

Asian Corporate Governance Association (ACGA)

Submission on the

"Consultation Paper on the Regulation of Sponsors"

Hong Kong Securities and Futures Commission

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About ACGA

The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership organisation based in Hong Kong and dedicated to the long-term improvement of corporate governance in Asia. ACGA undertakes research, education and advocacy initiatives in 11 Asian markets and actively works with investors, companies and regulators to strengthen standards and practices. It is funded by a regional and global membership base of more than 90 organisations, including financial institutions, companies, professional firms and universities. In January 2012, ACGA was honoured to welcome Norges Bank Investment Management of Norway as a new Foundation Sponsor.

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Introduction

We welcome the proposals that form the core of the consultation paper by the Securities and Futures Commission (SFC) on the Regulation of Sponsors as a constructive step that will build on the SFC's move towards a more active stance on enforcement and market engagement. The proposals are a much-needed response to the deterioration of sponsor behaviour in recent years and recognise the importance of providing all market participants with clearer guidance on the role of sponsors.

In light of the regulatory risks and challenges that Hong Kong and other global markets have faced in recent years, we believe that this is the right time to set a new course for the Hong Kong market based on higher performance standards for key intermediaries**,** driven by more efficient regulatory strategies. With this in mind, we strongly endorse the goal of ensuring that the SFC has more effective tools for regulating sponsors. IPOs set the tone of the Hong Kong market and sponsors should be crucial gatekeepers in the IPO process. As a result, sponsor performance is an essential ingredient in the creation of a fair and transparent marketplace capable of meeting the expectations of issuers, investors, and the public.

While we agree that the current proposals have potential to improve the governance and integrity of the Hong Kong market, we believe some important gaps remain. In particular, the role of sponsors in advising companies on the development of sound systems of governance prior to an IPO is one area that requires greater emphasis.

In addition, if the new regime is to have its intended effect, the SFC needs to show more willingness to sanction sponsors whose work negligently falls below acceptable standards. There has been some puzzlement in the market as to why the SFC is seeking additional powers when it has used its existing non-statutory powers so rarely to date. The regulator contends, with justification, that its existing powers are inadequate and the current system is fragmented across different codes, rules and practice notes. A more coherent regime therefore makes sense, but can only be effective if consistently implemented. This is especially critical in Hong Kong given the immense legal barriers that long-term investors face in seeking redress when sponsors fail to ensure that all material disclosures have been made.

We would also note that the SFC's effort to raise the bar on sponsor performance leads to a number of important questions about other aspects of the IPO process. In particular, we are concerned about the negative impact of recent market practice concerning fees for sponsors, underwriters, and other experts. Inappropriate reliance on success fees for underwriters (or bookrunners) has reduced incentives for sponsor due diligence and execution while encouraging aggressive, and sometimes questionable, IPO sales practices. As a result, we would be supportive of follow-on work by the SFC to address the later stages of the IPO execution process. In addition, we believe that the SFC would be wise to engage the market in an active discussion of fee structures with the goal of encouraging the development of unbundled sponsors' fees and more transparency on underwriting agreements. If fee structures were better aligned with higher execution standards, we believe that

sponsors would be strongly motivated to meet the more demanding norms envisioned by the SFC's proposals.

We therefore view this consultation paper as a positive start, but believe it is only stage one of a required review of the whole IPO process. We would encourage the SFC to issue a second consultation covering issuer and syndicate responsibility through marketing, bookbuilding, allocation, pricing and after-market trading. In the absence of a tighter regulatory framework for disclosure of agreements and commitments between a syndicate and an issuer, we believe that the quality of IPOs on the Stock Exchange of Hong Kong remains at risk.

Key Points

Please find below our comments on the critical substantive elements of the Paper, as well as responses to most of the 33 questions posed in the document.

Code of Conduct

The goal of providing a definitive Code of Conduct for sponsors is in the best interests of all market practitioners. It is imperative that the Code draws on the most effective elements of regulatory guidance and reflects a sensible degree of coordination with the Listing Rules. As a result, to ensure that sponsors' attention to corporate governance norms be established with appropriate clarity, we recommend that existing provisions of Practice Note 21[1] (PN 21) on the governance advisory role of sponsors play a more prominent role in the Code.

