



Hong Kong

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SFC CONSULTS ON PROPOSED CODE OF CONDUCT ON BOOKBUILDING AND PLACING ACTIVITIES AND PROPOSAL ON SPONSOR COUPLING

On 8 February 2021, the Securities and Futures Commission (the **SFC**) published a consultation paper on (i) a proposed SFC Code of Conduct for Hong Kong Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions (the **SFC Proposed Code**); and (ii) a proposal to introduce HKEx “sponsor coupling”, which would require at least one overall coordinator to also act as a sponsor.

The proposals followed a thematic review of selected SFC licensed intermediaries engaged in equity capital market or debt capital market Hong Kong bookbuilding and placing activities, which found that, in some offerings, the price discovery process had been hampered by various factors, in addition to the occurrence of “undesirable intermediary conduct”. The SFC’s thematic review also identified a number of good practices, which the SFC proposes to codify to enhance the quality of intermediary conduct and to ensure a level playing field. Separately, the SFC also identified that, particularly in larger IPOs, sponsors’ incentives and liabilities were often misaligned, leading to concerns that sponsors may compromise their due diligence enquiries in order to become the head of the underwriting syndicate.

The key features of the proposals, which were formulated in line with reports issued by the International Organisation of Securities Commissions (**IOSCO**) and based on the findings of the SFC’s thematic review, include:

- a new paragraph 21 in the Code of Conduct for Persons

Licensed by or Registered with the SFC (the **SFC Code of Conduct**), which will set out standards of conduct expected of intermediaries involved in bookbuilding and placing activities. These intermediaries will be defined as capital market intermediaries (**CMIs**);

- syndicate membership and fee arrangements must be determined at an early stage;
- intermediaries must be formally appointed under written agreements setting out their roles, responsibilities and fee arrangements; and
- for IPOs, at least one overall coordinator (**OC**) head of the syndicate must be appointed as a sponsor and this sponsor must be independent of the issuer.

The SFC states that the proposals will together:

- address the concerns regarding intermediaries’ conduct;
- tackle issues arising from competitive pressures; and
- align incentives with the responsibilities of intermediaries.

The consultation closes on 7 May 2021.

1. SFC Findings and Overview of Hong Kong Market and Current Practices

Typically, price discovery is conducted by way of bookbuilding, which, when conducted transparently and fairly, the SFC considers serves the interests of both issuers and investors. However, there are currently no specific conduct requirements for intermediaries involved in Hong Kong bookbuilding and placing activities.

Through the thematic review, the SFC identified the following concerns with the bookbuilding and allocation process:

- i) **Roles and functions of intermediaries** – generally, written agreements entered into by intermediaries did not clearly set out the roles and functions of the different intermediaries and titles given to intermediaries sometimes had little bearing on their seniority or responsibilities in relation to the transaction;
- ii) **Syndicate membership** – market participants raised concerns that some issuers have deviated from market practices by determining fee arrangements and syndicate membership at a late stage, with some “latecomers” often being unfamiliar with the issuer and unable to market the offering properly;
- iii) **Incentive structures** – some issuers may reward syndicate members for their ability to support very aggressive pricing, with syndicate members placing more emphasis on the quantity of orders sourced, particularly price-insensitive orders from corporate and individual investors. The SFC also found that while fixed fees have accounted for the majority of total underwriting fees, some issuers have increased the discretionary fee portion significantly;
- iv) **Inflated demand** – some intermediaries were found to be knowingly placing inflated orders and overstating demand, which, according to the SFC, undermines the price discovery process and can mislead investors;
- v) **Lack of transparency** – concerns were raised regarding the use of “X-orders”, where the identities of the investors are concealed and known only to the syndicate members who place the orders and to the issuers, which reduces the transparency of the order book and prevents the heads of syndicates from assessing real demand. The SFC also highlighted concerns that:
 - the use of “X-orders” may result in unusual, duplicated or potentially fictitious orders not being identified;
 - issuers may request “X-orders” in order to conceal the identities of prospective investors with whom they are closely associated in order to inflate “market driven demand” in the order book;
 - sell-side market participants sometimes use “X-orders” to prevent other syndicate members from poaching their clients; and
 - some investors (particularly sovereign wealth funds) may request “X-orders” to conceal their participation in a debt capital market (DCM) transaction;
- vi) **Conflicts of interest** – some syndicate members did not give priority to orders placed by their investor clients and the SFC expressed concerns that syndicate members with access to the order book are privy to non-public information which could be used to increase their chances of allocation in popular deals;
- vii) **Preferential treatment or Rebates Paid to Investors** – the SFC found that while the rebates paid to private banks are not meant to be passed on to the private banks’ clients, it does occur. The SFC considers that this undermines the fair treatment of investors as different investors in effect pay different prices for the same debt securities;
- viii) **Lack of documentation** – the SFC found that heads of syndicate did not maintain records or maintained insufficient or inadequate records of incoming client orders, important discussions with the issuer or the syndicate or the basis for making allocation recommendations; and
- ix) **Potential breaches of HKEx requirements** – the SFC found that, in some cases, syndicate members attempted to allocate IPO shares to

