

ClientAlert

Capital Markets

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Proposed Changes to the Sponsor Regime for Hong Kong Listings

The Hong Kong Securities and Futures Commission published a consultation paper in May with various proposals relating to the role of sponsors in new listings of equity securities.

Last year the Commission issued a report describing a number of deficiencies in sponsor work that it had identified during a theme inspection. Earlier this year, it revoked a sponsor's license and fined it HKD 42 million, citing the sponsor's failure to fulfill its professional duties in relation to a listing application.

The recent proposals have been the subject of some controversy in Hong Kong. They range over several areas:

- Prospectus liability for sponsors
- Publication of draft listing documents
- Sponsor obligations to ensure that issuers and directors fulfill their responsibilities and to notify regulators of non-compliance
- Issuers appointing more than one sponsor
- Sponsor due diligence responsibilities and the extent to which sponsors may rely on expert opinions
- Fee structures
- Sponsor qualifications

Prospectus liability

The position of a sponsor under the prospectus liability provisions in Hong Kong's Companies Ordinance depends upon interpretation of certain key terms. In a consultation paper it issued in 2006, the Commission noted that it was "unclear" whether or not sponsors had statutory liability for untrue statements in prospectuses. It did not, however, implement the changes it proposed in this area to spell out prospectus liability for sponsors.

The Commission's current proposals, couched as a clarification, contemplate civil and criminal liability for sponsors for untrue statements in a prospectus.



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While it would be for the prosecution to establish beyond reasonable doubt that the prospectus includes any untrue statements, and a material omission from the prospectus would constitute an untrue statement, criminal liability would not attach if the sponsor proved either that a relevant statement was immaterial or that it had reasonable grounds to believe and did up to the time of the issue of the prospectus believe that the statement was true. The Commission notes that it expects to address in a separate public consultation several critical questions on the scope of the liability provisions and available defenses.

As a related point, the Commission has indicated that it also intends to consider whether prospectus liability under the Companies Ordinance should extend to claims by purchasers in the secondary market. This was proposed and dropped in a consultation several years ago.

The Commission's proposals include a number of elaborations on the standards expected of sponsors in fulfilling obligations to ensure that disclosure in listing documents is accurate and complete.

Listing requirements to be fulfilled prior to application filing; publication of draft prospectus

Under the Stock Exchange's current listing rules, an "advanced" proof or draft of the listing document is expected to be filed with a listing application. In its consultation paper, the Commission criticizes sponsors in some cases for filing listing applications prematurely and for submitting draft disclosure documents that were substantially incomplete. In its report on sponsors last year and in previous public updates, the Commission highlighted cases in which application documents reflected inadequate disclosure and/or inadequate due diligence.

In Hong Kong, review drafts of listing documents are not made publicly available and it is not unusual for the Stock Exchange and/or Commission staff to provide several rounds of very detailed comments on the drafts. It is not until the time of issue of a listing document that a sponsor is required to make a declaration to the Stock Exchange that the listing applicant fulfills principal listing requirements. The Commission's view is that this timing has led to some sponsors filing applications before they have completed adequate due diligence. Some of the current consultation proposals are directed at changing these practices.

Under the current proposals, prior to filing a listing application, sponsors would be required:

- to complete all reasonable due diligence on the applicant;
- to come to a reasonable opinion that the information in the draft listing document filed with the application is substantially complete;

- to form a reasonable view that the applicant has complied with all applicable listing requirements and established adequate internal infrastructure to ensure ongoing compliance with regulatory obligations and to enable the directors properly to assess the applicant's financial conditions and prospects;
- to satisfy themselves that the applicant's directors are sufficiently experienced, qualified and competent;
- to satisfy themselves that sections of the listing document other than so-called expert sections are true, accurate and complete in all material respects as of the filing date.

The Commission proposes to have the Stock Exchange publish application drafts of listing documents on its website. This would bring the listing process in Hong Kong closer to that in the United States than that in the United Kingdom.