In both spirit and substance, the SFC's proposed new "Paragraph 17" of the Code of Conduct is closely aligned, in many respects, with PN 21. Under the heading "Advising a listing applicant", the proposed Paragraph 17.3(a) states that:

> "A sponsor should have a sound understanding of a listing applicant, including its history and background, business and performance, financial condition and prospects, operations and structure, procedures and systems, as well as the directors, key senior managers and (where applicable) controlling shareholders of the listing applicant."

The next paragraphs—17.3(b)(i) and (ii)—elaborate on how a sponsor should advise and guide a client:

> "A sponsor should advise and guide a listing applicant and its directors as to their responsibilities under the Listing Rules and other applicable regulatory requirements and take all reasonable steps to ensure that at all stages of the listing application process they understand and meet these responsibilities."
>
> "A sponsor should provide appropriate advice and recommendations to a listing applicant on any material deficiencies identified in relation to its operations and structure, procedures and systems, or its directors and key

[1] Practice Note 21 forms part of the Listing Rules of the Stock Exchange of Hong Kong.

> senior managers and ensure that any material deficiencies are remedied prior to the submission of a listing application."

These and other provisions in the draft Paragraph 17 are based on sections of PN 21 that cover due diligence in relation to a listing applicant's accounting and management systems and the appreciation of its directors regarding their legal, regulatory, business and governance obligations. Sponsors should, according to PN 21, interview "all directors and senior managers with key responsibilities for ensuring compliance with the Exchange Listing Rules and other legal and regulatory requirements….to assess:

(i) their individual and collective experience, qualifications and competence; and

(ii) whether they appear to understand relevant obligations under the Exchange Listing Rules and other relevant legal and regulatory requirements and the new applicant's policies and procedures in respect of those obligations."[2]

PN 21 concludes by stating:

> "To the extent that the sponsor finds that the new applicant's procedures or its directors and/or key senior managers are inadequate in any material respect in relation to the issues referred to at paragraph 15 above, the sponsor should typically discuss the inadequacies with the new applicant's board of directors and make recommendations to the board regarding appropriate remedial steps. It should also typically ensure that such steps be taken prior to listing."[3]

Despite the close alignment between the two documents, one significant area of difference is the positive emphasis contained in PN 21 (Paragraph 11) on corporate governance. It states explicitly that, "Typical due diligence inquiries in relation to the collective and individual experience, qualifications, competence and integrity of the directors" include:

a) reviewing written records that demonstrate <u>each director's past performance as a director</u> of the new applicant including participation in board meetings and decision making relating to the management of the new applicant and its business;

b) <u>assessing individually and collectively</u> the financial literacy, <u>corporate governance experience</u> and competence generally of the directors with a view to determining the extent to which <u>the board of the new applicant as a whole has a depth and breadth of financial literacy and understanding of good corporate governance,</u> having regard to any code on corporate governance practices that the Exchange publishes from time to time;" (underlining added)

[2] Practice Note 21, paragraph 15 (b).
[3] Practice Note 21, paragraph 16.

We note that the SFC's draft Paragraph 17 could be read as implying that sponsors should advise listing applicants on broader governance issues relating to the effectiveness of boards, board committees and directors as outlined, for example, in the Corporate Governance Code in the Listing Rules. Nonetheless, it could equally be interpreted narrowly as only requiring that sponsors ensure their clients abide by all relevant rules and regulations e.g., that listing applicants set up the required board committees, but receive no advice on how to run them properly. Indeed, much of the language of Paragraph 17 has a strong compliance flavour.

We believe that PN 21 embodies a more practical approach on corporate governance and provides sponsors with clearer benchmarks for appropriate engagement with listing applicants. Because Paragraph 17 of the Code of Conduct will presumably become the gold standard for what is expected of sponsors, we recommend that it be amended accordingly. In order to assist the SFC assess the extent to which sponsors have fulfilled their governance advisory role, we suggest a list of criteria against which they could be sensibly judged (see Appendix 1). We also believe that practitioners would benefit from more practical guidance on governance in order to reduce reliance on the unworkably vague suitability standards in the Listing Rules.