clients with which they were associated without seeking prior consent from the HKEx, in breach of HKEx requirements.

2. SFC Proposed Code of Conduct on Hong Kong Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions

The SFC Proposed Code focuses on the expected standards of conduct and systems and controls in the following areas:

- assessment of the issuer and the offering;
- appointment of CMI and OCs;
- advice to the issuer;
- marketing;
- rebates and preferential treatment;
- assessment of investors;
- bookbuilding, pricing and allocation;
- conflicts of interest; and
- disclosures to the issuer, other CMIs and investors.

Scope of Coverage (paragraph 21.1 of the SFC Proposed Code)

The SFC Proposed Code will regulate the conduct of intermediaries involved in the following activities conducted in Hong Kong:

- a) bookbuilding activities, which comprises collating investors' orders (including indications of interest) in a share or debt offering in order to facilitate (i) the price determination and the allocation of shares or debt securities to investors; or (ii) the process of assessing demand and making allocations;
- b) placing activities, i.e. distributing shares or debt securities to investors pursuant to bookbuilding activities; and
- c) advising, guiding and assisting the issuer in Hong Kong bookbuilding and placing activities.

Intermediaries engaged in any of the above-outlined activities will be referred to as CMIs. CMIs do not include financial advisers or other professionals who only provide advice to the issuer but do not participate in any bookbuilding or placing activities.

Types of Offerings

The SFC Proposed Code will cover the following types of share and debt offerings.

Equity Capital Market (ECM)

- a) shares to be listed on the HKEx issued by a listing applicant or listed company via:
 - IPOs (including share offerings in relation to secondary listings);
 - offerings of shares of a class new to listing; or
 - offerings of new shares of a class already listed under a general or special mandate.

The SFC Proposed Code will also cover (i) units or interests in SFC-authorized REITs listed or to be listed on the HKEx and (ii) shares listed on the HKEx when a shareholder places its existing listed shares to third party investors followed by a top-up subscription of new shares by the shareholder, to the extent that these offerings involve bookbuilding activities.

Debt Capital Market (DCM)

The SFC Proposed Code will cover all types of debt offerings (bonds with complex features, bonds issued by sovereigns or corporates, bonds targeting retail or professional investors, listed or unlisted bonds and high yield issues), provided that the offering involves bookbuilding or placing activities conducted by intermediaries in Hong Kong.

Outside of scope

The SFC Proposed Code will not cover offerings which do not involve bookbuilding activities, such as:

- a) bilateral agreements or arrangements between the issuer and the investors, such as "club deals";

- b) transactions where only one or several investors are involved and the terms of the offering are negotiated and agreed directly between the issuer and the investors; and
- c) transactions where shares or debt securities are allocated to investors on a pre-determined basis.

The SFC Proposed Code would also not cover a share offering which has been subscribed by an intermediary as principal deploying its own balance sheet, for onward selling to investors or otherwise.

Types of CMIs (paragraph 21.2 of the SFC Proposed Code)

OCs

The SFC Proposed Code will refer to heads of syndicate for an offering as OCs. OCs will be identified solely by reference to the activities they actually carry out, rather than by their titles.

In the case of a share offering, an OC is a syndicate CMI which, solely or jointly, conducts one or more of the following activities:

- a) overall management of the share offering, coordinating the bookbuilding or placing activities conducted by other CMIs, exercising control over bookbuilding activities and making allocation recommendations to the issuer;
- b) advising the issuer of the offer price and being a party to the price determination agreement with the issuer;
- c) exercising the discretion to reallocate shares between the placing tranche and public subscription tranche, reduce the number of offer shares, or exercise an upsize option or over-allotment option; or
- d) acting as the stabilising manager.

In the case of a debt offering, an OC is a syndicate CMI which, solely or jointly, conducts the overall management of the debt offering, coordinates the bookbuilding or placing activities conducted by other CMIs, exercises control over bookbuilding activities and makes pricing or allocation recommendations to the issuer.

