

Hong Kong: Regulation of IPO Sponsors**Summary**

On December 12, 2012 the SFC published its Consultation Conclusions concerning the regulation of IPO sponsors in Hong Kong. The most important proposals include:

- (i) a clarification (by way of an amendment to the Companies Ordinance) that Sponsors are subject to existing civil and criminal prospectus liability provisions;
- (ii) a requirement for sponsors to have completed all reasonable due diligence before submitting a listing application (A1 filing);
- (iii) a requirement for the A1 or 'Application Proof' prospectus (filed with the listing application) to be published on the HKEx website;
- (iv) guidance on the level of reliance that may be placed on, and the due diligence required for sponsors in relation to, expert reports; and
- (v) provisions to reinforce the role of sponsors, including a minimum period for which a sponsor must be appointed before a listing application may be made.

The proposed amendments take effect on October 1, 2013 – such that any sponsor submitting a listing application on or after that date will be required to comply with the new provisions. Amendments to the Companies Ordinance are also required, with the timing to be determined separately by the legislative process in Hong Kong.

This memo describes the background to the changes, summarizes the main proposals and looks at the likely practical impact going forward.

1. Background

The SFC has been looking more closely at IPO sponsors and the quality of their due diligence work for IPO applicants in Hong Kong for some time, and whilst it has wide disciplinary and enforcement powers (stemming from the licensing regime in Hong Kong and the Securities and Futures Ordinance (SFO)) the SFC is taking this opportunity to 'reset' the standard required of IPO sponsors. These proposals aim to ensure that by the time a listing application is lodged, all reasonable due diligence work has been completed and, as a result, all material information has been included in the Application Proof (save for matters which can only be dealt with at a later stage).

The quality of draft listing documents submitted with listing applications varies greatly and the SFC and HKEx are clearly trying to move away from the position where poor quality listing documents attract lengthy comments from regulators and where prospectus disclosure is governed more by regulators' comments than by the product of thorough due diligence.

On a macro level, the Hong Kong Stock Exchange has, to some extent in recent years, been able to rely on listings by large Chinese state-owned enterprises, although this will not continue indefinitely. After three years at the top of the global rankings for IPOs, Hong Kong will slip to fourth place in 2012 (behind New York, Nasdaq and Tokyo) narrowly beating Kuala Lumpur - thanks to the \$3.1 billion PICC listing, which priced at the bottom of its range with 17 bookrunners. The ability to continue to attract large 'foreign' multinational companies like Glencore, Prada and Samsonite to list in Hong Kong rests in no small part on the quality of the Hong Kong market. In addition, if the 'China' listings of the future take the form of smaller privately held companies, there is sufficient incentive for HKEx to ensure that sponsors only bring companies to the market after conducting thorough due diligence, and with all material items of note for investors disclosed in the prospectus.

2. The Proposals

The Table at Annex 1 contains a summary of the main proposals.

3. Practical impact

(a) Criminal Liability

The proposals dealing with civil and criminal prospectus liability are a clarification of the existing position – such that a person who has “authorized the issue of a prospectus” includes a sponsor. This clarification was deemed necessary given the lack of any case law in Hong Kong on the point and a certain level of confusion amongst market participants as to the proper interpretation of the existing statutory provisions. The clarification, while useful, is not a major change in our view. What will change however is the burden of proof under the criminal liability provisions of the Companies Ordinance which will shift towards the prosecution who will need to prove not only that the prospectus contains an untrue statement (the current position) but also that:

- a person authorizing the issue of the prospectus knew that, or was reckless as to whether, a statement in the prospectus identified by the prosecution was untrue; and
- the untrue statement was materially adverse from an investor's perspective.

Whether these changes make it any easier, in practice, for an investor to sue a sponsor is debatable; the lack of any class action regime in Hong Kong and the lack of any

mechanism whereby a secondary purchaser - ie. not being a subscriber to the IPO - can assert reliance on misstatements in a prospectus means that it is still an expensive exercise for individual investors to launch a claim.

In practice then, SFC disciplinary/enforcement action (whether by way of conditions imposed upon, or a suspension/cancellation of a sponsor's licence, or action taken under the SFO) will more often than not be the only viable recourse. Even before these proposals come into force, the SFC has shown that it is more than capable of pursuing sponsors and listed companies, with Mega Capital and Hontex being recent examples.

The SFC has stressed that these measures are not designed to make sponsors liable for prospectus defects in lieu of issuers or their directors. Sponsors may breach their obligations concerning due diligence under the Code of Conduct without triggering civil or criminal liability, which can only be assessed under the Companies Ordinance. A sponsor may have criminal liability together with an issuer and other persons if there is evidence that each of them knowingly or recklessly participated in issuing a prospectus containing false or misleading information. It is not, however, intended that a due diligence failure will of itself involve criminal liability.