Publication of draft listing documents and amendments during the review process is a standard procedure for initial public offerings in the United States. No public offering may take place in the United States unless and until the registration statement to which the public offering relates is declared effective by the Securities and Exchange Commission. Draft registration statements receive different treatment depending on the status of the applicants: (a) certain "foreign private issuers" are entitled to submit their draft registration statements for confidential review and draft registration statements submitted during the process are not made public; (b) all "emerging growth companies" are entitled to submit their draft registration statements for confidential review but the initial submission and all amendments will be made public no later than 21 days prior to the commencement of the roadshow; (c) other issuers are generally required to submit their draft registration statements publicly. The rationale is to increase transparency in the process and to notify market players of potential offerings, and these benefits have generally been considered as outweighing the costs of requiring an applicant to reveal intricate details of its business at an early stage of the process. In line with this policy, comment letters and responses from prior reviews are generally made publicly available on the Commission's website.

In contrast, in the United Kingdom, a prospectus must not be published until it has been finally approved by the U.K. Listing Authority, and no interim drafts are made public. The first disclosure in the United Kingdom by a company of its initial public offering will be its "intention to float" announcement, which might be followed by a "pathfinder prospectus" (which is strictly an advertisement rather than a prospectus) for offers to institutional investors only or a UKLA-approved "price-range prospectus" where the offer is also open to non-institutional investors. Each of these documents will assist the company in its book-building and marketing process, but they will only be published once the prospectus is in very nearly final form and

there is high degree of certainty that the offer will proceed. Companies looking to list in the United Kingdom are, therefore, better able to control the timing of the disclosure of sensitive, confidential information and are able to choose not to proceed with an offer or to amend details in a draft prospectus without confidential information becoming public.

Although the Commission's consultation paper is aimed at improving sponsor work in Hong Kong, this publication proposal has very significant implications for issuers, of course, since the time period between the filing of a listing application and issue of a listing document in Hong Kong is typically quite lengthy. Additionally, if issuers intend to list in more than one jurisdiction, this may raise further co-ordination and timing issues. Issuers would need to consider the overall benefits and drawbacks of the Hong Kong listing process.

Notifying regulators of material issues

The Commission proposes to augment current sponsor obligations by including a requirement that, at the time a listing application is filed, sponsors disclose to the regulators all material issues known to them that they reasonably view as necessary for consideration of whether an applicant is suitable for listing and whether the listing would be contrary to the interests of the investing public or the public at large.

A sponsor would also be required to notify the Stock Exchange of any material information it has about a listing applicant or application that concerns non-compliance with the listing rules or applicable legal or regulatory requirements. Under the current Corporate Finance Adviser Code in Hong Kong, if a sponsor becomes aware that a listing applicant is not in compliance with any relevant regulatory requirement, it is required to advise the listing applicant to bring the matter to the attention of the regulators at the earliest opportunity. The CFA Code does not currently require that a sponsor itself inform the regulators of the applicant's non-compliance, although of course a sponsor would be required to respond to enquiries from the regulators.

A sponsor would be required to notify the regulators of its reasons if it ceased to act as a sponsor for a particular applicant during the listing application process. Under the current listing rules, only the listing applicant is required to notify the regulators of the resignation or termination of a sponsor during the processing of the initial listing application.

Other augmentations and elaborations

The Commission has re-opened the debate on whether more than one sponsor should be able to be appointed; it proposes that there should be only one sponsor and that that sponsor must be independent of the listing applicant. Under the current rules, more than one sponsor may be appointed as long as at least one is independent of the listing applicant.

The Commission has suggested that sponsors' know-your-client obligations with respect to a listing applicant should specifically encompass not just the applicant's business, financial circumstances and investment or transactional objectives but also a "sound understanding" of the applicant's history, performance, financial prospects, operations, structure, procedures and systems, its directors, key senior managers and, where applicable, its controlling shareholders.

Sponsors are currently required to use all reasonable efforts to ensure that clients understand applicable regulatory requirements and their implications at all stages of a transaction. The Commission's proposals take this further. A sponsor would be required not only to "advise and guide" a listing applicant and its directors on their responsibilities and provide recommendations with respect to material deficiencies, but, additionally, to take all reasonable steps to ensure that the applicant and its directors understand and meet their responsibilities and that material deficiencies are remedied prior to filing an application for listing. This new requirement suggests that a positive obligation will be imposed on the sponsor to check and even confirm actual compliance by the applicant and its directors with the relevant rules.