Without more robust guidance from the SFC, it is hard to imagine the Stock Exchange alone can ensure that sponsors focus sufficient attention on the governance of listing applicants. It is also likely that the current unsatisfactory state of affairs—where companies often come to market in Hong Kong with demonstrably superficial governance processes—will continue. This would be a critical failure, as any casual review of the Stock Exchange's disciplinary process makes clear that the most common compliance problems are directly related to the failure of directors to grasp the practical implications of their undertaking under the Listing Rules and to cosmetic measures such as the use of compliance advisors. If the dynamics of governance are overlooked, we also believe that it may undermine many of the sensible objectives that the SFC is trying to achieve with this review of the sponsor and IPO regime.

Due Diligence

Thorough due diligence performed by a skilled and insightful team is essential to preparing an accurate listing application. In recent years, however, there is little doubt that Hong Kong's IPO industry has suffered from a race to the bottom as intermediaries have experienced aggressive competition, which has reduced their influence with issuers. This has resulted in rushed listing applications with flawed disclosure, often adhering to the form but not the spirit of the Listing Rules or established vetting processes. Indeed, we have observed a clear trend toward bureaucratic prospectuses, characterized by simplistic business model descriptions and copious risk factor sections that are designed to manage liability but not to answer practical questions of interest to any investor well-grounded in sector fundamentals.

It is essential that sponsors not simply be transmission vehicles for flawed or immature companies determined to get a listing. We strongly support the view that sponsors should be asked to assume a more professional posture as agents of the marketplace. As a result, we endorse the proposal that sponsors should not submit listing applications until they have completed all reasonable due diligence and until they are satisfied that listing applicants are ready to be listed. It is our hope that these measures will re-orient the market toward a precautionary approach and bring sponsors back into a more constructive relationship with the listing process.

Questions and Answers

Advising a listing applicant

Q1. Do you agree a sponsor should have a sound understanding of a listing applicant for which it acts?

Yes—and this understanding should explicitly extend to the governance of the listing applicant.

As a practical matter, however, it may be impossible for a sponsor to have a full understanding of a listing applicant if the sponsor is appointed late in the IPO application process or is only one of several sponsors working on the listing. We urge the regulator to examine how and when prospective issuers engage sponsors, and why there are sometimes multiple sponsors on a single transaction. The underlying logic of this submission, and Hong Kong's regulatory framework for sponsors, rests on the premise that the integrity of the sponsor's role depends upon a sufficiently long working relationship with the prospective issuer and clearly defined responsibilities.

Q2. Do you agree that a sponsor should advise and guide a listing applicant and its directors as to their responsibilities under the Listing Rules and other applicable regulatory requirements and take all reasonable steps to ensure that at all stages of the listing application process they understand and meet these responsibilities?

Yes—subject to our commentary above that this should not merely be a compliance exercise, but would include advice on the development of an effective governance culture and system within the listing applicant.

We fully recognise that the ultimate responsibility for sound governance lies with listing applicants and their directors. Yet it is also apparent that many applicants have little understanding of global governance norms and the evolving expectations of regulators, investors and other key stakeholders. Sponsors are not the only advisors of listing applicants—the Listing Committee of the Stock Exchange, for example, plays an indirect advisory role through its vetting of listing documents—but they are arguably the key pre-IPO advisor. They therefore have a special role to play in helping their clients prepare to become well-governed listed companies. This is

not something that can be delegated to legal or accounting advisors, or formalistically satisfied through a half-day seminar on the Listing Rules.

One wording change we would recommend to Question 2 and the relevant sections of Paragraph 17 relates to the phrase, "under the Listing Rules and other applicable regulatory requirements". This should perhaps be rephrased for greater clarity to "under the Listing Rules and other applicable regulatory requirements in Hong Kong". There may be a risk that this requirement is misinterpreted as applying to regulatory requirements outside Hong Kong as well.

