

► Recent Developments in the Regulation of Sponsors



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Introduction

2 stages in tightening of the sponsor regulatory regime:

- Amendments to the Listing Rules including a new Practice Note on Due Diligence by Sponsors effective 1 January 2005
- A specific regulatory regime for sponsors under the SFO which came into effect on 1 January, 2007

**LISTING RULE AMENDMENTS
EFFECTIVE 1 JANUARY 2005**

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Requirements for Sponsors

- New Chapter on Sponsors and Compliance Advisers (Chapter 3A Main Board Rules and Chapter 6A GEM Rules)
- New Practice Note on Due Diligence to be performed by Sponsors (Practice Note 21 Main Board Rules and Practice Note 2 GEM Rules)
- (At least) one Sponsor must be appointed to assist new applicant with IPO
- If more than one sponsor, all are responsible

Requirements for Sponsors (Cont'd)

- At least one Sponsor must be independent of the applicant in accordance with new independence test at Main Board Rule 3A.07 and GEM Rule 6A.07
- Each Sponsor must submit a Statement Relating to Independence to the Exchange (MB Rules Appendix 18/ GEM Rules Form K of Appendix 7)
- Sponsors must undertake to the Exchange to comply with the Listing Rules, ensure the accuracy of information and co-operate in any investigation

Requirements for Sponsors (Cont'd)

Sponsors' Obligations (MB Rule 3A.11/GEM Rule 6A.11)

Sponsors must:

- comply with the Sponsor's Undertaking
- be closely involved in the preparation of the listing document
- conduct reasonable due diligence inquiries
- have regard to the new Practice Note re. what is reasonable due diligence
- Practice Note sets out steps Exchange typically expects to be performed: actual steps may need to be more extensive

Requirements for Sponsors (Cont'd)

Sponsor's Declaration to the Exchange (MB Rule 3A.13/GEM Rule 6A.13)

Each Sponsor must submit a Declaration (Main Board Rules Appendix 19 and GEM Rules Form G of Appendix 7) covering due diligence re:

- the directors' declarations
- applicant's compliance with basic listing conditions
- the sufficiency of the listing document
- the applicant's systems and controls
- the directors' individual and collective experience, qualifications and competence

Requirements for Sponsors (Cont'd)

- ▶ the expert sections of the listing document including whether:
 - factual information relied on but not verified by the expert is true and complete
 - all bases and assumptions are fair reasonable and complete
 - expert is appropriately qualified, experienced and sufficiently resourced
 - appropriateness of expert's scope of work
 - expert's independence
 - that listing document fairly represents expert's views

Practice Note on Due Diligence by Sponsors in respect of Initial Listing Applications “Practice Note 21 of MB Rules and Practice Note 2 of GEM Rules

- Practice Note applies only to sponsor firms; not individuals
- Sets out steps Exchange typically expects to be performed: actual steps may need to be more extensive
- Requires sponsors to document (a) due diligence planning and significant deviations from plans and (b) conclusions as to applicant’s compliance with listing conditions

Termination of Sponsors (MB Rule 3A.17/GEM Rule 6A.17)

On the resignation or termination of the sponsor:

- The listing applicant must immediately notify the Exchange
- If the departing sponsor is the sole independent sponsor, the replacement sponsor must immediately notify the Exchange of its appointment, re-submit a listing application, revised timetable, listing fee and sponsor declarations and undertakings
- A new sponsor is not regarded as having fulfilled any of its obligations by virtue of work performed by its predecessor

Compliance Advisers

All listed issuers must appoint a Compliance Adviser from the date of listing until:

- for **Main Board issuers** – publication of financial results for the **first** full financial year after listing
- for **GEM issuers** – publication of financial results for the **second** full financial year after listing
- MB Rule 3A.19/GEM Rule 6A.19

Compliance Advisers must act impartially but need not be independent

Compliance Advisers (Cont'd)

