

A New Approach by Sponsors of Hong Kong IPOs

With proposed new requirements coming into play on or after 1 October 2013, there will be pressure on sponsors of Hong Kong listings to adapt to a new regulatory environment. If they are to prosper in the “new climate,” sponsors may need to assess the robustness of their operating procedures and develop a different approach to their due diligence processes when taking on prospective listing candidates.

The new regulatory requirements are being driven by the Securities and Futures Commission (SFC) who published the “*Consultation Conclusions on the Regulation of IPO Sponsors*” in December 2012. While this consultation exercise came on the heels of a series of high profile accounting scandals involving Chinese listed companies, the exercise was not driven by these events as the SFC had already found various problems, including unsatisfactory due diligence and inadequate internal systems and controls, when it inspected the work of underwriters in Hong Kong. The regulator reported that it has seen a “number of cases” where underwriters submitted an application for a listing before having completed their due diligence.

Investors have also complained that many IPOs in recent years have failed to at least match the market. In response to investors’ concerns, the SFC has taken a far more aggressive approach in dealing with complaints. In its boldest move against an underwriter yet, it revoked the listing-sponsor license of Mega Capital (Asia) Co. after revealing the inadequate and substandard due diligence work it conducted in preparation for the 2009 listing of clothing firm Hontex International Holdings Co.

Failings of the Current Regulatory Regime

The SFC has not only found major deficiencies in the due diligence work conducted by sponsors in the listing application process but also in the internal workings and control systems of the sponsors themselves.

While the SFC found no evidence that Mega Capital was involved in any fraud, many of Mega Capital’s failures and deficiencies in conducting its sponsor’s duties were disconcertingly similar to the deficiencies in the work performed by some sponsors that were brought to light in the SFC’s “*Report on Sponsor Theme Inspection Findings*” in March 2011. These deficiencies include (i) inadequate and sub-standard due diligence work; (ii) failure to act

independently and impartially; (iii) inadequate audit trail of due diligence work; and (iv) inadequate supervision of its staff.

In more recent developments, the SFC presented a petition to the Court of First Instance to wind up China Metal Recycling after it found evidence that the company inflated the size of its business and fabricated sales to secure a listing in 2009. Hong Kong police have also arrested several people in connection with this matter. This application marked the first time that the regulator has used Section 212 of the Securities and Futures Ordinance to initiate winding-up proceedings under the Companies Ordinance against a listed company, and is the latest sign that it is taking a firmer stance against market misconduct in Hong Kong. This move by the SFC also shows that the regulator is taking a more robust approach to enforcement action.

SFC Proposed Reforms: Important Aspects

The emphasis is on early, comprehensive due diligence and a properly drafted prospectus to accompany a listing application. The SFC proposals are intended to enable and encourage sponsors to take a responsible, proactive and constructive role when leading IPOs and, overall, to maintain investor confidence in Hong Kong’s IPO market.

As part of the consultation exercise, the SFC has consolidated and centralised the key obligations of sponsors in a new paragraph in the Code of Conduct. These provisions are designed to set a regulatory standard that clearly defines the quality of work expected from a sponsor firm and are therefore in the interest of public investors and all other stock market participants.

Important aspects of the reforms include initiatives to enhance the role of a sponsor to ensure that a sponsor’s ability to carry out its “gatekeeping” role is not undermined by competitive tensions. The SFC shall require that (i) a listing applicant formally appoints a sponsor at least two months before a listing application; (ii) a sponsor notifies the regulators of any instances of non-compliance and explains why if and when it ceases to act for a listing applicant; (iii) a listing applicant commits that it and all professional advisers involved in the IPO will fully co-operate with the sponsor in discharging the latter’s duties; and (iv) sponsor fees must be specified in a sponsor’s terms of engagement and be based solely on a sponsor’s role. The SFC wants to stop the current “no-deal, no-fee arrangements” that are all too common in today’s market. These measures will undoubtedly strengthen the sponsor’s “gatekeeping” role as they will need to have a much higher degree of certainty when deciding on whether or not to act for

A New Approach by Sponsors of Hong Kong IPOs

a potential listing applicant. In addition, in support of the confidence building process, the SFC will publish the advanced draft prospectus filed with a listing application on the Hong Kong Stock Exchange (SEHK) website.

