

CONSULTATION CONCLUSIONS
ON
THE REGULATION OF
SPONSORS AND INDEPENDENT FINANCIAL ADVISERS

October 2004



**SECURITIES AND
FUTURES COMMISSION**
證券及期貨事務監察委員會



**Hong Kong Exchanges
and Clearing Limited**
香港交易及結算所有限公司

TABLE OF CONTENTS

	<i>Page No.</i>
PART A : INTRODUCTION	1
PART B : DISCUSSION ON CONSULTATION PROPOSALS	3
PART C : SFC'S FUTURE ROLE IN THE REGULATION OF SPONSORS AND CORPORATE FINANCE ADVISERS	45

PART A

INTRODUCTION

BACKGROUND

1. In May 2003, the Securities and Futures Commission of Hong Kong (“the SFC”) and The Stock Exchange of Hong Kong Limited (“the Exchange”) jointly published a Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers (“the Consultation Paper”). The main objective of the Consultation Paper was to seek market views on our proposals (“Consultation Proposals”), which were aimed at upholding standards of disclosure and the integrity of the Hong Kong listing market, and consequently the attractiveness of the listing market to investors and issuers.
2. The consultation period for the Consultation Paper closed on 31 July 2003. We received a total of 129 submissions in response to the Consultation Proposals. The responses are available on the website of Hong Kong Exchanges and Clearing Limited (“HKEx”) at www.hkex.com.hk/consul/response/responses1.htm.
3. Since July 2003 and in consultation with the market, we have continued to develop and refine the proposals. In May 2004, we conducted a follow-up targeted consultation with those sponsor and financial advisory firms most directly interested.
4. The consultation and policy development process has been necessarily extensive for two primary reasons. Firstly, the roles of sponsors and independent financial advisers (“IFAs”) are of special importance in Hong Kong. That is due mainly to the unusually large proportion of listed companies and listing applicants whose domicile and main operations are located outside the jurisdiction. Secondly, the consultation process revealed a variance of expectations of investors, regulators and some sponsors and IFAs with regard to the duties of sponsors and IFAs; it was important to understand the reasons for this variance thoroughly before finalising our proposals.
5. This report summarises the main views and issues raised in responses to the Consultation Proposals in Part B of the Consultation Paper and sets out the final conclusions of the Exchange and the SFC. The Consultation Paper is available on HKEx’s website at www.hkex.com.hk/consul/paper/consultpaper.htm, as well as on the SFC’s website at www.hksfc.org.hk/eng/press_releases/html/index/index2.html. Where relevant, this report also sets out views and issues raised during the targeted consultation conducted in May this year.
6. We are grateful to all respondents for their contributions to this consultation exercise.

RESULTS OF THE MARKET CONSULTATION

7. Overall, respondents were supportive of the general direction of the Consultation Proposals including the efforts of the Exchange and the SFC to enhance the overall standard of sponsors and IFAs in Hong Kong. In addition, we received a diverse range of constructive comments on the way forward.
8. One of the most significant and well supported themes related to the roles of each of the SFC and the Exchange with regard to the regulation of sponsors and IFAs.
9. Respondents clearly endorsed the SFC, as statutory regulator, being responsible for assessment of eligibility, on-going supervision, disciplinary and enforcement of the conduct of corporate finance advisers who discharge the work of sponsors and IFAs, whilst the Exchange, as market operator, should continue to be responsible for implementation and administration of the Listing Rule requirements, including the practice notes on due diligence. We accept those views and have finalised the conclusions in this report on that basis.
10. Other comments included concerns over practical issues that may arise from implementation of some of the proposals. Whilst we are mindful of the need to enhance the Hong Kong regulatory regime for sponsors and IFAs, we have also taken into account practical issues that may arise from implementing the proposals.
11. Part B of this report focuses on the aspects of the Consultation Proposals that are more suitably dealt with by the Listing Rules, for example, due diligence and the procedural requirements for specific declarations on due diligence and independence.
12. In Part C, the SFC sets out initiatives to bring forth an enhanced regulatory framework for sponsors and IFAs. In light of respondents' diverse views on appropriate criteria for corporate finance advisers to be eligible to act as sponsors and IFAs, the SFC proposes to engage the public in a focused consultation on an enhanced regulatory regime, including licensing criteria and continuing compliance requirements.
13. The SFC aims to conduct the consultation in late 2004 / early 2005. Responses to the Consultation Proposals will be taken into account in formulating the proposals on which the SFC will consult.
14. Unless otherwise specified, all the proposed rule changes referred to in this report apply to both the Main Board and GEM Listing Rules.

PART B

DISCUSSION ON CONSULTATION PROPOSALS

15. In this Part we discuss the responses to and our conclusions on, the Consultation Proposals.

APPOINTMENT

16. The Consultation Proposals (at B.98, B.99, B.106 to B.110 and B.113) included the following:

- (a) new applicants be required to appoint a sponsor to assist them through the application process;
- (b) listed issuers be required to appoint a sponsor in the case of any application for listing that requires the production of a listing document for registration;
- (c) the concept of co-sponsorship would be discontinued. For large initial public offerings in which it is necessary for more than one sponsor to be engaged, one sponsor would be designated as ‘primary sponsor’. That sponsor would have the additional responsibility of coordinating the due diligence and acting as central contact point in dealings with the Exchange;
- (d) after the new applicant is listed:
 - (i) Main Board: the new applicant must appoint a sponsor firm as a financial adviser to advise it in specified circumstances for a period ending on publication of the financial results for the first full financial year after listing;
 - (ii) GEM: the new applicant must appoint a sponsor firm as a financial adviser to advise it in specified circumstances for at least the remainder of the financial year during which the listing occurs and the subsequent two financial years (that is, the Exchange will retain the period stipulated in the existing GEM Listing Rules);
 - (iii) the Exchange may waive the requirement for such financial adviser to be appointed if the new applicant can demonstrate that it has two experienced directors and a full-time experienced compliance officer, all with unblemished compliance records;

- (iv) the issuer will not be obliged to appoint as its financial adviser the same sponsor firm that was its sponsor (for example, for the purpose of handling its initial public offering); and
 - (v) during this period, the issuer will be obliged to seek, on a timely basis, advice from the financial adviser in relation to a number of prescribed events including the publication of any regulatory announcement, publication of any circular or financial report, where a notifiable transaction (connected or otherwise) is contemplated including share issues and share repurchases, and monitoring the use of the proceeds and adherence to the business plans as detailed in the prospectus;
- (e) the Exchange will retain the discretion to direct an issuer to appoint a sponsor firm to provide it with advice for a further period the Exchange specifies. This discretion may be used in the event of a breach of the Listing Rules or investigation of a possible breach of the Listing Rules; and
- (f) listed issuers must appoint an IFA in relation to connected transactions that require prior shareholder approval.

17. The following summarises respondents' comments.

- (a) There was argument that, given the costs associated with complying with the proposals, the Exchange should consult further with listed issuers, applicants and the investing public before reaching a conclusion regarding the Consultation Proposals.
- (b) A number of respondents considered that when, and under what circumstances, sponsors and financial advisers should be appointed should be a matter for the issuer.
- (c) In relation to the proposal regarding discontinuation of the concept of co-sponsorship, a number of respondents queried the meaning of "large IPO", why an initial public offering with a large offering size might warrant more manpower, and who would decide when more than one sponsor is required. It was suggested that the issue should be left for market practitioners to determine. Some respondents disagreed that for large initial public offerings, one "primary sponsor" should be appointed to coordinate the due diligence work and ensure sufficient resources are deployed. They were of the view that large initial public offerings are often international in nature and therefore, different sponsors

would be engaged in view of their different backgrounds and experience. To these respondents, sponsors should be free to clarify their areas of responsibility and liaise with the Exchange on an agreed basis. Others suggested that the concept should continue as it would enable firms which are not qualified to act as sponsors for the time being to act as co-sponsors.

