency and confusion could be unmanageable. In addition, any information given to potential public investors should, at the very least, be relevant and reliable, not information that is intended to be revised or updated during the listing application process. For instance, it is not unusual for a draft prospectus accompanying an A1 application to contain "stub financials" which are intended to be replaced by audited full-year financials in the applicant's final prospectus, such

"stub financials" being provided to enable the regulators to commence their review. Including information of this nature in a public A1 filing could cause confusion to the market and prove to be counter-productive.

The issue of public disclosure will be more pronounced in situations involving an already-listed company (e.g. in a spin-off IPO) and may have to be resolved on a case-by-case basis.

***Overseas experience*** – Whilst initial public filing appears to be the "standard position" in the U.S., important developments in the opposite direction have been made since the passage of major reforms to the U.S. securities laws in the form of the Jumpstart Our Business Startups Act ("JOBS Act") in April 2012. Among other measures intended to facilitate IPOs in the U.S., the JOBS Act permits qualifying "emerging growth companies" to file IPO registration statements on a confidential, non-public basis for initial review by the SEC. It has been reported that over 90% of companies that filed for an IPO in the U.S. in 2011 would have qualified for this benefit. We have conducted a study of the U.S. filing regimes and have summarized our findings in Appendix 3 to this paper.

As far as we are aware, an equivalent early public filing system does not exist in Australia, Singapore or the UK.

***Cost and benefit*** – The SFC highlighted, in paragraph 32 of the Consultation Paper, its concern that some sponsors are relying on the regulatory commenting process to improve a premature draft prospectus, and its hope that the proposed changes will encourage sponsors to take substantial responsibility for the quality of the prospectus from an early stage. Whilst we do see the force of this argument to some extent, we respectfully caution against hasty reaction. We believe the mischief can be addressed in other more conventional and straightforward ways, chiefly and effectively, by simple returning of a sub-standard draft prospectus and refusal to commence or cessation of the vetting process (as pointed out in the commentaries on our response to Question 5 above). The proposed regime would fundamentally change Hong Kong's IPO practice with a series of intended and unintended consequences. We believe there may be an imbalance of cost and benefit in this respect.

***Reducing Hong Kong's attractiveness as a market*** – In a volatile market where many IPO transactions may not reach the finishing line, an early public filing system would be particularly unattractive to a potential listing applicant who would be obliged to disclose its intention to list as well as a large amount of important information about its operations (such as financial information and business model) to the public (including competitors) long before there is any certainty that its listing can go ahead. Likewise, an early filing process will have professional cost implications for the listing applicant before there is any deal certainty. This could have a chilling effect and be highly detrimental to Hong Kong as one of the most successful IPO markets in the world.

To illustrate this point, we have reviewed public records of the Stock Exchange throwing light on the approximate "success rate" of Hong Kong listing applications (Main Board and GEM combined). Clearly, every year a substantial number of listings do not reach completion for various reasons:

Year ended	New applications received	Approvals in principle granted <sup>43</sup>	Lapsed, rejected and withdrawn applications <sup>44</sup>
30 Dec 2011	247	167	145
31 Dec 2010	204	164	74
31 Dec 2009	123	99	56
31 Dec 2008	137	105	119
31 Dec 2007	125	103	33

As an additional concern flowing from this, a public A1 filing system may unfairly associate certain sponsors with a significant number of lapsed or withdrawn listing applications. This could be highly distortive as these may be the result of market conditions rather than any failure on the part of the sponsors.

***Pre-clearing of issues*** – In our view, a public filing system of preliminary documents is likely to give rise to an overload of pre-clearance requests, which will be an additional strain on the regulators' resources.

## ***B. Our practical suggestions***

If the SFC decides to adopt the public A1 filing proposal, we would advise it to engage the industry group further regarding the operational details that are crucial for the smooth running of the new regime. At the very least, we believe the following issues should be thought through carefully to ensure the soundness of the new regime:

### ***1. Revolutionizing the vetting process***

The proposal calls for dramatic changes in the regulators' own vetting and commenting practices:

***Transparency of vetting and a meaningful disclosure system:*** The success of a public filing regime is highly dependent on the certainty, predictability and, most importantly, the *transparency* of the regulatory vetting process.

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<sup>43</sup> These are cumulative figures covering applications submitted during the relevant year as well as cases submitted before that year (source: HKEx website).

<sup>44</sup> *Ibid.*

Even if no updates are required to be filed publicly until the posting of the Web Proof Information Pack ("WPIP"), the question is how to make a meaningful disclosure regime out of public filings that comprises the A1 proof, the WPIP and the final prospectus. We invite the SFC to focus not only on how the quality of the A1 disclosure may be improved by making A1 filing public, but also on whether and how the public investor would actually be helped by these three specific public disclosures under the proposed system.

Public filing of the A1 proof means releasing to public investors preliminary documents that are by their nature subject to change over a few months. Care must be taken not to cause greater confusion than such documents would clarify. Even if only one single mark-up is expected to be publicly posted from the A1 proof to the final version, this mark-up may cause distorted impressions of the management of the IPO, in particular:

- mark-ups may give undue prominence to changes to the document, giving rise to misleading interpretations without either the listing applicant or its advisers having an opportunity to clarify why certain changes are made
- voluminous changes from the A1 proof to the final version may cause the market to form the impression that the listing applicant is poorly managed, or the sponsor has not performed its due diligence functions, when in fact the situation may well be caused by changes of circumstances, or comments from the regulators
- insertion of disclosures without stating whether they are meant to address a specific regulatory concern is not likely to help investors make an informed decision about the listing applicant

We believe that public readers must be given the appropriate context by having access to the regulators' comments, hence being able to differentiate between changes that are necessitated by comments from the regulators, as opposed to those brought about by the applicant's evolving business, changing external conditions, or discoveries made in the due diligence process.

More importantly, allowing public access to regulators' comments would allow other practitioners to get a better sense of where the key regulatory concerns are likely to be, and would allow the market to build up a consensus on normal standards of disclosure as well as customary ways to address specific issues, which would help improve market efficiency.

To assist the SFC in formulating the operational details, we have reviewed the commenting practice of the SEC in a U.S. IPO context and have summarized our

key findings in Appendix 3 to this paper<sup>45</sup>. We would like to draw to the SFC's attention the following key points:

- The disclosure review and comment process for SEC-registered IPOs is generally transparent to the investing public via the SEC's public website, typically on a real-time basis, except where policy concerns have given rise to specific exceptions. This transparency applies to substantially all the SEC's comments and questions and the registrant's responses to them.
- There are three principal exceptions to this general policy of transparency:
  - in order to protect a registrant's legitimate commercial interests and privacy concerns, registrants may apply for confidential treatment of specific and discrete items of information that would otherwise be subject to public disclosure, either in the course of the registration process or through government freedom of information requests;
  - in order to facilitate the capital raising process for certain foreign issuers (particularly foreign private issuers that have securities listed on, or are in the process of listing securities on, foreign exchanges), a "non-public" initial review process is available for qualifying foreign issuers; and
  - in order to enhance access to U.S. initial public offerings and listings by smaller companies, "emerging growth companies" are eligible for a confidential initial review process.

However, registrants opting in to either the "non-public review" policy available to qualifying foreign issuers or the confidential review process available to emerging growth companies must disclose their initial draft registration statements and response letters if and when they proceed with a public filing of the registration statement, and all other review correspondence is made public after the IPO is completed.

- The SEC's commentary process is primarily conducted in writing, although preliminary oral discussions in respect of specific comments and responses are common.
- In reviewing the applicant's prospectus, the SEC focuses on critical disclosures from both legal and accounting perspectives, and identifies issues on which clarification or additional disclosure is required – there is a striking contrast with Hong Kong, where regulatory comments are often requests for the sponsor to justify to the regulators the due diligence it has performed.

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<sup>45</sup> For more details of the SEC vetting process, see also the SEC's description of its Filing Review Process at <http://www.sec.gov/divisions/corpfin/cffilingreview.htm>.

***Accessibility of the SFC for consultation:*** At present, the market enjoys regular access to the Stock Exchange but suffers somewhat from lack of access to the SFC during the prospectus vetting process. In practice, when a comment is received from the SFC it is not always immediately apparent to the working party what the SFC's concern may be. Under the proposed system, both the SFC and the Stock Exchange must be available for consultation on specific issues. Denying the market the SFC's guidance may lead to a very inefficient process, with practitioners trying to pre-empt problems by second-guessing or opting for the most conservative approach to questions of due diligence and materiality of disclosure. This could result in excessive disclosure in increasingly lengthy prospectuses, at huge cost to market efficiency, investor protection, as well as environmental protection. We would also urge the SFC to put more transparency on its own vetting practice, much of which is currently unknown to the market – e.g. the bases on which it decides whether or not to vet an A1 draft prospectus, and if it does, at what point it will commence vetting.

