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# Proposed New Regulatory Regime For Sponsors

# The Code On Corporate Governance Practices: Interim Reporting Requirements

## Introduction

Building on the existing regime for the licensing of corporate finance advisers under Part V of the Securities and Futures Ordinance (the **SFO**), the Securities and Futures Commission (the **SFC**) has published proposals for additional specific entry criteria and ongoing compliance obligations for sponsors.

The proposals form the second of a two-stage initiative aimed at tightening the regulation of sponsors. The first comprised of amendments to the Hong Kong Stock Exchange's Listing Rules and the introduction of a new Practice Note on Due Diligence by Sponsors in respect of Initial Listing Applications which came into effect on 1 January 2005. To view our newsletter on those amendments, please click [here](/newsletters/hklaw/en/2004/16/nl-hklaw-20041116-16.html).

The new proposals are set out at Annex 1 (**Annex 1**) to the SFC's Consultation Paper on the Regulation of Sponsors and Compliance Advisers (the "Consultation Paper") which is available on the [SFC's website](http://www.sfc.hk). The consultation period ends on 31 August 2005.

Hong Kong listed companies with a 31 December year-end must comply with new Listing Rule requirements relating to the reporting of compliance with the new Code on Corporate Governance Practices in their half-year reports for the 6 months ended 30 June 2005, subject to the applicable transitional arrangements. Our newsletter on those requirements can be viewed by clicking [here](/newsletters/hklaw/en/2004/17/nl-hklaw-20041202-17.html).

The purpose of this note is to highlight the Consultation Paper's principal proposals for the new sponsor regime and the Listing Rules' requirements for companies with a 31 December year-end to report on compliance with the Code on Corporate Governance Practices in their half-year reports for the 6 months ended 30 June 2005. The text in blue can be clicked through to see more information on a selected subject. To view a more detailed note in full, please click [here](/newsletters/hklaw/en/2005/24/nl-hklaw-20050713-24.html).

## I. New Regulatory Regime For Sponsors

### Scope

Sponsors will continue to be required to satisfy the existing licensing eligibility criteria for Type 6 Regulated Activity (advising on corporate finance) and to comply with the relevant existing SFC codes and guidelines including the Code of Conduct for Persons Licensed by or registered with the Securities and Futures Commission (the **Code of Conduct**), the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (the **Internal Control Guidelines**), the Fit and Proper Guidelines and the Corporate Finance Adviser Code of Conduct.

The Consultation Paper proposes to add to the existing licensing regime specific requirements for sponsors. The proposals deal with four principal areas:

* management responsibility;
* formation of transaction teams and appointment of principals;
* internal systems and controls; and
* ongoing obligations.

### Initial Eligibility Criteria And Structural Requirements

In determining whether a corporate finance adviser is fit and proper to act as a sponsor, the SFC will take into account the factors set out below in addition to the basic requirements applicable to a Type 6 licensed person.

#### *Sufficient Expertise and Resources*

Sponsors must have sufficient expertise and resources to perform their sponsor work. The overall responsibility for ensuring that a sponsor has such expertise and resources rests with its management, which includes its board of directors, managing director, chief executive officer, responsible officers and other senior management personnel (**Management**).

#### *Management Responsibility*

A sponsor's management is ultimately responsible for:

* the supervision of its sponsor work and compliance with all relevant rules, regulations, codes and guidelines; and
* ensuring that each transaction is at all times adequately supported by the firm's resources and staffed by a "transaction team" with the right mix of skills, experience and expertise to advise on the transaction taking into account its nature, complexity and size.

#### *Formation of Transaction Teams*

Each transaction team must have at least one Principal as its supervisor and leader, but may have more than one if circumstances require. Each transaction team must have sufficient knowledge of Hong Kong's regulatory requirements and practices in securities offerings.

##### Transaction Teams' Local Regulatory Knowledge

Management will be required to ensure that each transaction team has a sufficient number of staff familiar with Hong Kong's regulatory requirements and practices in securities offerings.

#### *Principals*

Sponsors must have sufficient Principals engaged full-time to discharge their sponsor work (taking into account the volume, nature, complexity and size of such work). The minimum requirement will be for sponsors to have at least 2 Principals at all times.