Q3. Do you agree that a sponsor should provide appropriate advice and recommendations to a listing applicant on any material deficiencies identified in relation to its operations and structure, procedures and systems, or its directors and key senior managers and ensure that any material deficiencies are remedied prior to the submission of a listing application?

Yes—again subject to our commentary above on including corporate governance more explicitly.

- *Please see Appendix 1 for our recommended criteria on the governance structures, procedures and systems that listing applicants should have in place well before IPO.*

One caveat—the phrase "and ensure that any material deficiencies are remedied prior to the submission of a listing application" is potentially problematic. While we agree that sponsors should advise listing applicants on how to remedy any material deficiencies, to expect that all such issues can be resolved before the submission of the listing application may be unrealistic in certain circumstances. Governance problems can often take months or longer to resolve, hence the crucial task for the sponsor would be to reach consensus with its client that a problem exists, put in place a plan for fixing it, and then start implementing this prior to the IPO. Any such plan should be fully disclosed in the prospectus, allowing regulators and shareholders to assess progress post-IPO. This is a practice that has been observed more frequently in prospectuses over the past two years and is an appropriate use of disclosure policies; we believe that it should be encouraged. At the same time, overuse of vague risk factors concerning ill-defined governance problems should be discouraged.

Reasonable due diligence

Q4. Do you agree that before submitting a listing application a sponsor should complete all reasonable due diligence on the listing applicant save only any matters that by their nature can only be dealt with at a later date?

Yes—we strongly support a higher standard on the preparation of all listing material prior to submission of a listing application. The current system has resulted in a free-rider problem where less skilled sponsors or compromised sponsors representing

"difficult" clients rely on the Stock Exchange's Listing Division and Listing Committee to identify material deficiencies in their applications and provide feedback.

Q5. Do you agree that before submitting a listing application a sponsor should come to a reasonable opinion that the information in the Application Proof is substantially complete?

Yes.

Fundamental compliance issues

Q6. Do you agree that before submitting a listing application a sponsor should come to a reasonable opinion that the applicant has complied with all applicable listing conditions (except to the extent that waivers from compliance have been applied for), has established adequate systems and procedures and the directors have the necessary experience, qualifications and competence?

Yes—with the proviso that sponsor opinions should be extended to include an explicit view on an applicant's corporate governance capacity. The issues highlighted in Paragraph 56(c) of the SFC Consultation Paper concerning directors' experience, qualifications, and competence lend themselves to a one-dimensional, tick-the-box analysis which may bear little relationship to the actual functioning of a board.

Identifying material issues

Q7. Do you agree that a sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration of the application as described in paragraph 57 above are disclosed to the regulators when submitting a listing application?

Yes—this seems to be a sensible requirement and, if implemented in good faith, would help to strengthen the IPO process in Hong Kong. We have serious doubts, however, whether sponsors can or will do this, given the way in which the IPO industry in Hong Kong has changed for the worse in recent years—namely prospective issuers driving down sponsor fees, pressuring sponsors to withhold certain types of information from prospectuses, and playing them off against each other through the appointment of multiple sponsors. In the absence of active enforcement, it is hard to imagine that sponsors would voluntarily inform the regulator of material issues that might derail or delay a listing application.

For such a process to work, sponsors would need to have more engagement with listing applicants and be brought in at an earlier than is currently the case. This would create a strong justification for a separate fee.

Responsibility for disclosure

Q8. Do you agree that a sponsor, after reasonable due diligence, should ensure that at the time of issue a listing document 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?

Yes—as the Consultation Paper notes, this provision is "substantially similar" to the requirements of the Companies Ordinance regarding prospectus disclosure and is merely being "replicated and reinforced in the Code of Conduct".

Disclosure: non-expert sections

Q9. Do you agree that a sponsor, after reasonable due diligence, should have reasonable grounds to believe and does believe that at the time of issue of a listing document the information in the non-expert sections is true, accurate and complete in all material respects and that there are no material omissions?

Yes—as the Consultation Paper notes, this provision is reflected in a key obligation of the Listing Rules and is merely being "replicated and reinforced in the Code of Conduct".

