THE LAW SOCIETY OF HONG KONG 香港律師會

CONSULTATION PAPER ON THE REGULATION OF SPONSORS

Law Society's Submissions

The following are the views of the Law Society on the proposals in the Consultation Paper. We support the continuing efforts of the Securities and Futures Commission (SFC) in enhancing the regulation of sponsors and agree with a number of proposals. However, we disagree with the proposal to make explicit that sponsors are liable under Sections 40 and 40A of the Companies Ordinance and our principal objections are set out below. We note the recent trend of the SFC taking vigorous enforcement actions against non-performing listing sponsors and agree that sponsors failing to do a reasonable job should be subject to civil liabilities and misconduct enforcement actions.

Lack of *mens rea* for section 40A offence

The crucial shortcoming of the Section 40A offence is that there is no *mens rea* requirement which means that a person may be convicted unless he is able to prove the statement was immaterial or that he had reasonable grounds to believe the statement to be true. This shortcoming was acknowledged by the SFC in its consultation conclusions to the previous proposals to extend liability for prospectus misstatements.[1] Responding to the views of most respondents that criminal liability should only be imposed where there is fraud or recklessness (thus distinguishing professional mistakes from deliberate fraudulent acts or reckless behaviour), the SFC stated:

> *"The Commission agrees that mens rea should be present before criminal liability can be imposed. Therefore, it intends to amend section 40A of the Companies Ordinance to incorporate a mens rea element so that criminal liability would not be imposed unless there is intent or recklessness. The Commission notes that this proposed amendment would be in line with the criminal liability standard in the SFO."*

The Law Society feels strongly that the burden of proof in criminal actions must be on the prosecution. The civil liability standard under Section 40 should also be amended in line with the Securities and Futures Ordinance (SFO) so that a person is liable for a prospectus misstatement only if he is negligent.

[1] Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance of September 2006.

Dilution of responsibility of issuers' directors and experts
A key concern is that the practical effect of this proposal will be to make sponsors carry ultimate responsibility for the accuracy of IPO prospectuses, even in circumstances where they are the least blameworthy party. Despite the Consultation Paper's assurance that the SFC will pursue actions against directors and experts, the overwhelming majority of Hong Kong listed companies are incorporated offshore and virtually all their directors are resident outside Hong Kong. The reporting accountants of Mainland companies are now also frequently located outside Hong Kong.

It is therefore extremely difficult, if not impossible, for investors to obtain compensation from these parties and for the SFC to pursue criminal prosecutions against them. Hong Kong-based sponsors therefore risk becoming a very easy target for both investors and regulators. With no provision for liability to be shared in accordance with a party's share of responsibility, sponsors may be liable to investors notwithstanding they may be the least culpable party. This is fundamentally unfair.

Rather than seek to shift responsibility to sponsors, the focus of changes to the prospectus liability regime should be to on ensuring that issuers' directors and experts are liable where they are responsible for prospectus misstatements. We believe this is the fundamental basis for the issue of a prospectus. Indeed, we note that paragraph 2 of the Consultation Paper makes it clear that *"....the directors of a company are primarily responsible to investors to ensure that they are fully informed; directors have the deepest knowledge of the business and its prospects and are best placed to ensure that disclosure is accurate and meaningful."*

Hindsight in determining "reasonable" due diligence
Although sponsors would have a defence based on the conduct of reasonable due diligence, it is often only with the benefit of hindsight that what is reasonable due diligence can be ascertained. The Consultation Paper rightly states that reasonable due diligence cannot be expected to act as a guarantee of an absence of fraud, forgery or deliberate non-disclosure.

It is important that this philosophy is borne in mind and adhered to when assessing the merits of the various proposals expressed in the Consultation Paper. In particular, in a situation where, once a fraud has been exposed, the due diligence which will appear reasonable in hindsight may not be something which seemed reasonable at the time.

Impact of proposal
The Consultation Paper agrees that sponsors are only required to conduct reasonable due diligence. We need to be mindful that as a result of the proposals in the Consultation Paper, sponsors will not be asked to "guarantee" the soundness of the listing applicant or an investment into the applicant. Any proposal in this direction is not only fundamentally unfair given the responsibility of the directors as mentioned above, but will substantially increase the already considerable cost of listing and unnecessarily prolong the listing timetable which risks rendering the Hong Kong market uncompetitive.

