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31 July 2003

Hong Kong Exchanges and Clearing Limited
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For the attention of Mr Richard Williams, Head of Listing

Securities and Futures Commission
Corporate Finance Division
8th Floor, Chater House
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Hong Kong

For the attention of Mr Ashley Alder, Executive Director

Dear Sirs,

Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers ("Consultation Paper")

We take this opportunity to comment in response to the above Consultation Paper which proposes changes to the regulatory framework and the Listing Rules and the introduction of a Code of Conduct for Sponsors and Independent Financial Advisers. The proposed amendments are extensive and in some aspects far reaching.

We appreciate that it is an easier (albeit time consuming) task for us to prepare a critique of the Consultation Paper than it should have been for the Exchange to draft the Consultation Paper. We approached the Consultation Paper with an open mind. However, we find, having studied the Consultation Paper at length, that we are in disagreement with the vast majority of the proposals. We hope that the Exchange will examine and reflect on the points that we make with the same diligence with which we have examined and responded to the proposals in the Consultation Paper.

Our comments on the proposals themselves are set out in the Exchange's questionnaire. In addition, we set out below our comments on the consultation/review process.

Cost benefit analysis

We would urge the Exchange to carry out and publish a cost benefit analysis prior to making any decision on major revisions to the Listing Rules and the regulatory framework, such as those proposed in the Consultation Paper. We note the UK Financial Services Authority's ("FSA") commitment made in the "Open approach to Regulation" published in July 1998 to carry out and publish cost benefit analysis of regulatory proposals. We also note that sections 155(2)(a) and 157(3) of the Financial Services and Markets Act 2000 impose a statutory obligation on enactment upon the FSA in this regard. (As the Exchange is no doubt aware, in the United Kingdom (a market to which Hong Kong frequently looks for regulatory inspiration) the function of competent authority for listing was transferred from the London Stock Exchange to the FSA.) Given the often stated desire to bring Hong Kong's regulatory system more into line with international standards, we believe that the Exchange should commit to carry out and publish cost benefit analysis (as the FSA has done) in respect of proposed regulatory amendments.

We believe this is vital given the fact that the Exchange is a statutory monopoly, a regulator of listed companies and itself a listed company driven by (amongst other things) the corporate desire to minimise its operating costs and maximise its profits. Our suggestion for a cost benefit analysis is all the more important because many of the proposals would likely result in social and economic costs being imposed on businesses and investors in Hong Kong which do not appear to have been taken into account in the Consultation Paper. In addition, we believe that the proposals involve to a certain extent a duplication of the work and function of the SFC in relation to licensing matters which may result in unnecessary extra costs. Given the Exchange's monopoly position in Hong Kong, it should take into account these bigger picture issues. As Mr KC Kwong pointed out in his public response to the criticism levelled by Justice Rogers, the Exchange is under a statutory duty to act in the interests of the public. In fact, the Exchange is required to have particular regard to the interests of the investing public and to give precedence to those interests if they conflict with the Exchange's own commercial interests. A cost benefit analysis would bring Hong Kong into line with the best practice in the United Kingdom (corporate governance should apply to the regulators too) as well as enabling the Exchange to ensure that prior to putting forward major proposals, the Exchange actually has done the work necessary to demonstrate that (and the market accordingly has a basis upon which to believe that) the Exchange has complied with its statutory obligations and has, in fact, demonstrably put the public interest before its own commercial interests. In fact, we made the suggestion that the Exchange carry out a cost benefit analysis prior to making any decision on major changes to the Listing Rules in our response dated 31 October 2002 to the Exchange's consultation paper relating to initial listing and continuing listing eligibility and cancellation procedures. We are extremely disappointed that it would appear that, in the time that has passed since then, the Exchange has made no effort to raise the standard of its processes in respect of proposed regulatory changes to at least those adopted some five years ago in the United Kingdom.

We are also concerned that, given the title of the Consultation Paper, listed companies may not appreciate that certain of the proposals are likely to result in them incurring additional

costs. The Consultation Paper contains no analysis in this regard. It may be that listed companies will not take the (considerable) time necessary to evaluate the proposals because they may assume from the title of the Consultation Paper that the proposals do not affect them. A cost benefit analysis would have made it clear how listed companies are likely to be affected.

Failure to set out the detailed proposed changes

A major area of concern regarding the consultation process is that the wording of the proposed amendments to the Listing Rules are not set out in the Consultation Paper. The devil is always in the detail. Frankly, it is difficult to have a meaningful consultation process unless the exact proposed rule changes are disclosed. Contrast this Consultation Paper with the April 2001 consultation paper issued by the SFC on its review of the Codes on Takeovers and Mergers and Share Repurchases in which the wording of the proposed new rules was set out. We note that the Exchange actually used to adopt this (better and more open) approach in its past consultation papers; for example, the Consultation Paper on the 1998/1999 Review of Certain Chapters of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (issued in May 1999) and the Chapter 3A Consultation Paper. It appears that the Exchange no longer follows this more transparent approach to proposed regulatory changes. For example, no proposed detailed wording of the proposed amendments to the Listing Rules was set out in the Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues (issued in January 2002) which is of wide and far-reaching implications to listed issuers; amazingly, neither did the relevant consultation conclusions (published in January 2003) contain the detailed wording of the new rules. This is certainly a backward step which has been taken by the Exchange in terms of corporate governance. It is incomprehensible to us why the Exchange chooses not to consult the market on the basis of full disclosure and transparency of the proposed rule changes. Such an approach would certainly enable respondents to comment on the proposed changes more meaningfully.

Flawed questionnaire

We are concerned that the questionnaire drawn up by the Exchange, which the Exchange encourages respondents to use, is seriously flawed. First, not all of the proposed changes (not even all the major ones) are the subject of a question in the questionnaire.

We set out for illustration purposes a couple of examples.

- It is proposed by the Consultation Paper to abolish the role of "co-sponsor" (see page 35 of the Consultation Paper) yet this major proposal is not the subject of a question in the questionnaire. Moreover, there is no real justification made for the proposed change neither is there any analysis of the likely ramifications of such a proposed change.

- The Exchange has not included in its questionnaire a question to seek the market's response to its proposal to modify the existing GEM requirements that the sponsor must have a minimum of two executive directors engaged in a full time capacity in the sponsor's corporate finance business in Hong Kong and to only require that the sponsorship activities must be under the supervision of eligible supervisors. Why is this not included in the questionnaire? We believe that it is ridiculous for the Exchange to expect persons located thousands of miles away actively and effectively to supervise the handling of listing applications by persons working in their organization's Hong Kong office.

- The Exchange also has not included in the questionnaire its major proposal that "issuers should appoint sponsors in the case of any application for listing which requires the production of a listing document for registration and that the sponsor should be required to discharge responsibilities equivalent to those applicable in respect of an IPO prospectus" (page 38 of the Consultation Paper). These transactions will include rights issues, open offers and placing of securities of a class new to listing (e.g. warrants) for which the appointment of a sponsor is currently not required. A listed issuer effecting a rights issue or a placing of warrants is not a new applicant yet a listing document will be produced in such circumstances. A corporate finance firm which is not admitted to the sponsor list (or has been taken off the list because it cannot meet the new stringent requirements proposed by the Stock Exchange such as having a sufficient number of completed significant transactions and IPOs) will not be permitted even to advise clients on matters such as rights issues, open offers or placings of warrants. Depending on the difficulty involved for a sponsor firm to remain on the sponsor list (which may be very difficult under the current proposal), this proposal will need careful thought in order not to jeopardize unfairly the survival of corporate finance firms and limit the choice of issuers (when choosing advisers). This proposal would affect the livelihoods of corporate finance firms, yet there is neither any analysis of the justification or ramifications of the proposal in the Consultation Paper nor is the proposal highlighted in the questionnaire.

This approach of soliciting responses on the basis of an incomplete and selective questionnaire is clearly not the way in which to proceed if one wishes to carry out a proper consultation. Secondly, some questions do not relate to only one issue, but rather lump a number of issues together making it difficult for respondents to answer clearly using the questionnaire. The format of the questionnaire raises serious concerns about the consultation process.

Response document

The Exchange should issue a public document after the consultation process setting out details of the analysis and comments made by respondents. The Exchange should then explain and justify its proposed rule changes in the context of the analysis and comments received from respondents. There was a general perception amongst market practitioners to whom we spoke to after the paper issued by the Exchange regarding the proposed rule

changes following the receipt of views on the so-called Corporate Governance Consultation Paper that the Exchange had just counted the ticks for "agree" and the ticks for "disagree" without giving any meaningful disclosure of the analysis and comments received from the market and the Exchange's reaction to such in terms of the rule changes to be effected. The perception which has, unfortunately, been created is that the Exchange may not have properly considered the qualitative merits of the respondents' views. Again, contrast this with the paper issued by the SFC following the 2001 consultation paper on the Codes.

Sources upon which the proposals draw

We note that the proposals are stated to "draw on the current GEM Listing Rules, on the standards imposed by the UK Listing Authority ... on sponsors ... and the sponsorship policy statements of the Toronto Stock Exchange" (page 17 of the Consultation Paper). The Consultation Paper states that the "in the United Kingdom and Canada this role has been formalised to a greater extent than in most other markets, to help ensure that a high level of due diligence is undertaken.... The UK Listing Authority does not currently set out any specific criteria for the due diligence it expects a sponsor to undertake (or have undertaken on its behalf), although it does establish criteria for approval, function and appointment of a sponsor" (pages 17 and 18 of the Consultation Paper). We take it as read, that the statement by the Exchange that its proposals "draw on" the GEM Listing Rules, the rules in the United Kingdom and policy statements in Canada means that the Exchange's proposals are derived in some way from such. However, there is no analysis set out in the Consultation Paper to support such a conclusion, rather the facts suggest that this is not the case. The justification put forward by the Exchange for the Exchange's proposals is nonsensical.

First, the Exchange states that the rules in the United Kingdom "help to ensure that a high degree of due diligence is undertaken", but then the Consultation Paper itself acknowledges that there are no specific criteria in the United Kingdom for the due diligence which a sponsor is expected to undertake. The United Kingdom, the rules of which "help to ensure a high level of due diligence", just has criteria for the approval, function and appointment of a sponsor – this is exactly what the GEM Listing Rules currently provide. It would appear from the Exchange's own Consultation Paper that the practice in the United Kingdom (which the Consultation Paper supposedly draws on) would indicate that the approach currently adopted in the GEM Listing Rules is sufficient. The standards imposed by the UK Listing Authority appear in no way to justify the proposals made by the Exchange in the Consultation Paper.

Secondly, we are surprised that the Exchange has drawn upon the sponsorship policy statements of the Toronto Stock Exchange. When assessing firms applying to be admitted to the list of GEM sponsors and individuals applying to be principal supervisors or assistant supervisors of GEM sponsors, does the Exchange recognise sponsorship work carried out on the Toronto Stock Exchange as being relevant experience? We note that the Exchange states that it accepts experience derived from recognised overseas stock exchanges and

lists NYSE, NASDAQ, SGX, ASX and London Stock Exchange but the Toronto Stock Exchange is missing from this list.

In Hong Kong it is currently the standard practice for all listing documents to be the subject of a thorough verification process typically carried out by the sponsor's lawyer. This is exactly the same verification process which is standard in the United Kingdom. Perhaps this is recognised in the quote from the Consultation Paper above that in the United Kingdom the UK Listing Authority expects that the sponsor may have the due diligence "undertaken on its behalf". No explanation is provided by the Exchange as to why or in what way the United Kingdom experience might justify certain of the proposals put forward by the Exchange by indicating that the verification process has proved to be inadequate or flawed. Neither is there any analysis in the Consultation Paper which would tend to suggest that in Hong Kong the existing verification procedure has proved itself to be a flawed or inadequate procedure.

In respect of looking to the rules in the United Kingdom to justify the Exchange's proposals, we note that the Exchange has chosen only to look at the rules of the UK Listing Authority which maintains the Official List (which is the equivalent of Main Board). The Exchange presents a table in the Consultation Paper comparing the proposals with the UK Listing Authority rules and the existing Main Board and GEM rules and practices. We were astonished that the Exchange chose not to make any reference to the rules of the Alternative Investment Market ("AIM") (which is the equivalent of GEM) operated and regulated by the London Stock Exchange. In fact, we understand that the GEM Listing Rules were largely modeled after the AIM rules. Based on the AIM rules as of May 2003, an AIM company must retain a nominated adviser at all times. The term "nominated adviser" is, we understand, the AIM equivalent of a GEM sponsor. If an AIM company ceases to have a nominated adviser, we understand that the London Stock Exchange will suspend trading in the company's securities. If within one month of that suspension the AIM company has failed to appoint a replacement nominated adviser the admission of the company's AIM securities will be cancelled. We must say that the comparison table in the Consultation Paper with the headings "Existing GEM Rules" and "UK Requirement" is misleading in that readers will be led to believe that whilst the "Existing GEM Rules" requires a continuing sponsor, there is "no mandatory continuing sponsorship requirement" under the "UK Requirement" (see page 85 of the Consultation Paper). As illustrated above, there is actually a very strict requirement for a continuing sponsor for companies listed on AIM; the UK equivalent of GEM. This really casts serious doubt as to whether the Exchange has diligently reviewed the relevant rules of those other developed markets from which its proposals are stated to draw upon. Certainly, the Consultation Paper fails to present readers with a comprehensive and complete comparison in Annex 1 of the Consultation Paper and is, in fact, misleading in this respect.

A level playing field?

The Consultation Paper creates the impression that the Exchange has discriminated in favour of sponsors which are part of large investment banking and financial groups when formulating the proposals. This, to our mind, is illustrated very clearly in a number of areas.

First, the proposals relating to independence. The Exchange proposes that:

(a) *A sponsor may hold up to 5% of the issued capital of the new listing applicant.* Why should a sponsor be considered independent when it has a direct financial interest in the success of the listing as a shareholder? This proposal will facilitate firms whose affiliated direct investment arms have invested in the applicant to be sponsor. There is a clear and undeniable conflict of interest here. A shareholder is not independent.

(b) *A sponsor may hold shares in the new listing applicant if the fair value of such shareholding does not exceed 15% of the consolidated net tangible assets of the sponsor group.* If a sponsor has invested in the new listing applicant, how on earth can such a sponsor be said to be independent? Clearly such a sponsor/sponsor group has a financial interest (as an investor) in the success of the IPO and is not independent. The perception created is that this proposal panders to those large firms which have affiliated direct investment operations.

(c) *A sponsor (or a member of its group) is allowed board representation on the board of the new listing applicant provided it does not control the board or is not under the same control as it.* Any director is able to influence the company of which he/she is a director. (This fact is recognised by the Exchange that (inter alia) a director of the issuer or its subsidiaries falls within the definition of "connected person" in the Listing Rules. The connected party transaction rules are in fact designed to ensure (inter alia) that this inherent conflict of interest has a check and balance in the form of an IFA opinion and shareholders' approval.) Moreover, all directors are under a fiduciary duty to act in the best interests of the company of which he/she is a director regardless of whether this is in the best interests of the entity (i.e. the sponsor group) which they represent (i.e. the investor). Clearly, there is a real inherent conflict of interest. The direct investment businesses of the large investment banks will often seek board representation (and will often push for an IPO as their exit strategy) – again the proposal appears to pander to such entities' vested interests.

