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# IPO Sponsors and Prospectus Liability: The Bridge Too Far?

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## IPO Sponsors and Prospectus Liability: The Bridge Too Far?

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### Executive Summary

Hong Kong's prospectus law provides for statutory civil and criminal liability in respect of material misstatements for specified categories of persons, including those who "authorized the issue of the prospectus". Since the introduction of these provisions the mechanisms of control and liability in the securities market have undergone quantum changes, in particular, via the development of an overarching regulatory architecture. The manner in which a prospectus is now produced and issued in connection with an initial public offering ("**IPO**") is guided by non-statutory regulations as well as potential statutory liabilities.

The concept of the sponsor, as a person who assists a company seeking a listing, predates relatively recent regulatory developments that affect the undertaking of sponsor work, with notable changes being introduced in 2001 through to the most recent developments in October 2013. There is now a significant regulatory emphasis on the role of the sponsor as an important gateway mechanism intended to ensure the quality of disclosures made in IPO prospectuses.

In tandem with the evolving sponsor concept, an issue that has been extensively debated in the industry, including through a series of public consultation exercises undertaken by the SFC between 2003 and 2014, is the question of whether sponsors undertaking IPO work are or should be subject to statutory prospectus liability, and whether the existing law needs to be amended.

In August 2014 the SFC published its conclusion that IPO sponsors are persons who authorize the issue of a prospectus within the meaning of Hong Kong's prospectus law. While previous consultation exercises had pointed to the lack of clarity in the existing law and the need to make changes to it, the SFC also stated that no legislative amendments are required. The SFC's position implies that a court would not need to make any determination of whether a sponsor has in fact "authorized the issue of the prospectus" – if it were so, it would be open to a court to make a determination in the usual manner, possibly finding that some sponsors have engaged in the authorization act whereas others have not.

Appropriate law-based accountability, in addition to a sponsor's regulatory obligations, may be desirable in a well-developed marketplace. However, as the sponsor is a creature borne out of regulatory requirements and is not specifically referred to in Hong Kong's prospectus law, or in any other statutory law, it is equally important to clearly establish the basis for any legal liability. Whereas the SFC has referred to the specific duties and acts of an IPO sponsor and its central role in relation to the production and issue of an IPO prospectus, these are essentially driven by non-statutory regulatory requirements - accordingly, the precise source of a sponsor's statutory liability remains somewhat opaque.

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This paper examines the SFC's position with a view to understanding its basis in law. In some ways, this paper is akin to the due diligence exercise an IPO sponsor itself is required to undertake. As such, it does not seek to address the significant policy considerations surrounding whether sponsors should be liable, or issues in the current legislative drafting, save to the extent directly relevant to the above focus.

In the absence of a detailed explication in the SFC's consultation paper, any case law directly addressing the matter, or any other detailed published assessment of the SFC's position, this paper pursues three lines of enquiry:

- (1) since statutory law does not specifically recognize the sponsor concept *per se*, is there some other legal mechanism that recognizes the regulatory functionality known as the sponsor;
- (2) what is the scope of the phrase "authorized the issue of the prospectus" for the purposes of prospectus law and how might sponsor work fall within that scope; and
- (3) as an IPO is subject to legal, regulatory and commercial requirements, what other matters of practice may be relevant to consider?

The analysis suggests that the acts a sponsor normally undertakes to discharge its regulatory obligations do not appear to give rise to any legal presumption of it having authorized the issue of the prospectus, such that it would no longer be a question for the court to determine, even under a possible wider meaning of the "authorized" term. Nor does the special role of the sponsor in submitting the declaration of compliance required under Appendix 19 of the Listing Rules assist. Non-statutory regulations affecting IPO sponsors operate in a different sphere from that of prospectus laws, and no sound argument is identified that clearly bridges the two - it is noteworthy that over a decade of consultation exercises on the issue has not identified any such bridge.

Whether an argument based on 'considerations of a broader nature' works to bring sponsors within prospectus law, or whether this might be the basis of the SFC Position, is at present undetermined.

An unexpected finding was that elements underlying the SFC Position could potentially also capture underwriters. To the extent there is a legal basis for the SFC Position, underwriters that are not sponsors may therefore need to reconsider their liability position under Hong Kong's prospectus law.

The observations made in this paper serve to highlight that prospectus law has not kept pace with the evolution of the regulated marketplace and market expectations. The continuing lack of clarity of the sponsor's legal position in the face of the SFC's current view places sponsors at a disadvantage, in particular as the extensively discussed problems inherent in the current legislative drafting, such as absence of *mens rea* and the reversal of the usual burden of proof, remain.

The paper concludes with a review of the other significant powers the SFC may exercise in relation to sponsors failing to undertake their duties to the required standard. It is noted that these powers may provide meaningful sanctions, and remedies to investors, where sponsors have failed to properly undertake their regulatory duties. The options for resolving the current disjunct between prospectus provisions that have been overtaken by market conditions and expectations are briefly considered.

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## 1. INTRODUCTION

Public offers in Hong Kong must, unless exempted, comply with the prospectus provisions of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (“**CWUMPO**”)<sup>1</sup>. This ordinance provides that where a prospectus has been issued and contains untrue statements, persons who “authorized the issue of the prospectus” (the “**authorization act**”) may be subject to statutory civil and criminal liability (“**prospectus liability**”).<sup>2</sup>

A question that has been the subject of uncertainty and disagreement in the industry for the last 15 years or more is whether sponsors are, or should be, subject to prospectus liability. Under the CWUMPO as presently drafted, the debate has focussed on whether the sponsor is a person who, in the normal course of executing its role as a sponsor, engages in the authorization act.

After several public consultation exercises concerning the uncertainty, the Securities and Futures Commission (“**SFC**”) have more recently sought to put the issue to rest. In a very brief “Supplemental Consultation Conclusions on the Regulation of IPO Sponsors – Prospectus Liability”<sup>3</sup> (“**SFC 2014 Conclusion**”),<sup>4</sup> the SFC refers to a sponsor’s functions, duties and obligations and its obligation under the Listing Rules (“**Listing Rules**”) of The Stock Exchange of Hong Kong Limited (“**SEHK**”) to submit to the SEHK<sup>5</sup> a declaration of compliance<sup>6</sup> to support their position that (1) sponsors are “persons who authorize the issue of a prospectus within the meaning of the CWUMPO”,<sup>7</sup> (2) they are accordingly subject to prospectus liability, and (3) the SFC “will have no hesitation in relying on the existing criminal liability provisions in the CWUMPO”<sup>8</sup> insofar as IPO sponsors are concerned (the “**SFC Position**”).<sup>9</sup>

Given the considerable importance of the matter to Hong Kong’s market in initial public offers (“**IPO**”),<sup>10</sup> it is surprising that the SFC 2014 Conclusion does not contain any substantive or detailed analysis supporting its position, particularly as the SFC has itself stated that “In matters of legal and regulatory liability, certainty as to the scope of the regime is essential and is in the public interest.”<sup>11</sup> A clear framework is also important to IPO sponsors wishing to manage any potential prospectus liability through appropriate compliance procedures and policies.

This paper examines the SFC Position and the sponsor role under currently applicable law and regulation. Section 2 of the paper reviews the nature of the sponsor role, the relevant points of prospectus law, and the SFC’s previous public consultations on the matter of sponsor liability. The position in other jurisdictions employing a sponsor

<sup>1</sup> Cap. 32. Formerly known as the Companies Ordinance.

<sup>2</sup> Sections 40, 40A and 342E and 342F CWUMPO, as discussed below. Appendix 1 of this paper contains extracts of sections 40 and 40A of the CWUMPO.

<sup>3</sup> SFC, August 2014.

<sup>4</sup> See Appendix 2 of this paper for extracts from the SFC 2014 Conclusion.

<sup>5</sup> Under the dual filing regime, it must also be submitted to the SFC, however, the SFC 2014 Conclusion makes no specific reference to this.

<sup>6</sup> I.e., the sponsors declaration contained in Appendix 19 of the Listing Rules. See Appendix 3 of this paper for extracts from the Appendix 19 declaration.

<sup>7</sup> Paragraph 8 of the SFC 2014 Conclusion. See also paragraph 11.

<sup>8</sup> Paragraph 13 of the SFC 2014 Conclusion.

<sup>9</sup> The SFC identify the adoption of their position, referred to in the SFC 2014 Conclusion as a “reaffirmation”, as a highlight of the regulatory year in their Annual Report 2014-15 – see page 34.

<sup>10</sup> Currently on par with the largest exchanges in the world – as at the time of writing it is in fact the world’s largest IPO market.

<sup>11</sup> Paragraph 15.5, SFC’s “Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance”, August 2005.

concept is also briefly reviewed. Section 3 of the paper examines the SFC Position in detail, considering the relationship between laws and regulations, the concept of 'authorizing the issue of', and the relevant commercial considerations.

In Section 4 it is concluded that the investigation did not find any convincing grounds that support the SFC Position. It is noted that the SFC's other powers, particularly those under Part X of the Securities and Futures Ordinance ("**SFO**"), can provide alternative legal routes for punishing sponsors who fail to execute their duties to the requisite standard as well as meaningful remedies to persons affected by such failures. Whether such alternative routes obviate the need for statutory reform of sponsor liability is an open question. In the interim, it remains open to the SFC to clarify, for the guidance of firms undertaking sponsor work seeking to understand and manage their legal risks, the grounds on which it has taken its position.

## 2. IPO SPONSORS AND PROSPECTUS LIABILITY

Companies seeking a listing on the SEHK frequently do so via an IPO. Such listings involve two distinct components, a public offer and a listing exercise. While these two components are routinely undertaken as part of the same transaction, they are not necessarily connected insofar as one could make a public offer without undertaking a listing, or seek a listing without making a public offer.<sup>12</sup>

Where a public offer of shares or debentures to investors in Hong Kong is undertaken, it is subject to the provisions of the CWUMPO concerning prospectuses<sup>13</sup>. In contrast, a listing exercise per se is subject to the non-statutory requirements of the Listing Rules, the CWUMPO being irrelevant.

Where companies are engaging in both a listing exercise and a public offer (such as an IPO – overwhelmingly the most common case), the two processes are intimately connected and a sponsor will be involved as a central actor driving many aspects of the overall progress of the transaction. In considering the sponsor's role and its exposure to prospectus liability, this paper will assume a typical IPO structure, i.e. a public offer<sup>14</sup> combined with a listing application.

### 2.1 The sponsor

The concept of the sponsor in Hong Kong historically derives from the listing rules of The Stock Exchange in Great Britain and Ireland that required all applicants for listing to be "sponsored by a broker who must be a member of The Stock Exchange".<sup>15</sup> It is not a concept used in other major international exchanges save for the Premium Market of the London Stock Exchange and the Toronto Stock Exchange, although Singapore employs a similar concept in the form of the 'issue manager'.<sup>16</sup> In Hong Kong, the sponsor concept is not recognized either in the CWUMPO or in any Hong Kong statutes or subsidiary legislation,<sup>17</sup> a status mirrored in other jurisdictions using the sponsor concept, with the exception of Singapore where legislation specifically contemplates the issue manager.<sup>18</sup>

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<sup>12</sup> For an example of the latter, where a listing by way of Introduction is undertaken; see Listing Rules 7.13 to 7.17. In relation to the former, public offers under the CWUMPO without listings are in theory possible but for commercial reasons, including post-offer liquidity issues, they have been uncommon.

<sup>13</sup> A prospectus is defined in CWUMPO as a document that offers securities to the public or which is calculated to invite offers from the public in respect of securities.

<sup>14</sup> Comprising an offer for subscription and an offer for sale, as is typically seen.

<sup>15</sup> Rule 2 of the "Requirements for the listing of securities on The Stock Exchange in Great Britain and Ireland" (undated but at least prior to 1964), provided courtesy of the Financial Conduct Authority).

<sup>16</sup> The role of "Issue Manager" in relation to listings in Singapore on SGX is similar to that of a sponsor. An applicant to SGX must appoint an issue manager under SGX Listing Rule 111 and issue managers are expressly made civilly and criminally liable for the contents of the listing document under Singapore's Securities and Futures Act.

<sup>17</sup> This includes the Securities and Futures (Stock Market Listing) Rules, made under section 36(1) SFO, which give a measure of statutory backing to the Listing Rules by requiring the listing applicant to comply with the Listing Rules. The CWUMPO is an older piece of legislation introduced in 1933 and substantially revised in 1950 largely based on the UK Companies Acts of 1929 and 1948 whereas the modern form of the SEHK only came into being in 1980/1986 following the Stock Exchanges Unification Ordinance (cap. 361) of 1980 (the SEHK was incorporated in 1980 but trading only started in 1986). However, as already mentioned, the sponsor concept has also been in place for a considerable period of time and so little can be read into the sponsor not being mentioned. It has been suggested that sponsors may be liable as promoters, however, this is not the concern of the SFC Position.

<sup>18</sup> See the Securities and Futures Act (cap. 289)

When performing its tasks, a Hong Kong sponsor is subject to two distinct sources of duties: those it owes to the regulators and those it owes to the listing applicant under its engagement letter. This gives rise to a market regulation functionality and, separately, a client-based agency.

As regards the market regulation functionality, the sponsor serves as a primary mechanism for ensuring market quality of listing applicants and the related disclosures they make to the market. It plays a unique role in coordinating the listing application process including making an assessment of the company's suitability for listing, whether it satisfies the relevant eligibility requirements of the Listing Rules,<sup>19</sup> and generally guiding the company through the application process.

The Listing Rules require the company seeking a listing (the "listing applicant") to appoint a sponsor "to assist it with its initial application for listing"<sup>20</sup> and sponsors are required to provide a written undertaking to the SEHK to comply with the Listing Rules concerning sponsors.<sup>21</sup> To be eligible to act as a sponsor, a firm must be licensed by or registered with the SFC to advise on corporate finance (Type 6 regulated activity<sup>22</sup>) and be permitted under the terms of its licence or registration to engage in sponsor work.<sup>23</sup> As such, sponsors are therefore also subject to obligations imposed by the Code of Conduct for Persons Licensed by or Registered with the SFC (the "**Code of Conduct**"), which are non-statutory regulations issued by the SFC. Both sets of regulations, the Listing Rules and the Code of Conduct, require the sponsor to act impartially, to undertake an extensive due diligence of the listing applicant's affairs, and to oversee and be closely involved in the preparation of the listing document.<sup>24</sup> Impartiality is a critical factor in promoting greater confidence in the reliability of prospectus disclosures, leading to the sponsor having been described as a "reputational" intermediary.<sup>25</sup> Recent regulatory reforms have provided sponsors with greater authority over, and responsibility in relation to, the listing process, primarily with a view to enhancing market confidence and, by default, investor protection.<sup>26</sup>

Of particular interest to the present paper, as it has been cited by the SFC as a key factor in the SFC Position, is the declaration required to be made by the sponsor as set out in Appendix 19 of the Listing Rules (the "**Appendix 19 declaration**").<sup>27</sup> This declaration is a critical document for the listing to proceed: it is required to be submitted by the sponsor as soon as practicable after the Listing Committee of the SEHK has approved the listing application - without it, the company will not be admitted to listing. The Appendix 19 declaration, which must be signed by a Principal (who will be a responsible officer of the sponsor firm), represents a summation of the work that a sponsor is required to undertake. In it, the firm "declare[s] to the [SEHK] that", in summary<sup>28</sup>: it has submitted all documents required by the Listing Rules, the CWUMPO and the Securities and Futures (Stock Market Listing) Rules (Cap 571V) ("**SMLR**"); it has completed all reasonable due diligence inquiries it is required to undertake in relation to

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<sup>19</sup> See Chapter 8 of the Listing Rules.

