Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (ECM_DCM_consultation@sfc.hk)

7 May 2021

Our Ref.: C/CFAP, M129938

The Securities and Futures Commission
54/F One Island East
18 Westlands Road
Quarry Bay, Hong Kong

Dear Sirs,

Re: Consultation Paper on (i) the Proposed Code of Conduct on Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions and (ii) the "Sponsor Coupling" Proposal

The Hong Kong Institute of CPAs' Corporate Finance Advisory Panel ("CFAP") has considered the Consultation Paper on (i) the Proposed Code of Conduct on Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions and (ii) the "Sponsor Coupling" Proposal, issued by the Securities and Futures Commission ("SFC"). Based on their feedback, our views on the proposals are provided in the Appendix.

In principle, the Institute supports the underlying aims of the SFC's proposals which appear to be to address certain conduct issues identified among intermediaries and to bring more order and improve transparency in relation to the process of pricing initial public offerings and other equity and debt issues. To this end, we agree with a number of the specific proposals.

However, CFAP members also have concerns about the practicality of several of the proposals which would require key decisions to be made considerably earlier in the process than is currently the case, even though the market situation may be volatile and investor sentiment may continue to change during the bookbuilding period. For example, the appointment of overall coordinators ("OCs") and other capital market intermediaries ("CMIs"), and the determination of their roles, responsibilities and fee arrangements, would be brought forward. As a result, if the market view were to turn negative suddenly, the issuer might not be able to engage other syndicate members to ensure enough orders for the deal. Therefore, we suggest providing greater flexibility to issuers, e.g., to appoint other OCs and CMIs at a later stage.

Should you have any questions on this submission, please feel free to contact me at the Institute.

Yours faithfully,

Encl.

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Consultation Paper on (i) the Proposed Code of Conduct on Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions and (ii) the "Sponsor Coupling" Proposal

Proposed Code

Q1 - Do you consider the definitions of "bookbuilding activities" and "placing activities" to be clear and sufficient to cover key capital raising activities? If not, please explain.

We do not have any specific comments on the definitions of "bookbuilding activities" and "placing activities", as proposed suggested in paragraphs 42 to 49 of the consultation paper ("CP").

We note that it is indicated, in paragraph 43 of the CP, that Capital Market Intermediaries ("CMIs") do not include financial advisers or other professionals who only provide advice to the issuer (e.g. on pricing or marketing strategy) but do not participate in any bookbuilding or placing activities. Further, in paragraphs 44 and 48, it is indicated that the Proposed Code will not cover certain offerings that do not involve bookbuilding activities. We suggest, therefore, that, to avoid any confusion, it should be made clear in paragraph 21.1 of the Proposed Code that these activities are out of scope.

Q2 - Do you agree with the proposed scope of coverage for both equity capital market ("ECM") and debt capital market ("DCM") activities?

We do not have any specific comment on this question.

Q3 - Do you consider the role of an overall coordinator ("OC") to be properly defined? If not, please explain.

We do not have any specific comment on this question.

Q4 - Do you agree that the appointments of OCs and other CMIs and the determination of their roles, responsibilities and fee arrangements, should all take place at an early stage? If not, please explain.

While we understand the rationale, as explained in paragraphs 66 to 68 of the CP, to require the appointment of OCs and other CMIs and the determination of their roles, responsibilities and fee arrangements to take place at an early stage, we have some doubt about its practicability. This includes the proposals in the CP that, in the case of an equity offering, the appointment of an OC under a written agreement, specifying its role and a description of the fee arrangements should take place within two weeks after the submission of the listing application, and that all other CMIs should be appointed before any bookbuilding activities start. In addition, the proposed Sponsor OC must submit to the SFC all information about syndicate membership, indicating roles, total fees payable to all syndicate CMIs (as a percentage of gross proceeds), the ratio between the fixed and discretionary portion of fees and the allocation of the fixed portion of fees, four clear business days before the hearing.

