

## **Legislative Council Panel on Financial Affairs**

### **Sponsor Regulation and Other Investor Protection Initiatives**

#### **Purpose**

This paper briefs Members on the initiatives to enhance the regulation of sponsors and other investor protection proposals.

#### **Sponsor Regulation**

##### ***Background***

2. Initial public offerings (“IPOs”) have fuelled the growth of Hong Kong’s stock market over the last decade. It was the world’s largest IPO fund raising centre for three consecutive years up to and including 2011 and in that year, 101 listings (on the Main Board and GEM) raised total funds of HK\$260 billion. In 2012, 64 listings raised total funds of HK\$90 billion. Hong Kong is now firmly established as the primary venue for Mainland China enterprises to raise funds outside domestic markets and has attracted significant listings from other international jurisdictions. The market capitalization of companies from the Mainland and overseas now represents approximately 70% of the total.

3. The health of any stock market is dependent on the confidence that investors have in the reliability of information provided to them when a company first joins the market through an IPO.

4. Sponsors play a critical role in maintaining the quality and integrity of the IPO market. Among other things, they perform a lead role in coordinating all of those involved in the IPO process. They advise and guide directors and are centrally involved in the conduct of intensive due diligence on the company. Investors rely on sponsors to act as key gatekeepers of market quality and ensure the integrity of the listing document. At the heart of this lies the expectation that sponsors

have conducted sufficient due diligence to properly understand and assess a company aspiring to join the stock market.

5. In May 2012, the Securities and Futures Commission (“SFC”) published a consultation paper seeking comments on a number of proposals designed to enhance the regulatory regime of sponsors. 71 responses from sponsor firms, the investor community, lawyers, accountants and various corporate governance bodies were received. Consultation conclusions were published in December 2012. Respondents from the buy-side (mainly fund managers and other institutional investors) welcomed the initiatives. They agreed that there is a need to strengthen regulations to protect investors who rely on sponsors to act as crucial gatekeepers of market quality in an IPO process.

6. The major regulatory initiatives and legislative amendments that were proposed in the consultation are set out below.

### *Major regulatory initiatives*

7. Currently, a sponsor must have regard to a number of codes and guidelines<sup>1</sup> to ensure it discharges its role satisfactorily. To aid clarity, the SFC will consolidate key standards and requirements for sponsors’ conduct. These existing standards and requirements, together with the new proposals identified in the public consultation, will be the subject of a new paragraph 17 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code of Conduct”).

8. The SFC is also working with the Stock Exchange of Hong Kong Limited (“the Exchange”) to revise the Rules Governing the Listing

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<sup>1</sup> Codes and guidelines that are relevant to a sponsor are:

- (a) the Code of Conduct, which sets out overall principles and requirements applicable to the conduct of all licensed and registered persons;
- (b) the Corporate Finance Adviser Code of Conduct which provides specific conduct guidance to persons who are involved in advising on regulatory matters relating to the listing of securities;
- (c) the Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers (**Sponsor Guidelines**) which set out continuing compliance requirements, including specific competence requirements as well as the responsibilities of management and sponsor principals;
- (d) the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission which set out the requirement to maintain proper systems, controls and procedures; and
- (e) Chapter 3A and Practice Note 21 of the Listing Rules.

of Securities on the Stock Exchange of Hong Kong Limited (“the Listing Rules”) to implement the requirements.

9. The key requirements are elaborated in the following paragraphs.

### ***Due diligence***

10. A sponsor must ensure that it has completed all reasonable due diligence on a listing applicant and that the draft prospectus is substantially complete (except for matters that by their nature can only be dealt with later in the process) before it submits a listing application to the regulators.

11. A sponsor should ensure that all key issues are resolved at an early stage before an application is made, including issues concerning the operation, governance and structure of the applicant. Matters affecting the suitability for listing should be dealt with expeditiously and any key matters must be brought to the regulators’ attention immediately.

### ***Enhancing sponsors’ role as gatekeeper***

12. Recognizing that a sponsor should be afforded adequate authority and appropriate support to discharge its role effectively, a number of initiatives will be implemented –

- (a) Minimum appointment period – a sponsor should be formally appointed at least two months before a listing application is made. This is to ensure that a sponsor’s ability to carry out its gatekeeping role is not undermined by competitive tensions and allows more time for necessary due diligence work to be performed before a listing application is made. In the event that more than one sponsor is appointed in respect of the same IPO, each of them will be required to comply with the minimum appointment period, i.e. the listing application may only be made not less than two months from the date the last sponsor is formally appointed.
- (b) Reasons for ceasing to act – a sponsor must inform regulators in a timely manner of the reasons for ceasing to act as sponsor at any time after its formal appointment, regardless of whether a listing application has been submitted.