Syndicate CMIs and Non-Syndicate CMIs

Other CMIs will fall within the category of syndicate CMIs or non-syndicate CMIs as the case may be. They will be classified as such depending on whether they have a mandate and a direct relationship with the issuer. Examples of syndicate CMIs include bookrunners or lead managers (in the case of other senior syndicate CMIs) and co-managers and placing agents (in the case of less senior syndicate CMIs) and non-syndicate CMIs include, for example, sub-placing agents or brokers.

Standards of Conduct Expected of OCs and CMIs

The standards of conduct expected of CMIs are set out in paragraph 21.3 of the SFC Proposed Code and are baseline requirements with which all CMIs would have to comply. Paragraph 21.4 of the SFC Proposed Code sets out additional requirements applicable to OCs only.

i. Assessment of the Issuer and the Offering (paragraphs 21.3.1 and 21.4.7(a) of the SFC Proposed Code)

The SFC found from the thematic review that CMIs generally conduct assessments of the issuer and the offering before participating in the offering, however the assessments vary in scope and depth. The SFC considers that a proper understanding of the issuer and the offering is necessary in order for CMIs to market the shares or debt securities to their investor clients and for the OC to provide appropriate advice to the issuer.

Accordingly, the SFC Proposed Code will require a CMI, before engaging in an offering, to:

- a) *Take reasonable steps to obtain an accurate understanding of the issuer (which may vary depending on the type of offering and the role played by the CMI)*

This assessment of the issuer should include a sufficient understanding of the issuer's history, background, business and performance, financial conditions and prospects, operations and structure.

Where the CMI for a debt offering had been a CMI for a previous debt offering made by the same issuer, the CMI will be required to ascertain whether there have been any material changes in the issuer's circumstances of relevance to its role as CMI.

In order to assist CMI in conducting the necessary assessments, the SFC proposes that an OC should share information about the issuer with syndicate CMIs or take reasonable steps to ensure that the issuer provides this information to them. This information should then be shared with non-syndicate CMIs.

b) *Establish a formal governance process to review and assess the offering*

The formal governance process should review the offering and assess any actual or potential conflicts of interest between the CMI and the issuer and associated risks.

This would involve designating a member or members of senior management to assess, for example:

- the structure of the offering;
- any actual or potential conflicts of interest between the CMI and the issuer; and
- associated risks involved in participating in the offering (financial or reputational).

The SFC further states that a CMI should maintain sufficient resources and have effective systems and controls in place to ensure that it can properly discharge its obligations and responsibilities.

ii. Appointment of CMIs and OCs (paragraphs 21.3.2 and 21.4.1 of the SFC Proposed Code)

The SFC emphasises the importance of clearly defined roles and responsibilities of CMIs from the outset of the offering in order for sufficient resources to be allocated to discharge their duties properly, to avoid confusion for buy-side participants and to address concerns of some buy-side participants regarding the reliability of information provided by an intermediary.

Accordingly, the SFC proposes that:

- a) before a CMI (other than an OC) starts any bookbuilding or placing activities, it should ensure that:

1. it has been formally appointed by the issuer (or another CMI in the case of a non-syndicate CMI) under a written agreement to conduct such activities; and
2. the written agreement clearly specifies the roles and responsibilities of the CMI as well as a description of any remuneration (and the basis for payment) (the "Fee Arrangements"); and

- b) before an OC provides any services as stipulated in the SFC Proposed Code to the issuer client for a share offering (and in any event no later than two weeks after the submission of the listing application by or on behalf of the issuer to the HKEx) or before an OC participates in any bookbuilding or placing activities for a debt offering, it should ensure that:

1. it has been formally appointed by the issuer under a written agreement to conduct such activities; and
2. the written agreement clearly specifies the roles and responsibilities of the OC as well as a description of the fee arrangements.

iii. Advice to the Issuer (paragraphs 21.4.2 and 21.4.3 of the SFC Proposed Code)

The SFC proposes that an OC should provide advice to the issuer on syndicate membership, fee arrangements, market strategy, and pricing and allocation.

An OC should ensure that:

- its advice and recommendations are balanced and based on thorough analysis taking into account the issuer's preferences and objectives as well as prevailing market conditions and sentiment; and
- its advice is aligned with all legal and regulatory requirements (i.e., by advising and guiding the issuer and its directors as to their responsibilities under the relevant HKEx requirements and taking reasonable steps to ensure that they understand and meet these responsibilities (in the case of a share offering) and ensuring compliance with the specific requirements for an offering of debt securities listed on the HKEx); and

- the basis of its advice and recommendations are explained to the issuer, including any advantages and disadvantages, and advice is provided in a timely manner.