It is also questionable whether a substantial increase in due diligence will enhance investor protection. It is, in particular, unlikely to uncover fraud or deliberate non-disclosure of information which are the major risks faced by investors. If criminal

liability is introduced, avoidance of legal liability is likely to become a primary focus of prospectus drafting with the temptation to include as much information as possible. Prospectuses will become longer and more legalistic and of less practical use to investors.

Law Society's Response to the Consultation Questions

Question 1
Do you agree a sponsor should have a sound understanding of a listing applicant for which it acts? If not, why not?

Law Society's response
Yes, sponsors should have a sound understanding of a listing applicant. However, this does not amount to exhaustive knowledge of an applicant, and the expectations of sponsors must be realistic given commercial and timing restraints. Consistent with the requirement that due diligence needs to be reasonable, "*a sound understanding*" of the applicant should similarly be qualified by "*reasonableness*".

Question 2
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?

Law Society's response
Yes.

Question 3
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?

Law Society's response
No. This completely goes against the philosophy of a disclosure – based IPO regime.

Sponsors are expected to identify the material deficiencies and to have them disclosed in the prospectus for investors to consider and assess when deciding whether to invest in the IPO.

We disagree that sponsors are required to remedy such deficiencies because:

(i) sponsors are not in the business of and they do not have the expertise to remedy deficiencies in the operations and structure, procedures and systems of companies;

(ii) not all deficiencies can be remedied (or remedied completely) but instead investors should be given the opportunity to decide whether they wish to invest in the IPO notwithstanding such deficiencies;

(iii) if such deficiencies are so material as to affect the suitability of listing, the Stock Exchange has a right not to accept such listing. Under the current system, a sponsor is required to make a declaration with respect to a listing applicant, systems, procedures and directors and therefore there is already appropriate assurance that listing applicants with material deficiencies in these areas will not be sponsored for listing.

Question 4
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?

Law Society's response
Yes.

Question 5
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?

Law Society's response
The Law Society has no objection in principle to this proposal.

However, we wish to point out that under Rule 9.03(3) of the Listing Rules, at the time of submission of the listing application, the prospectus is required to be an "advanced proof" and if the Stock Exchange considers the draft prospectus is not in an advanced form, it will not commence its review.

The Law Society suggests that the SFC clarify what changes this proposal would bring about in addition to the current requirement as set out in the Listing Rules. In particular, the SFC should clarify whether there are any conceptual or practical differences between "advanced proof" and "substantially complete".

The current requirements of the Listing Rules also provide with the Stock Exchange discretion as to whether a draft prospectus constitutes an "advanced proof" or not - for instance, as a matter of practice, the Stock Exchange would regularly accept a draft prospectus which only includes the identity of two independent directors with the third one to be disclosed at a later stage. Would the proposal still provide the SFC and the Stock Exchange with such discretion? This would be important for sponsors to understand before they come to the view as to whether an Application Proof is substantially complete.

In addition, we hope that if the Application Proof is required to be substantially complete when submitted with the listing application, the Exchange's vetting process will become much faster than is currently the case. Otherwise, the listing process in Hong Kong will be excessively long. A long vetting period also risks further increasing costs due to the possibility the information in the Application Proof becomes stale.

Question 6
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?

Law Society's response
Yes, provided that the opinion should be expanded so that the applicant has either complied or is expected to comply with all listing conditions and has established or is expected to establish adequate systems and procedures.

The Law Society notes that whilst as a principle, it does not object to the sponsor being required to conduct most of its due diligence before submitting a listing application there will be matters which would not, by their nature, have been conclusively resolved before the listing application.

In terms of listing condition, for example, this would include the listing application satisfying a certain market capitalization (see Listing Rule 8.05(2), 8.05 (3), 8.08 and 8.09 for example) and in terms of adequate systems and procedures, certain committees of the board of the listing applicant might not have been formed at the time as there is no reason for them to be formed at such an early stage. Accordingly, it would be appropriate for the sponsor to be given certain flexibility if they are allowed to take into account matters which they would reasonably expect to occur subsequent to the listing application being made and that this flexibility be reflected in the opinion it is required to give.

Question 7
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?

Law Society's response
Yes.

Question 8
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?

Law Society's response
No. An obligation to "*ensure*" the sufficiency of prospectus information is excessive and unrealistic.
The obligation imposed by proposed paragraph 17.5 of the Code of Conduct[2] should be amended to reflect the current requirement of Listing Rule 3A.13 that, having made reasonable due diligence inquiries, the sponsor has ***reasonable grounds to believe and does believe that*** the listing document contains sufficient information. .