<sup>20</sup> Listing Rule 3A.02

<sup>21</sup> In the form provided in Appendix 17 of the Listing Rules and required to be submitted at the time of the application for listing.

<sup>22</sup> See Schedule 5 of the SFO for a definition.

<sup>23</sup> See the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC, particularly paragraph 17 thereof, and Appendix 1 of the SFC's Fit and Proper Guidelines.

<sup>24</sup> See Listing Rule 3A.06, paragraph 17.6 of the Code of Conduct, and Practice Note 21 of the Listing Rules.

<sup>25</sup> See Davies and Worthington, "Gower and Davies Principles of Modern Company Law" 9ed 2012, 25-27 at page 926.

<sup>26</sup> In the UK an enhanced role for sponsors was also the subject of the FSA's Consultation Paper 12/2, see chapter 3.

<sup>27</sup> Listing Rule 3A.13.

<sup>28</sup> See Appendix 3 of this paper for extracts from the Appendix 19 declaration.



the listing applicant's affairs; it is satisfied that the listing applicant is in compliance with the requirements of the Listing Rules; and that there are no other matters not disclosed to the SEHK that are relevant to the company's application for listing. This is a widely drafted and burdensome declaration to make, and its execution is not to be taken lightly.<sup>29</sup>

Where a sponsor has failed to properly execute the obligations imposed on by these regulations, it will be subject to the disciplinary powers of the SFC.<sup>30</sup>

In addition to the foregoing regulatory considerations, a sponsor also owes duties to the listing applicant under its engagement letter. However, the scope and nature of those duties is subject to extensive requirements imposed on the client relationship by the Listing Rules and the Code of Conduct that require, inter alia, the client to accept that the sponsor also has certain duties to the regulators that override the private commercial considerations that would otherwise apply. For example, the sponsor has an obligation to report to the SEHK (and the SFC) any instances of material non-compliance with the Listing Rules and the sponsor's engagement letter must require the directors of the listing applicant to permit this reporting including, should the sponsor cease to act prior to the listing being completed, permitting the sponsor to inform the regulators the reasons for it ceasing to act. A copy of the engagement letter must also be provided to the SEHK.<sup>31</sup> A sponsor's obligations to the SEHK in respect of the listing applicant also extend beyond completion of its engagement with the company (whether or not a successful listing) – should it subsequently become aware of any material undisclosed information obtained during its period as acting as sponsor it must report this to the SEHK/SFC.<sup>32</sup>

### **2.1.1 Sponsors and other parties**

Before moving on it is worth briefly distinguishing the sponsor role from certain other parties involved in an IPO – the different roles each play will become relevant to the subsequent discussion in this paper.

Current market practice is that sponsors will typically also be underwriters and vice versa, though this is not always the case.<sup>33</sup> As such, it will sometimes be wearing two hats. For example, when undertaking due diligence and verification, under the sponsor hat it is performing its regulatory and client obligations, but under the underwriter hat it is protecting its commercial interests in the deal. The two exercises are driven by different considerations but involve essentially the same tasks.<sup>34</sup> At other times the investment bank will clearly be wearing one or the other hat. Specific acts unique to the underwriter role include negotiating the terms of the underwriting agreement and

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<sup>29</sup> Not least, because a false declaration will be a breach of section 384 of the SFO, as well as creating potential issues for the continuing fitness and properness of the firm to engage in sponsor work.

<sup>30</sup> A bank that engages in sponsor work as a registered institution will also be subject to the regulatory oversight of the Hong Kong Monetary Authority although the SFC remains the lead regulatory for the industry.

<sup>31</sup> Listing Rule 3A.02 and 3A.17(1), and Code of Conduct 17.9(d).

<sup>32</sup> Para 17.9(c) and (d) of the Code of Conduct.

<sup>33</sup> E.g., WH Group and Kaisa IPOs 2014 and 2009 respectively.

<sup>34</sup> A sponsor is obliged to observe the requirements of Practice Note 21 of the Listing Rules. While underwriters are not subject to complying with the Listing Rules they will be aware of the elements that should form the basis of any comprehensive due diligence exercise, elements that flow out of a series of highly influential U.S. court decisions including in particular *Escott v BarChris Construction Corp* 283 F.Supp. 643 SDNY 1968, *Chris-Craft Industries v Piper Aircraft* 480 F.2d 341 2d Cir 1973, and particularly *Weinberger v Jackson* CCH Fed. Sec Law Rptr 95,693 N.D. Cal Oct. 11, 1990. The requirements of Practice Note 21 are in large part a codification of concepts and requirements enumerated in those cases.

agreeing the IPO pricing. Although the Listing Rules require an offer for subscription to be fully underwritten, underwriters are not themselves subject to specific IPO obligations toward the SEHK - it is the listing applicant's burden to procure satisfaction of the underwriting requirement. As a result the underwriter is commercially free to negotiate the terms of the underwriting - important as it must assume the financial risk of an under-subscribed offer.

Prospectus content is comprised of expert and non-expert sections. The expert sections of the prospectus are subject to express statutory provisions about the expert's liability. The sponsor is not regarded as an expert either for purposes of the CWUMPO<sup>35</sup> or for regulatory purposes<sup>36</sup> - experts make statements in a prospectus, a sponsor does not. The non-expert sections of the prospectus comprise disclosures by the company cum listing applicant, and these sections may contain information derived from third parties appointed by the company to advise it on specific issues. While such third parties will have particular areas of competence, such as solicitors, the disclosures made in the prospectus based on their advice are nevertheless disclosures of the company not the advisers. The sponsor has regulatory obligations to oversee, interrogate and generally drive the due diligence exercise in respect of both parts of the prospectus and will in the course of this undertaking advise the company. Nevertheless, as with the other non-expert parties involved in advising the company, its hand in the final product is invisible in that it makes no disclosures.

## **2.2 Prospectus liability**

Sections 40 and 342E of CWUMPO and sections 40A and 342F of CWUMPO<sup>37</sup> respectively provide for civil and criminal liability in respect of untrue statements<sup>38</sup> contained in a prospectus. Civil liability consists of liability to "persons who subscribe for any shares or debentures on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement included therein"<sup>39</sup> whereas criminal liability provides for imprisonment of up to 3 years and a fine of up to HK\$700,000<sup>40</sup>.

A number of persons are specifically identified in the CWUMPO as subject to liability under the civil provisions: directors<sup>41</sup>, promoters, and persons who have engaged in the authorization act.<sup>42</sup> Only persons under the last category are additionally subject to criminal liability, and it is this category that the SFC regards as applicable to sponsors.

The CWUMPO does not provide positive guidance as to who is to be regarded as authorizers; it provides only exemptions, i.e. who is not to be regarded as having given authorization for these purposes.<sup>43</sup> The CWUMPO therefore leaves open the question as to who is to be regarded as engaging in the authorization act. The company issuing the securities and receiving the proceeds of an offer is not expressly mentioned in the

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<sup>35</sup> Experts includes "engineer, valuer, accountant, and any other person whose profession gives authority to a statement made by him", per section 38C(3) of the CWUMPO.

<sup>36</sup> For example, see section 17.15(c) of the Code of Conduct.

<sup>37</sup> Sections 40 and 40A apply to securities of companies incorporated in Hong Kong whereas sections 342E and 342F apply to companies incorporated outside Hong Kong. The civil provisions were introduced in 1933, the criminal provisions in 1972; both remain unchanged as regards the phrase "authorized the issue of".

<sup>38</sup> Sections 41A and 343 of CWUMPO provide further interpretation of "untrue statement".

<sup>39</sup> Section 40(1) of CWUMPO.

<sup>40</sup> Section 40A(1) and the Twelfth Schedule of CWUMPO.

<sup>41</sup> Including any person who has authorized himself to be named and is named in the prospectus as a director or as having agreed to become a director either immediately or after an interval of time.

<sup>42</sup> Section 342F uses the wording "authorized the issue, circulation or distribution of the prospectus in Hong Kong".

<sup>43</sup> These exemptions are considered in Section 3.2.3 below.

CWUMPO yet its involvement in the issue of the prospectus is central. The express mention of the directors under the civil liability but not the criminal liability provision does not prevent them from also being regarded as engaging in the authorization act.<sup>44</sup> Given the breadth of the “authorizing the issue of” phrase, there is no reason to presume there could not be others who potentially engage in the authorization act. An understanding of the phrase therefore requires an examination of the legal interpretation of “authorization” and what that means specifically in conjunction with the “issue” of a prospectus. This is considered in Section 3 below where we will also return to the examination of the CWUMPO’s negating provisions.

As regards the SFC Position, what is clear is that for a sponsor to be subject to prospectus liability it will be necessary to establish that the acts a sponsor is required to engage in to fulfil its regulatory obligations (“**sponsor acts**”) amount to an authorization act. While sponsor acts undoubtedly render the sponsor fundamentally concerned in the preparation of the prospectus, it is not immediately apparent that sponsor acts are tantamount to authorization acts. That it is not clear is the origin of the SFC’s extensive public consultations on the matter since 2000. The next section reviews those consultations and the substantive analysis of authorization etc is dealt with in Section 3.

Before moving on it is worth briefly mentioning that a person “knowingly a party to the issue of a prospectus” that does not comply with certain requirements of the CWUMPO is subject to a fine<sup>45</sup>. This liability appears to be cast widely and it is likely that a sponsor could be regarded as a relevant person for these purposes. As those provisions do not require any authorization act, this area of liability is not relevant to the present investigation of the SFC Position.

### **2.3 The SFC’s public consultations**

The question of what degree of responsibility a sponsor should bear in an IPO is hardly a new one, nor unique to the Hong Kong market. The discussion in Hong Kong has been propelled by two primary and largely unchanging factors. First, that the undertaking of sponsor work impacts on the quality of disclosure to investors and so it is appropriate to impose sanctions on sponsors who fall short of expected standards. Second, it is the SFC’s preference that the sanctions available to be imposed on sponsors should include the statutory civil and criminal provisions of Hong Kong’s prospectus law. While the first factor is generally accepted, including among the investment banking community that engage in sponsor work, the second factor has given rise to much controversy.

While these two factors remain essentially unchanged, the role of and responsibilities placed upon IPO sponsors has been evolving while prospectus law remains unchanged.

Sponsor standards have been a subject of public consultation at least since 2000 when the SFC first proposed introducing a code of conduct that would cover corporate finance advisers and therefore sponsor work.<sup>46</sup> In 2001 the SFC concluded that “it was generally felt that sponsors should assume greater responsibility in ensuring a fair and orderly market during such offers” (i.e. IPOs) and that there was “a general expectation from the market that the SFC will regulate the conduct of sponsors during public offers.”<sup>47</sup> The

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<sup>44</sup> I.e. the list of persons in section 40 is not necessarily a mutually exclusive one.

<sup>45</sup> Sections 38 (language and content requirements), 38C (expert consent) and 38D (registration requirements) of the CWUMPO. To the extent that the omission of required disclosures renders a prospectus false or misleading, liability under sections 40 or 40A, or 342E or 342F will also become relevant.

<sup>46</sup> “A Consultation Paper for the Proposed Corporate Finance Adviser Code of Conduct”, SFC, May 2000

<sup>47</sup> “Corporate Finance Adviser Code of Conduct Consultation Conclusions”, SFC November 2001 pages 3 and 16 respectively.

code came into effect on 1 December 2001 and under the heading "Role of sponsor in a public offer" provided that sponsors

"should be responsible for:

- (a) the overall management of the public offer;
- (b) assessing the likely interest in, or the reception of, the offer by the public; and
- (c) putting in place sufficient arrangements and resources to ensure that the public offer and all matters ancillary thereto are conducted in a fair, timely and orderly manner."<sup>48</sup>

The specific issue of the statutory liability of sponsors was not publicly consulted on until 2003, subsequently giving rise to seven papers that the SFC has published on the matter from 2003 to 2014.<sup>49</sup> It is significant that the subject of all of these consultations has been the extension of prospectus liability to sponsors, or at least the need to clarify the extent of the existing provisions. Although this issue has been under close scrutiny and discussion for over 10 years it was not until the SFC 2014 Conclusion paper was issued that the SFC adopted the position that sponsors are subject to prospectus liability under the current legislation without any need to make amendments or clarifications thereto.

### 2.3.1 2003 Consultation

In January 2003 in response to perceived falling standards in Hong Kong's IPO market, the Government initiated a joint "Corporate Governance Action Plan for 2003" that was agreed between itself, the SFC and the SEHK. In view of concerns to ensure the quality of disclosure to investors the Action Plan envisaged "the introduction of proposals to extend the statutory liability for material misstatements in prospectuses to IPO sponsors" and that this "would involve making amendments to" sections 40 and 40A of the CWUMPO.<sup>50</sup> As part of this initiative, the SFC proposed to the Standing Committee on Company Law Reform ("**SCCLR**") that the statutory civil and criminal liability for misstatements in prospectuses be extended to IPO sponsors.<sup>51</sup> This proposal was also mentioned in a joint consultation paper issued by the SFC and SEHK in 2003.<sup>52</sup> In that consultation paper, it was noted in passing that there is an argument that sponsors (and underwriters) may already be liable under the prospectus law as promoters although this line of thinking was not followed.<sup>53</sup> Clarifying the extension of statutory liability to sponsors might take some time to achieve and it was suggested, as an interim measure, that sponsors and underwriters be required to authorize a statement in the prospectus as to the due diligence they had undertaken. This would have involved the introduction of a regulatory requirement that sponsors actually sign the prospectus. The SFC's view at that time seems to have been that if a sponsor (or lead underwriter) signed the prospectus then it would be held to be authorizing its issue.<sup>54</sup>

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<sup>48</sup> Rule 5.3 Corporate Finance Adviser Code of Conduct", SFC December 2001.

<sup>49</sup> In summary: May 2003 consultation paper; October 2004 consultation conclusions; June 2005 consultation paper; April 2006 consultation conclusions; May 2012 consultation paper; December 2012 consultation conclusions; and August 2014 supplemental consultation conclusions. All are available on the SFC website [www.sfc.hk](http://www.sfc.hk)

<sup>50</sup> Pages 14 and 16, respectively, of the 2003 Action Plan.

<sup>51</sup> See Chapter 10 of the Nineteenth Annual Report of the Standing Committee on Company Law Reform 2002/2003

<sup>52</sup> See paragraph 42 of Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers May 2003

<sup>53</sup> Any such argument would only work in relation to civil liability under section 40 of the CWUMPO as promoters are not a class of persons recognized for the purposes of the criminal liability provisions of section 40A. In any event, it is not relevant to the current SFC Position.

