Hong Kong Institute of
Certified Public Accountants
香港會計師公會

**By email (sponsors@sfc.hk) and by post**

27 July 2012

Our Ref.: C/CFC, M84357

Securities and Futures Commission
8th Floor, Chater House
8 Connaught Road Central
Hong Kong

Re: Consultation paper on the regulation of sponsors

Dear Sirs,

**Consultation paper on the regulation of sponsors**

The views of the Hong Kong Institute of Certified Public Accountants ("the Institute") on the above consultation paper, which seeks comments on proposals to enhance the regulatory regime of sponsors, are as explained below.

While, broadly speaking, a number of the proposals in the consultation paper appear to be reasonable, the Institute wishes to sound a general note of caution that, with the introduction of a more stringent regulatory framework for sponsors, the focus of regulatory efforts may shift even further towards Hong Kong licensed sponsors, and away from the directors of a listing applicant, whose intentional or negligent misconduct may be the root cause of specific problems that arise during a listing or subsequently.



--- Before answering the individual questions, which are set out in the Appendix to this letter, we would like to highlight below our observations in the issues which have wider implications.

I. Publication of Application Proof

It is proposed that the Application Proof of the listing document submitted with a listing application is made available on the website of Hong Kong Exchanges and Clearing ("HKEx") when the application is made. It appears that the rationale underlying the proposal is that public exposure is intended to ensure that the first submission draft is of a high quality and substantially complete. It is suggested in the consultation paper that this practice is broadly in line with the practice of making public drafts of listing documents submitted during the listing process in the United States ("US") (paragraphs 84 and 85 of the consultation paper).

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Nevertheless, it should be noted that the US Securities and Exchange Commission has been adopting a two-tier system over many years, allowing confidential treatment for foreign private issuers while domestic issuers are required to do public filings at the beginning of the registration process. This two-tier system was largely removed in December 2011 and as a result, essentially all listing applications were required to do public filings. However, with the introduction of the Jumpstart Our Business Startups ("JOBS") Act, which was enacted in April 2012, the US again allows confidential filings for companies meeting certain criteria.

It is also worth noting that applications for listing in the US are under a system which is substantially different from that adopted in Hong Kong. Unlike Hong Kong, initial public offering ("IPO") / listing applications in the US are not operated under a sponsoring framework. Furthermore, with the exception of the US, countries with more active capital markets such as the United Kingdom, Australia and Singapore do not adopt a system of allowing public access to draft listing documents in the early stage of listing applications. As such, we are of the view that it is not desirable to introduce a practice to Hong Kong that is not adopted in most other major markets. Additionally, requiring public disclosure of the Application Proof may not be the most appropriate means of ensuring the quality and near completeness of the draft listing documents.

We have significant reservations as to whether the public interest will be best served by making a draft prospectus, submitted with a listing application, publicly available prior to the final stage of an IPO process. It will also be to the potential detriment of a listing applicant, as it will subject the listing applicant's business to an undue level of public scrutiny at a pre-mature stage of its listing application, by disclosing to the public its business strategies, operational details, financial performance, market competitiveness and other commercially-sensitive information (e.g., major suppliers and customers). Although it is suggested that when a listing applicant decides to submit a listing application, it, and its management, should be well prepared and ready to go public and to subject the company to public scrutiny, there may be unforeseen circumstances, out of the control of the sponsor and the listing applicant, which lead to a deferral or even a withdrawal of a listing application. Therefore, early disclosure of business-sensitive details of a listing applicant, at the time when it submits a listing application, could easily become a deterrent to companies seeking a listing in Hong Kong. This will diminish Hong Kong's attractiveness and leading edge as a fund-raising hub, and have an adverse impact on the future development of the Hong Kong financial market.

If, nevertheless, this proposal proceeds, it will be made more meaningful if the comments and questions raised by the Stock Exchange and the Securities and Futures Commission ("SFC") on the Application Proof are also made publicly available on the HKEx website. This will give the market and potential investors an early notice of the regulators' feedback on the listing application.

II. Reliance on expert opinion

It is proposed 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 (paragraph 68 of the consultation paper, proposal 9).