- (c) Whistle-blowing obligation – a sponsor must notify the regulators of material non-compliance issues of listing applicants. This duty to notify the regulators continues after the sponsor ceases to act, if the material information came to its knowledge whilst it was acting as a sponsor.
- (d) Cooperation with sponsors – a sponsor’s appointment letter should specify an applicant’s obligations to facilitate the sponsor in discharging its responsibilities under the Code of Conduct, including an acknowledgement that the sponsor may be required to provide information to regulators, in which the applicant shall extend all necessary assistance to enable the sponsor to comply. The applicant should also be required to assist, and procure all relevant parties engaged by the applicant in connection with its listing (including experts) to assist, the sponsor in discharging its other responsibilities.

### ***Due diligence on expert reports***

13. Sponsors should act proactively when assessing expert reports. They should not place uncritical reliance on experts’ work but critically review the expert’s opinion with the rest of the information disclosed in the report against the totality of all other information known to the sponsor about the listing applicant, including the business model, track record, operations and sector performance. A sponsor has responsibility for all parts of a prospectus and accordingly it should be in a position to demonstrate that it is reasonable for it to rely on experts and their reports.

### ***Management Discussion & Analysis (“MD&A”)***

14. A sponsor is expected to work closely with the management of a listing applicant and its other advisers on relevant, adequate and comprehensible MD&A, and to avoid excessive or irrelevant disclosure that might overwhelm investors or obstruct them from identifying easily and understanding material and critical information.

### ***Publication of first draft of prospectus***

15. The Listing Rules will be amended to require the first draft of a prospectus submitted with a listing application to be published on the website of the Hong Kong Exchanges and Clearing Limited when the

application is made. This is mainly to encourage the submission of a quality prospectus which reflects a thorough understanding of the listing applicant and to enhance the efficiency of the application process.

16. To incentivise listing applicants and sponsors to submit quality documents at the time a listing application is made, the Exchange will strengthen its practice to reject a sub-standard document and will consider imposing a “cooling-off” period within which the submission of a revised draft will be disallowed.

### ***Streamlined regulatory commenting process***

17. Sponsor firms believe that the manner in which regulators comment on documents and how sponsors have configured disclosures as a reaction to these comments have given rise to cumbersome and lengthy prospectuses, and reduced the incentive to submit a substantially complete and carefully drafted prospectus. In light of this, the SFC and the Exchange are working together to streamline the commenting process.

### ***Sponsor principals***

18. The eligibility criteria for Principals<sup>2</sup> in the Sponsor Guidelines will be expanded, so that individuals who are highly experienced in the area of due diligence through leading IPOs in major overseas markets or who have participated actively and substantially in due diligence work in at least four IPOs in Hong Kong within the preceding five years and have passed a special examination may qualify as a Principal.

19. Type 6 licensed representatives or relevant individuals who intend to engage in sponsor work will be required to pass a new examination to enhance their competence.

### ***Legislative Amendments proposed by the SFC***

20. At present, the Companies Ordinance (“CO”) (Cap. 32) contains provisions dealing with civil liability and criminal liability for any untrue statement in a prospectus. Section 40 of the CO specifies those persons who are liable to pay compensation to those who subscribe for shares or debentures on the faith of a prospectus for the losses or

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<sup>2</sup> “Principal” means a Responsible Officer or an Executive or an Executive Officer that is appointed by a sponsor firm to be in charge of the supervision of the transaction team for a listing assignment.

damage they sustain by reason of any untrue statement. Four categories of persons who may be liable are specified –

- (a) every director or the company at the time of the issue of the prospectus;
- (b) every person who has authorized himself to be named and is named in the prospectus as a director or as having agreed to become one;
- (c) every promoter of the company; and
- (d) every person who has authorized the issue of the prospectus.

21. Section 40A(1) of the CO provides that where any untrue statement is included in a prospectus, a person who authorized the issue of the prospectus is liable to imprisonment and a fine unless he proves either that the statement was immaterial or that he had reasonable grounds to believe and did believe up to the time of the issue of the prospectus that the statement was true.

