



SFC DROPS PROPOSED AMENDMENTS TO SPONSORS' PROSPECTUS LIABILITY PROVISIONS

The Securities and Futures Commission (**SFC**) has announced that proposed legislative amendments to make explicit that sponsors may be subject to criminal and civil liability for deficiencies in IPO prospectuses are considered unnecessary and therefore will not be made. The SFC's "Supplemental Consultation Conclusions on the Regulation of IPO Sponsors – Prospectus Liability"¹ (**Supplemental Conclusions**), published on 22 August 2014, conclude that since sponsors are already included in the existing category of "persons who authorise the issue of a prospectus" who are liable for prospectus inaccuracies under what is now the Companies (Winding Up and Miscellaneous Provisions) Ordinance (**CWUMPO**)² (formerly the Companies Ordinance), there is no need to specify sponsors as a separate category of persons who are potentially liable.

Background

In May 2012, the SFC's "Consultation paper on the regulation of sponsors" set out proposals in two main areas:

- requirements for sponsors in conducting their work on new listings to be set out in a new Paragraph 17 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the **Code of Conduct**); and

- making explicit that IPO sponsors have civil and criminal liability under sections 40, 40A and 342F of what is now CWUMPO, for untrue statements in, including material omissions from, a prospectus.

The SFC published its "Consultation Conclusions on the Regulation of IPO Sponsors" (**Consultation Conclusions**) in December 2012, setting out various modifications to the original proposals relating to Paragraph 17 Code of Conduct. Those amendments, together with corresponding amendments to the Listing Rules of the Hong Kong Stock Exchange, took effect on 1 October 2013. The new regime for IPO sponsors introduced more onerous due diligence obligations for sponsors, particularly in relation to experts, as well as a new requirement that sponsors should have substantially completed their due diligence before applying for a company's listing. The new regime additionally requires an advanced draft of the prospectus (the **Application Proof**) to be made publicly available (by publication on the Exchange's website) when the listing application is made. Information included in the Application Proof must be complete other in relation to matters that can only be ascertained at a later date.

The Consultation Conclusions also stated the SFC's intention to recommend legislative amendments to clarify that sponsors are caught by the existing legislative provisions on liability for defective prospectuses. This clarification was considered desirable in view of the lack of case law on the point and the view expressed by some respondents to the consultation that the relevant provisions do not apply to IPO sponsors.

¹ <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openConclusionAppendix?refNo=12CP1&appendix=0>

² Sections 40(1)(d), 40A(1) and 342F(1) of CWUMPO.

The Consultation Conclusions indicated that the SFC would put forward legislative amendments to:

- address the way in which the criminal liability provisions in section 40A are framed; and
- state explicitly that sponsors are included in the category of persons who are liable on the basis that they authorise the issue of a prospectus.

The proposals relating to sponsors' statutory liability were among the consultation's most controversial topics³ and the sponsor industry voiced its concerns and objections to the proposals in a number of group responses to the consultation. The proposed statutory changes would have needed to be passed by the Legislative Council and these were not therefore implemented in October 2013, at the time the new sponsor conduct requirements were implemented under the revised Code of Conduct. Following publication of the December 2012 Consultation Conclusions, the SFC conducted discussions with industry participants and other interested parties regarding the proposed legislative amendments which were the only outstanding matters.



The Legislative Provisions and Previous Consultations

Sections 40A and 342F: Criminal Liability for Misstatements in Prospectus

Under Section 40A (Section 342F for overseas companies) of what is now CWUMPO, any person who has authorised the issue of a prospectus containing any untrue statement (being a statement which is misleading in the form and context in which it is included or a material omission⁴) may be liable to imprisonment and a fine, unless he proves either that the

³ Consultation Conclusions at paragraph 12.

⁴ Definition of "untrue statement" in Section 41A (Sections 343(2A) and (2B) for overseas companies).

statement was immaterial or that he had reasonable grounds to believe that the statement was true. Sections 40 and 342F carry maximum penalties of 3 years' imprisonment and a fine of HK\$700,000.