Paragraph 73 of the consultation paper sets out typical due diligence work that a sponsor is expected to perform on the work of the experts so as to demonstrate that it is reasonable for it to rely on an expert report. Paragraph 73(a) requires the sponsor to confirm that … the bases and assumptions adopted by the expert are fair and reasonable, the experts' scope of work is appropriate to the opinion …; 73(b) requires the sponsor to ensure that factual information on which an expert relies is consistent with the sponsor's knowledge of the applicant, including that derived from its other due diligence work; and 73(c) states that, where factual information is solely or primarily derived from management's representations and confirmations, the sponsor, unless the expert has done so, should make independent inquiries or assessments or obtain independently sourced information to verify the accuracy and completeness of the information.

While it is noted that there are apparently similar requirements under rule 3A.16 of the Listing Rules, the Listing Rules require a sponsor to "confirm that it has reasonable grounds to believe and does believe (to the standard reasonably expected of a sponsor which is not itself expert in the matters dealt with in the relevant expert section) … ", which, prima facie, is less onerous than "confirming … ", "ensuring …" and "verifying the accuracy and completeness … " of the expert's work.

It should be noted that an IPO process and the preparation of a prospectus is a collaborative process involving not only sponsors but also the contribution of other professionals and experts such as valuers, lawyers, reporting accountants, etc. We are concerned that a sponsor may not, and cannot be expected to, possess the specialised knowledge and qualifications of an expert so as to enable it to confirm the fairness, reasonableness and appropriateness of an expert's scope of work, the bases and assumptions that an expert has adopted and the factual information that an expert has relied on in forming the expert opinion. It is rightly pointed out, in paragraph 65 of the consultation paper, that a sponsor should not be required 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. Therefore, it is not realistic or fair to require a sponsor to assume the role of an expert. A sponsor should, to a reasonable extent, be allowed to rely on the expert's report or opinion, while performing due diligence with an attitude of professional scepticism in order to satisfy itself that it is reasonable to so rely, taking into account its own in-depth and wide-ranging knowledge of the listing applicant, accumulated since the sponsor was first engaged by the applicant. We recommend that the work of the sponsor should be considered in conjunction with the work of the other professionals and experts engaged in an IPO exercise.

As mentioned above, an IPO process, including the preparation of a prospectus, is a collaborative process between the sponsor and a number of professionals. It would be helpful if the SFC could provide further guidance to clarify and elaborate its expectation of the level of detailed due diligence work to be performed by a sponsor in connection with the expert report or opinion and the records that a sponsor is expected to keep as documentary evidence in support of its due diligence work done in this respect. This would facilitate the development of cooperative arrangements between the sponsor and other various professionals involved in an IPO exercise.

As regards documentation of a sponsor's due diligence work on an expert's report or opinion, we should like to clarify whether the SFC would accept the sponsor's work being evidenced by meeting notes / completed checklists / written confirmations, or whether the SFC would expect the sponsor to review and extract relevant working papers of an expert as part of its due diligence work. We understand that it is a common industry practice that the working papers of an expert remain the property of the expert and, in view of the confidentiality agreement between an expert and his client, the expert would not normally share his working papers with third parties. The Institute's statement 1.301 provides guidance to certified public accountants ("CPAs") in practice, among other things, as to the circumstances where CPAs should or must disclose the contents of their working papers. The statement was prepared in consultation with counsel in order to address legal issues arising from such disclosure.

The SFC's expectation of detailed due diligence work to be performed by a sponsor in this specific area may have wider industry/professional implications, which may need to be further discussed and addressed through the joint efforts of professional bodies, a representative group of sponsors and the SFC. A clearer understanding of the SFC's expectations in this respect may be essential to help facilitate a smooth cooperation and harmonious relationship between various parties and professionals working together in an IPO process.



III. Communications with regulators

It is proposed 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, concerning non-compliance with the Listing Rules or other applicable legal or regulatory requirements. 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 its ceasing to act (paragraph 82 of the consultation paper, proposal 13).