(d) *A sponsor is independent if less than 15% of the proceeds from the IPO go to settling debts due to a member of the sponsor group* (presumably we are not talking about the sponsor's fees here). Again, another clear and real conflict of interest. Why does the Exchange consider that a sponsor is independent when the repayment of debts due to it may be dependent upon the success of the listing? No doubt the sponsor firms affiliated with banks will be pleased with the proposal.

(e) *A sponsor is independent if the listing applicant's operations are funded by the sponsor group; providing the funding provided does not constitute a significant portion of total funding.* The Exchange states that is does "not propose to stipulate any threshold on the banking relationship between a sponsor and a new applicant". This benefits those sponsors which are part of banking groups. Clearly there is a real conflict of interest if the sponsor group lends money to the new listing applicant. A sponsor/sponsor group which is owed money by the listing applicant cannot be said to be independent.

Either a firm is independent or it is not independent. The Exchange's proposals do not set a test for independence. In each of the above permitted categories there is either real dependence or a real conflict of interest. The Exchange's proposals merely set a limit for the amount of dependence and amount of conflict of interest which the Exchange proposes allowing those large firms which are affiliated with banks or direct investment operations to have and still be able to act as sponsor. If this is the case, let's be honest about it and not try to pretend that the Exchange is proposing to insist that these sponsors which are part of banks or large investment banks must be independent.

Moreover, contrast the above tests of independence with the Consultation Paper's treatment of sponsors which are affiliated with audit firms. The Consultation Paper states that where the member of a sponsor group is the auditor or reporting accountant of the new listing applicant, the sponsor will not be independent.

The Consultation Paper claims: "This requirement mirrors practice set out in codes of ethics for accountants".

The Professional Ethics Statement 1.292 "Corporate finance advice" issued by the Hong Kong Society of Accountants ("HKSA") states as follows: "A firm should not promote an issue or sale to the public of shares or securities of a company on which it has reported or is to report. Neither should the firm undertake to accept nomination as auditor or reporting accountant of the company whose shares it is promoting to the public... It is not inappropriate however... for an auditor or reporting accountant to fulfil the responsibilities of a sponsor set out in Chapter 3 of the Listing Rules." The proposal in the Consultation Paper does not mirror the HKSA's ethics rules for accountants, it proposes the exact opposite. If this is an innocent (albeit outrageous) mistake/misrepresentation by the Exchange, one would only say that it strongly suggests that the Consultation Paper has not been researched and thought through properly.

An auditor must be independent of its audit client. This means really independent, not the watered down concept of independence proposed by the Exchange. An auditor cannot have a single share in its audit client nor can it have any board representation. Sponsor firms which are affiliated with an audit firm must also adhere to these strict independence rules and hence they will be truly independent, just as the audit firm will be. Moreover, such a firm when acting as sponsor cannot act as underwriter of the issue.

Underwriting is the biggest conflict of interest which the vast majority of sponsors face, but this conflict of interest is totally disregarded by the Consultation Paper. Why is this? Could it be perhaps that it is not in the commercial interests of the Exchange to tackle this conflict of interest? There are real and substantial conflicts of interest in acting as both sponsor and underwriter. For example, if the issue is not fully subscribed the sponsor which acts as underwriter may be contractually obliged to pay money (possibly a very substantial amount of money) out of its own resources to subscribe for the shares which were not taken up. This may act as a real financial incentive for such a sponsor when drafting the prospectus to present the issuer in an unduly favourable light to increase the prospects of a successful IPO and hence reduce the sponsor's underwriting risk. How can one possibly say such a sponsor is independent?

A sponsor which also acts as an underwriter also faces an inherent conflict of interest with its client in that the issuer wants the highest price for its shares, but the higher the price the greater the sponsor's underwriting risk. In difficult market conditions, the sponsor may well, in its role as underwriter, seek to renegotiate the pricing of the offering or postpone the offering. The issuer has little negotiating power as it is difficult to change sponsor. A listing applicant which changes sponsor has to refile its application for listing and restart the timetable. Given the Listing Rule requirement that the latest financial period reported on in the prospectus by the issuer's accountants must not have ended more than six months prior to the date of issue of the prospectus, restarting the listing timetable because of a change of sponsor may result in the accountants having to carry out another audit. This may involve even further delays and undoubtedly further expense for the issuer. A new sponsor will also have to carry out its own work on the issuer and its business and should not just adopt the work-product of the outgoing sponsor. The traditional arrangement of the sponsor also acting as lead underwriter has meant that companies applying for listing have been at the mercy of their sponsors as to the pricing/timing of the fund raising at a time when their negotiating power may be especially weak should they be relying upon the proceeds of the IPO for their business development. It would be naive in the extreme to think that such sponsors put the interests of the applicant for listing ahead of their own vested interests as an underwriter. There is a clear conflict of interest.

Contrast the fact that a sponsor affiliated with an audit firm will be truly independent with the Exchange's proposals which allow for dependency and conflict of interest for sponsors other than those affiliated with audit firms. A sponsor is supposed to be independent. Why does the fact that an affiliate firm acts in a truly independent capacity mean that the sponsor cannot be independent? Where is the analysis? The proposals are quite clearly unfairly discriminatory against firms such as ours and are unfairly in favour of large firms associated with banks and investment banks.

Secondly, the Exchange states that experience derived from NYSE and NASDAQ is accepted by GEM in assessing whether a person has the required work experience to be a principal supervisor or an assistant supervisor. From the Consultation Paper if appears that this practice will be adopted going forward under the proposed new regime. Whilst no doubt the large US investment banks will be happy, this is a serious cause for concern. Listings

on NYSE and NASDAQ are very, very, different from listings in Hong Kong. Typically, in the United States the lawyers draft the listing document, not the financial adviser. The Main Board and GEM Listing Rules in Hong Kong are quite different to the NYSE and NASDAQ rules. The listing process is markedly different. The content of a typical listing document in the US is also different from that in Hong Kong. How does the Exchange justify concluding that US work experience makes someone qualified to carry out sponsorship work in Hong Kong? In the absence of any analysis by the Exchange to justify its proposal, the proposal appears to be a concession to the large US investment banks.

Thirdly, it would appear from the Consultation Paper (although this is something else that the Exchange has not included in the questionnaire) that the Exchange proposes to modify the existing GEM requirements that the sponsor must have a minimum of two executive directors engaged in a full time capacity in the sponsor's corporate finance business in Hong Kong and instead only to require that the sponsorship activities be under the supervision of eligible supervisors. This appears to contradict the Exchange's stated emphasis on the importance of sponsors' standards. It is stated in paragraph 78 of the Consultation Paper that a number of waivers have been granted where it was the policy of the sponsor firm to appoint executive directors only at the head office level, which may not be located in Hong Kong. This proposed amendment again seriously raises the question whether the Exchange is giving favour to big international firms in this regard and whether this proposal was a concession requested by those big firms with which the Exchange has conducted preliminary consultation.

Under the SFO, all executive directors must be responsible officers and at least one responsible officer of a regulated activity must be an executive director. As defined in Part V of the SFO, an executive director means a director of the corporation who: (a) actively participates in; or (b) is responsible for directly supervising, the business of a regulated activity for which the corporation is licensed. It appears to us that under the SFO the sponsor firm must have at least one executive director in Hong Kong. We believe that it is a joke to expect persons located thousands of miles away actively and effectively to supervise the handling of listing applications by persons working in their organization's Hong Kong office. Let's be honest, the Exchange wishes to make it easy for the large international investment banks to do business in Hong Kong – no doubt the Exchange may have commercial reasons for taking such an approach. However, the approach taken in this regard is clearly not going to help ensure that high sponsorship standards are applied and maintained.

Background to the Consultation Paper

We note the claim by the Exchange in its justification of the proposals set out in the Consultation Paper that "[c]omments made in response to criticism support the view that an "expectation gap" concerning the responsibilities of sponsors exists between investors, regulators and some sponsors" (see page 4 of the Consultation Paper). As far as we are aware, we have never been the subject of any criticism (whether acting as sponsor or in any other professional capacity) and so we feel that we can comment on this matter with some

objectivity. Whilst we are concerned that not all sponsor (or FA and IFA) firms may carry out their work to the highest standards of professionalism and integrity, we believe that the Exchange's claim of an "expectation gap" warrants closer scrutiny.

Appendix 9 to the Listing Rules contains the Model Code for Sponsors. The following extract from the Exchange's Model Code for Sponsors needs to be read.

> "The purpose of the model code is to give guidance to sponsors on the Exchange's minimum expectations of the sponsor's role. The model code should be seen as setting guidelines rather than rigid rules to be followed in every detail. But failure by a sponsor to meet the Exchange's expectations without reasonable cause may render that person unacceptable to perform the role of sponsor in future."

The Model Code for Sponsors is very clear as to "the Exchange's minimum expectations of the sponsor's role". In those cases referred to by the Exchange where comments made in response to criticism supposedly support the Exchange's view that an "expectation gap" concerning the responsibilities of sponsors exists, did the Exchange commence disciplinary proceedings against the sponsors concerned for breaches of the Model Code for Sponsors? In how many cases has the Exchange used its power to render a person unacceptable to perform the role of sponsor because of a failure "to meet the Exchange's expectations" (as envisaged in the Model Code for Sponsors)? Whilst we are very much in favour of standards generally being raised, we consider that if the statistical evidence is that sponsors have been complying with the Exchange's Model Code for Sponsors (we invite the Exchange to provide the data) then the Exchange's claim of an "expectation gap" clearly does not hold up to scrutiny.

The Model Code for Sponsors clearly sets out for all to see (investors, regulators and all sponsors) the Exchange's "minimum expectations of the sponsor's role". This is very different from what the Exchange is now proposing in the Consultation Paper.

Interestingly, paragraph 5 of the Model Code for Sponsors states: "The sponsor should be closely involved in the preparation of the listing document and in ensuring that all material statements therein have been verified and that it complies with the Exchange Listing Rules and all relevant legislation". This clearly validates the use of the current verification procedures employed in the preparation of prospectuses. What the Exchange is proposing in the Consultation Paper is radically different. As a separate point of interest, the Model Code for Sponsors states that the "sponsor should be closely involved in the preparation of the listing document". We wonder how those large international sponsor firms which typically out-source the preparation of the listing document to their lawyers manage to comply with this requirement. Then again, as you know we have concerns about how level the playing field is. As for that "expectation gap", it has occurred to us that the real expectation gap might well be that the Exchange may not have expected to receive so much criticism itself about the quality (or lack thereof) of companies admitted to listing and this

Consultation Paper appears, to us at least, to be designed to close this particular "expectation gap".

It is a fact that the Exchange has come under criticism recently. For example, Justice Rogers made the argument that the regulatory function should be moved to an independent body. He cited conflict of interest and argued that it was the Exchange to blame for allowing "shonky" companies to list in Hong Kong and made the memorable comparison with "rabbits being put in charge of minding the lettuce". We make no comment on the criticisms themselves but believe the existence of such is relevant when considering the Consultation Paper. It is also a fact that the Exchange is actively trying to encourage more businesses from Mainland China to list in Hong Kong. This is natural enough to grow the Exchange's revenue base. However, there are well-founded concerns about accounting, legal and business ethics standards and practices in Mainland China. These concerns undoubtedly make businesses from Mainland China a higher risk for investors. The point is well-illustrated by recent scandals surrounding businesses from Mainland China. So, to summarize, on the one hand the Exchange is being criticized for allowing "shonky" businesses to list, on the other hand the Exchange is actively trying to attract companies to list on the Exchange which are from a high risk category of businesses. This is the background to the issue of the Consultation Paper by the Exchange. The Consultation Paper contains the Exchange's solution to this quandary; namely, shift the entire blame for anything and everything which may possibly go wrong to the sponsor regardless of who is really to blame. Whilst this analysis is an over-simplification of the Consultation Paper, we believe that it does go to the heart of the matter.

Summary

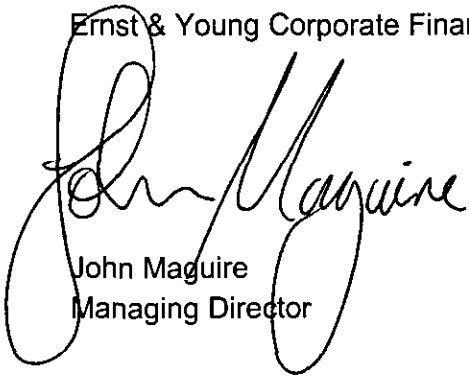
Given all of the above, we strongly recommend that the Exchange completely rethink its proposed approach taking into account the concerns raised above and in our detailed comments in response to the Consultation Paper. We urge the Exchange to issue a new consultation paper which addresses the concerns raised and which sets out the exact wording of any proposed new rules. Certainly, we do not believe that implementing the proposals as currently drafted would raise the standard of work carried out by sponsors and independent financial advisers, on the contrary, they may drive the more diligent firms out of these practice areas.

Finally, we note the Exchange's statement (page 2 of the Consultation Paper) that the Exchange may disclose to the public the whole or part of submissions received by it in response to the Consultation Paper. For our part, we would prefer that the Exchange discloses the whole of our submission to the public rather than selectively disclosing only parts thereof.

ERNST & YOUNG

If you have any questions on our comments or would like to discuss any aspect of them with us, please do not hesitate to contact John Maguire on 2849 9118 or Cecilia Ng on 2849 9148.

Yours faithfully,
For and on behalf of
Ernst & Young Corporate Finance Limited



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18 August 2003

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For the attention of Mr Richard Williams, Head of Listing

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Hong Kong

For the attention of Mr Ashley Alder, Executive Director

Dear Sirs,

Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers ("Consultation Paper")

I refer to our letter dated 31 July 2003 enclosing our response to the Consultation Paper and would like to correct an incorrect statement which was included in our response.

Paragraph 129 of the Consultation Paper states as follows:

> "With regard to work by experts or other professionals, the SFC Code of Conduct requires advisers to undertake reasonable checks to assess the relevant experience and expertise of the firm of experts or other professionals and to satisfy themselves that reliance could fairly be placed on their work. This includes satisfying themselves that the qualifications, bases and assumptions for the work of the expert or professional have been made with due care and objectivity, and on a reasonable basis. Such requirements are not applicable to: (i) a valuation report by a property valuer who is a member of a relevant regulatory or professional body; (ii) legal advice rendered by legal advisers; and (iii) an audit of results and accountants' reports by *accountants.*"

The wording of the Consultation Paper suggests that the requirements to assess the expertise of the professionals involved and to assess whether their work has been carried out to a certain standard are not applicable to property valuers, lawyers and accountants.

It is clear, however, from the SFC Code of Conduct that the carve out in respect of property valuers, lawyers and accountants only applies to the work carried out by such experts (and not to the experience and expertise of such expert). Accordingly, under the SFC Code of Conduct, a corporate finance adviser is required to assess the relevant experience and expertise of the firm of experts or other professionals even if such firm is a property valuer, lawyer or accountant.

