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By Hand

31 July 2003

Dear Sirs

COMMENTS ON
CONSULTATION PAPER ON THE REGULATION OF SPONSORS AND INDEPENDENT FINANCIAL ADVISERS

We enclose 5 copies of a joint submission by Freshfields Bruckhaus Deringer and Linklaters on behalf of a group of 14 investment banks in response to your joint "Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers". The group comprises the organisations listed in the Appendix.

If the Stock Exchange or the SFC has any questions regarding any aspect of this submission, or if you would like us to further elaborate on any of the points, please contact the following:

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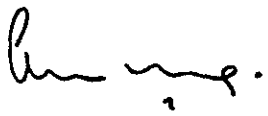
Yours faithfully



Christopher Wong

APPENDIX

List of Participating Banks

(a) ABN AMRO Asia Corporate Finance Limited;
(b) BOCI Asia Limited;
(c) China International Capital Corporation (Hong Kong) Limited;
(d) Citigroup Global Markets Asia Limited;
(e) Credit Suisse First Boston (Hong Kong) Limited;
(f) CLSA;
(g) Deutsche Bank AG, Hong Kong Branch;
(h) Goldman Sachs (Asia) L.L.C.;
(i) ING Bank N.V.;
(j) J.P. Morgan Securities (Asia Pacific) Limited;
(k) Merrill Lynch (Asia Pacific) Limited;
(l) Morgan Stanley Dean Witter Asia Limited;
(m) Nomura International (Hong Kong) Limited; and
(n) UBS Securities Limited.

31 JULY 2003

CONSULTATION PAPER ON THE REGULATION OF SPONSORS AND INDEPENDENT FINANCIAL ADVISERS

JOINT RESPONSE FROM FRESHFIELDS BRUCKHAUS DERINGER AND LINKLATERS ON BEHALF OF A GROUP OF 14 INVESTMENT BANKS

FRESHFIELDS BRUCKHAUS DERINGER

Linklaters

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SECTION A: OVERVIEW

1. INTRODUCTION

1.1 This is a joint submission by Freshfields Bruckhaus Deringer and Linklaters on behalf of a group of 14 investment banks set out in paragraph 1.2 (the ***Group***) in response to the "Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers" (the ***Paper***) jointly published by The Stock Exchange of Hong Kong Limited (***SEHK***) and the Securities and Futures Commission (***SFC***).

1.2 The Group comprises the following organisations:

(a) ABN AMRO Asia Corporate Finance Limited;
(b) BOCI Asia Limited;
(c) China International Capital Corporation (Hong Kong) Limited;
(d) Citigroup Global Markets Asia Limited;
(e) Credit Suisse First Boston (Hong Kong) Limited;
(f) CLSA;
(g) Deutsche Bank AG, Hong Kong Branch;
(h) Goldman Sachs (Asia) L.L.C.;
(i) ING Bank N.V.;
(j) J.P. Morgan Securities (Asia Pacific) Limited;
(k) Merrill Lynch (Asia Pacific) Limited;
(l) Morgan Stanley Dean Witter Asia Limited;
(m) Nomura International (Hong Kong) Limited; and
(n) UBS Securities Limited.

If you have any questions, please feel free to contact the following:

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SECTION B: EXECUTIVE SUMMARY

Introduction

The Group is **generally supportive** of the direction of the Paper to reinforce the regulatory regime for sponsors and other intermediaries and agrees that certain aspects of the regulation of sponsors and independent financial advisers (IFAs) require tightening or clarification.

Fundamental Concern

The Group's **fundamental concern** with a number of the proposals in the Paper is that they appear to charge sponsors with primary responsibility for incomplete or inaccurate disclosure (or other things which arguably go wrong), relegating the role of the issuer and its directors to a secondary level. The Group believes it essential to recognise that, no matter how rigorous and expansive the diligence procedures, it is the issuer's prerogative as to what information it reveals – or withholds – from its sponsors (or lawyers, shareholders, etc.). As in other regulatory regimes, sponsors should be free from culpability where they have made an appropriate inquiry but where their issuer-clients (or their agents – e.g., accountants) have been less than fully forthcoming. Whilst the Exchange identifies (at paragraph 16 of the Paper) that "the regulatory system does not exist to guarantee investors against losses", sponsors should not be placed in a position of effectively providing such a guarantee over the issuer and its directors – whom, ultimately, sponsors cannot control.

Issuers and their Directors are Primarily Responsible

Whilst sponsors do share responsibility for their work in bringing companies to the market, the Group strongly maintains that issuers and their directors must be held **primarily to account** and calls for tightened rules for issuers and their directors as well as visible enforcement actions against issuers and directors who breach the rules. This should apply to all issuers, irrespective of their jurisdiction of incorporation or place of principal operations. In addition, the regulators should have the responsibility for setting the training standards for directors prior to listing as well as on a continuing basis.

Widening the Expectation Gap

The Group is seriously concerned at the proposed requirement to conduct "reasonable investigations" by reference to a set of minimum review procedures. The Group believes that establishing a minimum standard will lead to a "race to the bottom" as certain market participants would deem a regulatory-prescribed minimum as an appropriate diligence standard. Further, the proposal for sponsors to make an express declaration in the prospectus and accept responsibility for its contents will likely **widen the expectation gap** that the Paper has set out to reduce, by relegating certain responsibilities of issuers and their directors to sponsors. Investors might well conclude that a sponsor's attestation in the prospectus means essentially that a sponsor confirms with certainty the information therein. (If that were possible, indemnification provisions in underwriting agreements, disclosure opinions from lawyers and "due diligence" defences would not be market standards in securities regimes around the world.) As noted above, a sponsor cannot "stand in the shoes" of its issuer-clients – it can only conduct diligence and perform services based on the information an issuer-client makes available to it, and it can only advise its issuer-clients about what the proper disclosures must be.

Summary of Responses

As you will have noted, our response to the Paper is lengthy. This is intentional. Where we have objections to, or concerns with, proposals in the Paper, we have attempted to explain those objections/concerns in some detail and, where possible, to provide alternative solutions which we would invite the Exchange and the SFC to consider. We hope that the detail that we have provided will enable the Exchange and the SFC to understand the bases for our concerns and to enable a constructive dialogue to take place in relation to such matters.

However, given the length of our responses, we thought it appropriate to try to summarise those responses, and to prioritise them. This is set out in the table below which needs to be read in conjunction with the cross-referenced sections in the more detailed responses.

As you might expect, the table below focuses on the areas where we have concerns or disagree with the approach taken in the Paper; however, a reading of the more detailed responses will indicate that there are many areas where we are supportive of the proposals, whilst perhaps suggesting changes in detail or emphasis.

CONSULTATION PAPER: QUESTION 13 **DECLARATION BY SPONSORS IN LISTING DOCUMENTS** See paragraph 30 of our response	• The proposal to require sponsors to make an express declaration of responsibility in the prospectus widens the "expectation gap", allowing investors to conclude that sponsors can somehow "stand in the shoes" of its issuer-clients. • This proposal creates statutory liability beyond those set out in current legislation and accelerates a process of reform of the law already in the Government's contemplation. • This is tantamount to an amendment of legislation by the backdoor, to which the Group strongly objects. The Paper is effectively seeking to amend the Companies Ordinance without going through due legislative process.
CONSULTATION PAPER: QUESTION 12 **REASONABLE INVESTIGATIONS** See paragraph 25 of our response	• The Group strongly disagrees with the proposal to prescribe a set of minimum review procedures in connection with a sponsor's obligation to carry out reasonable investigations, or "due diligence". • The Group recognises and supports the need for a non binding set of pro forma or sample review procedures, backed up by an affirmative obligation to "consider carefully the appropriate level of due diligence to be performed in the context of each issue."
CONSULTATION PAPER: QUESTION 12 **CONFIRMATION OF "EXPERT" SECTIONS** See paragraph 25 of our response	• The Group also strongly disagrees with the proposed form of confirmation of due diligence in respect of "expert" sections of a prospectus as it imposes a higher standard than that required under the Companies Ordinance.

CONSULTATION PAPER: QUESTION 5 **NUMBER OF ELIGIBLE SUPERVISORS** See paragraph 12 of our response	• The Group disagrees with the proposal of four Eligible Supervisors. The Group proposes a requirement of two Eligible Supervisors.
CONSULTATION PAPER: QUESTION 10 **INDEPENDENCE** See paragraph 23 of our response	• The Group supports the requirement that sponsors and IFAs must be independent and agrees that the Exchange should consider certain criteria indicating lack of independence, although these should not be an automatic bar. • The Group also agrees with the proposal to require sponsors and IFAs to submit a Confirmation of Independence, addressing each category of potential conflict. However, the Group does not agree with all of the criteria currently proposed. • A sponsor/IFA should not act where it is influenced by the factors of potential conflict making it inappropriate or impossible for the sponsor/IFA to give impartial advice to the issuer, in the absence of other circumstances which demonstrate independence. • The Group recommends the adoption of rules allowing "conflicted" sponsors to continue to act if a "qualified independent sponsor" is appointed.
CONSULTATION PAPER: QUESTION 8 **INDIVIDUAL UNDERTAKINGS TO THE EXCHANGE** See paragraph 17 of our response	• The Group does not agree with the proposal to require individual Eligible Supervisors to provide the Exchange with an undertaking. The Group has a major concern in relation to this proposal and would welcome further discussion with the Exchange about the nature of the responsibilities and liabilities attaching to such an undertaking. This proposal would create an unnecessary administrative burden and appears to go further than analogous GEM, Toronto, U.S. and UKLA rules under which, in general, individuals are agents for their employer (the sponsor-entity) which is ultimately responsible for the actions of its employees.
CONSULTATION PAPER: QUESTION 7 **MINIMUM CAPITAL REQUIREMENT** See paragraph 16 of our response	• The Group disagrees with the proposal to require sponsors to have minimum capitalisation. Capitalisation rules are set by the SFC for firms under the statutory regime of the SFO and for Hong Kong authorised banks under the Banking Ordinance and follow internationally accepted standards and guidelines (Basle).

CONSULTATION PAPER: QUESTION 5 **COMPETENCE AND EXPERIENCE OF INDIVIDUALS** See paragraph 12 of our response	• The Group disagrees with the proposal of four Eligible Supervisors and does not agree with all of the proposed experience criteria. • The Group strongly supports the proposal to recognise international transaction experience gained from an international financial centre (IFC). The Exchange should be flexible to deal with specific situations. • The Group proposes the following: 1. two Eligible Supervisors; 2. only one of the Eligible Supervisors needs to have experience of an IPO; and 3. each of the two Eligible Supervisors must have played a substantial role in at least three significant transactions. • The Group supports the Paper's position that the individual need not be a full time executive director of the firm.
CONSULTATION PAPER: QUESTION 12 **PRE-QUALIFICATION AS AN ACCEPTED SPONSOR FIRM** See paragraph 4 of our response	• The Group agrees with the proposal to establish a list of acceptable sponsor firms based on a clear set of objective criteria. • In order to be effective in removing or significantly narrowing the expectation gap, the Exchange should review the appropriateness of admitting sponsors with a doubtful track record of meeting appropriate standards onto the initial list of acceptable sponsors in order not to undermine the system from the outset.
CONSULTATION PAPER: QUESTION 3 **THE CONCEPT OF "UNACCEPTABLE INDIVIDUALS"** See paragraph 9 of our response	• The Group agrees with the establishment of a list of unacceptable individuals based on a clear set of objective criteria. • The Exchange and the SFC are urged to establish a mechanism for more serious cases to be referred to the SFC for consideration as a licensing matter.

CONSULTATION PAPER: QUESTION 9 **APPOINTMENT OF SPONSOR** See paragraph 20 of our response	• The Group agrees that newly listed issuers and their directors should receive on-going advice on Listing Rules and corporate governance matters. The Group supports the proposal that the listing sponsor will not be required to act as continuing sponsor. • The Group suggests that a newly listed company should be required to retain the services of a firm (which could be an investment bank, specialist investment advisory firm, lawyers or accountants) to advise on compliance with Listing Rules and corporate governance matters for the proposed periods of time after listing. However, the Group disagrees that the continuing firm should monitor matters such as use of proceeds and implementation of business plans. • The Group calls for further discussions with the Exchange on the role of on-going sponsorship as a practical matter.
CONSULTATION PAPER: QUESTION 8 **UNDERTAKINGS TO THE EXCHANGE** See paragraph 17 of our response	• The Group agrees with the proposal to require sponsor firms to provide the Exchange with an undertaking. • However, the Group feels very strongly that the new rules must make it clear that the responsibilities of a sponsor are regulatory duties "owed solely to the Exchange".

SECTION C: PRINCIPLES AND GENERAL COMMENTS

2. THE PRINCIPLES SUPPORTED BY THE GROUP

2.1 The Group is generally supportive of changes to the existing regulatory framework for sponsors and IFAs insofar as such changes are aimed at, and in fact have the effect of, meeting the following principles:

- **Aligning with international standards**
  The changes should ensure that Hong Kong's standards are in line with, but ***do not exceed, recognised international standards***. These changes should follow a ***regulatory philosophy*** consistently applied and sponsors and IFAs who already operate at recognised international standards should not be expected to have to change their current standards and practices. The setting of excessively high standards will likely ***widen the expectation gap*** that the Paper has set out to reduce by relegating certain responsibilities of issuers and their directors to sponsors. What is needed is enhanced and more effective enforcement, rather than a change of rules that will expose sponsor firms to increased legal liabilities and risks than those arising under the existing legal and regulatory framework.