<sup>54</sup> See paragraphs 153 – 160 of Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers May 2003

The SCCLR declined to endorse the SFC's proposal to amend the then Companies Ordinance (now the CWUMPO) and suggested that it would be better to deal with the issue using the SFC's regulatory powers - sponsors involved with dishonest prospectuses should have their licences revoked. The SFC's proposal that a sponsor (or lead underwriter) sign the prospectus and thereby bring itself under the scope of the authorisation concept was also not adopted. It was at this point that the requirement that the sponsor make a declaration to SEHK in relation to the due diligence it has carried out was adopted, i.e. the Appendix 19 declaration.<sup>55</sup>

### **2.3.2 2005/2006 Consultation**

The SFC consulted the market again on the issue of sponsor liability in 2005.<sup>56</sup> The SFC's view in 2005 was that the central role sponsors play in an IPO provides "justification to add sponsors to the parties liable for the prospectus" - the obvious implication being that the SFC did not then consider sponsor acts to amount to an authorization act, at least not clearly so since at that time the SFC also considered that the scope of the authorization concept was insufficiently certain. Whether the concept might capture major shareholders, guarantors or even persons stated in the prospectus to be responsible for that document was unclear. The SFC therefore proposed to amend the legislation to remove the authorization concept altogether and state clearly that sponsors are liable for the contents of a prospectus. In the SFC's own words "the proposed extension of liability to sponsors was one of the most controversial topics" of the 2005 Consultation paper - a majority of the respondents were against the proposal. In the (pre-Global Financial Crisis) environment of 2005, the SFC was persuaded by these respondents and dropped the proposal. The main factor that appeared to influence their decision not to take the proposal forward was that a new regulatory regime for sponsors was about to be introduced (the "Sponsor Guidelines"<sup>57</sup> which were subsequently substantially amended following the 2012 consultation).

### **2.3.3 2012 - 2014 Consultation**

The issue of sponsor liability was consulted on again in 2012.<sup>58</sup> Of course the regulatory landscape had significantly changed in the period between 2005 and 2012. The Global Financial Crisis (the most visible result of which in Hong Kong was the Lehman Brothers minibond saga<sup>59</sup>) had resulted in an expectation that regulators would take a much more active approach to the oversight of the financial markets - and be given appropriate powers to do so. The Hong Kong IPO market had suffered a number of scandals - the low point being the Hontex IPO in 2009 sponsored by Mega Capital (Asia) Company Ltd, which resulted in IPO proceeds of HK\$832 million being frozen and returned to investors, and the sponsor being stripped of its license and fined HK\$42 million. It is against this background that the SFC proposed to amend the CWUMPO to make it clear that sponsors would be both civilly and criminally liable for misstatements in prospectuses. Again citing the SFC, "certainty as to the meaning and scope of any liability regime is essential and is in the public interest". The SFC also flagged three other issues relating to the criminal and civil liability provisions in the CWUMPO that, at the time, it felt merited review. These were (1) the alignment of the scope of the criminal and civil provisions, (2) modification of the tests for civil and criminal liability and the relevant defences, and (3) the issue of whether it should be necessary to demonstrate reliance (i.e. actually having

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<sup>55</sup> See Paragraph 32 of Consultation Conclusions on the Regulation of Sponsors and Independent Financial Advisers October 2004

<sup>56</sup> Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance, August 2005 (see Proposal 8).

<sup>57</sup> Set out in Appendix 1 of the SFC's Fit and Proper Guidelines.

<sup>58</sup> Consultation Paper on the regulation of sponsors, May 2012

<sup>59</sup> For a summary, see AIIFL Working Paper No. 4, available at [www.AIIFL.com](http://www.AIIFL.com)

read the prospectus and purchased in the primary market only) as a prerequisite to civil liability.<sup>60</sup>

It indicated then (in May 2012) that a separate consultation paper would be issued to consider these issues.

The 71 responses to this consultation made publically available on the SFC's website<sup>61</sup> indicated that respondents were divided on the issue of whether sponsors should be made liable under the CWUMPO provisions. Perhaps unsurprisingly, investment banks and legal advisers representing them tended to be against while those on the 'buy side' tended to be for sponsor liability.<sup>62</sup>

The main conclusions to the 2012 consultation were issued in December 2012 (the "**December 2012 Conclusions**"). The SFC's position in those conclusions was that "diverging views and the lack of case law on the issue demonstrate the need to clarify whether sponsors are subject to existing civil and criminal prospectus liability provisions"<sup>63</sup> and they proposed to amend s.40, s.40A and s.342F of CWUMPO to put the liability of sponsors beyond doubt.

The regulatory changes set out in the December 2012 Conclusions came into effect on 1 October 2013. It was indicated that the changes to the CWUMPO that the SFC considered (at that time) necessary would follow a separate timetable required for amending primary law.

The SFC also noted in the December 2012 Conclusions<sup>64</sup> that the existing criminal liability provisions reverse the usual burden of proof and contain no *mens rea* element. Under the existing provisions, the prosecution only has to prove that a prospectus contains an untrue statement, and in response the defendant then has to establish that he had reasonable grounds to believe the statement or that it was not material, to avoid liability. The effect of this is to remove any *mens rea* element from the criminal offence of issuing a misleading prospectus. The SFC indicated that these issues would be addressed and the criminal provisions would be amended to include a *mens rea* element by requiring the prosecution to prove that the person authorizing the prospectus knew the statement was false or was reckless to the truth of the relevant untrue statement. The December 2012 Conclusions did not mention again the three issues stated above that the SFC had indicated would also be included in a separate consultation, however, the natural expectation was that they would also be revisited during the CWUMPO amendment process.

When responding in the December 2012 Conclusions to market views that sponsors, although they assist with its preparation, should not be responsible for the contents of a prospectus, the SFC referred to the Appendix 19 declaration requirement as evidence that a sponsor should be responsible.<sup>65</sup> The SFC did not at that time make the shift to their current views that no clarification of the CWUMPO is required.

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<sup>60</sup> See paragraph 129 of Consultation Paper on the regulation of sponsors, May 2012

<sup>61</sup> Both English language and Chinese language responses accessed in April and May 2015.

<sup>62</sup> The authors could find only one response which expressed the view that sponsors are already liable under the existing CWUMPO provisions.

<sup>63</sup> Paragraph 39, Consultation Conclusions on the regulation of IPO Sponsors, SFC December 2012.

<sup>64</sup> See paragraph 40 of Consultation Conclusions on the regulation of IPO sponsors 12 December 2012

<sup>65</sup> See paragraph 270 of Consultation Conclusions on the regulation of IPO sponsors 12 December 2012

### 2.3.4 August 2014 Supplemental Conclusions

Although the SFC 2014 Conclusion was issued as supplemental conclusions to the May 2012 consultation, they appear to depart from, rather than build on, the prior consultation exercises, other than to state its view “that its original position in the Consultation Paper – that sponsors are already covered under the existing law – is correct.”<sup>66</sup> The SFC had reassessed its position in relation to the need for legislative amendments and, after consultation with “industry participants and other interested parties”,<sup>67</sup> had concluded that (1) “no amendments are required to specify sponsors as a separate category of persons who authorize the issue of a prospectus because they are already covered by the broader category of potentially liable persons under the CWUMPO” and (2) “the proposed legislative amendments need not be pursued as they would serve no purpose”. The SFC seems largely to have reached this conclusion on the basis of the requirement under Listing Rule 3A.13 that a sponsor must make the Appendix 19 declaration, and more generally to a sponsors “functions, duties and obligations”.<sup>68</sup>

## 2.4 Other jurisdictions

Before moving on to an analysis of the SFC Position it is worth briefly noting the position in other jurisdictions that employ a sponsor (or similar) concept.

The Hong Kong position is similar to that in the UK where sponsors are required for Premium Listings on the London Stock Exchange and the UK Listing Rules require them to make a submission similar to the Appendix 19 declaration.<sup>69</sup> While the UK’s Financial Conduct Authority (“**FCA**”) has not made a position statement similar to the SFC, there is a view that UK sponsors may be potentially liable to investors under s.90 FSMA for loss suffered as a result of misstatements in prospectuses as a persons who authorize their contents. Sponsors will routinely disclaim this liability and, although untested in the courts, this disclaimer is generally considered by the market to be effective. There is no criminal liability for sponsors in the UK.

The UK Prospectus Rules also contemplate a wider group of persons who could be “responsible for the prospectus” as authorizers but this is tied to authorizing “the contents of the prospectus”.<sup>70</sup> It will be noted that this authorization is directly connected with content, not the issue of the prospectus as is done in the CWUMPO, and it remains unclear how sponsors may or may not be treated differently under these differing provisions. As in Hong Kong, sponsors in the UK are also not regarded as experts, nor do they appear to be regarded as professional advisers. It has been observed that, although the Prospectus Rules issued by the FCA states that “Nothing in the rules in this section is to be construed as making a person responsible for any prospectus by reason only of the person giving advice about its contents in a professional capacity”,<sup>71</sup> this does not exclude sponsors.<sup>72</sup> While this may be correct, it

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<sup>66</sup> SFC Consultation Paper, para 12. The statement refers to the 2012 Consultation Paper

<sup>67</sup> It is noteworthy that these consultations were not made public. If new changes were to be proposed that were not mentioned in the first round of consultations then a further public consultation would be procedurally appropriate. However, in this case the position adopted by the SFC about the existing law suggests a further public consultation may not be required.

<sup>68</sup> Paragraph 13 of the SFC 2014 Conclusion.

<sup>69</sup> UK Listing Rule 8.4.3R

<sup>70</sup> Rule 5.5.3R(2)(f).

<sup>71</sup> Rule 5.5.9. It seems likely that the reference to ‘professional capacity’ is intended to extend to persons regulated by designated professional bodies and recognized professional bodies for the purposes of the Prospectus Rules, i.e. solicitors, accountants, actuaries, conveyancers and surveyors.

<sup>72</sup> See Davies and Worthington, “Gower and Davies Principles of Modern Company Law” 9ed 2012, paras 25–35 at page 935.

would be fallacious to suggest that not exempting sponsors under this provision means that they are liable – a positive basis for liability is still required to be demonstrated.

In contrast, in Singapore, the Issue Manager is subject to both criminal and civil liability by virtue of express provisions in sections 253(4)(d) and 254(3)(d) of the Securities and Futures Act (cap. 289), respectively.<sup>73</sup> The Act differs from CWUMPO in two relevant regards: it requires the consent of the Issue Manager for the registration of the prospectus, and specifies that for liability to arise the Issue Manager must be named in the prospectus and must have, *inter alia*, made the false or misleading statement or omission with knowledge or intention, or recklessly.

In Canada, companies seeking a listing on the Toronto Stock Exchange (both TSX, the main market, and TSXV, the venture exchange) must generally appoint a member of the exchange to sponsor their application. The sponsor's role is a regulatory one similar to that of a Hong Kong sponsor.<sup>74</sup> In particular, the TSX listing rules require a sponsor to provide a "Sponsors' Report" to the exchange which serves a similar function to the Appendix 19 declaration. There does not appear to be any statutory recognition of sponsors – the statutory liability provision makes no reference to sponsors. In contrast, underwriters of Canadian offers are required by statute to provide a certificate relating to the disclosure in the prospectus and have express civil liability under statute.

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<sup>73</sup> The Act also provides liability for underwriters.

<sup>74</sup> See section 326 of the TSX Company Manual and Policy 2.2 of the TSXV Corporate Finance Manual.



### 3. DECONSTRUCTING THE SFC POSITION

The brevity of the SFC 2014 Conclusion leaves the market with only sweeping statements that link the performance of a sponsor's regulatory obligations to the authorization act. This leaves very little in the conclusion paper that provides detailed guidance as to the legal basis for the SFC's views, and equally little to analyze and assess. As mentioned in the SFC 2014 Conclusion, there is also an absence of case law on the subject.

Previous rounds of the SFC's public consultations have circled around the question of clarifying the CWUMPO authorization act provision and the issue of whether sponsors should or should not be subject to prospectus liability under that category. As a result, those consultations have not presented any developed arguments that support the view that sponsors engage in the authorization act. Against this backdrop, any analysis of the SFC Position requires some care to avoid reading too much into it. The approach taken in this Section is therefore more of an investigation, in some ways akin to the due diligence exercise undertaken by a sponsor when considering statements for inclusion in a prospectus and assessing whether there is a reasonable basis for the statement or considerations which cast doubt on it.<sup>75</sup>

The SFC Position does not appear to be that a sponsor could be subject to prospectus liability in some cases but not others – if it were so, it would be open to a court to make a determination in the usual manner, possibly finding that some sponsors have engaged in the authorization act whereas others have not. Rather, the SFC Position appears to be that sponsors are always subject to liability because they invariably are persons who authorize the issue of a prospectus. However, the precise source of this tenacious liability remains unclear. While the SFC 2014 Conclusion has noted the sponsors "specific duties", the Appendix 19 declaration, and its "other functions, duties and obligations",<sup>76</sup> this leaves it open to question whether the sponsor is to be regarded as engaging in the authorization act because of the nature of the sponsor role itself, certain acts normally engaged in by the sponsor, or some combination of the foregoing. This gives rise to three lines of enquiry:

**First:** given that the sponsor role is created by non-statutory regulations and is not specifically provided for in the legislation, does the law through some other mechanism recognize this regulatory functionality? This requires a consideration of the scope and nature of the relationship between non-statutory regulations and statute. This is explored in Section 3.1.

**Second:** what is the scope of "authorized the issue of" for the purposes of the CWUMPO, and how might sponsor work fall within that scope? This is explored in Section 3.2.

**Third:** as the preparation and approval to issue an IPO prospectus is a highly structured exercise driven as much by regulatory requirements as it is by legal considerations, what other matters of practice may be relevant to consider as regards the authorization act and the SFC Position? This is explored in Section 3.3.

In each of Sections 3.1, 3.2 and 3.3, a central point of the investigation is to understand more specifically the source of prospectus liability. Before moving on, it is worth clarifying some fundamental points of orientation, none of which should be contentious.

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<sup>75</sup> Compare the SFC's Code of Conduct para 17.6(c).

<sup>76</sup> Paragraph 11 of the SFC 2014 Conclusion.

- Status of statutes: the CWUMPO is statutory law. As such, the construction of what constitutes an authorization act is to be determined by the normal principles of statutory interpretation.
- Not a singularity: there is nothing in principle that prevents an authorization act from being comprised of different types of actions undertaken by different people, either acting together or acting separately.
- Sponsor acts and non-sponsor acts<sup>77</sup>: the primary focus of investigation is whether sponsor acts amount to an authorization act, however, this does not imply that any non-sponsor acts that sponsors typically engage in as a matter of market practice and as part of executing their sponsor appointment are not capable of amounting to an authorization act.
- Other acts of the sponsor: sponsors typically undertake other roles in relation to an IPO, such as underwriting, but any acts undertaken in that other capacity, being outside the scope of the sponsor role, are irrelevant for the purposes of the sponsor liability issue.
- Preparatory acts: certain acts are by their nature preparatory insofar that they put a third party in the position to undertake a transaction (e.g. a listing applicant to issue shares in an IPO), however, for the purposes of the CWUMPO, there may be relevant relationships, distinctions and overlaps to be made between, for example: preparation, approval, consent, enabling, authorization and issue. This is not to say that any such matters are always clear-cut and they will in any event need to be applied in the context of the various roles undertaken by parties involved in an IPO.

### **3.1 Relationship between law, regulation and the sponsor concept**

What is the legal source of a sponsor's alleged prospectus liability? To some extent, the SFC Position may appear to suggest that it arises out of regulatory considerations, or actions undertaken as a result of regulatory requirements, though exactly how is not clear.