In our view, this timetable may not be practical. The market is changing all the time and, in a volatile market, if any problems arise that prevent the CMIs for fulfilling their responsibilities, the issuer may not have sufficient time to identify other syndicate members to ensure sufficient orders for the deal. Greater flexibility may need to be provided to allow the issuer to appoint other OCs or CMIs at a later stage, where there is at least one independent OC (who may also be a sponsor) in the deal.

Q5 - Do you agree that an OC should provide advice to the issuer on: (i) syndicate membership and fee arrangements; (ii) marketing strategy; and (iii) pricing and allocation? If not, please explain. What else should the OC advise the issuer about?

We agree with this proposal, in principle, but see also our response to Question 18. It is mentioned in paragraph 43 of the CP, CMIs which are only advising the issuer but not participating in the bookbuilding process will not be covered in the Proposed Code. Therefore, in a situation where conflicting advice has been given to the issuer by a non-syndicate CMI and the OC, and the issuer decides to follow the CMI's advice rather than the OC's, would the OC still bear any responsibility for adverse consequences, given that the CMI will be outside the scope of the Proposed Code, even though it may also be an SFC licensed person?

Q6 - Do you agree that a private bank should not pass on to investor clients any rebates provided by the issuer? If not, please explain.

We agree with this proposal as it promotes fairness to all investors.

Q7 - Do you agree that an OC should provide relevant information to CMIs to enable them to identify investor clients which are Restricted Investors in share offerings or have associations with the issuer in debt offerings? If not, please explain.

We agree with this proposal.

Q8 - Do you agree that information about the underlying investors should be provided to an OC by CMIs placing orders on an omnibus basis when they place orders in the order book? If not, please explain.

We do not agree with this proposal if it is proposed that the names of the investors be provided to the OC. The OC is also a member of the syndicate and so a potential conflict of interest would arise if information about the underlying investors of other CMIs were provided to the OC. This could provide opportunities for poaching by the OC, given the power OC has in the deal, particularly a Sponsor OC.

Q9 - Do you think there would be difficulties in a large IPO or debt offering for OCs to remove duplicated orders and identify irregular or unusual orders in the order book? If so, please provide examples.

We consider that there would be difficulties in a large IPO or debt offering for OCs to remove duplicated orders and identify irregular or unusual orders in the order book. Although the SFC proposed an investor identification regime at the trading level for the securities market in Hong Kong (in its consultation paper dated 4 December 2020), there could still be various ways for investors to circumvent the requirement; for example, different names or identification documents could be used to open accounts in different brokers/ intermediaries for posting orders. Further, the time lag between the deal launching and allocation of securities is expected to become shorter and shorter (as short as T+1 after the launch of Fast Interface for New Issuance ("FINI") system). Therefore, we would expect that, in practice, it would become even more difficult for OCs to perform this task.

Q10 - Do you agree that OCs and CMIs should not accept knowingly inflated orders? If not, please explain.

While this seems reasonable, we have some doubts about the practicalities. It is understood to be common for investors to inflate their own orders to increase the chances of their orders being allocated in full, particularly for "hot deals", where investors tend to build a multiplier into their orders after taking into consideration of the expected allocation percentages. It is difficult

for OCs and CMIs to reject orders if they know the investors have the financial capacity to settle the allocation, or, alternatively, lack information about the investors' financial capabilities. However, if the proposal is confined to OCs and CMIs not accepting orders that they know to be inflated, including orders that they themselves may knowingly be inflating for non bona fide reasons, as suggested in paragraph 90 of the CP, in principle, this can be supported. At the same time, it is not easy to see how it can be enforced from a practical point of view.

Q11 - Do you agree that OCs should ensure the transparency of the order book? If not, please explain.

Please refer to our response to Q8 above.

Q12 - Do you agree that "X-orders" should be prohibited? If not, please explain.

CFAP members disagree with this proposal insofar as "X-orders" are used to protect other CMIs from potential lobbying/ poaching activities. Ring-fencing of investors is no more than a mutual understanding among the issuers and all banks in a deal. If there is a large, strong bank acting as the OC and leading the deal, it may not be possible for other participants, including the issuer, to prevent such activities, unless this kind of conduct is also prohibited under paragraph 21 of the Proposed Code.

