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31 July 2012

Securities and Futures Commission
8th Floor, Chater House
8 Connaught Road Central
Hong Kong

By email (sponsors@sfc.hk) and by post

Dear Sirs,

Consultation paper on the regulation of sponsors

We refer to the consultation paper on the regulation of sponsors (***Consultation Paper***) issued by the Commission in May 2012.

Unless otherwise specified, terms defined in the Consultation Paper have the same meanings when used in this letter.

We appreciate the Commission's efforts to enhance the regulation of sponsors. While we generally agree in-principle with the philosophy behind the Commission in making the proposals, we would like to express our view on certain matters discussed in the Consultation Paper as follows:

Q4. Do you agree that before submitting a listing application a sponsor should complete all reasonable due diligence on the listing applicant save only any matters that by their nature can only be dealt with at a later date?

4.1 Due diligence is an on-going exercise. To require completion of due diligence on an applicant before the sponsor can make the listing application (A1 filing) would be very difficult to accomplish in practice, and would unduly prolong the listing preparation process. This will in turn adversely affect the competitiveness of the Hong Kong capital market.

4.2 Further, the Listing Rules' listing application requirements have been devised and are being applied such that sponsors will continue with the due diligence after an A1 filing is made, to an extent considered necessary or appropriate. For example, under the current Listing Rules, a sponsor is only required to submit the applicant's draft profit and cash flow forecast memorandum to the Exchange as a 15-day document, and a draft of the sponsor's confirmation on the applicant's working capital sufficiency-related matters as a four-day document, in each case after the A1 filing takes place. The Exchange also recognises that under certain circumstances, it would be practically difficult for the A1 draft prospectus to include financial information, whether in audited or advanced draft form, in respect of the latest full financial year of the applicant, which may therefore be provided at a later stage in some cases.

4.3 Due diligence goes hand in hand as and when such information, and indeed as much other advanced information, about the applicant is available and finalised, and cannot be singled out to be conducted and completed out of context. Therefore, in our view, to require completion of due diligence before A1 filing would necessitate changes to the relevant Listing Rules or Exchange practices to a certain or a substantial extent, which however would not be conducive to facilitate and support a streamlined and efficient application process for listing in Hong Kong.

Q11. Do you agree that the sponsor should take [the steps set out in paragraph 73 of the Consultation Paper] in connection with an expert report?

[These steps include:

(a) the sponsor confirming that the expert is appropriately qualified and experienced, the bases and assumptions adopted by the expert are fair and reasonable, the experts' scope of work is appropriate to the opinion and the expert is independent from the listing applicant;

(b) the sponsor ensuring that factual information on which an expert relies is consistent with the sponsor's knowledge of the applicant including that derived from its other due diligence work;

(c) where factual information is solely or primarily derived from management's representations and confirmations, the sponsor, unless the expert has done so, making independent inquires or assessments or obtaining independently sourced information to verify the accuracy and completeness of the information; and

(d) the sponsor corroborating information obtained from different sources to ensure that it is consistent.]

11.1 We generally agree with codifying the steps under paragraphs (a), (b) and (d) above. These steps to a certain extent reflect or set out more clearly the existing requirements of or practices by sponsors.

11.2 We however have reservation about formally adopting the steps under paragraph (c) above in the form proposed, for the following reasons.

11.3 Given the reasonable amount of resources normally required to be dedicated by a sponsor to a listing application, we believe it too stringent and overly burdensome to require the sponsor to independently verify information relied on by an expert to compile its report for which that expert is professionally and/or legally responsible.

11.4 In practice, it would be extremely difficult, if not impossible, to have one verify the "completeness" of any information. Even an expert would not be able to do this at all or efficiently, let alone a sponsor which is not an expert in the particular field. To require this would render the process highly and disproportionately inefficient and cost-ineffective.

11.5 Further, each expert has its own area of expertise, and is typically required to do its work in compliance with its professional rules, standards or practices. Some areas of expertise, e.g., those concerning a mineral company or an insurance company, to name but a few, are highly industry-specific. A reasonable sponsor staff may not have the requisite expertise knowledge and experience, or may not be in a position, to himself/herself independently comprehend or critically evaluate the underlying factual information or statistics, etc., without the help from the professionally qualified expert.

11.6 All in all, we believe that the hardship exerted on a sponsor to require it to perform the extra work and steps under paragraph (c) above would outweigh the perceived benefits that they may bring. Those steps should and would have been done by the relevant experts to discharge their own professional duties if they so require.

Q18. Do you agree that the Application Proof submitted with a listing application should be made publicly available when the application is made?

18.1 In our view, to require the Application Proof to be made publicly available as early as the time when the A1 filing is made would not serve the purpose intended to achieve, but may impact on or even be harmful to the Hong Kong securities market in the following respects.

18.2 At the time of an A1 filing, the listing is still subject to many uncertainties, regulatory and commercially; and even if the process is smooth, the listing will only take place a few months afterwards. The Application Proof, as it will be in an advanced form, contains very detailed descriptions about the

applicant's business and its historical financials, and a lot of confidential information about the applicant's management and organisation, which can all be commercially sensitive. It can be detrimental to the applicant's business and operations during the interim period if such information is prematurely released and thus made known to the public, including the applicant's competitors.

18.3 Further, whether a listing application will progress and materialise to an actual listing depends on various factors, many of which (such as the general economy and the market conditions) are well beyond the applicant's control and not directly related to the quality of the applicant or its listing application. If an applicant's A1 filing is publicly announced, but the listing eventually does not occur or is noticeably delayed, this may create a "damaged goods" image on that applicant among the public and the investors, which may in turn dampen the interests of quality applicants who have plans to list in Hong Kong.

