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# Hong Kong Law Issue 154

## Hong Kong Stock Exchange Issues Guidance On Hard Underwriting Disclosure In Listing Documents

Hong Kong Exchanges and Clearing Limited (**HKEx**) has issued a new guidance letter HKEx-GL34-12 (**Guidance Letter**) in relation to the disclosure of “hard” underwriting arrangements in listing documents. Such arrangements are usually made when the applicant does not expect the demand for the offered shares to be strong.

### “Hard” Underwriting Agreements

Typically, listing applicants enter into underwriting agreements to ensure that the shares offered are fully underwritten as required by Rule 7.03 of the rules governing the listing of securities on the Stock Exchange of Hong Kong Limited (**Main Board Rules**). Unlike “soft” underwriting agreements, a “hard” underwriting agreement requires the underwriters to purchase a fixed value of any excess shares on offer, on the condition that the final fixed offer price is fixed at the lowest end of the indicative offer price range. The applicant would pay a fee for a “hard” underwriting agreement in addition to the other underwriting fees required for “soft” underwriting agreements.

### Disclosure Requirements for “Hard” Underwriting Agreements

If the listing applicant enters into a “hard” underwriting agreement before the prospectus is issued, the prospectus should disclose the salient terms of the agreement in accordance with the requirement of Main Board Rule 2.13(2) that the disclosure must be accurate and complete in all material respects and not be misleading or deceptive. The Guidance Letter recommends the following details to be included:

* The date of the agreement;
* The amount of the offered shares underwritten;
* The conditions of the agreement;
* The grounds for termination of the agreement; and
* The fees payable pursuant to the agreement.

If the “hard” underwriting agreement is entered into after the prospectus is issued, the issuer must prepare a supplemental prospectus to disclose the above information.

## SFC Fines Investors For Illegal Short Selling Of Expected Allocation Of Excess Rights Shares

On 26 April 2012, seven people were fined a total of $71,000 on eleven charges of illegal short selling, to which they pleaded guilty. The Eastern Magistrates Court also ordered the defendants to pay the Securities and Futures Commission (**SFC**) $21,820 in investigation costs.

In May 2010, Imagi International Holdings Limited conducted a rights issue entitling its shareholders to four rights per share, each right entitling the shareholder to one new share. Since only some of the rights were exercised, the excess rights shares were made available for subscription by other Imagi shareholders. The defendants subscribed for these excess rights shares and placed orders to sell the amount of shares that they thought they would be allocated or would be able to receive in time for the settlement. At the time of short selling the Imagi shares, the defendants had not received confirmation as to how many excess rights shares they would receive or when they would receive the entitlement.

In placing orders to sell Imagi shares at a time when they did not and could not have reasonable grounds to believe that they had a presently exercisable and unconditional right to sell them, the defendants were guilty of illegal short selling.

## SFC Issues Fine And Revokes Ipo Sponsor’S Licence For Failure To Discharge Sponsor’S Duties

The SFC has fined and revoked the licence of a licenced corporation (the **LC**) for its failure to discharge its duties as sponsor on the listing of a listed issuer (the **Issuer**). The SFC’s case against the Issuer for allegedly disclosing materially false or misleading information in its prospectus led to the investigation into the LC’s role as sponsor. As a result of the SFC’s findings, summarised below, the LC lost its licence to engage in Type 6 (advising on corporate finance) regulated activities and was fined $42 million, the highest penalty that the SFC has ever imposed. This is the first time that a finding of inadequate due diligence on the part of an IPO sponsor has resulted in the revocation of its licence.

### Inadequate Due Diligence

The SFC found that the LC’s due diligence work was sub-standard. Examples of its inadequacy included missing material information in its questionnaires completed by the Issuer’s customers and suppliers; over-the-phone interviews with customers and suppliers that were conducted on the day the listing application was filed; and failure to properly verify franchisee information and obtain franchisee transaction records. The LC did not follow up on missing information on the Issuer’s customers and suppliers.

### Inadequate Audit Trail of Due Diligence

The LC failed to adequately document their due diligence planning and significant aspects of their due diligence work. There were no records of any background checks or due diligence checks that the LC may have conducted.

### Inadequate Supervision of Staff

The due diligence work was conducted by inexperienced and junior members of its staff without proper supervision. The LC’s responsible officers who were the sponsor principals for the listing denied that they were responsible for the listing application.

### Sponsor’s Independence

The LC’s independence and impartiality were also called into question, as important information obtained by the LC during the due diligence process was provided by the Issuer and was not verified independently. For example, the LC’s interviews with the Issuer’s suppliers, customers and franchisees were arranged by the Issuer and conducted in its presence. As per the Issuer’s requests, the LC did not contact the interviewees indirectly and did not interview some of them in person. Written confirmations of the franchisees’ independence from the Issuer were obtained through the Issuer.

### Possible Breach of Undertaking

The LC was required to submit an undertaking and declaration to the HKEx that it had made reasonable due diligence enquiries and that it believed that the information in the Issuer’s prospectus was true in all material respects without material omissions. The SFC considered that the LC appeared to have breached that undertaking and declaration. There was no evidence that the LC was involved in any fraud and the SFC took into account that it had an otherwise clean record.

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