- The Exchange may require a listed issuer to appoint a Compliance Adviser at any other time for a period specified by the Exchange (MB Rule 3A.20/GEM Rule 6A.20)
- Normally where the issuer has breached the Listing Rules, eg. if breaches are persistent or serious or give rise to concerns as to the adequacy of compliance arrangements or the directors' understanding of the Listing Rules
- Issuer need not appoint the same Compliance Adviser as was appointed on listing

Compliance Advisers (Cont'd)

Compliance Advisers must:

- undertake to the Exchange to comply with the Listing Rules and cooperate in any investigation
- advise and guide the issuer in the 4 situations in which the issuer must consult its CA
- when consulted, ensure the issuer is properly guided and advised
- specific obligations on review of the issuer's financial reports and on a proposed change in use of the IPO proceeds

Compliance Advisers (Cont'd)

Issuers must consult their Compliance Adviser:

- before publication of any regulatory announcement or report, circular or financial report
- where a notifiable or connected transaction is contemplated (including share purchases and share repurchases)
- where the issuer proposes to use IPO proceeds other than as set out in the Listing Document or where its business activities, developments or results differ from information in the Listing Document
- where the Exchange makes an inquiry as to unusual movements in the price or trading volume of the issuer's securities

MB Rule 3A.23/GEM Rule 6A.23

Termination of Compliance Adviser (MB Rule 3A.26/GEM Rule 6A.26)

- A listed issuer can only terminate its Compliance Adviser if its work is unacceptable or there is a material dispute over fees which cannot be resolved within 30 days
- A replacement must be appointed within 3 months of a Compliance Adviser's resignation or termination

Independent Financial Advisers ("IFAs")

- New Rules added to MB Chapter 13 and GEM Chapter 17
- IFAs must be independent in accordance with new test at MB Rule 13.84 and GEM Rule 17.96
- IFAs must submit a Declaration of Independence
- IFAs must undertake to the Exchange to comply with the Listing Rules and cooperate in any investigation

IFAs (Cont'd)

IFA's Obligations

An IFA must take all “reasonable steps” to be satisfied that:

- it has a reasonable basis for making the statements required; and
- there is no reason to believe that any information relied on is not true or omits a material fact

IFA's Due Diligence

Note 1 to MB Rule 13.80/GEM Rule 17.92 sets out a non-exhaustive list of expected “reasonable steps”

IFAs (Cont'd)

Issuer's Obligation to Assist IFA

An issuer required to appoint an IFA must:

- give the IFA access to all persons, premises and documents relevant to performance of the IFA's duties;
- inform the IFA of material changes to information accessed by the IFA;
- obtain necessary consents for providing information to the IFA;

Experts' terms of engagement should give IFAs access to the expert, its reports, information relied on, correspondence etc.

**NEW REGULATORY REGIME FOR SPONSORS UNDER
THE SECURITIES AND FUTURE ORDINANCE**

TO TAKE EFFECT 1 JANUARY, 2007

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New Regulatory Regime For Sponsors Under The Securities And Future Ordinance

- Sponsors will still have to satisfy existing licensing eligibility criteria for Regulated Activity Type 6 (Advising on Corporate Finance) and comply with existing SFC Codes and Guidelines
- Specific eligibility criteria and on-going compliance obligations for sponsors will be set out in the Guidelines for Sponsors and Compliance Advisers which will form part of the Fit and Proper Guidelines

New Regulatory Regime For Sponsors Under The Securities And Future Ordinance

- Only firms meeting the new eligibility criteria will be able to conduct sponsor and compliance adviser work after January 1, 2007.
- Eligible firms wishing to act as sponsors will have to comply with on-going obligations.
- Firms that do not meet the new criteria will be imposed with a no-sponsor work licensing condition. This will also prevent them from acting as a compliance adviser.
- Firms holding a RA 6 licence must notify the SFC before **September 30, 2006** as to whether they wish to continue to conduct sponsor work. The SFC will issue forms in due course.