22. Sections 40 and 40A apply to prospectuses issued by companies that are incorporated in Hong Kong. For prospectuses issued by companies that are incorporated outside Hong Kong, section 342E extends civil liability under section 40 to every prospectus offering to the Hong Kong public shares or debentures of a company incorporated outside Hong Kong. Section 342F, which is similar to section 40A, applies to prospectuses offering to the Hong Kong public shares or debentures of a company incorporated outside Hong Kong.

23. It has been argued that sponsors may already be subject to civil and criminal liability under the CO for untrue statements in prospectuses because –

- (a) sponsors might fall under the definition of “promoters” who are subject to civil liability; and
- (b) some market participants take the view that a sponsor is a person who has authorized the issue of the prospectus.

There is however no Hong Kong case law on whether sponsors are subject to these provisions.

24. Statutory liability underpins prospectus accuracy. Given that sponsors have clear responsibilities for the contents of a prospectus, and since the position as to whether sponsors are subject to statutory

liability is unclear, there is merit in removing the ambiguity by clearly identifying sponsors as being liable for untrue statements in prospectuses.

25. Diverging views were received on this proposal during the consultation exercise conducted by the SFC. There was general support from buy-side market participants and opposition from sponsors and law firms. Respondents who disagreed with the proposal argued that it was not a clarification but an extension of statutory liability; there were also respondents who were of the view that the existing provisions already apply to sponsors. These diverging views and the lack of case law on the issue demonstrate the need to clarify whether sponsors are subject to existing civil and criminal prospectus liability provisions. It would be appropriate to clarify in the law that sponsors are subject to civil and criminal liability for untrue statements in prospectuses. This is in line with the philosophy in many major markets that a person who is involved in formulating the disclosures in a prospectus is held to be liable for errors or omissions in the disclosures.

26. One issue on which many respondents agreed concerned the way in which the criminal liability provisions are structured, i.e., the prosecution only has to prove that a prospectus contains an untrue statement, and in response the defendant has to prove either that the statement was immaterial or that he had reasonable grounds to believe, and did believe at the time of the issue of the prospectus that the statement was true. It would be appropriate to amend the criminal liability provisions so that the prosecution will bear the burden of proving that a defendant knowingly or recklessly made the untrue statement which must be material to a reasonable person who is likely to consider acquiring the shares or debentures. This proposed formulation is consistent with that in other SFO provisions such as sections 107 and 298 and will address most of the comments relating to the burden of proof and apparent absence of a specific requirement for “mens rea” or mental element of the offence.

27. Taking into consideration the feedback received from the consultation, the SFC proposes to amend the provisions in the CO along the following lines –

- (a) that, for the purposes of sections 40, 40A and 342F of the CO, every sponsor of the proposed listing will be deemed to be a person who has authorized the issue of the prospectus relating to the proposed listing on a recognized stock market;

- (b) a new definition for the term “sponsor” will be introduced. A sponsor will be a person that is described in the prospectus as a sponsor and performs, or holds out that the person is performing, any of the functions of a sponsor in relation to the proposed listing as described in the rules relating to the recognized stock market made under section 23 of the SFO; and
- (c) the criminal liability provisions will require the prosecution to bear the burden of proving that for a reasonable person who is likely to consider subscribing for or purchasing the shares or debentures, the untrue statement is –
  - (i) material for forming an opinion as to whether to subscribe for or purchase the shares or debentures; and
  - (ii) the defendant knew that or was reckless as to whether the statement was untrue at the time of the issue of the prospectus.

### ***International Practices***

28. In developing the proposals, the SFC has examined the burden of proof and sponsor’s criminal liability for Singapore, Australia, United Kingdom and United States. As the IPO ecosystem of markets differs, laws in different jurisdictions vary as they are developed to cater for the needs of the local market. The SFC is of the view that its concept of holding sponsors (and other specified person) liable is largely in line with the regulatory philosophy in many major markets (i.e. a person who is involved in formulating disclosures in a prospectus is to be held liable for errors and omissions) and there is a need for Hong Kong to develop its own approach to regulate sponsors in light of the particular characteristics of our IPO market.

