
Sponsors: The Regulatory Regime

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CHARLTONS
易周律師行
Solicitors

Hong Kong

Shanghai

Beijing

Yangon

www.charltonslaw.com

SPONSORS: THE REGULATORY REGIME

Introduction (Slide 2)

The subject of today's seminar is the new regulatory regime for sponsors which, after a number of years of proposals, consultations and counter-proposals, is now in effect.

The regulatory regime for sponsors has been tightened considerably over the past two years. The first stage of that process comprised the introduction of new sponsor obligations under the Listing Rules which came into effect on January 1 2005. As you'll be aware, those changes to the Listing Rules require sponsors to make a comprehensive declaration to the Exchange covering (among other things) the listing applicant's compliance with the requirements for listing, the completeness and accuracy of prospectus information and the sufficiency of the applicant's internal systems and its directors' understanding of the Listing Rules to ensure its compliance with the Listing Rules' requirements post-listing. Most significantly perhaps, the January 2005 changes to the Listing Rule introduced in the form of Practice Note 21, a comprehensive set of due diligence steps representing the basic steps the Exchange expects to be carried out in relation to new listing applicants.

The second stage of the regulatory authorities' efforts to raise the bar in relation to work performed by sponsors in relation to IPOs, comprised the new licensing regime for sponsors which came into effect on January 1 this year. This introduced a series of new eligibility criteria for licensed corporate finance advisers wishing to conduct sponsor work as well as a number of on-going obligations for sponsors. This new regime is intended to improve the standard of sponsor work and was one of the reasons given by the SFC in its consultation conclusions on its proposed amendments to the prospectus regime for not seeking to impose prospectus liability on sponsors under the Companies Ordinance, as had originally been proposed.

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Firms wishing to conduct sponsor work are required firstly to satisfy the licensing eligibility criteria for Regulated Activity Type 6 (Advising on Corporate Finance) and to comply with the existing SFC Codes and Guidelines, as has always been the case. Sponsors must therefore continue to comply with the existing SFC guidelines, namely the Fit and Proper Guidelines, the Guidelines on Competence, The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and the Corporate Finance Adviser Code of Conduct.

Since January 1 2007, they must also meet the eligibility criteria set out in The Additional Fit and Proper Guidelines for Sponsors and Compliance Advisers set out in Appendix I of the Fit and Proper Guidelines.

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Under the new regime, only corporate advisory firms meeting the new eligibility criteria are allowed to act as sponsors and compliance advisers. Eligible firms who wish to conduct sponsor work also have to comply with specific on-going obligations as set out in the Additional Fit and Proper Guidelines. Firms that do not meet the new criteria or do not wish to conduct sponsor work are imposed with a licensing condition restricting them from undertaking sponsor work which also prevents them from conducting compliance adviser work. Such firms do not need to meet the new increased minimum paid-up capital requirement for sponsors.

According to the SFC's figures, only 84 corporate finance advisers are now permitted to act as sponsors. A no-sponsor work licensing condition has been imposed on the other 183 licensed

corporate finance advisers.

The new Sponsor Guidelines adopt all the proposals put forward in the SFC's original June 2005 Consultation Paper with the exception of the proposal on mandatory professional indemnity insurance coverage for all sponsors and the proposal for annual confirmation to the SFC that the required assessment of internal controls has been conducted.

The Listing Rules of the Hong Kong Stock Exchange were also amended with effect from January 1 2007 so that a firm is allowed to act as a sponsor or compliance adviser only if its SFC license permits it to conduct sponsor work. The Exchange no longer imposes any additional initial or continuing eligibility criteria on sponsors. Those amendments also removed the Exchange's ability to sanction sponsors and compliance advisers: the SFC is now solely responsible for the discipline of sponsors and compliance advisers including in respect of breaches of the Listing Rules.

A ADDITIONAL ELIGIBILITY CRITERIA FOR SPONSORS

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The new eligibility criteria are as follows:

1. EXPERIENCE AND EXPERTISE IN SPONSOR WORK

A sponsor must have sufficient expertise, manpower and resources to conduct sponsor work. It is required to appoint a competent transaction team with sufficient manpower and resources to carry out each IPO transaction. A transaction team must have sufficient knowledge of the corporate finance practice and regulatory requirements of the Hong Kong market.