(b) Market impact

After October 1, 2013, we would expect to see the IPO sponsor role undertaken by the investment banks or the specialist corporate finance houses with sufficient expertise, and the systems and processes in place to support that type of work. Sponsor's fees are likely to increase to reflect the more complex regulatory background and the risks involved with potential criminal liability for misstatements. This together with increased emphasis on better quality due diligence work may mean that sponsors will concentrate their resources on larger listings - avoiding the smaller issues.

(c) Listing procedure

These proposals are intended to result in higher quality initial drafts which will in turn attract considerably fewer comments from the regulators. In order to make the point, the Stock Exchange will "strengthen its practice to reject a sub-standard document and will consider imposing a "cooling-off" period within which the submission of a revised draft will be disallowed". A separate announcement is expected from the SFC and the Stock Exchange with details as to measures to streamline and shorten the commenting process. So, while it may take longer for a Sponsor to be able to lodge a listing application, the stated aim of the SFC and the Stock Exchange is to streamline the listing process from that point on.

4. Timing / Consequential amendments

The proposals take effect on October 1, 2013 – such that any sponsor submitting a listing application on or after that date will be required to comply with the new provisions.

As well as amendments to the Listing Rules, consequential amendments are also proposed to the Corporate Finance Adviser Code of Conduct (CFA Code) and the Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers (Sponsor Guidelines) - see Appendices B and C respectively of the SFC's Consultation Conclusions Paper for marked-up copies. Amendments to the Companies Ordinance are also required, with the timing to be determined separately by the legislative process in Hong Kong.

If you have any questions, please feel to contact Freeman Chan, or any of your regular contacts at the firm.

5. Related Links

- SFC [Press Release](#)
- SFC [Consultation Conclusions](#)

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Annex I

	Current Position	Proposed	Comments
Reinforcing the role of a Sponsor & Fees	Comparable provisions do not currently exist.	<p><u>Minimum Appointment Period</u></p> <p>To avoid late appointment or sponsors being brought in at the closing stages of an IPO, a sponsor must be formally appointed at least <u>two months</u> before the listing application is made.</p> <p><u>Notification of Appointment / Ceasing to Act</u></p> <p>A sponsor will be required to notify the Stock Exchange when it is formally appointed or when it ceases to act regardless of whether a listing application has been submitted.</p> <p><u>Fees</u></p> <p>Sponsor fees should be specified in every mandate or appointment letter.</p> <p>The sponsor fee should not be contingent on the success or the final size of the offering and any staged payments should be proportional to the amount of work done up to that stage.</p> <p>Any “no deal, no fee” arrangements (or arrangements to that effect) should be avoided.</p> <p>The total amount of sponsor fees paid and payable should be disclosed in the listing document.</p>	<p>In many cases two months will not be sufficient time to enable the sponsor to meet its obligations including due diligence. A sponsor should consider the size and complexity of the listing applicant and the time it needs to prepare the listing application to the standard required.</p> <p>A sponsor should ensure that the terms of its appointment:</p> <ul style="list-style-type: none"> • contain clear provisions whereby the applicant acknowledges that the sponsor will provide information to the Stock Exchange or the SFC where required; • specify an applicant’s obligations to facilitate the sponsor in discharging its responsibilities under the Code of Conduct, including the applicant agreeing to procure all relevant parties engaged by the applicant in connection with the listing to assist; and • specify the sponsor’s fee, including the basis upon which the fee is determined, the payment structure and timing and any other factors that affect the fee.

Publication of first draft prospectus	<p>The first draft of the prospectus is submitted to the Stock Exchange together with Form A1.</p> <p>A draft of the prospectus will not be published until a later stage ie. upon publication of the WPIP (normally 2-3 months after the listing application is made).</p>	<p>The ‘Application Draft’ of the prospectus (submitted with Form A1) will be published on the HKEx website when the listing application is made.</p>	<p>The SFC will assess the effect of this requirement on IPO practice before considering whether it would be appropriate to also require publication of successive drafts, regulatory comments and responses from applicants.</p>
Prospectus liability	<p>Sections 40 and 40A of the Companies Ordinance set out provisions dealing with civil and criminal liability for untrue statements (including a material omission) respectively in a prospectus.</p> <p>However, it is not clear from these two sections that a sponsor has civil and criminal liability for any untrue statements in a prospectus.</p> <p>The existing penalties are a HK\$700,000 fine and three years’ imprisonment.</p>	<p>The CO will be amended to make sponsors expressly liable for untrue statements in a prospectus under sections 40 and 40A of CO, thereby confirming that civil and criminal liability applies to them.</p> <p>(Note: the proposed definition of “sponsor” relates to the firm not individuals – although the general criminal law would extend to situation where an individual has colluded in the making of an untrue statement eg. aiding and abetting.)</p>	<p>The SFC intends to:</p> <ul style="list-style-type: none"> • revisit the issue of penalties in a forthcoming review of the prospectus regime; and • issue a separate consultation paper to deal with the relevance of actual reliance on a prospectus as a prerequisite for private rights of actions and the ability of investors transacting in the secondary market to make claims based on defective prospectus disclosure.
Code of Conduct	<p>The obligations of sponsors are scattered in different sections of the Code of Conduct.</p> <p>Under the “know your client” requirement of the Code of Conduct, a corporate finance adviser should understand the business of its client, in particular, its background, the nature of its business and the financial circumstances and investment objectives in relation to the transaction under consideration.</p>	<p>The SFC will:</p> <ul style="list-style-type: none"> • consolidate the key standards and requirements for sponsor conduct in a new paragraph 17 of the Code of Conduct; and • require that a sponsor should have a sound understanding (based on reasonable due diligence) of a listing applicant, including its history and background, business and performance, financial condition and prospects, operations and structure, procedures and systems, as well as the personal and business backgrounds of the 	