We enclose our revised response to the Consultation Paper which incorporates our corrected response to paragraph 129 of the Consultation Paper. We apologise for any inconvenience.

If you have any questions on our comments or would like to discuss any aspect of them with us, please do not hesitate to contact John Maguire on 2849 9118 or Cecilia Ng on 2849 9148.

Yours faithfully,
For and on behalf of
Ernst & Young Corporate Finance Limited

John Maguire
Managing Director

ERNST & YOUNG
Ernst & Young Corporate Finance Limited

Response to the

Consultation Paper on The Regulation of Sponsors and Independent Financial Advisers

ANNEX 3

SUMMARY OF QUESTIONS

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*

Please state reason(s) for your view

- We agree that a list of acceptable sponsor firms should be maintained but we disagree with certain aspects of the proposal including the criteria for admission to the list.

- There is already a list of approved GEM sponsors. We believe that it is reasonable to extend the concept to Main Board sponsors. We believe that a single list should be maintained for both boards.

- During the transitional period, all GEM sponsors should be able to act as Main Board sponsors. It would be absurd if GEM sponsors (which have gone through an Exchange approval process every year) cannot act as Main Board sponsors. In the consultation paper issued by the Exchange in May 1998 regarding the establishment of the then proposed new market on emerging companies, i.e. GEM, the Exchange stated that faced with the increased risks (i.e. higher risk than Main Board) that are

associated with secondary market (i.e. GEM) companies, "the highest level of professionalism and integrity will be required of Sponsors". For this reason the Exchange introduced a pre-qualification scheme to regulate GEM sponsors. No such pre-qualification scheme is currently prescribed in the Main Board Listing Rules. We believe that being an approved GEM sponsor, and having satisfied the Exchange's detailed eligibility criteria which the Exchange has formulated to assure that GEM sponsors meet the high standards required of them (see the May 1998 Consultation Paper), should demonstrate that the sponsor firm has the competence to sponsor companies on the Main Board. Given the Exchange's perception of the relative risk profiles of Main Board and GEM companies, it would appear incongruous if the Exchange were to take the view that sponsors meeting the high standards required of GEM sponsors (with the higher risk profile of GEM new listing applicants) should not automatically be qualified to act as Main Board sponsors. See suggested criteria in replies to Q4 to Q7 below.

- Further, in exercising its powers, the Exchange needs to clearly set out how it will interpret the eligibility criteria (e.g. how "career break" will be interpreted and how long a career break may render an individual as ineligible to be approved as an eligible supervisor – see reply to Q5 below).

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*

Please state reason(s) for your view.

- We understand that the regulators wish to uphold the standards of IFAs. However, maintaining such a list is a duplication of the work and function

of the SFC in relation to licensing matters. As we understand it, a corporate finance firm cannot become or remain as a licensed corporation (licensed by the SFC) in the first place if the firm does not have a minimum of 2 responsible officers (at least one or both must be an executive director; even if the individual is not an executive director, he/she will have to be experienced enough to be a responsible officer) for a particular regulated activity (e.g. type 6 activity – advising on corporate finance). We understand that the regulators have only accepted IFA letters signed by investment advisers or dealers (the equivalent of responsible officers under the existing licensing regime) instead of investment representatives or dealer representatives (equivalent to licensed representatives who are not responsible officers under the existing regime). All licensed corporate finance firms should be allowed to perform IFA work except that in respect of certain firms/individuals, the SFC may impose a condition in the licence that it/he/she cannot advise on matters relating to the Takeovers Code in a sole capacity (whether in the capacity as a financial adviser ("FA") or an IFA).

- As stated above, the SFC already effectively maintains a list of advisers *who can advise on Takeovers Code related matters in a sole capacity* (and those who cannot advise on these matters in a sole capacity may act as co-advisers). It is understandable because Takeovers Code transactions are generally more complex and of wider implications whereas connected transactions may quite often be relatively simple e.g. leasing properties from/to a connected person based on market rental. The Exchange appears to agree that Takeovers Code transactions are more "significant" as it proposes to recognize takeovers as a category of significant transactions in this Consultation Paper whilst connected party transactions are not regarded as significant transactions (it appears that the Exchange proposes to include a connected transaction as a significant transaction only if the transaction constitutes both a connected AND major transaction). We understand that there may have been controversial connected party transactions and the Exchange wishes to uphold the standards of IFA letters but we disagree that maintaining a list of IFAs will solve the problem.

- If there is a single transaction which constitutes both a Takeovers Code transaction and connected transaction, then the listed company will have to check both lists to find an IFA who are on both lists. This is too complicated.

- It is not clear why the Exchange considers that an IFA for Listing Rules purposes (such as connected party transactions and material change to the nature of a GEM company's business which are not significant transactions) must demonstrate that it has completed at least three significant transactions (presumably as an FA or a sponsor) in the past 4 years. Although it is reasonable for the Exchange not to require IFA eligible supervisors to have done at least one IPO, it appears that a person who has done 3 IPOs in the past 4 years (and perhaps nothing else) will be qualified as an IFA eligible supervisor. The skill set that is required of an IFA may be different from that of a sponsor and may be narrower than that of an FA. The role of the IFA is to analyze and opine on the fairness and reasonableness of the terms of the transaction in question (from the independent shareholders' point of view) whilst sponsors and FAs, in addition to advising on the terms of the transactions, will have to advise clients on compliance matters.

- It seems bizarre that firms which are not on the sponsor list or the IFA list are considered eligible to act as FAs. Does it mean that the Exchange considers that less eligible persons can act as FAs?

- It is unclear how the Exchange expects that the proposed rules will raise the standards of IFAs.

- We are not aware of any similar requirement in other developed markets.

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*

Please state reason(s) for your view.

- Agree with (a) and (b)
- (a) is inevitable – any unlicensed persons giving corporate finance advice will be committing an offence anyway. (b) is understandable.
- Strongly disagree with (c)
- The Exchange has not given any rationale for the establishment of a blacklist. What is the purpose of such a list? Moreover, the Exchange has not set out the detailed criteria which it will apply in assessing whether an individual may be considered an unacceptable individual. If for certain reasons an individual is considered unacceptable to perform sponsor or IFA work, then theoretically speaking, it would appear that he/she may still be able to act as an FA. We do not understand the logic – why would an individual who has committed certain acts that have put him/her on the blacklist still be acceptable to act as an FA? If the answer from the Exchange is that he/she should not be fit and proper to act as an FA too, then we must say that the Exchange's proposal constitutes a complete duplication of the powers exercisable by the SFC (in respect of enforcement and licensing matters). This cries out for a cost benefit analysis. If the individual is considered unacceptable because he/she has breached certain rules and regulations, the SFC may likely have suspended or revoked his/her licence already and therefore he/she will not be permitted to act as an adviser (during the suspension period in case of suspensions). The Exchange admits in paragraph 59 of the Consultation Paper that there will inevitably be a degree of overlap between the SFC's licensing regime and the Exchange's sponsor and IFA regime and stated that suitable arrangements were being put in place. No details have been provided as to what these arrangements will entail. If the details have not yet been worked out, then undoubtedly it is premature to launch the consultation at this time and it would appear impossible for any cost benefit analysis to have been carried out.

- If one of the Exchange's criteria is that the individual has included wrong statements in public documents or produced public documents that were poorly written (which we think is too subjective), then the Exchange should stop vetting public documents because it might have been the Listing Division officers who may have requested inclusion of wrong or illogical statements in the documents (e.g. the Listing Division sometimes will not clear documents (and share trading may often not resume) if its comments are not taken up). Whilst we are prepared to engage the Listing Division in such circumstances, we know that certain other advisers may take the path of least resistance. It remains a mystery what the Exchange's criteria will be for putting people on such a blacklist.

- Furthermore, the Exchange has not set out in detail how an individual can remove his/her name from such a blacklist.

- We are not aware of any blacklist being published in other developed markets.

CRITERIA FOR INCLUSION ON THE LIST OF SPONSORS AND IFAS

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*

Please state reason(s) for your view.

- We agree that focus should be placed on the experience of the individuals within the firm instead of the corporation itself to remove the entry barrier for newly formed corporate finance firms (in particular those staffed with

personnel much more qualified than many existing firms in the market).

- Corporate finance firms which qualify as GEM sponsors under the current regime are already shouldering the administrative burden to renew the GEM approval to remain on the list of sponsors every year. The proposed regime of eligible supervisors will create pressure for firms to push through significant transactions in order to stay on the sponsor list (as opposed to the less onerous existing requirements on the two assistant supervisors under the GEM Listing Rules). We seriously wonder whether this is good for the market. See also reply to Q5 below.

- We disagree with the proposed requirement to have 4 "eligible supervisors". We propose that a sponsor firm should have at least 4 suitably qualified individuals but there should be a two-tier requirement similar to the existing GEM requirements (with suggested modifications).

- We do not understand the reasoning (if any) behind the Exchange's statement in paragraph 73 of the Consultation Paper that "creating two categories of eligible personnel may not best serve our needs". No explanation is given. We are of the view that a two-tier system similar to the existing GEM requirements (with each sponsor being required to have at least 2 principal supervisors and 2 assistant supervisors) works well. We also list out in the reply to Q5 below our suggestions on the modified experience requirements for principal and assistant supervisors.

- Under the proposals, a sponsor firm, having ceased to be on the sponsor list because it has not completed any IPO in the 4-year period, may never be able to get back on the list again unless it hires 4 new staff members who qualify as eligible supervisors (see analysis in reply to Q5 below). This is extremely harsh for those sponsor firms which may be very selective in accepting sponsorship appointments. Those firms who churn out IPOs may easily qualify but this does not indicate that the quality of work is high. Such a requirement would penalize the more prudent firms and may put them under pressure to accept a sponsorship appointment, which they would otherwise decline, just to stay on the list of sponsors.

- We strongly disagree with the IFA eligible supervisor requirement, the existing SFC licensing requirements suffice. We are not aware of any similar requirement in other developed markets.

- See our reply to Q2 for reasons behind our strong disagreement with the proposed IFA requirements.

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 proposals?

☐ *Yes*

☑ *No*

Please state reason(s) for your view.

- We strongly disagree with the proposed requirement for sponsor firms to have at least four eligible supervisors under a single tier approach. We believe that a better approach is that currently adopted in the GEM Listing Rules – namely to have at least two principal supervisors and two assistant supervisors and to have at least one principal supervisor and one assistant supervisor to be actively involved in a particular IPO. This reflects the fact that it is preferable for the person carrying out the day-to-day work (assistant supervisor) to have a minimum level of experience and for that person to be supervised by someone with a greater level of experience (principal supervisor).

  It appears that under the proposed rules, in theory, an IPO can be handled by only one person within the sponsor firm – an eligible supervisor having at least 4 years' relevant experience. Does that mean that the Exchange believes that quality will be better assured under the proposed rules which effectively allows for situations where an IPO can be handled by a person with 4 years' experience together with an assistant with perhaps 6 months' experience? We believe the existing two-tier system gives more confidence. If the Exchange then proposes that an IPO must be handled by at least two eligible supervisors, we disagree on the basis that it will increase the cost of maintaining a sponsor firm. We believe that an assistant supervisor with 3 years' corporate finance experience should be able to handle an IPO well under suitable supervision of the principal supervisor with perhaps 10 years' corporate finance experience. However, under the proposal such a person would not qualify as an eligible supervisor.

- Furthermore, maintaining 4 eligible supervisors may increase the running costs of a sponsor firm. Again, life is already hard for businesses in general under the current economic conditions. The Exchange's proposal may help the big firms eliminate smaller rivals. It really is a shame that no cost benefit analysis has been published.

- We agree that relevant overseas experience should be counted. We disagree that experience gained in listing companies on the NYSE or NASDAQ is relevant. The listing document is typically written by the lawyers in a US listing, not by the financial adviser. The listing process is different as are the relevant rules and legal framework. Moreover, the disclosure in a US prospectus is quite different from that in a Hong Kong prospectus. The Exchange should analyze the different roles played by financial advisers in US listing with sponsors in a Hong Kong listing and justify its position. This proposal appears to favour the large investment banks and does not reflect the work experience actually required to sponsor a Hong Kong listing.

- Under Rules 6.16 and 6.17 of the existing GEM Listing Rules, a principal/ assistant supervisor must have the required experience over the "5/3-year period prior to the date of declaration [application]". The Consultation Paper does not set out the detailed wording of the proposed rules. We assume that an eligible supervisor will need to possess the required experience over the "4-year period prior to the date of declaration [application]". Whilst it is fair to expect that the minimum number of years of corporate finance experience should be "continuous" experience (e.g. a year's break may seem to be long and an individual taking too long a break may not be able to keep abreast of developments in the securities industry), it would be unduly harsh to take the view that the experience is not continuous if the individual has taken short breaks between jobs (say one to three months to relax) and therefore a waiver is required (our concern is heightened by our understanding that certain key members of the new Listing Committee have expressly stated that the Listing Committee will not normally grant waivers these days). It is interesting to note that in the seminar on the Consultation Paper held by the Exchange and the SFC, the Exchange gave an unrealistic example of an ineligible individual having a career break of 5 years (surely no one would seriously try to claim that he/she can qualify as an eligible supervisor if he/she has 3 years' experience immediately prior to his/her application and then another one year of experience earned 10 years

ago!). In fact we have heard from market sources that the Exchange has in fact required waivers to be obtained for very short career breaks. To avoid unnecessary arguments or waivers, we believe that the Exchange should set out clearly the length of each career break allowed. Under the SFC licensing requirements, a licensed representative does not have to apply for a new licence again upon changing employers provided that he/she applies for transfer of his/her accreditation within 180 days after ceasing to be accredited to any principal (the licensed corporation). We suggest that the Exchange allows for a maximum of 180 days for EACH career break. If this is considered too long, perhaps a 90-day or 3-month period should be allowed for each career break (a person may have more than one career break) without the need to obtain a waiver. The Exchange must note and take into account that certain corporate financiers may be forced to leave a firm (not because he/she is no good but just because the relevant firm needs to cut costs) and it may well take time for them to find another job (which may not be easy under the current economic climate).

- The definition of "significant transaction" should also cover:
    - transactions involving a whitewash waiver application under the Takeovers Code,
    - share repurchase offers and off-market share repurchases under the Code on Share Repurchases,
    - an IPO which is approved in principle by the Listing Committee even though the IPO does not proceed,
    - listing by way of introduction,
    - privatization proposals (whether by way of scheme of arrangement or general offer),
    - schemes of arrangement and
    - all transactions involving a new listing application (such as reverse takeovers and listings of investment companies) and requiring the involvement of a sponsor.