***Comments must be in writing and the commenting process should be streamlined:*** At present, the market is used to receiving ad hoc (and very often verbal) comments from the regulators during all stages of the listing process right up to the day before publication of the applicant's prospectus. This will no longer be feasible under the public release of regulatory comments which, we believe, is a crucial corollary to the public filing regime. We also urge the SFC and the Stock Exchange to co-ordinate and streamline the commenting process so as to eliminate the duplication of comments between themselves, and to focus the comments on material issues.

***Public filing safe harbours:*** The SFC must also work out a list of matters that would call for confidential filings, such as spin-off new listings, or concurrent overseas listings conducted on a confidential basis. There should also be a mechanism in place whereby special requests could be made by the listing applicants and sponsors to allow certain types of information and/or response to remain confidential until the WPIP stage because of unique circumstances.

***Filing in English only:*** We believe that any public filing of the applicant's A1 proof prospectus should be in English only, as is consistent with the current English-only commenting regime. Bilingual filing will entail substantial additional expenditure in cost and time, leading to more inefficiency and reducing the attractiveness of Hong Kong as a market for prospective listing applicants.

***The Listing Rules should be checked thoroughly to avoid unintended consequences:*** The SFC and the Stock Exchange should carefully assess how this proposal may affect the application of other rules, such as those governing publicity. For example, if a listing applicant notices certain press articles discussing inaccurately information about itself following its A1 public filing, how would Listing Rule 9.08 affect its ability to address that in public?

## 2. *Supporting documents*

The implementation of the public A1 filing proposal may call for fundamental changes in the execution practice of market practitioners, e.g. the nature and timing of comfort letters to be provided by reporting accountants, opinions and reports by lawyers and other experts.

Many of the financial institutions authorizing this response paper have direct experience with typical SEC-registered transactions, including the due diligence documentation and procedures that need to be in place at the time of the first public filing of the registration statement. Broadly speaking, best practice in the U.S. requires, amongst other things, the following items to be ready before the first public filing:

- a substantially agreed form underwriting agreement (at least in terms of key due diligence issues and the representations and warranties given by the issuer);
- substantially agreed (as to form, content and scope) "lock-up" agreements with shareholders;
- substantially agreed forms of legal opinions; and
- substantially agreed form of accountant's comfort letter (as far as practicable).

These practices reflect the general principle that prior to the first public filing of the disclosure document, the underwriters' due diligence procedures should be advanced to a stage at which they may be reasonably comfortable that no undisclosed material issues requiring changes to the public disclosure will be uncovered prior to the completion of the offering.

Comparing current Hong Kong practice with the above, a number of key differences are immediately apparent. For example, in Hong Kong:

- the underwriting and lock-up agreements are not negotiated until very late in the process (sometimes even after the Listing Committee hearing)
- local counsel's opinion is not "locked down" at an early stage, but is continuously developed throughout the listing application process, particularly to address issues brought up by the regulators in the vetting process
- accountants do not typically negotiate their comfort letters early on the process

Further investigations must be carried out to ascertain whether the professional advisers involved in an IPO will be able to accommodate such changes under the professional standards to which they are respectively regulated, and if not, whether

changes in those standards will be called for before the infrastructure can be fully in place for public A1 filing. In particular, if the SFC is minded to ensure the supporting documentation is in place for the public A1 filing regime, this may be a good opportunity to explore with the accounting profession (and their regulators) the possibility of revising current practice by requiring auditors to sign their audit report and consent letters, and to negotiate the accountants' comfort letters, ahead of time for the public A1 filing.

### 3. *System capabilities*

Another important consideration is the system requirements for submission and uploading of A1 filings and comments in a public environment. The SFC may be considering a filing and disclosure system similar to the one currently supporting WPIP filings. We would like to remind the SFC that the posting logistics behind A1 filing and WPIP filing could be very different. Key areas for detailed consideration may include:

- submission windows (if any) and timing of public uploading
- formatting of the documents
- security and access issues
- standardized practice of redaction (e.g. for offer-related information in the disclosure document)
- length of time when the filing will remain on the public system

Public A1 filing is likely to impose much heavier pressure on the systems of the Stock Exchange's current capabilities. To illustrate this, 13 new listing applications<sup>46</sup> were accepted by the Stock Exchange during the month of June 2012 and as at 29 June 2012 there were 42 active applications in progress. In the same period, only six WPIPs were posted.

The volume of A1 applications can be dramatically more than this: more than 100 new listing applications in progress at one time is not unheard of in the past. Posting such a large volume of new listing disclosures is likely to cause information overload and significant confusion, unless suitable tools are developed in time to help the market navigate and digest all the information. There must also be a significant upgrading of the investors' education and/or publicity efforts to help the

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<sup>46</sup> including applications made pursuant to Chapter 8 of the Main Board Listing Rules and Chapter 11 of the GEM Listing rules, applications made by investment vehicles pursuant to Chapter 20 and 21 of the Main Board Listing Rules, and applications for transfers of listings from GEM to the Main Board (source: HKEx website)

market understand what A1 applications are, how to spot the key disclosure issues in each piece of filing (together with regulatory comments), and how to draw the correct conclusions from the three pieces of filings combined at the end of the process. In view of these new challenges, we urge the SFC to tread very carefully before making a decision.

#### **4. *Further consultation on operational details***

In view of the operational points we have identified above, if the SFC decides to adopt the A1 public filing proposal, we would strongly urge it to conduct further detailed consultation, possibly via a dedicated working group with participation from the Stock Exchange, financial institutions, lawyers, accountants and other key parties to the IPO process.

We also urge the SFC to consider whether it is more appropriate to adopt a more gradual approach, allowing time to observe the effects of the other proposals on market practice, and for the overall transparency of the vetting process to improve, before embarking on these drastic changes.

#### **C. *A possible alternative***

We have discussed above what we believe it will take in practice to ensure the soundness of a public A1 filing system. However, we remain concerned that the public A1 filing proposal may fall short of achieving the SFC's stated goals of high quality prospectus and efficiency. Indeed, we must guard against efficiency of the listing process being reduced instead of enhanced by the proposed system.

We remain doubtful about the proposal as, based on our survey covering a number of major financial markets of the world, we are not aware of any of such markets having adopted an early public filing regime for listing applications, except for the U.S.. It is not clear to us why the SFC believes that transposing this particular feature from the U.S. to Hong Kong would be beneficial, especially given the significant differences between these two markets.

We stress again that Hong Kong-style regulatory oversight of the due diligence process does not exist in the U.S.. The concept of a "sponsor" likewise does not exist in the U.S.. Public filing of listing documents in the U.S. has vastly different practical and regulatory implications from those in Hong Kong. We strongly urge the SFC to consider the underlying factors carefully before making a decision.

We believe the SFC should further explore administrative measures at its disposal before deciding, one way or the other, on the public A1 filing proposal. These measures include not commencing or suspending the vetting of any sub-standard A1 applications at any time during the process. In severe cases, imposing a cooling-off period before the application can be re-submitted may also be

considered. Again, we draw the SFC's attention to the sample letter in Appendix 2 featuring the SEC's employment of similar measures.

We believe these administrative measures may be more likely to achieve the stated goals without the drawbacks of the proposal. They would also be very effective in improving the quality of disclosure, as they are real deterrents the sponsor can use to bring home to the listing applicant the importance of achieving as high a standard as possible in the first draft of the applicant's prospectus. We trust that before making its decision, the SFC will carefully compare the pros and cons of using existing administrative tools, vis-à-vis introducing a new and untested process that calls for revolutions to existing market practice.