- **Issuers and their directors must be held to account**
  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. Sponsors/IFAs, on the other hand, are primarily responsible for failing to advise issuers on what must and need not be disclosed under Hong Kong's Listing Rules. Sponsors and IFAs should not be charged with primary responsibility for incomplete or inaccurate disclosure (or other things which arguably go wrong), relegating the role of the issuer and its directors to a secondary level. The proposed changes must be accompanied by correspondingly tightened rules for issuers and their directors as well as visible enforcement actions against issuers and directors who breach the rules. This should apply to all issuers, irrespective of their jurisdiction of incorporation or place of principal operations.

- **No back door legislation ahead of due legislative process**
  Any changes to the Listing Rules should not result in increased statutory liability of sponsors than is the case under the current statutory framework. For example, it is at least arguable that sponsors have liability under section 40 of the Companies Ordinance[1]. However, the Paper proposes that sponsors must sign the prospectus, thereby forcing sponsors to come within a class of persons expressly stated to be liable (*i.e.*, those who have authorised the prospectus). If the Exchange believes that a clear statement of sponsors' responsibility would be "helpful"[2], then the law itself should be changed, and any changes which have the effect of changing current law must not be made through changes to the Listing Rules; rather, these changes must be effected through the due process of the legislature – especially in light of the fact that the Government is currently considering revising Hong Kong's prospectus rules.

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1 See paragraph 158 of the Paper.

2 See paragraph 158 of the Paper.

- **Need for Balance between entry barriers and enforcement of high standards**
  In order to be effective in removing or significantly narrowing the expectation gap, the Exchange should review the appropriateness of admitting sponsors with a doubtful track record of meeting appropriate standards onto the initial list of acceptable sponsors in order not to undermine the system from the outset. However, if the intention is to let even those with doubtful track records onto the list of acceptable sponsors, the regulators will have to accept ending up with having to commit significant resources to enforcement. A balance between raised entry criteria and rigorous enforcement is required.

- **Regulators to take an active lead on education and training**
  It takes a significant amount to time and experience to gain a sound understanding of the letter as well as the spirit of the Listing Rules and the applicable laws and regulations on corporate governance. The regulators should have the responsibility for setting the training standards for directors prior to listing as well as on a continuing basis. Consideration should also be given to prescribed training and education for those sponsors and individuals about whose standard of work the regulators have concerns, even if they have done nothing which would justify them being removed from the list of acceptable sponsors or placed on the list of unacceptable individuals, as relevant.
  Such firms and individuals must appreciate (and be able to demonstrate their appreciation of) the nature of their ***responsibilities***.

- **Compliance track record and experience from international financial centres**
  Given that the Paper is seeking to ensure our standards are in line with those of other major IFCs, Hong Kong transactional experience should not be a prerequisite for eligibility. As such, acceptability criteria should treat experience gained in IFCs as satisfying any requirement to have transactional experience.

- **Enforcement must be effective**
  There must be immediate, visible as well as ***effective enforcement*** against those who break the rules by a team of professionals to back up the new rules. It is the range of ***credible sanctions*** and ***effective enforcement*** which operate as ***real deterrents*** to unscrupulous players. In this regard, the Group notes the SFC's press release dated 18 June 2003, titled "Disciplinary Focus of the SFC", in which the SFC stated that it will "*refocus its disciplinary resources on the areas of corporate finance, fund managers and investment advisers, and banks.*" In particular, the SFC stated that it would get tougher on misconduct so there would be a greater deterrent effect, with sponsor failings in discipline being one of its stated enforcement priorities in 2003.

3. GENERAL COMMENTS

3.1 It will take more than just the sponsors to shift market culture and practice.

The onus should not be completely pushed onto sponsors. The responsibilities for ensuring that issuers satisfy conditions for listing and, in particular, understanding the issues relating to eligibility for listing, and that directors are sufficiently versed on the Listing Rules and their fiduciary duties, need also to be shared between the following:

(a) **Regulators** – The regulators have been mandated to protect investors. This responsibility cannot be delegated to others, and includes the responsibility for ensuring that the securities listed on the SEHK are appropriate for investment by the public. In Hong Kong, this duty has always been performed by ensuring that issuers and their management make proper and full disclosure of information affecting the market and price of the listed securities. The regulators have not tried to restrict, except in exceptional circumstances, what securities are available for investment, but has instead left it to investors to determine what securities they want to trade in. The Group fully support this approach. Similarly, since no one can guarantee that any security is a safe and sure investment, the regulators have instigated various investor education initiatives to try to ensure that investors understand this. Again, the Group supports this. However, ongoing guidance on which issuers and securities should not be listed in Hong Kong should be provided to the market. For example, there should be specific guidance (say, by way of practice notes to, or interpretive releases of, the Listing Rules) as to the circumstances under which the Exchange would not accept an issuer or business for listing.

(b) **Directors** – Directors of the issuer must be properly trained. Quite often, directors are genuinely not aware of the rules applicable to them as listed company directors (and what the rules mean). See "Education and Training" below.

(c) **Investors** – There must be a more robust system of investor education. For example, the publications armed at investors should be given more publicity. The regulators should enhance investors' risk awareness that there is no "guaranteed" investment in the stock markets.

3.2 The Group does not consider the wholesale adoption of rules and practices from elsewhere appropriate.

(a) **The UK Model has since moved on:**

(i) The Paper (in particular the regulatory approach in listing applications[3] set out in the Paper[4]) draws heavily on the United Kingdom Listing Authority (***UKLA***) concept of a sponsor.

(ii) The current rules in the U.K. are set out in the UKLA Listing Rules which were revised in December 2001 for a demutualised London stock exchange to

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3 The regulatory approach in listing applications described in the Paper is near identical to that contained in the "UKLA Guidance Manual" published by the Financial Services Authority in April 2002.

4 See paragraph 158 of the Paper.

deal with the coming into force of the Financial Services and Markets Act 2000 (***FSMA***) and the move to a statutory regime for sponsors under sections 88 and 89 of the FSMA. The regulatory framework in the U.K. has since moved on, and it is no longer the case that the Hong Kong rules need to be amended in the same way as the U.K. to catch up with the UKLA Listing Rules.

(iii) We note that the FSA has since July 2002 been conducting an extensive review of the U.K. listing regime[5], which includes a consideration of whether "*the sponsor regime provides a cost effective method of ensuring appropriate due diligence is undertaken prior to an issuer being admitted to the official list.*"[6] The initial feedback[7] was that most respondents supported the current regime, although there was a concern that the requirements for qualifying as a sponsor were onerous. The FSA is expected to issue a further consultation by Spring 2004, which will consider whether the FSA should set out existing due diligence practices.

(b) **Have the Growth Enterprise Market rules worked well?**

(i) A number of the current proposals are existing GEM Listing Rules, given that the GEM Listing Rules were also drawn up with the benefit of the U.K. model. The rules and requirements of the Growth Enterprise Market (***GEM***) "*are designed to foster a culture of self compliance by listed issuers and sponsors in the discharge of their respective responsibilities.*"[8] The regulatory philosophy of GEM "*emphasises on enhanced disclosure rather than the combination of merit and disclosure based approach adopted by the Main Board.*"[9]

(ii) The common regime now proposed by the Paper does not sit well with this clear difference of regulatory philosophy and actual rules between the Main Board and GEM.

(iii) In the absence of a statement of an intended shift towards the GEM regulatory philosophy, we believe the Exchange needs to explain whether the current GEM requirements have improved the quality of GEM sponsors work and if not, why the current proposals would now have the desired effect if applied to Main Board sponsors.

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5 See "DP14 Review of the Listing Regime" (July 2002) and "FS14 Review of the Listing Regime" (January 2003).

6 Question 9, "DP14 Review of the Listing Regime" published by the FSA in July 2002.

7 Feedback Statement on the main issues arising from Discussion Paper 14 ("Review of the Listing Regime") published by the FSA in January 2003.

8 www.hkgem.com/aboutgem/e_default.htm: Website for the Growth Enterprise Market – "About GEM – Regulatory Philosophy and Major Features of GEM".

9 Paragraph 19.2, "Consultation Paper on a Proposed New Market for Emerging Companies", published by the Exchange in May 1999.

(c) **The proposed rules in Chapter 3A were considered too stringent:**

(i) In addition, a number of the proposals merely adopt the "proposed" Chapter 3A following the consultation exercise in May 2000 which the Paper itself recognises as being *"perceived by the market as creating too many additional burdens"*.

(ii) As a substantial portion of Chapter 3A is now being re-proposed, the Exchange appears to take the position that *"the expectation gap remains"* and the need to deal with this outweighs the burdens of some of the proposals. Some of the current proposals impose a significant burden on sponsors. The Exchange should therefore justify how the burden imposed by these proposals is proportionate to the benefits which are expected to arise from the imposition of the new rules.

(d) **The proposed due diligence procedures are taken from the Toronto rules:**

(i) The market characteristics as well as regulatory philosophy of the Hong Kong and Toronto stock exchanges are not the same. For example, the Toronto Stock Exchange does not have the higher entry barriers for sponsorship currently proposed by the Paper, and therefore can be justified in having a set of minimum due diligence procedures for sponsors to adhere to. It does not seem appropriate to "cherry pick" one part of the Toronto rules and apply them directly to the Hong Kong market.

(e) **The proposed due diligence declaration is mistakenly ascribed to U.S. rules:**

(i) Again, the Hong Kong and U.S. markets are not the same. The U.S. regulatory philosophy is different from Hong Kong and is heavily based on disclosure, with a resulting focus on accuracy of disclosure. Prospectus misstatement litigation in Hong Kong is almost unheard of; whereas a volume of case law (including judicial pronouncements on adequacies of due diligence procedures) has built up over the years in the U.S. (since 1968). In addition, the formulation of the defences to prospectus liability under U.S. securities laws is different from the formulation provided under section 40 of the Companies Ordinance – adopting the U.S. approach without the accompanying statutory defences is inappropriate.

(ii) Our system of law comprises statutes and case law (*i.e.*, judicial interpretations in cases). Judicial interpretations may result in the legislature changing the law to adopt such interpretation or to reverse them. The proposal requiring a due diligence declaration by a sponsor effectively imposes liability outside of that judicial or legislative process.

(iii) It would be wrong if sponsors have to give a public declaration in a form that is unrelated to the standards required of the sponsor (or the defences which may be available) under the provisions of section 40 of the Companies Ordinance. And in assessing whether reasonable investigations have been carried out, the Paper proposes to benchmark the actual due diligence work done against the Toronto review procedures.

SECTION D: SPONSOR / IFA FIRMS AND INDIVIDUALS

PRE-QUALIFICATION AS AN ACCEPTED SPONSOR FIRM

ACCEPTABLE SPONSOR FIRMS
(Paragraphs 50 to 52 of Part B of the Consultation Paper)

We propose that to be eligible to act as a sponsor to a new applicant or a listed issuer, the firm is required to be accepted by the Exchange for such purposes and admitted to a list of acceptable sponsors maintained by the Exchange. The Exchange may refuse an application as a sponsor or cancel a sponsor's admission to the list if the Exchange considers that the sponsor or applicant does not satisfy the criteria established in order for the firm to be included on the list of acceptable sponsors maintained by the Exchange. We propose that all first instance decisions in relation to eligibility on application; on-going eligibility and independence of a sponsor should be made by the Listing Division and subject to review, if necessary, by the Listing Committee.

Q.1 *Do you agree with our proposal?*
☐ *Yes*
☐ *No*

4. **RESPONSE:**

4.1 The Group agrees with the proposal to establish a list of acceptable sponsor firms. However, the Exchange should note the comments below in ensuring that this list will be meaningful and will have the effect of excluding substandard firms and individuals; and of excluding substandard work.

4.2 The Group expects the Exchange to exercise its powers and properly to enforce the rules.

5. **DISCUSSION OF ISSUES:**

5.1 **There is substandard work in the market.**

(a) The entry barriers for sponsor work have hitherto been relatively low, which has resulted in an increasing number of new entrants to the sponsor market. In addition, the intense pricing pressures drive fees down to a point where some have chosen to focus on volume and cost-efficiency with diminished focus on the part of some sponsors in the proper education and training of directors of issuers and the on-going development of the issuers brought to the market. These factors have in a number of cases contributed to demonstrably lower standards of work than those expected by the Exchange.

(b) However, excessive eligibility criteria for sponsors would not necessarily deter those who produce substandard work either because they do not care or do not have the financial resources to raise their standards. On the other hand, it may lead to prohibitively higher costs for those who consciously comply with the standards set by the Exchange.

(c) It is the range of ***credible sanctions*** and ***effective enforcement*** which operate as ***real deterrents*** to unscrupulous players, not the imposition of excessive eligibility criteria. Therefore, proper enforcement is key to raising overall standards in the market; in the

absence of effective enforcement, there is little incentive to raise or maintain standards.

5.2 **The initial list of acceptable sponsors must be meaningful.**

(a) The Group understands that the Paper is partly the result of cases of substandard sponsor work and scandals involving a number of listed companies shortly after an IPO. In order to be effective in removing or significantly narrowing the expectation gap, the Exchange should review the appropriateness of admitting sponsors with a doubtful track record onto the initial sponsors list in order not to undermine the system from the outset.

(b) The Exchange must therefore consider carefully whether or not to admit those sponsors which have the requisite experience but who the Exchange considers to be substandard on the basis of past dealings. This would **send the correct message** to the market of the Exchange's "enforcement intent", and would avoid starting the acceptability system on the backfoot by not getting the initial list right.

5.3 **The GEM legacy.**

(a) The GEM sponsor list can be used to illustrate the potential pitfalls of starting a new list of sponsors / IFAs. The proposed acceptability criteria for all sponsors "substantially mirror"[10] those currently in place from GEM sponsors. Arguably, the GEM sponsor pre-qualification system has not had the desired effect of filtering out substandard firms, notwithstanding the Exchange's statement in its GEM Consultation Paper (May 1988) that the increased investment risks of GEM companies justified the highest level of professionalism and integrity from sponsors. Since the inception of GEM, no GEM sponsor has been removed from the list of acceptable GEM sponsors or had its acceptability revoked.