18.4 Conversely, the rule proposed may be prone to abuse. Companies which are not genuine about their intention to list in Hong Kong may use the A1 filing as one of its advertising means, to entice investors and customers.

18.5 For decades, the Hong Kong securities market has been operated on the premise that an A1 filing is a confidential one, and that the applicant, the sponsors and all other parties involved shall endeavour to preserve its confidentiality throughout the process. To suggest the otherwise would, we believe, require a revamp of the mentality of the market players, and of the regulatory infrastructure that has been operating for years.

Q26. Do you agree that there should only be one sponsor on each engagement? If you do not agree, should the number of sponsors be limited and, if so, to how many? If you do not agree that the numbers of sponsors should be limited, why not?

26.1 We think that the number of sponsors involved in each listing application is not a determining factor that affects the standard of sponsors' work or the quality of the application. Multiple sponsors are often desirable and sometimes needed for different valid reasons in the execution of the deal, and depending on the scale, complexity or other aspects of the transaction, each sponsor firm will often make its contribution meaningfully to the process.

26.2 In our view, so long as there is a clear division of responsibilities upfront among the sponsors involved, and there is an ongoing, effective system of communication and supervision of work maintained and implemented among those sponsors' firms, there need not be a regulatory limit imposed on the number of sponsors engaged in each listing application.

Q27. If more than one sponsor is allowed, do you agree that they should all be required to meet the Listing Rules independence requirements?

27.1 From our experience, we believe that the existing securities regulatory framework and the current sets of related rules are adequate and effective to ensure sponsors' independence in a listing application.

Q32. Do you agree that it should be made clear that sponsors are liable for untrue statements (including material omissions) in a prospectus?

32.1 The SFO provides for civil and criminal liability for misstatements in prospectuses. Criminal liability is incurred where there is proved to be fraud or recklessness. In addition, sponsors and their staff are subject to investigation powers and disciplinary actions of the Commission which can result in the revocation of their licences and/or fines. We believe that these are effective and reasonable means of regulating the professional behaviour of sponsors. We disagree that sponsors be made liable for untrue statements (including material omissions) in a prospectus under the Companies Ordinance. We particularly disagree that criminal liability be imposed on sponsors under the Companies Ordinance for untrue statements in a prospectus. Those statements are made by the company which issues and authorises the issue of the prospectus.

32.2 We take the view that under the current prospectus liability regime of the Companies Ordinance, sponsors are not, and should not be, subject to civil or criminal liability for untrue statements in a prospectus for the purposes of Sections 40 and 40A of the Ordinance.

32.3 This is because legally, a sponsor does not, and should not be considered to, "authorise the issue of a prospectus" despite its sponsor's role and involvement in the relevant listing application. The persons who "authorise the issue of the prospectus" are the company itself and its directors acting by requisite meetings properly convened and held or by resolutions properly passed.

32.4 A sponsor is not, and should not be considered, a "promoter" either, within the meaning of Section 40 of the Companies Ordinance (***Section 40***).

Under Section 40(5)(a) of the Ordinance, for the purposes of Section 40, "the expression "promoter" means a *promoter* who was a party to the preparation of the prospectus, or of the portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company" (*emphasis added*).

In other words, for a person to constitute a "promoter" for the purposes of Section 40, he will have to be: (i) a "promoter" in the first place; and also (ii) a party to the preparation of the prospectus or the relevant portion of it. A "promoter" is not defined under that section as simply "a party who is involved in the preparation of the prospectus …", as has been so paraphrased under paragraph 121(a) of the Consultation Paper. To otherwise so interpret the expression focuses only on the second limb, but ignores the first limb, of the definition under Section 40(5)(a).

"Promoter" is otherwise not defined in the Companies Ordinance. We consider that a "promoter" of a company, for the general purposes of the Companies Ordinance, typically refers to a person engaged in, or engaged in procuring, the formation or incorporation of the company. This, we believe, is a reason for the need to exclude from the Section 40(5)(a) "promoter" definition "any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company". Ordinarily, a sponsor will not be engaged in, or engaged in procuring, the formation or incorporation of the company; and even if it is, for the sake of argument, it so acts in a professional capacity.

32.5 On the basis of the above, we are of the view that a sponsor is neither a "promoter" of a company nor a person who "authorises the issue of its prospectus" for the purposes of Sections 40 and 40A, and is therefore not subject to civil or criminal liability for untrue statements in the prospectus under the current prospectus liability regime of the Companies Ordinance. Accordingly, the proposal sought under Q32 of the Consultation Paper is not merely to clarify or remove any alleged ambiguity as to whether sponsors are already subject to Sections 40 and 40A of the Companies Ordinance – as we consider it unambiguous that this is not and should not be the case, but is to rewrite the law by expanding those sections to catch a new category of persons being the sponsors.

32.6 Each sponsor firm is a corporation or institution licensed or registered with the Commission under the SFO, and is thereby already subject to the existing stringent licensing rules and continuing requirements applicable to it. Further, with the protective, preventive and punitive legislative and regulatory mechanisms that have already been put in place under the SFO and related regulations, and with the implementation of other strengthened measures proposed under the Consultation Paper (except for those or as appropriately modified as described above), we believe that the sponsors' regulatory regime in Hong Kong would be an efficacious one in keeping up and enhancing the standards of sponsor work and in turn the quality of future listing applications.

* * *

We hope the above is clear. If you would like to discuss the above or any other aspect of the Consultation Paper with us, we are happy to do so, and please contact

Yours faithfully,
Baker & McKenzie

Baker & McKenzie