As we stated under "E. Sponsor fees (paragraphs 98 and 99)" above, we believe this proposal to adopt a public A1 filing system would only be able to achieve its intended objective if the sponsors are appropriately empowered and protected from the fear that it may be economically penalized simply because it is trying to comply with the requirements under the proposals. We think one way to achieve that is to provide at an early stage of the preparation of the listing application certainty to a sponsor of its engagement, so as to put the sponsor in a position to fulfill its responsibilities without the threat of being removed or terminated because it is abiding by the heightened due diligence standards and other requirements envisaged by the proposals. In this regard, we invite the SFC to consider mandating the following:

- that the listing applicant file a confirmation prior to the public A1 filing confirming the date of the written engagement of the sponsors (possibly with a requirement to provide a copy of such engagement letter to the regulators if required to do so), and under which:
  - (i) minimum overall economics for the sponsors have been determined, which reflect the heightened obligations of sponsors, and which would be paid by the applicant upon the earlier of termination of the IPO process and the closing of the IPO;
  - (ii) the applicant has provided the sponsors with an indemnity customarily provided to sponsors;
  - (iii) the applicant has agreed to and will continue to assist the sponsor with its due diligence and fulfilling its sponsor obligations; and
  - (iv) all material due diligence has been conducted under the guidance of such duly mandated sponsors;

and

- that the cornerstone process shall not commence until at least after the A1 filing.

***Q18: Do you agree that the Application Proof submitted with a listing application should be made publically available when the application is made?***

***Response:*** We have grave reservations about this proposal as it entails revolutionizing the vetting practice, which does not appear to be justified by sufficient practical benefits, or by any important gains in investor protection that we can foresee. If the SFC decides to adopt the public filing proposal, we would strongly advise the SFC to consider the practical suggestions we have outlined above in relation to transparency of the regime and the practicalities of obtaining supporting documentation from all professional parties involved. We would strongly recommend that the SFC consults the industry group further, possibly via a dedicated working group with participation from the Stock Exchange and relevant market professionals, to nail down the operational details. In the meantime, we would also respectfully caution the SFC against acting too hastily, and to investigate other alternative methods and existing administrative measures, such as returning documents and in appropriate cases imposing a cooling-off period before re-submission, which may serve most of the SFC's stated regulatory purpose without some of the major drawbacks. In particular, we believe that this proposal would put immense pressure on market participants and the regulators because this may encourage indiscriminate front-loading and pre-clearance of issues.

We also invite the SFC to consider our suggestions regarding how to put the sponsors in a better position to fulfill the heightened obligations envisaged under this proposal.

### **Part 3: Appointment of sponsors and independence**

#### **Multiple sponsors (paragraphs 105 – 111)**

We respectfully differ from the SFC's statement in paragraph 106 of the Consultation Paper that "the appointment of only one sponsor on each listing should provide greater assurance to the market as to the quality of listing documents". We invite the SFC to consider the following factors:

- Contrary to the SFC's statement in paragraph 106 of the Consultation Paper, we believe there are positive benefits in the current practice of multiple sponsors. At the very least, benefit of multiple sponsors may include (a) more available resources; (b) more experience, including a wider range of experience across a variety of industry sectors for listing applicants that individual firms may have come across in their previous transactions; (c) the benefit of multiple viewpoints being brought to bear on particularly difficult issues; (d) multiple firms potentially having the ability to be more persuasive in assisting the applicant to take a more constructive view; and (e) facilitating the development of consistent standards across the securities industry.
- A mandatory single-sponsor regime may be detrimental to the listing applicant, for example where the sponsor is requested to leave because its performance falls below the listing applicant's expectations, or where the sponsor is prevented from working on the transaction due to internal reasons (e.g. departure of the key principals or loss of independence). The listing applicant in this case would be in a very difficult position, as any replacement sponsor would have to do the groundwork from the beginning, and the listing process will have to be protracted, possibly at considerable expense to the applicant.
- There seems to be little empirical evidence that multiple-sponsor cases are more susceptible to due diligence or other compliance failures than single-sponsor ones. Examining a few often-cited cases of prospectus misstatements and a sponsor's suffering (potentially severe) disciplinary consequences, we do not see the argument playing out well. For example:
  - The 2009 listing of Hontex International Holdings Company Limited (possibly better described as an instance of a listing applicant's fraudulent practices, although sponsor's due diligence failures also featured in the case) was managed by a single sponsor.
  - The listings of Tungda Innovative Lighting Holdings Limited in 2002 and Shaanxi Northwest New Technology Industry Company Limited in 2003, in which the sponsor was discovered by the SFC to have committed due diligence failures, were again sponsored by that firm as a single sponsor.
  - The 2001 listing of Euro Asia Agricultural Holdings, in which the sponsor

subsequently faced SFC action (later settled without admission of liability) for various alleged malpractices, was also managed by a single sponsor.

- Where multiple sponsors are appointed to an IPO, *each one* of them is subject to their own compliance requirements. Under existing laws and regulations, there should not, in principle, be any question of sponsor firms leveraging off or "piggybacking" on others' performance. They must each individually perform their regulatory duties and keep all relevant records for themselves.
- Some IPOs (especially large ones) by their nature require a large distribution syndicate. Regardless of whether a financial institution takes on the title of sponsor, as an underwriter it will in practice conduct due diligence on the listing applicant. Mandatorily requiring one sponsor results in forcing other syndicate members to take up alternative titles such as joint global coordinators, joint bookrunners and joint lead managers. When this happens, from a regulatory perspective the SFC (and vicariously public investors) will arguably be in a worse-off position as these other syndicate members will be out of reach of sponsor's regulations.
- The proposal could lead to commercial difficulties, as listing applicants tend to assign underwriting fees based on the size of underwriting commitment and selling efforts, and it would be difficult for a single financial institution to be compensated, under normal IPO practice, in a way proportionate to its underwriting obligations as well as its regulatory exposure as the sole sponsor.
- In recent years, Hong Kong IPOs have predominantly been done on a joint sponsors basis. We do not see this as having any adverse effect on the quality of due diligence. We would invite the SFC to give empirical evidence of a higher failure rate with multiple-sponsor deals as opposed to sole-sponsor ones.

We have conducted a survey on the number of sponsors and underwriters in Hong Kong Main Board IPOs during the period between 1 January 2009 – 30 April 2012, and would like to raise the following observations for the SFC's consideration:

- During the surveyed period, the ratio between Main Board IPOs sponsored by one firm and those sponsored by multiple firms was 6:4.
- Most single sponsor deals tended to be smaller in the size of funds raised, as shown in the table below:

<b>Number of sponsors</b>	<b>Average size of funds raised in Main Board IPO (HKD)</b>	<b>Number of Main Board IPO transactions</b>
One	\$1,066,323,764	140

Two	\$5,876,956,744	62
Three	\$5,751,582,161	22
Four	\$30,775,234,968	8
Seven	\$93,515,292,800	1
Total	\$4,205,616,417	233

- The highest number of sponsors on the same transaction during this period was seven (Agricultural Bank of China).
- Underwriting syndicates could be a lot bigger – one syndicate during the surveyed period had 39 underwriters (AIA Group Limited, raising HK\$159 billion) and there were more than 20 transactions with syndicates that comprised 10 or more underwriters.
- Multiple sponsors are allowed but are not required under current rules. There is no regulatory pressure on the applicant to have more than one sponsor if problems should arise from multiple sponsors, such as discord between them. Likewise, a sponsor is free to resign its role if it feels it cannot adequately discharge its responsibilities due to the presence of multiple sponsors. We do not see any need to impose a mandatory single-sponsor requirement for all cases. We believe it should be a question for the applicant to decide how many sponsors should be appointed for its listing.
- We are not aware of any major market (including the U.S., UK, Australia and Singapore) that places a cap on the number of sponsors or underwriters. We understand, however, there is a limit of two sponsors on A share IPOs in the PRC.

Amongst the financial institutions authorizing this paper, there is no single unified view on the subject of a numerical cap on sponsors, except that *no member* of this group is in favour of capping the number of sponsors at one for each transaction. Some members of the group do not believe there should be any cap, and the listing applicant should be allowed to decide freely on the matter. However, some members of the group are supportive of a small numerical cap of two or three (or in the case of very big transactions, up to four) on sponsors working on each deal.

We acknowledge the SFC's concerns regarding the negative implications of multiple sponsors, but do not agree that focusing on the number of sponsors would necessarily produce a solution to the problem without addressing the underlying causes. We would invite the SFC to perform a more in-depth study of the fundamental issues behind this question.

In our view, the current pressure stems from the inequality of leverage between, on one side, the listing applicant and on the other, the sponsors individually or collectively. This sometimes leads to the sponsors' influence over the listing

applicant being diluted, which could affect how the sponsors are able to persuade the applicant to take up their recommendations or comply with their due diligence requests. Underwriters who do not take up a sponsor role could be even more disadvantaged in terms of access to the listing applicant for due diligence information, which is an important part of common group dynamics in a Hong Kong IPO. This could explain why there is an eagerness to participate in an IPO as sponsors, notwithstanding that financial institutions may not always be appropriately remunerated for such participation.