Where an issuer decides not to adopt an OC's advice or recommendations in relation to pricing or allocation, the OC should explain its concerns and advise the issuer against making a decision where the decision may lead to a lack of an open market, an inadequate spread of investors or may significantly and negatively affect the trading of shares in the secondary market (in the case of a share offering). The OC should also document any final decisions of the issuer which deviate materially from the advice or recommendations provided by the OC, including the OC's explanation to the issuer of any concerns associated with the decisions and advice provided. In the case of a share offering, any decisions made by the issuer that amount to material non-compliance with the requirements of the HKEx relating to the placing activities, should be reported by the OC to the SFC.

iv. Marketing (paragraphs 21.3.4, 21.4.4 and 21.4.7(b) of the SFC Proposed Code)

Under the SFC Proposed Code, an OC should advise and assist the issuer in developing an appropriate marketing and investor targeting strategy. The strategy may specify the types of investors targeted and the proportion of an offering to be allocated to each type of investors to establish the desired shareholder or investor base. In the case of IPOs, the strategy should also include the types of investors who may be appropriate to be cornerstone investors. An OC should advise the issuer to adjust the strategy as appropriate in response to changing market conditions and sentiment.

An OC should also inform other syndicate CMI's of the marketing and investor targeting strategy in order for them to carry out their own activities, and syndicate CMI's would be required to inform CMI's they engage of the strategy so that it can serve as a basis for their selling activities.

CMI's should not market to investor clients falling outside the strategy and investor clients who fall within the strategy but to whom the CMI does not actively market should have the opportunity to participate in an offering if they show interest.

A CMI should also be satisfied that shares are marketed to a sufficient number of investor clients so that the likelihood of undue concentration of shareholders is minimised.

v. Rebates and Preferential Treatment (paragraphs 21.3.7, 21.3.8, 21.4.4(c) and 21.4.5(b) and 21.4.7(c) of the SFC Proposed Code)

Under the SFC Proposed Code, a CMI should:

- a) not offer any rebates to its investor clients or pass any rebates provided by the issuer and:
 - in the case of an IPO – should not enable any investor clients to pay, for each of the shares allocated, less than the total consideration as disclosed in the listing documents (including the 1% brokerage fee); and
 - in the case of a debt offering – should not enter into any arrangements which may result in investor clients paying different prices for the debt securities allocated; and
- b) disclose to the issuer, the OCs, all of its targeted investors and the non-syndicate CMI's it appoints, any rebates offered by the issuer to CMI's and any preferential treatment of any CMI's or targeted investors, and:
 - in the case of a share offering – disclosures should be made by a CMI upon becoming aware of any such rebates or preferential treatment; and
 - in the case of a debt offering – disclosures should be made no later than the dissemination of the deal "launch message" to targeted investors.

Additionally, an OC should:

- a) disseminate this information to all syndicate CMI's for their onward disclosure to targeted investors and the non-syndicate CMI's they appoint;
- b) advise the issuer against providing any arrangements whereby:
 - in the case of an IPO, the investor clients would pay, for each of the shares allocated, less than the total consideration as disclosed in the listing documents; and

- in the case of a debt offering, the investor clients would pay different prices for the debt securities allocated; and
- c) provide advice and guidance to the issuer on the relevant disclosures.

vi. Assessment of Investor Clients (paragraphs 21.3.3 and 21.4.6 of the SFC Proposed Code)

To ensure that investor clients fall within the categories identified by the marketing and investor targeting strategy, the SFC Proposed Code will require CMIs to take reasonable steps to assess each investor client's profile, including investment preferences and past investment history, in addition to complying with the current Know Your Client (KYC) requirements under paragraph 5.1 of the SFC Code of Conduct.

Under the SFC Proposed Code, a CMI should also take reasonable steps to identify Restricted Investors (i.e., those investors to whom the allocation of shares to are subject to restrictions or require the prior consent of the HKEx) and inform the OC before placing an order on behalf of such clients.

The SFC further proposes that in order to facilitate the identification of Restricted Investors, OCs should provide more information to CMIs in respect of persons and entities related to the issuer. This will require OCs to obtain a list of such persons or entities from the issuer and provide this to all CMIs. An OC should also take reasonable steps to identify Restricted Investors so that they will only be allocated shares in accordance with HKEx requirements.