(b) The Paper proposes a pre-qualification system substantially similar to the existing GEM system. We are not convinced that a very similar system to the existing GEM system would work as a common regime for the two boards. We believe much of this can be attributable to **lack of enforcement**. The Exchange must be prepared to remove sponsors from the list on the basis of inability to fulfil the on-going eligibility requirements.

5.4 **Balance is therefore key.**

(a) The two key factors for any sponsor registration system are that there must be **effective criteria for entry as well as effective enforcement**. The lack of enforcement illustrates the need to bolster and balance both entry barriers and enforcement if the new common regime is to succeed.

6. SUGGESTIONS BY THE GROUP:

6.1 **There could be a "private watch list".**

(a) The Group recognises that it may be difficult to admit onto the initial list only those firms which demonstrate the higher standards now sought by the Paper. The more difficult issue is that if the standards for sponsor work required for pre-qualification

10 Consultation Paper on the Proposed Introduction of Chapter 3A to the Listing Rules on Sponsors and Financial Advisers" published by the Exchange in 2000.

under the new framework are benchmarked against international standards, would those firms which could be considered **"fringe players"** be initially excluded from the list so that they have to prove their worth before being accepted?

(b) One solution is to have a **"watchlist"** which tells firms on a private basis that unless there is real improvement during the first year of the new list, it is likely that they would be excluded from the sponsors list. In addition, sponsors could effectively be **on probation** (*i.e.*, conditional acceptance) during which time they may only undertake a limited number of IPO assignments so as to ensure that there is a focus on quality.

6.2 **Establishment of a "Sponsor Regulation Committee"**

(a) The Group does not object to the proposal that all first instance decisions in relation to eligibility on application, on-going eligibility and independence should be made by the Listing Division and subject to review by the Listing Committee and, thereafter, in accordance with the procedures set out in Chapters 2A and 2B of the Listing Rules. We recommend, however, the following:

(i) the processes and decisions of the Exchange/Listing Committee regarding sponsor regulation issues must be transparent, and decisions must be in writing and, in the absence of good reasons to the contrary, publicly available (similar to Takeover Panel cases). This recognises the importance of sponsor regulation issues, as it could spell an end to a firm's existence, or even a banker's livelihood and would also promote accountability to the public;

(ii) the criteria for cancelling a sponsor's admission to the list should be clearly expressed in the rules. Any desire on the Exchange's part to retain flexibility should be resisted because enforcement uncertainty is likely to hamper the development of the market. Firms may well be hesitant in committing resources into a heavily regulated market which has no clarity in its rules;

(iii) the Exchange's sponsors regulation team under its listing division as well as a **"Sponsors Regulation Committee"** (which would comprise of (say) two or three Exchange and SFC professional staff as well as all or most of the Listing Committee members) similar to the Regulatory Decisions Committee (RDC) in the U.K. deal specifically with sponsor regulation-related issues. A separate body, which is separate from the listing hearing process, would be **indicative of due process** in "adjudication matters".

6.3 In connection with removal from the list of acceptable sponsors, we recommend that the SFC should play a full role in this, since it is likely to impact on the firm's ability to satisfy the SFC that it is 'fit and proper' to be licensed/registered under the SFO. However, we urge the SFC and Exchange to agree on a formal mechanism whereby serious breaches are considered by the Enforcement Division of the SFC and less serious cases impacting on sponsor/IFA work considered only by the Exchange, rather than having two potentially inconsistent disciplinary procedures.

6.4 In addition, the SFC should provide guidance on whether and how an unacceptability status for sponsor/IFA work will affect the "fitness and properness" of individuals licensed by or registered with the SFC/HKMA.

PRE-QUALIFICATION OF ACCEPTABLE IFA FIRMS

ACCEPTABLE IFA FIRMS
(Paragraphs 52 to 53 of Part B of the Consultation Paper)

We propose that only firms on the list of acceptable sponsors or acceptable IFAs be eligible to act IFAs to issuers in relation to a connected party transaction. We propose that a process similar to that for admitting firms to the list of acceptable sponsors be adopted for IFA firms.

Q.2 *Do you agree with our proposal?*
- ☐ *Yes*
- ☐ *No*

7. RESPONSE:

7.1 The Group accepts the proposal relating to IFAs for the same reasons and on the same bases as set out above in relation to sponsors.

7.2 We assume (and expect) that acceptable sponsors would automatically qualify as acceptable IFAs.

8. SUGGESTIONS BY THE GROUP:

8.1 Please see our response in relation to sponsor firms above.

THE CONCEPT OF "ACCEPTABLE INDIVIDUALS"

ACCEPTABLE INDIVIDUALS
(Paragraphs 54 to 59 of Part B of the Consultation Paper)

We propose that only individuals who:

(a) are appropriately licensed/registered under the SFO;

(b) work for a sponsor firm or IFA firm (whichever is applicable) and are eligible supervisors or perform work under the supervision of an eligible supervisor; and

(c) are not on the list of unacceptable individuals

may do sponsor work or IFA work.

Q.3 Do you agree with our proposal?
☐ *Yes*
☐ *No*

9. RESPONSE:

9.1 Consistent with the Group's position on the above proposals of a list of acceptable sponsors and IFAs, the Group agrees with the establishment of a list of unacceptable individuals.

9.2 However, the Exchange should note the comments below in ensuring that this list will be meaningful by excluding individuals who have performed substandard sponsor work.

10. DISCUSSION OF ISSUES:

10.1 **Differentiation between different types of unacceptable individuals.**

(a) The reason why an individual is on the list should be included on the list of unacceptable individuals. A simple list of those individuals who are unacceptable which does not differentiate "fraudsters" from some people who need to learn to do things properly may not be meaningful. The basis on which individuals may be put on the list should be clearly spelt out in the rules.

(b) We do not object to the creation of a list of unacceptable individuals. This will have some deterrent effect towards unscrupulous players and assuming that the list is made public, it will warn and protect potential issuers. The key to this is the criteria which are used to place a person on the list of unacceptable individuals. However, the Exchange should also use the list to warn those individuals who perform sub-standard work to improve or else face being put on the list.

(c) Again, the SFC must play a full role in relation to placing individuals on the list, since it will be likely to impact on their 'fitness and properness' to be registered under the SFO (or, in relation to bank staff, under the Banking Ordinance). We would urge the Exchange and the SFC to establish a formal mechanism whereby more serious cases would be considered by the Enforcement Division of the SFC and less serious cases impacting only on sponsor/IFA work considered only by the Exchange, rather than having two potentially inconsistent disciplinary procedures.

11. SUGGESTIONS BY THE GROUP:

11.1 The Exchange should consider ways of making a differentiation between different types of unacceptable individuals. For example, the individual could be **cold shouldered (privately or publicly)** for a fixed period of time or he/she could get **life ban** from doing sponsor work. In this regard, the Exchange should consider again the merits of the **5-year window** as proposed under Rule 3A.09.

11.2 As explained above, the Exchange and the SFC are urged to establish a mechanism for more serious cases to be referred to the SFC as a licensing matter.

11.3 In addition, the SFC should provide guidance on whether and how an unacceptability status for sponsor/IFA work will affect the "fitness and properness" of individuals licensed by or registered with the SFC/HKMA.

COMPETENCE AND EXPERIENCE OF INDIVIDUALS

Competence and experience of the sponsor and IFA firms
(Paragraphs 60 to 66, 73 and 79 of Part B of the Consultation Paper)

We propose that the focus of our requirements will be on the experience of the individual member of staff, rather than the sponsor firm or IFA firm and that sponsor firms have at least four eligible supervisors and IFA firms have at least two eligible supervisors.

Q.4 *Do you agree with our proposal?*
- ☐ *Yes*
- ☐ *No*

Qualification and experience criteria of eligible supervisors
(Paragraphs 67 to 79 of Part B of the Consultation Paper)

We propose to merge the requirements relating to qualification and experience criteria for Principal Supervisors and Assistant Supervisors into a single new category called "eligible supervisors". We also propose to recognize overseas experience derived from recognized overseas exchanges (such as NYSE, NASDAQ, SGX, ASX, London Stock Exchange and Toronto Stock Exchange) for the purposes of assessment of individuals. Accordingly, the experience requirement of the four eligible supervisors required in each sponsor firm is proposed to be as follows:

- must have a minimum of 4 years of relevant corporate finance advisory experience derived in respect of companies listed on recognized stock exchanges or from other channels, such as corporate finance experience gained from employment with an issuer listed on the Exchange;

- substantive involvement in at least 3 significant transactions, which have been completed. At least one of those transactions must be in respect of a company listed on the Exchange. At least one transaction must have been an IPO and at least one of the transactions must have been completed within the previous two years. These requirements will be on-going requirements.

A substantive role means a role as a member of the sponsor firm's core transaction team in delivering or managing the delivery of one or more of the major components of due diligence work undertaken in respect of an engagement.

The definition of "significant transactions" is proposed to include: (i) IPOs; (ii) very substantial acquisitions or disposals (or their equivalent under the rules applicable to listing on other recognised stock exchanges); (iii) major transactions (or their equivalent under the rules applicable to listing on other recognised stock exchanges); (iv) connected and major transactions (or their equivalent under the rules applicable to listing on other recognised stock exchanges); (v) a rights issue or open offer by a listed company (or their equivalent under the rules applicable to listing on other recognised stock exchanges); and (vi) takeovers subject to the Takeover Code (or its equivalent in other recognised jurisdictions). Guidance will be provided to clarify that transactions involving the production of an exempt listing documents and the listing of investment companies will not be regarded as significant transactions.

We propose that the qualification and experience criteria for the two IFA eligible supervisors in an IFA firm be the same as for sponsor eligible supervisors save for the one IPO transaction experience requirement.

Q.5 *Do you agree with our proposal?*
- ☐ *Yes*
- ☐ *No*

12. RESPONSE:

12.1 The Group agrees that the focus of the Exchange's requirements should be on the experience of the individual members of staff, rather than the sponsor firm or IFA firm.

12.2 The Group **does not agree** with your proposal of four Eligible Supervisors. We note that the current requirement under the SFO is two Responsible Officers for each regulated activity.

12.3 The Group **does not agree** with all of the qualifications and experience criteria proposed in the Paper.

12.4 The Group agrees that the same experience criteria for IFAs should be adopted, although we assume (and expect) that an Eligible Supervisor for sponsor work would automatically qualify for IFA purposes.

12.5 In addition, the Group supports the Paper's position that, unlike Rule 6.16 of the GEM Listing Rules or the proposal in Rule 3A.21, the individual need not be a full time executive director of the firm.

12.6 The Group **strongly supports** the proposal to recognise international transaction experience gained from a recognised stock exchange.

13. DISCUSSION OF ISSUES:

13.1 **The required number of Eligible Supervisors is unrealistic.**

(a) The requirement for sponsor firms to have four Eligible Supervisors is taken directly from the UKLA Listing Rules and is unrealistic for Hong Kong. There are some 83 acceptable sponsors in the U.K., whereas in Hong Kong, approximately 70 firms have been a sponsor or co-sponsor of an IPO since January 2000. It would be unrealistic to expect the volume of the IPO market in Hong Kong, which is significantly smaller than the U.K. market, to be able to support the proposal to have four Eligible Supervisors for each sponsor firm.

(b) We are concerned that many firms will find it difficult to recruit four high calibre individuals with the requisite experience. In addition, we wonder how many firms can truly satisfy the requirement that at least one of the transactions must have been an IPO in Hong Kong. We note that at the time of the proposal to introduce the requirement of four eligible employees in the U.K., the initial proposal to exclude European Union (EU) transactions was reversed as a result of existing sponsors' concern that they would have had great difficulty meeting these criteria.

13.2 **International experience is important.**

(a) Staff turnover at investment banks is higher, particular in the current economic situation. For international investment banks, in particular, frequent secondments or transfers between locations allow banks to ensure that appropriate and experienced staff are located in Hong Kong. It would be too restrictive to require **all** Eligible Supervisors to have Hong Kong experience.

(b) As the Paper is intended to ensure that standards in Hong Kong are in line with international best practices, and that the requirement of "substantive role" is focused

on due diligence work, it would seem logical that an individual whose experience was gained only from equivalent transactions in other IFCs would be sufficient.

(c) The rules should expressly encourage having Eligible Supervisors with international experience. In addition, the Group notes that under current Note 3 to Rule 6.16 of the GEM Listing Rules, the Exchange reserves a discretion to waive or relax the relevant requirements. It would be helpful if the Exchange would set out certain criteria for such waivers and/or publish any waivers given, so that sponsors can better understand how this discretion is in practice exercised.

14. SUGGESTIONS BY THE GROUP:

14.1 **Number of Eligible Supervisors.** We propose that sponsorship activities be supervised by **two** Eligible Supervisors. This is for two reasons. First, the Eligible Supervisors will of necessity need to be senior investment banking staff - the current levels of Sponsor activity do not warrant firms investing in more than two such staff. Second, given the importance of the role, many firms may choose to appoint its SFO "responsible officers" to undertake this function. However, the SFO only requires two responsible officers for the regulated activity of "advising on corporate finance". If the Government has seen this appropriate more generally, this should be sufficient in the current context too.

14.2 **Corporate finance advising experience.** Each Eligible Supervisor must have a minimum of four years' relevant corporate finance advisory experience gained in any IFC.