- (d) In relation to the proposal regarding financial advisers, respondents submitted that:
- (i) the GEM regime should not apply to the Main Board given the differences in the nature of GEM and Main Board issuers;
 - (ii) they were uneasy with any view that the appointment of an on-going financial adviser would improve the quality of the information disclosed by listed issuers because such advisers could only provide advice and guidance upon being approached by listed issuers for advice and, even then, only with adequate information;
 - (iii) a pre-listing sponsorship period is more appropriate than a post-listing advice period, because there is a real need to prepare directors before the listing;
 - (iv) sponsors or financial advisers should not be responsible for monitoring the use of proceeds and the business objectives of listed issuers. It would be unreasonable to expect them to monitor issuers' affairs on a daily or other timely basis;
 - (v) newly listed issuers should be allowed to retain the services of professionals, such as lawyers, accountants, specialist investment advisory firms, or investment banks, to perform the function of financial adviser during the relevant period, rather than just sponsor firms; and
 - (vi) the Exchange should clearly state in the Listing Rules that issuers are required to be fully transparent to the sponsor and financial adviser and obliged to inform them of the events proposed in the Consultation Paper.

- (e) Respondents also queried:
 - (i) whether a financial adviser should be required for a company where there had been a change in control and the new controlling shareholder had not previously controlled a listed issuer in Hong Kong or another major international market; and
 - (ii) what an issuer should do if no sponsor firm wanted to act as its financial adviser.
- (f) In relation to the proposal that the Exchange may waive the requirement for a financial adviser:
 - (i) some respondents considered the grounds on which the Exchange would consider waiving the financial adviser requirement for Main Board issuers too onerous; for example a director or compliance officer may not have a clean compliance record because of factors beyond their control;
 - (ii) on the other hand, some respondents submitted that the exemption should be tightened by requiring that, in addition to other criteria, the issuer's directors should also have to be familiar with the Listing Rules; and
 - (iii) other respondents submitted that there is no need for an exemption at all; all new issuers should be required to engage a financial adviser in the post-listing period.
- (g) A number of respondents disagreed with the proposal that the Exchange should retain a discretion to direct an issuer to appoint a financial adviser for a further period beyond the initial post-listing period. Their concern was that the detailed circumstances as to when the discretion would be exercised were not set out in the Consultation Paper.

18. Set out below are our conclusions regarding these Consultation Proposals.

- (a) The Listing Rules will be amended to require that:
 - (i) new applicants appoint at least one sponsor to assist the new applicant with its initial application for listing;

- (ii) after a new applicant is listed, the listed issuer must appoint a Compliance Adviser to assist it for the following periods immediately following the date of listing:
- Main Board: for the period ending on publication of the financial results for the first full financial year after listing;
 - GEM: (like the current requirement in GEM Listing Rule 6.01) for the period ending on publication of the financial results for the second full financial year after listing; and
- (iii) (like the current requirement in GEM Listing Rule 6.02) a listed issuer must appoint a Compliance Adviser at any other time as may be directed by the Exchange.

(b) In relation to the requirement for a sponsor:

- (i) (and the proposal to discontinue the concept of co-sponsorship) whilst the Exchange will no longer distinguish between sponsors and co-sponsors, we agree that it would be appropriate to let the new applicant decide whether it wishes to engage one sponsor or a number of sponsors to assist it through the application process. Consequently, the Listing Rules will be amended to require that, where a new applicant retains more than one sponsor:
- each of the sponsors appointed by a new applicant will have responsibility for ensuring that the obligations and responsibilities set out in the Listing Rules are fully discharged; and
 - the Exchange must be advised as to which of the sponsors is designated as the primary channel of communication with the Exchange concerning matters involving the listing application;

(Also see paragraph 28 below)

- (ii) we also accepted respondents' submissions that the proposal for listed issuers to be required to appoint sponsors in the case of any application for listing that requires the production of a listing document for registration, would be excessive if it extended to documents routine in nature (for example, scrip dividend documents). We are satisfied that the objective of the proposal, that is, to ensure listed issuers issuing documents to the general public are being properly advised and guided by knowledgeable professionals, would be achieved by restricting the requirement to prospectuses rather than any listing document.
- (c) In relation to the requirement for a Compliance Adviser:
- (i) as discussed in the Consultation Paper, the objective of introducing this requirement is to ensure that directors of newly listed issuers receive the guidance and advice of an appropriately qualified firm in the period immediately following listing. We believe this will improve the corporate governance of newly listed issuers, which in turn will enhance market integrity and confidence;
 - (ii) pursuant to respondents' comments, we have given further consideration to the proposal regarding the circumstances in which the Exchange would consider waiving the Compliance Adviser requirement. We have concluded that it is not possible to set criteria for application of the waiver that would be suitable to the market and also ensure we achieve the objective of the Compliance Adviser requirements and minimise regulatory risk. Consequently, we will not proceed with the proposed waiver and all newly listed issuers will be required to appoint a Compliance Adviser;
 - (iii) we do not accept respondents' suggestions that the Compliance Adviser role can be performed by other professionals such as lawyers or accountants;
 - (iv) as with sponsor eligibility requirements, the eligibility criteria for Compliance Advisers will be considered by the SFC as part of its consultation on existing licensing requirements. In the interim the Listing Rules will provide that a Compliance Adviser must be a corporation or authorised financial institution acceptable to the Exchange appropriately licensed or registered to advise on corporate finance matters. The Exchange will determine whether a Compliance Adviser is acceptable by considering whether the candidate is an eligible Main Board or GEM sponsor firm;

- (v) we acknowledge that such Compliance Advisers can only, and should only be required to, provide advice and guidance if they are asked for it by issuers and if they are given adequate information. Accordingly, we will amend the Listing Rules to impose an obligation on listed issuers to consult with and, if necessary, seek advice from their Compliance Advisers on a timely basis in prescribed circumstances. Those circumstances will include the proposed publication of any regulatory announcement, circular or financial report;
 - (vi) in light of respondents' submissions that it would be unreasonable to expect Compliance Advisers to monitor issuers' affairs, such as use of initial public offering proceeds, on a daily or other regular basis, the Listing Rules will provide that the Compliance Adviser should discuss rather than monitor these issues with the issuer. This should be done no less frequently than, for example, at the time of reviewing the financial reporting of the issuer and upon the issuer notifying the Compliance Adviser of a proposed change in the use of proceeds of the initial public offering; and
 - (vii) with regard to the query concerning what action an issuer should take if no firm wishes to act as its Compliance Adviser, we do not consider any dispensation from the requirement is warranted. A failure to comply may raise issues about the issuer's continuing listing status.
- (d) In relation to the Exchange's discretion to require an issuer to appoint a Compliance Adviser after the initial period following listing, we will clarify in the Listing Rules that the circumstances mentioned in the Consultation Paper (that is, a serious or persistent breach of the Listing Rules or investigation of a possible breach of the Listing Rules) are likely circumstances in which the Exchange will consider using this discretion.

ELIGIBILITY AND MONITORING OF SPONSOR AND IFA FIRMS AND INDIVIDUALS

19. A number of the proposals in the Consultation Paper (proposals at B.52, B.54, B.73 to B.76, B.79, B.80, B.81, B.83 and B.168 to B.170) related to initial and continuing eligibility to be able to undertake sponsor or IFA work, including monitoring of that continuing eligibility.

20. For example, there were proposals:

- (a) that to be eligible to act as a sponsor or IFA, a firm must be accepted by the Exchange for such purposes and admitted to a list of acceptable sponsors or IFAs maintained by the Exchange;
- (b) regarding the competence and experience that would be required of firms before they would be accepted. Amongst other things, this included a proposed requirement for sponsor firms to be required to have at least four appropriately qualified and experienced eligible supervisors and IFA firms at least two such eligible supervisors;
- (c) that the Exchange would require sponsor firms to meet and maintain specified minimum capital requirements; and
- (d) that the existing requirement for an annual review of eligibility be replaced with a certification process and a targeted program of monitoring.

21. The following summarises respondents' comments.

- (a) A clear theme was that many respondents were concerned the proposals would duplicate the SFC's licensing regime (including its on-going inspection and surveillance of licensed entities) and, consequently, result in costly and potentially confusing duplication in the registration/licensing process and back-end enforcement activities.
- (b) Respondents submitted that the SFC already operates a licensing regime for intermediaries, a separate department to monitor the performance of licensees, as well as statutory investigative and sanctioning powers enabling it to identify and discipline intermediaries which fall short of the conduct requirements. As a consequence, they argued, rather than develop a duplicative regime under the Listing Rules, there should be a single regime administered by the SFC as statutory regulator.

