HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

香港會計師公會

香港金鐘道八十九號力寶中心二座四樓

BY EMAIL & BY HAND

Our Ref: C/EPL

8 June 2004

Mr. Richard Williams,
Head of Listing,
Hong Kong Exchanges and Clearing Limited,
11th Floor, One International Finance Centre,
1 Harbour View Street, Central,
Hong Kong.

Dear Richard,

Draft Proposed Amendments to the Listing Rules relating to the Regulation of Sponsors and Independent Financial Advisers

We have reviewed the Draft Proposed Amendments to the Listing Rules relating to the Regulation of Sponsors and Independent Financial Advisers which were released on 4 May 2004 for consultation. We set out our comments in the attached **Annex I**. Our comments represent the views of the HKSA Expert Panel of Listing which comprises mainly of members working in the corporate finance field.

We are fully supportive of any plans by the Exchange and the SFC to raise standards in the market. However, there are certain proposed requirements in the Draft Proposed Amendments on independence and due diligence which are of concern to the market practitioners. The details of these concerns are set out in Annex I. In view of the market practitioners' concerns, we request the Exchange to consult widely with the market practitioners and benchmark the proposals against the requirements in major overseas jurisdictions.

The HKSA Expert Panel on Listing also gave some thoughts on the proposed structure of the draft Exchange Practice Note and set out in **Annex II** its preliminary thoughts for the Exchange's consideration.

We trust that you will find our comments helpful. If you have any questions on any of our comments, please do not hesitate to contact me at 2287 7026.

Yours sincerely,

STEPHEN CHAN
TECHNICAL DIRECTOR (ETHICS & ASSURANCE)

SSLC/SO/jc
Encl.

4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong.
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776
Web: http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

Annex I

HKSA'S COMMENTS ON THE KEY DRAFT PROPOSED AMENDMENTS TO THE LISTING RELATING TO THE REGULATION OF SPONSORS AND INDEPENDENT FINANCIAL ADVISERS

1. Appendix A – Draft Sponsor Rule 3A.06 on Appointment of a sponsor

At the time of first notification to the Exchange of the intended initial listing application, or, if the sponsor is appointed after such notification, then upon whichever is the earlier of the sponsor agreeing its terms of engagement with the new applicant or listed issuer, and the sponsor commencing work for the new applicant or listed issuer, the sponsor must give to the Exchange an undertaking, in the terms set out in Appendix [ ] to:

(1) comply with the Listing Rules;

(2) comply with the Practice Note;

(3) use reasonable endeavours to ensure that all information provided to the Exchange during the listing application process is true in all material respects and does not omit material information required to be stated in the listing document or necessary to make the information provided, in light of the circumstances in which it was provided, not misleading, and to the extent that the sponsor subsequently becomes aware of information that casts doubt on the truth, accuracy or completeness of information provided to the Exchange, it will promptly inform the Exchange of such information; and

(4) assist the Exchange in the performance of any of its functions, including any investigation and any proceedings.

Note: For declarations required to be given by sponsors, refer to rules 3A.10 and 3A.17.

HKSA's Comments

The sponsor can only undertake to the Exchange to comply with the Practice Note on sponsor's due diligence, so far as applicable, practical and reasonable to do so. It is stated in the Practice Note that the scope and extent of appropriate due diligence by a sponsor may be different from, or considerably more extensive than, the steps described. The required undertaking would appear inconsistent with this general statement in the Practice Note.

Alternatively, the Exchange should set clearer benchmarks and not impose mandatory steps so as not to create a situation where a sponsor cannot undertake to the Exchange to comply with the Practice Note on sponsor's due diligence for valid reasons.

2. Appendix A – Draft Sponsor Rule 3A.08 on Impartiality of sponsors

A sponsor must perform its duties with impartiality and avoid relationships or connections with a new applicant or listed issuer that would compromise the sponsor's objectivity. Both the sponsor and the new applicant or listed issuer must make all reasonable enquiries and take appropriate action to ensure this is the case.

Notes: 1. Refer to rule 3A.13 below regarding the appointment of more than one Initial Sponsor by a new applicant.

2. In the event of an inconsistency between this rule and the Corporate Finance Adviser Code of Conduct or the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, the Exchange Listing Rules prevail. Refer also to rule 3A.23.

HKSA's Comments

We question the necessity and the relevance of including this paragraph in the draft sponsor rules given that Rule 3A.09 already set out a list of circumstances which the Exchange will consider that a sponsor is independent even if there is a business relationship (as long as the thresholds set out in Rules 3A.09 are observed). We cannot see how a sponsor can be impartial if he has a business relationship with the new applicant.