The relationship between law and regulation has often been unclear and a source of misunderstanding. A useful window on the problem was provided in the late 1980's in the United Kingdom. A significant body of securities market regulation was being developed pursuant to the Financial Services Act 1986, however, many of the new rules created were found to be in conflict with the substance of fiduciary law, creating a real problem for financial intermediaries as to how they should conduct their daily activities, and to which standards they were to be held accountable. The UK Law Commission examined the problem at length and considered four options under which the law could take account of regulation:

- by providing for safe harbours, meaning that compliance with a regulatory rule would constitute a defence to a legal action;
- by regarding the law and regulation as separate spheres of operation, neither having an any effect on the other;

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<sup>77</sup> As defined in Section 2.2, sponsor acts mean the acts a sponsor is required to engage in to fulfill its regulatory obligations. Where a sponsor is undertaking multiple roles, such as sponsor and underwriter, it is important to distinguish whether an act is being undertaken as a sponsor or as an underwriter, i.e. as discussed in Section 2.1.1.

- by restricting regulatory rule making powers to a replication of existing law; and/or
- by providing that regulations should be taken into account by courts in determining the relevant law.<sup>78</sup>

It is against this backdrop that one can turn to the means by which the relationship between law and securities regulation has more recently been handled in Hong Kong. The introduction of the SFO in 2003 empowered the SFC to make rules in the form of subsidiary legislation as well as regulations in the form of non-statutory codes. This rule and code making ability is a centrepiece of regulating the securities and futures markets and comprise a significant means by which products, transactions and intermediaries (including sponsors) in the Hong Kong market are regulated. In contrast, the CWUMPO is an older piece of legislation that was first put in place prior to the establishment of the SFC and its forerunners<sup>79</sup> and at a time when the securities industry in Hong Kong was effectively unregulated. Unlike the SFO, the CWUMPO was not designed in the framework of modern regulatory architecture and so does not contemplate regulatory spheres of action. Moreover, the supervision of Hong Kong's exchanges has historically been governed separately and independently of the CWUMPO, the prospectus requirements of the CWUMPO previously being handled by the Registrar General's Department.<sup>80</sup>

Given this background and the history of the sponsor role as earlier discussed, it is unsurprising that while the sponsor is created by and primarily subject to non-statutory regulations it is not specifically contemplated by the CWUMPO. It is therefore meaningful to ask whether the law may in other ways expressly recognize or incorporate the sponsor concept or its responsibilities.

The Code of Conduct states "This Code does not have the force of law and should not be interpreted in a way that would override the provision of any law."<sup>81</sup> This is generally accepted as meaning that, even though the SFC's regulatory codes have been issued pursuant to powers given to the SFC under the SFO,<sup>82</sup> breaches of the codes do not per se give rise to judicial or other proceedings. For example, in the context of sponsor work the SFC has confirmed that where a sponsor breaches its due diligence obligations under the Code of Conduct, this does not in itself trigger civil or criminal liability.<sup>83</sup> This reflects the general rule that regulations are not capable of affecting the law, save to the extent the law itself provides otherwise. It follows that mere compliance with a regulatory obligation cannot in itself give rise to any legal liability unless an act recognized by the law is also undertaken. Of course, the foregoing does not imply that actions undertaken for regulatory purposes cannot give rise to legal effects or consequences.

In the private law context, the court has recognized that the SFC's regulatory codes are incapable of overriding express contractual provisions.<sup>84</sup>

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<sup>78</sup> Consultation Paper No. 124 "Fiduciary duties and regulatory rules" 1992, see paras 6.17 to 6.20.

<sup>79</sup> The SFC was established in 1989, its precursors, the Securities Commission and Securities Trading Commission, in 1974 and 1976 respectively.

<sup>80</sup> The Securities (Stock Exchange Listing) Rules introduced in 1986 brought listing applications within the purview of the Securities Commission. See paras 11.20-21 of the Report of the Securities Review Committee 1988 (the 'Hay Davison Report').

<sup>81</sup> See the Explanatory Notes to the Code of Conduct. Similar statements are found in the SFC's other codes.

<sup>82</sup> Sections 169 and 399 of the SFO.

<sup>83</sup> SFC's 2012 December 2012 Conclusions, para 281.

<sup>84</sup> See *Kwok Wai Hing Selina v. HSBC Private Bank (Suisse) SA* [2012] HKCFI 964; [2012] 4 HKC 260; HCCL 7/2010 (21 June 2012) at 133-135  
<http://www.hklii.hk/eng/hk/cases/hkcfi/2012/964.html>

The SFO specifically contemplates the duties of certain persons in connection with listing work,<sup>85</sup> but not sponsors.

The SFO does provide that the SFC's codes are admissible in court as evidence where it appears relevant to any proceeding under the SFO.<sup>86</sup> To the extent that SFC regulatory codes recognize sponsors, the sponsor concept and the obligations imposed on it conceivably could become relevant to a court proceeding, but only in relation to a proceeding under the SFO. There is no corresponding provision in the CWUMPO.

In contrast, the Listing Rules (which create the sponsor concept) do not enjoy the foregoing admissibility status, even though they are also made pursuant to powers (given to the SEHK) under the SFO.<sup>87</sup>

The Listing Rules do have a measure of statutory backing by virtue of the SMLR. The SMLR is subsidiary legislation to the SFO<sup>88</sup> and is the basis of the dual filing regime, but it is not concerned with sponsors. The SMLR provide for, inter alia, certain requirements and procedures connected with applications for listings on the SEHK, its focus being on the "applicant", meaning "a corporation or other body which has submitted an application under section 3"<sup>89</sup> – as section 3 refers to "An application for the listing of any securities issued or to be issued by the applicant", the term "applicant" must exclusively mean the company cum listing applicant, not any person (such as a sponsor) who might submit the application form on its behalf.<sup>90</sup>

### **3.2 'authorized the issue of'**

To this point, there appears to be nothing that brings the sponsor concept within any contemplation of the CWUMPO or any other relevant law. The focus of this Section is whether the acts of a sponsor amount to it engaging in the authorization act. As the CWUMPO does not itself provide positive guidance on what constitutes an authorization act it is necessary to consider (1) the general law of authorization and (2) the usual IPO authorization processes, (3) the negative guidance of the CWUMPO and (4) possible wider meanings of the authorization act phrase, (5) relevant case law, (6) analogous statutory provisions, and (7) relevant academic literature.<sup>91</sup>

Before doing so, it is worth noting the composite nature of the phrase comprised in the authorization act: there must be an act that amounts to having "authorized", and that act must relate to "the issue of" a prospectus. As there seems to be no particular controversy in Hong Kong surrounding the "issue" part of this composite,<sup>92</sup> this analysis focuses on the meaning of "authorized". According to the Oxford English Dictionary<sup>93</sup> "authorize" means "sanction; ... give authority to". How this might apply to sponsors is explored in the next sections - the starting point is a narrow, or standard, reading of the phrase under the general law on authority-based agency before examining potential wider readings of the phrase.

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<sup>85</sup> Solicitors and certified public accountants, see sections 23 and 24 SFO.

<sup>86</sup> See sections 169(4) (concerning fitness and properness) and 399(6) SFO (of more general application).

<sup>87</sup> Section 23 of the SFO.

<sup>88</sup> Made by the SFC pursuant to section 36(1) of the SFO.

<sup>89</sup> Section 2 of the SMLR.

<sup>90</sup> The language of the SEHK's form of listing application (Form A1) when submitted by the sponsor is that the sponsor is "instructed by [the issuer company] to make an application for the listing" – see Appendix 5 of the Listing Rules.

<sup>91</sup> All searches were conducted using the databases of LexisNexis and Westlaw and encompassed Hong Kong, the United Kingdom, Canada, Australia, Ireland and the United States.

<sup>92</sup> In other markets, a re-sale structure might be employed or an offering is made "on behalf of" the company as issuer.

<sup>93</sup> Sixth edition, 1976.

### 3.2.1 The general law on authorization

Various sections of the CWUMPO confirm that a prospectus may be issued “by or on behalf of a company”.<sup>94</sup> For a person to authorize the issue of a prospectus on behalf of a company, the general law would require that such person have the authority to do so, which may be actual, implied or ostensible authority.

Actual authority requires a legal agreement between the principal and its agent.<sup>95</sup> As sponsor agreements are not required to, and do not normally, include any provision authorizing the sponsor to issue the prospectus on behalf of the company, sponsors cannot be regarded as agents having actual authority in that regard. While the Listing Rules require certain provisions to be included in the sponsor agreement (see above) none of them can be construed as granting a legal authority as aforesaid.

Neither ostensible authority nor usual (or implied) authority requires agreement between the principal and the agent. Ostensible authority arises where the principal (i.e., the listing applicant) makes a representation to a third person, that is intended to be and is in fact relied on, that the agent (the sponsor) has authority to bind the principal within the scope of their apparent authority<sup>96</sup>. In contrast, usual authority arises from the position the principal has put the agent in, sometimes described as the principal clothing the agent with apparent authority<sup>97</sup>, the scope of which is determined by the general commercial understanding prevalent at that time and place. Whether ostensible or usual, the authority is necessarily limited, by the nature of the representations made in the former case, and by the usual commercial understanding in the latter case.

If it were to be asserted that a sponsor has ostensible authority to authorise the issue of a prospectus, i.e. on behalf of the relevant company, it would be necessary to show that a representation had been made and relied on. A listing applicant generally represents to third parties, and it is well understood in the market, that a firm appointed to act as sponsor is authorized to undertake the acts that a sponsor is normally expected to in connection with a listing application; for example, its authority to engage in due diligence meetings, raise queries, interact with experts and the listing applicant’s professional advisers, and so on. This also includes all the matters the sponsor is required to do to satisfy its regulatory obligations, including submission of the Appendix 19 declaration. There is nothing in this scope of authority that necessarily, or in fact does, bring with it the power to issue the prospectus in the company’s name. This becomes apparent when one considers the usual sequence of events and corporate procedures that are undertaken in the final stages of an IPO process, which will also assist a better understanding of a sponsor’s position as regards its usual authority.

### 3.2.2 IPO process

There is no argument that a sponsor’s role, properly undertaken, is part of the critical path to a listing document cum prospectus being finalized and issued, i.e. the ‘critical path’ being a set of functions that, if not undertaken, implies the IPO cannot be completed. As the sponsor continues its work related to the listing document cum

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<sup>94</sup> See sections 37, 38 and 38D. It may also be noted that there are no general restrictions at law on a company from doing so, either in Hong Kong or, generally, other jurisdictions in which issuers listed on the SEHK are incorporated, and is subject only to the relevant approval and authorization procedure.

<sup>95</sup> For example, see *Freeman & Lockyer (A Firm) v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 per Diplock LJ at pp 502-503

<sup>96</sup> *Freeman v Lockyer*, op cit, at p.503. Ostensible authority may also cause an agent’s authority to be extended beyond any actual authority possessed by the agent.

<sup>97</sup> For example, see *First Energy (UK) Ltd v International Bank Ltd* [1993] BCLC 1490 per Steyn LJ at 1418.

prospectus, and as one moves closer to the finalization of the document, it may be asked at what point does the sponsor reach the limit of any actual, ostensible or usual authority that it possesses?

Key milestones in a typical Hong Kong IPO transaction are:

- Submission of the A1 listing application form to SEHK together with an Application Proof of the prospectus (an "AP"). The AP is a "substantially complete" draft of the listing document cum prospectus required<sup>98</sup> by the Listing Rules to be submitted and made public at this first formal stage. It is not, however, a prospectus for the purposes of the CWUMPO as there is no public offer at this stage and extensive redactions are made to the publication version of the AP to ensure it does not comprise an offer of shares.
- Listing Hearing. After completion of the vetting process the issuer's application will be heard by the Listing Committee. The timing of the hearing will usually be agreed between SEHK and the sponsor (acting on behalf of the issuer – see below). A successful hearing results in a conditional approval of the listing, one of the conditions for listing being the submission of the Appendix 19 declaration. The SEHK will in due course provide the issuer with an authorisation to register the prospectus.
- Board meeting. Immediately following a successful listing hearing the issuer will hold a board meeting (usually referred to as the "Long Board Meeting") at which it considers all material matters relating to the IPO and makes the formal decision to proceed. The sponsor will be in attendance at this meeting and its contribution may well be noted by the directors - although they may rely on guidance and advice from the sponsor, the decision to register and issue the prospectus will be made by the Board alone.
- Publication of the post hearing information pack (PHIP). The underwriters will commence the book-building process, marketing the shares to institutional investors.
- Registration of the prospectus. The prospectus is registered and the public offer is launched.
- Pricing. At the end of the marketing phase the underwriters and the issuer will agree the final offer price.
- Commencement of trading. The underwriters typically have until the morning prior to the commencement of trading to terminate the offering, however, any termination would not retrospectively "un-authorize" or "un-issue" the prospectus and so has no bearing on the authorization issue.

This sequence of events is well known to the IPO marketplace and is relevant to consider as regards the scope of the sponsor's authority.

During the application and vetting process the direct line of communication will be between the SEHK and the sponsor. Typically the issuer's board will pass a resolution prior to the A1 application to expressly authorise the sponsor to liaise with SEHK on its behalf and the sponsor will liaise with SEHK under this actual authority derived from the issuer. This authority will generally be limited to dealing with SEHK. The approval of the final form of the prospectus for registration will be expressly carved out from this authorisation and will be given by the Board itself at the Long Board Meeting.

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<sup>98</sup> Since the amendment of the regime in October 2013.

Notwithstanding the delegation to the sponsor of communication with SEHK, both the sponsor and the SEHK will be very wary as to not to allow the limits of this authority to be exceeded. For example, the sponsor will submit a standard form M104 with the A1 application that will set out prescribed additional information the SEHK requires to be included with the application. Before submitting this form, the sponsor will obtain an express back-to-back confirmation of the information included and an authority to submit this document.

Similarly, it is common for SEHK to request the applicant to provide a direct confirmation of information submitted by the sponsor on the applicant's behalf that the SEHK regards as unusual or material in nature.

These practices illustrate that the SEHK from time to time looks past the sponsor's functional role, and its role as the listing applicant's agent, which serves to underline the inherent limitations of the sponsor role in both those regards.

In view of the foregoing, the authority of the sponsor to act on behalf of the listing applicant in the transaction process is tightly controlled: while it is authorized to communicate with the SEHK, the authority expressly does not extend to the authorization of the registration or the decision to issue the prospectus. This reflects two quite different aspects of an IPO that a company cum issuer is concerned with: meeting the legal and regulatory requirements associated with the offer and listing on the one hand, and satisfying its corporate approval processes on the other.

### **3.2.3 Negative guidance**

Certain persons are regarded by the CWUMPO as not having authorized the issue of the prospectus. Since such persons may, but for the carve-out, possibly be regarded by CWUMPO as persons who have engaged in the authorization act, this could provide qualified guidance as to what the CWUMPO regards as giving rise to the authorization act.