14.3 **IPO experience.** We agree with this, but consider that **only one** of the Eligible Supervisors need have experience in IPO transactions involving the Exchange. It appears that this proposal may not specifically require the IPO experience to have been obtained within a particular time period. We support this, given that the ability of a sponsor firm to successfully complete IPO transaction depends on a number of factors, including market conditions. It may be difficult for firms to comply with this requirement on an on-going basis if a time period was imposed, especially if market conditions at the relevant time are unfavourable.

14.4 **Substantive role.** We suggest that the proposed definition of "substantial involvement" be amended in two respects:

(i) it should include persons whose role was to supervise the sponsor firm's core transaction team in carrying out a significant transaction; and

(ii) the definition should not be restricted to participating in or supervising the due diligence aspect of a transaction but should include participating in or supervising any aspect of a significant transaction.

As the proposed rules recognise international experience, the proposed definition of "substantive involvement" should refer to "the core transaction team of *the sponsor or sponsor's group*" or of other regulated firms/banks whether in Hong Kong or overseas.

14.5 **Number of "Significant transactions".** Each Eligible Supervisor must have substantive involvement in at least three significant transactions. We agree with this, on the basis that the required number of Eligible Supervisors will be two.

14.6 **Definition of "Significant transactions".** The proposed definition of "significant transactions" should clarify that IPOs include initial public offerings undertaken in Hong Kong or other IFCs. In addition, we believe that the Exchange should offer some flexibility by also taking into consideration voluntary sponsorship work (after the mandatory continuing sponsorship period) even though none of the transactions are Significant Transactions, as this type of work involves ongoing advice on the application and interpretation of the Listing Rules.

14.7 Accordingly, we propose that each Eligible Supervisor shall satisfy the following requirements:

(a) a minimum of **four years of relevant corporate finance advisory experience** derived in respect of companies listed on recognized stock exchanges or from other channels; and

(b) **substantive involvement** in at least **three significant transactions**:

(i) (in respect of one of the firm's two Eligible Supervisors only) at least one of the transactions must be in respect of a company **listed** on the Exchange

(ii) (in respect of one of the firm's two Eligible Supervisors only) at least one transaction must have been an **IPO**;

(iii) at least one of the transactions must have been completed within the previous **two years**.

14.8 **Experience criteria for IFAs.** We agree that the same experience criteria for Eligible Supervisors of IFAs should be adopted, although we assume (and expect) that Eligible Supervisors for sponsors would automatically qualify as Eligible Supervisors for IFA purposes.

14.9 **The definition of "recognised stock exchange" is too narrow.** We propose that the meaning of "recognised stock exchange" include other appropriate major listing locations (*e.g.*, Korea, Luxembourg, Singapore, Taiwan, Tokyo) provided that the types of transactions are similar to an IPO - *e.g.*, equity-linked products which require the preparation of an offering circular which is not materially different in content to an equity prospectus used in connection with an IPO in Hong Kong.

OTHER FACTORS RELEVANT TO THE ELIGIBILITY CRITERIA

Other factors relevant to the eligibility criteria
(Paragraphs 80 to 81 and 86 to 94 of Part B of the Consultation Paper)

We propose to retain discretion for the Exchange to refuse or cancel a sponsor's acceptance. The Exchange may ask a sponsor or prospective sponsor to provide further information during the assessment of their application. To provide clarity about the circumstances in which the Exchange may consider exercising this discretion we will publish details of the factors we will take into account in making an evaluation. The proposed factors include the following:

- The eligibility criteria requirements, including minimum capital, number of eligible supervisors, experience of individual eligible supervisors, are not met;
- The applicant is unable to satisfy the Exchange that it will be able to discharge the obligations in paragraph 7 of the proposed Code of Conduct for Sponsors and Independent Financial Advisers (these obligations include having effective supervisory, monitoring and reporting controls, an effective compliance function, adequate competence, professional expertise and human and technical resources and maintaining proper books and records);
- Current suspension or revocation of regulatory status (including where this is self-imposed as a result of settlement); and
- Suspension or revocation of regulatory status (including where this is self-imposed as a result of settlement) that has expired but in relation to which, the applicant is unable to satisfy the Exchange that appropriate and sufficient remedial steps have been taken.

We propose that the same factors be taken into account in determining the acceptability of IFAs as are taken into account for sponsors, save for the minimum capital adequacy requirement.

Q.6 *Do you agree with our proposal?*
☐ *Yes*
☐ *No*

15. RESPONSE:

15.1 The Group broadly agrees with the list of factors to be taken into account by the Exchange.

15.2 We assume that the factor as to suspension/revocation of the regulatory status of a sponsor in any overseas jurisdiction will only be taken into account where that is relevant to the sponsor's Hong Kong activities, e.g. because the individuals involved in relation to the activities giving rise to this suspension/revocation are also involved in the Hong Kong business.

15.3 The Group notes that the Exchange will elaborate on the circumstances under which the Exchange will consider exercising its discretion.

15.4 The Group agrees with the proposal to adopt the same factors for IFAs.

MINIMUM CAPITAL REQUIREMENT

Minimum Capital Requirement of Sponsor Firms
(Paragraphs 82 to 85 of Part B of the Consultation Paper)

We propose that sponsor firms are required to meet and maintain a minimum capital requirement of "total paid-up share capital and/or non-distributable reserves of not less than HK$10 million represented by unencumbered assets and a net tangible asset value after minority interests of not less than HK$10 million". Should the sponsor firm be unable to meet the capital requirement, we propose to accept as an alternative an unconditional and irrevocable guarantee from a company within the sponsor group or an authorized institution of not less than HK$10 million.

We do not propose that IFA firms should be subject to a similar requirement.

Q.7 (a) Do you agree with our proposal for sponsor firms?
☐ *Yes*
☐ *No*

Q.7 (b) Do you agree with our proposal for IFA firms?
☐ *Yes*
☐ *No*

16. <u>RESPONSE:</u>

16.1 The Group **does not agree** with the proposal to require sponsors to have minimum capitalisation.

16.2 The SFC is empowered under the SFO to make rules requiring licensed firms to maintain specified capital. The SFC has exercised its powers to make the Securities and Futures (Financial Resources) Rules. The Banking Ordinance sets out a prescribed regulatory capital regime for Hong Kong authorised banks. Both of these statutory regimes were introduced following international standards and after considerable time and effort had been spent on determining appropriate levels of regulatory capital for firms and banks carrying on their respective regulated businesses. In our view, it would be inappropriate for the Exchange to seek to impose additional capital requirements over and above those which have been set by the SFC and approved by the Government, or under the Banking Ordinance. The statutory levels were set to balance firms'/banks' commercial interest against the interests of the investing public/depositors to ensure that appropriate levels of capital were held to protect the latter. Given that the Government has entrusted that function to the SFC and Hong Kong Monetary Authority, we do not believe that it is appropriate for the Exchange to add to an already detailed capital framework.

16.3 For the same reasons, we **do not agree** with the proposal to require IFAs to have minimum capitalisation.

SECTION E: RESPONSIBILITIES OF SPONSORS / IFAS

UNDERTAKINGS TO THE EXCHANGE

Undertakings to the Exchange
(Paragraphs 95 to 97 of Part B of the Consultation Paper)

We propose that each of the sponsors and IFAs seeking to be admitted to the list of Sponsors or list of IFAs be required to declare that the contents of its application to be admitted to the list is true and does not omit any material fact. We also propose that each of the sponsors and IFAs seeking to be admitted to the list must sign an undertaking to the Exchange to comply with the relevant Listing Rules applicable to sponsors or IFAs, including the proposed Code of Conduct for Sponsors and Independent Financial Advisers; and to assist the Exchange with investigations, including by producing documents and answering questions fully and truthfully. Furthermore, we propose that eligible supervisors be required to provide the Exchange with a written undertaking in similar terms to that provided by sponsors firms and IFA firms. This will include an obligation to comply with the Listing Rules and the proposed Code of Conduct for Sponsors and Independent Financial Advisers. The proposed Code of Conduct for Sponsors and Independent Financial Advisers includes an obligation that the eligible supervisors and directors of sponsor firms and IFA firms use their best endeavours to ensure the sponsor firm or IFA firm complies with its obligations under the Listing Rules and the proposed Code of Conduct for Sponsors and Independent Financial Advisers. A breach of the undertaking will be deemed to be a breach of the Listing Rules and will be subject to disciplinary action.

Q.8 *Do you agree with our proposals?*
☐ *Yes*
☐ *No*

17. RESPONSE:

17.1 The Group agrees with the proposal to require sponsor firms to provide the Exchange with an undertaking, if it is clear that the responsibilities of a sponsor are owed solely to the Exchange.

17.2 The Group **feels very strongly** that the rules should expressly state that the responsibilities of a sponsor **are owed solely to the Exchange**.

17.3 The Group **does not agree** with the proposal to require individual Eligible Supervisors to provide the Exchange with an undertaking. The Group has a major concern in relation to this proposal and would welcome further discussion with the Exchange about the nature of the responsibilities and liabilities attaching to such an undertaking. This proposal would create an unnecessary administrative burden and appears to go further than analogous GEM, Toronto, U.S. and UKLA rules under which, in general, individuals are agents for their employer (the sponsor-entity) which is ultimately responsible for the actions of its employees (and see, for example, paragraph 124 of the SFC's Code of Conducts for Persons Licensed by or Registered with the SFC, which expressly provides for firms to take this responsibility).

18. DISCUSSION OF ISSUES:

18.1 The sole reason for providing undertaking.

(a) The Group can see that the reason for requiring sponsor firms to provide some form of undertaking to the Exchange in respect of compliance with applicable provisions of the Listing Rules, including the proposal Code of Conduct for Sponsors and IFAs, is to make the firm focus on its regulatory responsibilities under the Listing Rules and the Sponsors' Code.

(b) The same argument cannot be true for requiring individuals to provide undertakings. An individual will likely face internal and SFC disciplinary sanctions if he or she is found to have been in breach of his or her duties and responsibilities as an Eligible Supervisor. We note that the U.K. did not require individuals to provide such an undertaking under the pre-FSMA regime. We also understand that there is no equivalent requirement under the rules of the Toronto Stock Exchange.

(c) Further, the Exchange does not require the existence of an undertaking to be able to exercise its powers to discipline sponsors and IFAs, if their work has been substandard. Under the statutory framework under which the Listing Rules are made, the Exchange is able to apply the sanctions proposed for the sponsor regulation regime.

(d) The Government is currently undertaking a consultation on changes to company laws and this includes a consideration of whether to give statutory backing to the Listing Rules, *i.e.*, to allow the Exchange the power to impose fines.

18.2 The nature of the responsibilities under the undertakings must be beyond doubt.

(a) As the sponsor's undertaking establishes a contractual relationship between the sponsor and the Exchange – put in simple terms: the sponsor agrees to comply with the Listing Rules and if it does not, it agrees that the Exchange can take a range of measures against it - the new rules must make it clear that the responsibilities of a sponsor are "***owed solely to the Exchange***".

(b) This was expressly stated in paragraph 2.6 of the old UKLA Listing Rules and was only removed as a consequence of the coming into effect of the FSMA giving statutory backing to the UKLA Listing Rules. As the rationale for the undertaking is based on the pre-FSMA regime in the U.K., and the absence of an equivalent to the old paragraph 2.6 of the UKLA Listing Rules would create uncertainty amongst sponsors and expose them to additional potential liability, we **feel very strongly** that the Exchange should include the following provision into a new rules:

> *"The responsibilities of a sponsor/IFA under paragraphs [X] to [Y] of the Listing Rules are owed solely to the Exchange. Failure to carry out these responsibilities may result in the Exchange taking one or more of the steps referred into in paragraph [Z]."*

19. SUGGESTIONS BY THE GROUP:

19.1 The Group **feel very strongly** that the new rules should include a statement in the new rules that the responsibilities of a sponsor are owed solely to the Exchange.

19.2 **The form of the undertakings.**

(a) The undertakings should be set out in the prescribed application forms for sponsors and Eligible Supervisors. As to their forms, we have the following comments:

(i) The declaration in respect of the information supplied to the Exchange should include a materiality threshold to reflect the provisions of section 384 of the SFO. This avoids imposing a higher standard than the statutory framework under the SFO.

(ii) The obligation on sponsors to assist the Exchange with investigations should be included as one of the roles of sponsors to be set out in the Listing Rules, and not as an undertaking. We consider it important that sponsors' roles and obligations are clearly set out and codified, and are not scattered around the rules. We refer the Exchange to paragraph 2.9(c) of the UKLA Listing Rules.

(b) We propose that the following wording should be set out in the prescribed application form:

"Subject to our application as a sponsor/IFA being successful, we undertake to the Exchange to discharge our responsibilities as a sponsor/IFA under paragraphs [X] to [Y] of the Listing Rules and the Code of Conduct for Sponsors and Independent Financial Advisers."

APPOINTMENT OF SPONSOR

APPOINTMENT
(Paragraphs 98 to 113 of Part B of the Consultation Paper)

We propose to retain the requirement that new applicants (including deemed new applicants) will be required to appoint a sponsor to assist them through the application process.

After the new applicant is listed, we propose that:

(a) For Main Board: the new applicant must appoint a sponsor firm as a financial adviser for a period ending on publication of the financial results for the first full financial year after the listing.

(b) For GEM: the new applicant must appoint as sponsor firm as a financial adviser for at least the remainder of the financial year during which the listing occurs and the 2 financial years thereafter (i.e. we propose to retain the period stipulated in the existing GEM Listing Rules).

The issuer will not be obliged to appoint the same sponsor firm who handled their IPO. During this period, the issuer will be obliged to seek, on a timely basis, advice from the sponsor in relation to a number of prescribed events. The prescribed circumstances and services are proposed to include 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.