3. Appendix A – Draft Sponsor Rule 3A.09 on Independence of sponsors

At least one Initial Sponsor of a new applicant must be independent from the new applicant and a Continuing Adviser of a listed issuer must be independent from the listed issuer. The Exchange will consider that a sponsor is not independent if any of the following circumstances exist:

(1) the sponsor group collectively holds or will hold, directly or indirectly, more than 5% of the issued share capital of the new applicant or listed issuer or an associate or connected person of the new applicant or listed issuer;

(2) the fair value of the sponsor group's direct or indirect current or prospective shareholding in the new applicant or listed issuer exceeds or will exceed 15% of the consolidated net tangible assets of the sponsor and its subsidiaries at the most recent practice date;

(3) any member of the sponsor group is an associate of the new applicant or listed issuer, save and except where that relationship arises because of holdings of an investment entity's discretionary clients;

(4) 15% or more of the proceeds raised from the initial public offering of the new applicant are to be applied directly or indirectly to settle debts due to the sponsor group;

(5) 30% of the business operations of the new applicant, listed issuer or controlling shareholder of the new applicant or listed issuer is funded by banking facilities provided by a member of the sponsor group;

(6) the fair value of the direct or indirect shareholding of a director of the sponsor group or an associate of a director of the sponsor group in the new applicant or listed issuer exceeds HKD 5 million;

(7) the fair value of the direct or indirect shareholding of an employee or director of the sponsor who is directly engaged in providing the subject sponsorship services to the new applicant or listed issuer, or an associate of such an employee or director, exceeds HKD 1 million;

(8) a director of the sponsor group or an associate of a director of the sponsor group or an employee of the sponsor who is directly engaged in providing the subject sponsorship services to the new applicant or listed issuer or an associate of such an employee has a current business relationship with the new applicant or listed issuer, which would be reasonably considered to affect the sponsor's objectivity in performing its duties as set out in this Chapter, or might reasonably give rise to a perception that the sponsor's objectivity would be so affected; and new applicant listed issuer new applicant listed issuer

(9) the sponsor or a member of the sponsor group is the auditor or reporting accountant of the listed issuer or new applicant.

Notes: 1. In addition to being a breach of the Exchange Listing Rules, if it comes to the Exchange's attention that a sponsor is not independent as required by rule 3A.08, the Exchange will not accept documents produced by that sponsor in support of an application for listing or a request for approval or vetting of any document required under the Exchange Listing Rules.

2. *Sub-paragraphs (1) to (9) will not apply where the circumstance occurs because of an interest in a facility such as a managed account or managed fund held by the sponsor group or a relevant member of the sponsor group or associate of such member in relation to which that person or entity does not have discretion to select individual stocks to be acquired, held or disposed of.*

3. *In the event of an inconsistency between this rule and the Corporate Finance Adviser Code of Conduct or the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, the Exchange Listing Rules prevail. Refer also to rule 3A.23.*

HKSA's Comments

We propose that the Exchange should reconsider amending the Rules to require that the Lead Sponsor should always be independent.

In addition:

- 3A.09(5) – We consider that the 30% threshold set here is high and seek further clarification on the meaning of "business operations". The Exchange should provide further guidance on this.

- 3A.09(8) – We request that the Exchange provide further clarification as to what is meant by "business relationship", and whether the concept of materiality applies here.

- we note that while the Exchange has set out a list of circumstances where a sponsor is considered to be not independent, it has not addressed the issue of independence when a listed issuer has an interest in the sponsor.

4. Appendix A – Draft Sponsor Rule 3A.13 on Additional sponsors

Where a new applicant has more than one Initial Sponsor:

(1) the Exchange must be advised as to which of the Initial Sponsors is designated as the Initial Sponsor who would be the primary channel of communication with the Exchange concerning matters involving the listing application;

(2) the listing document must disclose whether each Initial Sponsor satisfies the independence test at rule 3A.09 and, if not, then how the lack of independence arises; and

(3) each of the Initial Sponsors assume an equal degree of responsibility and accountability for the accuracy and completeness of information contained in all submissions (including the listing documents) provided to the Exchange, in writing or otherwise, in respect of the new applicant's initial listing application and shall (save insofar as the Exchange Listing Rules designate the primary sponsor as having primary responsibility) be jointly and severally responsible for the discharge of the Initial Sponsors' duties as set forth in this Chapter.

Notes: 1. The Exchange would normally expect, but does not require, the Initial Sponsor acting as the primary channel of information to be independent from the new applicant..