2. MANAGEMENT SUPERVISION AND RESPONSIBILITY

The Guidelines make a Sponsor's Management ultimately responsible for the supervision of the sponsor work carried out by the firm and compliance with all relevant rules, regulations, codes and guidelines. A firm's "Management" includes its Board of Directors, Managing Director, Chief Executive Officer, Responsible Officers and other senior management personnel.

3. TRANSACTION TEAMS AND APPOINTMENT OF PRINCIPALS

Whenever a firm takes up an appointment as a sponsor, the Management is required to appoint a team (a "transaction team") comprising corporate finance staff competent in the context of the work to be carried out by the team.

Sponsors must have sufficient Principals to supervise their transaction teams and must have a minimum of 2 Principals at all times. At least one Principal must supervise each transaction team formed to undertake sponsor work.

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Eligibility Criteria For Principals

To qualify as a Principal, an individual must:

- i. be a Responsible Officer ("RO") licensed for Regulated Activity Type 6;
- ii. have at least 5 years' relevant corporate finance experience in respect of

companies listed on the Main Board and/or GEM Board preceding the appointment as Principal;

- iii. have played a substantial role in supervising a listing applicant as sponsor in at least 2 completed IPOs on the Main Board and/or the GEM Board in the 5 years immediately preceding his appointment..

5 Years' Relevant Corporate Finance Experience

For the purposes of condition (ii), relevant “corporate finance experience” may be made up of experience acquired in one or more of the following activities:

- a. IPOs
- b. notifiable or connected transactions as defined in the Exchange’s Listing Rules;
- c. a rights issue or open offer by a listed company in accordance with the Exchange’s Listing Rules;
- d. takeovers and share repurchases subject to the Codes on Takeovers and Mergers and Share Repurchases; and
- e. any other significant transactions or equity-fund raising exercises not listed in the above.

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The 5 years' corporate finance experience may be made up of experience acquired in one or more of the specified activities and need not be experience gained solely from IPOs. However, a majority of the relevant experience must have been acquired from transactions having an element of equity-fund raising by the listed issuers from the public and that experience must be sufficiently recent.

Some (but not all) of the 5 years' corporate finance experience may have been acquired in markets outside Hong Kong provided that those markets have comparable or higher legal and regulatory standards for the listing of companies and public offers of securities, regulate the conduct of sponsors or their equivalents and enforce rules and regulations governing these areas. If a person's experience has been acquired mainly overseas, he will need to satisfy the SFC that the relevant corporate finance experience requirement has been met.

IPO Experience

Experience on overseas IPOs will not satisfy the requirement that the Principal must have played a substantial role in supervising a listing applicant in 2 completed IPOs. The 2 completed IPOs must have been on the Hong Kong Main Board or GEM Board.

A "substantial role" in this context means a leading, supervisory role. The 2 IPO requirement need only be satisfied on a principal's initial appointment: it is not a continuing eligibility requirement.

Principals must be appointed by a board resolution. Supplement 10(s) which must be filed with the SFC on the appointment of a Principal, requires the Principal to declare that a board resolution has been passed appointing him or her

as a Principal. The sponsor firm must submit Supplement 10(s) completed by the Principal and endorsed by the firm to the SFC within 7 business days of the Principal's appointment.

The sponsor must also notify the SFC within 7 business days of the termination of a Principal's appointment.

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4. INTERNAL SYSTEMS AND CONTROLS

Sponsor firms are required to have effective internal systems and controls in place to ensure:

- i. adequate supervision and management of their employees conducting sponsor work;
- ii. that employees do not act beyond their proper authority; and
- iii. compliance with all applicable laws, regulations, codes and guidelines, including the Exchange's Listing Rules.

5. FINANCIAL RESOURCES

Sponsors are required to have a minimum paid-up capital of HK\$10 million at all times. This requirement has been prescribed in the Financial Resources Rules ("FRR").

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B ADDITIONAL ON-GOING COMPLIANCE OBLIGATIONS

1. MANAGEMENT RESPONSIBILITY

One of the Guidelines' core requirements is that the Management of a sponsor firm should assume ultimate responsibility for:

- the supervision of the sponsor work undertaken; and
- regulatory compliance.

Management must maintain effective communication with staff at the operational level to ensure that it is kept abreast of any key issues and risk areas in relation to its sponsor work.

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2. TRANSACTION TEAMS

Each transaction team appointed to an IPO transaction must have the manpower, expertise and Hong Kong regulatory experience which are appropriate to the size, complexity and nature of the transaction.