More controversially, the SFC also proposes the law should be clarified so that sponsor firms have civil and criminal liability for defective prospectuses; and criminal liability should depend on whether a sponsor firm knowingly or recklessly approved a prospectus containing an untrue statement (including an omission) which was materially adverse from an investor's perspective. These proposals still have to go through the legislative process before they are implemented.

"The changes, along with a streamlined regulatory process, will incentivize sponsors to raise standards, pick the right deals and manage them well which should in turn reduce risks for investors and all those involved in IPOs," said SFC Chief Executive Officer Mr. Ashley Alder.

Impact on Hong Kong: Concerns

The proposed reforms could potentially be another blow to an already struggling IPO market that has seen the number of deals decline and a drop in fees earned by banks that underwrite the offerings, amid weak overall stock market performance. SEHK was the world's largest by deal volume over the last three years and IPOs account for as much as 60% of investment banking revenue in Asia.



During the consultation exercise, sponsor firms have expressed concerns that implementation of SFC's proposed reforms would lead to an increase in the cost of acting as sponsor and the overall costs of listing – given that sponsors may be required to perform additional due diligence before a listing application is made. In particular, concerns were raised that the implementation of the proposals may adversely affect the attractiveness and competitiveness of Hong Kong as an international financial centre and a preferred listing venue.

While these may be valid concerns, the additional costs of due diligence do not necessarily need to be borne by the sponsor and there is nothing preventing a sponsor from passing on some of the costs to an issuer that is seeking a listing. Such

arrangements already exist in other financing transactions and therefore this practice could be adopted by sponsors of IPOs. Sharing the costs of due diligence with the issuer could also act as an additional screening measure for sponsor firms because an issuer that is uncomfortable with bearing the costs of conducting due diligence might not be the most suitable listing candidate in the first place.

New Approach by Sponsors

With the introduction of the new regulatory environment no sponsor will want to be the first 'named or shamed' by the Hong Kong regulators for failings in bringing a listing applicant to market. The process will be transparent with sponsors having to notify the regulators of any instances of non-compliance and explaining why they have ceased to act for a listing applicant. Sponsors will not want to risk their reputation if they are uncertain of bringing a candidate to the market.

With the emphasis on early and comprehensive due diligence, sponsors are being encouraged to take a longer view and far more proactive role in the listing process. Sponsors will not only be obligated to spot problems during the due diligence phase of the transaction, but also remedy any identified problems before advising the SEHK of its appointment.

Cost-effective solutions will be required. A 'red-flag' review through reputational screening and also a high-level financial due diligence exercise would provide a sponsor with an initial independent assessment of a potential listing applicant. A sponsor faced with too many 'red-flags' may decide a listing applicant is not ready for market and turn down a listing engagement. The costs of this initial due diligence exercise could be borne by the candidate.

While the new regulatory environment will undoubtedly lead to sponsors assessing their current operational processes when taking on listing applicants, an innovative approach to due diligence, and use of experienced independent advisers, may actually lead to a reduction of overall costs. More importantly, it would support sponsors' confidence in bringing good applicants to the market and thereby mitigating any reputational risk.

About FTI Consulting

FTI Consulting, Inc. (FTI) is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. Having undertaken multiple IPO investigative due diligence assignments in Hong Kong, FTI can advise sponsors in the new regulatory environment, providing experienced independent professionals covering a range of disciplines including field investigations, forensic financial reviews and strategic communications. More information can be found at www.fticonsulting.com.

A New Approach by Sponsors of Hong Kong IPOs



Russell Worth
Managing Director
+852 3768 4583
russell.worth@fticonsulting.com

Tom Cheung
Senior Consultant
+852 3768 4573
tom.cheung@fticonsulting.com

CRITICAL THINKING
AT THE CRITICAL TIME™

About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centers throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring.

www.fticonsulting.com

©2013 FTI Consulting, Inc. All rights reserved.