We strongly support a more rigorous focus on the preparation of the "non-expert" sections in prospectuses such as the industry overview, history of the listing applicant, business description, MD&A on financial information, use of proceeds and risk factors. Often these sections set the parameters for disclosure of material operational and strategic disclosures by listing applicants. If wrongly structured, they have the potential to mislead investors and create an inaccurate understanding of company fundamentals. In recent years, sponsors have relied heavily on industry studies, typically provided by third-party consultants, to craft key elements of the investment thesis. In many instances, these studies have provided distorted presentations of company and industry fundamentals. The most egregious cases feature the creation of hypothetical market niches that give the appearance of a "leading" market position for the listing applicant. This type of work is a poor substitute for thoughtful disclosure of a company's competitive position and has the potential to taint other critical disclosures prepared by expert parties.

We also question the recent pattern of framing the business section like an investor sales document. While this ensures that there is little discrepancy between the prospectus and analyst reports, it has reversed the natural order of disclosure and analysis. It has shifted the focus away from disclosure on a rounded set of fundamental business drivers that define the company and its competitive potential over the medium term. Instead, the disclosure process has been hijacked by reliance on simplistic financial and business metrics that are often at odds with much more material competitive criteria which are commonly used by sector experts.

Disclosure: expert sections

Q10. Do you agree that at the time of issue of a listing document a sponsor should be in a position to demonstrate that it is reasonable for it to rely on the expert sections of the listing document?

Yes—a clearer standard than provided under current rules in Hong Kong seems sensible here. We agree that it would not be reasonable to expect sponsors "to perform the work of an expert" or "to address issues which only an expert possessing specialised knowledge and qualifications is equipped to deal with". Yet common sense suggests that sponsors should not "blindly" rely on information contained in an expert report; they should instead make further inquiries if they have information which conflicts with an expert's report.

In particular, we believe that sponsors should be more alert to the importance of critical accounting issues related to the operational and financial performance of listing applicants during the track record period, including the integrity of earnings, the importance of tax concessions, and changes in the turnover mix that will have a strong impact on post-listing performance.

Due diligence on expert work

Q11. Do you agree that the sponsor should take these steps in connection with an expert report? Are the steps set out in paragraph 17.6(g) of the draft Provisions sufficient and appropriate?

Yes—in particular, we endorse the "professional scepticism" concept. We recognise that, with growing competition, some sponsors and expert parties have found themselves under pressure to seek expedient remedies for material performance and disclosure gaps. In particular, we remain concerned about the potential for over-reliance upon local government authorities for statements concerning regulatory compliance when the issues are, in fact, subject to complex regulatory interpretation at multiple levels of government.

Reliance on non-expert due diligence

Q12. Do you agree that a sponsor cannot delegate responsibility for due diligence?
Q13. Are the steps we propose a sponsor should take when seeking assistance from a third party in its due diligence work sufficient and appropriate?

Yes to both—we share the SFC's concerns expressed in paragraphs 74 and 75 of the Consultation Paper regarding the tendency of some sponsors to over-delegate due diligence to non-expert third parties and to seek "comfort letters" from legal counsel confirming they have met their obligations under Hong Kong's due diligence requirements. We also endorse the steps outlined in paragraph 76 and the principle that sponsors, while reasonably seeking assistance from third parties, must retain overall and ultimate responsibility for the due diligence exercise.

Many practitioners acknowledge that the IPO process has been under pressure in recent years. The outsourcing of due diligence in some instances to paralegals, often supervised by inexperienced corporate finance analysts, is one important element of the problem. While skilled local counsel can often make a valuable contribution to due diligence work, subtleties of interpretation are often neglected in an effort to provide what might be regarded as an expedient outcome. It is worth noting that this "once over lightly" strategy has left investors to do the forensic work post-facto, often with controversial and value-destructive results. Indeed, we believe that the proposed regulations have the potential to create stronger alignment between sponsors and other market participants with regard to appropriate disclosure of operational, valuation, and regulatory variables that drive long-term performance and valuation.

Communication with regulators

Q14. Do you agree that a sponsor should reasonably satisfy itself that all information provided to the Stock Exchange and the SFC during the listing application process is accurate, complete and not misleading and, if it becomes aware that the information provided does not meet this requirement, the sponsor should inform them promptly?