22. Set out below are our conclusions regarding these Consultation Proposals.

- (a) As discussed in the Consultation Paper, the objective of these proposals was to enable the Exchange to satisfy itself that those involved in undertaking sponsor and IFA work would meet, on a continuing basis, high standards of professionalism, competence and integrity, including by ensuring that a firm would have sufficient competent and experienced individuals to properly supervise and execute its engagements.
- (b) We acknowledge that overlapping regulatory responsibility is only acceptable when there is a clear regulatory reason for or benefit from such an approach.
- (c) Accordingly, in order to minimise the extent of any overlap, we have decided not to adopt these Consultation Proposals.
- (d) However, we consider that it is important to enhance standards. In light of respondents' views that any specific admission and on-going compliance criteria should be integrated into the SFC's existing licensing regime, the SFC will consider fine-tuning the existing regulatory regime by introducing specific eligibility criteria for intermediaries who wish to offer sponsor or IFA services. This might be achieved through a tiered approach to licensing corporate finance advisers for Type 6 Regulated Activity. The SFC aims to conduct a consultation exercise including in relation to the details of this proposal in late 2004/early 2005.
- (e) To avoid duplication, the Exchange intends to remove from the GEM rules the existing GEM sponsor list and ancillary requirements, including the existing GEM principal and assistant supervisor criteria and the existing GEM annual review requirement. However, these rules will remain largely unchanged until the SFC has completed its further consultation and has revised its existing licensing and regulation requirements for sponsor and IFA work.
- (f) As always, sponsors and IFAs (as well as Compliance Advisers) will continue to be required to exercise due skill and care in the performance of their functions, including the conduct of due diligence. The Listing Rules will retain the ability to issue public statements of criticism or public censures against sponsors (and Compliance Advisers) for breaching the Listing Rules.
- (g) As a consequence, the proposed transitional arrangements that were addressed by Consultation Proposals at B.184 and B.185 are no longer relevant and so will not be retained.

UNDERTAKINGS TO THE EXCHANGE

23. The Consultation Proposals (at B.96 and B.97) included the following:
- (a) a sponsor or IFA firm seeking admission to the relevant list be required to:
 - (i) declare the contents of its application to be true and not omitting any material fact; and
 - (ii) undertake to comply with the Listing Rules applicable to sponsors or IFAs, including the proposed Code of Conduct for Sponsors and IFAs (“the proposed Code”), and to assist the Exchange with its investigations including by producing documents and answering questions fully and truthfully;
 - (b) eligible supervisors be required to provide the Exchange with a written undertaking in similar terms to that provided by sponsors firms and IFA firms including an obligation to comply with the Listing Rules and the proposed Code;
 - (c) the proposed Code include an obligation that the eligible supervisors and directors of sponsor firms and IFA firms use their best endeavours to ensure the firm complies with its obligations under the Listing Rules and the proposed Code; and
 - (d) any breach of the undertakings be deemed to be a breach of the Listing Rules and subject to disciplinary action.
24. The following summarises respondents’ comments.
- (a) A majority of the respondents who disagreed with the proposals considered that the provision of undertakings by firms and individuals was not essential to the Exchange fulfilling its mandate to provide a “fair, orderly and efficient market for the trading of securities”.
 - (b) They argued that the rules are designed for governing the listing of securities and should not be extended to govern corporate financiers who are already subject to the regulatory regime administered by the SFC.

- (c) Other concerns were that:
- (i) the Exchange should not be given broader investigation powers, which would overlap with SFC powers;
 - (ii) the existing Listing Rules, SFC codes and fit and proper guidelines are adequate, given that, under the current system, sponsors and advisers can be sanctioned by the Exchange for any breaches; and
 - (iii) the requirements proposed are not requirements in other established jurisdictions.
- (d) A number of respondents agreed that sponsor firms should provide an undertaking. But they disagreed with the wording of the proposed Code, compliance with which was one element of the undertaking. Further, they did not agree that IFA firms should have to provide an undertaking because firms carrying on IFA work regarding connected transactions would have to give an undertaking whereas those carrying out IFA work on takeovers or financial advisory work in general would not be required to do so.
- (e) Some respondents agreed with the proposals but only if the Listing Rules were to state expressly that the responsibilities of a sponsor are owed solely to the Exchange.
- (f) Others indicated they would agree but only if the declaration were limited to the facts in the application form. Some respondents suggested that the declaration should include the wording “to the best knowledge of the sponsor”.
- (g) A majority of respondents disagreed with the proposal that individuals provide the Exchange with an undertaking. They argued:
- (i) individuals are only agents for their employer and the employer should ultimately be responsible for the actions of its employees;
 - (ii) the proposal would enable firms to shift liability to individuals and would thus have the effect of discouraging qualified persons to enter or stay in the profession;
 - (iii) a list of unacceptable individuals would be sufficient for the Exchange to impose penalties on individuals who do not comply with the Listing Rules;

- (iv) requiring individuals to use their best endeavors to ensure that the firm would comply with the obligations set out in the Listing Rules and the proposed Code is unrealistic because they may not be senior enough to ensure that the firm complies with all of the rules; and
 - (v) the Exchange should address the issue of confidentiality owed by a financial adviser to its clients.
- (h) On the other hand, there were views that individual undertaking was a development in the right direction. Respondents considered that the proposal could be improved by:
- (i) ensuring that the proposed measures do not remove or reduce directors' statutory responsibilities for the accuracy of the information contained in the prospectus; and
 - (ii) the Exchange providing detailed guidance in order to avoid an "expectation gap", as well as guidance to raise corporate governance awareness among directors.

25. Set out below are our conclusions regarding these Consultation Proposals.

- (a) We acknowledge respondents' concerns on the possible consequences resulting from the proposed undertaking. But we consider it appropriate to require an undertaking.
- (b) The undertaking reflects the contractual basis of Listing Rule obligations and will create a more direct regulatory relationship between the Exchange and firms, including a commitment on the part of the firm to abide by the appropriate standards and to co-operate with the Exchange in its investigations. Co-operation is important because it enables the Exchange to investigate breaches of the Listing Rules and related codes, not only in relation to sponsors, IFAs and individuals but also in relation to listed issuers and their directors.
- (c) However, taking into account respondents' concerns, the Exchange has decided not to proceed with the requirement for undertakings from individuals. The undertakings will be required of sponsor and IFA firms only.

- (d) The Exchange will amend the Listing Rules to provide that:
- (i) sponsors must give an undertaking to the Exchange no later than the date on which any documents in connection with the listing application are first submitted to the Exchange. If the sponsor is appointed after such date, then the undertaking must be given on the earlier of:
 - the sponsor agreeing its terms of engagement with the new applicant; and
 - the sponsor commencing work for the new applicant;
 - (ii) Compliance Advisers must give an undertaking to the Exchange no later than the earlier of:
 - immediately the Compliance Adviser agrees its terms of engagement with the listed issuer; and
 - the Compliance Adviser commencing work for the listed issuer; and
 - (iii) IFAs must give an undertaking to the Exchange no later than the earlier of the IFA agreeing its terms of engagement with the issuer and the IFA commencing work as IFA to the issuer.

INDEPENDENCE

26. The Consultation Proposals (at B.119 to B.122) included that:
- (a) a sponsor must not act for any new applicant or listed issuer, solely or in a co-sponsorship arrangement, if the sponsor is not independent from the issuer;
 - (b) the factors that might impact on its ability to act independently of an issuer include where:
 - (i) a sponsor or any member of the sponsor's group is holding more than 5% of the issued share capital of a new applicant;
 - (ii) the fair value of shareholding referred to above exceeding 15% of the consolidated net tangible assets of the sponsor group;

- (iii) a sponsor or any member of the sponsor's group is controlling the majority of the board of directors of the new applicant;
 - (iv) a sponsor is controlled by or is under the same control as the new applicant;
 - (v) 15% or more of the proceeds raised from an initial public offering is applied to settle debts due to a member of the sponsor's group;
 - (vi) a significant portion of the new applicant's operation is funded by the banking facilities provided by a member of the sponsor's group;
 - (vii) where a director or employee of the sponsor or a close family member of either a director or employee of the sponsor has an interest in or business relationship with the new applicant; and
 - (viii) where the sponsor or a member of the sponsor's group is the new applicant's auditor or reporting accountant;
- (c) similar criteria would apply to IFAs but with the addition that the Exchange would generally not consider an IFA to be independent if it has served as a financial adviser to the relevant listed issuer, its subsidiaries or any of its connected persons, for any significant assignment within two years prior to the proposed appointment; and
- (d) sponsors and IFAs would be required to submit a declaration in respect of their independence, addressing each category of potential conflict, at the beginning of any assignment, which requires the appointment of a sponsor or an IFA.

