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# SFC Publishes Consultation Conclusions On The Regulatory Framework For Pre-Deal Research Reports

The Securities and Futures Commission (**SFC**) published on 30 June 2011 its Consultation Conclusions (the **Conclusions**) concerning proposed amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) and the Corporate Finance Adviser Code of Conduct (**CFA Code**).

These proposals will expand the conflict-of-interests requirements to which research analysts are subject, extending them to research regarding companies about to be listed and Real Estate Investment Trusts (**REITs**). On the latter point, the Consultation Conclusions highlight Paragraph 5.12 of the Code on REITs, which makes it clear that the listing agents of a management company of a REIT should comply with all the requirements under the SFC Codes and guidelines, including the CFA Code, meaning that all the reforms discussed here apply equally to REITs.

Furthermore, the reforms oblige 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.

These Conclusions are the product of the SFC’s September 2010 Consultation Paper and market consultation process on the matter. The six respondents to the Consultation Paper were largely positive about the changes to the regulatory regime. For further discussion of the Consultation Paper, including information concerning the background to the proposals and current market practice as regards IPOs, please refer to [our newsletter of December 2010](/newsletters/hklaw/en/2010/101/nl-hklaw-20101210-101.html). The new regime is examined in detail in this newsletter but the key alterations to the proposals set forth in September are:

* The refinement to the proposal banning the provision to analysts of any forward looking qualitative information not contained in the prospectus – this was felt to be excessively strict and the information excluded has now been confined to material information which does not form part of the listing document or prospectus. The scope of the term “material information” extends to both historical and forward looking information.
* The extension of the SFC requirements for investment research concerning a listed company or REITs to business operations conducted in alternative form, such as a business trust. However the SFC state explicitly that no prejudgment has been made as the whether such a corporate form is suitable for listing on the Stock Exchange of Hong Kong (the **Exchange**).

The SFC, having considered the response from market participants, has elected to press forward with the reforms discussed in the Consultation Paper, subject to the adjustments detailed in this newsletter. The new regime will be effective from 1 September 2011, save for the elements which apply to new listings, which will affect any new listing where the listing application is submitted to the Exchange on or after 1 August 2011.

## Goal Of The Proposals

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.

## The Proposals And The Reaction Of Market Participants Thereto

### Extending the SFC requirements concerning analysts responsible for investment research

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. The SFC noted in the Consultation Paper 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 the SFC 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 (i.e. those concerning companies that are about to make their first listing of equity securities on the Exchange and are obliged to issue a prospectus). This is to ensure analysts’ independence and objectivity in relation to such reports. This requirement also applies to proposed listings of, and already listed, SFC-authorised REITs in Hong Kong.

Furthermore, the SFC state that the obligation on firms with an investment banking relationship with listed corporations to disclose this relationship in their research reports, now applies to an investment banking relationship with applicants for listing. An involvement with an IPO as a sponsor or the imparting of corporate finance advice will bring a firm within the scope of the term “investment banking relationship”. This obligation to disclose also applies to Pre-deal Research and should cover the nature of the conflict of interest, encompassing any potential benefits accruing from the investment banking relationship in question.

#### Response of Market Participants

These proposals received unanimous support from responding market participants, although calls were made for a revisiting of the SFC’s 2006 decision that it is inappropriate to ban Pre-deal Research entirely, which was made on the basis that such a ban would be disruptive to the IPO process and of little value to investors, The SFC refused to review this issue and also refused to consider the suggestion of one respondent that a “quiet period” of, at minimum, one month for investment banks assuming the role of sponsors be imposed, so that they are prevented from releasing Pre-deal Research for a certain time period to the occurrence of the IPO.

The SFC emphasized that it is the responsibility of the firm in question to ensure that procedures are in place to prevent conflict of interest problems arising between its analysts, who carry out Pre-deal Research, and its role as a sponsor or underwriter of an IPO. This should, according to the SFC, include constraints on the timing of the release of Pre-deal Research, but the exact length of any such “quiet period” is a matter for the firms themselves, having regard to their particular circumstances.