We would urge the SFC to place its focus on formulating proposals which may achieve a better balance of power between the listing applicant and the sponsors (as mentioned in our response to Question 18 above), which we believe will be a more constructive way forward.

***Q26: Do you agree that there should only be one sponsor on each engagement?***

***Response:*** The group does not have a unified view on this question, although no member of the group is in favour of limiting the number of sponsors to one. Some members of the group are supportive of a cap of a small number in the tenor of two to three (or in the case of very big transactions, up to four) on sponsors on each deal, while others believe the number should not be capped at all. We invite the SFC to consider further the underlying issues including the imbalance of leverage between the listing applicant on one side and the sponsor(s) on the other.

### **Independence of sponsors**

The key argument for requiring all sponsors appointed to the same transaction to be independent is set out in paragraph 108 of the Consultation Paper, namely that "in some cases where an independent sponsor has been appointed in order to meet the independence requirements, in practice another non-independent sponsor still leads all substantial sponsor work".

We do not see in this a persuasive argument for changing the regime. Under current rules, each individual sponsor firm has its own compliance duties and if any one sponsor firm, whether independent or not, has failed to perform its due diligence duties (for example by improperly delegating the work to its co-sponsor), it is immediately exposed to regulatory consequences. It is not clear to us why requiring all sponsor firms on the same transaction to be independent would necessarily remove the risk of improper delegation. We note, in addition, that in past SFC actions against IPO sponsors, the complaint did not appear to be related to the sponsors' independence.

Banning non-independent firms from acting as sponsor on an IPO will have significant impact on large financial conglomerates with multiple lines of business (including private equity, commercial banking, trustee services, amongst other service functions). Hong Kong's securities industry has not operated on the basis

that there is anything fundamentally wrong with such conglomerates, provided that rules on conflicts of interest, information barriers etc. are strictly adhered to. Indeed, for many years Hong Kong has attracted international financial institutions to set up here because it has struck the right balance between sound regulation and business flexibility.

We are not aware of any similar requirement in the major markets of the world, including the UK, Australia and Singapore, except general requirements to give impartial advice and manage conflicts of interest issues. Similarly, there is no such independence requirement for underwriters in the U.S., although applicable rules dictate that where one or more underwriters are affiliated with the listing applicant, the offering must be priced by a "qualified independent underwriter" unless an exemption applies, and relevant material relationships must be disclosed.

The SFC appears to be chiefly concerned about a notional practice where only one firm that satisfies the independence requirement is put on the deal purely as a figurehead while the majority of the sponsors' tasks are performed by other, non-independent firms. We believe this can be adequately addressed by closer scrutiny of the level of due diligence performed where non-independent sponsors are involved, or making sure that certain key aspects of the transaction must receive the unqualified sign-off of the independent sponsor. We believe these alternative approaches, rather than banning non-independent firms altogether from the transaction, would be a better way forward.

***Q27: If more than one sponsor is allowed, do you agree that they should all be required to meet the Listing Rules independence requirements?***

***Response:*** We disagree with this proposal. We believe the current requirements give adequate safeguards for investors and if required, the regulators are able to address potential problems by closer scrutiny of the due diligence performed where non-independent sponsors are involved in an IPO.

We agree with paragraph 109 of the Consultation Paper that, if more than one sponsor were to be appointed, this does not reduce or limit any of their responsibilities. However, we are very surprised by the SFC's proposal, if multiple sponsors continue to be allowed, to make co-sponsors jointly and severally liable for complying with the Code of Conduct requirements. This goes far beyond the scope of current law and regulations affecting sponsors (and indeed, any other financial intermediaries in Hong Kong's regulatory framework).

On the joint and several liability point, the SFC highlights a major problem in co-sponsors obtaining access to each others' work records. We agree fully with this, but believe an even more fundamental problem lies in the concept of joint liability applying in a co-sponsorship context. It would be highly inappropriate and unfair to make one professional advisory firm fully liable (as is implied in the joint liability concept) for the compliance failures of another firm. This would in essence make

each sponsor firm a performance guarantor for all the other sponsor firms on a transaction, for no reason other than that they are working on the same transaction. This would be repugnant to the accepted jurisprudence or regulatory philosophy of any advanced jurisdiction of which we are aware.

We appreciate that the joint and several liability concept has *not* been worked into the proposed new rules and would strongly urge the SFC to set it aside.

***Q28: Do you agree that if more than one sponsor is appointed each sponsor's responsibilities should remain unaffected and that each sponsor should comply with all the expectations of a sponsor?***

***Response:*** We agree that each sponsor is responsible fully for its own obligations to comply with rules and regulations, but we object strongly to the proposal that if multiple sponsors continue to be allowed, all sponsors are jointly and severally responsible for complying with relevant requirements. We believe this is highly inappropriate and unfair, and would go far beyond the scope of current law and regulations affecting financial intermediaries in a similar context.

## **Part 4: Prospectus liability**

### **Introduction**

In the final part of the Consultation Paper, i.e. paragraphs 116 to 129, the SFC discusses the question of prospectus liability for sponsors.

In summary, the SFC's analysis is as follows:

- accurate and complete disclosure in an applicant's prospectus is fundamental for investor protection
- statutory liability underpins prospectus accuracy
- there are statutory provisions (sections 40 and 40A of the Companies Ordinance) which already provide for civil and criminal liability
- it is unclear whether these provisions are broad enough to cover sponsors
- sponsors have a clear responsibility on a non-statutory basis for the contents of prospectuses - as the "gatekeeper" and with responsibility for due diligence
- the question is whether sponsors should have both non-statutory and statutory liability for the contents of an applicant's prospectus
- notwithstanding arguments to the contrary (including the potential distraction from the primary obligations of the company, its directors and experts and the risk that the end result may simply be everything gets thrown into the prospectus), on balance the statutory liability should be extended to sponsors, which will encourage sponsors to review disclosure in the prospectus critically and ensure a high level of accuracy and completeness
- this would make it clear that (1) investors could bring legal actions against sponsors (amongst others) in connection with inaccurate disclosures in a prospectus, (2) in "serious" cases, prosecutions could be brought against sponsors, and (3) it would put it beyond doubt that the SFC could bring civil proceedings seeking remedial action against sponsors in appropriate cases
- for these purposes sponsor means the licensed corporation or registered institution and not apparently the individual representatives of the sponsor
- international comparison is not particularly helpful – Hong Kong should take its own approach
- other issues relating to prospectus liability should be the subject of a separate consultation paper. These other issues include: (1) whether the criminal and

civil liability provisions should be more closely aligned, (2) whether the tests for criminal liability, and the defences available, should be modified and (3) whether the statutory liability – presumably particularly civil - should be expanded to cover investors who cannot prove they relied on the prospectus when investing and as to whom they cover and whether secondary market investors, not just initial IPO subscribers, should be able to claim).

## **General**

Prospectus liability is an important topic, which no doubt the investing public, particularly those investors who have suffered losses as a result of fraud in the context of IPOs, would like to be satisfied is being addressed pro-actively by the SFC and by other relevant regulators, e.g. the police authorities.

However, it is very much a separate topic from the "operational" proposals, which are addressed in the bulk of the Consultation Paper, and it involves legal and policy questions of a different and more complex nature and which would require primary legislative change (for the reasons we explain below). We would not want to see a review of the IPO application process become bogged down by debate about the complex issues involved in the question of statutory prospectus liability for sponsors.

Also, in our view, for the reasons addressed in detail below, Question 32 is intrinsically non-severable from the other questions set out in paragraph 129 of the Consultation Paper.

Our principal recommendation, therefore, is that all questions related to prospectus liability (namely Question 32 in the Consultation Paper, the questions identified in paragraph 129 of the Consultation Paper and other questions which are identified by us below) should be hived off and dealt with in a separate consultation paper.

This is not an attempt to put off "judgement day". We are very willing to engage in a full debate, and to do so constructively, as part of a separate consultation exercise. Further, in our view, such an approach would have a number of very important benefits.

Firstly, as we have mentioned, it would ensure that the operational changes discussed in Parts 1 to 3 above can be brought into effect as soon as possible to the extent they are adopted.