2. In the case of a new applicant appointing more than one Initial Sponsor, each Initial Sponsor is subject to the rules in this Chapter.

HKSA's Comments

We reiterate the proposal made by us in (3) above where we recommend that the Exchange should reconsider amending the Rules to require that the Lead Sponsor to be independent. Accordingly, we do not agree with Note 1 to the subject draft rule. Furthermore, the Lead Sponsor should be the primary channel of communication with the Exchange concerning matters involving the listing application.

5. Appendix A – Draft Sponsor Rule 3A.17 on Initial sponsors

Prior to the issue of the listing document, at least one of the persons named as a responsible officer or executive officer of each Initial Sponsor must, on behalf of the Initial Sponsor, submit to the Exchange a declaration to the effect that:

(1) all of the documents required by the Exchange Listing Rules to be submitted to the Exchange in connection with the new applicant's listing application have been submitted;

(2) having made reasonable due diligence inquiries, the Initial Sponsor has reasonable grounds to believe and does believe that:

(a) the answers provided by each director or proposed director of the new applicant in the director's declaration(s) in the form at Appendix [5B] would not cause a reasonable person with the experience and skills of a competent sponsor to inquire further about the truth of, or potentially misleading nature of, or possible omission of a material particular;

(b) the new applicant is in compliance with all of the qualifications for listing set out in the Exchange Listing Rules;

(c) the information in the non-expert sections of the listing documents:

(i) contains all information required by relevant legislation, codes, rules and guidelines;

(ii) is true in all material respects; and

(iii) does not omit material information necessary in order to make such information not misleading;

(d) where an expert (other than the Initial Sponsor) does not conduct its own verification of the factual information on which the expert states, or the Initial Sponsor otherwise believes, the expert is relying for the purposes of his or her expert opinion referred to in the listing documents (including any supporting or supplementary information given to the Exchange in relation to the listing application), such factual information is true in all material respects and does not omit a material fact necessary in order to make such factual information, in light of the circumstances in which it is provided, not misleading;

(e) sections of the listing documents purporting to be made on the authority of an expert are founded on assumptions that are fair, reasonable and complete (in so far as a non-expert in the position of the Initial Sponsor can reasonably be expected to reach a view);

(f) the expert (other than the Initial Sponsor) is independent from the new applicant and its directors and controlling shareholder(s);

Note: The Exchange will consider an expert to be independent for the purposes of this rule if it meets criteria equivalent to that set out in rule 3A.09 (where the standard of independence is not set by a relevant professional body).

(g) the expert (other than the Initial Sponsor) is appropriately qualified, experienced and sufficiently resourced to give the relevant opinion and has devoted sufficient resources to

the preparation of its opinion (in so far as a non-expert in the position of the Initial Sponsor can reasonably be expected to reach a view);

(h) the expert's scope of work is appropriate to the opinion given and the opinion required to be given in the circumstances (where the scope of work is not set by a relevant professional body and to the extent a non expert in the position of the Initial Sponsor can reasonably be expected to reach a view);

(i) the new applicant has established adequate procedures, systems and controls to enable it and its directors to comply with the Exchange Listing Rules, in particular rules 13.09, 13.10, 13.46 and 13.49 and Chapters 14 and 14A *[or rules 17.10, 17.11, 18.03 and 18.49 and Chapters 19 and 20 of the GEM Listing Rules]*, including accounting and management systems that enable the new applicant's directors to make a proper judgment as to the financial position and prospects of the new applicant and its subsidiaries, both before and after listing, and to release timely information, financial and otherwise, to the market as required by the Exchange Listing Rules; and

(j) the directors of the new applicant collectively have the experience, qualifications and competence to manage the new applicant's business and comply with the Exchange Listing Rules, and individually have the experience, qualifications and competence to perform their individual roles including that the directors appear to understand the nature and content of their obligations and those of the new applicant as an issuer under the Exchange Listing Rules and other legal or regulatory requirements relevant to their role;

HKSA's Comments

- In relation to 3A.17(d), we have difficulty in understanding the exact requirement. A redrafting in plain English is considered useful.

- In relation to 3A.17 (d) to (h), we consider that the sponsor can only say that the expert is appropriately qualified to give the relevant opinion and the expert has sufficient resources. However, it would be difficult for the sponsor to say that there are no factual misstatements on the basis on which the expert has prepared its report. Moreover, sponsors are not in a position to determine the scope and assumptions of the expert. For instance, if the new applicant is in the biotechnology industry and an expert is engaged to opine on the technical aspects, it would be impossible for the sponsor (who does not have the expertise) to confirm the matters in relation to the expert opinion.