		directors, key senior managers and (where applicable) controlling shareholders of a listing applicant.	
Due Diligence	Under the Listing Rules, a sponsor is required to conduct reasonable due diligence inquiries in order to make a declaration to the Stock Exchange that a listing applicant fulfils principal listing requirements.	<p><u>Before submitting a listing application</u></p> <p>A sponsor should:</p> <ul style="list-style-type: none"> • have performed all reasonable due diligence on the listing applicant (except for matters that by their nature can only be dealt with at a later date – see para 107 of the Conclusion Paper); • ensure that all material information as a result of this due diligence has been included in the Application Proof; and • come to a reasonable opinion that (i) the listing applicant is in compliance with all relevant listing qualification under LR Chapter 8 (disregarding any waivers applied for), (ii) has established procedures systems and controls to ensure compliance with the LRs and other relevant legal requirements and which enable its directors to make a proper assessment of the applicant's financial condition and prospects, and (iii) the directors have the collective (and individual) experience, qualifications and competence to manage the listing applicant and understand their obligations under the LRs and other relevant legal/regulatory requirements. <p><u>When submitting a listing application</u></p> <p>A sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration</p>	<p>A sponsor's failure to submit an Application Proof up to the required standard will put into question whether the sponsor has exercised due skill and care in the performance of its duties but will not of itself necessarily render the sponsor liable to disciplinary action.</p> <p>When considering a sponsor's non-compliance, the SFC will take account of all relevant facts and circumstances.</p>

		<p>of:</p> <ul style="list-style-type: none"> • whether the listing applicant is suitable for listing; and • whether the listing of the applicant's securities is contrary to the interest of the investing public or to the public interest, <p>are disclosed in writing to the Stock Exchange.</p> <p><u>At the time of issue of a listing document</u></p> <p>A sponsor (after reasonable due diligence) should have reasonable grounds to believe and should believe that the listing document contains sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the financial condition and profitability of the listing applicant.</p>	
<p>Reliance on experts and non-expert third parties</p>	<p>Under the Listing Rules, a sponsor is not required to give a confirmation with respect to information in the expert sections. Instead, the sponsor is required to confirm specific matters relating to the preparation of expert reports.</p> <p>Under the Listing Rules, a sponsor is required to ensure the truth, accuracy and completeness of the non-expert sections.</p>	<p><u>At the time of issue of a listing document</u></p> <p>In relation to expert reports - a sponsor (after performing the due diligence set out in paragraph 17.7 of the Code) should have no reasonable grounds to believe and should not believe that the information in the experts reports is untrue, misleading or contains any material omissions.</p> <p>In relation to non-expert sections - a sponsor (after reasonable due diligence) should have reasonable grounds to believe and should believe that:</p> <ul style="list-style-type: none"> • the information in the non-expert sections of the listing document is true, accurate and complete in all material respects and not misleading or deceptive in any material 	<p>In coming to a conclusion regarding an expert's report, a sponsor should consider:</p> <ul style="list-style-type: none"> • the expert's qualification, experience and independence; • the expert's scope of work • the bases and assumptions underlying the report; and • the expert's opinion together with the rest of the information contained with the report. <p>Paragraph 17.7 of the Code sets out the due diligence that a sponsor should perform in respect of expert</p>