The first group of persons are experts, who are in a special position as the CWUMPO requires (1) certain expert reports to be included in every prospectus<sup>99</sup> and (2) the consent of every expert that makes a statement in the prospectus to be given (and not withdrawn) before a prospectus can be issued.<sup>100</sup> Sections 40(1) and 342(E) of the CWUMPO provide that experts can be civilly liable as persons who authorize the issue of a prospectus but only in respect of untrue statements made by that expert. The criminal liability provisions of sections 40A(2) and 342F(2) of the CWUMPO go further, providing that experts will not by virtue of giving the required consent be deemed to have authorized the issue of a prospectus, whether or not the expert's statement contains an untrue statement. Consent-based defences therefore only arise in the civil context. The policy reason for this position seems based on a disclosure principle that could be said to follow on from a long line of cases which perhaps can be traced back to Lord Denning's dissenting judgment in *Candler v Crane, Christmas & Co*<sup>101</sup>, namely, that the expert has prepared statements knowing that others may rely on them. There is no corresponding policy based line of thinking that gives rise to criminal provisions, other than where fraud is concerned.

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<sup>99</sup> Third Schedule of the CWUMPO. E.g. the report by the auditors of the company.

<sup>100</sup> Sections 38C(1) and 38D(3)(a) of the CWUMPO.

<sup>101</sup> *Candler v Crane, Christmas & Co* [1951] 2 KB 164

Taken together, these provisions suggest that an expert's statutorily required consent could (but for the carve-outs) amount to an authorization act, drawing a close relationship between consent and authorization qua sanction.<sup>102</sup>

The second group of persons subject to a carve-out under the CWUMPO are the SFC, SEHK and HKEx when performing certain statutory functions. Sections 38D and 342C of CWUMPO specifically require every prospectus to be authorized by the SFC. The SFC has transferred this power to the SEHK where a prospectus is issued in connection with a listing on the SEHK<sup>103</sup> (under the "Securities and Futures (Transfer of Functions – Stock Exchange Company) Order" (the "**Transfer of Functions Order**"). Sections 40(1A), 40A(3), and 342F(3) of the CWUMPO specifically carve out the SFC, SEHK and HKEx by providing that they will not be regarded as having authorized the issue of a prospectus where they are undertaking functions derived from the statutory provisions of the CWUMPO. As this is an express statutory authorization function it does not appear to be of any immediate relevance to the sponsor question.

What will be noted from these carve outs for experts and the regulatory bodies is that, while each of them may be required to act in accordance with or comply with regulatory rules that affect the progress of an IPO transaction,<sup>104</sup> the carve outs are provided in respect of specific roles they perform pursuant to statutory, not regulatory, requirements.<sup>105</sup> There is no suggestion in the negative guidance provided by the CWUMPO that any regulatory considerations affecting these persons give rise to a deemed authorization argument (i.e. that would necessitate a statutory carve-out) – this is unsurprising given the chronology of the relationship between laws and securities regulation and the relative age of the CWUMPO.<sup>106</sup>

### 3.2.4 Narrower and wider meanings

Nevertheless, it is also clear from the foregoing that the authorization act is not always to be construed narrowly under the CWUMPO, i.e. as a singular act of authorization, in the sense of directing (so as to make happen) the actual issue of a prospectus. To the extent one accepts that experts engage in an authorization act because of the specific way the CWUMPO operates in this regard, it must also be accepted they do not have the power to direct the issue to happen in this sense – that remains exclusively with the company cum listing applicant. This distinction suggests a possible wider meaning that is capable of being applied to the authorization act phrase, one that encompasses involvement in some other relevant capacity in the process of issuing the prospectus, for example, authorization qua sanctioning (the "**wider meaning**").

Some support for a wider meaning is found in the CWUMPO itself: since section 40 of the CWUMPO identifies specific persons who are involved in the authorization process (such as directors), by implication, adding the "every person who authorized" provision suggests that the CWUMPO contemplates the existence of a broader category of persons. That a broader category exists is not particularly contentious and has also been referenced in the SFC 2014 Conclusion.<sup>107</sup> Applying a wider meaning for the purpose of establishing what persons fall into the broader category must be undertaken cautiously so as to avoid floodgates issues, and with regard to the originating statutory provisions.

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<sup>102</sup> Even though the connection is only capable of actually being established in respect of civil liability for an untrue statement.

<sup>103</sup> Cap 571AE, although the SFC continues to perform its function "concurrently with" the SEHK.

<sup>104</sup> For example, accountants that need to comply with the regulations of the Hong Kong Institute of Certified Public Accountants, and the HKEx/SEHK as regards the Listing Rules provisions and to the extent it is subject to the regulatory oversight of the SFC.

<sup>105</sup> I.e., requirements of the CWUMPO. When the SEHK performs its authorization function it is performing a statutory not regulatory role.

<sup>106</sup> Discussed in Section 3.1.

<sup>107</sup> Paragraph 8.



The fact that the sponsor is not specifically recognized by the CWUMPO (whereas the expert is) does not prevent the application of the wider meaning to the sponsor since here one is considering the de facto acts undertaken by a sponsor, not its regulatory or functional role per se. The CWUMPO's reference to "every person" who engages in the authorization act is certainly capable of applying to a sponsor. If it is then proposed that sponsors are to be regarded as engaging in an authorization act based on a wider meaning, it is necessary to identify the relevant characteristics of the sponsor's engagement that would cause the sponsor to fall under the wider meaning.

The wider meaning that arises in relation to experts cannot simply be applied to sponsors because of two important differences:

- experts are required to make statements in the content of a prospectus<sup>108</sup> whereas sponsors are not required to by the CWUMPO (or any regulation), and do not normally, provide any statement or make any disclosure in the prospectus but are merely named in the prospectus, along with the other non-expert parties who have participated in the IPO transaction – an important distinction given the likely policy reasons for the CWUMPO provisions already discussed; and
- unlike an expert, a sponsor's consent is not statutorily required prior to the registration of a prospectus.<sup>109</sup>

Having made this distinction, seeking to draw a parallel between an expert's position under the CWUMPO with that of a sponsor may be inappropriate and misleading given the sponsor's unique duties. The sponsor's critical path role may be relevant to consider for the purposes of the wider meaning, particularly given that sponsors are well aware investors may rely on the prospectus in making investment decisions. But this in itself seems insufficient to constitute it being caught by the wider meaning - other persons also play essential roles without which the IPO could not proceed. For example, no IPO can proceed if the underwriters withdraw or terminate their underwriting commitment,<sup>110</sup> and an underwriter's willingness to proceed is based on a commercial due diligence exercise and their satisfaction with the prospectus contents.<sup>111</sup> However, there is no suggestion in the SFC Position that an underwriting, which also arises out of a regulatory requirement, makes the underwriter liable to statutory liability.<sup>112</sup>

#### *The Appendix 19 declaration*

One matter that is unique to sponsors is its interaction with the regulators, in particular its statement of compliance in the Appendix 19 declaration. This declaration places the sponsor in a special proximity to the formal authorization process because it "constitutes a record or document ... provided to the [SEHK] in connection with the performance of its [authorization powers under the CWUMPO<sup>113</sup>] ... and is likely to be relied upon by the [SEHK]".<sup>114</sup> As the sponsor is key in supervising the formation of the document and interrogating its contents in a way that the SEHK is not in a position to do, could the Appendix 19 declaration amount to the sponsor engaging in the authorization act in the sense of "sanctioning" the prospectus – its contents and possibly the authorization to

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<sup>108</sup> As such, they are not experts for the purposes of the CWUMPO.

<sup>109</sup> In this regard it is of interest to note that in Singapore the consent of the Issue Manager is required – see sections 240(13) &(14) of the Securities and Futures Act (cap. 289).

<sup>110</sup> IPOs that involve an offer for subscription (as is invariably the case) must be fully underwritten, per Listing Rule 7.03.

<sup>111</sup> See the discussion in Section 2.2.1 above.

<sup>112</sup> The SFC 2014 Conclusion does not discuss the underwriter role per se.

<sup>113</sup> Pursuant to the Transfer of Functions Order.

<sup>114</sup> See Note 2 to Listing Rule appendix 19.

issue.<sup>115</sup> For example, because it facilitates the SEHK to undertake its authorization task. If so, how would this work in law as regards the CWUMPO provisions?

The above might suggest two lines of argument.

First, a weak one, is that the declaration and the SEHK's reliance on the declaration amounts to a partial delegation of the SEHK's authorization functions under the Transfer of Functions Order. Indeed, in the UK context it has been commented that the use of a sponsor amounts to "a partial delegation by the FCA<sup>116</sup> of its supervisory powers."<sup>117</sup> As the Transfer of Functions Order does not contemplate any ability to delegate, any "partial delegation" can only be in respect of the SEHK's supervisory powers, i.e. those of a regulatory nature but not its statutory power to authorize.

Second, perhaps a more promising proposition, is that the authorization act of the SEHK, and that of the sponsor, are different in nature – here the sponsor's submission of the Appendix 19 declaration amounts to an authorization act qua sanction under the wider meaning. The legal nature of the document, as a formal declaration to the SEHK, is clear but how this brings it within the contemplation of the CWUMPO is not. Unlike the expert, which gives its consent to the company, the declaration is only provided to the SEHK. The SEHK's "likely" reliance on the declaration for the purposes of executing its statutory powers notwithstanding, the legal mechanism by which any reliance would flow backward to cause a sponsor to be regarded as engaging in some form of authorization act for statutory purposes remains unclear.

The foregoing concerns become more acute when one considers the Appendix 19 declaration in its wider context. As already discussed,<sup>118</sup> when it was introduced as a requirement in 2003 its purpose was to provide a clear regulatory basis on which the SFC could assert its disciplinary powers over sponsors – it was certainly not intended by the SFC, nor understood by the market, that it should give rise to the sponsor engaging in an authorization act. It is notable that the provisions of the current form of the Appendix 19 declaration have not changed in any relevant regard since first being introduced in 2004. Accordingly, the Appendix 19 declaration neither appears to possess nor was intended to possess, the special legal consequences required by the above argument. This is consistent with a view of the SEHK's statutory powers to authorize remaining unique to it and not giving rise to other satellite authorization acts.

The import of the Appendix 19 declaration in relation the authorization act is discussed further in Section 3.3.1 below.

Before turning to that discussion, the following Sections consider case law, statutory analogues (including as to the meaning of 'sanction'), and existing literature.

### **3.2.5 Case law**

Searches of Hong Kong case law produced no judgments that considered sections 40 or 40A or any of the other related provisions of the CWUMPO.

It was therefore necessary to broaden the search to other jurisdictions by way of legal search engines, using the following keywords and key phrases: ""sponsor(s)", "liability", "civil liability", "authoris-", "authoriz-", "prospectus(es)", "statement(s)",

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<sup>115</sup> Although, as will be seen later, other statutes provide no assistance for such a "sanctioning" interpretation. See Section 3.2.6 below.

<sup>116</sup> Financial Conduct Authority, broadly the UK equivalent of the SFC.

<sup>117</sup> See Davies and Worthington, "Gower and Davies Principles of Modern Company Law" 9ed 2012, 25–27 at page 926.

<sup>118</sup> In Section 2.3.1 above.

"misstatement(s)", "duty", "contract-", and "director(s)". As noted above, our searches also encompassed non-Hong Kong jurisdictions on the basis that locating cases concerning sponsor liability might provide some insight to the authorization and issue of prospectuses and liability for untrue statements therein.

Of more than 200 judgments that were returned by the search engines, the material relevant to sponsor liability was less than 10.<sup>119</sup> None of the cases were helpful in advancing an argument that a sponsor engages in an authorization act – the most relevant being an indirect comment<sup>120</sup> on damages for misstatements in a prospectus where the shares in question were purchased below par from another stockholder.

### 3.2.6 Statutory analogues

In the absence of clear judicial guidance as to whether sponsors engage in the authorization act, it is possible to seek guidance by way of analogy to other statutory provisions. This required a two-step study: first, a search of Hong Kong legislation for the term 'authorizes'/'authorises', specifically looking for examples that impose liability for in relation to an authorizing act of some sort; and, second, a search for case law in respect of those analogous provisions for guidance as to what might constitute an authorizing act.

The first search returned some 1557 hits. These results were arranged by 'relevance' under the search engine, and the first 705 results were considered in detail. Of the 705 examples of the use of the term 'authorizes' in Hong Kong legislation, several examples were found in the SFO and the Companies Ordinance (Cap 622), with a further five examples being found in other areas of law.<sup>121</sup>

The relevant provisions in the SFO are market misconduct provisions that deal with the disclosure of false or misleading information, namely, section 277 and its counterpart in section 298, and section 301. These sections cover persons who "authorize[s] or [is]/[be] concerned in the disclosure, circulation or dissemination of" information. These sections also do not provide positive guidance as to what it is to authorize. It is worth noting that these provisions make the distinction between the authorization of, and being merely concerned in, a disclosure, a distinction that will be returned to below. These provisions are subject to defences that are available to persons who reproduce, re-transmit or broadcast the information in the ordinary course of their business. The defences are not relevant to sponsors as the defences are only available to persons who, in effect, act as a passive conduit for the information. Although much case law exists concerning the construction of other terms in these provisions, none of the case law reviewed specifically deals with what it means to 'authorize'.

One key matter that arose when examining these provisions under the SFO was that it was clear on the face of the statutes what the source of the power to 'authorize' was - a person can only be liable if they are in a position to authorize the disclosure, circulation or dissemination of information, and will have a defence if they are a mere passive conduit. This issue of identifying the source of authority would recur when considering other statutory analogues on 'authorization' below – in contrast with the provisions of the CWUMPO, where the source of the authorizing power is not made clear.

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<sup>119</sup> See Appendix 4.

<sup>120</sup> "while the sponsors for false prospectuses that are issued to bring in money to the common treasury are justly made to respond to all persons who take the invited action, yet the law recognizes no right of action in one who relies without invitation on a statement addressed to a particular class which he stays out of" - *Cheney v Dickinson* 96 C.C.A. 314, 172 Fed. 109 (28 L.R.A. [N.S.] 359)

<sup>121</sup> See Appendix 5.

Under the new Companies Ordinance, two provisions were considered analogous: sections 791(7) and 792(6). Both are the liability provisions for contravening the relevant section. The relevance of these two sections is straightforward: liability is expressly imposed on 'every responsible person of the company, and every agent of the company'. Similar to the provisions in the SFO, the source of the authority to 'authorize' the contravening act is clear – the power comes from the company itself and is given to responsible persons of the company and the company's agents, and liability attaches to those who act on behalf of the company, and would be determined in accordance with the normal rules of agency. As examined above at 3.2.1, there are considerable difficulties in applying the rules of agent authority and liability to sponsors to encompass the authorization act.

The remaining examples of analogous statutory provisions include: subsections 6(1A) and 6(3) of the Broadcasting Ordinance (Cap 562); subsection 40(2B) of the Buildings Ordinance (Cap 123); subsection 15(2) of the Air Passenger Departure Tax Ordinance (Cap 140); and subsection 82(1)(f) of the Inland Revenue Ordinance (Cap 112). All five of these provisions are liability provisions for criminal offences. The common thread that can be identified in them, is that they concern acts of authorization that may be compared with an agency relationship or the exercise of a power under statute – the source of the power to authorize other parties is always readily identifiable on the face of the statute. The enactment of the relevant provisions of the CWUMPO precedes these provisions, and so this common thread may merely represent an evolution in legislative drafting. Nonetheless, it raises a serious issue about the liability of sponsors for prospectuses – given that the source of the power of the sponsor to 'authorize' the issue of a prospectus is not clear on the face of the statute, construction of the statute to bring sponsors under the authorization provision could be troubled.