While it appears reasonable to impose an obligation on a sponsor to disclose to the Stock Exchange material information relating to a listing applicant or listing application which concerns non-compliance with the Listing Rules, since a sponsor is not an expert in other legal or regulatory requirements applicable to a listing applicant, it would not be appropriate for sponsors to have to identify and disclose any such non-compliance by

the listing applicant. The scope of this proposal needs to be made clearer. The term "other legal or regulatory requirements" appears to be too broad a scope, and it does not seem to have any jurisdictional limit. We also doubt whether the Stock Exchange would be the proper regulatory body to which a sponsor should report on non-compliance by a listing applicant with other legal or regulatory requirements, given that such matters are not within the Stock Exchange's regulatory remit.

We are also unclear how the information in relation to non-compliance, other than non-compliance with the Listing Rules, would be taken forward, and how the SFC would expect the Stock Exchange to handle such information. Further clarification by the SFC in this respect is essential to help the sponsor understand the implications, legal or otherwise, of disclosing such non-compliance issues to the Stock Exchange.

As regards when a sponsor is expected to disclose non-compliance matters to the Stock Exchange, we suggest that, rather than requiring the sponsor to do so when it becomes aware that there may be a non-compliance issue, as proposal 13 suggests, it would be pragmatic to require disclosure to be made when the listing applicant, after being advised by the sponsor, fails to disclose such non-compliance matters to the Stock Exchange within a certain period, or when the listing applicant declines to disclose such matters to the Stock Exchange without valid reasons. The latter approach is in line with the current requirements stipulated in the CFA Code 6.3.

IV. Sponsor's liability for prospectus

Paragraph 121 states that sponsors may already be subject to civil and criminal liability under the Companies Ordinance for untrue statements in prospectuses. As there is no case law in Hong Kong on whether a sponsor is subject to these provisions, the SFC believes that there is merit in clearly stipulating that sponsors are also subject to potential legal liability for untrue statements in a prospectus, along with others who authorise the issue of a prospectus or who are otherwise responsible for its contents (sections 40 and 40A of the Companies Ordinance). However, the SFC has not given any details about how it is going to implement this proposal.

Also, the consultation paper does not suggest that the lack of civil actions on prospectus misstatements in Hong Kong is due to lack of clarity in the Companies Ordinance provisions. It is noted that the Securities and Futures Ordinance already contains a number of provisions that render a person (sponsor) liable for an offence if he makes any fraudulent or reckless misrepresentation for the purpose of inducing others to invest money, or discloses false or misleading information to induce transactions. Therefore, rather than the existing law being insufficient for investors to take action in respect of misstatements in prospectuses, the absence of legal action by investors may be due to the lack of effective mechanisms for investors to enforce their rights, e.g., class action suits.

It is stated in paragraph 129 that, in addition to clarifying the issue of sponsors' liability for untrue statements in a prospectus, there are a number of other questions concerning prospectus liability which merit review, and the SFC intends to address these and other issues as part of its overall review of the prospectus regime in a separate consultation paper. We submit that a more important issue to be considered is whether the tests for establishing civil and criminal liability, including the existing defences referred to in the relevant provisions in the Companies Ordinance, should be modified. For example, whether further safeguards should be introduced to require proof of knowledge of wrongdoing, dishonesty, or intent to defraud before a prosecution could be initiated under the Companies Ordinance.

In view of the above, we are concerned that consideration of individual issues, including sponsors' liability under the Companies Ordinance, on a piecemeal basis, without the benefit of seeing a coherent overall picture, could result in inconsistent and fragmented changes. We strongly recommend, therefore, that a comprehensive review of Hong Kong's prospectus regime and the financial regulatory regime be conducted as a separate consultation exercise.

We hope that you find our comments to be helpful. Should you have any questions on our submission or wish to discuss it further, please contact Peter Tisman, the Institute's Director, Specialist Practices by telephone on 2287 7084 or email peter@hkicpa.org.hk.

Yours faithfully,



Chris Joy
Executive Director

CJ/PMT/ML
Enc.

# Appendix

## Comments from Hong Kong Institute of CPAs in response to the Consultation Paper on the regulation of sponsors

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

**If not, why not?**

Yes, this appears to be a reasonable requirement.