##### Eligibility Criteria for Principals

A Principal must:

* be a Responsible Officer licensed to carry on Type 6 Regulated Activity;
* have a minimum of 5 years' "relevant corporate finance experience"\*; and
* have played a substantial role in at least 2 completed GEM and/or Main Board IPOs in the 5 year period immediately preceding his/her appointment.  
    
  \*"Relevant corporate finance experience" means a person must have experience in one or more of the following:
  + IPOs;
  + Notifiable transactions under the Listing Rules;
  + A rights issue or open offer by a listed company; and
  + Takeovers subject to the Takeovers Code.

The experience requirements are initial eligibility criteria only and not continuing requirements. A substantial amount of such experience should have been gained in the Hong Kong market, although the SFC will consider comparable experience gained in other well-established securities markets with broad regulatory equivalence with Hong Kong.

##### Principals' Responsibilities

A Principal is expected to be the decision maker on all key issues relating to the work carried out by a transaction team. For example, the Principal should decide the breadth and depth of due diligence conducted on a listing applicant and the amount of resources to be deployed to the due diligence exercise.

While each transaction team must be led by at least one Principal, a Principal may oversee more than one transaction team provided that the Principal has the capability and competence to directly and properly supervise each team and the sponsor complies with the requirements of the Code of Conduct in respect of conflicts of interest (General Principle 6 and paragraph 10.1).

#### *Systems and Controls*

Sponsor firms will be required to have effective systems and internal controls to ensure:

1. adequate supervision and management of their employees conducting sponsor work;
2. that employees do not act beyond their proper authority; and
3. their compliance with all applicable laws, regulations, codes and guidelines, including the Listing Rules.

There should be clear and effective reporting lines between transaction teams and a sponsor's Management so that Management is kept informed of any material development and key issues relating to its sponsor work. It is expected that key issues about a transaction and/or the related sponsor work should be brought to the attention of the Principals and the Management so that decisions can be made in a timely manner and by those having the experience, skill and competence to make them.

## Ongoing Compliance

In addition to the entry criteria and obligations to ensure competent and properly staffed transaction teams, sponsors will be required to meet the on-going compliance obligations described below.

### *Internal Assessment and Annual Return to the SFC*

Sponsors will be required to carry out an annual self-assessment of their compliance with the requirement for effective systems and controls (as described under "Systems and Controls" above). Sponsors will have to confirm to the SFC that they have conducted such internal assessment in their annual return filed with the SFC under section 138 of the SFO.

### *Record Keeping*

The Internal Control Guidelines already require a sponsor's Management to maintain effective record retention policies to ensure compliance with relevant legal and regulatory requirements and to allow the firm, its auditors and other interested parties (eg. the Stock Exchange and the SFC) to carry out routine and ad hoc reviews or investigations.

The Consultation Paper's proposals further specify that sponsors should keep complete and up-to-date lists of all sponsor work that has been and is being undertaken. Those records should include the composition of the teams designated for the sponsor work (including any changes thereto) from start to finish. Such information must be made available to the SFC upon request.

Sponsors will also be required to keep records of the following:

1. the appointment of a Responsible Officer as a Principal; and
2. the sponsor's annual assessment of its internal systems and controls.

### *Continuing Professional Training (CPT)*

At least 50% of the required 5 CPT hours for staff of sponsor firms should be related to corporate finance, particularly IPO matters, and to Hong Kong listing practice and regulatory knowledge.

### *Minimum Capital Requirement And Professional Indemnity*

All sponsors will have to maintain a minimum paid-up capital of HK$10 million. Sponsors should also have professional indemnity insurance coverage for possible liabilities arising out of sponsor work. The SFC has invited the market to comment on the amount of minimum coverage.

### *Compliance with Existing Codes and Guidelines*

The Consultation Paper contains a reminder that sponsors, as SFC licensees, are subject to all relevant SFC Codes and Guidelines and not just the Corporate Finance Adviser Code of Conduct. In particular, the general obligation under paragraph 12.5 of the Code of Conduct to report to the SFC details of any breach of the applicable rules, regulations, codes or guidelines, applies equally to sponsors.

## Compliance Advisers

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

The firm and its Management will have to ensure that sufficient resources and staff qualified to advise on the Listing Rules are assigned to each engagement or transaction on which it is asked to advise.