Each transaction team must be supervised by at least one Principal. A Principal may supervise more than one transaction team if:

- Management is satisfied that each team is properly and adequately supervised

by at least one Principal who has the necessary capacity, capability and competence to supervise; and

- The sponsor ensures that there is no conflict of interest.

Members of a transaction team may work in other transaction teams if Management and the Principals of the relevant transaction teams are satisfied that the sponsor can properly discharge its responsibilities in relation to all the sponsor work undertaken and there is no conflict of interest.

The Guidelines emphasise the importance of clear identification of reporting lines and the assignment of supervisory and reporting responsibilities to appropriate staff members. Each member of a transaction team should report directly to the Principal(s) responsible for the supervision of that team.

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3. PRINCIPALS' RESPONSIBILITIES

A Principal is expected to be the decision maker on all key issues relating to the work carried out by the transaction team and should be aware of the key risks in such work and responsible for measures to address them. The Principal is also expected to be fully conversant with the key issues relating to any particular transaction and should be able to respond promptly to requests from the regulators for information.

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Principals' Responsibilities in relation to Due Diligence

1. Sponsor's Declaration (MB Rule 3A.13/GEM Rule 6A.13)

As soon as practicable after the hearing of the listing application but on or before the date of issue of the listing document, each sponsor must submit a declaration to the Exchange that:

- i. all documents required to be submitted to the Exchange by the Listing Rules have been submitted;
- ii. having made reasonable due diligence inquiries, the sponsor has reasonable grounds to believe and does believe that:
 - a. the answers provided in the directors' declarations are true and complete;
 - b. the new applicant complies with all conditions for listing under Chapter 8 of the Main Board Listing Rules or Chapter 11 of the GEM Listing Rules unless compliance has been waived by the Exchange;
 - c. the listing document contains sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the shares and the financial condition and profitability of the new applicant at the time of issue of the listing document;

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- d. the information in the non-expert sections of the listing document:
 - i. contains all information required by relevant legislation and rules;
 - ii. is true in all material respects, or, if it consists of opinions or forward looking statements, they have been made after due and careful consideration and on bases and assumptions that are fair and reasonable; and
 - iii. does not omit material information;
- e. the new applicant has established adequate procedures, systems and controls (including accounting and management systems) to enable it and its directors to comply with the Exchange Listing Rules and other relevant legal and regulatory requirements (including in particular the requirements of the listing rules in relation to the general obligation of disclosure, the issuer's obligation to respond to the Exchange regarding unusual price movements or trading volumes of its shares, Notifiable and Connected Transactions and the requirements for disclosure of financial information. The sponsor must also declare the sufficiency of the applicant's internal controls to enable its directors to make a proper assessment as to its financial position and prospects and to release timely information to the market as required under the Listing Rules;
- f. the new applicant's directors collectively have the experience,

qualifications and competence to manage the new applicant's business and ensure compliance with the Listing Rules; and

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- g. in relation to each expert section in the listing document, having made reasonable due diligence inquiries, the sponsor must declare that it has reasonable grounds to believe and does believe (to the standard reasonably expected of a sponsor which is not itself expert in the matters dealt with in the relevant expert section) that:
 - i. where the expert does not conduct its own verification of any material factual information on which the expert is relying for the purposes of any part of the expert section, such factual information is true in all material respects and does not omit any material information. Factual information includes factual information on which the expert states (or the sponsor believes) the expert is relying and supporting or supplementary information given by the expert or new applicant to the Exchange relating to the expert section;
 - ii. all bases and assumptions on which the expert section are founded are fair, reasonable and complete;
 - iii. the expert is appropriately qualified, experienced and sufficiently resourced to give the opinion;

- iv. the expert's scope of work is appropriate to the opinion given and the opinion required to be given in the circumstances;
- v. the expert is independent of the new applicant, its directors and controlling shareholder(s); and
- vi. the listing document fairly represents the views of the expert and contains a fair copy of or extract from the expert's report.

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2. Sponsors' Due Diligence Obligations on Initial Listing under Main Board Practice Note 21/GEM Practice Note 2

Sponsors are required to have regard to the new Practice Note entitled "Due Diligence by Sponsors in respect of Initial Listing Applications". The Practice Note however applies only to sponsor firms and not to individuals employed by them. It sets out the Exchange's expectations of the due diligence sponsors will typically need to perform to be able to give the Sponsor Declaration.