**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?**

**If not, why not?**

We consider that it would be more effective for education of a listing applicant's directors to be jointly provided by a sponsor and other relevant professionals, e.g., legal professionals, in particular on advising and guiding directors as to their responsibilities under "other applicable regulatory requirements". We agree that sponsors should take reasonable steps to ensure that directors of the listing applicant understand and meet their responsibilities throughout the listing application process.

**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?**

**If not, why not?**

No. We doubt whether a sponsor is the best person to be solely responsible for providing appropriate advice and recommendations to a listing applicant on material deficiencies in relation to its operations and structure, procedures and systems. Currently there is no framework for assessing the quality of the operations, structure, procedures and systems, so such an assessment would be very judgmental. Furthermore, advice/ recommendations for improvements in this respect would more appropriately be provided by relevant professionals or experts who possess relevant experience and expertise in the field. It is noted that this proposal is more onerous than the existing requirement under rule 3A.15(5) of the Listing Rules, which requires a sponsor to "confirm that it has reasonable grounds to believe and does believe that the new applicant has established procedures, systems and controls (including accounting and management systems) which are adequate having regard to the obligations of the new applicant … "

**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?**

**If not, why not?**

No. Due diligence is a continuing process which lasts until the issuance of a listing document. Strictly speaking, due diligence on the listing applicant cannot be "completed" at the time when a listing application is made. It can, at most, be expected that due diligence is "substantially or largely" completed before submitting a listing application.

**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?**

**If not, why not?**

While we have no objection to this, we would like to clarify whether the SFC's interpretation of "information in the Application Proof is substantially complete" is same as that indicated in rule 9.03(3) of the Listing Rules, which states: "The disclosure of the requisite information as set out in Chapter 11 must be substantially completed in the advanced proof of the prospectus … ". It is important that when such Listing Rule requirement is transferred to the Code of Conduct, similar guidance or interpretation as to the requisite information that is expected to be "substantially completed" in the Application Proof will also be provided in the Code of Conduct.



**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?**

**If not, why not?**

Yes.

**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?**

**If not, why not?**

Yes.

**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?**

**If not, why not?**

No. We are of the view that, as directors / management of the listing applicant have primary responsibility for the financial records, they should also be responsible for ensuring that 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. The sponsor's role / responsibility in this respect should be considered in conjunction with that of the directors / management of the listing applicant and other professionals, e.g. the reporting accountant, involved in the preparation of the listing document.

**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?**

**If not, why not?**

Yes. Nevertheless, as regards omissions, the concept of "materiality" should be added to draft paragraph 17.5 (b)(ii) (Appendix A to the consultation paper).

**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?**

**If not, why not?**

No. As the expert sections are prepared by experts that have the relevant professional knowledge, qualification, experience and expertise in certain specialised area, it would be unfair to require a non-expert (sponsor) to "demonstrate" that it is reasonable for it to reply on the expert sections. We believe that a sponsor, while performing due diligence with a reasonable level of professional scepticism, should, to a certain extent, be allowed to rely on the expert sections, unless there is evidence indicating that it is unreasonable to do so.

**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?**

**If not, why not?**

No. Refer to our covering letter, II Reliance on expert opinion, for further details.

**Q12. Do you agree that a sponsor cannot delegate responsibility for due diligence?**

**If not, why not?**

While we agree that a sponsor should not delegate responsibility for due diligence, we would like to point out that a sponsor has to seek assistance and input from relevant and appropriate professionals and experts in conducting due diligence, in particular on technical matters. Therefore, a sponsor should be able to rely to a reasonable extent on the opinion or advice of third parties in the due diligence exercise, e.g., legal opinion on the title of an asset or interpretation of the terms of material contracts.

**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?**

**If not, why not?**

Yes.

**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?**

**If not, why not?**

Yes. However, a sponsor should not be disciplined for breach of this requirement in the situation when it was misled by the directors or other parties.

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

**If not, why not?**

Yes.

**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?**

**If not, why not?**

No. Refer to our covering letter, III Communications with regulators, for further details.

