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# Proposed Increased Regulation Of IPO Intermediaries

The consultation paper on the regulation of sponsors and independent financial advisers (the **Consultation Paper**) published by the Hong Kong Stock Exchange (the **Exchange**) and the SFC sets out their proposals for greater regulation of corporate finance advisers acting as sponsors or independent financial advisers (**IFAs**) to new applicants or listed issuers on the Main Board or GEM. Central to the proposals is the administration by the Exchange of a new regime determining the acceptability of firms to act as sponsors and IFAs. New requirements are also imposed, including obligations on individuals, to ensure that sponsor and IFA work, particularly due diligence, is carried out to a satisfactory standard.

## Acceptable Sponsors and IFAs

Only firms admitted to the Exchange's list of acceptable sponsors will be eligible to act as sponsors to a new applicant or listed issuer. To act as an IFA to a listed issuer, the firm must be on either of the Exchange's lists of acceptable sponsors or acceptable IFAs. Eligibility depends on the corporate finance advisory experience of a firm's 'eligible supervisors', of which sponsor firms must have at least 4 and IFA firms must have at least 2. The on-going requirement is that an eligible supervisor must have at least 4 years' relevant corporate finance advisory experience (which may include overseas experience) and have played a substantive role in at least 3 completed significant transactions. Those transactions must include at least one of each of the following: a transaction involving a company listed on the Exchange; a transaction completed in the previous 2 years; and, for sponsor firms only, an IPO.

### What are 'significant transactions'?

It is proposed that the following will be accepted as 'significant transactions' in determining whether an eligible supervisor meets the required experience criteria:

1. IPOs
2. very substantial acquisitions or disposals
3. major transactions
4. connected and major transactions
5. a rights issue or open offer by a listed company
6. takeovers subject to the Takeover Code.

The equivalents of the transactions at 2-6 above under the rules applicable to listing on other recognised stock exchanges (or in the case of item 6, its equivalent in other recognised jurisdictions), will also be accepted as 'significant transactions'.

It is also proposed that guidance be given to clarify that transactions involving the production of an exempt listing document and the listing of investment companies will not be regarded as 'significant transactions'.

The concept of co-sponsorship (whereby firms not qualified as sponsors act as co-sponsors) is abandoned so that only acceptable sponsors may be retained as sole or joint sponsors. Sponsors (but not IFAs) will have to maintain a minimum capital requirement of not less than $10 million or a guarantee for that amount.

## The Code of Conduct

A new Code of Conduct for Sponsors and Independent Financial Advisers (the **Code of Conduct**) will set out the responsibilities of sponsors and IFAs, their eligible supervisors, directors and other staff members. This includes guidance on the minimum due diligence procedures expected. Compliance with the Code of Conduct will be mandatory under the listing rules. Failure by a sponsor or IFA firm, or their staff members to comply with the provisions of the Code of Conduct applicable to them will be subject to disciplinary action by the Exchange. Significantly, the due diligence responsibilities of sponsor and IFA firms will also apply directly to their eligible supervisors.

## Sponsors' Due Diligence

Proposed changes to the Main Board and GEM Listing Rules will require sponsors to conduct reasonable investigations to satisfy themselves that:

* the new applicant is suitable for listing, its directors appreciate the nature of their responsibilities and the applicant and its directors can be expected to honour their obligations under the Listing Rules and the Listing Agreement;
* the non-expert sections of the new applicant's listing application and prospectus are true and 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' (i.e. those parts purporting to be made on the authority of, or to be a copy of or an extract from a report, opinion or statement of, an expert) of the new applicant's listing application or prospectus are not true or omit to state a material fact required to be stated or necessary to avoid the statements being misleading.

The Code of Conduct sets out the minimum due diligence expected to be performed in conducting 'reasonable investigations' in the form of non-exhaustive descriptions of the subject matter and extent of due diligence. In relation to non-expert sections of a document, the essence of the guidance given is that sponsors must make site visits and conduct their own investigations rather than take information provided by management at face value. In relation to the expert sections, the crux of a sponsor's responsibilities is that it must determine that it can reasonably rely on the completeness and accuracy of the information, given its knowledge of the application/issuer, the agreed scope of work and its assessment of the reasonableness of the assumptions and qualifications made. The guidance given is only as to the minimum procedures expected, the adequacy of the extent of due diligence being always a question of judgement in the particular circumstances. If the sponsor identifies, or should reasonably have identified, a problem, it is obliged to undertake more detailed and extensive investigations into the problem subject matter.