We also propose to retain the discretion to direct an issuer to appoint a sponsor firm to provide it with advice for any period it 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.

We also propose to retain the requirement that listed issuers are required to appoint an IFA in relation to connected party transactions that require any shareholders to abstain from voting and transactions or arrangements that require controlling shareholders to abstain form voting. We will clarify that an IFA must be a firm either on the list of acceptable Sponsors or list of acceptable IFAs.

Q.9 *Do you agree with our proposals?*
☐ *Yes*
☐ *No*

20. <u>RESPONSE:</u>

20.1 The Group agrees with the proposal to retain the requirement that new applicants (including deemed new applicants) will be required to appoint a sponsor to assist them through the application process.

20.2 The Group **suggests** that a newly listed company should be required to retain the services of a firm (which can be an investment bank, specialist investment advisory firm, lawyers or accountants) to advise on compliance with Listing Rules and corporate governance matters for the proposed periods of time after listing for Main Board and GEM listed issuers, respectively. The Group sets out below its views on the list of services to be provided by the appointed firm.

20.3 The Group calls for further discussions with the Exchange on the role of on-going sponsorship as a practical matter.

20.4 The Group agrees with the proposal for the Exchange to retain the discretion to direct an issuer to appoint a sponsor firm (or, following our suggestion above, one of the

firms referred to above) to provide it with advice for any period it specifies. We expect, however, this discretion to be sparingly exercised.

20.5 The Group also agrees with the proposal regarding the appointment of an IFA.

21. DISCUSSION OF ISSUES:

21.1 Whilst we agree that there should be a period following listing when the issuer and its directors are guided through their initial period of life as a listed company, we are of the view that one of the firms referred to above who is sufficiently qualified may be better placed to provide guidance to the listed issuer and its directors. Sponsors tend to focus more on financial issues, whilst a listed issuer and its directors should be more focused on compliance with legal and regulatory issues under the Listing Rules.

22. SUGGESTIONS BY THE GROUP:

22.1 The prescribed circumstances and services proposed in the Paper, including advice on 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 would need to include a specific obligation on issuers to inform their continuing sponsors of such events. It would **not be reasonable** for sponsors to probe into an issuer's affairs after listing (and more importantly, issuers often do not allow them to do so).

22.2 In addition, the Group **does not agree** that the continuing "sponsor" should probe into the issuer's affairs by monitoring the use of the proceeds and adherence to the business plans as detailed in the prospectus.

22.3 If it is helpful, we could provide the Exchange with a list of the services that should be provided by a continuing sponsor as referred to in paragraph 20.2 above.

INDEPENDENCE OF SPONSORS

INDEPENDENCE
(Paragraphs 114 to 123 of Part B of the Consultation Paper)

We propose that a sponsor must not act for any new applicant or listed issuer, whether as a sponsor or joint sponsor, from which it is not independent. The Exchange will expect a sponsor to consider a broad range of factors that might impact on its ability to act independently of an issuer. Some of these factors are considered below, but sponsors should note that this list of factors of when a sponsor will not be regarded as independent is not exhaustive and the existence of other relationships or interests which might give rise to a material interest in the success of a transaction will be considered. The specified circumstances are:

- a sponsor or any member of the sponsor's group is holding more that 5% of the issued share capital of a new applicant;
- the fair value of shareholding referred to above exceeding 15% of the consolidated net tangible assets of the sponsor group;
- a sponsor or any member of the sponsor's group is controlling the majority of the board of directors of the new applicant;
- a sponsor is controlled by or is under the same control as the new applicant;
- 15% or more of the proceeds raised from an IPO is applied to settle debts due to a member of the sponsor's group;
- a significant portion of the listing applicant's operation is funded by the banking facilities provided by a member of the sponsor's group;
- 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
- where the sponsor or a member of the sponsor's group is the new applicant's auditor or reporting accountant.

In addition to fulfilling the independence requirement as mentioned above, we also propose that the Exchange will generally preclude from concluding that an IFA is independent if it has served as a financial adviser to the relevant listed issuer, its subsidiaries or any of its connected persons any significant assignment within two years of appointment.

We also propose to require sponsors and IFAs 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.

Q.10 *Do you agree with our proposals?*
☐ *Yes*
☐ *No*

23. <u>RESPONSE:</u>

23.1 Whilst the Group agrees that conflicts of interest must be dealt with by the sponsor, it **does not agree with all** the criteria currently proposed. The Exchange is referred to the suggestions set out below.

23.2 The Group also agrees with the proposal to require sponsors and IFAs to submit a declaration in respect of their independence (the ***Confirmation of Independence***), addressing each category of potential conflict (*i.e.*, the factors impacting on

independence), at the beginning of any assignment which requires the appointment of a sponsor or an IFA.

24. DISCUSSION OF ISSUES:

24.1 Confirmation of Independence

(a) In giving the Confirmation of Independence, sponsors should consider a broad range of matters, including each of the factors impacting on independence. The presence of any of these factors should not be an automatic bar.

(b) If the Exchange finds that the sponsor has been **influenced** by the **factors impacting on independence** which made it **inappropriate** or impossible for the sponsor to give impartial advice to the issuer, then, in the absence of **other circumstances**, the Exchange could take enforcement action against the sponsor for breach of the Confirmation of Independence.

24.2 Factors on independence

- **The Sponsor Group holding more that 5% of the issuer.**
  The 5% threshold is too low. We propose **10%** at the time of listing, as this fairly reflects the nature of the majority of companies in Hong Kong and the PRC – family or state controlled companies often with one single controlling shareholder. Shareholdings should be regarded as passive before they reach negative control (*i.e.*, 25%). (See also "Other circumstances" below).

- **The fair value exceeds 15% of the Sponsor Group's consolidated NTA.**
  We agree with this proposal, but subject to approval on a case-by-case basis if, for example, there are other circumstances which go to address the potential conflict. See "Other circumstances" below.

- **The Sponsor Group controls the majority of the issuers' Board.**
  We agree with this proposal, but subject to approval on a case-by-case basis if, for example, the sponsor can demonstrate independence in operation from the Sponsor Group entity or business unit which controls the issuer. See "Other circumstances" below.

- **A sponsor is controlled by or is under the same control as the issuer.**
  We agree with this proposal.

- **15% or more of the IPO proceeds is applied to settle debts due to the Sponsor Group.**
  We agree with this proposal.

- **A significant portion of the issuer's operation is funded by Sponsor Group's banking facilities.**
  This proposal should be subject to approval on a case-by-case basis if, for example, the sponsor can demonstrate the existence of effective Chinese walls. See "Other circumstances" below. It may also raise concerns amongst sponsors whose group is involved in commercial banking in Hong Kong. In any event the meaning of "significant" is not clear.

- **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 issuer.**

The relevant employee should be a senior member of the sponsor's staff and the interest must be a material interest.

- **Where the Sponsor Group is the issuer's auditor or reporting accountant.** We agree with this proposal, particularly in light of recent corporate scandals.

24.3 **Other circumstances**

(a) The existence of the following circumstances may indicate that a sponsor or a member of its group is independent even if one or more of the above potential conflicts exist (i.e., : the potential conflict does not **influence** the sponsor in a way which makes it **inappropriate or impossible** for the sponsor to give impartial advice to the issuer):

(i) the sponsor does not have a material interest in the success of the IPO by the issuer;

(ii) some or all of the sponsor's interest results from a holding in a business area that is separated by a "Chinese Wall" from the business area of the sponsor;

(iii) the sponsor has no board representation or does not actively participate in the management of the issuer; or

(iv) the interest in the issuer is held in a market-making capacity or by fund managers on a non-discretionary basis, as well as holdings which would otherwise be exempted from disclosure under the disclosure of interests provisions of the SFO.

24.4 In addition, the factors above which the sponsor is required to consider should be qualified by reference only to the knowledge of those persons who work in the division of the investment bank undertaking sponsorship work (i.e., the assumption is that if the sponsor does not know of the matters, then he would *ipso facto* not be in a position of conflict).

24.5 **Qualified Independent Sponsor**

(a) The Group strongly recommends to the Exchange the adoption of a set out rules allowing "conflicted" sponsors to continue to act if a "qualified independent sponsor" is appointed.

(b) We note that in the U.S., a conflict of interest would **not be an automatic bar** to acting as an underwriter or otherwise assist in the distribution of a U.S. SEC-registered offering of securities (see NASD Rule 2720(c)(1)), as the NASD rules allow conflicted underwriters to act as such if an "qualified independent underwriter" (QIU) is engaged. A QIU is a firm which satisfies the conditions for QIUs set out in NSAD Rule 2720(b), including a condition that it must have been actively engaged in the investment banking or securities business for the past five years.

(c) NASD Rule 2720(c)(3) provides for a number of instances where a conflicted underwriter may act. One such instance arises where the securities are offered at a price no higher than that recommended by a QIU which shall also participate in the preparation of the prospectus and which shall exercise the usual standards of "due diligence" in respect thereto.

(d) The Group would like to explore with the Exchange whether we could develop and adopt a similar set of rules in Hong Kong where a sponsor which is not independent is can continue to act as sponsor if a "qualified independent sponsor" (QIS) is also engaged to act. There could be prescribed circumstances where the use of a QIS is permitted. We envisage that the QIS would be a co-sponsor with the "conflicted sponsor" and will act as the designated sponsor for the purposes of the application of listing and will give all necessary declarations to the Exchange in order to avoid any perception of lack of impartiality in the sponsor's dealings with the Exchange.

(e) We could provide further details to the Exchange in relation to the rules for QIUs if this is helpful.

SECTION F: RESPONSIBILITIES OF SPONSORS AND DUE DILIGENCE

RESPONSIBILITIES

RESPONSIBILITIES

Reasonable investigations
(Paragraphs 124 to 152 of Part B of the Consultation Paper)

We propose that the Main Board and GEM Listing Rules be amended to require sponsors to conduct reasonable investigations to satisfy themselves that:

- the new applicant is suitable for listing, the new applicant's directors appreciate the nature of their responsibilities and the new applicant and its directors can be expected to honour their obligations under the Exchange Listing Rules and the Listing Agreement;
- "non-expert sections" contained in the new applicant's listing application and listing documents are true and that they do not omit to state a material fact required to be stated or necessary to avoid the statements being misleading; and
- 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.

We propose that sponsors be required to comply with a Code of Conduct that will set out, among other things, the minimum due diligence a sponsor would be expected to undertake to satisfy the obligations to conduct reasonable investigations we propose including in the Listing Rules.

We propose that the Main Board and GEM Listing Rules be amended to require IFAs:

- to take all reasonable steps to satisfy themselves that the terms and conditions of the transaction or arrangement are fair and reasonable and in the interest 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; and
- to make a declaration in their report of the due diligence they have 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.

Q.11 *Do you agree with our proposals?*
☐ *Yes*
☐ *No*

25. RESPONSE:

25.1 The Group agrees that responsibilities of sponsors need clarification. However, the Group proposes a **wider revision** of the rules governing the responsibilities of sponsors.

25.2 The Group **strongly disagrees** with the proposal to prescribe a set of minimum review procedures in connection with a sponsor's obligation to carry out reasonable investigations, or "due diligence".

25.3 The Group also **strongly disagrees** with the proposed form of confirmation of due diligence in respect of "expert" sections as it imposes a higher standard than that required under the Companies Ordinance.

26. DISCUSSION OF ISSUES:

26.1 **A clear regulatory philosophy is vital:**

(a) ***The "shift towards a disclosure based, post-vetting regime".*** We note that the Paper, at paragraph 25, recognises that "the trend in other developed markets is for regulatory authorities to move away from pre-vetting of corporate disclosure materials to post-vetting of documents on a selective basis, with enforcement being taken against the issuer, its directors and advisers in relation to any defects. The Group's position is that the regime for listing applications and IPOs in Hong Kong should entail the following two key separate components:

(1) the satisfaction of **conditions for listing, all** of which are **specific and quantitative** in nature, with penalties and sanctions imposed under the Listing Rules on issuers, directors and, where relevant, sponsors for their respective failures; and

(2) the making of **adequate disclosures in a prospectus**, with potential liability for misstatements arising under statutory provisions (including in the SFO and the Companies Ordinance) for those found to be liable (whether civil or criminal) by the due process of the law.

In this regard, the SFO has already gone some way in strengthening the enforcement tools of the SFC. For example, the new market misconduct regimes in Parts XIII and XIV of the SFO impose liability (criminal and civil) for disseminating information that is false or misleading as to a material fact or through the omission of a material fact, where that information is likely to induce others to trade in securities in Hong Kong and the person knows the information is false or misleading or is reckless or (for Part XIII only) negligent as to that.

(b) ***These two key components must remain separate.*** We have serious concerns that the Paper's approach appears to have mixed the above two components together by requiring the sponsor to undertake due diligence (which relates to (1) above) in order to confirm "suitability" (which relates to (1) above). Of particular concern to the Group is the Paper's attempt to accelerate market reforms (or at the very least, plug the gap pending such reforms) by squarely placing on sponsors' shoulders the responsibility of assessing the "suitability" of the issuer for listing and imposing on sponsors an obligation to perform extensive due diligence procedures on a full range of matters, thereby moving responsibility from the issuer, its business, its directors and its controllers.

(c) ***Mixing the two components will hamper the current efforts to raise standards.*** As discussed below, part of the current problems in our market arises from the lack of clarity in the role of sponsors (and the lack of enforcement under the existing rules). The Group strongly believes that a set of conditions for listing all of which are specific and quantitative in nature is vital to our revised sponsors' regime. On the other hand, the retention of a vague concept of "suitability" as well as the introduction of numerous qualitative due diligence procedures (expressed as a minimum) will not remove the lack of clarity surrounding the existing rules and practices.

