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

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(2526 5304)

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Intermediaries and Investment Products Division
Securities and Futures Commission
8th Floor, Chater House
8 Connaught Road Central
Hong Kong

Attn.: Sponsor Consultation

Dear Sirs,

Consultation Paper on the Regulation of Sponsors and Compliance Advisers

The Hong Kong Institute of Certified Public Accountants ("the Institute") has considered the above consultation paper, which seeks comments on a proposed set of additional requirements imposing specific eligibility criteria and on-going compliance obligations on sponsors in order to help raise their standards. The Institute's comments on the proposals are provided below.

While, broadly speaking, the proposals in the consultation paper appear to be quite reasonable and non controversial, 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 tend to shift even further towards sponsors, who are licensed in Hong Kong, instead of towards the directors of listed companies, whose intentional or negligent misconduct may be the root cause of specific problems that arise during a listing or subsequently. Were this to occur, we believe that it would send the wrong signal to the market and would be potentially damaging to Hong Kong's reputation as a major international financial centre.

As regards the detail of the proposals, there are some areas of ambiguity, which require clarification, and certain apparent differences and potential inconsistencies between the description and explanation of the proposals contained in the main text of the consultation paper and the more specific provisions contained in Annex I to the consultation paper. We draw attention to some of these below.

1. Principals

Paragraph 1.3.2 of Annex 1 states, "*a sponsor should have at least two Principals at all times*".

In the case of a sponsor that has only two Principals, which is not uncommon, there may be situations where, for example, one of the two Principals resigns and the sponsor is unable to find an immediate replacement. In such

4th Floor, Tower Two, Lippo Centre,
Queensway, Hong Kong
香 港 金 鐘 道 89 號 力 寶 中 心 二 座 四 樓

Tel 電話 :(852) 2287 7228
Fax 傳真 :(852) 2865 6776
(852) 2865 6603

Web 網址: www.hkicpa.org.hk89
E-mail 電郵: hkicpa@hkicpa.org.hk

circumstances, we suggest that there should be a reasonable grace period to allow for the sponsor to appoint another Principal to fill the vacancy, during which period the sponsor firm would be able to continue carrying out its sponsor role.

We would suggest that the Securities and Futures Commission ("SFC") consider allowing a grace period of, say, at least three months to allow a sponsor to bring itself back into compliance with the requirement for at least two Principals.

2. Eligibility Criteria for Principals

(a) Paragraph 1.4.1(2) of Annex 1 requires that a Principal should have "*a minimum of 5 years of relevant corporate finance experience in respect of companies listed on the Main Board and/or GEM Board*." A note to this paragraph explains that corporate finance experience includes "*providing advice on*

(i) IPOs,
(ii) notifiable transactions,
(iii) a rights issue or open offer by a listed company,
(iv) takeovers and share repurchases subject to the Codes on Takeovers and Mergers and Share Repurchases."

The term "relevant" needs to be more clearly defined, otherwise it could be viewed as a subjective decision whether a person's experience/role in relation to the activities specified was considered to be "relevant".

We note that paragraph 55 of the paper indicates that the SFC would generally regard having <u>experience in one or more</u> of the activities listed in that paragraph as fulfilling the experience requirements. However, this is not reflected clearly in paragraph 1.4.1(2) of Annex 1, which simply lists the four activities with a note, stating: " 'Corporate finance experience' includes providing advice on the following matters..." (i.e., the four areas mentioned in paragraph 55). The detailed eligibility criteria should be drafted more precisely to reflect the SFC's express intention to provide clear and objective benchmarks, against which applicants can be assessed. It is also important, from the point of view of applicants, that they be given sufficient guidance to be able to assess their own ability to fulfil the requirements to be a Principal.

In addition, the activities specified in paragraph 1.4.1(2) of Annex 1 are considered to be too narrow and restrictive. We would suggest that the list be expanded in scope and should cover, at least, the following additional activities:

- listings by way of introduction
- "reverse takeovers" (deemed to be a new listing applicant under the Stock Exchange Listing Rules)
- connected transactions
- whitewash waiver applications under the Codes on Takeovers and Mergers and Share Repurchases
- privatisations by way of a scheme of arrangement

(b) Paragraph 1.4.1(3) of Annex 1 requires that a Principal should have "*played a substantial role in advising a listing applicant as a sponsor in at least two completed IPOs on the Main Board and/or GEM Board.*"

As with the term "relevant experience" mentioned in (a) above, the interpretation of "substantial role" is also open to debate. To avoid ambiguity, as far as possible, we would suggest that more specific guidance be given on the interpretation of "substantial role" (e.g., by way of examples or further additional definitions).

As regards the requirement to have had experience in at least two "completed IPOs", we would like to point out that there are situations in which an IPO has not been completed, although the bulk of the sponsor's work on it has been completed. This could be due to a variety of reasons, which may be beyond the sponsor's control, e.g., a listing applicant may decide not to be listed (even after substantial amount of the work has been done and listing approval from the listing committee has been obtained), as a result of, say, a sudden market downturn. We believe that some flexibility in relation to the requirement for experience in "completed IPOs" is needed, and a sponsor's experience in a substantially completed IPO transaction should also be recognised. We suggest that the benchmark for a "substantially completed IPO" could be, e.g., when listing approval has been obtained.

(c) Note (2) to paragraph 1.4.1 of Annex 1 clarifies that the requirements set out at paragraphs 1.4.1(2) and (3) apply to Principals as initial eligibility criteria only, and are not continuing requirements.