- Whilst the UKLA counts "issue of securities involving the preparation of listing particulars" as a significant transaction, no explanation is given why the Exchange proposes to exclude listing of investment companies (involving a new listing application, the issue of a listing document and/or prospectus and fund raising activities). The Exchange's proposed definition of significant transaction appears to contradict the proposal

made by the Exchange in paragraph 113 of the Consultation Paper that "issuers should appoint sponsors in the case of any application for listing which requires the production of a listing document for registration and that the sponsor should be required to discharge responsibilities equivalent to those applicable in respect of an IPO prospectus". Whilst a sponsor is required to be appointed and to take significant responsibilities and commit significant resources in processing a transaction requiring the appointment of a sponsor (such as listing of investment companies which can be in the form of an IPO), it is unreasonable and unjustifiable that such a transaction is not regarded as a significant transaction. Processing a new listing application which is not an IPO (for example a new listing by way of introduction) is no less simple than processing an IPO. Certainly, they both elicit numerous questions from the Exchange. We see no basis for the Exchange's proposal not to recognize the listing of investment companies as a significant transaction. Nor does it seem logical for the Exchange not to recognize listing by way of introduction (involving a new listing application and the issue of a listing document but not involving any fund raising) as a significant transaction. The Exchange should rethink its proposed list of "significant transactions" and in any event should set out clearly its reasoning for any proposed list of "significant transactions" and should produce a comprehensive list to avoid unnecessary arguments in future.

- We suggest that (i) a principal supervisor must have a minimum of 5 years of relevant corporate finance experience and a substantive involvement in at least 3 significant transactions which have been completed over the 5-year period (one in HK, one must be an IPO, one completed within the past 2 years) and (ii) an assistant supervisor must have a minimum of 3 years of relevant corporate finance experience and a substantive involvement in at least 1 completed significant transaction (no IPO requirement – as in the existing GEM Listing Rules).

- In setting the requirement for the minimum number of completed significant transactions, the Exchange should realize that many transactions cannot be completed for a variety of reasons. Under the proposal, a firm devoting significant resources (say half of its IPO team) to working on a big IPO for say 9 months where the applicant eventually cannot be listed (even after all work has been done and the prospectus has been issued) because of a sudden market downturn will not be able to claim this as a significant transaction albeit that the staff of such firm will

have accumulated and demonstrated very valuable IPO experience during this transaction. The existing proposal may lead to a situation where a firm may have to compromise quality (e.g. each eligible supervisor handling a number of IPOs at one time each with the assistance of, say, a very junior staff member, bearing in mind the risks that an IPO cannot be completed for reasons not within the control of the sponsor), launch poor quality IPOs or push through other significant transactions just for the sake of keeping itself on the list. As such, we believe that the number of completed significant transactions should be set at a reasonable level. The real issue is quality not quantity. This needs to be recognized.

- Another pitfall of the proposal may be illustrated with the following example. A sponsor firm has 4 eligible supervisors. To ensure the quality of the work performed by the firm, 2 eligible supervisors (one with 4 years' experience and one with 10 years' experience) will be handling a significant transaction each time. After 4 years when it comes to the time for review of eligibility to remain on the sponsor list, the firm has not completed any IPO (the IPOs handled by the 4 eligible supervisors did not go ahead because of poor market conditions or problems uncovered during the due diligence process) but has completed many other significant transactions and the firm has enjoyed the reputation of having experienced personnel of high calibre. However, under the Exchange's proposal, the firm will then be taken off the sponsor list. The real issue is quality not quantity. This needs to be recognized. The Exchange also proposes in paragraph 113 of the Consultation Paper that "issuers should appoint sponsors in the case of any application for listing which requires the production of a listing document for registration and that the sponsor should be required to discharge responsibilities equivalent to those applicable in respect of an IPO prospectus". These transactions will include rights issues, open offers and placing of securities of a class new to listing (e.g. warrants) for which the appointment of a sponsor is currently not required. This will make things even worse because the firm, having been taken off the list, cannot even advise clients on rights issue, open offers or placing of warrants. Under the Exchange's proposal, unless the firm hires 4 new eligible supervisors, it can never be admitted to the sponsor list again by accumulating relevant experience because it can no longer sponsor IPOs or handle transactions involving the issue of listing document that requires registration. The firm may probably need to fire the old supervisors who are no longer eligible supervisors in order to

justify the cost of hiring 4 new supervisors. Those old supervisors may have difficulty getting a similar job again or have to lower their asking salaries and title in order to get a job. Not only will the firm have survival problems, the supervisors will have survival problems. This illustrates our belief that the ramifications of the proposal have not been thought through and will penalize the prudent, conservative firms which are selective in accepting sponsorship engagements and will reward cowboys who will sponsor companies regardless of their quality.

- The Exchange proposes (in paragraph 75 of the Consultation Paper) to recognize relevant corporate finance advisory experience derived from other channels, such as relevant corporate finance experience gained from the employment with an issuer listed on the Exchange, and proposes that the individual must demonstrate that he/she has played a substantive role in at least 3 significant transactions. However, the Exchange defines "substantive role" as "a role as member of the sponsor's 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".

  We wonder how this will apply to experience gained from other channels such as experience gained from employment with a listed issuer or with the regulators.

  Does it mean that there may be a scenario where an accountant employed by a listed issuer (which has been very active in corporate finance transactions over the past 4 years and which itself listed or carried out a spin-off within such 4-year period) who has assisted the listed issuer in executing such corporate finance transactions (although the company may have engaged a financial adviser or sponsor in respect of such transactions) may qualify as an eligible supervisor whilst a well-known and experienced corporate finance adviser who last completed an IPO, say, 5 years ago may not be so qualified? This approach will not raise standards. Again, given the cautious approach taken by the Listing Committee these days, one would not expect that too many waivers may be given regarding eligibility.

  Furthermore, the Exchange should also clarify whether vetting experience gained at the corporate finance department of the Listing Division of the Exchange will be considered as eligible experience, noting

that such experience only relates to interpretation of the rules (and application of unwritten practices) and does not relate to many other aspects of the work actually performed by the sponsor (in particular, actually giving advice (surely this is critical) and due diligence work). There have been incidents where, for the purpose of an annual review, the GEM Listing Division requested employment histories (and information on career break, if any) of all supervisors (who had not changed employment since the last review or application) again (even though information regarding their previous employments had already been provided at the time of first application by the supervisors whilst in employment with the firm). However, the GEM Listing Division did not raise any queries about the supervisor who used to work with the GEM Listing Division. It appears that the experience gained with the GEM Listing Division was considered by the GEM Listing Division to be suitable experience beyond doubt. No doubt it would be a disaster for the career prospects of many persons employed by the Listing Division if it were to be recognized that their work does not involve providing advice and does not automatically make them suitable to qualify as an assistant or principal supervisor. This whole area of the GEM Listing Division automatically "approving" their former colleagues is of particular concern because market practitioners often come across questions raised by the Listing Division which evidence that the person asking the question has little understanding of the rationale/application of particular Listing Rules, basic accounting concepts and/or legal concepts.

- The Exchange has not included in its questionnaire a question to seek the market's response to its proposal to modify the existing GEM requirements that the sponsor must have a minimum of two executive directors engaged in a full time capacity in the sponsor's corporate finance business in Hong Kong and to only require that the sponsorship activities must be under the supervision of eligible supervisors. Why is this not included in the questionnaire?

  Moreover, this proposal is inconsistent with the Exchange's emphasis on the importance of sponsor firms' standards. Paragraph 78 of the Consultation Paper states that a number of waivers have been granted where it was the policy of the sponsor firm to appoint executive directors only at the head office level, which may not be located in Hong Kong. The proposed amendment raises the question whether the Exchange is giving favour to big international firms in this regard and whether this is

something raised by big firms with which the Exchange has conducted preliminary consultation. Under the SFO, all executive directors must be responsible officers and at least one responsible officer of a regulated activity must be an executive director. As defined in Part V of the SFO, an executive director means a director of the corporation who: (a) actively participates in; or (b) is responsible for directly supervising, the business of a regulated activity for which the corporation is licensed. We believe that it is a joke to expect persons located thousands of miles away (and in a different time zone) actively and effectively to supervise the handling of listing applications by persons working in their organization's Hong Kong office. Let's be honest, the Exchange wishes to make it easy for the large international investment banks to do business in Hong Kong – no doubt the Exchange may have commercial reasons for taking such an approach. However, this is clearly not in going to help ensure that high sponsorship standards are applied and maintained. We are of the view that the Exchange should maintain the existing requirement that a sponsor must have at least two executive directors engaged in a full time capacity in the sponsor's corporate finance business in Hong Kong. However, we consider that it is not necessary for a principal supervisor to be an executive director of the sponsor firm.

- It is proposed in paragraph 75 of the Consultation Paper that 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". We are not sure why the Exchange singles out due diligence work as the test. We suggest that the Exchange should just follow the wording adopted in the existing GEM Listing Rules, i.e. making reference to "providing advice". We note that this is also the wording used in the UKLA rules. To be honest, to be a successful corporate finance adviser, one must be able to provide sound advice instead of just being able to perform due diligence work. That is why they are known as "advisers" instead of "due diligence reviewers".

- See reply to Q2 for the reasons behind our strong disagreement with the proposed IFA requirements.

- The Exchange should also ensure that Listing Division staff vetting IPOs (and all other transactions) and communicating with the advisers (those making or answering phone calls) should be of sufficient seniority and

experience to avoid further increasing the costs of the sponsors and financial advisers by having to deal with unnecessary/illogical comments or unreasonable requests from inexperienced Listing Division staff who sometimes, sadly, display a lack of understanding of basic commercial/accounting/legal concepts.

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*

Please state reason(s) for your view.

- We agree that there should be a clear set of criteria to ensure transparency.

- We agree that there should be a minimum capital requirement but disagree with the HK$10,000,000 requirement – we believe that the Exchange should adopt the SFC's licensing requirements (see reply to Q7 below).

- We disagree with the assessment by the Exchange of the matters set forth in paragraph 7 of Annex B – this is a duplication of the work of the SFC.

- In order for a firm to become a licensed corporation under the SFO, the firm is already subject to most of the above requirements including: (a) fulfilling the ongoing minimum capital and liquid capital requirement under the Financial Resources Rules, (b) maintaining a proper internal control and compliance function, (c) fulfilling the fit and proper criteria, and (d) keeping proper books and records (otherwise, it would not be possible to file monthly or half-yearly returns under the Financial Resources Rules and submit audited accounts within four months after the financial year end).

- All licensed corporations are subject to audit by the SFC. The Exchange must be clear how it is going to check all these matters to avoid wasting both the Exchange's and the sponsor's resources in respect of duplication of regulatory audits.

- It is inevitable that if one's SFC licence is suspended, one cannot give investment advice during the suspension period.

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*

Please state reason(s) for your view.

- Apart from those firms which do not hold clients' assets and which are not licensed to carry out the regulated activity of dealing in securities (minimum paid-up capital of HK$100,000 and no liquid capital requirement), the minimum paid-up capital of firms engaging in the regulated activities of dealing in securities and advising on corporate finance is HK$5,000,000 and the minimum liquid capital is HK$3,000,000 (or 5% of ranking liabilities if higher).

  There is no explanation provided by the Exchange in the Consultation Paper why it considers a HK$10,000,000 paid-up capital and net tangible asset requirement to be appropriate. The Exchange does state its view that the sponsor should have adequate resources to fulfil its role as a sponsor and the responsibility it accepts. However, this does not explain why HK$10,000,000 is considered appropriate. Furthermore, allowing the use of a corporate or bank guarantee instead of having the minimum paid-up capital is clearly inconsistent with the Exchange's reasoning that the sponsor should have adequate resources to fulfil its role as a sponsor.

  The Consultation Paper tries to justify the HK$10,000,000 figure by stating the fact that all GEM sponsors fulfil this requirement (paragraph 85 of the Consultation Paper). This is no justification at all. Of course the GEM sponsors fulfil this requirement; otherwise, they would not have been admitted to the list of GEM sponsors. This does not mean that this

requirement is appropriate. A sponsor may not need a paid-up capital and net tangible asset value of HK$10,000,000 to ensure that it has adequate resources to fulfil its role and to take up its responsibility as a sponsor.

- We suggest that the Exchange adopt the SFC minimum capital requirements – HK$5,000,000 paid-up capital and HK$3,000,000 liquid capital

- As most of the sponsor firms will have to comply with the HK$5,000,000 minimum paid-up capital requirement and the HK$3,000,000 (or 5% of ranking liabilities) minimum liquid capital requirement, we suggest that the Exchange should adopt this requirement as the benchmark. Liquid capital offers better protection. Furthermore, most of such firms have to file monthly FRR returns to the SFC. By adopting the same capital requirements, the SFC may promptly notify the Exchange of any shortfall (should the firm itself fail to notify the Exchange).

- We note from Annex 1 of the Consultation Paper that there is no such requirement in the UK.

7 (b) *Do you agree with our proposal for IFA firms?*

☑ *Yes*

☐ *No*

Please state reason(s) for your view.

Agree with this particular point but we think that there should not be any proposal regarding eligibility to act as an IFA at all.

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*

Please state reason(s) for your view.

- We agree that sponsor firms should give such an undertaking – we disagree with the wording of the proposed Code of Conduct for Sponsors and Independent Financial Advisers that such firms will be asked to undertake to comply with.

- We disagree that IFA firms should give such an undertaking. It seems illogical that firms carrying out IFA work on connected party transactions would have to give such an undertaking but firms carrying out IFA work on Takeovers Code related transactions or FA work in general would not be required to do so.

- We strongly disagree with the proposal that eligible supervisors should give personal undertakings. We note that the Exchange did not quote in Annex 1 of the Consultation Paper any similar requirement in any other developed markets. There is absolutely no justification for such an unreasonable proposal. The Exchange must recognize the fact that the working team members of a sponsor firm in respect of an IPO are not directors of the listing applicant. Furthermore, the root of most of the problems associated with corporate scandals has been the behaviour of the directors of the issuer not the behaviour of the sponsor or its staff.

- Whilst the Exchange may argue that it is the individuals' competence and behaviour that matters, the Exchange should examine thoroughly whether the eligible supervisors are realistically in a position to undertake all the matters which the Exchange proposes them to undertake. The eligible supervisors' undertaking will include an obligation that they use their best endeavours to ensure that the sponsor firm complies with its obligations under the Listing Rules and the proposed Code of Conduct for Sponsors and Independent Financial Advisers. The Exchange states in paragraph 73 of the Consultation Paper that the purpose of the experience requirement is to provide a minimum benchmark against which to assess whether an individual appears to have the knowledge and experience necessary to manage the application procedure for a listing application in a competent manner and advise his/her client on the application and interpretation of the Listing Rules. Whilst individuals may ensure that they themselves comply with the rules, eligible supervisors may not be executive directors of the sponsor firm or may not be senior enough to ensure that the sponsor firm complies with all the rules e.g. keeping the minimum capital requirement and maintaining proper books and records (they may not even have access to the accounts of the sponsor firm), maintaining an effective compliance function (they may not themselves be compliance officers), maintaining adequate resources (they may just be employees, not directors). It is interesting to note that whilst the Exchange proposes personal undertakings from eligible supervisors, it on the other hand proposes to relax the requirement that a sponsor must have at least two executive directors engaged in a full time capacity in the sponsor's corporate finance business in Hong Kong (see paragraph 78 of the Consultation Paper).