Q15. Do you agree that a sponsor should deal with all enquires raised by the regulators in a cooperative, truthful and prompt manner?

Yes to both.

Q16. Do you agree that a sponsor should disclose to the Stock Exchange in a timely manner any material information relating to a listing applicant or listing application of which it becomes aware which concerns non-compliance with the Listing Rules or other applicable legal or regulatory requirements?

Yes—we believe that there is good reason to go beyond the current standard, which only requires a sponsor to advise a listing applicant to inform the regulator of any areas of material non-compliance as soon as possible[4]. There is no specific obligation on a sponsor to inform the regulator itself. The proposed standard would introduce such an affirmative obligation and is consistent with the philosophy underlying the consultation paper—that sponsors should ensure the market is properly provided with accurate, comprehensive and up-to-date information about a listing candidate.

[4] Corporate Finance Advisor Code of Conduct (2003), paragraph 6.3

Q17. Do you agree that if a sponsor ceases to act for a listing applicant during the listing application process, it is required to inform the Stock Exchange in a timely manner of the reasons for ceasing to act?

Yes—although we are cognizant of the fact that there is a complex market dynamic surrounding sponsor withdrawals and that it may be extremely difficult for sponsors to state their reasons openly. A disclosure obligation that resulted largely in boilerplate statements would not represent progress. As a result, we look forward to constructive suggestions from sponsors concerning an enhanced approach to this topic. As noted above, we believe that more a more visible enforcement effort is crucial to change behaviour in this area.

Publication of application proof

Q18. Do you agree that the Application Proof submitted with a listing application should be made publicly available when the application is made?

Yes—as with the provisions above, we believe that publication of the first draft of a listing document ("application proof" or "A1") would encourage significant changes in market behaviour. Unlike the current process that typically encourages a protracted testing process between sponsors and market regulators to determine minimum disclosure standards in a prospectus, issuers and sponsors would instead be incentivised to get it right the first time.

This approach would have the added benefit of ensuring that market participants were able to play a more informed role in the price discovery process, since prospectuses would be available earlier and a broader range of investors and independent research providers could query disclosures relevant to valuations.

Publication of the application proof would also help to eliminate the risk of a false market in instances where sponsors withhold the prospectus from the market under the guise of protracted "anchor" marketing. This can work to the detriment of listed peers who are often asked to respond to claims made by potential issuers without the benefit of a publicly available prospectus.

However, for this system to work effectively we would recommend consideration of some additional points:

- Any substantive or material changes in content between the A1 filing and the final prospectus should be highlighted, with sufficient explanation of the reasons for the changes.
- Retail investors should be warned not to rely on the A1 in their investment decision-making.
- The media should be warned not to treat the A1 as the final prospectus.
- It would be useful to examine in more detail practices in other developed markets where the publication of draft prospectuses is required.

Furthermore, we believe that the syndicate structure for an IPO should be finalised when the application proof is published. This would address a commercial concern that banks already working on an IPO may have regarding publication of the application proof—namely that doing so might encourage other banks to jump in and pitch for a bookrunner/senior syndicate role. We also believe that the late addition of multiple non-sponsor bookrunners negatively affects the quality of marketing (ie, a lack of understanding of the business due to a lack of due diligence) and could reduce the incentives for high-quality due diligence (since more bookrunners will likely diminish the fees that sponsors can earn from their dual sponsor/bookrunner role). We support the dual role of sponsor and bookrunner and encourage sponsors to emphasise their role in due diligence during their marketing as bookrunner.

Proper records

Q19. Do you agree that a sponsor's records should be sufficient to demonstrate that the sponsor has complied with all applicable legal and regulatory requirements and in particular compliance with the Provisions?

Q20. Do you agree that a complete set of a sponsor's records in connection with a listing transaction should be retained in Hong Kong for at least seven years after completion or termination of the transaction?

Yes to both—we share the paper's concern about inadequate record-keeping and the reliance on "10-b-5" style comfort letters. It is hard not to regard this practice as little more than liability management.