### **Other Investor Protection Initiatives**

#### ***Extension of SFO provisions to Listed Non-corporate Entities***

29. Apart from corporations, other vehicles (such as collective investment schemes (“CIS”), business trusts and partnerships) may be listed on the Exchange. Currently, some SFO provisions apply only to



listed entities that are in corporate form. These include provisions on market misconduct, disclosure of price sensitive information / insider information, disclosure of interests, and the SFC's statutory powers to investigate and take actions.

30. To enhance the regulation of listed entities that are not in corporate form, the SFC has reviewed the relevant provisions of the SFO and believed that they should be extended to apply to all listed entities. This would promote consistency of regulation and enhance market transparency for all listed entities. This would also be conducive to investor protection. The SFC has consulted the public on the proposals as follows –

- (a) in 2010, the SFC published a consultation paper seeking comments on proposals, amongst others, to amend the market misconduct provisions in Parts XIII and XIV of the SFO to make it explicit that these provisions apply to all listed CIS (including real estate investment trusts) and to amend the disclosure of interests provisions in Part XV of the SFO so that these provisions will apply to all listed CIS with an exemption for listed open-ended CIS; and
- (b) in 2012, a further consultation paper was published seeking comments on proposals, amongst others, to –
  - (i) amend the market misconduct provisions in Parts XIII and XIV of the SFO and the SFC's statutory powers to investigate and take action under Parts VIII and X of the SFO so that these provisions expressly cover all listed entities that are not in corporate form;
  - (ii) extend the statutory disclosure requirement for price sensitive information/inside information under Part XIVA of the SFO to all listed entities that are not in corporate form;
  - (iii) amend the disclosure of interests provisions in Part XV of the SFO so that these provisions apply to all listed entities that are not in corporate form with an exemption for listed open-ended CIS; and
  - (iv) clarify in the SFO that for listed depositary receipts (DRs), the overseas issuers whose shares/units are the underlying shares/units (and not the relevant depositary bank) is the “issuer” of

the DRs so that the overseas issuer is the listed corporation in respect of the DRs.

31. General support for the proposals was received in both consultations, with comments on technical issues. The market agreed in general that the proposals would help enhance investor protection as well as market transparency for all listed entities, whether they are companies or other types of business organization. In view of the support, the SFC has made recommendations on the relevant legislative amendments to the Administration. In gist, the proposed amendments would clearly extend the application of the SFO provisions to all listed entities including those that are not in corporate form such as CIS (constituted as a trust or other non-corporate form), listed business trusts or listed entities structured as a partnership or joint ventures and clarify that for listed DRs, the issuer of the DRs is the overseas issuer of the shares / units and not the depositary bank.

### ***Supervisory Cooperation with Overseas Regulators***

32. The increasingly globalised economy means that there are more financial services related regulatory issues that are cross-jurisdictional and require supervisory co-operation and co-ordination between regulators in different countries. Securities regulators worldwide are working together to enhance cross-border supervisory cooperation. For example, the International Organization of Securities Commission produced a set of principles in this regard in 2010.

33. Although section 186 of the SFO enables the SFC to provide assistance to overseas regulators by using its powers under Part VIII of the SFO, this does not extend to its supervisory power in section 180. As a result, the SFC is not able to assist overseas regulators by exercising its supervisory power to obtain information at their request unless that information is also relevant for the SFC's own supervisory purposes.

34. It is proposed to amend sections 180 and 186 of the SFO to enable the SFC to require from a licensed corporation (or an associated entity or related corporation) copies of documents relating to regulated activity and obtain answers to questions concerning such documents (or relevant transactions) on behalf of an overseas regulator. This must be for the purpose of ascertaining compliance with legal or regulatory requirements which are administered by the requesting overseas regulator and which relate to transactions in financial products that it regulates and that are similar to those regulated by the SFC. The existing requirement

in section 186(4) for the SFC to take into account the extent to which an overseas regulator is able and willing to provide reciprocal assistance in response to a comparable request from the SFC would be extended to cover such supervisory assistance. The proposal would ensure that our regulatory regime is on par with the international standards and enhance SFC's supervisory work.

### **Advice Sought**

35. The Administration is working with the SFC on the legislative proposals in paragraphs 27, 30, and 34 above. We aim at introducing the legislative amendments into the Legislative Council in 2013-14. We welcome Members' comments on the proposals.

**Financial Services and the Treasury Bureau  
Securities and Futures Commission  
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