**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?**

**If not, why not?**

Yes, but between submission of the listing application and expiry of the mandate.

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

**If not, why not?**

No. Refer to our covering letter, I Publication of Application Proof, for further details.

**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?**

**If not, why not?**

We consider that the term "all applicable legal and regulatory requirements" appears to be vague and too extensive. Further clarification by the SFC in this respect would be helpful to foster better understanding of this requirement. As this refers to the sponsor's records, to take into account the practicality aspect, we consider that it would be more appropriate to say "… sufficient to demonstrate, in all material respects, that the sponsor has complied with…"

**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?**

**If not, why not?**

Yes.

**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?**

**If not, why not?**

We agree that before accepting an appointment as a sponsor, a firm should ensure that it has sufficient staff with relevant and appropriate knowledge, skills and experience in IPO, due diligence and listing matters, However, it is not practicable to require a firm to ensure

that it has sufficient staff with appropriate industry specific knowledge, skills and experience required of the listing applicant in order to take up an assignment. A sponsor should be allowed to seek outside assistance and advice on industry specific matters.

**Q22. Do you agree that the provisions of the Sponsor Guidelines concerning the Transaction Team should be transferred to the Code of Conduct?**

**If not, why not?**

Yes.

**Q23. Do you agree that a sponsor should maintain effective systems and procedures to ensure that an appropriate due diligence plan is formulated, updated as necessary and implemented in respect of each assignment and there are clear and effective reporting lines to ensure that key issues are escalated to Management for deliberation?**

**If not, why not?**

No. We consider that the current definition of "Management" in the "Glossary" section of the draft Code of Conduct provisions (paragraph 17.12) at Appendix A of the consultation paper, which defines it to include a sponsor firm's Board of Directors, Managing Director, Chief Executive Officer, Responsible Officers, Executive Officers and other senior management personnel, may cast the net too wide by covering the senior management of other business sections of the firm. In addition to sponsorship service, the sponsor firm, in particular those larger ones, may have other businesses such as underwriting, brokerage, research, venture capital investment, etc. It may not be relevant or necessary to bring the key issues in relation to sponsoring an IPO to the attention of the management of other business sections, in addition to the sponsorship section, for deliberation. We suggest that "Management" be defined to refer to those in the sponsorship and relevant sections, as appropriate.

Nevertheless, we agree that a sponsor should maintain effective systems and procedures to ensure that an appropriate due diligence plan is formulated, updated as necessary and implemented in respect of each assignment.

**Q24. Do you agree that a sponsor's Management is obliged to adequately supervise the performance of due diligence including but not limited to the key issues discussed in paragraph 97?**

**If not, why not?**

Yes, subject to our comment on the definition of "Management" per our answer to Q23.

**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?**

**Do you have alternative suggestions to address the issues?**

We prefer the proposals set out in paragraphs 103 (a) and (b).

**Q26. Do you agree that there should only be one sponsor on each engagement?**

**If you do not agree, should the number of sponsors be limited and, if so, to how many?**

**If you do not agree that the numbers of sponsors should be limited, why not?**

We have no strong view on this proposal. There is, however, no objective evidence provided in the consultation paper to indicate that problematic IPOs are caused by multiple sponsors, or that the appointment of multiple sponsors lowers the overall standard of sponsors' work, rather than resulting in their complementing each other's work.

**Q27. If more than one sponsor is allowed, do you agree that they should all be required to meet the Listing Rules independence requirements?**

**If not, why not?**

No. We do not favour any change to the status quo, and suggest retaining the existing requirement under rule 3A.07 of the Listing Rules, which stipulates "at least one sponsor of a new applicant must be independent … "

**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?**

**If not, why not?**

Yes.

**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?**

**If not, why not?**

Yes.

**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?**

**If not, why not?**

Yes.

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

**If not, why not?**

Yes.

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

**If not, why not?**

No. Refer to our covering letter, IV Sponsor's liability for prospectus, for further details.

**Q33. Do you have any views on the proposed definition of "sponsor"? Please explain your views.**

No specific views.