We consider that a suitable alternative would be to require the sponsor to hold meetings with the various experts and to ascertain from them if there are any matters that the experts would like to draw to the attention of the sponsor. Furthermore, to the extent that the sponsor has any doubts about the experts' scope and assumptions or contrary evidence has been obtained by him, he would be expected to discuss the matters with the experts and document the findings.

6. Appendix A – Draft Sponsor Rule 3A.19 on Continuing sponsors

A Continuing Sponsor is required to assist a listed issuer when requested by the listed issuer by being actively involved in giving advice to the listed issuer in the circumstances set out in rule 3A.18 above including by using reasonable endeavours to discharge the following responsibilities with due care and skill:

(1) ensure the listed issuer is properly guided and advised as to compliance with the Exchange Listing Rules;

(2) have on-going communication, which should take the form of both formal and informal meetings, with the listed issuer;

(3) accompany the listed issuer to any meetings with the Exchange that the listed issuer is asked to attend, unless otherwise requested by the Exchange;

(4) no less frequently than at the time of reviewing the financial reporting of the listed issuer and upon the listed issuer notifying the Continuing Sponsor of a proposed change in the use of proceeds of the initial public offering, monitor, with the listed issuer, the operating performance and financial condition by reference to the listed issuer's business objectives and use of issue proceeds as stated in its listing document, and compliance with the terms and conditions of any waivers granted from the Exchange Listing Rules;

(5) no less frequently than at the time of reviewing the financial reporting of the listed issuer and upon the listed issuer notifying the Continuing Sponsor of a proposed change in the use of proceeds of the initial public offering, monitor whether any profit forecast or estimate that appeared in the listing document, will be or has been met by the listed issuer and ensure the listed issuer notifies the Exchange and informs the public in a timely and appropriate manner if it fails to or anticipates failing to meet the profit forecast or estimate;

(6) no less frequently than at the time of reviewing the financial reporting of the listed issuer and upon the listed issuer notifying the sponsor of a proposed change in the use of proceeds of the initial public offering, monitor compliance with the undertakings provided by the listed issuer and its directors at the time of listing, and, in the event of non-compliance, discuss the issue with the listed issuer's board of directors and make recommendations to the board regarding appropriate remedial steps;

HKSA's Comments

In relation to 3A.17(4),(5) and (6) we have difficulty in understanding the exact requirements of what is meant by "no less frequently". A redrafting in plain English is considered useful.

7. Appendix B – Draft Practice Note – Due diligence – paragraph 9

The due diligence steps the Exchange expects sponsors will typically perform in relation to the Directors' Declarations and the collective and individual experience, qualifications, competence and integrity of the directors to manage the new applicant's business and fulfill the directors' undertakings to use their best endeavours to procure the new applicant's compliance with the Listing Rules include:

(a) confirmation of each director's educational and professional qualifications and work history and an analysis of those qualifications compared to those of directors of other issuers operating in the same industry;

(b) searches of relevant regulatory and professional bodies in the jurisdictions in which the directors have worked about the directors and the companies for which they have been directors or officers or substantial shareholders ("related companies"), for example, for public sanctions imposed;

(c) searches for civil legal actions and judgments to which any of the directors or their related companies have been a party, save and except for those solely relating to personal domestic matters, for example, family law or estate proceedings;

(d) a review of the directors' past performance as directors of the new applicant including, as relevant, participation in board meetings and decision making relating to the management of the new applicant and its business;

(e) assessment of the financial literacy of the directors individually and collectively;

(f) assessment of the corporate governance experience and competence of the directors individually and collectively;

(g) a review of the financial and regulatory track record of other listed issuers of which any of the new applicant's directors was a director, by reference to annual reports, other company disclosures, media articles and information about those companies on the website of the relevant stock exchange, for the period commencing one year before the director was appointed a director of the listed issuer and ending one year after the director ceased to be a director of the listed issuer; and

(h) criminal record searches for each director for each jurisdiction in which he or she has resided for a cumulative period of more than 1 year in the previous 20 years and in which such searches can reasonably be conducted.

HKSA's Comments

We also question why and how the directors should be assessed of their financial literacy unless certain benchmarks are provided by the Exchange. In any case, we believe that the current rules (which require one of the independent non-executive directors to have appropriate professional qualifications or appropriate accounting or related financial management expertise) are sufficient. Furthermore, we believe that certain of the above requirements may be difficult to carry out in practice and whether the information obtained would be useful.