27. A summary of respondents' comments is below.

- (a) Some respondents disagreed with our proposals, asserting that not all of the circumstances set out would affect the ability of a sponsor to give "impartial advice" and discharge its duties independently. In particular, whether a business relationship (past or present) between the issuer and the sponsor's directors or employees could materially affect its independence would be subject to judgment. They did not consider a director or employee's shareholding in, or business relationship with the new applicant should exclude a firm from acting as a sponsor.

- (b) Some respondents submitted that it is not helpful to try and set down, in the form of rules, guidance regarding where a conflict of interest exists. They prefer this be a matter for the sponsor's judgment and, where there is a conflict, the Exchange should allow the sponsor to take up the role subject to full disclosure in the listing prospectus.
- (c) Some respondents were of the view that the proposed thresholds in respect of shareholding, proceeds and banking facilities were too low and that the absence of a materiality test would be too restrictive. On the other hand, some argued that the rules should be stricter by prohibiting any connection between the sponsor (or IFA) and the issuer.
- (d) A number of respondents disagreed that the Exchange should prohibit a sponsor from acting for a new applicant if a member of the sponsor group is the auditor or reporting accountant of the new applicant. They argued this requirement does not mirror the ethics rules for accountants, which require a sponsor firm that is affiliated with the audit firm to be independent of its client, by not having any shares, board representation or an underwriting role.
- (e) It was contended that inclusion of the sponsor group's shareholding as a circumstance affecting independence is unfair because it is common for sponsors to receive shares in lieu of cash for services. Consequently, the proposal would bar sponsors with lower NTA from receiving shares and would also cap the sponsors' investment decisions.
- (f) Some respondents suggested that the shareholding and business relationship indicator should be restricted to those employees involved in the transaction. Certain of the respondents considered that the advisory fees due to sponsors in relation to listing work should be excluded from "proceeds to settle debt". Others preferred that the circumstances should be subject to approval on a case-by-case basis, and if conflicted, the sponsor should be allowed to act if a "qualified independent sponsor" is appointed. On the other hand, a number of the respondents suggested that the control threshold should be set at "one third of the members of the board" rather than just "majority of the board" and that the proceeds to settle debts due to the sponsor group should be net proceeds rather than gross. There were also views that the proceeds threshold should be lower, at no more than 5%.

- (g) Respondents sought clarification of terms such as “sponsor group”, “control”, “majority of the board” and “close family members”.
- (h) A number of respondents considered that IFAs should not be subject to the same independence criteria as sponsors.
- (i) It was suggested that the Exchange should reduce to 12 months the timeframe outside of which an IFA can have served as a financial adviser to the relevant issuer and still remain eligible to act.
- (j) Some respondents considered that as long as the firm and the eligible supervisor responsible for the IFA assignment have not acted as corporate finance advisers to the issuer in the two years prior to appointment, there should be no reason to exclude them from doing IFA work.
- (k) Some respondents suggested that rather than the declaration as to independence being required to be submitted at the beginning of an assignment, it should be submitted at the time of first notification of the transaction to the Exchange, or, if the IFA or sponsor is appointed after that time, then upon appointment.

28. Set out below are our conclusions regarding these Consultation Proposals.

- (a) We note respondents’ concerns regarding the proposed independence criteria. We also recognise that there will always be diverse views on appropriate independence thresholds or tests. But the principle underlying the proposed independence criteria, which to a large extent represents current Exchange practice, is to ensure a level playing field. To that end, we consider that the Consultation Proposals are generally appropriate.
- (b) The Listing Rules will include a requirement that sponsors, Compliance Advisers and IFAs perform their duties with impartiality, that is, without bias. Additionally, the Listing Rules will provide that, subject to the comments in paragraph (g) below, sponsors and IFAs must be independent.
- (c) However, taking into account respondents’ submissions, we have modified certain of the factors proposed in the Consultation Paper impacting on independence. We have also made the proposed criteria a bright-line test, which should assist with its application in practice.

(d) The Listing Rules will provide that a sponsor will not be independent from an issuer if any of the following circumstances exist:

(i) the sponsor group (which will be defined in the Listing Rules) and any director or associate of a director of the sponsor collectively holds or will hold, directly or indirectly, more than 5% of the issued share capital of the new applicant, save and except where that holding arises as a result of an underwriting obligation;

(ii) the fair value of the direct or indirect current or prospective shareholding of the sponsor group in the new applicant exceeds or will exceed 15% of the net equity shown in the latest consolidated financial statements of the sponsor's ultimate holding company or, where there is no ultimate holding company, the sponsor;

(iii) any member of the sponsor group or any director or associate of a director of the sponsor is an associate or connected person of the new applicant;

(iv) 15% or more of the proceeds raised from the initial public offering of the new applicant are to be applied directly or indirectly to settle debts due to the sponsor group, save and except where those debts are on account of fees payable to the sponsor group pursuant to its engagement by the new applicant for sponsorship services;

(v) the aggregate of:

- amounts due to the sponsor group from the new applicant and its subsidiaries; and
- all guarantees given by the sponsor group on behalf of the new applicant and its subsidiaries,

exceeds 30% of the total assets of the new applicant;

(vi) the aggregate of:

- amounts due to the sponsor group from:

→ the new applicant;

- the new applicant's subsidiaries;
- any controlling shareholder of the new applicant; and
- any associates of any controlling shareholder of the new applicant; and
- all guarantees given by the sponsor group on behalf of:
 - the new applicant;
 - the new applicant's subsidiaries;
 - any controlling shareholder of the new applicant; and
 - any associates of any controlling shareholder of the new applicant,

exceeds 10% of the total assets shown in the latest consolidated financial statements of the sponsor's ultimate holding company or, where there is no ultimate holding company, the sponsor;

(vii) the fair value of the direct or indirect shareholding of:

- a director of the sponsor;
- a director of any holding company of the sponsor;
- an associate of a director of the sponsor; or
- an associate of a director of any holding company of the sponsor

in the new applicant exceeds HKD 5 million;

(viii) an employee or director of the sponsor who is directly engaged in providing the subject sponsorship services to the new applicant, or an associate of such an employee or director, holds or will hold shares in the new applicant or has or will have a beneficial interest in shares in the new applicant;

- (ix) any of the following has a current business relationship with the new applicant or a director, subsidiary, holding company or substantial shareholder of the new applicant, which would be reasonably considered to affect the sponsor's independence in performing its duties as set out in the Listing Rules, or might reasonably give rise to a perception that the sponsor's independence would be so affected, save and except where that relationship arises pursuant to the sponsor's engagement by the new applicant for the purpose of providing sponsorship services:
- any member of the sponsor group;
 - an employee of the sponsor who is directly engaged in providing the subject sponsorship services to the new applicant;
 - an associate of an employee of the sponsor who is directly engaged in providing the subject sponsorship services to the new applicant;
 - a director of any member of the sponsor group; or
 - an associate of a director of any member of the sponsor group;
- (x) the sponsor or a member of the sponsor group is the auditor or reporting accountant of the new applicant.
- (e) In relation to "fair value" we simply mean the value as it would be determined if the relevant asset was to be included in financial statements at fair value.
- (f) With regard to respondents' objections referred to at paragraph 27(d) above we note that relevant ethics rules for accountants restrict auditors from acting where a member of the auditor's group promotes, deals or underwrites shares. In the light of this, we consider this Consultation Proposal that a sponsor would not be permitted to act for the new applicant if a member of the sponsor group is the auditor or reporting accountant of the new applicant appropriate.