In the case of debt offerings, the SFC proposes that a CMI should identify whether its investor clients may have any associations with the issuer, the CMI or a company in the same group of companies as the CMI. The OC will also be expected to provide sufficient information to CMIs to enable them to identify such investors. The CMI should inform the OC of these investors to enable the OC to assess whether any orders may negatively impact the price discovery process.

vii. Bookbuilding

The SFC states that a CMI has the responsibility to ensure that the price discovery process is credible and that the order book is transparent and incorporates only bona fide orders. An OC should ensure that the pricing and allocation recommendations made to the issuer fully take into account the principles and factors stipulated under the SFC Proposed Code.

Order Book (paragraphs 21.3.5 and 21.4.5(a) of the SFC Proposed Code)

As outlined above, the SFC identified concerns regarding the use of "X-orders". Accordingly, the SFC proposes to require the identities of all investors to be disclosed in the order book, except for orders placed on an omnibus basis, in which case information about the underlying investors should still be provided to the OC and the issuer but need not appear in the order book.

Additionally, the SFC proposes that:

- a) a CMI should:
 - take reasonable steps to ensure that all orders placed in the order book on behalf of its own investor clients, itself and its group companies represent bona fide demand and that inflated orders are not knowingly placed;
 - make enquiries with its investor clients about orders which appear unusual; and
 - maintain adequate records of orders placed by its investor clients so as to substantiate that there are no fictitious or knowingly inflated orders placed in the order book.
- b) an OC should:
 - ensure that the identities of all investor clients are disclosed in the order book, except for orders placed on an omnibus basis;
 - make enquiries with CMIs if any orders appear to be unusual or irregular;
 - consolidate the order book by taking reasonable steps to identify and eliminate duplicated orders, inconsistencies and errors; and
 - segregate and clearly identify in the order book any proprietary orders of CMIs and their group companies.

Pricing and Allocation ((paragraphs 21.3.6, 21.4.2(a)(iii), 21.4.5(b), 21.4.5(c) and 21.4.6(a)(ii) of the SFC Proposed Code)

The SFC identified from the IOSCO reports that conflicts of interests between the issuer and the CMI or its investor clients may lead to under or over-pricing. The SFC also highlighted concerns regarding allocations of shares or debt securities, with the IOSCO ECM and DCM reports indicating that allocation decisions are being affected by conflicts of interest. From the SFC's thematic review, it was further found that allocation recommendations were primarily based on the judgment of individual staff and their understanding of the issuer's objectives or preferences and that CMI allocation policies were deficient in that the criteria set out in the policy was broad and did not provide sufficient guidance to staff, particularly with respect to potential conflicts of interest. The SFC also found that there was insufficient documentation of allocation decisions and their rationale in order to demonstrate compliance with an allocation policy and appropriate management of conflicts.

In order to address these concerns, the SFC proposes that:

- a) an OC should discuss with and advise the issuer on the final offer price taking into account the results of bookbuilding activities, the issuer's characteristics and prevailing market conditions and sentiment;
- b) in the case of debt offerings, the OC should ensure that the orders placed by investors which have associations with the issuer, CMIs and their group companies will not negatively impact the price discovery process.

In line with the IOSCO recommendations, the SFC further proposes that an OC should develop and maintain an allocation policy which sets out the criteria for making allocation recommendations to the issuer, which should, at a minimum, take into account:

- the issuer's objectives, preferences or recommendations;
- prevailing market conditions and sentiment;
- the type and characteristics as well as the circumstances (such as clients' financial profiles, investment experience and objectives) of targeted investors;
- the spread of investors, such as the sizes and number of large holdings; and

- the overall subscription rate for the offer.

An OC should communicate the allocation policy to the issuer at an early stage to ensure that the issuer understands the factors determining allocation recommendations, and an OC should make allocation recommendations in line with the policy. In the case of an IPO, allocation recommendations should ensure that allocations to Restricted Investors comply with the HKEx requirements and be made with a view to achieving an open market, an adequate spread of shareholders and promoting the orderly and fair trading of shares in the secondary market. The OC should also document allocation recommendations provided to the issuer, including its rationale.

CMIs must also establish and implement an allocation policy to ensure a fair allocation of shares or debt securities to their investor clients where they place an order on an omnibus basis and an OC gives them an overall allocation. The policy should set out, for example:

- the marketing and investor targeting strategy as agreed with the issuer;
- the investor clients' order sizes and circumstances (such as clients' financial profiles, investment experience and objectives);
- price limits for the investor clients' orders;
- any minimum allocation amounts indicated by investor clients; and
- any applicable legal and regulatory requirements.