The search for statutory analogues was further extended by way of a search in the Ordinances of Hong Kong for the use of the word 'sanction' in a similar way to 'authorizes' in the relevant sections of CWUMPO. This search returned 175 results over 20 Ordinances<sup>122</sup>. The word is not widely used – primarily in the context of sanction under statute, by the Court, or in the case of companies, specifically in respect of liquidators. The word is used as a synonym for 'permits', but is not defined statutorily, and seems to be given its natural language meaning. There is a secondary use of the word as a synonym for 'punish' in a small number of examples, such as those found in the SFO. No analogous use of the word creating liability in connection with the 'sanctioning' of an act was found.

### **3.2.7 Literature review**

Academic material in this area largely does not lend support to the concept that the role of sponsors is to authorize prospectuses, as understood for the purposes of prospectus liability. For this purpose, a search of academic commentary was made via the legal search engines,<sup>123</sup> again using different pairings of ten keywords and phrases: "sponsor(s)", "liability", "civil liability", "authoris-"/"authoriz-", "prospectus(es)", "statement(s)", "misstatement(s)", "duty", "contract-", and "director(s)". Further manual searches were also conducted in respect of other related papers. Of 300 papers identified through the search engines<sup>124</sup>, less than 20 were of direct relevance to this study.

Of the articles that were directly concerned with the Hong Kong sponsor liability issue, all were supportive of the changes that the SFC had proposed in their earlier consultation papers, in particular, the need to make explicit the liability of sponsors. None offered support for the idea that sponsors should be or are liable, under existing statutory

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<sup>122</sup> See Appendix 6.

<sup>123</sup> Conducted with the same scope as before though restricted to the period 1996 to 2014

<sup>124</sup> See Appendix 7.

provisions, for untrue statements in prospectuses on the basis that sponsors authorize the issue of the prospectus.

Of more relevance to the present concerns, in 'Liability for Misinforming the Market'<sup>125</sup>, Professor Alcock suggests that it is not clear whether a sponsor can be said to be authorizing a prospectus. The argument is made in the context of the UK provisions and in light of the fact that the obligations owed by sponsors are to the regulators, and those who merely provide professional advice to issuers are specifically excluded from responsibility. As already discussed above,<sup>126</sup> the FCA's Prospectus Rules are silent on the matter as regards sponsors. Hong Kong sponsors have two sets of responsibilities, one to the client the other to the regulators.<sup>127</sup>

### **3.3 Procedural and commercial considerations**

The involvement of an IPO sponsor in the progress of an IPO transaction and the document production exercise involves numerous parties, both experts and non-experts, as already discussed.<sup>128</sup> It also encompasses concerns other than purely regulatory requirements, particularly since what is commonly referred to as "the prospectus" is, in an IPO, a composite document: the Listing Rules require a compliant listing document for the purposes of the listing exercise; the CWUMPO requires a compliant prospectus for the purposes of the public offer component. Although the content requirements are technically different,<sup>129</sup> they broadly cover the same disclosure territory. Any adviser to the issuer cum applicant undertaking a due diligence exercise for the purposes of procuring adequate disclosure will engage in fundamentally the same type of due diligence and verification exercise.<sup>130</sup> The procedures applying to each component document filing are different and are in practice dovetailed to ensure compliance with both the regulations and the law. Together, this in effect leads to the sponsor engaging in actions that serve to satisfy not only regulatory requirements but also legal ones.

#### **3.3.1 The Appendix 19 declaration: content and procedure**

Consider the following two scenarios:

**Scenario A:** ACo is a company seeking to make a public offer. There is no listing involved. Recognizing it will need to prepare a prospectus, ACo appoints a third party adviser.<sup>131</sup>

**Scenario B:** BCo is a company seeking to list on the SEHK by way of an IPO. It appoints a sole sponsor.

In each scenario the appointment agreement includes a provision that the third party is to guide the company, undertake due diligence, and provide a confirmation of compliance to the company that is in substance the same as the language of the Appendix 19 declaration.<sup>132</sup>

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<sup>125</sup> 2011; J.B.L. 2011, 3, 243-260.

<sup>126</sup> Section 2.4.

<sup>127</sup> See Section 2.1 above.

<sup>128</sup> Section 2.1.1.

<sup>129</sup> The relevant requirements being the Third Schedule of the CWUMPO for prospectuses and Appendix 1 of the Listing Rules for listing documents.

<sup>130</sup> See the discussion in Section 2.1.1.

<sup>131</sup> As already noted, this would be an uncommon scenario in Hong Kong – due to commercial not legal or regulatory considerations. Public offers without listings, or POWs, do take place in other jurisdictions.

<sup>132</sup> With the necessary redactions for ACo as no listing is involved. So far as the CWUMPO is concerned, this will require confirmation that the procedural steps of obtaining the authorization

When a final draft of the prospectus documents for each company has been prepared, the two scenarios diverge:

**Scenario A:** ACo's adviser provides the confirmation to ACo. The adviser has completed its task, but the prospectus has not as yet been issued. The steps it has undertaken could be described as preparatory in nature, focussing on getting the contents of the document right, so as to put ACo in the position it could with some assurance proceed to have the prospectus authorized and registered prior to its issuance. ACo must now make the further necessary arrangements – it may seek ACo's assistance or may ask anyone else, for example, a firm of solicitors or accountants, to facilitate the next steps. Because ACo's adviser is not acting as a sponsor in connection with a listing application the SFC Position is of neutral effect.

**Scenario B:** BCo's sponsor cannot provide the confirmation to BCo until an additional matter is undertaken, namely, the submission to the SEHK<sup>133</sup> of the Appendix 19 declaration. This declaration could only be made by the sponsor if it is appropriately licensed or registered and has been properly appointed as a sponsor.<sup>134</sup> This step appears to be a relevant factor to the SFC Position in distinguishing the sponsor's "specific duties in relation to the preparation of a prospectus [...] from those of directors and experts".<sup>135</sup> Within the context of the regulatory sphere, this distinction is certainly true - neither BCo nor any of its directors or experts<sup>136</sup> or anyone else can make the Appendix 19 declaration.

It is unclear, and not explained in the SFC 2014 Conclusion, on what basis this distinction, of BCo's special position arising out of regulatory considerations, would be relevant to the question of whether BCo's sponsor engages in an authorization act but is irrelevant to ACo's adviser although it engaged in substantively the same acts in relation to the prospectus.

Scenarios A and B therefore serve to highlight that the SFC Position does not appear to be based solely on the substance of what the adviser does in relation to the document contents per se<sup>137</sup> but appears to turn on compliance with a requirement that is regulatory or procedural in nature. One line of response might be that it is not the procedural nature of the submission or document per se that generates liability but the acts undertaken leading to the declaration being made and/or the reliance the SEHK places on it. Scenarios A and B bring focus to the question of whether it is the acts undertaken or the declaration made, or a combination of them, that give rise to prospectus liability.

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and subsequent registration required by section 38D of the CWUMPO can successfully be undertaken.

<sup>133</sup> Note that the SFC 2014 Conclusion expressly mentions only the submission of the declaration to the SEHK and makes no reference to its provision to the SFC pursuant to the dual filing procedure.

<sup>134</sup> Note that if it was not licensed or registered to advise on corporate finance (Type 6 regulated activity) it would be in breach of section 114 of the SFO. Its engagement letter also needs to comply with regulatory requirements including submitting a copy to the SEHK.

<sup>135</sup> SFC 2014 Conclusion, paragraph 11.

<sup>136</sup> Expert is defined in section 38C(3) of CWUMPO to "include[s] engineer, valuer, accountant, and any other person whose profession gives authority to a statement made by him.

<sup>137</sup> The SFC 2014 Conclusion does not provide any insight as to whether the adviser in Scenario A would be liable as having engaged in an authorization act (however, that possibility is considered in Section 3.2).

Consider the following Scenario C:

**Scenario C:** similar to Scenario B, CCo is a company seeking to list on the SEHK by way of an IPO. CCo appoints two sponsors, "Goodco", who does all the work, and "**Badco**", who fails to perform its regulatory obligations and in effect is a sponsor in name only. Nevertheless, Goodco and Badco each submit their Appendix 19 declarations and CCo is admitted to listing. The prospectus is subsequently found to contain materially misleading information.

This is not an unreasonable example as it has been a concern of the SFC and the HKEx that where more than one sponsor is appointed both sponsors undertake their responsibilities fully, rather than one relying on the work undertaken by the other.<sup>138</sup>

Does Badco have the option of arguing that, since it has not engaged in any action in relation to the prospectus and has merely signed a false declaration,<sup>139</sup> it has not engaged in the authorization act? It would appear not, since this would imply that liability under the SFC Position depends on what a sponsor in fact does<sup>140</sup> but, as already discussed,<sup>141</sup> this does not appear to be the SFC Position – Badco is still a sponsor, albeit a bad one, and so is subject to prospectus liability.

The basis on which Badco has engaged in an authorization act remains opaque. Scenario C brings the focus back to the Appendix 19 declaration and the difficulty of explaining how the step of submitting it is a critical factor.

One might seek to argue that the declaration constitutes a representation (irrespective of whether or not the acts represented were undertaken) that is relied on by the SEHK in performing its statutory function. Such reliance has already been discussed above and is a questionable source of prospectus liability.<sup>142</sup>

An alternative might be to argue along the lines that the declaration constitutes a voluntary<sup>143</sup> assumption of responsibility for the contents of the prospectus or alternately the sponsor's submission to prospectus liability. This approach also does not lead to a satisfactory explanation on several grounds. First, under civil law it may be possible for a sponsor (including one such as Badco) to expressly assume responsibility, though any consequential liability to investors might not derive from the CWUMPO provisions as they require an authorization act – it is a stretch to fit an assumption of responsibility of contents within that phrase. Second, under criminal law, it is not possible for a person to voluntarily assume liability for an act that they did not commit – the *actus reus* is missing. Badco's act of assuming responsibility in these circumstances may be a crime (e.g. fraud) but that would not amount to liability under the CWUMPO. Finally, if one considers the history of the Appendix 19 declaration, its essentially private nature between the SEHK and the sponsor,<sup>144</sup> and the general understanding of its function by sponsors and the market more generally, it is improbable that the declaration could have such an import.<sup>145</sup>

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<sup>138</sup> A concern that has been emphasised in the recent sponsor reforms. See also Listing Rule 3A.10 and the SFC's "Report on Sponsor Theme Inspection Findings, March 2011.

<sup>139</sup> In effect stating that it has breached section 384 of the SFO. And also likely giving rise to the SFC's disciplinary sanctions.

<sup>140</sup> I.e., in terms of undertaking its sponsor role, conducting due diligence and so on, leading up to submission of the Application Proof and the Appendix 19 declaration.

<sup>141</sup> See the discussion under Section 3 above.

<sup>142</sup> Section 3.2.4 above. Scenarios A and B also serve to bring that problem into sharper focus.

<sup>143</sup> Voluntary because, although the declaration is mandated by the Listing Rules, it is always open to a sponsor to step back from the transaction.

<sup>144</sup> See also Section 3.2.4 above.

<sup>145</sup> See the discussion of the declaration in Sections 2.3.1, 2.3.3 and 3.2.4 above.

A common thread in the above discussion is the problem of connecting the Appendix 19 declaration with a prospectus liability that turns on considerations related to content - the CWUMPO itself provides only for fines in instances of non-compliance with procedures.<sup>146</sup> As already discussed,<sup>147</sup> for policy reasons it would be an odd result, and one which would need clear justification, if one were to make liable for disclosures a person who has not made any, a result made more difficult to justify if the relevant person (i.e. one such as Badco) was not involved in procuring the relevant disclosures.

The SFC 2014 Conclusion does not assist an understanding of why the third party adviser in Scenario B (but not Scenario A) and Badco in Scenario C have engaged in the authorization act such that it is no longer a matter of fact for a court to determine based on the law. As the additional acts BCo's sponsor undertakes are driven by non-statutory regulations, the argument also returns to the difficulty of establishing statutory liability based on non-statutory regulatory requirements. These issues remain unsettled yet are in need of resolution if prospectus liability is to be applied to sponsors based on the existing law.

These considerations might also be viewed through a reverse lens: where a new applicant is seeking a listing but there is no public offer component,<sup>148</sup> a sponsor is still required to be appointed, its substantive regulatory obligations remain unchanged, including the requirement to make the Appendix 19 declaration. Yet there is absolutely no suggestion that a sponsor performing these tasks should be subjected to any liability above and beyond regulatory liability. Investors in the secondary market following an Introduction or an IPO may rely on the disclosure documents that have been produced but in the event of untrue statements in those documents they will have no recourse to the CWUMPO as that ordinance is only concerned with the primary market.<sup>149</sup>

### **3.3.2 An embedded commercial factor**

The foregoing discussion can be summarized as follows: the work process undertaken in relation to the production of document content is similar for both CWUMPO-compliant prospectuses and listing documents, however, there are procedural differences. Failing to recognize this content versus procedure distinction contributes to a possibly muddled understanding of the sponsor role. This can be demonstrated via a consideration of the following three propositions:

- (x) if the sponsor discharges its work undertaking then a CWUMPO-compliant prospectus can be issued;
- (y) if no sponsor has discharged its work undertaking then no CWUMPO-compliant prospectus can be issued ;
- (z) if and only if the sponsor discharges its work undertaking can a CWUMPO-compliant prospectus be issued.

If one only considers the requirements of prospectus law, only proposition (x) is capable of being true; propositions (y) and (z) are false because it is not a requirement under the CWUMPO that a sponsor is engaged in connection with the preparation and issue of a CWUMPO-compliant prospectus.

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<sup>146</sup> See Section 2.2 above.

<sup>147</sup> Section 3.2.3 above.

<sup>148</sup> Such as a listing via an Introduction, see Rules 7.13 to 7.17 of the Listing Rules. In this context, CWUMPO is irrelevant.

<sup>149</sup> Subject to the specific circumstances contemplated by section 40(7) and the Twenty Second Schedule of the CWUMPO. The regulatory requirements (within which the Appendix 19 declaration is bundled) are also of no assistance to secondary market investors so far as the CWUMPO is concerned, however, they may be relevant for liability under the SFO – see Section 4.4 below.



Moving beyond the confines of prospectus law, the market reality is that a company seeking to raise funds via an IPO needs the listing to proceed with the public offer in order to obtain adequate marketability for its shares: if the Listing Committee rejects the listing application, the company would not proceed with the public offer. Propositions (y) and (z) are only true insofar as these commercial requirements are concerned. Accordingly, the SFC's statement that the sponsor's role "must be discharged and the [Appendix 19] declaration provided before the prospectus is issued; it would not otherwise be authorized for registration under the CWUMPO"<sup>150</sup> is correct only if the usual IPO commercial considerations are assumed. The SFC Position thus contains an embedded commercial consideration – without it, there is no specific connection between sponsor work and a CWUMPO-compliant prospectus.

If one accepts that a commercial consideration may be relevant to the question of whether a party engages in the authorization act, it becomes necessary to consider, from a commercial perspective, other parties involved in the IPO, for example, the underwriter. As already discussed<sup>151</sup> underwriters bear the primary financial burden of a failed offer and as such have a significant commercial stake in the quality of the prospectus disclosure and the general marketing of the offer. The underwriter's agreement on the offer price is an essential element to the offer proceeding.<sup>152</sup> The underwriter must also be commercially satisfied with all arrangements – important to the listing applicant as underwriters possess a right to terminate an IPO, the market practice being that this right will extend beyond the submission of the Appendix 19 declaration.<sup>153</sup> These commercial concerns are also reflected in the underwriting agreement where the underwriter will require from the listing applicant representations and warranties concerning the accuracy and completeness of the disclosures made in the prospectus – appropriate since the company's knowledge of its own affairs is primary knowledge compared to the knowledge of the underwriter which sits in a secondary tier.