### Listing of business operations which take a form other than that of a corporation

During the Consultation process, the SFC received queries from market participants regarding the possibility of listing a business in the form of a business trust. Although the SFC declined to comment on whether such listings are appropriate for the Hong Kong market, it did note that any investment research by a corporate form other than that of a corporation, including a thrust, should be within the scope of the SFC requirements which apply to listed companies or listing applicants. To achieve this, the SFC has amended Paragraph 16 of the Code of Conduct, extending its application to corporate forms other than a corporation or a REIT, References to “listed corporation” have been replaced with references to “issuers”, in order to emphasise that the rules apply to corporate entities other than corporations or REITs.

## The Integrity Of Information Being Provided To Research Analysts

In the Consultation Paper the SFC identified three key concerns relating to the integrity of information provided to research analysts and stated that the following reforms must be undertaken:

1. Devising a means of preventing the leakage to the public of non-prospectus information during or prior to the offer period.
2. Ensuring the Applicants and their representatives do not influence the content of Pre-deal Research reports by releasing information to an analyst which is not contained in the prospectus. This can be used as a means of circumventing the strict prospectus rules regarding the publications 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:

* The Codification of Control Procedures regarding the kind of information to which analysts have access
* Codifying the rule that analysts should not seek non prospectus information
* Codifying the existing practices adopted by sponsors in relation to a new listing of equity securities, in order to maintain the integrity of the flow of information to analysts.

Each of these reforms will new be examined in detail.

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

In the Consultation Paper, the SFC proposed to codify the 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 they 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. The term “material information or forward looking information” was originally intended by the SFC to connote the following:

1. any material information which enables a reasonable person to form as a result thereof a valid and justifiable opinion of the shares and the financial condition and profitability of the company at the time of the issue of the prospectus; and
2. any forward-looking information, whether such information is quantitative or qualitative in nature.

At the time of drafting this explanation of the term, the SFC had no plans to qualify the concept of forward-looking information with a materiality concept. However, as discussed immediately below, this approach has been modified in light of responses from market participants.

#### Response of Market Participants

This proposal was also the recipient of widespread market support. As regards the concept of “material information”, respondents were unanimous in their belief that analysts should not have access to information which is not in the prospectus, yet is material. However, forward looking information proved a more divisive topic, although there was once again unanimous agreement among respondents that analysts should not be given access to an Applicant’s financial projections where these are not included in the prospectus.

One respondent, representing a consortium of banks, proposed that the ban on providing forward looking qualitative information not contained in the prospectus, such as general industry trends and future growth of the industry or section in which the listing applicant operates, be lifted. The argument put forward in support of this suggestion was that analysts have different needs to investors when it comes to the information which an Applicant should supply to them. This kind of forward looking qualitative information would be of use to analysts and not investors and thus should be made available to the former without being included in the prospectus.

While accepting that some forward looking information may not be required by investors to form a valid and justifiable view of the Applicant’s financial status and profitability, the SFC refused to accept that all such information is not needed by investors when making an investment decision vis-à-vis the Applicant.

The approach settled upon by the SFC, with regard to this issue, is to apply a single test to all types of information, rather than attempting to define precisely what kind of forward looking information may be made available to analysts when not contained in the prospectuses. The test applied by the SFC is “whether the information is material to an investor in forming a valid and justifiable opinion of the Applicant and its financial condition and profitability”. Furthermore, the SFC state that when evaluating whether any information, especially forward looking information, is to be considered material and thus within the scope of a ban, regard must be had as to whether including such information in a prospectus would be likely to have a significant influence on a “reasonable person’s opinion of the Applicant and its financial condition and profitability”.

### Analysts should not seek non-prospectus information

In the Consultation Paper, the SFC also proposed 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.