- (g) We have accepted the suggestion that a sponsor, even if it is not independent, should be allowed to act so long as there is another qualified independent sponsor. We consider that this will minimise the risk of advice being incomplete or lacking objectivity. Accordingly, the Listing Rules will provide that, in the case of a new applicant that appoints more than one sponsor, only one of the sponsors will be required to be independent. But we will require the listing document to disclose whether each sponsor is independent and, if not, then how the lack of independence arises. (Given the requirement to act with impartiality discussed at paragraph (b) above, a sponsor or IFA must still perform its duties without bias whether or not it is independent.)
- (h) With regard to IFAs, the Listing Rules will provide that the Exchange will consider an IFA not to be independent if any of the following circumstances exist:
- (i) the IFA group (which will be defined in the Listing Rules) and any director or associate of a director of the IFA holds, directly or indirectly, in aggregate more than 5% of the issued share capital of the issuer, another party to the transaction, or an associate or connected person of the issuer or another party to the transaction;
 - (ii) any member of IFA group or any director or associate of a director of the IFA is an associate or connected person of the issuer or another party to the transaction;
 - (iii) any of the following exceeds 10% of the total assets shown in the latest consolidated financial statements of the IFA's ultimate holding company or, where there is no ultimate holding company, the IFA:
 - the aggregate of:
 - amounts due to the IFA group from:
 - * the issuer;
 - * the issuer's subsidiaries;
 - * any controlling shareholder of the issuer; and
 - * any associates of any controlling shareholder of the issuer; and

- all guarantees given by the IFA group on behalf of:
 - * the issuer;
 - * the issuer's subsidiaries;
 - * any controlling shareholder of the issuer; and
 - * any associates of any controlling shareholder of the issuer;
- the aggregate of:
 - amounts due from the IFA group to:
 - * the issuer;
 - * the issuer's subsidiaries; and
 - * any controlling shareholder of the issuer; and
 - all guarantees given on behalf of the IFA group by:
 - * the issuer;
 - * the issuer's subsidiaries; and
 - * any controlling shareholder of the issuer;
- the aggregate of:
 - amounts due from the IFA group to any of the following (defined as "the Other Parties"):
 - * another party to the transaction;
 - * any holding company of another party to the transaction;
 - * any subsidiary of any holding company of another party to the transaction;

- * any controlling shareholder of:
 - another party to the transaction; or
 - any holding company of another party to the transaction, which controlling shareholder is not, itself, a holding company of another party to the transaction; and
- * any associate of any such controlling shareholder; and
- all guarantees given by any of the Other Parties on behalf of the IFA group; and
- the aggregate of:
 - amounts due to the IFA group from any of the Other Parties; and
 - all guarantees given by the IFA group on behalf of any of the Other Parties;
- (iv) any of the following has a current business relationship with the issuer or another party to the transaction, or a director, subsidiary, holding company or substantial shareholder of the issuer or another party to the transaction which would be reasonably considered to affect the IFA's independence in performing its duties as set out in the Listing Rules, or might reasonably give rise to a perception that the IFA's independence would be so affected, save and except where that relationship arises pursuant to the IFA's appointment for the purpose of providing the subject advice:
 - any member of the IFA group;
 - an employee of the IFA who is directly engaged in providing the subject advice to the issuer;
 - an associate of an employee of the IFA who is directly engaged in providing the subject advice to the issuer;
 - a director of any member of the IFA group; or

- an associate of a director of any member of the IFA group;
- (v) within the previous two years:
- a member of the IFA group has served as a financial adviser to:
 - the issuer or its subsidiaries;
 - another party to the transaction or its subsidiaries; or
 - a connected person of the issuer or another party to the transaction; or
 - an employee or a director of the IFA who is directly engaged in providing the subject advice to the issuer:
 - was employed by or was a director of another firm that served as a financial adviser to any of the issuer or its subsidiaries, another party to the transaction or its subsidiaries or a connected person of the issuer or another party to the transaction; and
 - in that capacity, was directly engaged in the provision of financial advice to the issuer or another party to the transaction;
- (vi) the IFA or a member of the IFA group is the issuer's auditor or reporting accountant.
- (i) We intend to implement the proposals regarding a requirement for statements relating to independence to be given by sponsors and IFAs. But, instead of requiring that the independence statement (or, in the case of IFAs, declaration) be submitted at the time of first notification of the transaction to the Exchange, the Listing Rules will require that:
- (i) sponsors submit the statement to the Exchange no later than the date on which any documents in connection with the listing application are first submitted to the Exchange. But if the sponsor is appointed after such date, then the earlier of the date when the sponsor agrees its terms of engagement with the new applicant and when the sponsor commences work on the assignment; and

- (ii) IFAs submit the declaration to the Exchange no later than the earlier of the IFA agreeing its terms of engagement with the issuer and the IFA commencing work as IFA to the issuer.
- (j) The Exchange will also amend the Listing Rules to provide an obligation on the part of sponsors, IFAs and issuers to inform the Exchange as soon as possible should they become aware of a change to the information submitted in the independence statement or declaration.

RESPONSIBILITIES

29. The Consultation Proposals (at B.146, B.147, B.148, B.149, B.156 and Annex 2) included proposals that:
- (a) sponsors conduct reasonable investigations to satisfy themselves that:
 - (i) the new applicant is suitable for listing;
 - (ii) the new applicant's directors appreciate the nature of their responsibilities;
 - (iii) the new applicant and its directors can be expected to honour their obligations under the Listing Rules;
 - (iv) "non-expert sections" contained in the new applicant's listing application and listing documents are true and do not omit any material fact required to be stated or necessary to avoid the statements being misleading; and
 - (v) there are no reasonable grounds to believe that the "expert sections" contained in the new applicant's listing application and listing documents are not true or omit to state a material fact required to be stated or necessary to avoid the statements being misleading;
 - (b) IFAs take all reasonable steps to satisfy themselves that the terms and conditions of the transaction or arrangement are fair and reasonable and in the interests of the issuer and its shareholders as a whole and that there are no grounds to believe that any expert advice or opinion relied on in relation to the transaction are not true or omit a material fact;

- (c) both sponsors and IFAs comply with a Code of Conduct for Sponsors and IFAs that would set out, amongst other things, the minimum due diligence a sponsor and an IFA would be expected to undertake to satisfy the obligations to conduct reasonable investigations; and
- (d) declarations be given:
 - (i) by sponsors and, where they are different, lead underwriters, in the listing document regarding the extent of the due diligence undertaken; and
 - (ii) by IFAs in their report regarding the due diligence performed in order to reach a conclusion that the terms of the relevant transaction or arrangement are fair and reasonable and in the interest of the issuer and its shareholders as a whole.

30. The following summarises respondents' comments.

- (a) Regarding the requirement for sponsors and IFAs to conduct due diligence:
 - (i) some respondents agreed with our proposals, indicating that they considered the thrust of the proposals was already implicit in taking on such assignments;
 - (ii) some respondents regarded the proposals as useful in bridging the expectation gap and clearing any misconceptions that sponsors may have in relation to their responsibilities;
 - (iii) there were also suggestions that the Exchange should issue guidance or practice notes or a code of practice with detailed explanatory notes to help firms complete appropriate due diligence. It was suggested that legal and audit practices could be taken as a reference;
 - (iv) however, whilst agreeing that it is important for sponsors to perform proper due diligence, a majority of respondents expressed concerns that sponsors were being asked in effect to shoulder the responsibilities of directors of issuers (in particular, new applicants) and other experts;
 - (v) some respondents considered that the starting point for a due diligence review rests on information provided by the issuer and its directors or management, and that there is no infallible way to cross check or verify all data;

- (vi) a number of respondents felt that it would be impossible for sponsors to satisfy themselves that the directors “can be expected” to honour their obligations under the Listing Rules. They argued that no matter what “investigations” are conducted by sponsors, sponsors would not be in a position to predict directors’ future acts. Sponsors can only take reasonable steps to make directors aware of their obligations;
- (vii) some respondents also considered that if the sponsorship regime is to be revised in the direction proposed in the Consultation Paper, an assessment of “suitability for listing” should be defined by reference to a clear set of prescribed eligibility criteria. Under current arrangements the Listing Committee has an unfettered discretion to reject listing applications on the basis that they are not suitable. Consequently sponsors are not in a position to make an assessment of suitability;
- (viii) in respect of the confirmation relating to the “non-expert” sections, a number of respondents contended that sponsors may have difficulty in assessing the correctness and completeness of some of the information notwithstanding that they have carried out work to the extent possible to ascertain truthfulness and completeness. They submitted that sponsors would include in the listing document an express warning of practical difficulties in this regard, but that the Exchange would normally request such warning statements be deleted;
- (ix) respondents also expressed concerns about the proposal regarding the “expert” sections including that:
- sponsors may not be in a position to “investigate” the work done by experts;
 - it may be impossible for sponsors to form a view as to whether the experts have properly discharged their obligations owing to the specialised nature of their work; and
 - sponsors may only assist in the assessment of the qualification, experience and independence of such experts; so as long as the expert is independent from the issuer and qualified for providing the information set out in the expert section, the Exchange should rely on their work;