Additional Licensing Eligibility Criteria for Sponsors

Additional criteria for determining whether a sponsor is “fit and proper” include:

- The firm must have sufficient expertise and resources to perform sponsor work
- Management must be responsible for all sponsor work
- Each transaction must be staffed by a “transaction team” with the right mix of skills and expertise and supervised by a “Principal”
- Firms must have “sufficient” Principals to discharge sponsor work: minimum requirement for 2 Principals;

Additional Licensing Eligibility Criteria for Sponsor (Cont'd)

A Principal must be a Responsible Officer licensed for Regulated Activity Type 6 who has:

- a minimum of 5 years' relevant corporate finance experience; and
- played a substantial role in at least 2 completed IPOs on MB or GEM in the 5 years immediately before his appointment

The experience requirements are initial eligibility criteria only.

“Relevant corporate finance experience” means the person must have experience in **one or more** of the following areas: IPOs, notifiable or connected transactions, a rights issue or open offer by a listed company, takeovers and share repurchases subject to the Codes on Takeovers, Mergers and Share Repurchases and any other significant transactions or equity-fund raising exercises.

Additional Licensing Eligibility Criteria for Sponsor (Cont'd)

Firms must have effective systems and internal controls to ensure:

- adequate supervision and management of employees conducting sponsor work;
- employees do not exceed their authority;
- regulatory compliance

There must be effective reporting lines between transaction teams and management

Proposed Additional On-going Compliance Obligations for Sponsors

Internal Assessment

Sponsors will have to conduct an annual self-assessment of their compliance with the requirement for effective systems and controls

Any material non-compliance will have to be reported promptly to the SFC

Record Keeping

Lists of all sponsor work undertaken (including the composition of transaction teams) will have to be kept.

Additional Licensing Eligibility Criteria for Sponsor (Cont'd)

Continuing Professional Training

At least 50% of CPT hours must be spent on corporate finance, particularly IPO matters, and Hong Kong listing matters and regulatory knowledge.

Minimum Capital Requirement

There will be a minimum capital requirement of HK\$ 10 million for all sponsors.

The proposal for mandatory professional indemnity insurance for all sponsors was not adopted.

Compliance Advisers

Only firms qualified as Sponsors under the proposals will be eligible to act as Compliance Advisers to newly listed issuers.

Transitional Arrangements

The new requirements will come into effect on January 1, 2007.

New RA 6 Licence Applicants wishing to conduct sponsor work

Must submit applications for RA 6 licences with documentation showing compliance with new eligibility criteria including HK\$10 million paid-up capital requirement.

Existing RA 6 Licensees who do *not* intend to act as sponsors

- Need not meet the higher minimum paid-up capital requirement
- Will be imposed with a no-sponsor work licensing restriction

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Transitional Arrangements

Existing RA 6 Licensees who intend to act as sponsors and have a previous IPO track record

- Previous IPO track record means they've conducted at least one IPO transaction on either MB or GEM in previous 5 years
- Must make a written submission to SFC that it meets eligibility criteria and give names of Principals
- Must provide evidence that it can meet HK\$10 million paid-up capital requirement.
- SFC will issue notification of decision not to impose no-sponsor work condition.
- New licences will not be issued

Existing RA 6 Licensees with no IPO track record

- No IPO track record means they have not, on a firm basis, completed any IPOs in the previous 5 years
- Must make a written submission to the SFC with supporting evidence that it complies with the new eligibility criteria and give names of Principals
- Must provide evidence that it can meet HK\$10 million paid-up capital requirement.
- SFC will issue notification of decision not to impose no-sponsor work condition.
- New licences will not be issued

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Transitional Arrangements

Firms that intend to act as compliance advisers

- A firm must be eligible to act as a sponsor to conduct compliance adviser work.

Commission Inspections

Commission Inspections

Sponsors and Compliance Advisers will be subject to on-going supervision by the SFC. SFC will be entitled to inspect both on a routine and ad hoc basis.

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