The proposals expand upon sponsors' existing obligations under the Stock Exchange's listing rules and current practice notes with respect to expert sections in a listing document. A sponsor would be required to be able to demonstrate that it is reasonable for it to rely on each expert's report or opinion in light of the sponsor's actual knowledge of the applicant. The sponsor would be required to assess not only the expert's qualifications, independence and experience, but also the basis and assumptions for the report or opinion and the scope of work, as well as to verify independently the accuracy and completeness of factual information provided by the listing applicant (unless the expert has already done this). The proposals spell out an obligation for sponsors to corroborate information

from different sources to ensure that it is consistent. The Commission does not, however, give further details of the nature and scope of this proposed sponsor duty in determining the adequacy of reports or opinions by particular experts, such as accountants' comfort letters on selected financial numbers, property valuation reports and legal opinions on regulatory and other matters affecting issuers.

The Commission's paper outlines a number of specific due diligence expectations of sponsors. It notes that sponsors may not delegate responsibility for due diligence. The Commission accepts that sponsors may engage third party firms to assist in the process, although it expects sponsors to exercise professional judgment as to the competence of third parties, the tasks they perform, the results of the work and whether further action is required. The Commission notes the need for sponsors to ensure that the assistance they receive from third parties does not go beyond those parties' areas of professional expertise. This issue does not arise just with respect to the due diligence process. It also arises from time to time in relation to the opinions that experts are asked to provide. Each issuer's circumstances will vary, but there have been instances where it has appeared from descriptions in prospectuses that experts in one area may have been asked to opine on matters that involved judgments in both that area and in other areas not squarely within the scope of their professional competence.

Sponsors are currently – and will continue to be – required to maintain and retain records of due diligence plans, processes and conclusions. The proposals include a requirement for complete records to be retained in Hong Kong for at least seven years after completion or termination of a transaction.

The Commission emphasizes management oversight and input, particularly in respect of the due diligence process, and the requirement for sponsors to dedicate sufficient resources and staff with sufficient experience to each sponsor role.

The Commission proposes to apply its revised sponsor provisions to listing agents appointed in respect of offerings of real estate investment trusts in Hong Kong.

Fee structures

The Commission notes in its paper that fees charged for sponsor services in Hong Kong may not in some cases reflect the amount of work or the responsibilities involved. Although it does not propose specific requirements in this area, the Commission states that fee arrangements should not inhibit sponsor work. It specifically states that "no deal, no fee" arrangements should be avoided.

Sponsor qualifications: submissions invited on qualifications for supervisors

Sponsor firms are currently required to appoint at least two individuals as "Principals" for their work in this area. These individuals need to be qualified for these roles, and the requirements in this regard include demonstrating specific corporate finance and sponsor experience in Hong Kong. This means that it can be difficult for individuals with experience in other jurisdictions to qualify. The Commission notes that it may be possible to expand the eligibility criteria without compromising the standards expected, and has invited suggestions for alternative qualifications.

Means of implementing the proposals

The proposed changes to the regime would be effected by statutory amendments and revisions to existing regulatory guidance and to relevant listing rules.

The Commission proposes to revise the Code of Conduct applicable to persons licensed or registered under the Securities and Futures Ordinance in Hong Kong to include items addressing many of the current proposals and to consolidate sponsor obligations that currently appear in various codes and guidelines and in the Stock Exchange's listing rules. This would include some matters that are currently addressed in the declaration that sponsors are required to provide to the Stock Exchange at the time of issue of a listing document.

The codes issued by the Commission are not law. However, non-compliance can be taken into account by the Commission in determining whether or not a particular person is fit and proper to hold a license. Additionally, codes of conduct are admissible in evidence in legal proceedings under the Securities and Futures Ordinance and a court may take any provision into account where relevant in determining any question arising in the proceedings.

The Commission has invited comments on its proposals and related matters. The consultation period ends **July 6, 2012**.

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