- If the Exchange insists on personal undertakings, we believe that the Exchange should also insist that all the Listing Division staff provide similar personal undertakings that they will fully comply with the Listing Rules and will ensure that the Listing Division as a whole will apply the Listing Rules in a transparent and consistent manner. With so many unwritten rules and practices currently adopted by the Listing Division and prima facie glaringly inconsistent applications (with no explanation) of the Listing Rules by the Listing Division, we hope the Exchange will appreciate that it is really hard for anybody to say for sure that he/she has complied with the Listing Rules. Most other advisory firms with which we have spoken agree with us that it is very difficult to provide authoritative

advice to clients on the Listing Rules these days because of the inconsistency of application and interpretation of the Listing Rules by the Listing Division. As a start to redress this issue, the Listing Division should publish ALL listing decisions of the Listing Division and the Listing Committee on a monthly basis.

- The Exchange proposes in paragraph 96 of the Consultation Paper that the sponsors should also undertake "to assist the Exchange with investigations... by producing documents and answering questions fully and truthfully". The Exchange should consider and address how the obligation to answer questions will be consistent with the duties of confidentiality which a financial adviser owes to its client.

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*

Please state reason(s) for your view.

- We see no need for Main Board companies (apart from H-share companies) to retain a continuing sponsor

- If the Exchange is worried that an issuer will have difficulty in complying with the Listing Rules, then, with respect, we believe that the Exchange should not approve the listing of such issuer in the first place. H-share companies are different in that the company and securities laws in Mainland China may not be as mature as in Hong Kong. GEM companies need a continuing sponsor because they are of a higher risk profile and the sponsor will have to monitor the implementation of the business plan as disclosed in the prospectus (there is no such business plan requirement for Main Board companies).

- The Exchange has stated in paragraph 105 of the Consultation Paper that "it is evident that in practice many directors of Main Board applicants have little experience of the requirements and application of the Listing Rules or of the responsibilities and obligations of directors of listed issuers". The Exchange must recognize that the root of the problem is the education of these directors and the competence of the senior management staff who have access to top level decisions and who advise the directors on compliance matters. The proposals to require Main Board applicants to appoint a continuing sponsor and to require Main Board issuers to appoint a sponsor in respect of a wider variety of transactions (as proposed in paragraph 113 of the Consultation Paper) will no doubt create more

business for the sponsor firms (and therefore higher costs for the applicants/issuers). We have serious concerns as to whether the overall benefits will outweigh the overall associated costs in applying such a requirement across the board. This is yet another proposal which cries out for a cost benefit analysis. If we were in the United Kingdom, we would have had one.

The role of a continuing sponsor is not as proactive as the Exchange may have thought. The continuing sponsor may not be able to provide any meaningful advice if it is not being approached for advice or has not been provided with adequate and relevant information. If a Main Board issuer entered into a connected transaction without knowing that this is a connected transaction and therefore did not inform or consult the continuing sponsor, the continuing sponsor may never know that the rules were breached.

Furthermore, we wonder if the Exchange has conducted any survey on the level of notifiable transactions conducted by and the instances of breaches of the Listing Rules by Main Board issuers during the period up to the end of the first full financial year after listing – the period of the proposed continuing sponsorship. Given that this proposal will result in additional costs, it is disappointing that no such analysis is set out in the Consultation Paper. Again, there should be a cost benefit analysis.

We are also concerned that, given the title of the Consultation Paper, listed companies may not appreciate that certain of the proposals are likely to result in them incurring additional costs. The Consultation Paper contains no analysis in this regard. It may be that listed companies will not take the (considerable) time necessary to evaluate the proposals because they may assume from the title of the Consultation Paper that the proposals do not affect them. A cost benefit analysis would have made it clear how listed companies are likely to be affected.

- We note that the Exchange proposes granting a waiver from strict compliance with the continuing sponsorship requirement if the Main Board applicant has at least two directors (the Exchange should clarify whether it means executive or non-executive directors, or both) with a "clean sheet" and more than 5 years' experience acting as directors of listed companies in Hong Kong AND a full-time compliance officer with a "clean sheet" and experience equivalent to an eligible supervisor. We

consider that this is too onerous to require both criteria to be satisfied for a waiver to be granted, bearing in mind the costs involved in recruiting two such directors as well as a compliance officer who needs to have experience equivalent to an eligible supervisor (note: it depends on what specific experience needs to be possessed by an eligible supervisor – see reply to Q5 above). If the Exchange is going to implement the Main Board continuing sponsorship requirement after the consultation exercise, we suggest that a waiver should be granted if the Main Board applicant has at least one executive director with more than 5 years' experience acting as a director of listed companies in Hong Kong OR a full-time compliance officer with at least 3 years' experience gained from prior employment with the Exchange or the SFC, a firm licensed to carry out the regulated activity of advising on corporate finance or the corporate finance department of a law firm OR a full-time company secretary (some company secretaries may not be full-time employees of an issuer) with a relevant professional qualification (company secretary, lawyer or accountant) and at least 5 years' post-qualification working experience and having passed the required industry examinations (to make sure they know the securities law and Listing Rules e.g. those required to be taken before the SFC grants licence to a person performing the regulated activity of advising on corporate finance).

The Exchange must realize that the key directors of certain successful companies may be individuals who have devoted all their focus and energy to the business itself and have not acted as directors of other companies (including listed companies). It is certainly important for directors to understand and comply with the Listing Rules. However, it is more important, from an investment point of view, that the directors know their business and create wealth for shareholders. All these directors need is someone within the company who knows the rules and can assist them in compliance matters.

- We disagree with the proposal in paragraph 110 of the Consultation Paper that the Exchange retain discretion to direct an issuer to appoint a sponsor firm to provide it with advice for any period it specifies. First, in what circumstances would the Exchange exercise such discretion other than in the event of a persistent or serious breach of the Listing Rules? Secondly, a financial adviser (as opposed to a sponsor) may perform this advisory work. It is also a matter of concern that the Exchange proposes retaining this discretion whilst it admits (in paragraph 113 of the

Consultation Paper) that it would be difficult to establish clear criteria which would allow consistent decision-making in exercising discretion to require appointment of a sponsor.

- The Exchange also proposes in paragraph 113 of the Consultation Paper that "issuers should appoint sponsors in the case of any application for listing which requires the production of a listing document for registration and that the sponsor should be required to discharge responsibilities equivalent to those applicable in respect of an IPO prospectus". Depending on the difficulty involved for a sponsor firm to remain on the list (which may be very difficult under the current proposal), this proposal will need careful thought in order not to jeopardize unfairly the survival of corporate finance firms and limit the choice of issuers (when choosing advisers). We consider that the Exchange should retain the existing rules requiring a new listing applicant (at the time of IPO or a deemed new listing) to appoint a sponsor (and that H-share companies and GEM companies should be required to appoint a continuing sponsor). A listed issuer effecting a rights issue or a placing of warrants is not a new applicant yet a listing document will be produced in such circumstances. We do not consider it necessary for a sponsor to be appointed in such circumstances. See replies to Q5 above and Q12 below for our reasoning. After reading all these proposals, it appears that the Exchange does not welcome any financial adviser to advise on Listing Rules matters unless the adviser is on the sponsor list (and/or the IFA list) because, upon implementation of these proposals, an adviser would not be permitted to work on the majority of Listing Rules transactions if it is not a sponsor.

- The Exchange also states in paragraph 113 of the Consultation Paper that the Listing Rules should contain requirements generally applicable to sponsor firms where a sponsor firm gives advice or guidance to an issuer in relation to interpretation or application of the Listing Rules. For example, the sponsor firm must provide such service with due care and skill. Under the SFC Code of Conduct, all corporate finance advisers "must act with due skill, care and diligence and observe proper standards of market conduct". Under the Code of Conduct for Persons Licensed by or Registered with the SFC, a licensed person (i) when conducting its business activities "should act with due skill, care and diligence, in the best interests of its client and the integrity of the market" and (ii) when providing advice to a client "should act diligently and carefully in providing the advice and ensure that its advice and recommendations are based on

thorough analysis and take into account available alternatives". All licensed corporate finance advisers must do this anyway. It appears odd that the Exchange wishes to single out the importance of the due care and skill of sponsors in advising on Listing Rules. Does it mean that the Exchange does not believe that FAs should exercise due care and skill when advising on Listing Rules? Of course not. What is the Exchange's justification for the proposed duplication of requirements? What would the results of a cost benefit analysis be?

- We note that the Exchange has stated in paragraph 98 of the Consultation Paper that it is not proposing to continue the concept of co-sponsorship. We are stunned that this major proposal is not the subject of any question in the questionnaire. We also note that the Exchange has stated in paragraph 64 of the Consultation Paper that it had "witnessed numerous instances where firms have acted as co-sponsors to new listing applicants in name only" and had "encountered instances where the lead sponsor was not able to provide information requested by the Exchange and had to ask the co-sponsor to provide the necessary information". We do not know the circumstances under which the Exchange has drawn such conclusions. If the Exchange formed this impression because the particular sponsor did not answer certain questions over the telephone immediately, it would be too harsh a criterion to apply in judging the sponsor. Care must be taken in providing answers to the regulators and preparing the prospectus and therefore it may take some time to double check certain issues before providing answers to the Exchange. Furthermore, as all sponsors to a particular listing applicant bear the same level of responsibility, they will have to discuss issues among themselves to make sure they can reach a unified view. Perhaps there exist sponsor firms which do not do their job to the standard which they should. However, it seems that the malpractice of these isolated sponsors may have resulted in the foregone conclusion of the Exchange that all co-sponsors and joint sponsors, who are not the primary sponsors, are not doing the job. All sponsors, be they co-sponsors or joint sponsors, take the same level of responsibility as the primary sponsor. As what we take to be yet another concession to the large investment banks the Exchange states in paragraph 98 of the Consultation Paper that for large IPOs it may be necessary for more than one sponsor to be engaged. The Exchange must recognize the fact that the joint sponsors in the large IPOs will not be doing exactly the same job – for example, only one of the them will be drafting the prospectus

(assuming that they have not delegated this task to their lawyers as is often the case on large IPOs sponsored by US investment banks) but all sponsors will have to review the prospectus. As the Exchange now focuses on the experience of the individuals instead of the firm, we agree that there is no need to maintain a co-sponsor list (for firms which do not qualify as sole or lead sponsor because of a lack of corporate history). However, we suggest maintaining the concepts of co-sponsors and joint sponsors (see reply to Q10 below).

- In respect of looking to the rules in the UK to justify the Exchange's proposals, we note that the Exchange has chosen only to look at the rules of the UKLA which maintains the Official List (which is the equivalent of Main Board). The Exchange presents a table in the Consultation Paper comparing the proposals with the UKLA rules and the existing Main Board and GEM rules and practices. We were astonished that the Exchange chose not to make any reference to the rules of the Alternative Investment Market ("AIM") (which is the equivalent of GEM) operated and regulated by the London Stock Exchange. In fact, we understand that the GEM Listing Rules were largely modeled after the AIM rules. Based on the AIM rules as of May 2003, an AIM company must retain a nominated adviser at all times. The term "nominated adviser" is the AIM equivalent of a GEM sponsor. If an AIM company ceases to have a nominated adviser, we understand that the London Stock Exchange will suspend trading in the company's securities. If within one month of that suspension the AIM company has failed to appoint a replacement nominated adviser the admission of the company's AIM securities will be cancelled. We must say that the comparison table in the Consultation Paper with the headings "Existing GEM Rules" and "UK Requirement" is misleading in that readers will be led to believe that whilst the "Existing GEM Rules" requires a continuing sponsor, there is "no mandatory continuing sponsorship requirement" under the "UK Requirement" (see page 85 of the Consultation Paper). As illustrated above, there is actually a very strict requirement for a continuing sponsor for companies listed on AIM; the UK equivalent of GEM. This really casts serious doubt as to whether the Exchange has diligently reviewed the relevant rules of those other developed markets from which its proposals are stated to draw upon. Certainly, the Consultation Paper fails to present readers with a comprehensive and complete comparison in Annex 1 of the Consultation Paper. We believe this is another example of the poor quality of work displayed in the Consultation Paper.

- We note that the Exchange's statement of the exact circumstances under which an IFA is currently required to be appointed under the Listing Rules may be inconsistent with the current requirements of the Listing Rules and would urge the Exchange to clarify the matter.

- The Exchange has stated in paragraph 99 of the Consultation Paper (and paragraph 30 of Annex B) that it will retain the requirement for an IFA to be appointed (a) in relation to connected party transactions that require any shareholders to abstain from voting and (b) transactions or arrangements that require controlling shareholders to abstain from voting.

  In respect of (b), the Exchange should perhaps not use the phrase "retain the requirement" because this has only been a practice and is not a requirement explicitly stated in the Listing Rules. We note that the Exchange proposes to codify this practice as mentioned in the Consultation Conclusions on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues issued in January 2003 (however, this is another consultation paper which does not contain the proposed detailed wording of the new rules); the Exchange has not issued the new rules so far.

  In respect of (a), the statement by the Exchange of the existing requirement appears to be inconsistent with the current interpretation of the Listing Rules (which has been adopted for a long time) and we wonder whether the Exchange is proposing to change the relevant rules in Chapter 14 of the Main Board Listing Rules and Chapter 20 of the GEM Listing Rules as well. Under the existing definitions of connected persons and connected transactions, there may exist connected transactions that require shareholders' approval but no shareholder will have to abstain from voting (e.g. when the connected person is not a shareholder of the issuer and no shareholder of the issuer has any interest in the transaction) – see Chapters 1 and 14 of the Main Board Listing Rules and Chapters 1 and 20 of the GEM Listing Rules. However, it is clearly stated in Rule 14.30(7) of the Main Board Listing Rules and Rule 20.16 of the GEM Listing Rules that an IFA opinion/letter is required if the connected transaction involves the issue of a circular (only required for transactions requiring shareholders' approval – see Rule 14.29(2) of the Main Board Listing Rules) or requires shareholders' approval. It appears from the wording in the Consultation Paper that if no shareholder is required to

abstain from voting in respect of the connected transaction, no IFA is required. We note that the Consultation Paper follows the wording in the Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues issued in January 2002 and the related Consultation Conclusions issued in January 2003. However, we do not understand why the Exchange would propose amending the existing rules to dispense with the IFA requirement for connected transactions in respect of which no shareholder is required to abstain from voting. If this is not what the Exchange intended to mean, we are concerned that the error shows that the Consultation Paper may have been hastily produced (coupled with the fact that no detailed wording of this and any other of the proposed rules are made available for public consultation). We are also concerned that the new Listing Rules, when drafted, may contain errors given the self-imposed deadline to implement the new rules by December 2003. There is a need to publish another consultation paper with detailed wording of all the proposed rules before the Exchange issues any new rules; otherwise, market practitioners, in particular corporate finance advisers who are most affected by the new rules, have no chance to comment on the detailed wording of the proposed rules (word by word) at all.

- We strongly disagree that an IFA must be a firm either on the list of acceptable Sponsors or list of acceptable IFAs (see reply to Q2 above).

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*

Please state reason(s) for your view.