8. Appendix B – Draft Practice Note – Due diligence – paragraph 10

10. The due diligence steps the Exchange expects sponsors will typically perform in relation to the new applicant's compliance with the qualifications for listing, including the public float requirements include:

    (a) using effective information barriers (that is, Chinese walls) where necessary or appropriate, a review of the lists of placees and underwriters (including subunderwriters), in particular those introduced by the new applicant or its directors or substantial shareholders, or associates of any of the new applicant, its directors or substantial shareholders, to identify whether any of the placees or underwriters (including sub-underwriters) may be connected persons of the new applicant;

    (b) ensure the proposed underwriters and placement agents to the listing applicant are appropriate, considering their credentials in light of their role and responsibilities;

    (c) searches of the company registry in the new applicant's place of incorporation to confirm that the new applicant is duly incorporated in that place and that the new applicant conforms with its memorandum and articles of association; and

    (d) a review of the material financial statements of the new applicant and other companies covered by the listing application, if any, (e.g. the new applicant's subsidiaries) including the internal financial records, tax certificates and supporting documents to the tax certificates for the trading record period and assess the accuracy and completeness of the information submitted by the new applicant to satisfy the trading record requirement. Such review would include interviewing the new applicant's accounting staff and internal and external auditors and reporting accountants and, where relevant, obtaining comfort from the new applicant's external auditor or reporting accountants based upon agreed procedures.

HKSA's Comments

- In relation to sub-paragraph (a), we consider that it would be impossible for the sponsor to review the list of placees because underwriters/placing agents do not usually give their client list to the sponsor. The underwriters should take their own responsibilities in respect of the independence of placees.

- In relation to sub-paragraph (d), we consider that it is not necessary for the sponsor to review the internal financial records, tax certificates and supporting documents to tax certificates. The sponsor should not be expected to replicate the work of the reporting accountants. In addition, it would be unrealistic to expect the sponsor to review all the internal financial records to ensure that the financial information in the accountant's report is "accurate and complete".

9. Appendix B – Draft Practice Note – Due diligence – paragraph 11

The reasonable due diligence steps the Exchange expects sponsors will perform as the basis for forming a belief on reasonable grounds that the information in the non-expert sections of the listing documents (including supporting or supplementary documents relied on by the Exchange in assessing the new applicant's listing application) is true and complete in all material respects and does not omit a material fact necessary in order to make the listing documents and all particulars and information therein not misleading include:

(a) where a new applicant has prepared its listing document, assess the financial information published in that document including:

(i) obtaining written confirmation from the new applicant that the financial information published in that document (other than that already reported upon by a reporting accountant) has been properly extracted from the relevant underlying accounting records;

(ii) being satisfied that the confirmation referred to at paragraph (i) has been given after due and careful inquiry by the new applicant; and

(iii) being satisfied that a reasonable person with the experience and skills of a competent sponsor would not have cause to inquire further about the truth or omission of a material particular regarding the confirmation referred to at paragraph (i);

(b) assess the new applicant's business operations, performance and finances for the purpose of the listing documents, business plan and any profit forecast, including an assessment of the reasonableness of budgets, projections and assumptions made when compared with past performance, including historical sales, revenue and investment returns, payment terms with suppliers, costs of financing, long term liabilities and working capital requirements, and an assessment of whether there has been any change since the publication of the last audited financial statements that would require disclosure to ensure the listing document is complete and not misleading. This would include interviewing the new applicant's senior management, major suppliers and customers, creditors and bankers;

(c) a critical analysis as to whether it is reasonable to conclude that the new applicant's management will use the proceeds of the issue as disclosed in the listing documents, taking into account the outcome of the sponsor's assessment of, in particular, the new applicant's existing cash and liquid reserves, projected liabilities, working capital requirements and expenditure controls;

(d) undertake a physical inspection of material assets, whether owned or leased, including property, plant, equipment, inventory and biological assets referred to in the listing documents or otherwise used, or to be used, in connection with the new applicant's business as stated in the listing documents;

Notes: 1. Without limiting the generality of the requirements of this Practice Note, it is not intended that this be an audit. By physical inspection the Exchange simply means visiting the site of the asset in order to inspect, in person, that the asset exists, and confirming its extent, quality and quantity and that there is appropriate documentation in place to confirm the asset is appropriately held by the new applicant, for example, a certificate of title, or right of land use.

2. *Where confirmation of an asset, including as to its extent, quality and quantity, genuinely cannot be achieved without the use of an expert, the sponsor should ensure that an appropriately qualified independent expert is instructed to conduct the inspection and attend the inspection with the expert. In such cases the sponsor should also ensure the expert is required to provide a report in respect of the inspection.*

(e) undertake an analysis of the new applicant's production methods;

(f) undertake an analysis of the new applicant's management of its business including actual or proposed marketing plans, including distribution channels, pricing policies, after-sales service, maintenance and warranties;

(g) review the business aspects of all contracts material to the new applicant's business;

Note: By business aspects the Exchange simply means not legal aspects.