Secondly, we do not understand the SFC to be suggesting generally that sponsors or their representatives have been inclined to permit deliberately inaccurate or misleading prospectuses to be issued. Rather, the SFC's view appears to be that for a variety of reasons, including commercial drivers, sponsors have not done their work sufficiently carefully, completely or early enough in the process and that in some cases the deficiencies have been quite serious. By separating out and

deferring consideration of the question of prospectus liability from the "operational" proposals, all concerned can assess the impact of the "operational" proposals first. The implementation of "operational" proposals are much more likely in our view to have a positive impact on the matters really of concern to the SFC. It may well be that the "operational" proposals would result in a significant enhancement of standards in the SFC's eyes, so much so that it then becomes unnecessary to get involved in and distracted by the complex and potentially controversial issues involved in changing primary legislation.

Thirdly, and arguably most importantly of all, a separate consultation process dealing with all aspects of possible statutory reform would recognize (1) the fundamentally collaborative nature of the IPO application process and (2) that it is the directors (and where appropriate experts) who are primarily responsible for the contents of an applicant's prospectus. As regards the second point, it seems to us that there are significant weaknesses in the enforcement regime as regards directors and management of a listing application. The biggest question is what more can be done (both in Hong Kong and, we would suggest, in those jurisdictions outside of Hong Kong in which the listed businesses and their management are located) to introduce effective enforcement and sanctions against the managers and promoters of businesses who are willing to present a materially false or misleading picture of the listing applicant and its business. The difficulties with cross-border enforcement are well known. We would support the SFC and other enforcement agencies in Hong Kong working closely with the new Hong Kong Government, Legislative Council and the Judiciary to strengthen these aspects (e.g. by strengthening the existing statutory liability provisions or through the introduction of new law and regulation in mainland China, including extradition law) in parallel to any review of sponsor statutory liability.

Moreover, despite what the SFC suggests in paragraphs 124 and 125 of the Consultation Paper, we are concerned that introducing sponsor statutory liability (particularly if it is achieved in a crude manner by simply adding a reference to sponsors into the existing section 40 and 40A in the Companies Ordinance) risks having unfortunate and undesirable consequences. Firstly, despite what the SFC suggests, we do think it will further distort the approach that directors and management of listed applicants will take. They will be more likely to perceive that it is going to be the sponsors and the sponsors alone that are in the firing line, rather than themselves, so that if anything there will be less risk of real liability on the part of directors and management. Secondly, we consider it will discourage potentially very capable sponsors or individuals from being willing to participate in sponsor activity, potentially tending to lower the quality of those willing to do sponsor work. Thirdly, notwithstanding what the SFC say in paragraph 128 of the Consultation Paper, we do think it will tend to exacerbate further the approach of putting everything "including the kitchen sink" into the prospectus. This is already a problem under the current regime.

Largely missing from the Consultation Paper is a cost-benefit analysis of enhancing the regulatory framework in the manner proposed by the SFC. A cost-benefit analysis appears to be entirely absent from the section of the paper dealing with prospectus liability. Introducing statutory criminal and civil liability for sponsors would undoubtedly change the game in terms of potential liability and risk of proceedings. Potentially unintended negative consequences would include: (1) dissuading some corporate finance advisers from taking on the role of sponsor and (2) for those that continue to accept engagements, an insistence upon significantly additional cost and a slower process. This insistence would come not only from the management of the sponsor, but also from their professional indemnity insurers, an issue which was identified during the last (2006) consultation discussion about statutory sponsor liability. Despite what the SFC appear to suggest in paragraph 128 of the Consultation Paper about international practice, we consider that Hong Kong would risk becoming by far and away the most difficult place to do IPOs, so far as sponsors are concerned. Hong Kong would become out of kilter with other jurisdictions which have a disclosure-based regime. To that extent Hong Kong may lose some of its competitive advantage and the changes may have a chilling effect on Hong Kong IPOs. For reasons which we address below, we are not convinced that the benefits of introducing statutory sponsor liability are sufficiently significant to outweigh these risks.

### **Response to Question 32**

Our primary recommendation, as set out above, is that all questions relating to statutory sponsor liability should be the subject of a separate consultation exercise. However, we wish to engage the SFC as constructively and fully as possible. We considered it would be helpful therefore to set out, in anticipation of a full consultation exercise, our position in relation to Question 32 and the other issues raised by the SFC. In summary, our views are as follows. We set out the rationale for these views in more detail below.

Firstly, there is the question of whether there is, currently, any existing statutory prospectus liability for sponsors, i.e. whether sponsors are covered by sections 40 and 40A of the Companies Ordinance already. In our view, the answer is "no", for reasons which we explain below.

Secondly, in our view, it must follow that the proposal by the SFC, namely that sections 40 and 40A should cover sponsors, is not merely a "clarification" of the law; it is an extension of the law. This must be dealt with by way of amendment to the Companies Ordinance. In our view it would be inappropriate, and may not result in an effective change of the law, to seek to add sponsors in an indirect way, for example by obliging sponsors under the Listing Rules or the Code of Conduct, to issue an acknowledgement stating that they have "authorized" the issue of the prospectus. We say that particularly bearing in mind that, on any basis, sections 40 and 40A are not well drafted. They contain significant ambiguities and, as the SFC

will know, in key respects appear to unsatisfactorily reverse the burden of proof against defendants without stating clearly the appropriate level of mens rea.

Thirdly, there is the core question of should there be any statutory prospectus liability for sponsors, and, if so, in what form. For the reasons explained below, this raises multiple questions, as explained below, and cannot be properly answered by a simple "yes" or "no" as the SFC's Question 32 might suggest. However, we are able to set forth the following propositions, in order to assist the SFC as much as possible in considering the issues involved:

1. **No statutory liability for sponsors should be introduced.**
2. **If an individual within a sponsor firm becomes involved in sponsor work dishonestly and knowingly permits or facilitates the issue of an applicant's prospectus with a materially false statement, we believe that no-one (and certainly not the sponsor firms) would seriously challenge the proposition that there should be some form of liability, at least criminal liability, as well as arguably civil liability to investors who, in reliance on the statement being true, subscribed for securities in the offering and suffered loss. However, in such circumstances, there is already a clearly established basis for such liability as a matter of common law. There are also potential liabilities under the SFO<sup>47</sup>.**

There is no need to amend sections 40 and 40A to cater for such circumstances. Indeed, amending sections 40 and 40A to introduce liability for the sponsor in such circumstances would not be appropriate because the individual in question would have clearly been acting outside the scope of his employment, i.e. "on a frolic of his own", and it would be wrong to ascribe liability, particularly criminal liability, to the sponsor itself for the reasons set forth below

3. **Statutory liability for sponsors is inconsistent with the fact that the primary sources of information and the primary obligation to get the contents of the applicant's prospectus right are the directors and management (as well as the experts).**
4. **Statutory liability for sponsors is inconsistent with the fact that the sponsors' role is not legislated for by statute (contrast the role of auditors in respect of a company's audited financial statements).**

Indeed, as the SFC points out, in a number of important markets, there is no equivalent to the role of the sponsor at all.

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<sup>47</sup> under ss.107-108, 277, 298 and 391 SFO

5. **If there is, contrary to the propositions above, going to be any statutory sponsor prospectus liability, it should be limited in the way described below.**
6. **Question 32 does not incorporate any "materiality" requirement. Clearly, such a qualification must be built in to any provisions dealing with criminal and civil liability for sponsors.**

We note that section 40 has no such materiality qualification at the moment. It must be sensible to build it in to eliminate the possibility of any spurious claims. Section 40A already seeks to exclude "immaterial" statements, but we note that this reverses the burden of proof and puts the onus on the person accused of an offence to show that the statement was immaterial. We believe strongly that such a reversal of the burden of proof would be wrong.

7. **Sponsors should not be liable, absent proof of dishonest knowledge, for any statement in an applicant's prospectus that originated from an expert, e.g. a reporting accountant or a lawyer or any other type of expert.**
8. **We would go further and maintain that, insofar as the proposal would involve imposing criminal liability on sponsors in respect of non-statutory obligations, there should be no liability for recklessness in respect of any untrue statements in the prospectus: dishonest knowledge should be the (minimum) requisite element of the offence.**
9. **Following on from the point made in 4 above, liability should be imposed on a sponsor (the licensed corporation or registered institution) only if the necessary mens rea can be imputed under established legal principles of corporate liability, to the sponsor, via the knowledge and intent of its senior management.**

If contrary to our views, "recklessness" were to be introduced, it should not be sufficient, for institutional liability, for that to be the recklessness of any single individual or even group of individuals, particularly if they are relatively junior.