Paragraphs 16.7(b) and 16.11(c) of the Code of Conduct are to be revised by the SFC, in order to oblige firms to put in place written policies and control procedures which prevent analysts responsible for preparing a research report from becoming privy to material information.

The SFC stated clearly at the time 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, such material cannot be formulated or prepared by the Applicant.

#### Response of Market Participants

Once again, the reaction to the SFC proposals was largely very positive. The group representing a number of banks was against the proposal, once more on the grounds that research reports and prospectuses are intrinsically different and have entirely different aims, and that to deny analysts access to qualitative forward looking information would have the effect of removing one of their most valuable data sources.

The group also claimed that the duty to control the information flow to the analysts should lie with the Applicant and that Applicants should be required to ensure the prohibited information is not provided to analysts, and all material information made available is contained in the prospectus.

The SFC do not address in detail the former argument made by the group, in relation to the central tenet of the proposal, possibly because they dismissed a similar argument in the previous section of the Conclusions regarding codification of Control Procedures.

However in relation to the latter point concerning control of the data flow, the SFC highlight the crucial role of sponsors in providing information to analysts via “analysts briefing papers”. This, according to the SFC, places sponsors in the perfect position to certify that any material information they pass on to analysts is also included in the prospectus. Analysts, for their part, are instructed by the SFC not to request material information from Applicants that is not reasonably expected to form part of the prospectus or be publicly available. Finally, should the analyst receive information not contained in the briefing papers which could be material, she should inform the sponsor and applicant who must then assess the information and decide whether to include it in the prospectus.

The SFC also stated, in response to a suggestion from a market participant, that it was unnecessary to draw up guidelines which make explicit what information analysts should and should not ask Applicants for, as this is an area where analysts themselves know the boundaries of what is acceptable. Furthermore, following a query from another respondent, the SFC state that as a matter of good practice, a firm’s conflicts of interest policy should demand that its analysts disclose instances when they are provided with information not contained in the prospectus, which may have a negative effect on their integrity and ethics.

### Codifying the existing practices for sponsors in relation to a new listing of equity securities, in order to maintain the integrity of the flow of information to analysts.

The Consultation Paper contained an SFC proposal to codify existing market practice in relation to sponsors’ responsibilities during a listing of new equity securities. This proposal creates 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. This is to be achieved via the amendment of Paragraph 5.10 of the CFA Code.

#### Response of Market Participants

Nearly all respondents supported the imposition of a duty on sponsors to ensure that information supplied to analysts is included in the prospectus or listing document. The SFC is of the opinion that the position of a sponsor during the IPO process, as an intermediary between the Applicant and connected analysts, places them in an ideal position to ensure that the Applicant is properly advised in how to interact with analysts.

However once again the group respondent took a viewpoint contrary to that of the SFC, claiming that it was unreasonable to expect sponsors to accept responsibility for (a) syndicate members whose research analysts do not comply with the Research Guidelines, the Code of Conduct for or the Code of Conduct, and (b) any consequences arising from such non-compliance by syndicate members.

Countering this argument, the SFC noted that in syndicates where there is more than one sponsor, sponsors forming part of the syndicate are jointly responsible for compliance with the CFA Code. In light of this, the SFC rejected the assertion that the proposed modification to the regulatory regime imposes an unreasonable burden when sponsors act in a group.

One respondent suggested that sponsors should be obliged to ensure the presence of a compliance officer at presentations in order to block any possible attempts by listing applicants to disclose material information without incurring the accompanying liability. However the SFC refused to support an explicit obligation, nothing that it is the responsibility of the sponsor to implement the specific procedures needed to monitor the flow of information.

Finally the SFC voiced its approval of a respondent’s submission that effective monitoring and supervision practices of sponsor and underwriter should be part of the control procedures implemented by firms employing Pre-deal Research analysts. The form that these procedures take should be determined by the type, size and complexity of the firm in question.

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