26.2 **No backdoor legislation:**

(a) ***One step at a time.*** The Paper mentions, at paragraph 34, that the Corporate Governance Action Plan for 2003 announced by the Government envisaged "the introduction of proposals to extend the statutory liability for material misstatements in prospectuses to IPO sponsors, and possibly other intermediaries". Whilst we all know that this part of reform of the Companies Ordinance is some time behind Listing Rules reforms, the Group is of the strong view that any statutory changes will involve a due process involving the regulators, the Government as well as the lawmakers and that it would not be right to impose mandatory provisions on persons which have the effect of exposing them to liability which they would (or at least may) not otherwise have under current laws. **In the regard, the Group firmly expresses its position to the Exchange that we should all wait for the statutory changes (with the corresponding consultation and legislative processes) to take place.**

(b) ***The trend is to move away from qualitative criteria of suitability.*** We understand that the setting of qualitative criteria is unique to the U.K. and Hong Kong markets.[11] The Financial Services Authority (FSA) has made some attempt to narrow the scope of this by referring to "eligibility" for listing, rather than "suitability". There appears to be a current trend to move away from requiring sponsors to be responsible for assessing an issuer's suitability for listing, towards a clear and unambiguous responsibility on the sponsor to confirm that an issuer has satisfied all the quantitative conditions for listing.

26.3 **We need a robust set of sponsors' responsibilities.**

(a) ***Sponsors' responsibilities are unclear.*** The functions and responsibilities of a sponsor are at present contained in the Listing Rules, mainly in Chapter 2 and Appendix 9. Many of the sponsorship rules are expressed in terms of principles (in particular Appendix 9) or as general statements of practice. The has resulted in a vague set of standards for sponsors which has become as difficult for sponsors to apply as it has for the regulators to bite its enforcement teeth on. **This has led to some failing to understand their responsibilities as sponsors.**

26.4 **Why are sponsors' responsibilities unclear?**

(a) ***Qualitative criteria add to lack of clarity of a sponsor's role.*** A number of the principles or statements of a sponsor's role are expressed as qualitative and involve a degree of judgment. There are no clear rules or statements as to their application or interpretation. For example:

(i) "A sponsor should satisfy himself, on the basis of all available information, that an issuer is suitable for listing." (Paragraph 1, Model Code; see also paragraph 3.04, Listing Rules)

(ii) "A sponsor should satisfy himself that the board of directors have the necessary range of skills and experience available." (Paragraph 2, Model Code)

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11 "Primary Market Comparative Regulation Study – Key Themes" by PricewaterhouseCoopers, paragraph 3.2, page 15.

(b) The above qualitative criteria have added to the lack of clarity in the current sponsor's rules. Furthermore, paragraph 8.04 of the Listing Rules state that "both the issuer and its business must, **in the opinion of the Exchange**, be suitable for listing." This has understandably added to confusion amongst some sponsors of the scope of their responsibilities. Please see the next point.

26.5 **We need to clarify the meaning of "suitability".**

(a) ***Suitability for listing should be defined to mean satisfaction of quantitative conditions of eligibility for listing.*** The Group's position is that if the sponsorship regime is to be revised in the direction proposed by the Paper, an assessment of "suitability for listing" (by either the Exchange or sponsors) should be defined to mean the satisfaction by the issuer of a clear set of **specified, quantitative eligibility conditions for listing**.

(b) ***The Exchange can retain flexibility by other means.*** We recognise that the Exchange may wish to have ultimate discretion as to whether or not an issuer is accepted for listing on the Exchange. Paragraph 8.04 is one of the ways the Exchange has retained such flexibility. For example, it could be a condition of listing that the issuer does not carry on a business (such as gaming – until recently) which is not eligible for listing as stipulated by the Exchange (say, in a practice note) or is too reliant on a connected party for its revenues or profits.

27. SUGGESTIONS BY THE GROUP:

27.1 **Our proposals for sponsors' responsibilities**

(a) We propose a two-pronged approach, as follows:

(i) The Listing Rules would set out a set of clear and unambiguous sponsors' responsibilities, and define "suitability for listing" by reference to specified quantitative conditions for listing.

(ii) The Listing Rules should require directors and senior staff of an issuer to undergo accredited pre-listing training, as well as a participate in accredited continuous education programmes.

(b) What we now need is to have a very clearly defined set of responsibilities – but this does not mean that they need to be overly-long or prescriptive. We recommend the Exchange to start from a clean slate and set out clearly the responsibilities of a sponsor (adopting in part the UKLA model) along the lines set out below.

27.2 **Sponsors' responsibilities**

(a) ***In relation to the issuer.*** We set out below our proposed sponsors' responsibilities in relation to the issuer. A sponsor must:

(i) satisfy itself, to the best of its knowledge and belief, having made due and careful enquiry of the issuer and its advisers, that **the issuer is suitable for listing, meaning that it has satisfied all applicable conditions for listing** under the Listing Rules;

(ii) provide to the Exchange any information or explanation known to it which the Exchange may reasonably require for the purpose of **verifying whether**

the Listing Rules are being and have been complied with by the sponsor or by the issuer;

(iii) for each transaction in respect of which it acts as sponsor in accordance with the Listing Rules, submit to the Exchange at an early stage (and, in any event, no later than the date on which any documents in connection with the transaction are first submitted to the Exchange for approval) a **confirmation of independence** in the prescribed form;

(iv) take all reasonable steps to ensure that a **confirmation or declaration** required to be provided to the Exchange by a sponsor under the Listing Rules is **correct and complete in all material respects**; and

(v) advise the Exchange in writing without delay of its resignation or dismissal (as sponsor), giving details of any relevant facts or circumstances;

(vi) with due care and skill, ensure that **the issuer is properly guided and advised** as to the application or interpretation of the Listing Rules;

(vii) comply with any relevant **eligibility criteria** for sponsors set out in the Listing Rules.

(b) ***In relation to the application for listing.*** The sponsor shall have general responsibility for **communications with the Exchange**, the lodging of all documents in support of an application with the Exchange and seeking the Exchange's approval for listing documents or shelf documents.

(c) ***Sponsors' Declaration.*** Provided that the sponsors' responsibilities are defined as those set out above, the sponsor must complete a form of **Sponsors' Declaration** confirming to the Exchange that, to the best of its knowledge and belief, it has discharged all of the relevant services of a sponsor set out in the Listing Rules with due skill and care and has satisfied itself, having made due and careful enquiry of the issuer and its advisers:

(i) that the directors of the issuer have had explained to them, either by the sponsor itself or other appropriate professional advisers, the **nature of their responsibilities and obligations as directors** of a listed company under the Listing Rules and, in particular, understand what is required of them to ensure that the company complies with its continuing obligations under the Listing Rules;

(ii) that all the documents required by the Listing Rules to be included in the application for listing have been or will be **supplied to the Exchange**;

(iii) that all other requirements of the Listing Rules relating to an application for listing have been or will be **complied with**; and

(iv) that **all matters known** to it which, in its opinion, should be taken into account by the Exchange in considering the application for listing of the securities for which application is being made **have been disclosed** in the listing document or otherwise in writing to the Exchange.

In addition, a sponsor would be required to report on the working capital and profit forecast set out in the prospectus in the same manner as it is currently required to do,

and be satisfied that these are given in the prospectus after due and careful enquiry by the issuer.

Sponsor firms should provide the above Sponsor's Declaration as the only such confirmation or declaration. As such, the Exchange should review the requirements for document submission under the "Revised Guidance for New Listing Applications" (June 2003) with a view to removing any requirements which exceed or duplicate the Sponsor's Declaration – *e.g.*, the requirement under paragraph 31 of "Form I.B. Additional Information to be Submitted" to confirm whether there are any other "*material issues which could detrimentally affect the suitability of listing of the Company.*"

27.3 **Education and training**

(a) ***We need a system of accredited training and education with a prescribed syllabus for issuers' directors.*** We believe that there should be a proper focus on the training and education provided to directors, with a set of prescribed content for such training and education.

(b) ***For directors.*** Prior to listing, directors need to understand their responsibilities once the issuer starts life as a listed company. It has taken many intermediaries years of day-to-day experience to gain an understanding of the letter as well as the spirit of the Listing Rules. A briefing session lasting 30 minutes or 2 hours cannot therefore possibly instil the level of knowledge required of listed company directors.

27.4 **Reasonable investigations**

(a) ***Sponsors' reasonable investigations.*** We have the following observations:

(i) ***Mixing U.K. and U.S. approaches to due diligence.*** The approach proposed in the Paper raises concerns in that it mixes U.K. and U.S. approaches to due diligence. The U.K. approach is driven by the responsibilities which a sponsor is required to carry out under the Listing Rules, particularly the requirement on the sponsor to make a declaration that the issuer has satisfied all conditions for listing. The sponsor will invariably instruct third parties (reporting accountants, valuers and lawyers) to carry out specified due diligence on their behalf. Due diligence has been developed in the U.K. to investigate the issuer for the purpose of assessing eligibility for listing. It has become established practice for accountants to prepare long-form reports and for the issuer's lawyers to prepare legal due diligence reports. The information included in the prospectus will undergo a vigorous verification process that provides independent sources to substantiate or evidence each statement in the prospectus. A paper trail of confirmations addressed to the sponsor serves to back up its confirmations to the UKLA.

(ii) ***U.S. approach.*** U.S. style due diligence is very focused on disclosure of material information and the discovery of material omissions for disclosure. There is much less focus on a qualitative assessment of the suitability of an issuer – that is for the purchaser to decide. The emphasis on due diligence is clearly to establish statutory defences against liability for misstatements or omissions.

(iii) ***Suitability for listing.*** The Paper proposes that sponsors assess a listing applicant's suitability (as supposed to eligibility) for listing. However,

suitability for listing is a U.K.-based, wider concept – whether the securities are suitable for the public to invest in – with eligibility being narrower – whether the securities are eligible for admission by reference to specified criteria.

(iv) ***The Hong Kong approach to due diligence.*** Hong Kong has been increasingly influenced by U.S. style due diligence (but includes the verification process) due to the increasing number of offerings into the U.S.. The difference in approach has also created tensions in due diligence practices. Whilst there is no right or wrong approach on U.K. or U.S. style due diligence, Hong Kong has seen a shift towards U.S. style due diligence. In one change of the rules, the Paper will result in a confusing mix of approaches between the U.K. and U.S. due diligence models.

(b) ***Disagree with setting out minimum due diligence standards.*** The Group **strongly disagrees** with the proposal to prescribed certain **minimum** due diligence review procedures for the following reasons:

(i) The establishment of a minimum standard will lead to a "race to the bottom" as certain market participants would deem a regulatory-prescribed minimum as an appropriate diligence standard.

(ii) The Group believes it essential to recognise that, no matter how rigorous and expansive the diligence procedures, it is the issuer's prerogative as to what information it reveals – or withholds – from its sponsors (or lawyers, shareholders, etc.). As in other regulatory regimes, sponsors should be free from culpability where they have made an appropriate inquiry but where their issuer-clients (or their agents – e.g., accountants) have been less than fully forthcoming.

(iii) Whilst the Exchange identifies (at paragraph 16 of the Paper) that "the regulatory system does not exist to guarantee investors against losses", sponsors should not be placed in a position of providing such a guarantee over the issuer and its directors – whom, ultimately, sponsors cannot control.

(iv) As mentioned above, the minimum review procedures being proposed are taken (almost completely) from the Toronto stock exchange. Toronto and Hong Kong are two different markets; for example, Toronto does not have the higher barriers of entry currently proposed for sponsors in Hong Kong and can therefore justify having a set of minimum review procedures. We do not think that those procedures would necessarily fit the Hong Kong market.

(v) The divergence or tension between U.K. and U.S. style due diligence adopted in the Hong Kong makes it inappropriate to set out due diligence work under one set of minimum criteria.

(vi) Performing fully the due diligence as set out in the minimum review procedures will not necessarily provide a defence to liability. Please refer to the **Appendices** for a description of the laws and it can be seen that the defences to liability are somewhat different.

(vii) We do accept, however, that some of those who do sponsor work will not have had the benefit of any due diligence training or any exposure to due diligence exercises which conform to the standard set out in the minimum

review procedures. Accordingly, a set of **pro forma or sample review procedures** can be included in the Sponsors' Code as being non-binding.

(viii) We propose that the Listing Rules could include an affirmative obligation to "**consider carefully the appropriate level of due diligence** to be performed in the context of each issue." (see IPMA Guidance Note 4), together with express recognition of the various matters raised in Rule 176 of the U.S. Securities Act of 1933 as set out in Appendix 1.

(ix) In addition, the Group **strongly objects to** the proposed form of confirmation of due diligence in respect of "expertised" sections as it imposes a higher standard than under section 40 of the Companies Ordinance:

(A) Under section 40 of the Companies Ordinance, a person must have had **reasonable ground to believe** and did up to the time of the issue of the prospectus believe that the **person making the statement was competent to make it** and that person had given and not withdrawn the consent required by section 38C to the issue of the prospectus.

(B) The Paper proposes that a person must have **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.

(c) ***Due diligence requirements on IFAs.*** The same reasons apply to due diligence issues for IFAs.

SECTION G: THE PROPOSED SPONSORS CODE

CODE OF CONDUCT FOR SPONSORS AND INDEPENDENT FINANCIAL ADVISERS
(Annex 2)

At Annex 2 we set out the proposed Code of Conduct for Sponsors and Independent Financial Advisers.