- (x) respondents submitted that the Consultation Proposals contained no clear definition of “reasonable investigation” and, accordingly, they would expose sponsors to the risk of being penalised even though they had carried out sufficient due diligence. They also argued that sponsors should not be penalised for malpractices on the part of other parties involved in the listing process;
 - (xi) certain of the respondents suggested that the SFC should incorporate a “due diligence defence” into the *Securities and Futures Ordinance* (“SFO”) or *Companies Ordinance* to support the due diligence obligation of sponsors;
 - (xii) similar concerns regarding shouldering responsibilities perceived to be those of directors and experts were also raised in relation to IFAs;
 - (xiii) respondents submitted that IFAs do not take steps to satisfy themselves that the terms and conditions of a transaction **are** fair and reasonable; rather they seek to establish **whether** they are or are not fair and reasonable; and
 - (xiv) some respondents considered that time constraints faced by an IFA would render it impossible to carry out studying and analysis to the extent sought by the Exchange. They also submitted that IFAs should be allowed to rely on material given to them in arriving at their conclusions; action could be taken against the providers of information if it was discovered to be false.
- (b) Regarding the detailed due diligence steps set out in the proposed Code:
- (i) whilst agreeing with the approach adopted, some respondents considered it more appropriate to incorporate the proposed Code (and all other relevant practices and codes) into the SFC Corporate Finance Adviser Code (“the SFC CFA Code”). They believed that a single code would promote certainty and remove the risk of potential confusion between separate but overlapping regulatory requirements;
 - (ii) other respondents regarded the existing SFC CFA Code to be sufficient;

- (iii) a number of respondents took the view that rather than being incorporated into the Listing Rules, the terms of the proposed Code should take the form of guidance to help sponsor firms to improve their corporate governance and operations;
 - (iv) some respondents also considered that the requirements in the proposed Code should apply to firms only since it is the firm and not the individual that accepts and performs the required work for an issuer;
 - (v) a majority of the respondents expressed concerns that certain provisions of the proposed Code were too onerous for practitioners to comply with. Some suggested the proposed Code was too lengthy and some of the review procedures were commercially impractical. Other respondents criticised some of the proposed Code's obligations are subject to a wide range of interpretations. They were of the view that sponsors should be allowed to rely on experts and other professionals' investigations and representations after a reasonable review of the work done by them; and
 - (vi) other respondents took a contrary view, suggesting that the minimum scope of the due diligence set out in the proposed Code would enable rogue corporate finance practitioners to defend inadequate work.
- (c) Regarding the requirement to give public declarations:
- (i) some respondents welcomed the proposals on the basis that they would enhance and clarify the responsibilities of sponsors, which would benefit investors;
 - (ii) other respondents regarded the proposals as a backdoor legislative amendment. They considered that it would create statutory liability beyond that set out in current legislation and would have the effect of requiring sponsors to admit liability for a document for which the law may not otherwise find them liable. To these respondents, the fundamental concern was that sponsors would be charged with primary responsibility for incomplete or inaccurate disclosure, relegating the role of the issuer and its directors to a secondary level. They believed that sponsors can only conduct due diligence based on the information available to them, and only advise clients about proper disclosures;
 - (iii) some respondents believed that the Exchange was proposing to shift the responsibilities of professional parties and directors to sponsors;

- (iv) some respondents did not see any benefit in providing confirmations to the Exchange or to the public; they believed that an effective disciplinary system would be sufficient to encourage sponsors to exercise due care in carrying out their obligations;
- (v) some respondents who made such assertions were of the view that they would be unable to perform the “due diligence investigations” proposed in the Consultation Paper, and that it would be unreasonable to ask lead underwriters to make the same declaration as sponsors because of the difference in their roles;
- (vi) it was suggested that it would often be impracticable for the lead underwriter to carry out the full scope of due diligence because, in some cases, the lead underwriter is introduced late in the listing application process. It was also suggested that the requirement would make it difficult to secure underwriters in a poor IPO environment, or that the underwriters willing to participate may not be staffed with qualified personnel to carry out the work required by the Exchange; and
- (vii) some respondents commented that IFAs should not have to give a separate declaration because IFAs already set out in their opinion letters the due diligence they have performed including documents reviewed, analysis undertaken and comparisons made.

31. Respondents also made comments in relation to specific paragraphs of the proposed Code, including the following.

Paragraph 9: It was suggested that the circumstances for the termination of the sponsor relationship were too restrictive.

Paragraph 11: There was a query as to whether the requirement that sponsors take overall responsibility for preparation of the listing and other documents meant that the sponsor took legal responsibility for the content of those documents including expert opinions. Another respondent suggested the requirement that the sponsor “ensure” the listing documents comply with the Listing Rule requirements be replaced with a requirement that the sponsor “use reasonable endeavours to ensure” such compliance.

- Paragraph 12:** Respondents queried how the obligation to avoid conflicts of interest and to withdraw when conflicts arose sat with the independence requirement and proposed restrictions on resignation/termination.
- Paragraph 13:** It was suggested that the requirement went too far as it implied that the sponsor had to take responsibility for addressing all issues raised by the Exchange.
- Paragraph 16:** A respondent submitted that making the extent of due diligence required for a particular issuer “appropriate to the circumstances” did not provide sufficient guidance as to what was required, and that the sponsor’s performance was likely to be judged after the event by reference to a standard also established after the fact.
- Paragraph 17:** There was a query as to whether the Exchange does in fact rely heavily on the sponsor; the respondent contended that the Exchange makes extensive inquiries of its own and places no reliance on the sponsor.
- Paragraph 19:** A couple of respondents contended that the obligation to conduct “intrusive” investigations was excessive.
- Paragraph 20:** A number of respondents questioned how a sponsor could check the credentials of sub-underwriters and placement agents and what arrangements a sponsor could make to ensure public shareholders are not connected to and financed by a connected person if such relationships and beneficial shareholdings are deliberately concealed.
- Paragraph 21:** There were suggestions that the auditors should be responsible for reviewing the internal systems and controls of the issuer, in particular as they related to financial reporting. Other respondents questioned whether the sponsor was being asked effectively to underwrite future performance, and also questioned how a sponsor could assess the integrity of a director.

Paragraph 22: A respondent queried how a sponsor could review a director's general business acumen. Some respondents indicated that for Mainland China the types of reference checking and database searches mentioned are difficult, if not impossible, to perform. This may be the case for other countries also. Even in Hong Kong criminal record searches may not be possible and regulatory bodies such as the SFC and HKMA can only release information that is not protected by statutory secrecy provisions.

Paragraph 23: Some respondents repeated comments about the difficulties of obtaining required information, particularly in Mainland China.

Paragraph 24: It was noted that a sponsor would face difficulty in determining whether a material fact had been omitted and argued it was unreasonable, in paragraph 24(a), to underwrite directors' future intentions.

In relation to paragraph 24(b), a concern was raised that sponsors could not second guess experts and so were not in a position to assess the integrity of financial information provided by the issuer's accounting staff and internal and external auditors. Other respondents suggested "integrity" of financial information be replaced with "fairness and reasonableness" of financial information, and that the period in relation to which financial statements needed to be reviewed should reflect the trading record period under the relevant rules, that is, two years for GEM and three years for the Main Board. Respondents also requested that it be made clear that the comfort letter should not be published.

In relation to paragraphs 24(f) and (g), it was suggested "analysis" be replaced with "review".

In relation to 24(h) it was suggested that the review of material contracts be limited to contracts for the two years prior to listing on the basis that the GEM track record period was only two years.

In paragraph 24(l) submissions suggested that "investigation" be replaced with "analysis" and that this due diligence should be on a "best efforts basis" as such information was seldom available in Asian markets.

In relation to paragraph 24(m) it was suggested that the investigation and confirmation of proprietary interests, intellectual property rights, and licensing arrangements should be the responsibility of lawyers and valuers; sponsors should be able to rely on their representations after conducting a reasonable review.

A number of respondents submitted that a sponsor was not in a position to conduct the technical feasibility investigation required by paragraph 24(n) or to investigate the new applicant's stage of development and commercial viability as required by paragraph 24(o). They also submitted that for trade secrecy reasons the issuer may be reluctant to disclose to the sponsor all of the information required for it to conduct technical feasibility investigations.

Paragraph 25: Respondents suggested that the ability of sponsors to conduct due diligence of expert material was constrained by the fact that experts were retained by the issuer and the sponsor has no contractual relationship with the expert. In particular, respondents were concerned that sponsors may not be able to confirm that the expert had no direct or indirect interests in or relationship with the issuer.

Respondents also submitted that sponsors are not competent to determine the appropriateness of the scope of expert work and assumptions relied on, particularly as these matters may need to be determined by reference to professional standards such as accounting standards.