- We suggest that the current rules and practice and Listing Committee ruling that co-sponsors or joint sponsors are allowed in certain circumstances be retained.
- The Exchange proposes that:

(a) A sponsor may hold up to 5% of the issued capital of the new listing applicant. Why should a sponsor be considered independent when it has a direct financial interest in the success of the listing as a shareholder? This proposal will facilitate firms whose affiliated direct investment arms have invested in the applicant to be sponsor. There is a clear and undeniable conflict of interest here.

(b) A sponsor may hold shares in the new listing applicant if the fair value of such shareholding does not exceed 15% of the consolidated net tangible assets of the sponsor group. If a sponsor has invested in the new listing applicant, how on earth can such a sponsor be said to be independent? It beggars belief that the Exchange can in good faith put such a proposal forward. One can only assume this proposal is to pander to those large firms which have affiliated direct investment operations.

(c) A sponsor (or a member of its group) is allowed board representation on the board of the new listing applicant provided it does not control the board or is not under the same control as it. Any director is able to influence the company of which he/she is a director. Moreover, all directors are under a fiduciary duty to act in the best interests of the company of which he/she is a director regardless of whether this is in the best interests of the entity (i.e. the sponsor group) which they represent. Clearly, there is a real inherent conflict of interest. The direct investment businesses of the large investment banks will often seek board representation (and will often push for an IPO as their exit strategy) – again the proposal appears to pander to such entities' vested interests.

(d) A sponsor is independent if less than 15% of the proceeds from the IPO go to settling debts due to a member of the sponsor group (presumably we are not talking about the sponsor's fees here). Again, another clear and real conflict of interest. Why does the Exchange consider that a sponsor is independent when the repayment of debts due to it may be dependent upon the success of the listing? No doubt the sponsor firms affiliated with banks will be pleased with the proposal.

(e) A sponsor is independent if the listing applicant's operations are

funded by the sponsor group; providing the funding provided does not constitute a significant portion of total funding. The Exchange states that is does "not propose to stipulate any threshold on the banking relationship between a sponsor and a new applicant". Whilst the Exchange is very specific in setting the thresholds for the other circumstances (e.g. 5% shareholding, 15% net tangible asset value, use of 15% of the proceeds – gross or net?), it is ambiguous when it comes to banking relationships. The Exchange actually proposed a specific percentage regarding banking facilities in the Chapter 3A Consultation Paper. Whilst the Exchange has stated in paragraph 115 of the Consultation Paper that it proposes to adopt an approach similar to the Chapter 3A Consultation Paper regarding independence, we do not know why the specific percentage is now replaced with the ambiguous phrase "significant portion". The only explanation given by the Exchange on "not... to stipulate any threshold on the banking relationship between a sponsor and a new listing applicant" is that "ultimately such depends on whether the facilities provided are significant to the new listing applicant". We find this explanation totally unconvincing. By the same token, why can the Exchange set a threshold for use of the net proceeds for debt repayment at 15%? Why is 15% considered significant – why not 20% or 25%? The perception is once again, quite frankly, that the Exchange may be pandering to those sponsors which are part of banking groups. Clearly there is a real conflict of interest if the sponsor group lends money to the new listing applicant.

- Either a firm is independent or it is not independent. The Exchange's proposals do not set a test for independence. In each of the above permitted categories there is either real dependence or a real conflict of interest. The above proposals merely set a limit for the amount of dependence and amount of conflict of interest which the Exchange proposes allowing those large firms which are affiliated with banks or direct investment operations to have and still be able to act as sponsor. If this is the case, let's be honest about it and not try to pretend that the Exchange insists that these sponsors which are part of banks or large investment banks must be independent.

- Moreover, contrast the above tests of independence with the Consultation Paper's treatment of sponsors which are affiliated with audit firms. The Consultation Paper states that where the member of a sponsor group is

the auditor or reporting accountant of the new listing applicant, the sponsor will not be independent.

The Consultation Paper states: "This requirement mirrors practice set out in codes of ethics for accountants". This statement is outrageous.

The Professional Ethics Statement 1.292 "Corporate finance advice" issued by the Hong Kong Society of Accountants states as follows: "A firm should not promote an issue or sale to the public of shares or securities of a company on which it has reported or is to report. Neither should the firm undertake to accept nomination as auditor or reporting accountant of the company whose shares it is promoting to the public... It is not inappropriate however... for an auditor or reporting accountant to fulfil the responsibilities of a sponsor set out in Chapter 3 of the Listing Rules." The proposal in the Consultation Paper does not mirror the ethics rules for accountants it proposes the exact opposite. If this is an innocent mistake/misrepresentation by the Exchange, one would only say that it strongly suggests that the Consultation Paper has not been researched and thought through properly.

An auditor must be independent of its audit client. This means really independent, not the watered down concept of independence proposed by the Exchange. An auditor cannot have a single share in its audit client nor can it have any board representation. A sponsor firm which is affiliated with the audit firm must adhere to the same stringent independence tests as the audit firm and hence such a sponsor will be truly independent as well. Such a firm when acting as sponsor cannot act as underwriter of the issue.

- Underwriting is the biggest conflict of interest which most sponsors face but it is totally disregarded by the Consultation Paper. Why is this? There are real and substantial conflicts of interest in acting as both sponsor and underwriter. For example, if the issue is not fully subscribed the sponsor who acts as underwriter may have to pay money out of its own resources to subscribe for the shares which were not taken up. This may act as a real financial incentive for such a sponsor when drafting the prospectus to present the issuer in an unduly favourable light to increase the prospects of a successful IPO and hence reduce the sponsor's underwriting risk. How can one say such a sponsor is independent?

A sponsor which also acts as an underwriter faces an inherent conflict of interest with its client in that the issuer wants the highest price for its shares, but the higher the price the greater the sponsor's underwriting risk. In difficult market conditions, the sponsor may well, in its role as underwriter, seek to renegotiate the pricing of the offering or postpone the offering. The issuer has little negotiating power as it is difficult to change sponsor. An applicant which changes sponsor has to refile its application for listing and restart the timetable. Given the Listing Rule requirement that the latest financial period reported on in the prospectus by the issuer's accountants must not have ended more than six months prior to the date of issue of the prospectus, restarting the listing timetable because of a change of sponsor may result in the accountants having to carry out another audit. This may involve even further delays and undoubtedly further expense for the issuer. A new sponsor will also have to carry out its own work on the issuer and its business and should not just adopt the work-product of the outgoing sponsor. The traditional arrangement of the sponsor also acting as lead underwriter has meant that companies applying for listing have been at the mercy of their sponsors as to the pricing/timing of the fund raising at a time when their negotiating power may be especially weak should they be relying upon the proceeds of the IPO for their business development. It would be naive in the extreme to think that such sponsors put the interests of the applicant for listing ahead of their own vested interests as an underwriter.

Contrast the fact that a sponsor affiliated with an audit firm will be truly independent with the Exchange's proposals which allow for dependency and conflict of interest. A sponsor is supposed to be independent. Why does the fact that an affiliate firm acts in a truly independent capacity mean that the sponsor cannot be independent? Where is the analysis? In our view, the proposals are quite clearly discriminatory against firms such as ours and are unfairly in favour of large firms associated with banks and investment banks.

- Regarding the declaration of sponsor's independence, the Exchange proposes in paragraph 121 of the Consultation Paper that the sponsor is required to submit such declaration "at the beginning of any assignment which requires the appointment of a sponsor". By requiring a declaration, we presume the Exchange may not accept a declaration without mentioning the name of the listed issuer (as opposed to a consultation on a no-name basis). Whilst we agree that a sponsor (or, in fact, any FA)

must assess any conflict of interest and make sure that it can act in its proposed capacity in a particular assignment, it may not be practicable and appropriate to make such a declaration "at the beginning of the assignment". For an IPO, the assignment may begin say 6 months before the expected submission of the relevant listing application. What if the listing application is not submitted eventually? For other price sensitive assignments e.g. a proposed change in control involving a redomicile (and therefore a listing application), it may be inappropriate for the sponsor to make a declaration at such an early stage of the assignment when the structure is being formulated and when knowledge of the assignment is being kept within a very limited number of parties involved. We suggest that the Exchange require the sponsor to submit such declaration at the time of first notification of the transaction to the Exchange (i.e. at the time of submitting the listing application for an IPO or at the time of submitting the draft announcement of the relevant transaction), or if the appointment is to be made after such notification, at the time of such appointment. The Exchange should encourage prior written consultation by the sponsor on a no-name basis in cases of doubt (note: verbal consultation appears to be valueless because we understand that it may prove to be unreliable in certain cases even if the sponsor has sought to consult a very senior person at the Listing Division).

- We agree to codify the requirement regarding the independence of IFAs.

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*

Please state reason(s) for your view.

- We agree that it is important that sponsors perform proper due diligence on listing applicants and we support the concept of setting out guidelines to ensure a level playing field.

- However, we strongly disagree that, in light of the conduct of certain "bad boys" in the industry, all sponsors should be made to shoulder additional responsibilities that are unreasonable and unrealistic, in particular making a public positive affirmation of the truthfulness and completeness of the

"non-expert sections" (basically everything apart from the expert sections) and making a public double-negative affirmation of the truthfulness and completeness of the "expert sections". Whilst a sponsor should carry out proper due diligence on the listing applicant and also review and discuss the expert reports with the experts, it is totally unrealistic and unworkable to require the sponsor to make such blanket declarations in the prospectus. Due diligence (for which a guideline is now proposed) and proper internal documentation thereof is a defence put forward by the advisers in the event of prosecution, litigation or disciplinary proceedings. Whilst the Exchange is now anxious to deflect criticism and educate the public that the Exchange should not be blamed for corporate failures, the Exchange should not impose rules on intermediaries to give the false impression to the public that any corporate failure is all the intermediary's fault by requiring sponsors to make such declarations in prospectuses. The directors of the listing applicant take the ultimate responsibility which cannot be shifted to any professional party – it is their own company and business.

- We note that the Exchange has stated in paragraph 156 of the Consultation Paper that "sponsors... 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 subject to the modification noted below". What is the form of the private statement that is being referred to? Appendix 7J of the GEM Listing Rules? Since the Exchange has not set out the exact wording of the proposed rules, we are unable to consider and comment upon the exact wording of the declaration. The wording in paragraph 156 of the Consultation Paper (extracted in the introductory paragraphs preceding Q13 below) is different from the wording in paragraph 146 of the Consultation Paper (extracted in the first introductory paragraph of this question above); and yet both differ from the wording of the proposed Code of Conduct for Sponsors and Independent Financial Advisers (see paragraphs 24 and 25 of Annex B). We would like to reiterate that there is a need to publish another consultation paper with detailed wording of all the proposed rules before the Exchange issues the new rules; otherwise, market practitioners, in particular sponsors who are most affected by the new rules, have no chance to comment on the detailed wording of the proposed rules (word by word) at all. We fail to understand why the Exchange chose not to adopt an open and transparent approach to the consultation process. This hardly sets a good corporate governance

example to the market.

- According to paragraph 145 of the Consultation Paper, non-expert sections include unaudited financial information (i.e. all financial information other than the accountants' report on which the reporting accountants express an audit opinion). Unaudited financial information includes historical factual statements (such as turnover by product, turnover by geographical breakdown, net tangible asset statement, indebtedness statement, liquidity and financial resources statements) and forward looking statements (such as working capital statements and profit forecasts). The reporting accountants' engagement normally only covers issue of an accountants' report, a stub-period audit (if any), a review of working capital forecast and a review of profit forecast (if any), being those specifically stated in the Listing Rules as required from the reporting accountants. Such engagement normally also covers a review of the indebtedness statement (as the listing applicant or the sponsor will not normally send bank confirmations themselves) and the net tangible asset statement. For anything other than an audit, no professional accountants will give any opinion. In order for the sponsor to make the declaration (that it has performed reasonable investigation and that it believes the information is not materially false or misleading) which is close to giving an opinion, does it mean that the sponsor has to carry out audit work on all the unaudited financial information? For example, sending its own bank confirmations? The reporting accountants will not opine on the indebtedness statement but will only issue a comfort letter after they have performed the agreed upon procedures. The reporting accountants normally set out in such a comfort letter the procedures they have performed (including reviewing the accounting records and obtaining independent confirmations) and state that "these procedures, however, do not constitute an audit and cannot necessarily be expected to reveal all significant matters concerning the issuer's indebtedness" and that they "have relied upon the representations of the issuer's directors regarding the completeness of the relevant information in the statement of indebtedness". The Consultation Paper seems to suggest that the sponsor will have to carry out more detailed procedures in order to make the declaration. Furthermore, nobody can confirm the truthfulness of forward looking statements (as opposed to factual statements) and directors' opinions. Whilst the sponsor will perform the necessary due diligence on the profit forecast and publish a comfort letter thereon in the prospectus, it cannot confirm that the statement is "true" (an auditor will

only give a "true and fair view" on historical financial statements audited by it). It would be ridiculous to suggest that anyone can possibly confirm that a forward looking statement is "true". Non-expert sections also include industry information, e.g. quoting certain industry reports, market research reports and so forth. It is unfair to require the sponsor to openly declare the truthfulness and completeness of such information. Furthermore, nobody is in a position to declare the truthfulness and completeness of another person's opinion e.g. the directors' opinion. Any suggestion to the contrary would plainly be ludicrous.

- The sponsor should not be required to make a declaration of the truthfulness and completeness of the non-expert sections in the prospectus. This is the responsibility of the directors of the listing applicant. We do not suggest that the sponsor should escape responsibility if it has not performed proper due diligence. However, the proposals are pushing things way beyond the limit. If a sponsor is willing to give this blanket public declaration about the truthfulness and completeness of the prospectus, we think the regulators should be worried rather than happy about the work done by and competence of the sponsor because the sponsor surely does not know what it is declaring.

- According to paragraph 145 of the Consultation Paper, "expertised" sections are those sections of a disclosure document prepared by a third party expert or professional. According to paragraph 146 of the Consultation Paper, the Exchange proposes that any part of a prospectus purporting to be made on the authority of an expert or purporting to be a copy of or an extract from a report, opinion or statement of an expert, shall be called the "expert sections" and all other parts of the prospectus are the "non-expert sections". We would therefore expect (and would appreciate the Exchange to clarify) that expert sections should include accountants' report, valuation report, any legal opinions quoted in the prospectus, summary of laws of relevant jurisdictions in which the applicant is incorporated and operates (to be covered by legal advice/opinion), statements relating to legal issues (Hong Kong laws and also the laws of the jurisdictions in which the share offer may be made) and information extracted from the accountants' report and valuation report etc. The Exchange should note that in most of the prospectuses, not all professional parties are named as an expert in the statutory and general information section. In particular, lawyers as to Hong Kong law are normally not named as experts in this section of the prospectus. If the

Exchange requires the sponsors to make the proposed public declaration in respect of the non-expert sections, then we believe the sponsors will seek to ensure that other professional parties do take the necessary responsibilities in respect of their work by requiring the issue of more legal opinions and expert advice. This is only reasonable because most of the other professional advisers (apart from the lawyer to the sponsor and underwriters) owe their duties to the applicant instead of the sponsor. The increase in number of legal opinions and expert advices will undoubtedly increase the applicant's cost. Why has the Exchange not set out a cost benefit analysis in the Consultation Paper?