The SFC's 2006 consultation conclusions⁵ on its earlier proposals to amend the Companies Ordinance prospectus regime⁶ proposed removing the liability of persons who "authorise the issue of a prospectus" due to uncertainty as to who is covered by the term. In proposing the removal of liability, the SFC commented that the expression "creates uncertainty as to whether major shareholders, guarantors and other persons indirectly associated with the offering will have responsibility" and that the question of who has authorised a prospectus will be one of fact depending on the particular circumstances.⁷ Experts (such as reporting accountants and property valuers) whose reports are included in a prospectus are not however criminally liable under Section 40A for untrue statements in their reports: Section 40A(2) provides that an expert who has consented to the inclusion of his report in a prospectus is not deemed to have authorised the issue of the prospectus.

Sections 40 and 342E: Civil Liability for Misstatements in Prospectus

Section 40 of CWUMPO renders the following persons liable to compensate investors who subscribe for shares on the faith of a prospectus for losses suffered as a result of relying on an untrue prospectus statement:

- the issuer's directors at the time of issue of the prospectus;
- persons named in the prospectus as directors, or as having agreed to become directors, who have authorised themselves to be so named;
- a promoter of the company; and
- any person who has authorised the issue of the prospectus.

Section 40 applies to Hong Kong-incorporated companies and, by virtue of Section 342E, to overseas companies.

⁵ The SFC's "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance"

⁶ As set out in the SFC's "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance" published in August 2005.

⁷ Ibid. at paragraph 15.6.

Experts (such as reporting accountants or property valuers) may be liable in respect of an untrue statement made by them as experts, but are not otherwise regarded as having authorised the prospectus.⁸

The SFC's 2005 consultation paper on reforming the prospectus regime proposed removing the liability of "persons who authorise the issue of a prospectus" and "promoters" under Section 40 due to the uncertainty as to who these terms cover.⁹ It also proposed to extend liability under Section 40 to: (i) the issuer and/or offeror of the shares or debentures on the basis that "the net proceeds from a new issue go to the issuer and the directors may not have sufficient funds to pay successful compensation claims".¹⁰ Liability was also to be imposed on sponsors and on each person who accepts, and is stated in the prospectus as accepting, responsibility for all or any part of a prospectus. In the event, the SFC concluded that it was premature to impose prospectus liability on sponsors given that a new regime imposing qualification criteria on corporate finance advisers wishing to act as sponsors was to come into effect in January 2007.¹¹ Following the publication of the consultation conclusions, no action was taken to implement the other changes to the prospectus liability regime which the consultation conclusions stated would be taken forward despite there having been few objections to the changes.

Remaining Defects of CWUMPO Provisions

With its conclusion that no amendment is required to Sections 40, 40A or 342F of CWUMPO to ensure that sponsors may be liable for prospectus misstatements, the SFC has missed the opportunity to rectify the defects, particularly in relation to the Section 40A criminal offence, which it had identified in both its December 2012 Consultation Conclusions on the Regulation of IPO Sponsors and its 2006 Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance.¹²

There are two fundamental problems with Sections 40A and 342F:

⁸ Section 40(1) CWUMPO.

⁹ The SFC's "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance" at paragraphs 15.5 and 15.6.

¹⁰ SFC Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance, at page 24.

¹¹ In the form of the Fit and Proper Guidelines for sponsors now set out in the Code of Conduct.

¹² At page 28.

i) Lack of Mens Rea

For a person to be criminally liable under Hong Kong law, a person is typically required to either intend to commit a particular act or be reckless as to whether his action will have a particular consequence.

There is however no mens rea (or state of mind) requirement for the Sections 40A and 342F offences. A person who authorised the issue of the prospectus will be liable if the prospectus contains a statement that is misleading in a material respect unless he can prove that he had reasonable grounds for believing the statement to be true. The standard is effectively one of negligence.¹³

ii) Reversal of Burden of Proof

The burden of proof for criminal offences normally rests with the prosecution, requiring the prosecution to prove the offence "beyond reasonable doubt". In the case of Sections 40A and 342F, the criminal burden of proof is reversed. The prosecution need only establish that the prospectus contains an untrue statement; it is then for the defence to establish either that the statement was immaterial or that he had reasonable grounds to believe, and believed up to the time of issue of the prospectus, that the statement was true.