The requirement should be to demonstrate that recklessness was embedded in the corporate culture, although of course evidence to show that a significant number of individuals displayed a generally reckless approach to their work, might begin to point towards such a reckless culture.

10. **Both sections 40 and 40A as currently enacted reverse the burden of proof and put the onus on the persons "authorizing" the issue of the prospectus to demonstrate that they had reasonable grounds to believe that the untrue statements were, in fact, true. This should of course be a**

**defence for any person accused of prospectus liability. However, we strongly believe that the reversal of the burden of proof (as currently reflected in the statutory provisions) in respect of sponsors would be entirely inappropriate.**

Otherwise, there would be a failure to recognize the full responsibility of the directors and others for the contents of the prospectus, a failure to recognize that sections 40 and 40A were drafted without any apparent regard to the role of sponsors, and a failure to recognize fairly and properly the limits on direct access to information and the economics involved in comparing the role of the sponsor relative to the role of the listing applicant's promoters. In short, it would impose prima facie strict liability on sponsors, which cannot be right given the secondary nature of their role in putting together a prospectus.

11. **There should be no risk of statutory prospectus liability under either sections 40 or 40A on individual members of a sponsor's team.**

Such liability should be restricted (as the SFC seem to suggest) to the sponsor entity, on condition that the necessary mens rea can be imputed to it – see point 9 above.

Amongst other issues, if individual sponsors' liability were to be imposed, this would appear to raise difficult practical issues. One example is the need for professional indemnity director and officer insurance coverage. This was an issue covered in earlier consultation exercises (see paragraph 75 of the 2005 Consultation Paper, paragraph 4.7 of the 2005 Joint Response Paper and paragraph 127 of the 2005 Consultation Conclusions). As noted in the 2005 Joint Response, this was not something which could be introduced given how commercially prohibitive such insurance cover would be for sponsor firms – a position which would appear still to be applicable now.

Of course, this leaves open the prospect, in appropriate and serious cases, that criminal sanctions could be imposed on individuals under the existing law.

12. **Any criminal penalty for prospectus liability should be restricted to a fine and there should not be a possibility of imprisonment.**

This would be on par with, and directly analogous to, the position reached under the recent amendments to the Companies Ordinance in respect of auditors' liability. On the basis that liability is restricted to sponsor entities, as the SFC seem to suggest, imprisonment would not make sense in any event.

13. **Except in respect of fraud (where there is arguably already such liability under the existing common law), we believe that there should be no introduction of civil liability for sponsors, at the very least not until sufficient time has elapsed to see whether – in the light of the**

**implementation of other proposals - such an amendment to the legislation is necessary in order to curb apparent sponsor delinquency.**

We are greatly concerned that sponsors, in the event of a problematic IPO, would just be too easy a financial target. Indeed, the SFC has flagged in the last (third) sentence of paragraph 126 its wish to be in a clear position to go after sponsors for "remedial orders". It does not seem right that either the SFC or investors could, in respect of untrue statements made by directors or persons other than the sponsor, where it appears likely that those persons were dishonest in making those statements, choose only to pursue the sponsor for damages, leaving it to the sponsor to seek claims by way of indemnity against the directors.

As mentioned earlier, this would fail to recognize the responsibility of the directors and others for the contents of the applicant's prospectus, it would fail to recognize that sections 40 and 40A were drafted without any apparent consideration of the role of sponsors, and it would fail to recognize fairly and properly the limits on direct access to information and the economics involved in comparing the role of the sponsor relative to the role of the listing applicant's promoters. It would, in our view, if anything, reinforce in the minds of directors and senior management of listing applicants that they are likely to "get away with it" if they should make false statements in a prospectus, because they would know that the SFC would first and foremost go after the sponsors.

It would tend to dissuade financial institutions from acting as sponsor. It would make Hong Kong a less attractive venue for IPOs.

The combination of new operational measures, coupled with disciplinary action against sponsors and, in appropriately serious cases, criminal action, should be a sufficient and proportionate deterrent to encourage good sponsor behavior. We would also, rhetorically, ask the question: why are the SFC's existing disciplinary powers not sufficient? The SFC has used these powers to suspend licences, or revoke them. The possible exercise by the SFC of such powers appears to be a very strong disincentive against misconduct by a sponsor and its representatives. SFC disciplinary action can be launched and concluded much more quickly than a criminal prosecution or a civil compensation claim. We would suggest that the prospect of disciplinary action serves as a more effective safeguard for investors than that of a possible criminal prosecution which would take several, if not many, years to result in a conviction.

Perhaps most significantly, statutory civil liability for sponsors would create an unlevel playing field between sponsors and accountants, property valuers and other experts contributing to a prospectus. See the proviso to section 40(3) of the Companies Ordinance. There does not appear to be any justification for

such a distinction, whether as a matter of policy or practice. It would be most unfair to introduce such liability for sponsors prior to introducing something similar, if at all, for auditors and other experts providing information for inclusion in the prospectus. After all, the experts are providing directly information for inclusion into the prospectus.

14. **On any basis, we believe very strongly that any statutory civil liability should be restricted to initial investors in the IPO itself.**

The extension of statutory civil liability to secondary market investors would in our view be an unprecedented and very significant extension of the scope of liability. It would significantly extend the effect of the existing section 40. We cannot see how it could possibly be argued that this is necessary in order to curb delinquent sponsors. We reserve the right to address this in the separate consultation exercise proposed by the SFC.

The foregoing sets out our position on the key issues raised in the SFC's Consultation Paper as regards statutory prospectus liability for sponsors. In order to avoid cluttering up the above presentation, in the following sections we set out further detailed analysis to explain the basis for our views as to (1) the current scope of sections 40 and 40A of the Companies Ordinance, (2) the intrinsic non-severability of Question 32 from the other questions which the SFC wishes to make the subject of a separate consultation paper, and (3) the appropriate mechanisms for any introduction of statutory sponsor prospectus liability.

**Is there existing statutory prospectus liability for sponsors?**

Firstly, as we said above, there is the question of whether there is, currently, any existing statutory prospectus liability for sponsors. As we stated above, in our view, the answer is "no".

The SFC itself acknowledges that "*the position is unclear*"<sup>48</sup> as to whether sections 40 and 40A of the Companies Ordinance cover sponsors. As a matter of law, it must follow from this view expressed by the SFC, that the courts would construe sections 40 and 40A as not covering sponsors. It is a fundamentally important principle of legal policy that a person should not be penalized except under clear law. This principle is reflected in what has come to be known as the principle against doubtful penalization. The principle against doubtful penalization requires the strict construction of penal enactments: where there is lack of clarity, or ambiguity, it will be resolved by the courts in favour of the most narrow construction of the statutory provision. It is important to note that penal statutory provisions are not limited to criminal statutes. The principle in fact extends with varying degrees of emphasis to any form of detriment, whether criminal or civil –

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<sup>48</sup> See paragraph 122 of the Consultation Paper.

the key concept is detriment. Similarly, relieving provisions from penal provisions, whether criminal or civil, must be construed liberally. Of itself, applying this fundamental legal principle, sections 40 and 40A should be construed as not covering sponsors.

We would argue that, on balance, the better view is that natural and ordinary interpretation of sections 40 and 40A of the Companies Ordinance points strongly against the legislative intention, at the time the provisions were enacted in Hong Kong, being to include sponsors within their ambit. If one looks at the relevant legislative history, sections 40 and 40A have been in place since 1972 (eight years before the Stock Exchanges Unification Ordinance was passed). We believe, therefore, that the provisions pre-dated the concept of "IPO sponsor". We believe it is significant that, at the time that IPO sponsors were introduced into Hong Kong, no consideration proposal was made to amend either provision to cover sponsors. In our view, the language used in section 40 and 40A points towards, and only towards, those persons who are the primary or original source of the information contained in the prospectus. Sponsors obviously do not contribute information to the prospectus as a primary or original source : they co-ordinate the drafting and the due diligence process.