- It is unrealistic to expect sponsors to be able to carry out investigations to satisfy themselves that there are no reasonable grounds for believing that expert sections are untrue or omit to state a material fact required to be stated to avoid the statement being misleading. For example, how can the sponsor be expected to investigate the financial information stated in the accountants' report? Should they engage another audit firm to review the work carried out by the reporting accountants? Or how about a PRC legal opinion given in respect of a valuation of property situated in the PRC? Should the sponsor engage another PRC law firm to review the work done by the PRC lawyer giving the opinion? Clearly the sponsor itself cannot be expected to have the expert knowledge and expertise itself to review the work of an expert in a specialized field. The experts should take responsibility for their own work. Whilst accountants rely on property valuation reports (when auditing the value of valued properties) and property valuers rely on PRC legal opinions (when valuing PRC properties) in producing their own opinion, they do not make any such *declaration on other experts' statements*. Whilst it would no doubt be convenient to be able to blame only one party (i.e. the sponsor) for any failings in the listing document, this would be unfair and unrealistic. It appears that if the proposals are implemented, there is a possibility that the sponsor may be the only professional party who may be prosecuted (criminal liability), say, if the profit record has been faked. If, despite our strong objections, the Exchange eventually requires sponsors to make a declaration on expert sections, we consider that the Listing Rules should specifically state that (a) all expert opinions/advice should also be addressed to the sponsor (at present, they are normally only addressed to the applicant) and (b) all experts should confirm to the sponsor that they have reviewed all the relevant information contained in all the prospectus drafts provided to them and that after reasonable investigation they have

no grounds to believe that (i) the facts provided by the directors of the applicant are materially false or misleading; (ii) there are other matters which may affect their opinion; (iii) all opinions expressed and estimates made by the directors of the applicant have not been arrived at after due and careful consideration on their part and are not founded on bases and assumptions that are fair and reasonable. Obtaining such should be a defence to the sponsor and the sponsor should be afforded the remedy of seeking compensation from the experts. If the Exchange does not currently propose imposing any rules to clarify the responsibilities of other professional parties in a listing exercise (as mentioned earlier, who normally do not owe a duty to the sponsor), we cannot see any justification for attempting to hold the sponsor responsible for the expert sections.

- We are not aware of any requirement in other developed markets that the sponsor has to take responsibility of the work of other experts. We believe that this is because such a suggestion is so unreasonable.

- We agree that the scope of the sponsor's work on both non-expert sections and expert sections should be set out in the Code of Conduct for Sponsors and Independent Financial Advisers (subject to the suggested modification of the exact wording and scope as set out in reply to Q12 below). We suggest that the sponsor should lodge with the Exchange a private declaration regarding the non-expert sections of the listing document in the following wording: "we confirm, as at [the date of the listing document], that after reasonable investigation we have no grounds to believe that (a) the facts contained in the non-expert sections (i.e. sections other than... [making specific references to expert sections]) of the listing document are false or misleading in any material respect; (b) there are other matters the omission of which would make any statement in the non-expert sections of the listing document misleading; (c) all opinions expressed and representations and estimates made by the directors of the applicant in the listing document have been arrived at otherwise than after due and careful consideration on their part and are founded on bases and assumptions that are unfair and unreasonable". However, the Exchange must realize that the sponsor will have to rely on representations made by the directors of the applicant in relation to certain matters. Whilst we agree that the sponsor should review the work of the experts, we strongly disagree with the proposal for the sponsor to make any form of declaration regarding the expert sections.

- As far as IFAs are concerned, we do not consider that it is necessary or appropriate for the Exchange to introduce any rules (such as the eligibility, due diligence, undertaking and declaration requirements and a code of conduct) other than codifying the circumstances under which an IFA will be required and will be considered to be independent. The proposed due diligence requirements are unnecessary given that all corporate finance advisers are already required to comply with the SFC Code of Conduct.

- The wording of the proposed rule on IFAs is fundamentally flawed. The Exchange proposes that IFAs have "to take 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" – see paragraph 147 of the Consultation Paper and paragraph 30 of Annex B. The job of the IFA is to opine on "whether or not" the terms of the transactions are fair and reasonable. The IFA could not have been independent if it is capable of ensuring "that the terms of the transaction are fair and reasonable", implying that it has actively participated in negotiating/structuring or advising the listed issuer on the terms of the transaction. The Exchange must make sure that the wording in the proposed Code of Conduct for Sponsors and Independent Financial Advisers (paragraph 30 of Annex B) is amended in this respect. This is a sloppy error which strongly suggests that the Consultation Paper has been hastily produced. We agree that an IFA is required to take reasonable steps to satisfy itself whether or not the transaction is fair and reasonable.

- Under the SFC Code of Conduct, all licensed corporate finance advisers should:

  (a) undertake reasonable checks to assess the relevant experience and expertise of the firm of experts or other professionals and to satisfy themselves that reliance may fairly be placed on their work; and

  (b) satisfy themselves that the qualifications, bases and assumptions for the work of the expert or professional have been made with due care and objectivity, and on a reasonable basis.

  It is explicitly stated that the requirements in (b) are not applicable to: (i) a valuation report by a property valuer who is a member of a relevant

regulatory or professional body; (ii) legal advice rendered by legal advisers; and (iii) an audit of results and accountants' reports by accountants.

We wonder why the proposed Code of Conduct for Sponsors and Independent Financial Advisers seeks to extend the scope of the SFC Code of Conduct (to include assessment of the work of all experts) and seemingly to require an explicit statement effectively to endorse all expert statements.

- It is unreasonable to require the IFA to state "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" (see paragraph 147 of the Consultation Paper and paragraph 30 of Annex B). First, the IFA is not an expert in those particular fields. If this statement is required, it should be the relevant expert who should confirm this matter – it is the expert's own report! Secondly, expert advice and opinion cannot be "true". Is this not self-evident? The Exchange should fine tune the wording in the proposed Code of Conduct for Sponsors and Independent Financial Advisers (if such a code of conduct for IFAs is eventually published). We suggest that the SFC Code of Conduct should be followed and the IFA should not be required to assess the reasonableness of property valuation reports, legal opinions/advice and audited financial reports. We do not object to requiring a sponsor/FA to review these expert advice/opinions to see if the opinions may contradict information possessed by the sponsor (as long as no declaration is required) but an IFA's access to the issuer's information is usually more restricted than that of a sponsor/FA (which will have been involved in the structuring and negotiation of the transaction prior to the involvement of the IFA) and it is unfair to require the IFA to review these expert advice/opinions (whilst the issuer's FA is not required to do so). Having said that, we do not object to the requirement that an IFA will have to take reasonable steps to assess the reasonableness of expert reports such as business valuation reports. This is implicit under the SFC Code of Conduct already. There is no need for the Exchange to repeat this.

- Whilst the IFA must perform certain due diligence to reach a conclusion whether or not the terms of the transaction are fair and reasonable, we wonder what sort of due diligence and declaration is, in the opinion of the Exchange, required of an IFA. We note that the Exchange has

commented in paragraph 136 that "IFAs are often too willing to accept at face value information provided by issuer's management or advisers retained by the issuer's management". Whilst the Exchange has sought to set out the proposed scope of work expected of an IFA in paragraph 30 of Annex B, the Exchange has not proposed in the Consultation Paper any detailed wording for the due diligence declaration to be made in the IFA letter. The Exchange should set out the proposed details to avoid the otherwise inevitable different interpretations by different Listing Division staff. We agree that the IFA should set out in its advice letter details of the work performed by it in reaching its conclusion (which is being done anyway); however, it should not be in the form of a declaration and we have reservation regarding certain due diligence work proposed by the Exchange in the Code of Conduct for Sponsors and Independent Financial Advisers (see reply to Q12 below).

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*

Please state reason(s) for your view.

- We agree that there should be a Code of Conduct for Sponsors to make sure there is a level playing field and to avoid cowboy sponsors contaminating the market. However, certain provisions in the proposed Code of Conduct for Sponsors seeks to impose totally inappropriate and unrealistic obligations on sponsors (see comments below).

- We disagree that the Code of Conduct should apply specifically to the individuals working in the sponsor firm including directors, eligible supervisors and other staff members (and eligible supervisors should not be required to give personal undertakings to confirm, inter alia,

compliance with this proposed code – see reply to Q8). Are there similar requirements in other developed markets? All professional staff of the sponsor firm are licensed representatives who need to observe the SFO and the codes and guidelines issued by the SFC. The sponsor itself should make sure that all its staff members working on the relevant assignments should duly observe the proposed Code of Conduct for Sponsors.

- We disagree that there should be a Code of Conduct for Independent Financial Advisers. All corporate finance advisers are required to comply with the SFC Code of Conduct. The proposed code for IFAs is an unnecessary duplication of, and an illogical extension of, the SFC Code of Conduct. Does that mean that FAs and those IFAs who do not qualify to advise on Listing Rules transactions (based on the Exchange's proposed eligibility rules) but, say, do qualify to advise on Takeovers Code related matters do not have to apply the standards required of those IFAs who qualify to advise on Listing Rules matters (as set out in the proposed code of conduct)? If the Exchange eventually adopts such a code of conduct, we would suggest that the Exchange makes the following amendments to the proposed code of conduct applicable to IFAs.

- Certain provisions in the proposed Code of Conduct for Sponsors and Independent Financial Advisers seek to impose totally inappropriate and unrealistic obligations on sponsors and IFAs. For example (the list is not exhaustive):

    - *(paragraph 11 of Annex 2)* It is proposed that "a sponsor must... take overall responsibility for the preparation of listing documents and any other documents..., and must ensure that the documents are in compliance with the Listing Rules and all relevant legislation". Why should sponsors take responsibility for documents such as legal opinions and other documents produced by other experts? How can sponsors, who are not lawyers and who need to rely on legal opinions, confirm that all relevant legislation has been complied with? Sponsors should only take responsibility for preparation of those parts of the listing document other than the expert sections. The same applies to the "other documents" referred to in the proposal. Sponsors are not qualified to give legal advice and can only rely on relevant legal advice regarding compliance with all relevant legislation. See also reply to Q11

above.

- *(paragraph 20 of Annex 2)* It is proposed that sponsors "must satisfy themselves that the free public float at the time of the issuer's admission is genuine, represents bona fide shareholders independent of controlling shareholders and complies with the requirements of the Listing Rules". Whilst it is always the responsibility of the sponsor to ensure all Listing Rules are complied with, including the initial public float requirement, the references as to "genuine" and "bona fide shareholders independent of controlling shareholders" should be removed. It is further proposed that "the sponsor may not simply rely on assurances given by the directors of the issuer and must make arrangements to ensure that all of the public shareholders are genuinely unconnected to, and not financially supported by, any connected person". The sponsors normally rely on confirmations given by the allottees of the shares and by the connected persons. The sponsors also normally review the relevant allotment lists to see if there are any suspicious allottees. Further work will be performed if there is suspicion. The sponsor therefore does not simply rely on assurances given by the directors – it also relies on confirmations from the allottees and the placing agents. Apart from the above, we do not understand what sort of arrangements the Exchange expects can realistically be performed which will ensure the "genuineness" of the public float. However, if the Exchange considers that the sponsor should not just perform the above-mentioned work under normal circumstances, we would like the Exchange to step into the shoes of the sponsors and set out clearly what should be done (and how long it will take to carry out all the relevant procedures) to ensure that every single public shareholder is genuinely unconnected to, and not financially supported by any connected person. Does the sponsor need to trace the money flows in respect of each subscriber and investigate the bank statements of each subscriber and each connected person (assuming the necessary legislation were to be passed to permit the sponsor access to such bank records)? Is this really what the Exchange thinks is realistic? If the regulators have reason to believe that in certain IPOs the initial public shareholders were not genuine public shareholders, the Exchange (and/or the SFC) should take action against those involved. Now

the "good boys" seem to be shouldering heavier responsibilities because of the acts of the "bad boys". Furthermore, the Exchange should make it clear in the Listing Rules that all placing agents and underwriters must supply the sponsor with their placees lists. No doubt the Exchange is aware that often certain underwriters are only willing to submit their own placees list to the Exchange without copying it to the sponsor or lead underwriter; they say that this is to ensure that their clients will not be lured away by other underwriters (i.e., competitors).

- *(paragraph 22 of Annex B)* Sponsors must review the "general business acumen" of the directors and senior management and their "responsible business conduct and practices", whatever that means. How realistic is this to do? What procedures should a sponsor carry out in conducting such a review? Is not the management's business acumen illustrated best by the historic financial performance of the company? What does "responsible business conduct and practices" mean? Some might say that a cosmetics company which tests its products on animals is not engaging in "responsible business practices". This proposal is so vague as to be meaningless.

- *(paragraph 25(e) of Annex 2)* It is the expert's own responsibility to confirm that it does not have a relationship with or interest in the issuer. It is unrealistic to require the sponsor to confirm other people's relationship and interest. What steps can the sponsor independently take to ensure that such a confirmation can be truthfully given by it? This is something that the relevant expert should confirm and take responsibility for.

- *(paragraph 30(d)(i) of Annex 2)* Again, it is unrealistic to propose that the IFA should have to investigate the independence of any third party expert.

- Certain parts of the Code of Conduct for Sponsors and Independent Financial Advisers will have to be re-worded in order to make the requirements reasonable and workable. For example (the list is not exhaustive):

  - *(paragraph 12(a) of Annex 2)* It is proposed that "a sponsor must

take all reasonable steps to avoid situations that are likely to involve a conflict of interest". Does that mean a sponsor must not underwrite the share offer of the company to which it is the sponsor? Obviously, most of the sponsor firms would not welcome our suggestion that sponsors should not underwrite share offers they sponsor in order for them to be truly independent (see reply to Q10 above). The reason why such firms would be unhappy is that the big fees are on the underwriting, not on the sponsorship work. However, we would appreciate if the regulators would explain thoroughly why it considers that a sponsor does not have a conflict of interest if it underwrites the issue. Joint sponsors should be allowed in certain circumstances, as allowed under the current practice. If the Exchange is minded to permit conflicts to exist (as suggested, in our opinion, by the Consultation Paper) then we would suggest extending the wording to require a sponsor "to take all reasonable steps to manage the conflict which may arise, including securing the appointment of another sponsor which does not have any potential or perceived conflict of interest".

- *(paragraph 21 of Annex B)* Sponsors must satisfy themselves based upon "reasonable investigations" that "the new applicant and its directors appreciate the nature of their responsibilities under the Listing Rules and the Listing Agreement and can be expected to honour those responsibilities and obligations". It is proposed that this requirement "continues to operate after the applicant becomes an issuer whenever the sponsor advises the applicant in relation to compliance with the Listing Rules or the Listing Agreement" and that the scope of reasonable investigations includes "the extent of initial and continuing training each director has received... about... the responsibilities and obligations they will be accepting as directors of a listed issuer; and... the effectiveness of the internal control procedures... to ensure directors are made aware of all information relevant to compliance...". As the Exchange is considering changing the rules to require the appointment of a sponsor in the case of any application for listing which requires the production of a listing document for registration (paragraph 113 of the Consultation Paper), it would follow that one would have to check the adequacy of directors' training and the issuer's internal control procedures in respect of an assignment involving a rights issue/open offer or a

placing of warrants. We wonder what value is being added by performing all these investigations on a listed issuer (not being treated as a new applicant) which is only seeking to raising equity capital. Furthermore, the costs to be incurred by the listed issuers for raising equity capital will be higher whilst efficiency will be compromised. Again, a cost benefit analysis might have been really useful here.

