SECURITIES AND FUTURES COMMISSION

CONSULTATION PAPER ON THE REGULATION OF SPONSORS AND COMPLIANCE ADVISERS

("Consultation")

1. Inconsistency with Legislative Framework

The proposed Annex in the Consultation establishes an administrative system which is inconsistent with the due process afforded under the legislative framework of the Securities and Futures Ordinance ("SFO").

In general, the proposed Annex provides guidance as to how the Securities and Futures Commission ("SFC") will interpret "fitness and properness" under the SFO and for this purpose, will clarify the specific application to sponsors and compliance advisers of the Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct") and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC ("ICG"). We support this.

However, the proposed Annex goes beyond merely providing guidance. It effectively establishes a mini-licensing system within the SFO licensing system by requiring each sponsor firm to have at least 2 Principals who must meet prescribed eligibility criteria. The mini-licensing system under the proposed Annex appears to be extra-judicial in that does not appear to operate by licensing condition. This leads to at least 2 significant consequences:

(a) Lack of Appeals Procedure – The mini-licensing system does not seem to be supported by an appeals procedure. Under this mini-licensing system, a firm that does not have at least 2 Principals who strictly meet prescribed eligibility criteria and that is unable to obtain a variation from the SFC of the prescribed eligibility criteria, has 2 options, namely (i) to cease sponsor work, or (ii) to carry on sponsor work under the risk of disciplinary action. The firm does not have the right to appeal a decision by the SFC refusing a variation.

In contrast, under the SFO licensing system, where the SFC declines to grant a license or imposes a condition on a license, the applicant for the license or the subject to the condition of the license has a right to appeal to the Securities and Futures Appeals Tribunal.

(b) Lack of Transparency – The mini-licensing system under the proposed Annex will not be transparent.

Where the SFC is minded to refuse to grant a variation in prescribed eligibility criteria, it is not obliged to inform the applicant, to give the applicant an opportunity of being hard and to provide reasons for its final determination. In contrast, under the SFO licensing system, where the SFC refuses a license or imposes a condition on a license, the applicant has the benefit of such procedural fairness.

Furthermore, the mini-licensing system does not make it apparent to issuers and the investing public whether a firm is or is not permitted to carry out sponsor and compliance adviser work. The SFO requires that the SFC publish the names of all licensed persons, the regulated activities for which they are licensed and the conditions of their license. No comparable transparency is mandated where, as is proposed in the Consultation, sponsor and compliance adviser eligibility is governed outside of the statutory licensing framework.

2. Application

The application of the proposed Annex to sponsors is unclear. The proposed Annex does not define the terms "sponsor". The SEHK Listing Rules specifically contemplate multiple sponsors for a single issue and in this case, it is unclear whether the proposed Annex applies equally to each sponsor. We assume that the proposed Annex will apply to all sponsors equally but, in our view, the proposed Annex should clarify the position.

3. Compliance Adviser

The proposed Annex emphasizes transaction teams and sponsor experience. The role of a compliance adviser is different from the role of a sponsor. It is difficult to see why compliance advisers should meet these same requirements as the listing transaction has completed and no further sponsoring is required.

We understand that certain corporate finance firms who regularly act as sponsors are reluctant to act as compliance advisers and would be happy to see this work undertaken by other firms which specialize in advisory work. These other firms may not wish to (or may not be able to) comply with the requirements applying to sponsors.

4. Minimum Capital Requirement

The Consultation proposes that sponsor must have a minimum paid-up capital of HK$10 million on the basis that it will ensure that a sponsor (i) is a firm of "substance and commitment" and, (ii) will have sufficient resources to remain in business for a period of time while a prospective issuer decides whether or not to appoint it. It is unclear that the minimum paid-up capital requirement will achieve these 2 objectives. A firm's paid-up capital neither represents its actual working capital nor its substance and commitment.

While the imposition in the proposed Annex of minimum paid-up capital requirement on sponsors appears to be intended to be an interim solution pending amendment to the Securities and Futures (Financial Resources) Rules ("FRR"), in our view, if it is desired to proceed with minimum paid-up capital requirements for sponsors, these requirements should be directly implemented by amending FRR rather than by an interim proposed Annex provision.

5. Professional Indemnity

The Consultation proposes that sponsors should have professional indemnity coverage for possible liabilities arising out of its sponsor work. This requirement suggests that sponsors are likely to face claims from investors. The basis for such claims is uncertain under the present law although we note that the SFC proposes in the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance to establish beyond doubt that sponsors are liable for a misleading statement in a listing document. We consider that it is premature to require sponsors to obtain professional indemnity coverage until this proposal has been more thoroughly canvassed.

We note that the (rather vague) requirements to be imposed on sponsors to have the relevant expertise and adequate resources to perform their roles as sponsors may make it very difficult for sponsors to argue that the inclusion of a misleading statement in a listing document is not as a result of a failure by a sponsor.

A requirement for professional indemnity coverage raises a possible concern that certain firms may be unable to secure coverage at economical rates, with the result that they will no longer be able to act as a sponsor. On the other hand, if such coverage is guaranteed for all firms, then firms with lower risks will effectively subsidize firms with higher risks.

Finally, we note that the SFO expressly empowers the SFC to make rules to provide for insurance coverage in relation to specified risks. The establishment of insurance requirements through the proposed Annex

appears to be a method of avoiding legislative negative vetting. In our view, if it is desired to require professional indemnity coverage, the requirement should be made by subsidiary legislation.

The Law Society of Hong Kong
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