		<p>respect; and</p> <ul style="list-style-type: none"> • there are no matters or facts the omission of which would make any information in the non-expert sections of the listing document misleading in any material respect. 	<p>reports.</p> <p>Blind reliance on information provided by experts or third parties engaged to work on an IPO does not mean that a sponsor has performed reasonable due diligence.</p> <p>A sponsor must critically review an expert's report and apply the sponsor's own knowledge and experience of the applicant and the environment in which it operates.</p> <p>A sponsor should be involved in agreeing the scope of the expert's work at the outset or, where appropriate, engaging the expert to perform additional work.</p>
<p>Reliance on '10b-5 type' comfort letters</p>		<p><u>Note:</u> The SFC does not consider that the existence of such a letter can have any bearing on whether a sponsor has in fact met its regulatory obligations in Hong Kong to conduct due diligence.</p> <p>Giving undue weight to such letters - except in cases where specialist work is clearly only within the competence of the adviser (eg. legal advice/opinions on proprietary rights) - may give rise to concerns that a sponsor has over-relied on legal counsel during the due diligence process, and as a result has not met its obligations to conduct reasonable due diligence.</p>	<p>In seeking the assistance of a legal adviser or other professionals a sponsor should distinguish between matters that fall within a person's professional competency and those that do not in order to determine whether it is appropriate to delegate the work to that party.</p>

<p>Disclosure of non-compliance / Communication with the Regulators</p>	<p>Under the Listing Rules, a sponsor must use reasonable endeavours to ensure that all information provided to the Stock Exchange during the listing application process is true in all material respects and does not omit any material information. If the sponsor subsequently becomes aware of information that casts doubt on the truth and accuracy of the information provided to the Stock Exchange, it should promptly inform the Stock Exchange</p>	<p>A sponsor should disclose to the Stock Exchange in a timely manner any material information it becomes aware of relating to a listing applicant or listing application which concerns <i>non-compliance</i> with the Listing Rules or other legal or regulatory requirements relevant to the listing.</p>	<p>The duty to report any non-compliance continues after the sponsor ceases to act for a listing applicant if the material information came to its knowledge whilst it was still acting as a sponsor.</p>
<p>Proper records</p>	<p>The Code of Conduct requires a corporate finance adviser to maintain proper books and records, and be able to provide a proper trail of work done upon request by the SFC.</p>	<p>A sponsor should maintain adequate records so as to demonstrate its compliance with the Code of Conduct (and in particular with paragraph 17). See paragraph 17.10 of the Code of Conduct.</p> <p><i>A complete set</i> of a sponsor's records in connection with a listing assignment should be retained in Hong Kong for at least 7 years after completion or termination of the relevant transaction.</p>	<p><i>A complete set of records</i> refers to records that are sufficient to demonstrate the basis on which a sponsor's due diligence has been completed. The SFC will not expect a sponsor keep the underlying records of the listing applicant, working papers of experts and third parties or original documents not prepared by the sponsor. To the extent that these documents are examined to enable a sponsor to reach the opinions, assurances and conclusions required of it, it is sufficient for the sponsor to record the key aspects of the documents examined.</p> <p>The requirement does not preclude the storage of documents in electronic form or in off-site storage facilities, assuming the records are readily accessible to the regulators when required.</p>

<p>Resources, systems and procedures</p>	<p>Under the Code of Conduct, a licensed or registered person should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.</p>	<p>A sponsor should maintain sufficient resources and effective systems and controls to enable it to carry out its obligations under the Code of Conduct and the LRs, including (in respect of each assignment):</p> <ul style="list-style-type: none"> • ensuring before accepting any appointment, that it has sufficient staff with appropriate levels of knowledge, skills and experience to devote to the assignment throughout the period of the assignment; • ensuring that it is appointed sufficiently in advance of the expected date of a listing application; and • appointing a transaction team which includes at least one principal who acts as the supervisor of the transaction team; and • ensuring that there are clear and effective reporting lines so that decisions on critical matters are made not by the transaction team but by management (or a committee designated by management for this purpose – being independent of transaction team, and having appropriate seniority and expertise to consider difficult or sensitive issues, conflicting information and material non-compliance by a listing applicant). <p>Upon completion of a listing transaction, a sponsor should submit to the SFC its team structure chart in respect of that listing countersigned by the Principal who supervised the transaction.</p>	
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<p>New examination for Sponsor Principals</p>	<p>Comparable provisions do not currently exist.</p>	<p>A new regulatory examination will be in place for individuals seeking to be licensed as Type 6 representatives or relevant individuals who intend to engage in sponsor work.</p> <p>They will be required to pass the examination not more than three years before and not later than 6 months after the date of their first engagement in sponsor work.</p> <p>Individuals who have engaged in sponsor work within three years preceding October 1, 2013 in at least one completed IPO transaction are exempt from this examination requirement.</p>	
<p>Applicability of these Provisions to listing agents of REITs</p>	<p>A REIT is regulated under other codes (in particular the REIT Code) but there are no specific requirements under these codes to govern the conduct of a listing agent when acting in a listing of a REIT.</p>	<p>The SFC will extend the requirements governing sponsor work to a listing agent that assists the listing of a REIT.</p>	

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