CMIs should allocate shares or debt securities to investor clients in accordance with the allocation policy and document any reasons for material deviations from the allocation policy.

When allocating shares or debt securities, a CMI is expected to assess whether the investor client has the ability to take up the allocation and whether the size of the order appears unusual. This also applies to an OC when making recommendations to the issuer regarding allocations of shares or debt securities to its own investor clients.

vii. Conflicts of Interest and Proprietary Orders of CMIs and their Group Companies (paragraph 21.3.10 of the SFC Proposed Code)

In order to address concerns regarding conflicts of interest (and a lack of controls therein) and CMIs potentially taking

advantage of non-public information in the order book when placing proprietary orders, the SFC proposes that a CMI should:

- a) establish and implement policies and procedures to identify, manage and disclose actual and potential conflicts of interest with investor clients which may arise when the CMI has a proprietary interest in an offering;
- b) establish and implement policies to govern the process for generating its own proprietary orders as well as making allocations to such orders;
- c) give priority to investor clients' orders over its own proprietary orders and those of its group companies; and
- d) only be a "price taker" in relation to its proprietary orders and those of its group companies and ensure that these orders are based on market-driven demand and would not materially influence the pricing of the offering.

Proprietary orders placed by a group company will exclude those placed on behalf of clients or funds and portfolios under its management, but will include orders placed on behalf of funds and portfolios in which the CMI or its group companies have a substantial interest.

The OC and CMI should also segregate and clearly identify in the order book and "book messages" its own proprietary orders and those of its group companies, other CMIs and their group companies.

The SFC Proposed Code also stipulates that a CMI should take reasonable steps to disclose to the issuer why any risk management transactions it intends to carry out for itself, the issuer or its investor clients would not affect the pricing of the new offering.

[Review and Approval of Orders and Allocations \(paragraph 21.3.11\(b\) of the SFC Proposed Code\)](#)

The SFC proposes that the senior management of a CMI should review and approve certain types of orders and allocations, including:

- proprietary orders of the CMI and any of its group companies;
- orders from investor clients which may appear unusual (e.g., orders which might appear to be related to the issuer); and
- allocations to Restricted Investors in the case of share offerings.

viii. Communications with Issuers, other CMIs and Targeted Investors (paragraphs 21.3.8 and 21.4.7 of the SFC Proposed Code)

In line with the IOSCO reports, the SFC proposes that CMIs should:

- a) provide information about Restricted Investors for a share offering, and about investor clients which have associations with the issuer, CMIs and their Group Companies for a debt offering, to the OC and non-syndicate CMIs appointed by them to enable them to properly discharge their duties;
- b) disseminate the marketing and investor targeting strategy to non-syndicate CMIs to facilitate their marketing of the shares or debt securities to investor clients; and
- c) provide "book messages" and other information related to the offering.

OCs and CMIs should disseminate information in a timely manner and ensure that is complete, accurate and has a proper basis.

ix. Keeping of Records (paragraphs 21.3.9 and 21.4.8 of the SFC Proposed Code)

A CMI should maintain books and records sufficient so as to evidence the work done throughout the transaction and demonstrate compliance with the legal and regulatory requirements and internal policies and procedures, which includes documenting key communications with the issuer, investors and other CMIs; maintaining audit trails; and documenting the basis of allocation decisions with justifications for any material deviations from the CMI's allocation policy.

Additionally, OCs should document all changes in the orders in the order book throughout the bookbuilding process and all key discussions with, and key advice or recommendations provided to, the issuer.

x. Resources, Systems and Controls (paragraph 21.3.11 of the SFC Proposed Code)

General Principle 3 of the SFC Code of Conduct sets out that an intermediary should have and effectively employ the resources and procedures which are needed for the proper performance of its business activities.

Further to this, the SFC Proposed Code sets out specific requirements in relation to:

- a) Chinese walls, requiring:
 - a CMI to take adequate measures to prevent the flow of information which may be confidential or price sensitive amongst staff performing different activities and to prevent and manage any conflicts of interest which may arise, in particular requiring the establishment and maintenance of effective Chinese walls and wall-crossing policies and procedures;
- b) Appointment of non-syndicate CMIs (i.e. sub-placing agents), requiring:
 - a CMI to exercise due skill, care and diligence in the selection and appointment of a non-syndicate CMI to assist it in placing shares or debt securities, which will involve taking reasonable steps to ensure that the non-syndicate CMI is able to comply with the SFC Proposed Code. This may involve enquiring with the non-syndicate CMI to understand and review:
 - o its marketing strategy and assess how it ensures that all investor clients which are targeted investors and have indicated an interest in the offering are allowed to participate in the offering;
 - o its process for assessing whether investor clients are independent from or associated with the issuer;

