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# SFC Publishes Consultation Paper On The Regulatory Framework For Pre-IPO Research Reports

## Introduction

The Securities and Futures Commission ("**SFC**") has published a Consultation Paper on possible amendments to the regulatory framework governing investment research reports issued before a first listing of equity securities on the Hong Kong Stock Exchange ("**Pre-deal Research**"). The central proposal is to extend analysts' existing obligations as detailed in paragraph 16 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Code of Conduct**") to the preparation of Pre-deal Research. These proposals involve amendments to:

1. The Code of Conduct; and
2. The Corporate Finance Adviser Code of Conduct ("**CFA Code**")

Ensuring the independence and objectivity of Pre-deal Research reports are key goals for the SFC. The following is a summary of the principal proposals included in the Consultation Paper, a copy of which is available on the SFC website at [*here*](https://www.sfc.hk/sfcConsultation/EN/sfcConsultFileServlet?name=predealresearch&type=1&docno=1).

### Background to the proposed reform

The Consultation Paper recognises that analysts play a vital role in the Hong Kong capital market, acting as gatekeepers between companies and investors and providing investors with expert research and advice on the quality of the securities of public companies.

Difficulties arise however when analysts face a conflict of interest. This can occur where an analyst or his/her employer has a financial interest in an issuer, the value of whose securities the analyst is tasked with assessing impartially on behalf of third party investors. That interest has the potential to affect the analyst's ability to objectively present the issuer's financial position.

Paragraph 16 of the Code of Conduct addresses conflicts of interest by regulating the conduct of analysts and their employers with regard to investment research on securities traded in Hong Kong or research which has an effect on such securities. Processes designed to address conflicts of interest, for instance between a firm's trading and financial interests, are mandated as are procedures to prevent undue influence being placed on analysts by outsiders. Disclosure of any potential or actual conflicts and the analyst's ethical behaviour is required.

### The Scope of the Reform

The issues in relation to conflict of interest outlined above apply also to analysts examining a company or SFC authorised real estate investment trust ("**REIT**") which is preparing to list on the Exchange, and also to listed REITS. The SFC therefore proposes to extend the scope of paragraph 16 of the Code of Conduct beyond analysts covering companies listed in Hong Kong to:

1. Companies that are about to list their securities on the Exchange for the first time and which are obliged to issue a prospectus; and
2. Listings of and listed REITs

As retail investors typically do not have access to Pre-deal Research reports, the SFC aims to prevent such reports by analysts who are employed by a sponsor, manager, placing agent or underwriter to the offering (or by a related company) ("**Connected Analysts**") from being used as a means to disclose material information not disclosed in the prospectus solely to professional investors. This is to be achieved by preventing Pre-deal Research reports from containing or being based on information which is not in the public domain or the prospectus. In order to ensure compliance, the SFC intends to amend the CFA Code so as to place an obligation upon sponsors [[1]](#footnote-27) in relation to a new listing of equity securities. This is discussed in more detail below.

### Regulatory Framework for Pre-deal Research

At present, Hong Kong securities regulation does not deal specifically with Pre-deal Research. In a 2005 Consultation Paper [[2]](#footnote-29), the SFC considered banning the issue of Pre-deal Research reports written by Connected Analysts imposing an obligation to publish leaked Pre-deal Research reports by Connected Analysts and imposingalso imposing an obligation to publish leaked Pre-deal Research reports by Connected Analysts, and commentary on such leaked research reports, in the prospectus of the relevant listing applicant. However, following the consultation, it was determined that such a ban would be disruptive to the Initial Public Offer ("**IPO**") process and of little value to investors. Such research can, for instance, play an important role in the price discovery process. The focus shifted therefore to confronting the problems of unequal distribution of information and inaccurate information contained in Pre-deal Research reports.

### IPO Current Market Practice

The current practice is that the "pre-marketing" or "investor education" activities of Connected Analysts normally take place after the applicant for listing ("**Applicant**") receives from the Exchange a letter setting out the Listing Committee's comments and any conditions attached to the listing approval sought. In the case of REIT listing applicants, this process ordinarily commences after the REIT listing applicants and their listing agents receive the SFC's approval-in-principle letter.

The "pre-marketing" or "investor education" process is ordinarily preceded by the Connected Analysts distributing Pre-deal Research to professional and institutional investors under the placing tranche.

After the "pre-marketing" or "investor education" process, the underwriters commence the "book-building" procedure, where the underwriters approach potential institutional investors to gauge their interest in purchasing securities in the offering at various prices. This book-building process is usually conducted contemporaneously with a management road show and normally starts approximately two to three weeks before the start of the public offer period. Applicants will usually issue and distribute a "red herring" to assist in the book-building and management road show process.

Since January 2008, Applicants have posted a near complete prospectus (or near complete offering circular in the case of a public offering of SFC authorised Collective Investment Schemes, including REITs) on the HKEx Website at around the same time as the "red herring" is made available to institutional investors. This ensures public access to substantially the same information as that provided to institutional investors by the Applicant. The prospectus, which contains all relevant information relating to the offering and the accompanying share application form is issued later, upon registration with the Registrar of Companies in Hong Kong or authorisation by the SFC in the case of a REIT. A large majority of IPOs allow an offer period of three and a half days between the issue of the prospectus and the close of the offer.