In contrast, while the sponsor is not 'non-commercial', its commercial role is highly qualified by regulatory requirements imposed on it that it cannot properly be described as a 'purely commercial' party, certainly not to the same extent as an underwriter. First, in general terms it is not unreasonable to say that a sponsor's role is substantially a regulatory one, as described in Section 2.1 above, a position perhaps supported by the fact that other major IPO markets are able to be commercially managed without any sponsor concept. Second, the terms of the sponsor's role under its engagement letter with the listing applicant are not freely negotiated - its contents are subject to strict regulatory requirements.<sup>154</sup> Third, the sponsor is not required to, and normally does not, have any right to permit or deny a company from proceeding; its only right in this regard is to resign, for example, if it reaches an impasse with the listing applicant on a matter interacting with the sponsor's own regulatory obligations.<sup>155</sup> Fourth, the sponsor

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<sup>150</sup> SFC 2014 Conclusion, paragraph 11.

<sup>151</sup> Section 2.1.1 above.

<sup>152</sup> Where a fixed price offering is made this agreement will be made before the public offer commences. However, it is now typical market practice for a price range to be agreed with the underwriters for the purpose of launching the public offer, the final price being determined prior to the final allocation and completion of the offer exercise.

<sup>153</sup> The circumstances set out in the underwriting agreement are relatively widely drawn in view of the financial risk undertaken.

<sup>154</sup> Listing Rule 3A.05. See also the discussion in Section 2.1 above.

<sup>155</sup> In which case it will also need to inform the SEHK of the reasons for termination - Listing Rule 3A.17(1). This could of course lead to the SEHK treating this as a red flag leading to it making additional enquiries of the listing applicant. However, a resignation does not imply the listing applicant is unsuitable for listing - the listing applicant may always proceed to address or resolve any relevant concerns with other sponsors. E.g., the WH Goup IPO 2014.

does not itself make any disclosures or give any undertakings etc in the prospectus.<sup>156</sup> Fifth, its financial risk is limited to its fee, and regulations limit that risk by forbidding “no deal; no fee” arrangements.<sup>157</sup> Sixth, although sponsors are, like underwriters, also in the secondary tier of knowledge, representations and warranties are not a typical feature of sponsor engagement letters (unlike underwriting agreements).<sup>158</sup>

Given these considerations, it is not clear on what basis an embedded commercial factor should result in a sponsor but not an underwriter being regarded as having engaged in an authorization act - the SFC does not assert that the underwriter role attracts prospectus liability.

One returns to the core question: what is the source of a sponsor’s alleged prospectus liability? Previous sections have discussed the problems surrounding the regulatory requirements. If commercial considerations are relevant, this seems to inconsistently impose commercially-based liability on the sponsor to the exclusion of other significant commercial parties.

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<sup>156</sup> As mentioned in Section 2.3.1 above, requiring sponsors to sign the prospectus and make a compliance statement in it had been considered by the SFC as a means of possibly bringing sponsors under prospectus law but it was not pursued.

<sup>157</sup> Code of Conduct para 17.11(b)(ii)

<sup>158</sup> For a description of the usual terms in a sponsor engagement letter, see “Study Manual for Paper 15 Sponsors (Principals) and Paper 16 Sponsors (Representatives) of the Licensing Examination for Securities and Futures Intermediaries”, Hong Kong Securities and Investment Institute, 2013 at paras 2.23 to 2.31.

#### 4. CONCLUSIONS

The sponsor's role as a gateway mechanism to the market is well understood and widely accepted. It owes regulatory obligations to the SFC and SEHK that in numerous ways dictate the nature and scope of its relationship with the listing applicant. The sponsor's liability to regulatory sanctions and contractual remedies that arise out of its twin duties, respectively to the regulators and the listing applicant, is clear. In contrast, the exact source of sponsor liability under Hong Kong's prospectus law, if any, remains uncertain. The investigation undertaken in Section 3 was centred on the nexus between non-statutory regulations that create sponsors and impose obligations on them, and the law. While it is recognized that legal, regulatory and commercial aspects of IPO transactions are fundamentally inter-connected, one must be careful not to conflate them when seeking to dissect the source of, or establish legal liability.

In Section 3.1 it was noted that while sponsors are borne out of non-statutory regulation they are not specifically recognized by the CWUMPO. Neither the sponsor concept nor the regulations giving rise to sponsors and their functions, duties and obligations are capable of affecting the law. Although provisions of the SFO do operate to bring certain regulatory codes with the court's contemplation, including some of those concerning sponsors, these provisions arise only in relation to proceedings under the SFO, not the CWUMPO.

In Section 3.2 the scope of the authorization act phrase was examined. While sponsors do not appear to be authorizers under the usual law of agency, the most appreciable line of investigation considered suggested that the phrase "authorized the issue of the prospectus" is capable of having a wider meaning than used under the law of agency that might be capable of capturing sponsors. Defining the wider meaning specifically to avoid floodgates issues, and identifying the characteristics of sponsor work that would cause it to be captured by the wider meaning is problematic. This was highlighted when seeking to distinguish the sponsor role from underwriters - a possible wider meaning that might capture sponsors would also seem to capture underwriters (Section 3.2). Other statutory provisions concerning authorizing acts provide no clear support for bringing the sponsor under the CWUMPO provisions. Nor do other statutes assist in bringing one nearer to a closed definition of the wider meaning as regards the authorization act qua sanctioning.

Section 3.3. identified commercial issues embedded in the SFC Position that would appear to pull the underwriter within the scope of prospectus liability and/or create issues in applying prospectus liability to sponsors but not underwriters. The SFC Position expressly deals only with sponsors, one possible reason being that current market practice is that a sponsor will typically also be an underwriter - the SFC has indicated that should these roles be decoupled, it "may need to consider whether it is appropriate ... to clarify prospectus liability in respect of underwriters".<sup>159</sup> However, it is not invariably the case that a sponsor is also an underwriter and vice versa.<sup>160</sup> That elements underlying the SFC Position might already capture underwriters is both unexpected and relevant to underwriters that are not sponsors. In any case, other aspects of the SFC Position clearly are incapable of applying to the underwriter role, in particular the Appendix 19 declaration.

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<sup>159</sup> Paragraph 20 December 2012 Consultation Conclusions, op. cit.

<sup>160</sup> E.g., 14 of the Hong Kong underwriters on the WH Group IPO in 2014 did not undertake a sponsor role.

The possible role of the Appendix 19 declaration was considered in Sections 3.2 and 3.3. A problem in relying on that declaration as a source for sponsor prospectus liability is that it requires a transmogrification of the declaration from its introduction as a purely regulatory measure. It was also found to lead to the counterintuitive position that a regulatory requirement may be more relevant to disclosure-based liability than participation in content production. This places it at odds with both policy and legal considerations weighing on prospectus liability insofar as it would lead to liability coming to rest on a person who makes no representations in the offer document, irrespective of the extent to which they have (or have not) engaged in due diligence as regards its contents. Moreover, a sponsor's failure on the procedural point is expressly dealt with by section 384(3) of the SFO.

Although each of the potential avenues discussed come with problems attached there is nevertheless a sense that the overarching role of the sponsor uniquely permeates through each of the arguments in a way that the roles of other parties, including the underwriter, do not. Taken together, might they not therefore reflect or constitute considerations of a broader nature that can and do affect the private law basis of the sponsor's twin duties to the client and the regulators thus serving to bring the sponsor's acts within the authorization act? For example, the present market reality in Hong Kong is that public offers under the CWUMPO only happen in connection with a listing exercise. While a detailed analysis of sponsor work suggests that its regulatory obligations render it not a purely commercial party, particularly when compared with the underwriter role,<sup>161</sup> the sponsor role when considered at a macro level may suggest otherwise.

In this regard, the developing emphasis on the sponsor role is notable. Prior to the establishment of the SFC, "the requirement for a sponsoring broker [was] merely a formality, [the sponsor] plays no part in ensuring the quality of the application ... The Exchange believe[d] that the sponsor's role ... should act as a conduit between the company and the SEHK".<sup>162</sup> In 2001 the SFC began to specifically regulate the conduct of sponsors requiring them to be responsible for the overall management of the public offer.<sup>163</sup> The most recent developments<sup>164</sup> include (1) providing the sponsor with more authority over the management of the listing process, (2) requiring the posting of Application Proofs for public view to the HKEx website, together with a 'naming and shaming' of sponsors who submit drafts that are not substantially complete, (3) placing greater emphasis on the sponsor's role in relation to the adequacy of experts reports<sup>165</sup>, and (4) specifying a minimum period that is considered the minimum for a sponsor to undertake its work. These developments clearly put the sponsor in a key position that fundamentally influences the quality of disclosure in a prospectus, which is the central concern of the CWUMPO prospectus liability provisions. Does this not then create a sufficient argument, attaching only to the sponsor, that bridges the gap between statutory prospectus law and the sponsor's regulatory position?

The elephant in the room is that the regulation of the market place, and the role of the IPO sponsor within it, has undergone quantum changes since the CWUMPO prospectus liability provisions were introduced. The past two decades in particular has seen significant developments, including the introduction of the SFO in 2003 a number of provisions of which are relevant to sponsor work.<sup>166</sup> It is patent that prospectus law has not kept pace with these changes. While sponsor regulation is undoubtedly of value to the marketplace as a whole, the CWUMPO and non-statutory regulations appear to

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<sup>161</sup> See Section 3.3.2 above.

<sup>162</sup> Report of the Securities Review Committee 1988 (commonly known as the 'Hay Davison Report') para 5.30.

<sup>163</sup> See Section 2.3 above.

<sup>164</sup> Introduced on 1 October 2013.

<sup>165</sup> While the report in its final form is still made by the expert, the sponsor's role in finalizing it is highlighted.

<sup>166</sup> These are reviewed in Section 4.4. below.

operate, so far as sponsors are concerned, in different spheres, irrespective of the changes to sponsor regulation since 2001. This paper has found nothing that clearly bridges these two spheres, and it is noteworthy that over a decade of consultation exercises on the issue has not identified any such bridge. Whether an argument based on 'considerations of a broader nature' works to bring sponsors within prospectus law, or whether this might be the basis of the SFC Position, is at present undetermined.

#### **4.1 Doubtful Penalisation**

This situation leaves sponsors and the market in uncertain territory. In the absence of statutory reform, it is therefore necessary to consider the principle against doubtful penalisation, a principle of statutory interpretation that a person should not be penalised except under a clear law.<sup>167</sup> A court should strive to avoid a construction that penalises a person unless it is clear that this was the legislative intent.

The investigation of the SFC's Position in this paper leads to the conclusion that the scope of the CWUMPO liability provisions remains unclear. The SFC have themselves previously acknowledged significant inadequacies with these provisions, in particular, that the criminal liability provisions lack a *mens rea* element and reverse the usual the burden of proof. Given this combination of ambiguity and deficiency of the current provisions, the principle against doubtful penalisation implies that a court might not extend their application to a class of persons who do not clearly fall under their scope. As the SFC have expressed the view that public interest would be served by the application of these provisions to sponsors, there is a clear case that the SFC should initiate legislative changes to that effect.

#### **4.2 SFC's statutory duties**

The SFC has a statutory duty under section 5(1)(p) of the SFO "to recommend reforms of the law relating to the securities and futures industry". There are obviously a number of important considerations in deciding what reforms to recommend, and the desirability for clarification has been extensively noted and discussed in the previous rounds of consultations. The SFC may take the view that its duty under section 5(1)(p) is not relevant since it is of the view that no change to the law is required. However, the brevity and lack of detail in the SFC 2014 Conclusion, which diverges so significantly from the context of the overall consultation process and their previous views on this issue, would appear to warrant a more detailed commentary for the benefit of the sponsor market.

Sponsors should be in a position to understand their liabilities and put in place appropriate compliance systems – a factor recognized in section 5(1)(m) of the SFO. The significance of preserving and fostering the IPO market to Hong Kong's economy is widely recognized and should not be underestimated: by way of a rough indicator of the relative size of the market, one can compare market capitalization to Hong Kong's GDP – this stands at over 4,000%<sup>168</sup> as compared to other international markets which generally stand at around 50 to 200%.

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<sup>167</sup> For a full discussion of this principle and its origins see Bennion on Statutory Interpretation, F.A.R. Bennion, 5<sup>th</sup> Edition 2008

<sup>168</sup> Market capitalization divided by Hong Kong GDP. As at Q1 2015 these respectively stood at HK\$26,543 billion and HK\$573,373 million giving a figure of %4,637. Source: <http://www.sfc.hk/web/EN/files/SOM/MarketStatistics/b05.pdf> and <http://www.censtatd.gov.hk/hkstat/sub/sp250.jsp?tableID=030&ID=0&productType=8> accessed June 2015.

### 4.3 A current issue

One year on from the SFC's 2014 Conclusion, the relevance of the sponsor liability issue may yet come more sharply into focus as a result of ongoing cases. One such example may arise in relation to Qunxing Paper Holdings Company Limited ("**Qunxing**"), a company that was listed on the SEHK in 2007, although trading in its shares has been suspended since March 2011.

In December 2013, the SFC initiated proceedings against Qunxing. The SFC alleges that Qunxing has contravened sections 277, 298 and 384 of the SFO and/or section 342F of the CWUMPO for materially false or misleading information contained in its prospectus for its initial public offering in 2007, as well as in its annual results from 2007 to 2011. While the SFC obtained an injunction prohibiting the disposal of assets up to HK\$1,968 million against Qunxing in order to satisfy any potential compensation orders pursuant to s 213,<sup>169</sup> the SFC has only been able to identify HK\$150 million – a small fraction of the amount needed to compensate investors. While assets are located in Mainland China, there have been difficulties in seizing control of them.<sup>170</sup>

With insufficient assets from Qunxing available to satisfy the needs of investor compensation, one possible avenue for seeking compensation may be for investors to pursue the sponsors under section 342E of the CWUMPO, taking a measure of confidence in the SFC Position.

In light of the SFC Position one must also ask what is the SFC's attitude toward the sponsors of the Qunxing IPO. Or, for that matter, the sponsors of previous significant IPO sponsor failures such as Mega Capital (Asia) Company Ltd (the Hontex IPO<sup>171</sup>) or Sun Hung Kai International Ltd (the Sino-Life IPO<sup>172</sup>) - the sanctions imposed on those sponsors do not prevent a criminal action under section 342F of the CWUMPO.<sup>173</sup>

### 4.4 Alternative statutory provisions

When the CWUMPO was enacted, and for many decades thereafter, investors in public offers were afforded little or no regulatory protections, and the available recourses to compensation for wrongdoing other than under section 40 of the CWUMPO depended on investors bringing common law actions. Pursuing a wrongdoer under the CWUMPO's criminal prospectus provisions may solve one issue – punishing the wrongdoer – but may not very effectively resolve another – compensating investors. Today, the situation is radically different, particularly since the introduction of the SFO and the SFC's

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<sup>169</sup> *Securities and Futures Commission v. Hontex International Holdings Co Ltd & ors* [2011] (unrep. HCMP 630/2010, 2 August 2011); *Securities and Futures Commission v. Tiger Asia Management LLC and Others* (2013) HKCFAR 324

<sup>170</sup> The sole operational branch of Qunxing, Shandong Qunxing, owns the majority of the assets of Qunxing. In February 2014, Shandong Qunxing commenced bankruptcy proceedings by way of a reorganization application to the Binzhou Court in China, which was approved. To protect the interests of investors, the SFC sought receivership of Qunxing in March 2014. However, under the Enterprise Insolvency Law of the People's Republic of China, Hong Kong receivers are not entitled to handle assets within the PRC. Moreover, Shandong Qunxing announced that the claims of its creditors in China amounted to RMB 4,900,000,000, and Qunxing's control over Shandong Qunxing has since been removed as the Zouping government has established an entity to acquire the entire equity interest in Shandong Qunxing in order to protect the interests of the creditors in China.