This being the case, it is unclear whether, in the situation where a Principal changes employer and, having been a Principal of employer X, wishes to become a Principal of employer Y, he/she has to reapply and again demonstrate compliance with the initial eligibility criteria (i.e., the requirements set out at paragraphs 1.4.1(2) and (3)), in order to transfer his/her accreditation as a Principal to employer Y. We believe that this point needs to be clarified and it should not be necessary to demonstrate ongoing compliance with the eligibility criteria, otherwise it would mean that, (a) the criteria in effect become continuing criteria in some circumstances, and (b) an impediment would be created to Principals changing their employment to another sponsor.

3. Systems and Controls and Internal Assessment

Paragraph 1.5.3 of Annex 1 requires that a sponsor "*should carry out an assessment annually in order to ensure that its obligation to have effective systems and controls under 1.5.1 is complied with*. *Any material non-compliance issue should be reported to the Commission promptly*."

This requirement appears to confuse two different issues that are raised in the main body of the consultation paper, namely, (i) the requirement for a sponsor to conduct an annual assessment of its internal controls and systems and to submit an annual return (paragraph 60) and (ii) the general

obligation to report any material non-compliance with the requirement of Annex I promptly to the SFC (paragraphs 65-67). The distinction is between non-compliance with the requirements relating to internal controls and non-compliance in relation to the matters that are the subject of the system of internal controls.

Paragraph 64 of the paper proposes that "*a sponsor is required to submit a confirmation that the management has conducted the required annual assessment on the firm's internal controls and systems … This confirmation will form an additional part of the annual return that SFC licensees are currently required to file with the Commission under the SFO."*

It may be that, in the course of the annual review, a sponsor discovers weaknesses in the system of internal controls (in its scope, operation, etc). It is not clear if the "material non-compliance issue" referred to in paragraph 1.5.3 of Annex 1 is intended to refer to this possibility. If there are any problems of this nature, they may come to light only during the annual review and, therefore, it is likely that they would be reported, primarily, at that time.

Separately, there may be cases of specific non-compliance with applicable legal and regulatory requirements, failures of supervision of staff, etc., that may come to light outside of the annual review of internal controls. It is these instances of non-compliance that appear to be the subject of paragraphs 65-67, and may also be the kind of "non-compliance issue" referred to in paragraph 1.5.3 of Annex 1.

The ambiguities referred to above, in relation to "material non-compliance issue" referred to in paragraph 1.5.3 of Annex 1, should be clarified.

We note that the SFC issued the document, "*Management, Supervision and Internal Control Guidelines for Persons Licensed By or Registered With the Securities and Futures Commission*" in April 2003, which is designed to provide guidance to licensed or registered persons on the SFC's expectations in relation to internal controls. The document also contains various key controls and attributes of an adequate internal control system, as well as possible effective methods of achieving those attributes.

As regards requiring the management of a sponsor firm to conduct an annual assessment of the firm's internal controls and systems, in order to help sponsors better understand and properly fulfil this requirement, the Institute would suggest that the SFC describes more fully the scope of "systems and controls" for the purpose of this section and provides some basic guidance and recommendations on, e.g., how the annual assessment is expected to be conducted; any framework or basis that may be used to assess the effectiveness of a sponsor's internal controls and systems; specific matters that would normally be expected to be covered by the annual assessment, etc. If the guidelines referred to above are intended to be referred to as a source of guidance on some of these issues, then this should be made explicit.

4. Minimum capital requirements / Professional indemnity

It is proposed that, "*sponsors should have professional indemnity insurance coverage for possible liabilities arising out of their sponsor work*" (paragraph 75 of the paper).

Rather than accepting the premise of the consultation paper, we would like to understand better the reasons for proposing a professional indemnity insurance ("PII") requirement in addition to a minimum capital requirement, given that the two requirements may be seen as serving a similar purpose. Some of our members working in the corporate finance field point to the practical difficulties in obtaining PII coverage at a reasonable cost, and they query the need and justification for imposing such a requirement.

5. Compliance Advisers

Section II of Annex 1, paragraph 1 requires that "*in order for a corporate finance adviser to act as a compliance adviser, it is a pre-requisite that it must first be qualified to act as a sponsor under this Annex*".

Paragraph 78 of the paper proposes that "*any firm that qualifies to work as a sponsor can act as a compliance adviser*", as the SFC believes that the role of compliance adviser is an extension of corporate finance advisory work conducted by a sponsor during the listing application.

We disagree with this proposed requirement and believe that the nature of a sponsor's work and that of a compliance adviser are different and distinct. We note that under the Main Board and GEM Listing Rules, a listed issuer must appoint a compliance adviser for the period commencing on the date of initial listing of its equity security until the publication of financial results for the first/second full financial year after its listing. It is clear from the Listing Rules that the role and nature of the responsibilities of a compliance adviser are to assist newly listed companies and their directors in complying with post-listing rules and requirements.

As regards the qualification needed to be a compliance adviser, the Institute believes that corporate finance advisers licensed for Type 6 Regulated Activity under the Securities and Futures Ordinance, in particular those who have experience in providing advice on Listing Rule matters, should be eligible to act as compliance advisers. A qualification to be a sponsor, on the other hand, should not be a pre-requisite.

6. Transitional Arrangements

The transitional arrangements, referred to in paragraph 84 of the consultation paper, need to be handled carefully and with a reasonable degree of flexibility, so that, for example, work on substantially completed IPOs (see item 2(b) above) may, where appropriate, be taken into account, and sponsor firms are not put under undue pressure to take on work that they might otherwise hesitate to undertake simply in order to meet the new requirements on the Effective Date.

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 feel free to contact me at the Institute on 2287 7084.

Yours faithfully,

Peter Tisman
Director, Specialist Practices
Hong Kong Institute of Certified Public Accountants

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