On the other hand, we understand the SFC's concern, as outlined in paragraph 91 of the CP, that issuers could ask CMIs to use "X-orders" to conceal the identities of prospective investors with whom they are closely associated. We suggest, therefore, that the SFC may consider imposing a rule on market participants that certain specific uses of "X-orders" are prohibited, instead of disallowing "X-orders" altogether.

Q13 - Do you agree that OCs and CMIs should be required to establish and implement allocation policies? If not, please explain.

We agree that this could help to promote increased transparency. We suggest that such policies should serve as guidance and OCs and CMIs should be required to maintain proper records and to document the decision making process on the final allocation, where it differs significantly from the policy.

Q14 - Do you agree that client orders must have priority over proprietary orders at all times? If not, please explain.

We are not sure about the efficacy of implementing such a rule as CMIs could instead place their proprietary orders with other CMIs. If CMIs orders may be "price takers" only, as proposed (see Question 15), the SFC may need to explain further why CMIs should not be permitted to obtain a proportionate allocation for themselves on a proprietary basis as well as for their clients.

Paragraph 107 of the CP raises a concern that CMIs may take advantage of non-public information about the order book when placing proprietary orders to increase their chances of allocation in popular deals and, in particular, allocate more shares or debt securities to their proprietary orders than their client orders. We understand that the establishment of Chinese walls and certain specific physical/ information segregation between the buy-side and sell-side of the CMIs are required under the existing Code of Conduct provisions and SFC circulars. If there is misuse of sell-side information by buy-side of CMIs, and these existing rules are not being enforced, it raises questions about the value of introducing new rules which may also be difficult to enforce. If Chinese wall arrangements are not always working effectively, as suggested at paragraph 119 of the CP, then the focus should perhaps be on strengthening these existing requirements.

Q15 - Do you agree that proprietary orders can only be price takers? If not, please explain.

We agree with this proposal.

Q16 - Do you agree that a CMI's proprietary orders and those of its Group Companies should also include orders placed on behalf of funds and portfolios in which a CMI or its Group Companies have a substantial interest? If not, please explain.

Please refer to our response to Q14.

As a separate matter, in paragraph 111, the CP suggests that senior management of a CMI should review and approve certain types of orders and allocations, including:

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

We have reservations about the proposals in (a) and (c) above, as this would seem to shift responsibility for investment decisions from the investment manager to senior management of the CMI. The senior management of a CMI may not always have extensive experience in placing orders and making allocations and would tend to rely on the recommendations of their staff (i.e., the investment manager) in relation to investment decisions. It may be preferable to ask the investment manager to keep senior management in the picture regarding significant decisions relating to (a) and (b). Regarding (a) in particular, this would seem to be amenable establishing a general policy internally.

As mentioned in our response to Question 9, it is expected that the settlement process time will be becoming shorter and shorter (T+1 under the FINI proposal), which could also make it more difficult to add another step, i.e., senior management approval into the process.

As for the point at (b), this appears to be more of a risk management issue, which should, if anything, be monitored by a separate team (e.g., the risk management/ compliance team), rather than the senior management of the CMI.

Q17 - Orders received and entries placed in the order book are subject to constant amendments and updates throughout the bookbuilding process. Do you think it is feasible for the OC and CMIs to maintain records which evidence every change? If not, please explain.

As suggested in the question, constant amendments and updates are made during the bookbuilding process which would make it very difficult for the OCs and CMIs to maintain records that evidence every change.

Q18 - Do you agree with the scope of fee-related advice to be provided by an OC to an issuer? If not, please explain.

We agree, in principle, with the proposed scope of fee-related advice to be provided by an OC to an issuer and believe that, in practice, issuers will seek advice from OCs on fee arrangements, among other things. Nevertheless, generally, caution need to be exercised when codifying market practices, as this arrangement could also give rise to and entrench conflicts of interest between OCs and other CMIs, who will each be competing to maximise the benefits for their own investors, particularly on "hot" IPOs.