Paragraph 26: In relation to paragraph 26(c), a respondent was of the view that a sponsor could not judge what was "of significance to the Exchange in determining the suitability of listing" because there is no published guidance about the Exchange's thinking in this respect. It was also submitted that the power of the Exchange to require such a declaration would have unintended consequences, for example, by inordinately increasing the sponsor's legal risk.

Paragraph 28: It was suggested that the word “review” be used instead of “investigation”, and that the requirement be to review whether transactions are “either on normal commercial terms or, if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favourable to the listed issuer than terms available to or from (as appropriate) independent third parties”.

Paragraph 30: Respondents commented that the requirement in paragraph 30(b) that the IFA “thoroughly research relevant market and economic conditions and trends relevant to pricing the transaction” was unrealistic in a 21-day time frame for producing the opinion and suggested using “review” instead of “thoroughly research”.

Similarly, in relation to paragraph 30(d), respondents suggested that it would be difficult in the available time to determine the scope of work, assumptions and independence of experts.

As with paragraph 28, submissions were also made in relation to paragraph 30(d) that “review” should be used instead of “investigation”.

32. Set out below are our conclusions regarding these Consultation Proposals as they relate to sponsors. (Our conclusions as they relate to IFAs are set out at paragraph 33 below.)

Overview

- (a) In light of respondents’ comments, the fact that sponsors in practice authorise prospectuses, and our view that the Exchange’s regulatory objectives do not require the sponsor to make a public declaration in the listing document, the Exchange has not pursued the proposal referred to at paragraph 29(d)(i) above.
- (b) Instead, a sponsor will be required to make a declaration to the Exchange to the effect that:
 - (i) all the documents required by the Listing Rules to be submitted to the Exchange on or before the date of issue of the listing document and in connection with the new applicant’s listing application have been submitted;

- (ii) having made reasonable due diligence inquiries, the sponsor has reasonable grounds to believe and does believe that:
- the answers provided by each director or proposed director of the new applicant in the directors' declarations are true and do not omit any material information;
 - the new applicant is in compliance with all the conditions in Chapter 8 of the Listing Rules, in particular, rules 8.02, 8.03, 8.05B, 8.06, 8.07, 8.10, 8.11, 8.12, 8.13, 8.13A, 8.14, 8.15, 8.16, 8.17, 8.18, 8.19, 8.20 and 8.21A except to the extent that compliance with those rules has been waived by the Exchange in writing;
 - the listing document contains sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares and the financial condition and profitability of the new applicant at the time of the issue of the listing document;
 - the information contained in the non-expert sections of the listing document:
 - contains all information required by relevant legislation and rules;
 - is true in all material respects, or, to the extent it consists of opinions or forward looking statements on the part of the directors of the new applicant or any other person, such opinions or forward looking statements have been made after due and careful consideration and on bases and assumptions that are fair and reasonable; and
 - does not omit material information;
 - the new 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 (in particular rules 13.09, 13.10, 13.46, 13.48 and 13.49 and Chapters 14 and 14A of the Main Board Listing Rules or rules 17.10, 17.11, 18.03 and 18.49 and Chapters 19 and 20

of the GEM Listing Rules), 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, both before and after listing; and

- the directors of the new applicant collectively have the experience, qualifications and competence to manage the new applicant's business and comply with the Listing Rules, and individually have the experience, qualifications and competence to perform their individual roles including an understanding of the nature of their obligations and those of the new applicant as an issuer under the Listing Rules and other legal or regulatory requirements relevant to their role; and

(iii) in relation to each expert section in the listing document, having made reasonable due diligence inquiries, the sponsor has reasonable grounds to believe and does believe (to the standard reasonably expected of a sponsor which is not itself expert in the matters dealt with in the relevant expert section) that:

- where the expert does not conduct its own verification of any material factual information on which the expert is relying for the purposes of any part of the expert section, such factual information is true in all material respects and does not omit any material information;
- all bases and assumptions on which the expert section is founded are fair, reasonable and complete;
- the expert is appropriately qualified, experienced and sufficiently resourced to give the relevant opinion;
- the expert's scope of work is appropriate to the opinion given and the opinion required to be given in the circumstances (where the scope of work is not set by a relevant professional body);
- the expert is independent from the new applicant and its directors and controlling shareholder(s); and
- the listing document fairly represents the views of the expert and contains a fair copy of or extract from the expert's report.

- (c) The Listing Rules will provide that sponsors must have regard to a new practice note which will provide guidance as to the Exchange's expectations of the due diligence steps sponsors will typically perform.
- (d) The practice note replaces the proposed Code. Those elements of the proposed Code which duplicated or overlapped with the SFC CFA Code have been removed in the practice note which now focuses on due diligence.
- (e) Both the declaration and practice note will only apply to sponsor firms; not individuals.

Due diligence and the practice note

- (f) The requirement in the Listing Rules for due diligence to be undertaken reflects existing best practice and does not replace or affect the independent obligations of directors, issuers and experts, or indeed the obligations of sponsors as corporate finance advisers under applicable laws and codes administered by the SFC. The amendments do not relegate issuer and director responsibilities to a secondary level, below sponsors.
- (g) The Listing Rule amendments and new practice note crystallise our existing expectations regarding the role of sponsors in minimising the risks to investors associated with issuers; in particular, new applicants and related disclosure in prospectuses.
- (h) Due diligence by sponsors is important because, contrary to the views of some respondents, the Exchange places significant reliance on this work. The Exchange does not have the resources or mandate to gain the detailed knowledge of an issuer's business which the sponsor is expected to have accumulated through its preparation of the applicant for listing. Consequently, the Exchange and the market are entitled to rely on the competence and integrity of the sponsor in assisting the issuer to prepare and present the listing application and listing documents.
- (i) We have, however, noted the concerns of some respondents regarding the practicality of the due diligence expectations in the Consultation Proposals.
- (j) The practice note will not impose prescriptive obligations; rather it will provide guidance as to how sponsors can satisfy the obligations in the Listing Rules to conduct due diligence, prior to making the required declaration.

- (k) The Listing Rules and practice note will make it clear that the obligation is to conduct “reasonable due diligence”. The practice note will refer to the Exchange’s expectations of due diligence sponsors will **typically** perform rather than “minimum due diligence” steps. The practice note will stipulate that it will be the sponsor firm’s responsibility to determine, by reference to the steps set forth in the practice note, the due diligence steps that are appropriate for any particular new applicant and the extent of each step. That may mean that in a particular case certain steps referred to in the practice note are not necessary; there may also be due diligence steps other than those in the practice note that are necessary.
- (l) This non-exhaustive approach does not mean that sponsor conduct will be judged after the fact by reference to an unspecified standard; the overriding principles of “reasonableness” and “appropriateness” will apply in all cases. It is not possible to provide an exhaustive list of expected due diligence steps and neither is it desirable; this might encourage a box-ticking mentality. Rather, the Listing Rules and the practice note will emphasise that, ultimately, it is a matter for the sponsor to determine, in the circumstances, the extent of due diligence to be undertaken in order to make the declaration to the Exchange.
- (m) More specifically:
- (i) we will clarify sponsors’ obligations in relation to the preparation of listing documents; sponsors must be “closely involved in the preparation of” rather than “responsible for” the documents;
 - (ii) we will remove references to sponsor conflicts of interest on the grounds that this is already covered by the SFC CFA Code;
 - (iii) we will replace references to “investigation” with expressions such as “review” and “assess”, and will remove the adjective “intrusive” from descriptions of due diligence steps;
 - (iv) to address respondents’ concerns about due diligence inquiries to be undertaken in relation to directors of the new applicant and in order to be less prescriptive, we will:
 - remove references to a director’s “business acumen”;

- remove reference to confirming each director’s relevant educational and professional qualifications and work history; and
 - remove references to undertaking searches including criminal record and other regulatory searches;
- (v) we will replace the requirement to assess the “integrity” of financial information, with an expectation that sponsors will review material financial statements and assess the accuracy and completeness of the information submitted by the new applicant to satisfy the trading record requirement. The practice note will specify that such review may include interviewing the new applicant’s accounting staff and internal and external auditors and reporting accountants and, where relevant, obtaining comfort from the new applicant’s external auditors or reporting accountants based upon agreed procedures;
- (vi) we will change the time period for material financial statements, which sponsors are expected to review, from three years to “the trading record period”;
- (vii) we will amend the due diligence steps in relation to “technical feasibility”. The practice note will refer to the sponsor being expected to reach “an understanding of the technical feasibility” and “assess” the stage of development of the new applicant’s business;
- (viii) to address concerns about sponsors’ access to experts retained by the new applicant, we will include in the Listing Rules an obligation on new applicants (as well as their directors) to assist sponsors including, amongst other things, by:
- giving the sponsor all information reasonably available or known to the new applicant’s directors that is relevant to the sponsor’s performance of its duties; and
 - affording the sponsor full access at all times to all persons, premises and documents relevant to the sponsor’s performance of its duties;
- (ix) we will take up the suggestion made in relation to the wording of paragraph 28 of the proposed Code; and