The Exchange's introduction stresses that:

- i. a sponsor should make such inquiries as may be necessary until the sponsor can reasonably satisfy itself in relation to the disclosure in the listing document. A sponsor should examine with professional scepticism the accuracy and completeness of statements and representations made, or other information given, to it by the new

applicant or its directors. An attitude of professional scepticism means making a critical assessment and being alert to information, including information from experts, that contradicts or brings into question the reliability of such statements, representations and information;

- ii. the Practice Note cannot be seen as setting out the actual due diligence steps which will be appropriate in any particular case. It contains only the requirements the Exchange typically expects to be performed. The scope and extent of due diligence will always be a matter of judgment in the particular circumstances and may therefore need to be considerably more extensive than the steps set out in the Practice Note;
- iii. sponsors are required to document their due diligence planning and significant deviations from their plans. That includes demonstrating that they have considered what inquiries are necessary in the relevant circumstances. Sponsors are also expected to document their conclusions as to the applicant's compliance with the conditions for listing under MB Chapter 8 and GEM Chapter 11; and
- iv. in circumstances where it is appropriate for the sponsor to engage third party professionals to assist it in carrying out due diligence (eg. in reviewing legal proceedings to which the new applicant is a party), the Exchange expects the sponsor to satisfy itself that it is reasonable to rely on information or advice provided by the third party professional. That would include, for example:
 - a. being satisfied as to the competence of the professional, the

scope of work to be undertaken by the professional and the methodology proposed to be used by the professional; and

- b. being satisfied that the third party professional's report or opinion is consistent with the other information known to the sponsor about the new applicant, its business and business plans.

The Practice Note's requirements as to expected due diligence investigations relate to the following 5 areas:

- the new applicant's directors
- compliance with the qualifications for listing;
- the non-expert sections;
- the expert sections; and
- the new applicant's accounting and management systems and directors' understanding of the Listing Rules' obligations.

Charltons has prepared a "Record of Compliance" to assist you in the conduct of due diligence. Some of you may have attended the seminar I gave before on the Record of Compliance, but for those who didn't, this contains a number of due diligence checklists covering the 5 areas covered by the Practice Note on Due Diligence. These are intended to provide you with the due diligence steps that will typically be necessary to enable you, as sponsors, to make the required Sponsor Declaration.

1. **The New Applicant's Directors (including executive and non-executive directors)**

The typical due diligence inquiries required by Paragraph 11 of the Practice Note in relation to the collective and individual experience, competence and integrity of directors include:

- i. reviewing written records that demonstrate each director's past performance as a director of the new applicant including participation in board meetings and decision making relating to the management of the new applicant and its business;
- ii. assessing individually and collectively the financial literacy, corporate governance experience and competence generally of the directors to determine whether the board as a whole has a depth and breadth of financial literacy and understanding of corporate governance, having regard to any code on corporate governance practices published by the Exchange; and
- iii. reviewing the financial and regulatory track record of each publicly listed company (including companies listed on other stock exchanges) of which any of the new applicant's directors is or was an executive or non-executive director (eg. by reference to company disclosures, media articles and information about those companies on the relevant stock exchange website).

The Record of Compliance includes at Annex 8 a checklist of due diligence inquiries (including those set out in the Practice Note) for the purposes of the declaration as to the experience, qualifications and competence of the

applicant's directors (as required by Rule 3A.15(6) (GEM Rule 6A.15(6))).

Annex 9 sets out a further checklist of due diligence inquiries for the purposes of the declaration as to the accuracy of the information provided in the Directors' Declarations ((as required by Rule 3A.15(1) (GEM Rule 6A.15(1))). This includes steps such as obtaining copies of directors' ID cards and carrying out bankruptcy and litigation searches. To supplement these inquiries, Annex 10 sets out the form of a letter to be obtained from each director of the applicant confirming the completeness and accuracy of the answers given in his Director's Declaration and confirming that the director is not the person revealed in any results of a search against his name.

2. Compliance with Listing Qualifications

The typical due diligence inquiries required by Paragraph 12 of the Practice Note include:

- i. searching the company registry in the new applicant's place of incorporation to confirm that the new applicant is duly established in that place and is in compliance with its memorandum and articles of association (or equivalent documents);
- ii. reviewing material financial information, including:
 - a. financial statements of the new applicant;
 - b. financial statements of the new applicant's subsidiaries and other companies material to the group's financial statements;and

- c. the internal financial records, tax certificates and supporting documents for the trading record period.