<sup>171</sup> Listed in 2009.

<sup>172</sup> Listed in 2009.

<sup>173</sup> Of course, what makes this awkward to contemplate is that while there has been no change to the CWUMPO during this period, there was at the relevant times general uncertainty as regards whether the CWUMPO applies to sponsors but this does not affect the law.

demonstrated willingness to exercise its powers thereunder and "to make legislation work".<sup>174</sup>

So far as the punishment element is concerned, some perspective on the CWUMPO is needed. Whereas the CWUMPO provides for up to 3 years imprisonment and/or a HK\$700,000 fine, the SFO provides for significant penalties that can apply in connection with IPO prospectuses. Sponsors submitting a false Appendix 19 declaration will be in breach of section 384 of the SFO, which provides for up to 2 years imprisonment and/or a HK\$1 million fine. Sponsors may also be considered subject to section 298 of the SFO, which provides for up to 10 years imprisonment and/or a HK\$10 million fine for persons "concerned in the disclosure" of false or misleading information inducing transactions. While sponsor liability under section 298 has not been tested in the courts, establishing a sponsor as being "concerned in" the disclosure of information appears to be a lower hurdle than establishing that it has "authorized" the issue of the prospectus.<sup>175</sup>

The SFC's power to fine sponsors for regulatory breaches, while not amounting to criminal liability, is also substantial, being up to HK\$10 million or three times the profit gained or loss avoided as a result of the misconduct<sup>176</sup> – it was under the latter provision that Mega Capital (Asia) Company Ltd was fined HK\$42 million. The SFC may also register its financial orders with the Court, giving them the standing of a court order.<sup>177</sup> The ability to fine under the SFO also extends to persons that may be a wider group than those individuals at the sponsor who for the purposes of the CWUMPO must be shown to participate in the authorization act - the SFO applies not only to persons licensed by or registered with the SFC (including responsible officers and executive officers) but also to persons involved in the management of the organization.<sup>178</sup>

So far as compensation is concerned, where a sponsor is found criminally liable under section 40A of the CWUMPO this would be relevant to a civil suit brought under section 40. In contrast, if criminal liability is imposed on a sponsor under the SFO provisions described above, claimants under section 40 are not so benefitted. Each civil claim under the CWUMPO will in any case need to be taken by each investor individually because Hong Kong does not recognize class action lawsuits. An investor bringing an action will also be subject to the usual rules of court pertaining to evidence etc. In contrast, where investor compensation is sought by the SFC under the SFO provisions, this will be aided by a conviction under either the SFO or the CWUMPO, and by the powers given to the SFC under the SFO which are considerable and include the power to investigate transactions, obtain records and documents, compel persons to give statements or explanations and further extend to third parties.<sup>179</sup> These powers are relevant to consider in light of section 213 of the SFO, which has been used by the SFC to obtain restoration orders for persons who have suffered loss. Section 213 applies in respect of any contravention of the prospectus provisions of the CWUMPO, the SFO, any notice or requirement given or made under or pursuant to any of the relevant provisions, or any of the terms and conditions of any licence or registration under the SFO. If a sponsor is subject to the CWUMPO, then a breach of it will therefore directly bring it within the scope of section 213. However, it is not necessary for a sponsor to be subject to the CWUMPO for section 213 to apply since the sponsor could be subjected to it either via a breach of the SFO or, arguably, via a breach of the terms and conditions of its license.

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<sup>174</sup> Mark Steward, outgoing Executive Director of Enforcement of the SFC, as quoted in the South China Morning Post 21 August 2015.

<sup>175</sup> If a sponsor was regarded as having authorized the issue of the prospectus it would be potentially liable under both section 40A of the CWUMPO and section 298 of the SFO.

<sup>176</sup> Section 194(2) and 196(2) of the SFO.

<sup>177</sup> Section 194(5) and 196(5) of the SFO.

<sup>178</sup> See sections 194(7) and 196(8) of the SFO.

<sup>179</sup> It has been argued that these powers go a long way to obviating the need for class action law suits, at least so far as investor compensation for corporate wrongdoing is concerned. See Johnstone, S. "A flawed debate", *International Financial Law Review* May 2015, pp 38-39.

While the SFC has started to make active use of section 213 to obtain investor restoration orders,<sup>180</sup> the scope of this section has not as yet been tested in relation to sponsors, the SFC instead relying on its powers to fine sponsors under section 194 of the SFO.<sup>181</sup>

#### **4.5 Terra non firma**

The focus of this paper has been a detailed investigation of the legal basis of the SFC 2014 Conclusion, not the wider issue of whether or not it is desirable to impose prospectus liability on sponsors.

It is clear that a sponsor's functions, duties and obligations are, in the extant regulatory framework, at the centre of driving an IPO forward, including performing tasks without which a listing could not occur. Nevertheless, none of the foregoing, under the law, appear to support a definitive argument that sponsor work is tantamount to having engaged in an authorization act. It does not make statements in the prospectus and its consent is not required by the CWUMPO for a prospectus to be lawfully authorized, registered and issued. The other acts a sponsor is required, by its client and by the regulators, to undertake in an IPO, including the submission of the Appendix 19 declaration, are not acts that comprise or reflect any actual, ostensible or usual authority to issue the prospectus. Bringing a wider "sanctioning" meaning to the authorization act also does appear to provide any clear answers.

The central conclusion of this paper therefore is that neither the nature of the sponsor's role nor the actions it engages in are sufficient to give rise to any clear legal position that it has authorized the issue of the prospectus. Something more, outside the sponsor's core regulatory duties, and outside the usual scope of what a sponsor in fact does, would be required. This conclusion therefore in some ways reiterates the starting point for the SFC's public consultations almost 15 years ago, leaving Hong Kong's sponsor community on uncertain ground. Indeed, it is arguable that the SFC 2014 Conclusion leaves Hong Kong's sponsors in a more confused position.

Hong Kong has traditionally been a small market in global terms. Around the time the SFC was created, most listed companies were local and the market capitalization accounted for barely 1% of the world market, the market growing to become the tenth largest market in the world at the time the SFO was introduced.<sup>182</sup> Market growth has continued rapidly and Hong Kong now frequently holds the leading position in the global IPO market. These developments highlight that the current situation is unsatisfactory and in need of proper evolution and clarification. The presence of clear punishments and remedies under the SFO is extremely helpful, however, as they arise out of administrative discipline and market abuse provisions they are not customized to prospectus law. The best means of achieving clarity will undoubtedly be to modernize the law and not try to work within provisions that have been overtaken by market practices and expectations. The SFC have, since 2005, undertaken a series of consultation exercises as to the future handling of the prospectus provisions of the CWUMPO, the intention being that, in the long term, the prospectus regime will be transferred to a discrete part of the SFO.<sup>183</sup> It is imperative that this transfer

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<sup>180</sup> The landmark case being *SFC v Tiger Asia and Others* ([2013] HKCFA).

<sup>181</sup> For example, in the *Hontex IPO* section 213 was used against the issuer, whereas section 194 was used to fine the sponsor.

<sup>182</sup> Source: Report of the Securities Review Committee 1988 (the 'Hay Davison Report') para 4.2; <http://www.world-exchanges.org/statistics/monthly-query-tool>

<sup>183</sup> Consultation Paper on Possible Reforms to the Prospectus Regime, August 2005; Consultation Conclusions on Possible Reforms to the Prospectus Regime September 2006; Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance, October 2009; Consultation



incorporates a revision to and development of prospectus law if it has not been done sooner. Whenever this development occurs, there will undoubtedly be a renewed debate as to whether, and if so on what terms, a sponsor should be subjected to statutory civil and/or criminal liability. Such development must also encompass the position of the underwriter, particularly in view of the fact that underwriters are clearly subject to liability in many other major markets.

## **APPENDICES**

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## **Appendix 1 – Extracts from Sections 40 and 40A of the CWUMPO<sup>184</sup>**

“Section 40: Civil liability for misstatements in prospectus

(1) Subject to the provisions of this section, where a prospectus invites persons to subscribe for shares in or debentures of a company, the following persons shall be liable to pay compensation to all persons who subscribe for any shares or debentures on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement included therein, that is to say-

(a) every person who is a director of the company at the time of the issue of the prospectus;

(b) every person who has authorized himself to be named and is named in the prospectus as a director or as having agreed to become a director either immediately or after an interval of time;

(c) every person being a promoter of the company; and

(d) every person who has authorized the issue of the prospectus:

Provided that where under section 38C the consent of a person is required to the issue of a prospectus and he has given that consent, he shall not by reason of his having given it be liable under this subsection as a person who has authorized the issue of the prospectus except in respect of an untrue statement purporting to be made by him as an expert.

(1A) Subsection (1)(d) shall not apply-

(a) to the Commission;

(b) where the relevant prospectus is authorized by a recognized exchange company pursuant to a transfer order made under section 25 of the Securities and Futures Ordinance (Cap 571), to the Commission or the recognized exchange company; or

(c) where the relevant prospectus is authorized by a recognized exchange controller pursuant to a transfer order made under section 68 of that Ordinance, to the Commission or the recognized exchange controller.”

“Section 40A: Criminal liability for misstatements in prospectus

(1) Where a prospectus issued after the commencement\* of the Companies (Amendment) Ordinance 1972 (78 of 1972) includes any untrue statements, any person who authorized the issue of the prospectus shall be liable to imprisonment and a fine, unless he proves either that the statement was immaterial or that he had reasonable grounds to believe and did up to the time of the issue of the prospectus believe that the statement was true.

[...]

(3) Subsection (1) shall not apply-

(a) to the Commission;

(b) where the relevant prospectus is authorized by a recognized exchange company pursuant to a transfer order made under section 25 of the Securities and Futures Ordinance (Cap 571), to the Commission or the recognized exchange company; or

(c) where the relevant prospectus is authorized by a recognized exchange controller pursuant to a transfer order made under section 68 of that Ordinance, to the Commission or the recognized exchange controller.”

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<sup>184</sup> Source: Companies (Winding-up and Miscellaneous Provisions) Ordinance, Chapter 32 of the Ordinances of Hong Kong

## Appendix 2 – Extracts from the SFC 2014 Conclusion<sup>185</sup>

"7. With respect to prospectus liability of sponsors, the SFC's position when the Consultation Paper was issued was that, although there was a strong argument that sponsors were already covered by the relevant legislation (which was also the SFC's view), given the fact that sponsors and others had expressed contrary views and given that there had been no Hong Kong case law on the subject, it may be helpful to specify sponsors in the relevant legislation ([the CWUMPO]) as a category of persons who authorize the issue of prospectuses. The amendment would have made explicit to all market participants that sponsors are potentially liable under the CWUMPO.

8. However, this amendment would be unnecessary [...] if in fact sponsors were already persons who authorize the issue of a prospectus within the meaning of the CWUMPO. The CWUMPO provides for a broad category of persons whose roles or functions are not specified but who nevertheless are capable of falling within a class of persons who have "authorised the issue of the prospectus" [...] and are therefore potentially liable.

[...]

10. [...] After careful consideration the SFC has concluded that no amendments are required to specify sponsors as a separate category of persons who authorize the issue of a prospectus because they are already covered by the broader category of potentially liable persons under the CWUMPO referred to in paragraph 8 above.

11. The SFC has noted that a sponsor has specific duties in relation to the preparation of a prospectus which are distinct from those of directors and experts. These include the requirement [under Listing Rule 3A.13] to provide a declaration to [the SEHK] stating that the sponsor believes that the prospectus contains "all information required by relevant legislation and rules", and is "true, accurate and complete in all material respects". The sponsor also performs other functions, duties and obligations in respect of an IPO prospectus, all of which must be discharged and the declaration provided before the prospectus is issued; it would not otherwise be authorized for registration under the CWUMPO.

12. The SFC has accordingly reaffirmed its view that its original position in the Consultation Paper – that sponsors are already covered under the existing law – is correct. Sponsors are among those persons who have potential statutory criminal and civil liability under the CWUMPO for untrue statements (including material omissions) in a prospectus. It has therefore concluded that the proposed legislative amendments need not be pursued as they would serve no purpose."

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<sup>185</sup> Supplemental Consultation Conclusions on the Regulation of IPO Sponsors – Prospectus Liability, SFC, 22 August 2014

### Appendix 3 – Extracts from the Appendix 19 declaration<sup>186</sup>

"We, ....., are the sponsor appointed by ..... (the "Company") on [Date] [...]

Under rule 3A.13 we declare to [the SEHK] (the "Exchange") that:

(a) all of the documents required by the Exchange Listing Rules, the [CWUMPO and other applicable laws and regulations] to be submitted to the Exchange [...] in connection with the Company's listing application have been submitted;

(b) having made reasonable due diligence inquiries, we have reasonable grounds to believe and do believe that:

[...]

(iii) the Company's listing document contains sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares, the financial condition and profitability of the Company at the time of the issue of the listing document;

(iv) the information in the non-expert sections of the listing document:

(A) contains all information required by relevant legislation and rules;

(B) is true, accurate and complete in all material respects and not misleading or deceptive in any material respect [...]

[...]

(vii) there are no other material issues bearing on the Company's application for listing of and permission to deal in its securities which, in our opinion, should be disclosed to the Exchange;

[...]

(d) in relation to the information in the expert reports, we, as a non-expert, after performing reasonable due diligence inquiries, have no reasonable grounds to believe and do not believe that the information in the expert reports is untrue, misleading or contains any material omissions.

Signed: .....

Name: .....

For and on behalf of: ..... [insert the name of sponsor]

Dated: .....

Notes:

(1) [...] the sponsor will be ultimately responsible for supervision of the work carried out by the sponsor firm and quality assurance in respect of that work. [...]

(2) [...] this form constitutes a record or document which is to be provided to the Exchange in connection with the performance of its functions under "relevant provisions" (as defined in [Schedule 1 of the SFO] and is likely to be relied upon by the Exchange. Therefore, you should be aware that giving to the Exchange any record or document which is false or misleading in a material particular will render relevant persons liable for prosecution for an offence under subsection 384(3) of the Securities and Futures Ordinance (Cap 571) as amended from time to time."

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<sup>186</sup> Source: Listing Rules of The Stock Exchange of Hong Kong Limited.

## **Appendices 4 -**

Appendices 4 to 7 can be found at:

[http://www.aiifl.com/wp-content/uploads/Working\\_Papers/SJ-WP17\\_APPENDICES.pdf](http://www.aiifl.com/wp-content/uploads/Working_Papers/SJ-WP17_APPENDICES.pdf)