- (x) we will omit the obligation for sponsors to check the credentials of placees and underwriters and to ensure they are not connected or financed by a connected person.
 - (n) We also accept respondents' concerns about sponsors satisfying themselves that new applicants are suitable for listing. Given that, apart from the quantitative requirements in the Listing Rules, there are few guidelines as to how the Exchange might exercise its general discretion to find a new applicant unsuitable, we will not include this in the final declaration.
 - (o) We do not agree that auditors rather than sponsors should be responsible for reviewing the internal systems and controls of the issuer. The auditor's review is not focused on compliance with the Listing Rules. The sponsor, in light of their knowledge of the Listing Rules and understanding of the new applicant's business, should be responsible for reaching a view as to the adequacy of the financial reporting and operational systems and controls as regards the issuer's ability to comply with the Listing Rules.
33. Set out below are our conclusions regarding the Consultation Proposals as they relate to IFAs.
- (a) Many of the conclusions set out above regarding sponsors also apply to IFAs.
 - (b) In light of the obligation in Main Board Listing Rule 14A.22 (and GEM Listing Rule 20.22) requiring that an IFA must set out various matters in its letter, including the reasons for the opinion, the key assumptions made and the factors taken into consideration in forming that opinion, we do not consider it necessary for an IFA also to make a declaration in respect of the due diligence it performs.
 - (c) However, the Exchange will insert into the Listing Rules additional rules requiring an IFA to take all reasonable steps to satisfy itself that:
 - (i) it has a reasonable basis for making the statements required by paragraphs (1) to (5) of Main Board Listing Rule 14A.22 (or the GEM Listing Rule 20.22); and
 - (ii) there is no reason to believe any information relied on by the IFA in forming its opinion or any information relied on by any third party expert on whose advice or opinion the IFA relies in forming its opinion, is not true or omits a material fact.

- (d) That should also address the comment that the “reasonable reliance” requirements for IFAs should not assume that the IFA forms a positive opinion in respect of the relevant transaction.
- (e) A note in the Listing Rules will set out the due diligence steps the Exchange expects an IFA will typically perform. These steps are a modified version of paragraph 30 of the proposed Code. Amongst other changes, the steps will omit “thoroughly” and refer to “other conditions and trends” relevant to the pricing of the transaction. We have also simplified the extent of due diligence to be conducted by the IFA in relation to opinions provided by other experts and relied on by the IFA.
- (f) The Listing Rules will also require that:
 - (i) an IFA be appropriately licensed by the SFC and discharge its responsibilities with due care and skill; and
 - (ii) an issuer must afford any IFA it appoints full access to all persons, premises and documents relevant to the IFA’s performance of its duties, and keep the IFA informed of any material change to any information previously given to or accessed by the IFA.

COMPLIANCE AND SANCTIONS

34. The Consultation Proposals (at B.177 and B.178) included proposals that sponsors and IFAs and their eligible supervisors and staff all be subject to disciplinary sanctions including:
- (a) private reprimand;
 - (b) public statement with criticism;
 - (c) public censure;
 - (d) declaration that an individual is an unacceptable person or cannot be an eligible supervisor for a specified period of time;
 - (e) suspension of a firm from the list of acceptable sponsors or list of acceptable IFAs for a specified period of time;

- (f) declaration that an individual is an unacceptable person or cannot be an eligible supervisor; and
- (g) removal of a firm from the list of acceptable sponsors or list of acceptable IFAs.

35. The following summarises respondents' comments.

- (a) Whilst agreeing with our proposals, some respondents submitted that the SFC should play a full role in the disciplinary process.
- (b) It was suggested that there should be an appeal mechanism in place for sponsors and IFAs and that the available sanctions should not include private reprimand as such disciplinary action is not transparent.
- (c) Other respondents disagreed that the Exchange should maintain or publish a "list of unacceptable individuals".
- (d) Some of the respondents who disagreed with our proposals took the view that the existing rules provide sufficient measures regarding any breach of duty by sponsors relating to matters governed by the Listing Rules. They also considered it inappropriate to extend such measures to individuals, since, they argued, it is the firm and not individual which undertakes the engagement to perform the work. These respondents were of the view that the proposed lists of sponsor and IFA firms and list of unacceptable individuals would be sufficient for the Exchange to assess and monitor the work and professional conduct of an individual.
- (e) Other respondents argued that, without cogent reasons to the contrary, sponsors and IFAs should be regulated by the SFC; not by both the SFC and the Exchange. They were of the view that the current SFC licensing/registration system already empowers the SFC to take disciplinary action against sponsors and IFAs if necessary.
- (f) Some respondents did not consider it necessary or appropriate to introduce any rules applicable to IFAs other than codifying the circumstances under which an IFA would be considered independent. They also disagreed that IFAs and individuals should be subject to any sanctions under the Listing Rules as all licensed corporations are already subject to sanctions by the SFC.

36. Set out below are our conclusions regarding these Consultation Proposals.

- (a) To ensure firms and individuals meet the required regulatory standards, particularly in relation to the conduct of due diligence, we consider that the Exchange and SFC should have a suitable hierarchy of sanctions available. However, we are not proposing to introduce into the Listing Rules new sanctions for sponsors, Compliance Advisers or IFAs. The Exchange and SFC will co-operate at various levels to ensure that misconduct by sponsors, Compliance Advisers and IFAs, including breaches of their obligations and responsibilities, are investigated and adequately sanctioned in order to ensure market integrity is maintained.

PART C

SFC'S FUTURE ROLE IN THE REGULATION OF SPONSORS AND CORPORATE FINANCE ADVISERS

37. The Consultation Proposals included proposals relating to eligibility criteria for sponsors and IFAs. The Exchange and the SFC have agreed that, rather than addressing eligibility in the Listing Rules, the SFC will consider fine-tuning its existing licensing and regulation requirements to incorporate specific initial and continuing eligibility requirements for sponsor, Compliance Adviser and IFA work.
38. In this Part, the SFC discusses the proposed way forward.

EXISTING REGULATORY FRAMEWORK FOR SPONSORS AND IFAs

39. Under the SFO, corporations providing corporate finance advice are required to be licensed for Type 6 Regulated Activity and relevant employees are required to be licensed as representatives. At present, the SFO licensing regime does not distinguish between those corporate finance advisers that carry out sponsor or IFA work, and those that do not.
40. At present the suitability, appointment and specific responsibilities of Sponsors and IFAs are dealt with in the Listing Rules.
41. The SFC is responsible for the on-going supervision of sponsors and IFAs as licensed corporate finance advisers. All corporate finance advisers are subject to the provisions of the SFC CFA Code and are expected to meet the conduct, regulatory principles and standards set out in the SFC CFA Code. These include a duty to keep books and records in relation to advisory work undertaken and also a duty to exercise due care and skill.
42. Pursuant to paragraph 4.4 of the SFC CFA Code, corporate finance advisers must also comply with the Listing Rules applicable to sponsors.

ENHANCED REGULATORY FRAMEWORK FOR SPONSORS, COMPLIANCE ADVISERS AND IFAs

43. The thrust of the responses to the Consultation Paper supported the maintenance of a list of eligible sponsors and IFAs. There was also overwhelming support for the SFC to be the single regulator to administer the eligibility criteria for sponsors and IFAs. Some respondents advocated tougher enforcement in order to enhance overall market standards.
44. The SFC therefore aims to conduct a focused public consultation on specific eligibility criteria requirements created separately for sponsors, Compliance Advisers and IFAs in late 2004/early 2005. The SFC will also conduct an investor survey in Q3 2004 in preparation for the consultation.
45. In formulating its proposals for the public consultation, the SFC will initially conduct a round of soft consultation in the industry. The SFC will also explore how to develop its licensing, inspection and enforcement functions in this area including the manner in which the SFC will co-ordinate efficiently with the Exchange.