Such review would normally include interviewing the new applicant's accounting staff and internal and external auditors and reporting accountants and, where relevant, obtaining comfort from the new applicant's external auditors or reporting accountants based upon agreed procedures; and

- iii. assessing the accuracy and completeness of the information submitted by the new applicant to demonstrate that it meets the trading record requirement.

Annex 12 of the Record of Compliance sets out typical due diligence steps (including those set out in the Practice Note) for assessing a listing applicant's compliance with the conditions for listing as set out in Chapter 8 of the Main Board Rules and Chapter 11 of the GEM Rules.

3. Non-expert Sections

The typical due diligence inquiries required by Paragraph 13 of the Practice Note in respect of a new applicant and the preparation of its listing document include:

- i. assessing the financial information to be published in the listing document including:
 - a. obtaining written confirmation from the new applicant and its directors that the financial information (other than that already

reported on by a reporting accountant) has been properly extracted from the relevant accounting records; and

- b. being satisfied that the above confirmation has been given by the applicant and its directors after due and careful inquiry;
- ii. an assessment of the new applicant's performance and finances, business plan and any profit forecast or estimate, including an assessment of the reasonableness of budgets, projections and assumptions made when compared with past performance, including historical sales, revenue and investment returns, payment terms with suppliers, costs of financing, long-term liabilities and working capital requirements. This would normally involve interviewing the new applicant's senior management and would often involve interviewing major suppliers and customers, creditors and bankers;
- iii. assessing whether there has been any change since the date of the last audited balance sheet included in the listing document that would require disclosure to ensure the listing document is complete and not misleading;
- iv. assessing whether it is reasonable to conclude that the proceeds of issue will be used as proposed by the new applicant, taking into account the sponsor's assessment of, in particular, the new applicant's existing cash and liquid reserves, projected liabilities, working capital requirements and expenditure controls;
- v. a physical inspection of material assets, whether owned or leased, including property, plant, equipment, inventory and biological assets

(eg. livestock or crops) used or to be used in connection with the new applicant's business.

A “physical inspection” requires the sponsor to visit the site to view the asset and to assess its extent, quality and quantity and the purpose for which it is to be used. Where in the reasonable opinion of the sponsor, assessment of an asset, including as to its extent, quality, quantity and use, genuinely cannot be achieved without the use of an expert (eg. where in undertaking the inspection, the sponsor becomes suspicious that the asset does not exist to the extent represented or is not used for the purpose claimed) the sponsor must ensure that the new applicant appoints an appropriately qualified independent expert to conduct all or part of the inspection. The sponsor should ensure that the expert is required to provide a written report of the inspection.

- vi. reaching an understanding of the new applicant's production methods;
- vii. reaching an understanding of the manner in which the new applicant manages its business, including as relevant actual or proposed marketing plans, including distribution channels, pricing policies, after-sales service, maintenance and warranties;
- viii. reviewing the business aspects (ie. non-legal aspects) of all contracts material to the new applicant's business;
- ix. reviewing all current and recently resolved (eg. within previous 12 months) legal proceedings and other material disputes in which the new applicant is involved and which the new applicant knows to be contemplated and may involve the new applicant or one of its

subsidiaries;

- x. analysing the business aspects of economic, political or legal conditions that may materially affect the new applicant's business;
- xi. considering the industry and target markets in which the new applicant's business has principally operated and is intended to principally operate, including geographical area, market segment and competition within that area or segment (including existing and potential principal competitors and their relative size, aggregate market share and profitability);
- xii. assessing whether there is appropriate documentation in place to confirm that the material assets, whether owned or leased, including property, plant, equipment, inventory and biological assets used/to be used, in connection with the new applicant's business, are appropriately held by the new applicant (eg. reviewing relevant certificates of title and rights of land use);
- xiii. assessing the existence, validity and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights of the new applicant;
- xiv. reaching an understanding of the technical feasibility of each new product, service or technology, developed, being developed or proposed to be developed pursuant to the new applicant's business plan that may materially affect the new applicant's business; and
- xv. assessing the stage of development of the new applicant's business

and assessing the new applicant's business plan and any forecasts or estimates, including reaching an understanding of the commercial viability of its products, services or technology, including an assessment of the risk of obsolescence and also market controls, regulation and seasonal variation.