(h) review the circumstances of all current legal proceedings and other material disputes to which the new applicant is a party and all proceedings or material disputes the new applicant knows to be contemplated and which will involve the new applicant or one of its subsidiaries;

(i) undertake an analysis of the business aspects of economic, political or legal conditions that the sponsor reasonably considers may materially affect the new applicant's business;

(j) research the industry and target markets in which the new applicant's business has principally operated and will principally operate, including geographical area, market segment and competition within that area and/or segment (including existing and potential principal competitors and their relative size, aggregate market share, profitability and cash flow requirements);

(k) if applicable, confirm the existence and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights of the new applicant;

(l) research and assess the technical feasibility of each new product or technology developed, being developed or proposed to be developed pursuant to the new applicant's business plan that the sponsor reasonably considers may materially affect the new applicant's business; and

(m) assess the stage of development of the new applicant's business and the commercial viability of its product/s, service(s) or technology, including an assessment of the risk of it becoming obsolete as well as market controls or regulation and seasonal variation, in order to determine the reasonableness of the new applicant's business plan and forecast assumptions, if any.

HKSA's Comments

In general we believe that a sponsor should only be required to carry out the due diligence steps where it is practical, possible and reasonable for him to do so.

In relation to sub-paragraphs (e), (j), (l) and (m), it cannot be assumed that sponsors are experts in production and technology. In some industries, production methodology is considered to be highly confidential information. Companies have trade secrets to protect,

especially for high technology industries. It is therefore impractical for the sponsor to analyze production methods and assess technical feasibility and stage of development of products or technology developed and to be developed and conduct industry research in specific markets and segments in respect of all listing applicants.

10. Appendix B – Draft Practice Note – Due diligence – paragraph 12

The due diligence steps the Exchange expects sponsors will typically perform in relation to the expert sections of the listing documents (including supporting or supplementary documents relied on by the Exchange in assessing the new applicant's listing application)include:

(a) interview the expert, review the terms of engagement (having particular regard to the scope of work, whether the scope of work is appropriate to the opinion required to be given and any limitations on the scope of work which might adversely impact on the degree of assurance given by the expert's report, opinion or statement) and review publicly available information about the expert to determine:

(i) the expert's qualifications and experience; and

(ii) whether the expert is competent to undertake the required work;

(b) review the expert sections of the draft listing documents (including supporting or supplementary documents given to the Exchange in relation to the application) to ensure that the following are disclosed appropriately:

(i) the factual information on which the expert relies;

(ii) the assumptions on which the expert opinion is based; and

(iii) the scope of work performed by the expert in arriving at his/her opinion;

(c) by reference to the sponsor's knowledge of the new applicant's business, assess whether the factual information disclosed by the expert as the information relied on in forming the expert's opinion is consistent with other information known to the sponsor about the new applicant and is all the information a reasonable non expert would expect the expert to rely on in forming his/her opinion;

(d) where the expert does not conduct its own verification of the factual information on which the expert states, or the sponsor otherwise believes, the expert is relying for the purposes of the expert opinion referred to in the listing documents, assess whether the information is true in all material respects and does not omit a material fact necessary in order to make the statements in the listing documents, in light of the circumstances under which the statements are made, not misleading;

(e) by reference to the sponsor's knowledge of the new applicant's business, assess whether the assumptions disclosed by the expert as those on which the expert's opinion is based, are fair and reasonable and, to the extent a reasonable non expert could form such a view, are complete;

(f) in the event of the expert's opinion being qualified, assess whether the qualification is clearly stated such that a reasonable investor could appreciate the implications of the qualification;

(g) interview the expert and assess, to the extent a reasonable non-expert could, whether the scope of work undertaken by the expert and resources applied by the expert to the engagement are reasonably sufficient to enable the expert to arrive at the opinion reached and required to be reached; and

(h) where the standard of independence is not set by a relevant professional body, confirm that the expert is independent from the new applicant and its directors and substantial shareholder(s). This would include confirming that the expert does not have a direct or indirect material interest in the securities or assets of the new applicant, its connected persons, or any associate of the new applicant.