## Effective Date And Proposed Transitional Arrangements

To allow firms time to meet the new requirements, the proposed Effective Date of the requirements will be 12 months after the publication of the consultation conclusions.

### *Firms with an IPO track record*

Sponsors with a track record in IPOs (ie. they have advised on at least one completed Main Board or GEM IPO in the 5 year period immediately preceding the Effective Date) will need to file a confirmation with the SFC to the effect that they meet the additional requirements on the Effective Date.

The specific requirements that sponsors will be need to meet on the Effective Date are:

1. the obligation to maintain effective systems and controls;
2. the obligation to maintain sufficient resources to conduct sponsor work; and
3. the appointment of sufficient Principals (the minimum being 2).

The Principals' names will need to be included in that confirmation.

### *Firms with No IPO Track Record*

Firms that do not have a track record in IPOs will need to file a confirmation with the SFC that they meet the new requirements at the Effective Date supported by evidence of compliance (eg. details of the Principals' experience).

### *Non-qualifying Firms*

Firms that do not file a confirmation with the SFC as to their compliance with the new sponsor requirements will not be allowed to conduct sponsor or compliance adviser work after the Effective Date, but will continue to be eligible to conduct all other corporate finance work under their Type 6 licence.

### *SFC Inspections*

The SFC will conduct inspections both on a routine and ad hoc basis to ensure compliance with the new requirements.

### Consultation

The 2 month consultation period for these proposals ends on 31 August 2005. Comments should be sent:

1. by mail to Intermediaries and Investment Products Division, Securities and Futures Commission, 8/F Chater House, 8 Connaught Road Central, Hong Kong, Attn. Sponsor Consultation;
2. by fax to (852) 2526 5304;
3. by on-line submission to the [SFC website](http://www.sfc.hk) (by entering the subsection "Consultation Papers and Conclusions" under the section "Speeches, Publications and Consultations" on the [SFC website](http://www.sfc.hk); or
4. by e-mail to [sponsorconsult@sfc.hk](mailto:sponsorconsult@sfc.hk).

## II The Code On Corporate Governance Practices: Interim Reporting Requirements

### Half-Year Report Requirements

Amendments to the Main Board and GEM Listing Rules relating to the Code on Corporate Governance Practices (Appendices 14 and 15, respectively, of the Main Board and GEM Listing Rules) came into effect for accounting periods commencing on or after 1 January 2005. The one exception is with respect to disclosure relating to Code provision C.2 on internal controls, for which the effective date is accounting periods commencing on or after 1 July 2005.

The relevant disclosure requirements for half-year reports are set out in paragraph 44(1) of Appendix 16 of the Main Board Rules and in GEM Rules 5.34(2) and (3). These require the inclusion of a statement as to whether the company meets the Code provisions set out in the Code on Corporate Governance Practices. Where there have been any deviations from such Code provisions, the company must also give considered reasons for such deviations.

For a company with a 31 December year-end, the requirements for its half-year report for the 6 month period ended 30 June 2005 are as follows:

1. the report must disclose any deviations from the Code provisions of the Code on Corporate Governance Practices (with the exception of Code provision C2 on internal controls);
2. it need not give considered reasons for each deviation. In respect of each deviation, it must instead, either:
   1. give considered reasons as to why it does not propose to comply with the relevant Code provision in the future; or
   2. set out the steps it has taken or proposes to take in order to be able to comply with the relevant Code provision in the future.

The requirements for a listed company with a 30 June year-end will be the same for its half-year report ending 31 December, 2005 except that it will additionally need to disclose any deviation from Code provision C2.

### Requirements For Preliminary Half-Year Results Announcements

Paragraph 46(4) of Appendix 16 of the Main Board Rules and GEM Rule 18.78(4) require the preliminary announcement of a listed company's results for the first 6 months of each financial year to include a statement as to whether the company meets the Code provisions set out in the Code on Corporate Governance Practices. The company must also disclose any deviations from such Code provisions and give considered reasons for them.

A company with a 31 December year-end is required to include in its preliminary results announcement for the 6 months ended 30 June 2005 a summary only of the major areas of deviation from the Code provisions of the Code on Corporate Governance Practices (with the exception of Code provision C.2). Considered reasons for such deviations are not required.