Question 9
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?

Law Society's response
Yes. Please note however that proposed paragraph 17.5(b)(ii) of the Code of Conduct will need to be amended as it currently fails to include a "*materiality*" requirement for prospectus omissions.

Question 10
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?

Law Society's response
No. While sponsors coordinate the process of prospectus preparation, it is necessarily a collaborative process. It is thus essential that experts are fully responsible for the sections of the prospectus which they alone are qualified to prepare.

Rather than require sponsors to prove that their reliance on experts' reports is reasonable, they should be entitled to rely on such reports unless it is unreasonable for them to do so. Thus, the sponsor should be able to rely on an expert's statement unless it had reasonable grounds to believe and did believe that information in the expert's statement was untrue or omitted a material fact necessary to make the information not misleading

Question 11
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?

[2] At page 39 of the Consultation.

Law Society's response
The Law Society considers that these steps are adequate. However, there are concerns that the result of these proposals is that liability for defective work performed by experts will effectively be shifted to sponsors.

Primary liability for defects in the expert sections must lie with the experts themselves and they should be responsible for all steps necessary to ensure the accuracy and completeness of their reports, including the verification of factual information on which their reports are based.

Some of the proposed obligations to be placed on sponsors involve a number of practical difficulties. For example, the proposed paragraph 17.6(g)(ii) requires a sponsor to work with the reporting accountants to assess the financial information against business performance and other operating aspects and assess the veracity of any management discussion and analysis of financial performance. To be effective, there will need to be a corresponding obligation on reporting accountants to collaborate with sponsors on these matters. The financial information contained in an accountants' report is subject to audit procedures. A sponsor is not properly qualified to assess, evaluate or review the audit procedures performed by qualified accountants. In fact, a sponsor has to place reliance on the accountants' report to assess the business performance of an applicant.

Question 12
Do you agree that a sponsor cannot delegate responsibility for due diligence? If not, why not?

Law Society's response
We agree to the principle that sponsors should be responsible for the overall due diligence exercise. This responsibility should, however, be subject to their right to delegate to appropriately qualified experts due diligence tasks on matters for which they lack the necessary expertise.

The "non-expert" sections of a prospectus may also contain statements that are within the core competence of experts to confirm, such as, for example, market research, legal opinions on title, applicable legal requirements and internal control reviews. For matters that require an expert opinion, the sponsor should be able to delegate the work to suitably qualified experts and rely on an expert's statement unless it has reasonable grounds to believe that information in the expert's statement is untrue or omitted a material fact necessary to make the information not misleading.

Question 13
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?

Law Society's response
A clear distinction should be made in paragraph 17.6(h) between due diligence tasks that should involve an expert opinion or confirmation and those that do not. For those

due diligence tasks which do not involve an expert opinion or confirmation, the proposed steps are appropriate.

Question 14
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?

Law Society's response
Yes, although this obligation should be subject to a materiality threshold so that minor inaccuracies need not be notified.

Question 15
Do you agree that a sponsor should deal with all enquires raised by the regulations in a cooperative, truthful and prompt manner? If not, why not?

Law Society's response
Yes.

Question 16
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?

Law Society's response
Yes, provided that, with respect to legal or regulatory requirements, the sponsor is only required to disclose to the Stock Exchange *material non-compliance*. It is a fact that a lot of businesses may have not complied with all legal and regulatory requirements in the jurisdictions in which they operate, in particular, those requirements which relate to operational aspects of the business such as employment, safety and health.

It is questionable whether there will be any value for the sponsor to bring to the attention of the Stock Exchange such non-compliance where, because these are not material, the sponsor and the listing applicant have reasonably formed such a view the non-compliance is not material to investors and would not be disclosed in the prospectus.

Question 17
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?

Law Society's response
A sponsor should be required to disclose the reasons for its ceasing to act only if it concerns matters of non-compliance with the Listing Rules.

Question 18
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?

Law Society's response
No.

We are not convinced that a public filing will achieve the SFC's goals by improving the quality of listing documents and enhancing the efficiency of the listing application process. In situations where a listing is delayed or cancelled or listing approval is not granted, the disclosure of commercially sensitive information could be detrimental to the applicant's interests.

This may serve as a disincentive for potential candidates to seek a listing on the Hong Kong Stock Exchange.

Question 19
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?

Law Society's response
Yes, except the obligation should be to retain records sufficient to demonstrate "reasonable" compliance. Given the detailed nature of the obligations under the Provisions, it should be sufficient for a sponsor to have records of due diligence in keeping with the spirit, if not the letter, of the Provisions.