Q.12 *Do you agree with the approach adopted in the proposed Code of Conduct for Sponsors and Independent Financial Advisers?*

☐ *Yes*

☐ *No*

28. RESPONSE:

28.1 The Group agrees with the approach adopted in the proposed Sponsors Code.

29. DISCUSSION OF ISSUES:

29.1 However, the Group urge that the proposed Sponsors' Code and other existing codes and practices (e.g., Appendix 9, Listing Decisions etc.) are codified into the CFA Code. A single Code would promote certainty and remove the risk of potential confusion between separate but over-lapping regulatory requirements. We would be grateful if the Exchange and the SFC could explore this.

29.2 In any event, on the basis of our understanding that the Sponsors' Code sets out detailed elaboration of the CFA Code and is meant to be either more detailed or more stringent in all respects than the CFA Code, the SFC should make it clear that satisfaction of the Sponsors Code would also mean that the CFA Code (insofar as it relates to sponsors) had been satisfied.

29.3 In relation to the requirement to retain documents, the Group is of the view that these provisions are already fully dealt with by the extensive requirements of the Securities and Futures (Keeping of Records) Rules and the CFA Code; the duplication of provisions would result in increased costs and, detailed compliance and risk confusion as to what the different rules required..

29.4 The Group has specific comments on the Sponsors' Code and would appreciate the opportunity to discuss these with the Exchange, rather than add to this already lengthy submission.

SECTION H: DECLARATION BY SPONSORS IN LISTING DOCUMENTS

Declaration by sponsors and lead underwriters in listing documents to be registered
(Paragraphs 153 to 165 of Part B of the Consultation Paper)

We propose that both sponsors and lead underwriters (where the latter are different from the former) should make a statement in listing documents regarding the extent of their due diligence which would track the form of statement currently given to the Exchange on a private basis by sponsors subject to the modification noted below. A sponsor is also expected to ensure that the document presents a fair impression of the issuer and that it has been written in plain language. The sponsor's due diligence obligation is modified in respect of reports and information published in a listing document with the consent of an expert. The form of declaration proposed recognises this distinction. In respect of "non-expert sections" of a listing document we propose that the following statement should be made "[Sponsor firm and underwriter] confirm(s), at the date of this document, that after reasonable investigation it believes/they believe and have reasonable grounds to believe that the information set out in this listing document at [make specific references] is not materially false or misleading" and, in respect of "expert sections", an alternative test of due diligence that "it/they have no grounds to believe and do not believe that the information set out in those sections of the listing document at [make specific references], which have been prepared and authorised by [name], is materially false or misleading".

Q.13 *Do you agree with our proposals?*
- ☐ *Yes*
- ☐ *No*

30. RESPONSE:

30.1 The Group **strongly objects** to this proposal which amounts to an amendment of legislation by the backdoor.

31. DISCUSSION OF ISSUES:

31.1 We make the following observations in relation to this aspect of the Paper:

(a) The changes proposed by the Paper effectively amend the current law by the back door, without the appropriate legislative due process to consider its appropriateness. The Government's Corporate Governance Action Plan 2003 plans to consider this area, but before any changes are made, due process must have taken place.

31.2 This proposal also creates statutory liability beyond that set out in current legislation and accelerates a reform timetable put out by the Government. This proposal may have the effect of requiring sponsors to admit liability for a document for which the law may (on the current basis) otherwise find them not to be liable.

(a) Once (and if) the laws are changed to impose such liability, there will be proper statutory defences and safe harbours. However, the proposed requirement will put market participants in a very precarious situation where obligations drawn from U.K., U.S. and Canada will be imposed on sponsors without the counterbalance of the defences and safe harbours that are available in those markets.

(b) Additionally, the proposed form of confirmation of due diligence in respect of "expertised" sections imposes a higher standard than under current section 40 of the Companies Ordinance:

(i) Under section 40 of the Companies Ordinance, a person must have had **reasonable ground to believe** and did up to the time of the issue of the prospectus believe that the **person making the statement was competent to make it** and that person had given and not withdrawn the consent required by section 38C to the issue of the prospectus.

(ii) The Paper proposes that a person must have **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.

(c) Contrary to the statement made in paragraph 140 of the Paper, U.S. securities laws **do not impose a positive duty** on sponsors or lead underwriters to carry out "reasonable investigations" or "due diligence".

31.3 Contrary to the statement made in paragraph 154 of the Paper, lead underwriters in the U.S. are **not required to sign the prospectus**.

31.4 The Group's **fundamental concern** with this proposal is that sponsors will be charged with primary responsibility for incomplete or inaccurate disclosure (or other things which arguably go wrong), relegating the role of the issuer and its directors to a secondary level. Whilst the Exchange identifies (at paragraph 16 of the Paper) that "the regulatory system does not exist to guarantee investors against losses", sponsors should not be placed in a position of providing such a guarantee over the issuer and its directors – whom, ultimately, sponsors cannot control.

31.5 Further, this proposal will likely **widen the expectation gap** that the Paper sets out to reduce by relegating certain responsibilities of the issuer and its directors to sponsors. Investors might well conclude that a sponsor's attestation in the prospectus means essentially that a sponsor confirms with certainty the information therein. (If that were possible, indemnification provisions in underwriting agreements, disclosure opinions from lawyers and "due diligence" defences would not be market standards in securities regimes around the world.)

31.6 As noted above, a sponsor cannot "stand in the shoes" of its issuer-clients – it can only conduct diligence and perform services based on the information an issuer-client makes available to it, and it can only advise its issuer-clients about what the proper disclosures must be.

31.7 The paper therefore seeks to impose what in effect amounts to strict liability on sponsors where current legislation does not, nor may future legislative changes do so either. Indeed, future legislative changes may contain certain safe harbours or exceptions to what the Exchange is now proposing.

31.8 The Government has already announced that it is looking into making sponsors and other professionals liable for prospectuses; it would only be right to wait for the due legislative process (and the related consultation period), rather than to prejudge the upcoming public discussion.

32. SUGGESTIONS BY THE GROUP:

32.1 As the Government has a clear timetable and agenda to update the regulatory framework in Hong Kong, including a detailed overhaul of current legislation, we are of the firm view that the Exchange should not usurp that process.

IFA Due Diligence Declaration
(Paragraph 147 of Part B of the Consultation Paper)

We propose that IFAs are required to take all reasonable steps to satisfy themselves that the terms and conditions of the transaction or arrangement are fair and reasonable and in the interest of the issuer and its shareholders as a whole, and that there are no grounds to believe that any information, expert advice or opinion relied on in relation to the transaction or arrangement are not true or omit a material fact. IFAs should include in their reports a signed declaration setting out the due diligence they have performed in order to reach a conclusion that the terms of the transaction or arrangement are fair and reasonable and in the interest of the issuer and its shareholders as a whole.

Q.14 *Do you agree with our proposals?*
☐ *Yes*
☐ *No*

33. RESPONSE:

33.1 The Group **strongly objects** to this proposal for the same reasons as stated above.

SECTION I: REPORTING, COMPLIANCE AND SANCTIONS

REPORTING OBLIGATIONS AND MONITORING

REPORTING OBLIGATIONS AND MONITORING
(Paragraphs 166 to 170 of Part B of the Consultation Paper)

We propose to replace the requirement for an annual review with a certification process and a targeted programme of monitoring.

We propose to require sponsor firms and IFA firms and their eligible supervisors to submit annual confirmations that they remain eligible to act in such capacity. In addition, they are required to report to the Exchange as soon as they became aware if they no longer satisfy the eligibility criteria set out in the Listing Rules or any information provided by them in connection with their application or continued inclusion on the list of Sponsors or the list of IFAs has changed. The Exchange may also conduct a specific review in relation to the continued inclusion of the sponsor firm or IFA firm (or any of it's employees) if it becomes aware or has reason to believe that the suitability of the firm/individual may be in question.

The monitoring tools we propose to use will vary according to circumstances and may include one or more of the following:

- Complaints;
- Desk based reviews of transactions;
- Reviews of referrals;
- Liaison with other agencies, professional or regulatory bodies;
- Meetings with management and other representatives from a sponsor firm or IFA firm;
- On-site visits after prior notification;
- Reviews of notifications and confirmations from sponsors or IFAs; and
- Reviews of past services provided, and documentation produced, pursuant to the Listing Rules by a sponsor or an IFA.

Q.15 *Do you agree with our proposals?*
☐ *Yes*
☐ *No*

34. RESPONSE:

34.1 The Group agrees with the Exchange's proposals as set out above.

COMPLIANCE AND SANCTIONS

COMPLIANCE AND SANCTIONS
(Paragraphs 171 to 181 of Part B of the Consultation Paper)

We propose that sponsors and IFAs and their eligible supervisors and staff all be subject to disciplinary sanction. As noted in paragraph 54 we do not propose having a list of acceptable directors and individual staff members who are not eligible supervisors. Thus, all persons licensed as representatives to advise on corporate finance will be entitled to do sponsorship or IFA work under the supervision of an eligible supervisor, unless they have been declared to be an unacceptable person.

We propose disciplinary sanctions for sponsors and IFAs similar to those under the current GEM Listing Rules, but with some variations for individuals. As with our sanctions for issuers and directors, we propose a graduated hierarchy of shaming and disabling sanctions that provide the flexibility to ensure the sanction is appropriate to the circumstances. Our proposed sanctions are:

- Private reprimand;
- *Public statement with criticism;*
- Public censure;
- Declaration that an individual is an unacceptable person or cannot be an eligible supervisor for a specified period of time;
- Suspension of a firm from the list of acceptable sponsors or list of acceptable IFAs for a specified period of time;
- Declaration that an individual is an unacceptable person or cannot be an eligible supervisor; and
- Removal of a firm from the list of acceptable sponsors or list of acceptable IFAs.

Q.16 *Do you agree with our proposals?*
☐ *Yes*
☐ *No*

35. RESPONSE:

35.1 The Group agrees with the Exchange's proposals as set out above. However, we recommend that the SFC should play a full role in the disciplinary process (see paragraph 6.3 and 10.1(c)above).

SECTION J: ABILITY TO MEET ELIGIBILITY CRITERIA

ABILITY OF EXISTING GEM AND MAIN BOARD SPONSORS AND IFAs TO MEET ELIGIBILITY CRITERIA FOR ACCEPTABLE LISTS
(Paragraphs 186 to 189 of Part B of the Consultation Paper)

For those respondents to this Consultation Paper who are currently on the list of GEM Sponsors or who currently perform or who have in the past 2 years performed work as Sponsor to Main Board applicants for listing or have in the past 2 years acted as an IFA, we would appreciate your response to the following questions:

Q.17 Would you meet the proposed eligibility requirements for sponsor firms or IFA firms (whichever is applicable), including the requirement that sponsor firms have four eligible supervisors and HK$10 million capital or that IFAs have two eligible supervisors if those requirements:

(a) were in effect today?
- ☐ Yes
- ☐ No

(b) were in effect in 6 months time?
- ☐ Yes
- ☐ No

(c) were in effect in 18 months time?
- ☐ Yes
- ☐ No

(d) were in effect in 30 months years time?
- ☐ Yes
- ☐ No

36. RESPONSE

36.1 We do not propose to respond to this question on the basis that the number of Eligible Supervisors we have available is a function of the market, which we cannot predict with certainty. Members of the Group expect to be able to qualify as acceptable sponsors.

Q.18	If your answer to any of questions 17 (a)-(d) was negative, please state which criteria would cause your firm not to meet the requirements and comment on whether the proposed transitional arrangements would give you a sufficient opportunity to meet all the requirements? Would this change if the second transition period (in which existing GEM sponsors would only be required to have 3 eligible supervisors to be on the list of acceptable sponsors) was 2 years instead of 1 year? Do you have any other suggestions or comments on how to address the issues arising out of the impact analysis at paragraphs 186 to 188 of Part B of this Consultation Paper?

37. RESPONSE

37.1 As proposed above, the Group considers that **two** Eligible Supervisors to be appropriate. Please see also the Group's other suggestions on the experience and qualifications of Eligible Supervisors. In addition, the Exchange should offer some flexibility in relation to the requisite experience and qualifications (such as an individual having only international experience) of Eligible Supervisors.

37.2 Given the need for reform, we question whether a two-year transition period is too long.

SECTION K: CONCLUSION

We hope that you have will seen that there are many areas where we are supportive of the proposals. Where the Group has objections to, or concerns with, proposals in the Paper, we have attempted to explain those objections/concerns and, where possible, to provide alternative solutions which we would invite the Exchange and the SFC to consider.

The Group believes that changes must ensure that the majority who play by the rules and play fair with investors will face a ***lighter regulatory burden***. In addition, the changes should ensure that there is a real ***regulatory incentive*** to do quality work, to comply with both the letter and the spirit of the rules and to adhere to high standards of work, as well as a ***regulatory disincentive*** for those who do not.

The subject matter of the Paper and the suggestions made in this Paper are **extremely important** to the Group. We hope that the detail that we have provided will enable the Exchange and the SFC to understand the bases for our concerns and to enable a constructive dialogue to take place in relation to such matters. We would therefore **welcome a meeting** with the Exchange and/or the SFC to discuss aspects of this submission.

If you have any questions, please feel free to contact the following:

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APPENDIX 1: U.S. SECURITIES LAWS

Introduction

(a) The core of the prospectus law in the U.S. is stated in section 5 of the Securities Act of 1933, as amended (the ***1933 Act***). Section 5 makes it unlawful to sell any securities (including through the use of a prospectus) absent registration or an exemption from the registration requirements. Section 5 of the 1933 Act makes it unlawful to distribute any prospectus unless a registration statement has been filed and such prospectus complies with the contents requirements of section 10 (as well as Schedule A).

(b) Contrary to the statement made in paragraph 140 of the Paper, U.S. securities laws do not impose a positive duty on sponsors or lead underwriters to carry out "reasonable investigations" or "due diligence".