- *(paragraph 24 of Annex 2)* The Exchange should (after carefully considering the comments made) reformulate the statement(s) to ensure that the work required of the sponsor on the non-expert sections is feasible and reasonable. Please refer to our reply to Q11 for details. In short, no professional party can perform reasonable investigations to satisfy itself that the non-expert sections are true and do not omit a material fact. All that can be done on the non-expert sections would be to ensure that there is no ground to believe that (i) statements of facts are materially false or misleading, (ii) there is material omission, (iii) opinions expressed and representations and estimates made by directors have been arrived at otherwise than after due and careful consideration and are founded on bases and assumptions that are unfair and unreasonable.

- *(paragraph 24(b) of Annex 2)* It is proposed that a sponsor should assess the integrity of financial information "including... obtaining comfort from the issuer's external auditor or reporting accountants based on agreed upon procedures". As stated in reply to Q11 above, apart from what is explicitly required under the Listing Rules, the reporting accountants would normally only review the indebtedness statement and net tangible asset statement as part of the agreed upon procedures. They do not normally give any comfort on financial information such as turnover by product, turnover by geographical location (the SSAP definition of segmental information may be different from the geographical breakdown requirement under the Listing Rules), commentary on profit record (fluctuations, etc.). With respect, the Exchange should discuss in detail with the accounting bodies and accounting firms as to what agreed upon procedures the reporting accountants will be willing to perform (together with the level of comfort and the estimated costs to be borne by the listing

applicants) before proposing this type of stringent requirement on sponsors.

- *(paragraph 24(d) of Annex 2)* Whilst the sponsor should extensively interview the issuer's senior management in assessing the issuer's business plan and forecasts, we are not sure what the Exchange means by "extensively interviewing third party customers, suppliers, creditors and bankers"- extensive in terms of the content of the interview, or extensive in terms of number of such parties being interviewed? Furthermore, the applicant may have customers, suppliers and creditors who are not third parties. We note that the Exchange does not use the word "extensively" in paragraph 24(c) when proposing that the sponsor should "review, assess or interview the issuer's major suppliers and customers". We propose amending the wording in paragraph 24(d) to "interviewing major customers, suppliers, creditors and bankers". To avoid confusion in the market the Exchange should publish a checklist of matters which the sponsor will be expected to cover in such interviews.

- *(paragraph 25 of Annex 2)* The reference to sponsors taking "all reasonable steps to satisfy themselves that there are not reasonable grounds to believe that the expert sections... are not true or omit a material fact" should be removed. Instead, "the sponsor should take reasonable steps to satisfy itself that there is nothing that has come to its attention which casts doubt on the reliability of the expert sections". As explained in our reply to Q11, the sponsor cannot endorse the work of the experts.

- *(paragraph 25(a) of Annex 2)* Instead of "investigating the background and expertise of the relevant expert or professional", we propose adopting the wording used in the SFC Code of Conduct i.e. "undertaking reasonable checks to assess the relevant experience and expertise of the firm of experts or other professionals". The word "investigating" is inappropriate. To be frank, if an expert possesses the relevant professional qualifications (including any relevant licence to practice the relevant profession), it is difficult for a sponsor (or financial adviser) to form the view that such person has insufficient expertise. If the Exchange believes that certain experts do not have relevant and

sufficient Listing Rules experience, it should invite experts to submit their credentials to the Exchange and, after reviewing such, should publish a list of experts which the Exchange considers to have relevant and sufficient Listing Rules experience. The sponsor may be liable to be sued by the expert for defamation if the sponsor does raise any concern about the expert's background and/or expertise.

- *(paragraph 25(c) of Annex 2)* Again, to be consistent with the SFC Code of Conduct, property valuation reports, legal opinions/advices and reports on audited results should be excluded. For instance, we do not understand how the sponsor is in a position to assess (i) the reasonableness of, say, an audit qualification (say, in respect of a particular item in the accounts in the first year of the track record – which qualification may not render the applicant unsuitable for listing under the Main Board Listing Rules) and (ii) the consequences of such qualification for the extent to which investors could rely on the qualified accountants' report. In respect of (i), what does the Exchange expect the sponsor to do – to audit that account item again? In respect of (ii), what does the Exchange expect to see in the sponsor's due diligence files – to form an opinion on whether this is alright? Other than prominent disclosure and adopting the "buyer beware" approach, we do not see what the sponsor can do. We are of the view that, in respect of property valuation reports, legal opinions/advices and reports on audited results, performing the work as stated in paragraph 25(d) is sufficient.

- *(paragraph 29 of Annex B)* The Exchange should make it mandatory for listed issuers to engage the service of the continuing sponsor regarding the issue of public documents required under the Listing Rules. Some listed issuers may use lawyers for certain work which would otherwise be carried out by the continuing sponsor. Otherwise, the continuing sponsor cannot take any responsibility for such documents. Again, the sponsor should not be required to make any public declaration in the documents.

- *(paragraph 30 of Annex B)* See replies to Q9 and Q11 above for suggested amendments to the exact wording to be used.

- *(paragraph 30(d) of Annex B)* See reply to Q11 above. The wording should be amended to "in relation to any third party expert providing an opinion or valuation relevant to the transaction (other than (i) a valuation report by a property valuer who is a member of a relevant regulatory or professional body; (ii) legal advice rendered by legal advisers; and (iii) an audit of results and accountants' reports by accountants):" to mirror the wording in the SFC Code of Conduct.

- *(paragraphs 30 and 33 of Annex B)* The references as to "sponsor" acting as an IFA should be amended to "financial adviser".

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*

Please state reason(s) for your view.

- We strongly disagree with the proposal regarding making declaration or signing the prospectus (see replies to Q11 and 12 above)

- We agree with the statement made in paragraph 162 of the Consultation Paper: "prominent disclosure of the sponsor's role in performing due diligence on the prospectus both distracts from the responsibilities which would properly be borne by the directors and will lead to increased professional fees for new applicant companies".

- We are not aware of any developed market in the world which adopts an extensive pre-vetting procedure and at the same time requires the IPO intermediaries to sign the listing document. If the Exchange wishes to influence the contents of the listing document (for example insisting during the vetting process that certain amendments are made to the listing document) then there would appear to be a strong case to be made that the Exchange should also take some responsibility for the contents of the listing document.

- We do not understand why lead underwriters (where they are not the sponsors) should make a declaration in listing documents regarding the extent of their due diligence. Whilst the Exchange proposes such declaration, it has not set out what it considers to be the duties of the lead underwriters (where they are not the sponsors). Lead underwriters may only be licensed to carry out the regulated activity of dealing in securities (but not advising on corporate finance) and may not be staffed with eligible personnel possessing the necessary skills to carry out the due diligence work as required by the Exchange. We are puzzled as to the basis upon which the lead underwriters may declare their due diligence work. Furthermore, the due diligence that may have been undertaken by lead underwriters will be for the purpose of deciding whether to take the financial risk of underwriting the share offer instead of declaring the truthfulness and completeness of the statements in the prospectus. This proposal does not appear to have been thought through.

- The Exchange has stated in paragraph 165 of the Consultation Paper that "[t]he potential increase in costs for... prospective issuers [in view of additional due diligence] we believe... to be acceptable as the potential benefits for investor protection and the integrity of the Hong Kong markets provide adequate incentives against which to balance the potential costs imposed on issuers". We wonder what the basis of the Exchange's belief is.

Has market research been carried out? Has a cost benefit analysis been carried out? How can the Exchange claim to balance the costs against the benefits without having carried out a proper cost benefit analysis? What due diligence has the Exchange carried out in support of this claim? The Exchange has been making an effort to attract more Mainland companies to list in Hong Kong and has been hosting numerous conferences in this regard. We are not sure whether the Exchange has conducted surveys amongst prospective applicants (in particular Mainland companies) to check the level of listing expenses (and the possible increase because of the proposed added responsibilities of the IPO intermediaries) which they would be willing to pay. For companies listed in 2002 and the first half of 2003 raising gross proceeds below HK$100 million, listing expenses (including underwriting commission) accounted for about 14% to 33% of the gross proceeds. The percentages were as high as 35% to 40% for certain GEM companies. At the seminar on the Consultation Paper held by the Exchange and the SFC, the Exchange commented that the proposals may help create a more level playing field in that sponsor firms which "cut corners" in the past might have to raise their fees now. We believe this observation to be questionable. First, it depends on whether the particular client is willing to pay a higher fee. To be honest, under the current economic conditions, quite a lot of small to medium size clients (especially Mainland applicants) do not understand or appreciate the extent of work that the professional advisers will be performing and therefore may adopt the approach of: whoever charges the least gets the job. Secondly, those sponsor firms which also act as underwriters and which used to "cut corners" might still try to get business by charging low sponsorship and advisory fees (and not carrying out proper due diligence) because the bulk of the reward for them is from the selling and underwriting commission. The incentive is to push the IPO out to earn the lucrative commission and to add to their track record of "completed IPOs" to stay on the sponsor list.

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*

Please state reason(s) for your view.

- We strongly disagree (see replies to Q11 and 12 above) with this proposal.

- Why should an IFA be required to confirm the truthfulness and completeness of the information provided to it by the issuer? We are totally lost as to what the Exchange expects of an IFA and how that fits in with reality. Standards will not be raised if the Exchange imposes unworkable and unrealistic requirements. The Exchange should consider the scope of work of and limitations faced by corporate finance advisers in the real world.

- How can the IFA satisfy itself as to whether any third party expert advice or opinion relied upon is untrue or omits a material fact? They cannot. They are not the experts in the relative fields and they have not carried out the work which the expert will have carried out. This requirement would require the IFA to engage another expert to audit the work of the expert in question.

- We are not aware of any similar requirement in any other developed market.

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*

Please state reason(s) for your view.

- We agree that the Listing Division should make first instance decisions in relation to eligibility, on-going eligibility and independence. However, does it mean that no waivers on eligibility will be granted in future? The Listing Committee should continue to make any decision regarding

requests for a waiver and also suspension of sponsorship activities.

- We do not understand what the Exchange means by proposing "to replace the annual review process with a certification process and a targeted programme of monitoring". The current annual review process for GEM sponsorship entails the filing of annual confirmations (with detailed transaction lists) by firms and their principal/assistant supervisors to demonstrate that they remain eligible to act in such capacity. It appears that the only difference in the annual review process under the current proposal is to dispense with the Listing Committee approval requirement. We agree that the Listing Committee should not be inundated with such routine approval procedures if there is no controversy involved. It appears that the Exchange actually wishes to impose a new and additional monitoring programme.

- We disagree with the proposed monitoring programme – it is too subjective and should only be considered if the Exchange adopts a post-vetting regime.

- First, the monitoring programme duplicates the SFC's audit work on licensed corporations. Secondly, the exact meaning of certain proposed monitoring tools proposed by the Exchange is unclear (see below). Thirdly, the Exchange needs to be absolutely sure that the persons doing the review must be of the right calibre and of sufficient seniority. Fourthly, certain of the proposed tools should only be applied if the Exchange adopts a post-vetting regime. It is going too far for the Exchange to, on the one hand, have significant influence on the form of the wording of disclosure in the prospectus (by insisting that its comments be taken up during the vetting process) and, on the other hand, to then use such pre-vetted documents against the sponsor.

    - *"Complaints"* – We understand that the Exchange is always very anxious about complaints and adverse press coverage. The Exchange should be very careful in deciding when action should be taken when a complaint arises. To be honest, it is so easy for sponsor firms or brokers to cause trouble for their competitors (e.g. when one is not able to be allocated shares from a popular IPO) by lodging anonymous complaints to the Exchange alleging misconduct of a particular sponsor or lead manager. We consider that the Exchange should only entertain serious complaints which

are not anonymous.

- *"Desk based review of transactions"* – What does this mean? Does this mean that the Exchange will assess the competence of the sponsor firm during the IPO vetting process? This is worrying. Normally it is difficult for market practitioners to get to speak to senior staff at the Listing Division (or to get some of them to return calls). It is also worrying to imagine that a sponsor firm may be considered by the Listing Division to be good if it processes IPOs by just taking up all the suggestions made by the Listing Division. It seems that sponsor firms which are conscientious, stick to principles and which are not afraid to argue on logic and reasonableness (rather than taking the path of least resistance) may have to be worried. What an irony.

- *"Reviews of referrals"* – Again, what does this mean? What sort of monitoring tool is it? How can anyone comment meaningfully on this proposal?

- *"Liaison with other agencies, professional or regulatory bodies"* – What is the Exchange proposing to do? No doubt the Exchange will duly observe all legislation regarding data privacy. This should be in the form of properly documented formal liaison with the consent of the sponsor firm.

- *"On-site visits after prior notification"* – The Exchange should be clear about what it will do during the on-site visits. Will the Exchange envisage that it will have the authority to go through confidential transaction files? The Exchange should make it very clear in the Consultation Paper if this is being proposed and should consider and address how the sponsor firm can fulfil the duties of confidentiality which it owes to its client.

- *"Reviews of past services provided and documentation produced"* – We wonder what the Exchange means by "past services provided" (provided to whom? the Exchange?). The Exchange needs to be very careful when making judgement on the standard of documentation produced. For example, we hope that the Exchange will not pre-judge that a draft prospectus is not up to standard if information such as market share or competitors'

information is not included (because such information is not verifiable to a standard acceptable to the professional parties). Furthermore, the quality of the printed prospectus may have been heavily affected by the pre-vetting process of the Exchange e.g. it is far from unheard of for the sponsor to be required to adopt drafting comments first raised by the Exchange on the bulk-printing day.

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*

Please state reason(s) for your view.

- We agree that sponsors should be subject to sanctions under the Listing Rules given the responsibilities imposed on sponsors by the Listing Rules.

- We do not consider that it is necessary or appropriate for the Exchange to introduce any rules applicable to IFAs (such as the eligibility, due diligence, undertaking and declaration requirements and a code of conduct) other than codifying the circumstances under which an IFA will be required and will be considered to be independent. We also disagree that IFAs should be subject to any sanctions under the Listing Rules as all licensed corporations are already subject to sanctions by the SFC.

- We disagree that any sanctions be imposed on the individuals. Licensed individuals are already subject to sanctions by the SFC.

- We disagree with the proposal to maintain a list of unacceptable individuals (see reply to Q3 above).

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*

- It is not realistic to try and provide an answer for (c) and (d) – people come and go and who knows how many IPOs and other significant transactions

can be completed.

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?

- The Exchange has stated in paragraph 187 of the Consultation Paper that "[e]ven those firms who currently have less than 3 persons who satisfy the eligible supervisor requirement could use the initial one-year transitional period to identify 3 eligible supervisors and use the additional year to identify a fourth". This may be easier said than done.

- Instead of allowing longer transitional periods, the Exchange should reconsider the proposed eligibility criteria.