HKSA's Comments

In general, we consider that the sponsor should not be expected to take responsibility for the expert sections. The sponsor cannot be expected to have the expert knowledge and expertise himself to review the work of an expert in a specialized field. The experts should take responsibility for their own work. For example, in the case of a PRC legal opinion, how is a sponsor qualified to know whether the PRC legal adviser has adequately considered all relevant PRC laws and regulations in coming to its opinion? Sponsors are not experts in PRC law. If the PRC lawyer has overlooked a particular legal or regulatory requirement which is applicable, this might be the omission of a material fact which, had it not been overlooked, would have affected the expert's opinion. How is a sponsor supposed to know whether the PRC lawyer (for example) has verified which laws/regulations are applicable?

In relation specifically to sub-paragraph (d), a better approach would be for the expert to be obliged under the Listing Rules to carry out his own verification of the information relied upon by him. An expert should take ownership of his expert opinion.

11. Appendix C – Draft IFA Rules – 13.80(2)

We propose the following rules be inserted in Chapter 13 under a subheading: "Independent financial advisers":

13.80 For the purposes of an independent financial adviser, appointed under rule 13.39(6)(b) or rule 19.05(6)(a)(iii), giving advice as required by the Exchange Listing Rules, an independent financial adviser must take all reasonable steps to satisfy itself:

(1) in respect of the matters set out at paragraphs (1) to (5) of rule 14A.22; and

(2) that there are no reasonable grounds to believe that any information, expert advice or opinion relied on by the IFA in forming the opinion, is not true, is potentially misleading or omits a material fact.

Note: For the purposes of this rule we expect reasonable steps should include but not be limited to the following:

(a) obtaining all information and documents of the issuer relevant to an assessment of the fairness and reasonableness of the terms of the transaction, for example, if the transaction involves the purchase or sale of products or services, obtain information and documents showing the prices at which the issuer buys and sells such products and services to third parties;

(b) thoroughly researching the relevant market and other conditions and trends relevant to the pricing of the transaction;

(c) reviewing the reasonableness of any assumptions or projections relevant to the transaction;

(d) in relation to any third party expert providing an opinion or valuation relevant to the transaction:

(i) investigating the background, expertise and independence of the third party expert;

(ii) assessing the appropriateness of the scope of work;

(iii) reviewing the reasonableness of any bases, methods and assumptions used in the report and the rationale for those bases, methods and assumptions;

(iv) reviewing the reasonableness of projections or qualifications in the expert's report; and

(v) reviewing the factual information on which the expert states, or the independent financial adviser otherwise believes, the expert is relying for the purposes of his or her expert opinion, to ensure it is true and complete in all material respects and does not omit a material fact necessary in order to make the statements in the expert's report not misleading; and

(e) reviewing and assessing any alternative offers and the reason given, if any, by the management for rejecting these offers and ensuring that adequate and balanced disclosure of this information and analysis is provided in the opinion letter.

HKSA's Comments

We consider that the IFA can say that the expert is appropriately qualified to give the relevant opinion and the expert has sufficient resources. However, it would be impossible for the IFA to satisfy itself as to whether any third party expert advice or opinion relied upon is untrue or omits a material fact. They are not experts in the relative fields and they have not carried out the work that the expert will have carried out. We have already commented upon the same issues in relation to sponsors.

12. Appendix C – Draft IFA Rules – 13.84

An independent financial adviser must not act for any issuer from which it is not independent. The Exchange will consider that an independent financial adviser is not independent if any of the following circumstances exist:

(1) the independent financial adviser and any associate or connected person of that independent financial adviser (referred to in this rule as the "IFA group") have, directly or indirectly, a material interest in the issuer or an associate or connected person of the issuer;

(2) any member of the IFA group is an associate of the issuer, save and except where that relationship arises because of holdings of an investment entity's discretionary clients;

(3) a member of the IFA group provides banking facilities to the issuer or an associate or connected party of the issuer;

(4) a member of the IFA group is a creditor or debtor of:

(a) the issuer;
(b) an associate of the issuer; or
(c) a connected party of the issuer;

(5) a director or employee of the independent financial adviser, or an associate of such a director or employee, has a material interest in, or a current or contemplated business relationship with, the issuer;

(6) the independent financial adviser has served as a financial adviser to the issuer or any associate or connected person of the issuer, including whilst employed by a different firm, within 2 years prior to commencement of the independent financial adviser as independent financial adviser to the issuer; and

(7) the independent financial adviser or a member of the IFA group is the issuer's auditor or reporting accountant.

Notes: 1. In addition to it being a breach of the Exchange Listing Rules, if it comes to the Exchange's attention that an independent financial adviser is not independent, the Exchange will not accept documents produced by that independent financial adviser for any purpose required under the Exchange Listing Rules.