Question 20
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?

Law Society's response
Yes.

Question 21
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?

Law Society's response
Yes.

Question 22
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?

Law Society's response
Yes.

Question 23
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?

Law Society's response
Yes.

Question 24
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?

Law Society's response
Yes.

Question 25
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?

Law Society's response
All the suggested proposals should achieve the proposed objectives.

Question 26
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?

Law Society's response
No, the market reality is that an applicant may want to appoint more than one sponsor in order to take advantage of the underwriting services provided by different sponsors or their ECM divisions.

Appointing an additional sponsor is also necessary if a sponsor fails to meet the independence requirements. See our response to Question 27 below.

We also question the SFC's claim (in paragraph 106 of the Consultation Paper) that *"where there is more than one sponsor, an inevitable risk is duplication of work and an increased chance that key issues are missed."* The fact of the matter is that each sponsor is a regulated entity owing duties to the SFC and therefore would each need to discharge its duties including performing its own diligence work in order to give individual declarations under the current regime. We are not convinced that, as a result of *anecdotal* evidence and the risk that there is duplication of work, listing applicants are not allowed to benefit from the services and expertise brought about by multiple sponsors.

We think the number should not exceed three for a new issue to be manageable with at least one independent sponsor. The Law Society also believes there should not be any limit and this should be a matter for individual listing applicants to decide.

Question 27
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?

Law Society's response
No.

A sponsor may fail to meet the independence requirement because, for example, the sponsor group has extended pre-IPO financing to a potential applicant to facilitate its listing process. It is not uncommon for Chinese domestic entities to require an offshore loan for implementing a pre-listing reorganisation.

If all sponsors have to meet the independence requirements, it may be difficult for a potential listing candidate to obtain pre-IPO financing from a third party who is not intimately involved in the listing process. We consider that the proposal in paragraph 109 of the Consultation Paper will be adequate to safeguard the public's interests.

Question 28
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?

Law Society's response
Yes.

Question 29
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?

Law Society's response
Yes.

Question 30
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?

Law Society's response
Yes.

Question 31
Do you agree that the Provisions should equally apply to a listing agent appointed for the listing of a REIT? If not, why not?

Law Society's response
Yes.

Question 32
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?

Law Society's response
No. As stated in the opening paragraphs of this response, the Law Society has a number of fundamental reasons for objecting to the proposed extension of liability.

In addition, Hong Kong has an extremely comprehensive regime under which sponsors and their staff may be civilly or criminally liable in respect of prospectus misstatements which include potential civil and criminal liability for misrepresentation under:

- sections 107 and 108 of the SFO
- sections 277 and 298
- section 384 disclosure of false or misleading information inducing transactions and possible criminal liability
- ssections 281 and 305 SFO further provide for investors who have suffered loss to seek compensation

Investors are additionally protected under the laws of contract and tort. Sponsors and their staff are further subject to the extensive disciplinary and investigation powers of the SFC which can result in the revocation of licences and fines.

We therefore question whether there is any real need to extend liability under sections 40 and 40A Companies Ordinance.

There is concern the proposed extension of such liability will lead to a lowering of the standard of proof. As stated earlier, criminal liability should be reserved for cases involving fraud or recklessness and that negligence should be a prerequisite for civil liability. Imprisonment, in particular, should not be a penalty except in the case of fraud.

The degree of sponsor liability proposed is out of step with international practice. Although Singapore imposes criminal liability on issue managers (the equivalent of sponsors), this is only where an issue manager knows or is reckless as to whether a prospectus statement is false or misleading.[3] Hong Kong sponsors already face criminal liability under the SFO in those circumstances.[4]

While the Law Society accepts sponsors' due diligence responsibilities, the key risks faced by investors are fraud and deliberate non-disclosure of information, which even the most assiduous due diligence may not detect. In that light, expectations of sponsors must be reasonable and realistic and in the relatively rare situations in which there has been fraud or deliberate concealment, the emphasis should be on making those who are primarily responsible pay the price. Shifting the responsibility of issuers' directors and experts to sponsors is likely to dilute the responsibility borne by the former resulting in worse not better prospectuses for investors.

Question 33
Do you have any views on the proposed definition of "sponsor"? Please explain your views.

Law Society's response
We agree to the proposed definition.

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3 July 2012
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[3] Section 253(4)(c) Singapore Securities and Futures Act.
[4] Section 298 SFO.