- o its procedures and controls to ascertain whether it can reasonably ensure that all orders are bona fide;
- o its allocation policy, to ensure that it addresses or takes into account the requirements under the SFC Proposed Code, and the procedures to ensure that allocation is made in compliance with that policy; and

c) Surveillance and monitoring, requiring:

- a CMI to conduct independent surveillance and monitoring on a regular basis to detect irregularities, conflicts of interest and leakage of price sensitive or confidential information and any potential non-compliance with applicable legal and regulatory requirements or its own internal policies and procedures.

xi. Fee Arrangements (paragraphs 21.3.2, 21.4.1, 21.4.3 and 21.4.9 of the SFC Proposed Code and Schedule 11 to the SFC Code of Conduct)

Owing to concerns from a number of buy-side and sell-side participants regarding fluid syndicate membership and fee arrangements, the SFC Proposed Code will require fee arrangements to be specified in the written agreements with the CMIs and OCs and OCs will be required to advise issuers on the fee arrangements. The SFC does not however consider this sufficient so as to address the root cause of undesirable intermediary behaviour.

The SFC notes that the determination of syndicate membership and fee arrangements at an early stage of the offering will allow the OCs and CMIs to better focus their efforts and resources on providing advice to the issuer and conducting Hong Kong bookbuilding and placing activities in compliance with the proposed conduct requirements, which will enhance the transparency and credibility of the price discovery and allocation process. The SFC also states that early agreement of fixed fees is consistent with international market practice.

Under the SFC Proposed Code, fixed fees to be paid to the OCs should be determined at the time of their appointment and that this should cover the advisory services provided by an OC and proportions of shares or debt securities ordinarily expected to be sold by the OC. The issuer can subsequently appoint other syndicate CMIs, and at the time of their appointment determine

their fixed fees based on the volumes they are expected to sell. The SFC clarifies that issuers can still pay CMI's discretionary fees to incentivise sales outperformance.

The SFC further states that they consider it appropriate for the ratios of fixed fees to discretionary fees and allocations of fixed fees to syndicate members to also be agreed at an early stage. Based on feedback from soft consultations and IPO prospectuses published between 1 January and 30 September 2020, the SFC states that the market norm for fees in share offerings is around 70-75% fixed fees and 25-30% discretionary fees. The SFC does however recognise that the ratio may differ in certain situations.

The SFC therefore proposes that each written agreement to be entered by an OC or CMI to specify the fee arrangements (including the allocation of fixed fees to the particular CMI as a percentage of the total fees to be paid to all syndicate CMIs) and the fee payment schedule.

An OC should further advise and guide an issuer on fee-related matters in the determination of:

- a) the ratio of fixed to discretionary fees to be paid to all syndicate CMIs participating in the offering;
- b) the basis of allocation of fixed fees to syndicate CMIs;
- c) the basis of allocation of any discretionary fees to syndicate CMIs. In the case of a debt offering, this allocation should be determined no later than at the time of pricing; and
- d) the fee payment schedule.

The SFC further proposes that the following information be submitted to the SFC four clear business days prior to the Listing Committee Hearing for an IPO in order to assist with the identification of arrangements that substantially differ from market norms:

- a) information about the syndicate membership, indicating roles;
- b) the total fees to be paid to all syndicate CMIs participating in the offering;

- c) the ratio between the fixed and discretionary portions of the fees to be paid to all syndicate CMIs participating in the offering (in percentage terms); and
- d) the allocation of the fixed portion of the fees paid by the issuer to each syndicate CMI participating in the offering.

The SFC clarifies that issuers may make alterations to fee allocations as an IPO timetable progresses but the SFC should be informed of any material changes once they are agreed between the issuer and syndicate CMIs together with the rationale for such changes.

The SFC also proposes that a confirmation should be provided to the SFC no later than listing that the issuer has determined allocations of any discretionary fees to each syndicate CMI as well as the fee payment schedule. Total monetary benefits, including fixed and discretionary fees and any bonuses, paid to each syndicate CMI by the issuer should be provided to the SFC within two weeks after the first day of dealings.

Additionally, it was noted that some market participants are in favour of issuers making the following public disclosures:

- a) any an early stage, the syndicate membership and the names of the OCs;
- b) all underwriting fees for IPO transactions (which are disclosed in the prospectus for the Hong Kong public offer tranche but infrequently disclosed for the international placing tranche); and
- c) the total monetary benefits, including fixed and discretionary fees and any bonuses paid to each syndicate CMI after the completion of the IPO.