## Declaration by Sponsors and Lead Underwriters

The proposal likely to be of most concern is the proposed US-style declaration in the prospectus by the sponsor and lead underwriter, as to the due diligence performed in providing the Exchange with assurances of the completeness and accuracy of the prospectus. This would build upon the statement currently given by sponsors to the Exchange on a private basis. In relation to non-expert sections, confirmation is required that 'after reasonable investigations' they believe and have reasonable grounds to believe that the information is not materially false or misleading. For expert sections, the required confirmation is that they have no grounds to believe and do not believe that the information is materially false or misleading.

## IFAs' Due Diligence and Declaration

Proposed amendments to the Main Board and GEM Listing Rules will require that IFAs:

* 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; and
* make a declaration in their report of the due diligence they have performed in order to reach their conclusion as to the fairness and reasonableness of the relevant transaction or arrangement.

The Code of Conduct sets out the minimum due diligence procedures expected of IFAs in 'taking all reasonable steps' to satisfy themselves of the matters required by the listing rules.

## Individuals' Undertakings

Potential acceptable sponsors and IFAs will be required to undertake to the Exchange to comply with the relevant listing rules, including the Code of Conduct, and to assist the Exchange with any investigations. In addition, it is proposed that eligible supervisors give separate undertakings to the Exchange to comply with the listing rules and the Code of Conduct. Breach of these undertakings will be liable to disciplinary action.

## On-going Advice for Listed Issuers

It is proposed that newly listed issuers on both the Main Board and GEM must appoint a firm from the sponsor list to provide on-going advice for a transitional period immediately following listing. For all new Main Board issuers (not just H-share issuers), the period will end on publication of the financial results for the first full financial year after listing. There will be no change to the GEM time limit, ie. the remainder of the financial year during which listing occurs and the following 2 financial years. During the prescribed period issuers will be obliged to seek the advice of a sponsor (which need not have acted on the IPO) in specified circumstances. These include the publication of any regulatory announcement, circular or financial report; where a notifiable transaction is contemplated; and monitoring the use of proceeds and adherence to the business plans set out in the prospectus. Where an issuer is required to produce a listing document, the sponsor's responsibilities are equivalent to those applicable to an IPO prospectus.

## Independence of Sponsors and IFAs

New directions are given as to when a proposed sponsor or IFA cannot be regarded as independent of the applicant and is therefore unable to act in such capacity. The Consultation Paper sets out a non-exhaustive list of such circumstances. It also stresses that there may be other relationships or interests which might give rise to a material interest in the success of a transaction which sponsors and IFAs will need to take into account in assessing their independence. Sponsors and IFAs will be required to declare their independence on any appointment as sponsor or IFA.

### Factors affecting the independence of sponsors and IFAs

The following is a non-exhaustive list of situations where sponsors will not be considered sufficiently independent of an applicant to act in those capacities:

1. a holding by any member of the sponsor's group of more than 5% of the new applicant's issued share capital;
2. the fair value of the shareholding referred to above exceeds 15% of the consolidated net tangible assets of the sponsor group;
3. a sponsor or any member of its group controls the majority of the board of directors of the new applicant;
4. a sponsor is controlled by or is under the same control as the new applicant;
5. 15% or more of the proceeds raised from an IPO is to be applied in settlement of debts due to a member of the sponsor's group;
6. a significant portion of the applicant's operation is funded by banking facilities provided by a member of the sponsor group;
7. where a director or employee of the sponsor, or their associates, has an interest in, or business relationship, with the applicant; and
8. where the sponsor or a member of the sponsor's group is the new applicant's auditor or reporting accountant.

The above criteria will also apply to IFAs. It is also proposed that the Exchange will generally preclude an IFA from concluding that it is independent if it has acted as a financial adviser to the listed issuer, its subsidiaries or any of its connected persons on any significant assignment with 2 years of appointment.

## Sanctions

It is proposed that sponsors, IFAs, their eligible supervisors and staff may all be subject to disciplinary sanctions for failure to meet the requirements applicable to them. All staff members licensed under the SFO to advise on corporate finance will be entitled to do sponsorship or IFA work under the supervision of an eligible supervisor unless they are on the Exchange's list of 'unacceptable persons'. The possible sanctions will be similar to those under the current listing rules and include a declaration that an individual is an unacceptable person or cannot be an eligible supervisor, absolutely or for a specified period, and suspension or removal of a firm from either of the lists of acceptable sponsors or acceptable IFAs.

The cut-off date for comments on the Consultation Paper is close of business on 31 July, 2003. These may be made by completion of the questionnaire annexed to the Consultation Paper which can be downloaded from the [HKEx website](http://www.hkex.com.hk/) and the [SFC website](http://www.sfc.hk/web/EN/index.html).

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