Q19 - Would you envisage substantial practical difficulties in an issuer determining the syndicate membership, the ratio between the fixed and discretionary portions of the fees to be paid to all syndicate CMIs and fixed fees allocation four clear business days before the Listing Committee Hearing? If yes, please cite examples.

We do not agree with this proposal as it may be unfavourable to small and medium-sized CMIs, which may lack the time and track record to substantiate to issuers that they have the ability to handle the deal, resulting in issuers being likely to play safe and to appoint larger banks.

As regards syndicate membership, we suggest that the SFC should allow flexibility to increase the syndicate CMIs, to a limited degree, after the hearing, especially if the deal is not launched immediately after the hearing.

While it would be good to have syndicate members confirmed at hearing for an IPO, the Proposed Code should require only that the syndicate be "substantially formed" at the time of the hearing (or 4 days before hearing), as it is unlikely that new OCs would have sufficient time to re-perform all the OC's functions and due diligence in the window between the hearing and launch of the deal. The number of CMIs that could be added post-hearing could make reference to the deal size and the time between the hearing and deal launch.

Therefore, instead of requiring the confirmation of all OC appointments within two weeks after submission of A1 proof prospectus, the issuer could be required to confirm most OC appointments at the time of submission of A1 proof prospectus, leaving a degree of flexibility to appoint say, at most one or two more OCs later.

Further, to ensure sufficient time is given to a new OC to perform due diligence, there could be an additional requirement that late appointments must be made, say, at least one month before the deal is launched. This one month period would also, to certain extent, discourage the issuer from adding OCs after submission of A1 proof prospectus without considering the issue seriously.

As regards fees and fee ratios, the CP itself notes:

"*Separately, the issuer can still pay CMIs discretionary fees to incentivise sales outperformance, especially in difficult market conditions and these fees can only be determined when the selling process is complete or substantially complete*" (paragraph 129).

"*Fees are primarily a commercial matter; fee ratios and allocations necessarily vary from one offering to another, and may be affected by unforeseen circumstances, including changes in market sentiment at the time of the offering*" (paragraph 130).

However, it is still concluded that "*it would seem 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.*" This is indicative of the inherent problems and potential inconsistencies that may emerge when trying to formalise and codify all aspects of market practice and evolving commercial arrangements.

We would agree that a certain amount of fixed fee could help to cover the fixed costs of banks in performing their syndicate work and, in turn, could improve the quality of work of the banks. On the other hand, paying a large fixed fee for underwriting services would reduce the incentive of banks to work hard for orders. Therefore, a fixed fee should not form such a substantial part of fees to CMIs.

Q20 - Would you envisage substantial difficulties in issuers determining the allocation of discretionary fees and the fee payment schedule no later than listing? If yes, please cite examples.

We have no comment on this proposal.

Q21 - Do you agree that (i) the syndicate membership (including the names of OCs) should be disclosed at an early stage; (ii) the total fees to be paid to all syndicate CMIs participating in the offering for the international placing tranche should be disclosed in the prospectus; and (iii) the total monetary benefits paid to each syndicate CMI should be disclosed after listing? If not, please explain.

While, in principle, we agree that the syndicate membership (including the names of OCs) should be disclosed at an early stage, this could conflict with the original idea of redacting the public A1 proof prospectus to avoid it constituting a prospectus under section 2(1) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) ("CWUMPO"); or an advertisement under section 38B(1) of the CWUMPO; or an invitation to the public, in breach of section 103(1) of the 2 Securities and Futures Ordinance (Cap. 571). See also our response to Question 19.

We agree that the total monetary benefits paid to each syndicate CMI should be disclosed after listing. In addition, we suggest that the issuer should be required to disclose the percentage of shares finally underwritten by each CMI as well. It seems to have become more and more common for lead banks to take a substantial portion of underwriting fees with only a limited underwriting commitment. In the longer term, such disclosure, could also help upcoming potential issuers to assess how each bank is actually performing in a more appropriate way.

"Sponsor coupling" proposal

Q22 - Do you agree with the "sponsor coupling" proposal? If not, please explain.