The December 2012 SFC Consultation Conclusions proposed to rectify these defects by recommending to the Government that sections 40A and 342F should be amended so that the prosecution would bear the burden of proving that:

- i) a person who authorises the issue of a prospectus knows that, or was reckless as to whether, the prospectus statement identified by the prosecution was untrue; and
- ii) the untrue statement was materially adverse from an investor's perspective.¹⁴

With the adoption of the position that no amendment to the CWUMPO prospectus liability provisions in the SFC's latest supplemental consultation conclusions, the chance to fix the criminal offences has been missed.

¹³ December 2012 Consultation Conclusions on Regulation of Sponsors at paragraph 286.

¹⁴ Ibid. at paragraph 289.

Prospectus Liability: The Bigger Picture

As was highlighted by respondents who objected to the proposals to impose prospectus liability on sponsors, the SFC has at its disposal a raft of provisions, both civil and criminal, under the Securities and Futures Ordinance (**SFO**) to punish those responsible for prospectus misstatements and make them compensate investors for any resulting loss.

These include the following criminal offences:

- s298 offence (Disclosure of False or Misleading Information Inducing Transactions) which carries maximum penalties of 10 years' imprisonment and a HK\$10 million fine;
- s107 offence (Fraudulently or Recklessly Inducing Investment) carrying maximum penalties of 7 years' imprisonment and a HK\$1 million fine; and
- s384 offence (Provision of False or Misleading Information) punishable by up to 2 years' imprisonment and a fine of up to HK\$1 million.

To date, however, there have been no prosecutions against either the directors of issuers or sponsors in respect of a defective prospectus under either the CWUMPO provisions or the above SFO provisions.

Instead, the SFC's modus operandi has been to bring civil proceedings under Section 213 SFO against issuers first to obtain compensation for investors. In the case of Hontex International Holdings Company Limited (**Hontex**), the SFC succeeded in obtaining a court order for Hontex to make a HK\$1.03 billion repurchase offer both to subscribers of Hontex shares in the IPO and secondary market purchasers and an order for payment of the SFC's HK\$7 million costs. Section 213 proceedings are also ongoing against Qunxing Paper Holdings Company Limited (**Qunxing**) in respect of false or misleading information in the company's 2007 IPO prospectus and in its annual results for 2007 to 2011. The SFC has obtained an order freezing the amount of funds raised by Qunxing in the IPO and is seeking orders to restore the initial public shareholders and warrant holders to their position pre-IPO. Although there were allegations of criminal liability in both cases, no criminal proceedings were brought. It is significant that bringing proceedings under Section 213 SFO does not preclude criminal proceedings being brought either for any of the market misconduct offences in Part XIV SFO or under Sections 40A or 342F CWUMPO. This contrasts with the position in respect of the civil market misconduct offences

under Part XIII SFO: no double jeopardy provisions prevent the bringing of proceedings under both Parts XIII and XIV in respect of the same conduct. Indeed this is one of the criticisms that have been levelled against the SFC's use of Section 213, although it has not in fact brought criminal proceedings in respect of conduct in respect of which it has already brought Section 213 proceedings.

Where the SFC has brought proceedings against sponsors for inadequate due diligence, it has taken disciplinary action under section 194 SFO. This allows the SFC to impose a fine of up to HK\$10 million and revoke the sponsor's corporate licence for "market misconduct" – broadly defined as any breach of the SFO or of any provision of the prospectus regime now set out in CWUMPO. The SFC is thus able to penalise sponsors without going to court: enabling it to play the role of both prosecutor and judge in dealing with disciplinary and licensing-related matters. Its decisions are reviewable only by the Securities and Futures Appeals Tribunal, whose findings can in turn be appealed on a point of law only to the Court of Appeal.

The SFC has disciplined two IPO sponsors for due diligence deficiencies under section 194 SFO: Mega Capital (Asia) Company Limited (**MegaCapital**), the sponsor of the Hontex IPO, and Sun Hung Kai International Ltd, the sponsor of the listing of Sino-Life Group Limited. MegaCapital had its SFC licence revoked and was fined HK\$42 million, while Sun Hung Kai was fined HK\$12 million and had its licence suspended for 12 months.

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