For factual matters contained in the prospectus, the persons who are the primary or original source of information are the directors of the company at the time of the IPO (either formally appointed as directors or de facto directors) and, quite possibly, the controlling shareholders. (In practice, the controlling shareholders are often directors, or have representatives on the board.) This is mirrored in the scope of subsections 40(1)(a), (b) and (c). Subsection 40(1)(a) covers directors. Subsection 40(1)(b) covers persons who have authorized themselves to be named as directors in the prospectus or who have agreed to become directors. Subsection 40(1)(c) covers "promoters". Promoters is defined in subsection (5) in a way which, in our view, excludes professionals such as the sponsors who are merely involved in the process as professional advisers, but includes those involved in giving input, as an original source, to the preparation of the prospectus. In other common-law jurisdictions, perhaps most notably India, where the companies legislation has the same common source, i.e. from England, the term "promoter" is clearly understood to mean the founder/controlling shareholder, i.e. the principal behind, the company. We believe this is precisely what is meant by the word "promoter" in section 40. The term "authorized", in our view, carries with it a clear connotation of a principal. For example, by way of analogy, the owner of an asset, may "authorize" an agent to manage it or sell it. In section 40A (concerned with criminal liability) the only term used is "authorized". We recognize that subsection 40A(3) might be construed as indicating a wider meaning of "authorized". However, we would argue that section 40A(3) was included only out of an abundance of caution to protect the SFC and the Stock Exchange itself and was almost certainly not necessary in order to give that protection.

Finally, we would point out that it would have been relatively simple, had such been the intention, to include sponsors expressly in the language of sections 40 and 40A. But this did not happen.

**Should there be any statutory prospectus liability for sponsors?**

The fact that Question 32 is intrinsically non-severable from the other questions set out in paragraph 129 of the Consultation Paper can be demonstrated readily by simply looking closely at Question 32. Question 32 asks: "*Do you agree that it should be made clear that sponsors are liable for untrue statements (including material omissions) in a prospectus?*" However, one cannot properly begin to answer this question without answering the following questions:

- (a) what statements – all untrue statements, or just material untrue statements?

As stated above, in our view at most it should be material, untrue statements.

- (b) should a distinction be drawn between statements that are based on information provided by (1) the directors and (2) experts?

As stated above, this is a significant factor.

- (c) when reference is made to liability, should this be civil liability or criminal liability or both?

See our views set out above.

- (d) what should be the tests for establishing civil liability and/or criminal liability?

Again, see our views set out above.

- (e) whether the liability is civil or criminal or both, under what circumstances is it envisaged that sponsors would be liable for untrue statements in an applicant's prospectus? Is it under all circumstances or only in certain circumstances, and if so in which circumstances?

As set out above, we strongly believe that, at the very most, sponsors should be liable if it can be shown that they acted dishonestly, i.e. with knowledge that the applicant's prospectus contained material false or misleading information.

- (f) should the liability be that of the sponsor entity, i.e. the SFC licensed corporate entity, or should it be the individuals who represented the sponsor in carrying out the sponsor work?

We generally agree with the SFC that, if there is to be any change to the existing statutory provisions, it should be limited to introducing statutory liability (in our view only criminal) for the sponsor entity. Even here, though, there is a difficult legal and/or policy question involved here as to on what basis one could or should impute the necessarily mental ingredient to the corporate entity. Or to put the same question slightly differently, in what circumstances should fault on the part of the representatives of the sponsor be attributed to, and result in liability on the part of the sponsor itself? Traditionally, one can only do so if the board of directors of the corporate entity can be shown to have the requisite knowledge or intent.

- (g) does there have to be a connection, and if so what connection, between the activity of the representatives of the sponsor in respect of the prospectus and the untrue statement in the prospectus?

In our view the answer must be clearly "yes", there must be a connection.

- (h) does there have to be fault/knowledge on the part of the representatives of the sponsor, and if so to what degree and of what nature?

See our answers set out above.

- (i) liability does not exist in a vacuum. It must be liability to another person or persons. Accordingly, liability to whom and in what circumstances and to what extent?

See our comments set out above.

- (j) in what circumstances would it be appropriate for the sponsor to be excused from liability? The existing language of sections 40 and 40A seems highly unfair to sponsors and inconsistent with the approach taken in other jurisdictions operating a disclosure-based system. The existing provisions reverse the burden of proof and put the onus on the person accused of prospectus liability to show that they acted reasonably in all of the circumstances. It seems to us that this cannot be right for sponsors. At the very least, if sponsors are to be covered by section 40 or 40A, we would expect the provisions to be amended to make it very clear that the burden of proof is on those trying to find the sponsor liable to show, for example, knowledge on the part of the sponsor of the false or misleading contents of the prospectus.

- (k) where there is fault, potentially more serious fault, on the part of others in relation to the untrue statement, what would be the interrelationship (including potentially apportionment) of liabilities (if any) between the sponsor and the other persons?

See the expressions of concern about this we have set out above.

- (l) finally, how would any framework of liability in respect of untrue statements in prospectus be applicable to Chinese versions of the prospectus?

Some of these questions are the questions identified in paragraph 129 of the Consultation Paper, but in our view they are all integral to Question 32.

**If liability should be introduced, how should it be introduced?**

In our view, if statutory sponsor liability is going to be introduced (and we believe it should not), it should only be introduced by way of legislative amendment. Firstly, as the SFC accepts, the legislation is at least unclear; that is clearly unsatisfactory, and for the reasons set out above, one cannot penalize somebody based on unclear legislation. Secondly, for the reasons explained above, in any event the legislation would need to be amended, not least to ensure that the burden of proof is not reversed. Thirdly, if we are correct that there was no legislative intent to include sponsors under sections 40 or 40A, it would only be appropriate to change the position through the legislature.

If the SFC were, for example, simply to amend the Listing Rules or the new Code of Conduct, to require sponsors to make a statement to the effect that they "authorize" the prospectus, that would be highly unsatisfactory. Firstly, it would not resolve the ambiguity in the legislation. It would still be open to a court to conclude that a statement made pursuant to a requirement imposed by the SFC, i.e. a statement by a sponsor to the effect that it "authorized" the prospectus, was not sufficient to fall within sections 40 or 40A. Secondly, it would be unsatisfactory as a matter of principle to attempt to cure a genuine ambiguity in legislation by introducing a provision under the Listing Rules or the Code of Conduct, neither of which have the force of law. Thirdly, the question would need to be addressed as to what scope of "authorization" would be appropriate – the whole of the prospectus; or only parts of the prospectus and, if so, which parts?

By way of concluding comments, we would make two general observations.

Firstly, we would urge the SFC to proceed with due caution. It cannot be right that, just because sponsors are directly amenable to the SFC's jurisdiction (whereas other professionals involved in the collaborative listing process, and the management of the listing applicant itself, are not), that the SFC should push as quickly as possible to establish statutory liability for sponsors.

Secondly, we were somewhat surprised by the manner in which the question has been raised in the Consultation Paper. Whilst the courts have not adjudicated upon the scope of sections 40 and 40A of the Companies Ordinance, we would expect the

SFC and the Department of Justice to have a view on the correct interpretation of the existing provisions. We would invite the SFC to indicate its view and the view of the Department of Justice. We assume that the SFC would have consulted the Department of Justice at some time prior to the Consultation Paper being issued. We think it would be helpful, as part of the debate, for those views to be expressed.

***Q32: Do you agree that it should be made clear that sponsors are liable for untrue statements (including material omissions) in a prospectus?***

***If not, why not?***

***Response:*** No, we do not agree if what is intended is statutory liability through sections 40 or 40A, either at all, or certainly as they are presently worded. However, we consider that the question is too simplistic. The question, along with other related questions, should be addressed, as the SFC suggests, in a separate consultation exercise.

***Q33: Do you have any views on the proposed definition of "sponsor"?***

***Response:*** In principle, we agree with the SFC that the definition of sponsor should be restricted to the relevant corporate entity.

## **Appendix 1**

### **List of financial institutions authorizing this response paper**

*(in alphabetical order)*

1. Barclays Capital Asia Limited
2. BNP Paribas Capital (Asia Pacific) Limited
3. BOC International Holdings Limited
4. CCB International (Holdings) Limited
5. China International Capital Corporation Hong Kong Securities Limited
6. CIMB Securities Limited
7. CITIC Securities International Company Limited
8. Citigroup Global Markets Asia Limited
9. Credit Suisse (Hong Kong) Limited
10. Daiwa Capital Markets Hong Kong Limited
11. Deutsche Securities Asia Limited
12. Goldman Sachs (Asia) L.L.C.
13. The Hongkong and Shanghai Banking Corporation Limited
14. Jefferies Hong Kong Limited
15. J.P. Morgan Securities (Far East) Limited
16. Macquarie Capital Securities Limited
17. Merrill Lynch Far East Limited
18. Morgan Stanley Asia Limited
19. Nomura International (Hong Kong) Limited
20. Religare Capital Markets (Hong Kong) Limited
21. Rothschild (Hong Kong) Limited
22. Standard Chartered Securities (Hong Kong) Limited
23. UBS Securities Hong Kong Limited

## Appendix 2

### Example of SEC letter returning a draft registration statement

Mail Stop 3561

[REDACTED] 2008

[REDACTED]

Re: [REDACTED]  
Registration Statement on Form S-1  
Filed [REDACTED] 2008  
File No [REDACTED]

Dear [REDACTED]:

This is to advise you that a preliminary review of the above registration statement indicates that it fails in numerous material respects to comply with the requirements of the Securities Act of 1933, the rules and regulations under that Act, and the requirements of the form. For this reason, we will not perform a detailed examination of the registration statement, and we will not issue any comments because to do so would delay the review of other disclosure documents that do not appear to contain comparable deficiencies.

