

Hong Kong Regulator Turns Up the Heat on IPO Sponsors

Introduction

On 9 May 2012 the Securities and Futures Commission (SFC) released its [Consultation Paper on the Regulation of Sponsors](#) (Consultation Paper), attaching draft new rules to regulate the duties and liabilities of IPO sponsors in Hong Kong.

Having on numerous occasions made public allusions to a forthcoming paper in preceding weeks and months, the regulator spared no efforts in preparing the market for this development. Is the Consultation Paper the bombshell we have all been expecting? In this briefing we shall examine some of the key proposals under two headings: sponsors' conduct issues and fundamental regulatory issues.

Sponsor's conduct issues

The SFC proposes to revamp and restate some of the existing rules affecting specific aspects of the sponsors' conduct as licensed intermediaries.

Know (and keep close to) your client

A key theme of the proposed new rules is that an IPO sponsor should have a "sound understanding" of a listing applicant. This expressly extends to the applicant's history and background, business and performance, financial condition and prospects, operations and structure, procedures and systems, and key personnel including directors, senior managers and controlling shareholders. In substance, this appears to be no more than an expansion and restatement of an existing requirement under the Corporate Finance Adviser Code of Conduct (CFA Code).

Another proposed requirement is for the sponsor actively to advise and guide the listing applicant and its directors as to their responsibilities under relevant laws and regulations.

Get into shape before submitting the A1

The regulators have been outspoken about their dissatisfaction with attempts to bring "half-baked" cases to the A1 listing application stage.

For many years, the A1 was officially known as the "advance booking form", with which the Hong Kong Stock Exchange ("Stock Exchange") was asked to open a file on a listing proposal. Since 2009 when Forms A1 and C1 (the formal application form) were combined, the process has been streamlined. Practitioners are expected to have advanced draft documents (including an advanced draft prospectus) at the A1 stage, rather than wait till the later C1 stage. Evidently, this has not been very successful in acclimatizing all practitioners to the "get everything done before the A1" regulatory philosophy. In practice, some cases are simply too premature, in terms of the amount of due diligence the sponsor has done on the applicant and the quality of the disclosure document, for an A1 filing which under current rules is no longer an "advance booking", but the formal application for listing.

To hammer this in, the SFC has made a number of proposals regarding the status the due diligence is expected to have reached **before** filing the A1 listing application, including:

- the sponsor should complete all reasonable due diligence save only any matters that by their nature can only be dealt with at a later stage
- the sponsor should have come to a reasonable opinion that the information in the application proof prospectus is complete
- the sponsor should have come to a reasonable opinion that:

- (a) the applicant has complied with all applicable listing conditions (except where waived)
- (b) the applicant has established adequate systems and procedures to ensure compliance with applicable laws and regulations
- (c) the directors have the necessary experience, qualifications and competence
- the sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration of whether the applicant is suitable for listing, are disclosed to the regulators when submitting the listing application
- there will be a positive obligation for sponsors to advise and make recommendations to the applicant on any material deficiencies in its operations and structures, procedures and systems, to make sure that any material deficiencies are remedied before the A1 filing

More specific responsibilities at issue of prospectus

The SFC's next theme is spelling out more clearly the sponsor's responsibilities for prospectus disclosure and due diligence, which must be formally complete at the time of issue of the prospectus. These include requiring the sponsor:

- after reasonable due diligence, to ensure that at the time of its issue the prospectus contains sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the financial condition and profitability of the listing applicant
- to be able to demonstrate that it is reasonable for it to rely on the expert sections of the prospectus – the SFC will specify certain typical steps the sponsor should take to reach this position, including checking the qualifications and experience of the expert, assessing the bases on which the expert has made assumptions, verifying key facts used by the expert with the sponsor's own understanding of such facts, among other things
- after reasonable due diligence, to have reasonable grounds to believe and to believe that the information in the non-expert sections of the prospectus is true, accurate and complete in all material respects and that there are no material omissions

Alert the regulators

Whilst there are existing regulatory and legal requirements for sponsors to ensure all information provided to the regulators are true and accurate, the proposed new rules will impose a clearer positive obligation to inform both the SFC and the Stock Exchange of any circumstances where any information previously provided is no longer able to meet such requirements. In addition there will be an express obligation for sponsor to deal with regulators' enquiries in a cooperative, truthful and prompt manner.

There will also be a new obligation for a sponsor, if it ceases to act for an applicant, to inform the Stock Exchange in a timely manner of the reason for cessation to act.

Resourcing and supervision

The current requirements for management assuming full responsibilities for a sponsor firm's operation will be enhanced and expanded by specifying a number of aspects where the sponsor firm's management must take supervisory responsibility, including:

- accepting a mandate to act as sponsor
- implementation of the due diligence plan
- allocation of persons with appropriate knowledge, skills and experience to each assignment

- oversight of the standard and extent of the due diligence work and the performance of relevant personnel
- resolving suspicious circumstances, difficult or sensitive issues, conflicting information and material non-compliance

Record-keeping

Under current rules, the sponsor is required to maintain proper books and records. The proposed rules will specify that such records should be sufficient to demonstrate that the sponsor has complied with all applicable legal and regulatory requirements.

A complete set of the sponsor's records must be retained in Hong Kong for at least seven years after completion or termination of the transaction.

The regulatory environment

The SFC invites the market to re-think some of the key aspects of our legal and regulatory environment for the IPO process.

Public release of the application proof prospectus

The SFC has made a proposal to require the application proof prospectus to be made publicly available on the Stock Exchange's website.

In the past five years, Hong Kong has settled into the Web Proof Information Pack (WPIP) environment whereby the disclosure document will not be available to the public until after the Listing Committee hearing, by way of posting of the WPIP on the Stock Exchange's website.

The posting of a much earlier version of the draft disclosure document is in line with the SFC's objective to push the working parties to bring more aspects of the transactions to a mature stage before the listing application is filed.

In practice, however, this initiative will necessitate some dramatic changes in not only the execution practice of sponsor firms and professional advisers, but also the working style of the regulators themselves, who under current practice provide comments on the prospectus on an ad hoc basis throughout the entire drafting process of the document. Some logistical problems are foreseeable if this practice continues and the working parties are obliged to post a new edition of the document each time an amendment is made, either as required by the regulators, or to reflect due diligence findings. If this proposal is adopted, much additional thinking have to go into the details – for example, whether the regulators' comments, the applicant's responses and the updated draft prospectuses (currently all in English only) will have to be translated into Chinese.

Sponsors' prospectus liability

The SFC also consults the market on the desirability of clarifying the extent to which sponsors may be held liable under the Companies Ordinance provisions for material misstatements or omissions in a prospectus.

There is likely to be extensive debate on this important issue, as it will directly impact on the exposure of sponsors (and potentially also their professional advisers) to civil compensation claims by investors as well as prosecutions under the criminal limb of the liability provisions.

Any changes in this aspect will require legislative amendment and will be subject to further formal consultation.

Sponsor principals and multiple sponsors

The SFC also consulted the market on what steps could enlarge the categories of individuals qualified to act as principals in a sponsor firm without affecting the overall quality of sponsor work, whether a limit should be imposed on the number of sponsors appointed to an IPO transaction, and whether (if more than one sponsor is allowed) all of them must be independent from the applicant.

Conclusion

The Consultation Paper appears to be a classic “mixed bag”: whilst some of the proposals are non-controversial clarifications and rewriting of existing requirements, others are fairly fundamental to the existing regulatory environment and will likely stir up lively debate in relevant circles. Consultation will close on 6 July 2012.

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