Annex 13 of the Record of Compliance sets out a checklist of due diligence inquiries into the applicant's business for the purposes of the declaration as to the completeness and accuracy of the information in the non-expert sections of the prospectus (as required by Rule 3A.15(6) (GEM Rule 6A.16(6)). Annex 25 further contains the form of a letter which should be obtained from all directors of the applicant confirming the truth and completeness of the information in the prospectus and that any opinions or forward looking statements have been made after due and careful consideration and upon bases and assumptions that are fair and reasonable.

4. Expert Sections

The typical due diligence inquiries required by Paragraph 14 of the Practice Note in relation to the expert sections include:

- i. interviewing the expert, reviewing its terms of engagement (with particular regard to the scope of work, whether the scope of work is appropriate to the opinion required and any limitations on the scope of work which might adversely impact on the degree of assurance given by the expert's report, opinion or statement) and reviewing publicly available information about the expert to assess its qualifications, experience and resources and its competence to undertake the work;

- ii. a review of the expert sections of the draft listing document to form an opinion as to whether the following are disclosed and commented on appropriately: the factual information relied on by the expert; the assumptions on which its opinion is based; and the scope of work performed;
- iii. where the expert does not conduct its own verification of any material factual information on which the expert states (or the sponsor believes) the expert is relying for the purposes of its opinion, verifying such information to be able to give the declaration under MB Rule 3A.16(1)/GEM 6A.16(1) that such information is true in all material respects and does not omit any material information;
- iv. where the sponsor is aware that the new applicant has made formal or informal representations to an expert in respect of an expert section or a report made in connection with the listing application, assessing whether the representations are consistent with the sponsor's knowledge of the new applicant's business and its business plans;
- v. with reference to the sponsor's knowledge of the new applicant, its business and business plans, assessing whether the assumptions disclosed by the expert as those on which its opinion is based, are fair, reasonable and complete;
- vi. where the expert's opinion is qualified, assessing whether the qualification is adequately disclosed in the listing document; and
- vii. where the standard of independence is not set by the relevant professional body, obtaining written confirmation from the expert

that it is independent of the new applicant, its directors and controlling shareholder(s), and being satisfied that there is no cause to inquire further about the truth of such confirmation. This would include confirming that the expert does not have a direct or indirect material interest in the securities or assets of the new applicant, its connected persons or associates beyond that allowed by MB Rule 3A.07/GEM Rule 6A.07.

With respect to the requirement for sponsors to verify any material factual information relied upon (but not verified) by an expert, some uncertainty has arisen as to sponsors' obligations in relation to an accountants' report which is required to be included in a prospectus. Accountants' reports do not confirm that the accountants have "verified" the information on which they have relied for the purposes of issuing their report. The question has therefore arisen as to whether sponsors are obliged to go behind an accountants' report and carry out accounting style "verification" of the information relied upon by the accountants. The Exchange has however confirmed that the work performed by accountants in accordance with the relevant accounting standards to give the opinion in their report that the historical financial information included in a prospectus gives a true and fair view of the issuer's financial position will constitute "verification" of the factual information relied upon to reach that view for the purposes Rule 3A.16(1). Accordingly, sponsors are not required to verify the financial information relied upon by reporting accountants for the purposes of issue of their report.

Annex 16 of the Record of Compliance sets out a checklist of due diligence inquiries (including those specified in the Practice Note) for the purposes of

the declarations relating to the expert sections of the prospectus (as required by Rule 3A.16 (GEM Rule 6A.16)).

5. The New Applicant's Accounting and Management Systems and Directors' Understanding of Listing Rule Obligations

The expected steps under Paragraph 15 of the Practice Note include:

- i. assessing the new applicant's accounting and management systems that are relevant to:
 - a. the obligations of the new applicant and its directors to comply with the Listing Rules and other legal/regulatory requirements, in particular the financial reporting, disclosure of price sensitive information and notifiable and connected transaction requirements; and
 - b. the directors' ability to make a proper assessment of the financial position and prospects of the new applicant and its subsidiaries, before and after listing.