Basis of prospectus liability

(a) Section 11(a) of the 1933 Act imposes civil liability in respect of a registration statement (which is effectively the prospectus) which "contained an untrue statement of a **material** fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading".

(b) The term "material" is defined in Rule 405 of the 1933 Act as meaning "matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered".

(c) U.S. case law[12] has this construed as meaning "a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question."

(d) Section 11 only applies to registered offerings (and not, for example, Rule 144A offerings).

Persons liable under section 11

(a) Unless the person acquiring the security can prove that at the time of such acquisition he knew of such untruth or omission, such person may sue:

- every person who **signed** the registration statement;

  Note that section 6 of the 1933 Act requires that, upon filing, a registration statement **must be signed by** (a) the issuer, (b) its principal executive officer or officers, (c) its principal financial officer, its comptroller or principal accounting officer, and (d) the majority of its board of directors.

Contrary to the statement made in paragraph 154 of the Paper, lead underwriters are not required to sign the prospectus.

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12 Escott v. BarChris Construction Corp., 283 F.Supp. 643 (S.D.N.Y. 1968). This was the first fully litigated decision interpreting the civil liability provisions of section 11.

- every person who has consented to being named as a **director** or a **proposed director**;
- every **accountant, engineer, or appraiser, or other expert** whose has consented to being named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation;
- every **underwriter** with respect to such security.

(b) All of the persons specified above are jointly and severally liable, except that (1) an expert is liable only with respect to the portion of the registration statement prepared or certified by him, and (2) the aggregate liability of an underwriter who purchased only a portion of the issue is limited to the aggregate price of the securities he underwrote.

Defences to liability

(a) Except as to the issuer whose liability is absolute, section 11(b) provides an affirmative defence for a person who can demonstrate that he met a prescribed standard of diligence with respect to the information in the registration statement. For this purpose, the standard of diligence is divided into "**expertised**" and "**unexpertised**" portions[13].

(b) With respect to the **expertised** portions (which includes official statements or extracts therefrom):

- The due diligence obligation of the person (other than the expert who prepared that portion) is that "he had **no reasonable ground to believe** and did not believe that the statements therein were **untrue** or that there was an **omission to state a material fact** required to be stated therein or necessary to make the statements therein not misleading".
- In other words, the burden of due diligence *investigation* lies solely upon the expert; all other persons have a qualified right to rely upon his efforts.

(c) With respect to (1) the **unexpertised** portions and (2) liability of the expert for the portions **expertised by him**:

- The due diligence obligation of the person is that "he had, **after reasonable investigation, reasonable ground to believe** and did believe that the statements therein were **true** and that there was **no omission to state a material fact** required to be stated therein or necessary to make the statements therein not misleading".
- There is therefore 2-step test: (1) there must be reasonable investigation **and**, after such investigation (2) there must be no reason to doubt.

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13 Lawyers having drafting responsibility would not be "experts"; and accountants are only "experts in relation to the audited financial statements.

Standard of reasonableness

(a) Section 11(c) provides that in determining "what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

(b) Rule 176 of the 1933 Act ("Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act") provides that "in determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in section 11(c), relevant circumstances include, with respect to a person other than the issuer:

- The type of issuer;
- The type of security;
- The type of person;
- The office held when the person is an officer;
- The presence or absence of another relationship to the issuer when the person is a director or proposed director;
- Reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts;
- When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant; and
- Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time it was filed.

APPENDIX 2: U.K. SECURITIES LAWS

Introduction

The principal sources of statutory prospectus liability under U.K. securities laws are as follows:

(a) Financial Services and Markets Act 2000 (***FSMA***) - Section 79(3);

(b) Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations 2001 (***FSMA Regs***) – Article 6;

(c) FSMA - Section 397; and

(d) FSMA – Section 118.

Section 79(3), FSMA and Article 6, FSMA Regs

(a) A sponsor will be responsible for the listing particulars under section 79(3) of the FSMA and article 6(1)(e) of the FSMA Regs if it "**authorises**" all or part of the contents of the listing particulars. There is some doubt about whether a sponsor will be considered to have "authorised" the contents of the listing particulars.

(b) Various statutory defences are available to a sponsor under section 79(3) of the FSMA in relation to an action brought against the sponsor as a person responsible for the listing particulars.

(c) The principal defence requires the sponsor to demonstrate that at the time the listing particulars were submitted to the UKLA, it **reasonably believed, having made reasonable enquiries,** that the relevant statement was **true and not misleading** or a statement was properly omitted.

(d) In practice, this will be shown in the same way as the sponsor shows it has made due and careful enquiry for the purposes of the Listing Rules, that is by being involved in an adequate due diligence process and obtaining appropriate comfort from the issuer and the issuer's other advisers.

Section 397, FSMA

(a) Section 397 of the FSMA imposes criminal liability on anybody:

- **knowingly or recklessly** making a **misleading, false or deceptive** statement, promise or forecast
- **dishonestly concealing any material facts** whether in connection with a statement, promise or forecast made by him or otherwise
- doing any act or engaging in any course of conduct which creates a **false or misleading impression as to the market** in or the price or value of an investment, if (in the case of any of the above) he does so for the purpose of inducing someone to make or refrain from making an investment or to exercise or refrain from exercising any rights conferred by an investment.

Statements made in listing particulars could be caught by this section. A sponsor, as someone involved in the production of the listing particulars, could be viewed as a

person making any misleading statement which might be contained in the listing particulars.

(b) It should be a defence to an action brought under section 397 of the FSMA if the sponsor can prove that it did not know that statements in the listing particulars were "misleading, false or deceptive" and that it was not reckless in allowing any such statements to be made.

(c) Again, in practice, this would be shown by the sponsor being able to demonstrate that it had been involved in an adequate due diligence process and that it had obtained appropriate comfort from the issuer and the issuer's other advisers.

Section 118, FSMA

(a) Section 118 of the FSMA introduced a new civil offence of **market abuse**. Sponsorship activities might result in the committing of an offence under the "**false or misleading impressions**" head of market abuse set out in Section 118(2)(b) and further described in Chapter 1.5 of the FSA's Code of Market Conduct.

(b) The offence will be committed by behaviour that is both (i) "likely to give a regular user of the market [in the London-listed security] a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments of the kind in question" and (ii) "likely to be regarded by a regular user of that market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their position in relation to the market [the so-called "reasonable user" test]".

(c) The market abuse offence has similar scope to that of the third limb of Section 397 described above but an increased likelihood of enforcement action due to the prospect of an increased focus on compliance by the FSA and the lower standard of proof required for market abuse. As with Section 397, statements made in listing particulars could clearly be market abuse, and a sponsor, as someone involved in the production of the listing particulars, could be viewed as a person making any misleading statement which might be contained in the listing particulars.

(d) In determining whether the behaviour involved (contents of and omissions from the listing particulars) falls below the standards expected, the Code of Market Conduct states that the **reasonable user** is likely to consider all the circumstances of the behaviour, including the high standard of knowledge and experience expected of a sponsor, whether the listing particulars comply formally with the Listing Rules and the nature of the investors in the securities in question.

(e) It will be a **defence** to an action for market abuse if the sponsor can prove that it **believed on reasonable grounds** that its behaviour did not amount to market abuse or that it **took all reasonable precautions and exercised all due diligence** to avoid engaging in market abuse.

(f) In practice, this could be shown by the sponsor being able to demonstrate that it had been involved in an adequate due diligence process and that it had obtained appropriate comfort from the issuer and the issuer's other advisers.

APPENDIX 3: HONG KONG SECURITIES LAWS

Introduction

The principal sources of statutory prospectus-related liability under Hong Kong securities laws are as follows:

(a) Companies Ordinance – Sections 40 and 40A;

(b) Securities and Futures Ordinance – Sections 107, 108, 277, 281, 298, 305 and 391.

Section 40, Companies Ordinance

Section 40 of the CO provides that the following persons shall be liable to pay compensation in respect of any untrue statement included in a prospectus:

(a) every a **director** of the issuer;

(b) every **director or proposed director** who consented to his being named in the prospectus;

(c) every person being a **promoter** of the issuer;

We do not agree with the Paper's statement that sponsors are arguably "promoters" on the basis that they arrange the sale of the issuer's shares.

(d) every person who has **authorised the issue** of the prospectus; and

(e) every **expert** who has consented to the issue of the prospectus, but only in respect of an untrue statement purporting to be made by him as an expert.

It is certainly not clear whether sponsors are considered "promoters" within the meaning of section 40 of the Companies Ordinance. "Sponsorship" was not a concept that existed in Hong Kong at the time when the Government amended section 40 of the Companies Ordinance in the Companies Ordinance (Amendment) Bill 1972, to add to the list of persons liable to subscribers of shares any expert consenting to inclusion of his report. This amendment followed the earlier change to section 43 of the U.K. Companies Act 1948. At the time of the amendment to section 43 of the 1948 Act, the Cohen Committee "*rejected a suggestion that the same civil liability as attaches to directors and promoters for untrue statements should attach to bankers, brokers, solicitors and accounts whose names appear on the prospectus.*"[14] It appears that the concept of promoters does not contemplate the role of an investment bank in an IPO. This is contrasted with the position under the Singapore Companies Act which defines a "promoter" to mean "*a promoter of a corporation who was party to the preparation of the prospectus or of any relevant portion thereof*"[15].

Defences to liability

A defence to the prospectus liability under section 40 is available where:

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[14] Paragraph 1.67, Report of the Companies Law Revision Committee on the Protection of Investors (1971).

[15] Section 4, Singapore Companies Act (Chapter 50).

(a) For the purposes of section 40, the contents of prospectus are divided into "**expertised**" and "**unexpertised**" portions.

(b) With respect to the **unexpertised** portions: "he had **reasonable ground to believe**, and did up to the time of the allotment of the shares or debentures, as the case may be, believe, that the statement was **true**".

(c) With respect to the **expertised** portions: "he had **reasonable ground to believe** and did up to the time of the issue of the prospectus believe that the **person making the statement was competent to make it** and that person had given and not withdrawn the consent required by section 38C to the issue of the prospectus".

(d) With respect to the liability of an expert with respect to the **expertised** portions: "he had **reasonable ground to believe** and did up to the time of the issue of the prospectus believe that the **person making the statement was competent to make it** and that person had given and not withdrawn the consent required by section 38C to the issue of the prospectus".

(e) With respect to a statement made by an official person or contained in a copy of or extract from a **public official document**, it was **a correct and fair representation** of the statement or copy of or extract from the document.

(f) With respect to liability of an expert for the **expertised** portions made by him as an expert: he was **competent** to make the statement and that he had **reasonable ground to believe** and did up to the time of the allotment of the shares or debentures, as the case may be, believe that the statement was **true**.

(g) "Promoter" (發起人) means a promoter who was a party to the preparation of the prospectus, or of the portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company.

Under Section 40A, any person who authorises the issue of a prospectus which contains any untrue statements shall be liable to imprisonment and a fine, unless he proves either that the statement was immaterial or that he had reasonable grounds to believe and did up to the time of issue of the prospectus believe that the statement was true.

Securities and Futures Ordinance

(a) Under section 107 of the SFO, any person who makes a fraudulent or reckless misrepresentation to induce another to offer to or to enter into any agreement to acquire, dispose of, subscribe for, or underwrite securities is generally guilty of an offence.

(b) Under section 108, a person who makes a fraudulent, reckless or negligent misrepresentation by which another person is induced to offer to or to enter into an agreement to acquire, dispose of, subscribe for or underwrite securities is also liable to pay compensation to the other person for any monetary loss suffered by reason of relying on the misrepresentation. This provision does not apply where section 40 of the Companies Ordinance applies.

(c) Sections 277 (civil offence liability) and 298 (criminal offence liability) of the SFO prohibit inducing the sale of securities by disclosing information which:

- is false or misleading as to a material fact, or is false or misleading through the omission of a material fact; and

- the person knows, or is reckless (or, under Part XIII, negligent) as to whether, the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact.

Sections 281 and 305 of the SFO then allow investors who have suffered loss as a result of market misconduct in breach of the above two provisions (respectively) to sue various parties for compensation for such loss.

(d) Section 391 of the SFO imposes civil liability on various persons responsible for any communication being made to the public in Hong Kong (or to a group of members of the public, e.g. shareholders of a listed company), which concerns securities or may affect the price of securities, which is false or misleading in a material particular, and which the persons involved know is, or are reckless or negligent as to whether it is, false or misleading in a material particular. Investors who suffer loss as a result of relying on the communication can sue for damages for the loss. This provision does not apply where section 40 of the Companies Ordinance or section 108 of the SFO applies.

Liability for false or misleading statements

Section 254 of the Securities and Futures Act imposes civil liability, and section 253 imposes criminal liability, on the following persons in respect of a false or misleading statement in or omission from the prospectus:

(a) the person making the offer or invitation (*i.e.*, the issuer);

(b) every a **director** of the issuer;

(c) every **proposed director** who consented to his being named in the prospectus;

(d) each **underwriter** (but not a sub-underwriter) who consented to his being named in the prospectus;

(e) every **expert** who has consented to the issue of the prospectus, but only in respect of an untrue statement purporting to be made by him as an expert; and

(f) any other person who made the false or misleading statement or omitted to state the information or circumstance, as the case may be, but only in respect of the inclusion of the statement or the omission to state the information or circumstance.

Defences

A person is not liable if it can be proved that he:

(a) made all inquiries (if any) that were reasonable in the circumstances; and

(b) after doing so, believed on reasonable grounds that the statement was not false or misleading or that there was no omission from the prospectus in relation to that matter.

In addition, a person is not liable if it can be proved that he placed reasonable reliance on information given to him by another person (other than his own employees or agents).