You are advised that we will not recommend acceleration of the effective date of the registration statement and that, should the registration statement become effective in its present form, we would be required to consider what recommendation, if any, we should make to the Commission.

We suggest that you consider submitting a substantive amendment to correct the deficiencies or a request for withdrawal of the filing.

Sincerely,

[REDACTED]  
Assistant Director

cc: [REDACTED]  
Facsimile No [REDACTED]

## Appendix 3

### Confidentiality and the Disclosure Review Process of the SEC – a Brief Summary of Policy and Practice in the U.S.

#### *Background and General Practice*

The SEC comment process is an integral part of the preparation of disclosure documents in U.S. IPOs. Prior to the offering, prospective IPO companies (known as "registrants") provide the SEC with a draft registration statement that is prepared in accordance with its disclosure rules. The registration statement must include both a prospectus and certain required exhibits, including material contracts. The SEC reviews the draft registration statement, including the disclosure and financial statements contained in the prospectus, from both a legal and accounting perspective. The SEC focuses on critical disclosures that appear to conflict with SEC rules or the applicable accounting standards and on disclosure that appears to be materially deficient in explanation or clarity<sup>49</sup>.

The SEC provides its written comments and questions in a letter to the registrant, identifying specific parts of the disclosure and requesting clarification or additional information. The registrant, after consulting with their counsel, reporting accountants, and underwriters, then promptly responds with a letter explaining the disclosure or agreeing to provide additional information. The letter may, if appropriate, be accompanied by an amended registration statement or other supporting information. Often, the registrant and its SEC examiner will discuss the comments and responses orally. This iterative process continues until the SEC examiner is satisfied that no further amendments to the disclosure is required, and advises the registrant that the review is complete.

Generally, the disclosure review and comment process for SEC-registered IPOs is a transparent one, visible to the investing public. Registrants publicly file each iteration of their draft registration statement on the SEC's public website, EDGAR, along with the registrant's responses to SEC comments given during the review process. Because each such draft is publicly filed, and because the registrant's response letters typically cite the SEC comment letters at length, substantially all of the disclosure review correspondence (and the corresponding amendments to the registration statement) is typically available in real-time to the investing public<sup>50</sup>.

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<sup>49</sup> SEC: *Division of Corporation Finance Filing Review Process*

<sup>50</sup> The general transparency of the disclosure review process is partially mitigated by the SEC's Rule 83, which permits filers to request confidential treatment for certain information provided in the course of the registration process (including issuer response letters, supplemental information requested by the SEC, and exhibits to the registration statement, such as material contracts). However, the Rule 83 procedures require specific and detailed justification for confidential treatment requests, and blanket requests for confidential information are typically denied.

In addition, the SEC has a policy of uploading the full text of its own response letters to EDGAR after the completion of the IPO, to enhance the transparency of the SEC's disclosure review process<sup>51</sup>.

There are two significant exceptions to this general rule:

- certain "foreign issuers"<sup>52</sup> qualify for "non-public" treatment of their draft registration statements and review correspondence under SEC policy (the "foreign issuer policy"), and
- "emerging growth companies" or "EGCs" under the JOBS Act of 2012, which are eligible for "confidential"<sup>53</sup> treatment of their draft registration statements and review correspondence under the Securities Act of 1933 ("EGC confidential treatment").

### *The SEC's Foreign Issuer Policy*

As noted above, the SEC accords certain "foreign issuers" the opportunity to submit their draft registration statements to the SEC on a "non-public" basis for initial review. Historically, under this process neither the draft registration statements nor the correspondence between the registrant and the SEC examiner were made public, allowing the registrant to substantially resolve any major disclosure and accounting issues before the first public filing of the draft registration statements.

The foreign issuer policy (it is not a formal rule) is intended to facilitate global financings by foreign issuers, particularly where the registrant had listed or was offering securities in its home market in connection with the IPO<sup>54</sup>. However, the SEC has recently cut back the scope of the foreign issuer policy, by excluding FPIs

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<sup>51</sup> This policy was first established in 2004. SEC Press Release, June 24, 2004. At that time, the relevant correspondence was to be released no earlier than 45 days after the SEC staff completed their review of the related disclosure filing. SEC Press Release, May 9, 2005. In December 2011, this period was shortened to 20 business days, to further enhance the transparency of the process. SEC Press Release, December 1, 2011. This policy applies generally and without regard to whether the registrant has used either of the confidential/non-public review processes described below.

<sup>52</sup> Briefly, "foreign issuers" are defined under U.S. securities laws in opposition to "domestic issuers" – in short, companies incorporated in the U.S. or with another significant connection to the U.S.. Foreign issuers include both foreign governments and similar entities and "foreign private issuers" or "FPIs".

<sup>53</sup> There is a distinction between the "non-public" process available to foreign issuers and the "confidential" process that EGCs are entitled to. The SEC has no obligation to maintain the confidentiality of the foreign issuer's submissions. This privilege could be lost where, for example, the registrant publicly discusses or discloses the proposed or pending IPO.

<sup>54</sup> SEC: Confidential Processing of Foreign Issuer Filings, March 31, 2001

that are not so dual-listed and bringing them into parity with domestic issuers (if they are no longer eligible for the foreign issuer policy, or the EGC confidential treatment process described below)<sup>55</sup>.

### *EGC Confidential Treatment under the JOBS Act of 2012*

In April 2012, the U.S. Congress passed the JOBS Act, which includes a broad set of reforms intended to facilitate access to the U.S. public markets by "emerging growth companies"<sup>56</sup>. One of the most notable was the introduction of a confidential registration statement review process for EGCs that is fundamentally similar to the SEC's foreign issuer policy. This was among the recommendations of the IPO Taskforce in their October 20, 2011 report to the U.S. Treasury on methods of improving access to the U.S. IPO market. This report, which was a strong influence on the drafters of the JOBS Act, noted that the SEC's foreign issuer policy gave FPIs a "significant advantage" over domestic companies, and that implementing a similar system would remove a significant impediment to the IPO process by shielding registrants from the public eye and allowing them to delay the disclosure of competitively sensitive information<sup>57</sup>.

Under the new system, an EGC's draft registration statements and review correspondence will be kept confidential until the registrant's first public filing of its registration statement on EDGAR, to which they will be attached as exhibits<sup>58</sup>. Similarly, foreign issuers under the revised foreign issuer policy must attach their non-public drafts and response letters as exhibits to the first publicly-filed registration statement<sup>59</sup>. As noted above, the full review correspondence (for both EGCs and qualifying foreign issuers) will be released on EDGAR after the completion of the offering, in line with the SEC's general policy.

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<sup>55</sup> In December 2011, the SEC announced changes to its Foreign Issuer Policy, restricting the types of foreign issuers that are eligible for non-public review. The Foreign Issuer Policy is now available only for: (1) foreign government debt securities; (2) FPIs that are listed or concurrently being listed on a non-U.S. exchange; (3) FPIs being privatized by a foreign government; and (4) situations where the public filing of an initial registration statement would conflict with the law of an applicable foreign jurisdiction. SEC: Non-Public Submissions from Foreign Private Issuers, December 8, 2011.

<sup>56</sup> The EGC designation is fairly broad, and is expected to be used by many aspiring IPO companies, including many FPIs. Estimates vary, but it is generally understood that a substantial majority of companies that completed SEC-registered IPOs in 2011 would have been eligible for EGC status.

<sup>57</sup> *Rebuilding the IPO On-Ramp*, p.29

<sup>58</sup> This public filing must take place at least 21 days prior to the road show for the offering (or, if there will be no road show, the anticipated effective date of the registration statement). SEC: JOBS Act FAQs - Confidential Submission Process for Emerging Growth Companies

<sup>59</sup> SEC: Non-Public Submissions from Foreign Private Issuers, December 8, 2011