Such assessment should cover the new applicant's compliance manuals, policies and procedures including corporate governance policies and any letters given by the reporting accountants to the new applicant commenting on the new applicant's accounting and management systems or other internal controls; and

- ii. an interview of all directors and senior managers with key responsibilities for compliance (including the chief financial officer,

company secretary, qualified accountant and any compliance officers)
to assess:

- a. their individual and collective experience, qualifications and competence; and
- b. whether they appear to understand relevant obligations under the Listing Rules and other relevant legal and regulatory requirements and the new applicant's policies and procedures in respect of those obligations.

If the sponsor finds that the new applicant's procedures or its directors and/or key senior managers are inadequate in any material respect in relation to the issues referred to in paragraphs i. and ii. above, the sponsor should typically discuss the inadequacies with the new applicant's board of directors and make recommendations to the board regarding appropriate remedial steps (eg. tailored training for individual directors and senior managers). The sponsor should ensure such steps are taken prior to listing.

Another area of uncertainty has been the extent of sponsors' obligations with respect to the requirement that the sponsor assess the issuer's "*accounting and management systems that are relevant to the directors' ability to make a proper assessment of the financial position and prospects of the Company and its subsidiaries, both before and after listing*" (see paragraph i.b above). The Exchange has confirmed that this assessment should be focused on compliance with the Listing Rules and the obligation should be read as requiring sponsors to ensure that the issuer's internal controls are adequate to

ensure that material changes to the issuer's financial position and prospects are disclosed fully and in a timely fashion.

Sponsors' due diligence inquiries in relation to the issuer's internal controls should include ensuring that a compliance manual is operational and adequate, that a compliance officer has been appointed and that directors have adequate knowledge of their Listing Rule obligations. In addition, the sponsor should assess the adequacy of arrangements for ensuring compliance with, among other things, the connected party requirements, disclosure of advances to entities, disclosure of price sensitive information, including the requirement to issue financial reports and accounts within the required time frames and satisfying the stipulated content requirements and, as mentioned above, information about material changes to the financial position and prospects of the issuer.

Annex 18 of the Record of Compliance contains due diligence steps for the purposes of the declaration as to the adequacy of the Applicant's internal systems and controls to facilitate compliance with its Listing Rule obligations and enable a proper assessment of the Applicant's financial position. These are based on the SFC's Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission. In relation to this declaration, the Record of Compliance also includes at Annexes 19 and 20 respectively, a suggested checklist of procedures in relation to price sensitive information and a suggested Code on Disclosure of Price Sensitive Information which should be adopted by a listing applicant.

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Principals' Responsibilities in Relation to Due Diligence

In relation to the conduct of due diligence in relation to a listing applicant, the Principal should be responsible for determining the breadth and depth of due diligence and the amount of resources to be deployed for the due diligence exercise. The Principal should also be responsible for making a critical assessment of the results of the due diligence and an overall assessment of the adequacy of the due diligence review. The Principal must also ensure that all issues arising from the review are resolved.

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Principals' Responsibilities in Relation to Due Diligence

Key to the performance of the sponsor's responsibilities under the Guidelines is the existence of effective communication lines and reporting responsibilities to ensure that key information, issues and risk areas that come to light during the course of due diligence are firstly, reported by transaction team members to the Principal supervising the relevant transaction and that Management is made aware of such issues.

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Principals' Responsibilities

Under Listing Rule amendments which came into effect on January 1 this year, the Principal(s) most actively involved in an IPO transaction must sign relevant documents. These include, in the case of a Main Board listing, the Form A1,

Form B (the Declaration and Undertaking with regard to Directors), Form C1, the formal application and the Sponsor's Declaration. In the case of a GEM listing, the Principal responsible for supervising the IPO should sign Form A, the application form and the sponsor's declaration.

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4. INTERNAL CONTROLS AND ASSESSMENT

Sponsor firms are required to conduct an annual assessment of their internal systems and controls in relation to (i) the provision of adequate supervision and management of employees conducting sponsor work (ii) ensuring that employees do not exceed their authority and (iii) regulatory compliance, to ensure that such systems and controls remain effective. Any material non-compliance with Hong Kong's laws, rules and regulations must be reported promptly to the SFC under the Code of Conduct.

The annual assessment may be an internal and/or external or audit which should focus on the effectiveness of the internal controls and supervision, including reporting lines and the due diligence process, and identify any key operational risks associated with sponsor work in the light of the transactions the firm has advised on as sponsor in the preceding 12 months. Given the differences in size and business model among sponsors, the SFC expects each sponsor to devise its own specific systems and controls in light of its business operations and to decide the scope of its annual assessment on the basis of those systems and controls.