For a company with a 30 June year-end, the requirements for the preliminary announcement of its results for the 6 months ending 31 December 2005 will be the same, except that where it has deviated from Code provision C2, if it considers such deviation to be a major area of deviation, it must include such deviation in its summary of the major areas of deviation.

The Stock Exchange's summary of the disclosure requirements relating to the Code on Corporate Governance Practices is attached at Annex A.

# Annex A

# Brief Summary of Disclosure Requirements

**Financial Period**

**Reporting Document**

**Rule Reference**

**Minimum Disclosure Requirements**

1st quarter

Preliminary results announcement

No obligation to report on compliance with the Code

Financial report

No obligation to report on compliance with the Code

Interim/half-year

Preliminary results announcement

Transitional arrangement

First interim/half-year results announcement for the accounting period commencing on or after 1 January 2005:

* A summary of the major areas of deviation
* Need not give considered reasons

Main Board Appendix 16, Para. 46(4)

GEM Rule 18.78(4)

**Subsequent interim/half-year results announcements**:

* A statement as to whether the issuer meets the Code Provisions
* Disclose any deviations from the Code Provisions and give considered reasons for such deviations

(Issuer may refer to the Corporate Governance Report in the immediately preceding annual report, and summarising any changes since that annual report)

Financial report

Transitional arrangement

**First interim/half-year report for the accounting period commencing on or after 1 January 2005**:

* Disclose any deviations from the Code Provisions
* Need not give considered reasons for deviations
* In respect of each deviation, either:
  + give considered reasons as to why the issuer does not propose to comply with the relevant Code Provisions in the future; or
  + set out the steps the issuer has taken or proposes to take in order to be able to comply with the relevant Code Provisions in the future

Main Board Rules 3.25(2) & (3)(b)

Main Board Appendix 16, Para. 44(1)

GEM Rules 5.34(2) & (3)(b)

GEM Rule 18.55(4)

**Subsequent interim/half-year reports**:

* State whether the issuer has complied with the Code Provisions
* Either:
  + give considered reasons for each deviation; or
  + refer to the Corporate Governance Report in the immediately preceding annual report, and providing details of any changes together with considered reasons for any deviation not reported in that annual report

Summary interim/half-year report

Main Board Rules 3.25(2) & (3)(b)

GEM Rules 5.34(2) & (3)(b)

Same as interim/half-year financial results announcement

3rd quarter

Preliminary results announcement

No obligation to report on compliance with the Code

Financial report

No obligation to report on compliance with the Code

Annual

Preliminary results announcement

Transitional arrangement

**First annual results announcement for the accounting period commencing on or after 1 January 2005**:

* A summary of the major areas of deviation
* Need not give considered reasons for deviations

Main Board Appendix 16, Para. 45(5)

GEM Rule 18.50(6)

**Subsequent annual results announcements**:

* A statement as to whether the issuer meets the Code Provisions
* Disclose any deviations from the Code Provisions and give considered reasons for such deviations

(Issuer may refer to the immediately preceding interim/half-year report or to the Corporate Governance Report in the immediately preceding annual report, and summarising any changes since that report)

Financial report

Main Board Appendix 16, Para. 34

Main Board Appendix 23

GEM Rule 18.44(2)

GEM Appendix 16

* A separate Corporate Governance Report which must, as a minimum, contain the information required under Appendix 23 to the Main Board Rules or Appendix 16 to the GEM Rules

Summary financial report

Main Board Rules 3.25(2) & (3)(a) Main Board Appendix 16, Para. 50(2)

* A separate Corporate Governance Report which must, as a minimum, contain the information required under Appendix 23 to the Main Board Rules or Appendix 16 to the GEM Rules

Main Board Appendix 23

GEM Rules 5.34(2) & (3)(a)

GEM Rule 18.81(2)

GEM Appendix 16

The Corporate Governance Report may take the form of a summary of the Corporate Governance Report contained in the annual report, which must contain as a minimum:

* a narrative statement indicating overall compliance with the Code
* highlighting any deviation from the provisions of the Code
* giving considered reasons for deviations from the Code - may refer to annual report

*This note is a summary only of the Consultation Paper's proposals for sponsors and of the Listing Rules' requirements for the interim reporting of compliance with the Code on Corporate Governance Practices. Specific advice should be sought in relation to any particular situation.*

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