It is already common practice for sponsors to use a detailed internal compliance system in order to ensure the independence and integrity of Pre-deal Research reports and to ensure that they are disseminated only to professional investors, and that there is no leakage of their contents whereby reports run the risk of technically constituting a prospectus. The SFC considers that as a result of these private initiatives, the implementation of a new regime regarding Pre-deal Research, with the principles underlying existing compliance procedures codified as a minimum expected standard, should pose no great practical difficulties.

### Proposed Amendments: Extend the Requirements under Paragraph 16 of the Code of Conduct to Pre-deal Research

The SFC notes that the risk of conflict of interest for Connected Analysts writing Pre-deal Research papers is the same as it is for Connected Analysts writing reports on listed companies. Accordingly it proposes extending the existing conflict of interest requirements for analysts writing research reports on listed corporations in paragraph 16 of the Code of Conduct to Pre-deal Research reports. This is to ensure analysts' independence and objectivity in relation to Pre-deal Research reports. This extension would also apply to proposed listings of and listed SFC-authorised REITs in Hong Kong.

### Proposed Amendments: The integrity of information provided to research analysts

The SFC identifies three key concerns relating to the integrity of information provided to research analysts:

1. Devising a means of preventing the leakage to the public of non prospectus information during or prior to the offer period.
2. Ensuring that Applicants and their representatives do not influence the content of Pre-deal Research reports by releasing information to the analyst which is not contained in the prospectus. This can be used as a means of circumventing the strict prospectus rules regarding the publication of information about the Applicant.
3. Preventing Connected Analysts from enjoying an advantage over other analysts due to their ability to obtain additional information by virtue of their links with the issuer.

These areas are being addressed by the SFC in three ways:

#### 1. The Codification of Control Procedures regarding the kind of information to which analysts have access

It is current market practice that firms employing research analysts preparing Pre-deal Research reports on an Applicant should be required to establish, maintain and enforce a set of written policies and control procedures to ensure that firms do not provide these analysts with any material or forward looking information (whether qualitative or quantitative) concerning the Applicant that is not reasonably expected to be included in the prospectus or publicly available.

Sponsors assist in this regard as they generally prepare the necessary data for analysts' briefings and also coordinate and manage the meetings between analysts and the Applicant's representatives. They will have control procedures in place to ensure that the Applicant's representatives do not communicate to the analysts any material information that is not contained in the prospectus or which analysts from other firms do not have access to.

To ensure the integrity of these control measures, the SFC proposes to amend paragraph 16.7 of the Code of Conduct in order to make firms responsible for ensuring that they do not pass any material or forward looking information (whether qualitative or quantitative), not reasonably expected to be included in the prospectus or otherwise publicly available, to any analyst charged with preparing a Pre-deal Research report on an Applicant.

#### 2. The Codification of the rule that analysts should not seek non prospectus information

The SFC also proposes amending paragraph 16.11 of the Code of Conduct to require that research analysts preparing Pre-deal Research reports on an Applicant should not seek from the Applicant or its advisers, either directly or indirectly, any material or forward looking information (whether qualitative or quantitative) concerning the Applicant that is not reasonably expected to be included in the prospectus or publicly available.

The SFC states that this proposal is not designed to prevent analysts from undertaking their own due diligence exercises, including for example site visits organised by the Applicant. Nor is it intended to disallow the inclusion of forward looking material prepared by the analysts themselves in Pre-deal Research reports. However the material cannot be formulated or prepared by the Applicant.

#### 3. The creation of an obligation upon sponsors, in relation to a new listing of equity securities, to take steps to ensure that all material information or forward looking information (whether qualitative or quantitative) disclosed or provided to analysts is contained in the relevant prospectus, offering circular or similar document

Paragraph 5.3 (a) of the CFA Code contains the principle that sponsors are the primary guide and manager of the Applicant throughout the IPO process. As noted above, one of their key responsibilities is the control of meetings between analysts and Applicant representatives in order to ensure that no material information which is not reasonably expected to be contained in the prospectus or otherwise publicly available is disclosed to the analysts. This does not mean they must be present at every meeting, but they certainly must be present at the main analyst briefings.

The SFC proposes to amend the CFA Code to create an obligation on sponsors, in relation to a new listing of equity securities, to take steps to ensure that all material or forward looking information (whether qualitative or quantitative) disclosed to analysts is contained in the relevant prospectus, offering circular or similar document. If adopted, this obligation would apply equally to listing agents in the case of REITs.

## Applicant Responsibility for Disclosure of Information

The SFC also discusses and dismisses the suggestion, put forward by market practitioners, that sole responsibility for the disclosure to analysts of material or forward looking information should fall upon the Applicant and its directors. The argument advanced by the market participants was that as the directors and the Applicant are responsible for the content of the prospectus, the sponsor should have no duties in this area.

However the SFC notes that sponsors have a responsibility, under paragraph 5.3 of the CFA Code of Conduct, for the overall management of the public offer and putting in place sufficient arrangements and resources to ensure that the public offer is conducted in a fair, timely and orderly manner. This includes ensuring that Applicants are properly informed about what information may or may not be disclosed to analysts. The SFC suggests that of the three groups, analysts, sponsors and Applicants, the latter are usually the least informed as regards the intricacies of the IPO process and as a result, the responsibilities in this specific area should not lie with them.

 *This note contains a summary only of the principal proposals contained in the SFC's Consultation Paper on the Regulatory Framework for Pre-deal Research. Specific advice should be sought in relation to any particular situation.*

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1. The term "sponsor" also refers to listing agents in the case of new listings of REITs. [↑](#footnote-ref-27)
2. Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance 2005. [↑](#footnote-ref-29)