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5. RECORDS

Sponsors are required to keep a complete and up-to-date list of all sponsor work that has been and is being undertaken. The list should include the names of the companies advised, the nature of the transactions, the composition of transaction teams (including variations) and the title and role of each team member from start to finish. Such information must be made available to the SFC upon request.

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Sponsors should also keep records of the following appointments and assessments made by Management in order to demonstrate compliance with the Sponsor Guidelines:

- i. the appointment of the transaction team for each sponsor engagement;
- ii. the appointment of a RO as a Principal, the cessation of such an appointment and the decision-making process behind such appointment;
and
- iii. the annual assessment of the sponsor's internal systems and controls.

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6. CONTINUING PROFESSIONAL EDUCATION

The Sponsor Guidelines stipulate that at least 50% of the CPT hours (currently 5) that ROs and licensed representatives are required to undertake annually as holders of a corporate finance adviser licence should relate to sponsor work, e.g. skills that are relevant to their role as sponsors and knowledge of the relevant regulatory rules and their changes.

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7. MINIMUM CAPITAL REQUIREMENT

Sponsors must maintain paid-up share capital of at least HK\$10 million at all times.

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COMPLIANCE ADVISERS

The Sponsor Guidelines stipulate that corporate finance firms have to be eligible to act as sponsors under those guidelines (i.e. a firm must not have a licensing condition prohibiting it from conducting sponsor work) in order to act as compliance advisers under the Exchange's Listing Rules. Accordingly, any firm subject to a no-sponsor work licensing condition cannot conduct compliance adviser work.

INDEPENDENT FINANCIAL ADVISERS

The new regulatory regime does not impose any additional regulations on IFA's.

The Exchange has however changed its practice as to when it considers a firm “acceptable” to act as an IFA. With effect from 1 January 2007, a firm will be acceptable as an IFA if:

- i. it is licensed or registered to conduct sponsor work; or
- ii. it has completed at least two significant corporate finance transactions.

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COMMISSION INSPECTIONS

Sponsors and compliance advisers are subject to the on-going supervision of the SFC. The SFC is entitled to inspect the operations of sponsors and compliance advisers both on a routine and ad-hoc basis to ensure their compliance with relevant regulations. Failure to comply may result in the SFC imposing licensing conditions and/or issuing restriction notices curtailing a sponsor’s operations. The SFC may also impose a range of sanctions including reprimands, fines, suspension or revocation of licences for breach of the relevant regulatory requirements. Failure to comply may result in the SFC imposing licensing conditions and/or issuing restriction notices curtailing a sponsor’s operations. The SFC may also impose a range of sanctions including reprimands, fines, suspension or revocation of licences for breach of the Relevant regulatory requirements.

COMPLIANCE WITH EXISTING CODES AND GUIDELINES

The SFC has reminded sponsors that, as SFC licensees, they are subject to all relevant SFC Codes and Guidelines and not just the Corporate Finance Adviser Code of

Conduct. In particular, the general obligation under paragraph 12.5 of the Code of Conduct to report to the SFC details of any breach of the applicable rules, regulations, codes or guidelines, applies equally to sponsors.

PROHIBITION ON ACTING AS ADVISER TO GEM LISTED COMPANIES IN CERTAIN SITUATION

I will just finish by mentioning that under the Listing Rule amendments which came into effect on January 1 this year, certain rules previously set out in the GEM Listing Rules Chapter on the Eligibility of Sponsors and Compliance Advisers (Chapter 6) (which has now been repealed) have been moved to Chapter 6A. GEM Listing Rule 6A.37 provides that where a listed issuer proposes to issue a listing document specified in Rule 6A.36 during any period for which it is required to maintain a Compliance Adviser (ie.during the period ending with the publication of its financial results for the second full financial year commencing after listing under Rule 6A.19 or any other period when it is required by the Exchange to maintain a Compliance Adviser under Listing Rule 6A.20), then the issuer must appoint a sponsor **other than its current Compliance Adviser** to act as its adviser in relation to the transaction in question. The listing documents specified in Rule 6A.36 to which this prohibition apply are:

- (i) any listing document which constitutes a Companies Ordinance Prospectus;
- (ii) any listing document issued in relation to a rights issue or open offer; and
- (iii) any listing document issued in relation to a notifiable or connected transaction.