3. HKEx “Sponsor Coupling” Proposal

Further to discussions with market participants, the SFC found that:

- where an IPO transaction is led by a large group of syndicate CMIs with a variety of titles, and heads of syndicate are not clearly identified, buy-side participants may be faced with a confusing situation. The SFC states that market participants have indicated that preferably

IPO transactions should be led by one or a small group of clearly identified senior syndicate members from the outset in order to ensure consistency;

- there is an increased interest on the part of CMI's to be appointed as heads of syndicate for IPOs;
- when heads of syndicate also act as sponsors for an IPO, advantages can accrue for the overall offering. However, an increasing proportion of the heads of syndicate did not act as sponsors during the nine months ended 30 September 2020 as compared to 2018; and
- underwriting fees are substantially higher than sponsor fees, as illustrated by the SFC's analysis of the 99 IPOs during the nine months ended 30 September 2020, which found that the average sponsor fee was HK\$6.3 million and the average underwriting fixed fee was HK\$43.9 million. The SFC states that this indicates a misalignment between fees and sponsor costs and responsibilities, particularly in larger IPOs where sponsors typically incur substantial costs and regulatory breaches can potentially result in severe consequences. The SFC further states that where sponsors also act as the head of syndicate, the total fees may properly compensate the additional sponsor resource commitments and responsibilities. If sponsors are not appointed as head of syndicate from the outset, the SFC is concerned that they may be incentivised to compromise due diligence to secure the appointment.

The SFC outlined that their soft consultations found market participants were resistant to proposals to require all OCs to be sponsors based on concerns that it would limit the issuer's flexibility in appointing OCs with strong marketing capabilities and may prejudice standalone boutique sponsor firms with no marketing capabilities. Accordingly, the SFC proposes that:

- a) the listing applicant should appoint at least one sponsor which is independent of the listing applicant who should also be appointed as an OC for the IPO or have a group company which is also appointed as an OC for the IPO (the "**Sponsor OC**");
- b) the Sponsor OC should be appointed as OC and sponsor at the same time and at least two months before filing the listing application; and

- c) the listing applicant can appoint other OCs (which may or may not be sponsors of the IPO) no later than two weeks after the submission of the listing application.

The SFC hopes that the proposals will ensure that at least one sponsor would be free of potential incentives to limit due diligence in order to secure an OC role, that the Sponsor OC would be in a position to give comprehensive advice to the listing applicant throughout the transaction and that buy-side participants can look to the Sponsor OC to provide well informed and authoritative answers to their questions.

Further, the SFC proposes that:

- a) before accepting an appointment by the issuer to act as an OC, an OC should either:
 - ensure that it (or one of its group companies) is also appointed as a sponsor, which is independent of the issuer client, and that both appointments are made at the same time at least two months before the submission of the listing application to the HKEx by or on behalf of the issuer; or
 - obtain a written confirmation from the issuer that at least one sponsor, which is independent of the issuer client, or one of the group companies of that sponsor, has been appointed as an OC for that IPO, in which case its appointment as an OC should be made no later than two weeks after the submission of the listing application to the HKEx by or on behalf of the issuer; and
- b) under paragraph 17 of the SFC Code of Conduct, before accepting an appointment by a listing applicant to act as a sponsor, a sponsor should either:
 - be independent of the listing applicant and ensure that it or one of its group companies is also appointed at the same time as an OC in connection with that listing application; or
 - obtain written confirmation from the listing applicant that at least one sponsor, which is independent of the listing applicant, or one of

the group companies of that sponsor, has been appointed as an OC in connection with that listing application.

The SFC further outlines that it would be appropriate for the Sponsor OC to submit information on the syndicate membership and fees (as outlined above and to be submitted under paragraphs 21.3 and 21.4 of the SFC Proposed Code). If more than one intermediary is appointed as a Sponsor OC, they should arrange for one of them to provide this information to the SFC. Notwithstanding this, each Sponsor OC is jointly and severally liable for ensuring that the information is accurate and complete and has been provided to the SFC within the stipulated timeline.

4. Implementation Timeline

The consultation will remain open until 7 May 2021, following which respondents' comments will be considered and consultation conclusions will be issued together with the revised SFC Proposed Code and proposed amendments to paragraph 17 of the SFC Code of Conduct and the GEM Placing Guidelines. As market participants may need to update internal controls and procedures to implement the SFC Proposed Code, the SFC proposes a six-month transition period for the industry to comply following gazettal.

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