Sufficient resources

Q21. Do you agree that before accepting any appointment as a sponsor, a firm should ensure that, taking account of other commitments, it has sufficient staff with appropriate levels of knowledge, skills and experience to devote to the assignment throughout the period of the assignment?

Yes—with the evolution of the Stock Exchange of Hong Kong as a global listing venue, the demands placed on sponsors to provide a consistent quality control function have naturally risen. Appropriate staffing, training, compensation, and compliance systems are a natural component of reliable performance. We are mindful of the traditional tension between client bankers, execution teams and other intermediaries. In the current system, bad news is suppressed and quick fixes are the norm. Much has been written in recent years about moral hazard. While we have no desire to overstate the nature of the problem in the Hong Kong market, it is hard to ignore the fact that senior investment banking professionals have distanced themselves from a practical discussion of obvious market failures. Put bluntly, paying only for client relationships or deal completion does not result in a healthy market.

Sponsor principals

Q25. Which, if any, of the proposals in paragraph 103 would achieve the objectives of enlarging the category of individuals qualified to act as Principals whilst not affecting the overall quality of sponsor work?

We share the concern about the qualifications of Principals. One would hope, however, that progress on approval of the proposed regulations should, in itself, serve as an important counter-weight to the hurried acceptance of less qualified Principals. Of the items in Paragraph 103, we would endorse items 103(a), (b), and (c) with the additional suggestion that overseas experience, especially if it results in relevant sector expertise, would be a valuable addition to the transaction skills often emphasised in the Hong Kong market.

Multiple sponsors

Q26. Do you agree that there should only be one sponsor on each engagement?
Q27. If more than one sponsor is allowed, do you agree that they should all be required to meet the Listing Rules independence requirements?
Q28. Do you agree that if more than one sponsor is appointed each sponsor's responsibilities should remain unaffected and that each sponsor should comply with all the expectations of a sponsor?

We strongly support the spirit of the SFC's effort to provide greater accountability by capping the number of sponsors. The multiple sponsor pattern observed in recent years has diluted accountability and encouraged a counterproductive pattern of issuer and sponsor behaviour that works to the detriment of all market participants. There may be cases when two sponsors are better than one, but we do not believe that three or four sponsors would normally be appropriate for one transaction.

The existence of multiple sponsors with limited and separate responsibilities not only raises complications as to who is primarily responsible for ensuring due diligence meets regulatory requirements, it complicates the advisory role that sponsors should play on corporate governance. Individual sponsors may have different levels of interest and commitment to this work, thus resulting in a poor outcome, confusion on the part of the issuer, or both.

In the event of multiple sponsors, steps must be taken to ensure that the SFC's key regulatory goals are not frustrated, as it will be much harder for the regulator to apportion responsibility for weak governance preparation in such a situation. In this context, enhanced record-keeping as well as more public disclosure by the Stock Exchange on the success or failure of listing applications would be valuable catalysts for more constructive market behaviour.

Overall manager of a public offer

Q29. Do you agree that the provisions of the CFA Code relating to the management of a public offer should be transferred to the Code of Conduct?

Yes.

Information for analysts

Q30. Do you agree that the obligation in the CFA Code relating to the provision of information to analysts should be transferred to the Code of Conduct?

Yes—we strongly endorse this proposal. Any steps that can be taken to ensure the creation of a level playing field for analysts and investors are critical to the creation of a fair market.

Scope of provisions

Q31. Do you agree that the Provisions should equally apply to a listing agent appointed for the listing of a REIT?

Yes—REITs and other trust structures have the potential to be a growing asset class for the Hong Kong market. Given their potential appeal for yield-sensitive investors, it is important that they meet the highest standards of the market.

Prospectus liability

Q32. Do you agree that it should be made clear that sponsors are liable for untrue statements (including material omissions) in a prospectus?

Yes—we broadly support the SFC in its effort to establish civil and criminal liability for deliberately untrue statements or omissions in a prospectus. This effort is fundamental to market accountability and underpins a broader and more effective set of remedies in the event of sponsor malfeasance.