We note that the proposal reflects what is commonly happening in the market. At the same time, we also note the comments at paragraph 141 of the CP:

"*In our soft consultations, there was resistance to proposals to require all OCs to be sponsors to address these concerns. Some market participants were of the view that this would limit flexibility for the issuer to appoint OCs whose strengths mainly lie in marketing. There were also concerns that this proposal might prejudice standalone boutique sponsor firms with no marketing capabilities.*"

The statistics in footnote 32 indicate that, of the 127 sponsors licensed by the SFC as at 30 September 2020, around 94% either were licensed for dealing in securities or had a group company which was licensed or registered for this activity, and that of the 127 sponsors, 72% engaged in IPO transactions as a syndicate member in the year ended 30 September 2020.

Given that "sponsor coupling" appears to be a common practice already, we wonder whether there is a need, and whether it would be beneficial to the market, to mandate it. Arguably, where the sponsor is also an underwriter, whose primary objective is to sell the issuer's shares, this could create a conflict of interests and, conceivably, compromise the standard of due diligence work. While we are not suggesting that this arrangement be prohibited altogether, on the other hand, establishing a rigid requirement on sponsor coupling may not be helpful.

The CP notes, at paragraph 140(e):

Underwriting fees are substantially higher than sponsor fees. Based on our analysis of the 99 IPOs listed during the nine months ended 30 September 2020, the average sponsor fee was $6.3 million and the average underwriting fixed fee was $43.9 million. In one IPO, it was disclosed that the sponsor fee was around $12 million whilst the underwriting fixed fee was close to $350 million. This indicates a misalignment between fees and sponsor costs and responsibilities, especially in larger IPOs where sponsors typically incur substantial costs and where the potential consequences of regulatory breach can be severe. When sponsors also act as the head of syndicate, the total fees may properly compensate the additional sponsor resource commitments and responsibilities. However, if sponsors are not appointed as head of syndicate from the outset, there are concerns that they may be incentivised to compromise due diligence to secure the appointment.

This seems to highlight the potential dilemma. While it is suggested above that, if sponsors are not appointed as head of syndicate, they may be incentivised to compromise due diligence to secure the appointment, on the other hand, given the clear mismatch between underwriting fees and sponsor fees, Sponsor OCs may have their objectivity and judgment clouded when it comes to conducting due diligence in order to retain the OC appointment and gain future appointments. The sponsor coupling proposal may not be the best way to deal with this apparent discrepancy between the incentives and the responsibilities of intermediaries in this case.

Ultimately, requiring an OC to be a sponsor could also result in taking business away from quality independent sponsors (licensed corporations that have hands-on Responsible Officers working on the IPOs) that do not have an equity capital market function. The proposal could mean that more IPOs will go to the large banks with an impressive selling record (but not necessarily as good a record as sponsor), squeezing out smaller sponsor firms that could be better advisers to the issuer.

So, while, in practice, it is quite common for sponsors to be syndicate members and even act as OCs, making it a Code requirement for at least one OC to be a Sponsor OC may not be warranted.

An alternative suggestion to help deal with some of the issues raised in paragraph 140 might be to require, where an OC is not already a sponsor, that at least one independent OC be appointed at around the same time as the sponsor, and to encourage that OC to liaise with the sponsor, as appropriate.

Q23 - Do you think one Sponsor OC is adequate or should more OCs be required to act as sponsors? For example, should the majority of OCs be required to act as sponsors (i.e., if the issuer appoints three OCs, two must also act as sponsor)? Please explain.

Please see our response to Question 22 above. In addition, requiring the majority of OCs to be Sponsor OCs could disadvantage smaller boutique sponsor firms that do not have wherewithal to act as OCs and reduce the flexibility for issuers to determine whom to appoint as OCs.

Q24 - Do you have any comments on the proposed implementation timeline?

A longer lead time of, say, 12 months may be preferable to enable the industry to update and implement their internal policies, procedures and controls.

Hong Kong Institute of CPAs
7 May 2021