While we believe that the probability of criminal charges being brought against sponsors in future is low—given the high level of proof required—it seems reasonable that the regulator should have the right to exercise such powers in extreme cases. Given that the Companies Ordinance already "contains separate provisions dealing with civil liability and criminal liability for any untrue statement, including a material omission, in a prospectus", and that these provisions arguably apply to sponsors as well as listing applicants, it makes sense for the SFC to seek a clarification of the law on this point.

Some might argue that the SFC could use Section 384 of the Securities and Futures Ordinance on the "provision of false or misleading information" as a tool to prosecute sponsors. After all, this section allows for both fines and imprisonment. One limitation, however, is that it does not cover the omission of information.

How to define a sponsor?

Q33. Do you have any views on the proposed definition of "sponsor"?

We support the proposed language.

Appendix 1

Assessing Pre-IPO Corporate Governance Preparation
In order to help sponsors advise listing applicants on their governance preparation prior to IPO, and by extension assist the SFC to assess the extent of progress made, ACGA proposes the following eight items with accompanying criteria. This is not intended to be a definitive list, but rather a starting point for thinking about how governance development could be objectively assessed. Nor are the suggested criteria intended to be final or prescriptive—they are merely an outline of what some minimum standards might look like.

1. **Timing and selection of independent directors (INEDs)**:
   INEDs to be appointed at least 6-12 months prior to IPO. A description of how each independent director was selected and by whom (ie, the listing applicant, the sponsor or another party). Full disclosure on any personal, social or commercial relationship between the controlling shareholder and the independent directors (eg, did they go to school together?).

2. **Timing of the formation of audit and other board committees:**
   At least 6-12 months prior to IPO for the audit committee. Evidence that the audit committee has been properly established, understands its function and has met several times prior to IPO. Other board committees should also be functioning prior to IPO.

3. **Evidence that directors understand their fiduciary duties:**
   Sponsor or other specialist to interview directors and provide a record of their answers. Directors to complete a questionnaire on their basic duties.

4. **Experience of directors as board directors:**
   Evidence that all directors, not only INEDs but executive directors and non-executive directors, have been directors previously—not simply managers of companies. Also evidence of experience relative to the risk factors of the company.

5. (If the answers to Q3 and Q4 are “no” or “partially”): **Education and training of directors prior to the IPO:**
   What training was organised? By whom, when and where? What level of competence was reached? How will this training be refreshed after the IPO?

6. **Evidence of a system of internal controls:**
   Assessment by the sponsor or another specialist of the strengths and weaknesses in the applicant’s system of internal controls and the human resource capacities overlaying it. Also evidence that the applicant is trying to improve its controls before the IPO.

7. **Understanding of key business risks:**
   Assessment by the sponsor of the applicant's understanding of its major risks, how it is managing them and the financial and human resources devoted to this task. Also evidence that the applicant is aware of new risks that come with being a listed company.

8. **Appointment of an experienced company secretary:**
   At least 6-12 months prior to IPO.

It is worth emphasising that while the Listing Rules require management and business continuity for three years prior to an IPO, there is no requirement for any governance continuity: independent directors can and often are appointed just before a listing, for example. This makes a mockery of Practice Note 21 and the obligations of both sponsors and listing applicants in this critical area.

A governance system is not something that can be created overnight. We believe that two to three years is the minimum period required for a young company to digest governance concepts and begin to meet the standards set down in the Hong Kong Corporate Governance Code. The criteria above, therefore, are very much at the lower end of what is sensible.

We recommend that sponsors be required to produce a detailed and documented statement of the extent to which listing applicants meet the above criteria, not just a general formulaic statement.

We recognise that there may be limits as to what a sponsor can achieve with a listing applicant on corporate governance prior to an IPO. For example, if an application is rushed for reasons beyond a sponsor's control, there will not be time to put proper governance systems in place; or if an applicant simply refuses to take the advice of a sponsor. In such circumstances, we believe it is incumbent upon the sponsor to inform the regulator of the material governance deficiencies in an applicant, and for the regulator in turn to inform the market (eg, through a "health warning" on a prospectus).

End.