2. In the event of an inconsistency between this rule and the Corporate Finance Adviser Code of Conduct or the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, the Exchange Listing Rules prevail. Refer also to rule 13.86.

HKSA's Comments

The Exchange should provide further clarification as to what is "material interest" for the purpose of Rule 13.84 (1) and (5).

Annex II

Some preliminary thoughts of the HKSA on the structure of the draft Practice Note regarding due diligence by sponsors in respect of initial listing applications for consultation purposes

1. Primary responsibility for completeness and accuracy of information

The Practice Note should state this essential principle at the outset that the management of the issuer has the primary responsibility for the reliability and completeness of the information contained in the prospectus. This is to avoid any misunderstanding on the part of the issuer's management concerning their primary responsibility.

2. Exposure to criminal/civil liabilities if found to be in breach of Practice Note

2.1 The Practice Note should state the following:

(a) What is the legal status of such Practice Note applicable to the sponsors?

(b) What is the consequence under the listing rules if a sponsor is found to be in breach?

2.2 The Practice Note should draw particular attention to the fact that a sponsor who is found to be in breach of the draft Practice Note will likely be exposed to other criminal and civil liabilities. This is important to warn the sponsors of the ramifications of any breach of the Practice Note.

3. Change term from "due diligence" to "reasonable investigation"

The term "due diligence" should be changed to "reasonable investigation". This is because the term "reasonable investigation", rather than "reasonable due diligence", is used in other jurisdictions, such as, USA and Australia. It is easier for the sponsors, clients and the investing public to understand the term "reasonable investigation", instead of the more abstract phrase "due diligence".

4. Reasons/objectives of reasonable investigation

4.1 It would be more instructive for the Practice Note to state clearly at the outset why undertaking reasonable investigation is necessary. This is important because the sponsors need to appreciate the context in which they have to discharge their responsibility for reasonable investigation.

4.2 One important reason for the reasonable investigation process is to ensure that the prospectus complies with the relevant listing rules and the Companies Ordinance.

4.3 Another reason is to enable the sponsor involved in issuing the prospectus to rely on some kind of safe harbours, should any defect be found in the prospectus.

4.4 Also, reasonable investigation will safeguard the issuer against any damage in reputation and litigation risks in the future.

5. Concept of materiality

5.1 Regarding a sponsor undertaking reasonable investigation and inquiry, the Practice Note should address the concept of materiality of certain information or defect since this will determine eventually the level of disclosure in relation to a certain information/defect to be made in the prospectus. This is important because the materiality of a matter to be disclosed will determine the degree and extent of reasonable investigation required in relation to it.

5.2 Materiality has two aspects as follows:

(a) the qualitative aspect, i.e., whether a matter is material for the purpose of making sure that the prospectus contains all the information required under the listing rules and Companies Ordinance; and

(b) the quantitative aspect, i.e., whether a matter is material in relation to its impact on the present and future financial position of the issuer.

6. Safe harbours

The Practice Note should provide safe harbours for sponsors where the sponsor will be regarded as having properly discharged his responsibility for reasonable investigation and not be held to be in breach of the Practice Note under certain circumstances, such as, if it can be demonstrated that:

(a) a false or misleading statement or omission was due to a reasonable mistake; or

(b) a false or misleading statement or omission was due to reasonable reliance on information supplied by another person, such as, representations by the management of the issuer or a third party expert; or

(c) in relation to the non-expertised parts of the prospectus, the sponsor, after making reasonable investigation, had reasonable grounds to believe, and did believe until the time of the allotment or issue of shares that the defective statement was true and not misleading, or that there were no omissions of material facts from the defective statement; or

(d) a sponsor should not be required to make reasonable investigation concerning the expertised parts of the prospectus. However, a sponsor should be required to establish that he had no reasonable ground to believe and did not believe that the expertised part of the prospectus was materially untrue or omitted material facts. Of course, a sponsor should take great caution to avoid any allegation that it had a reasonable ground to believe that those expertised parts of the prospectus were false or misleading.

7. Standard of reasonable investigation and burden of proving reasonable investigation

7.1 The Practice Note should provide for the standard of such reasonable investigation to be carried out by sponsors. Presumably, this should be the common law standard, i.e., the reasonable man test and the burden of proving reasonable investigation would be on the balance of probabilities.

7.2 It is certainly helpful for the Practice Note to state, by way of examples only, the kinds of due diligence that the sponsor is required to perform in relation to certain matter. However, the examples provided in the Practice Note should not be prescriptive in nature. This prescriptive approach to due diligence would render the due diligence process unduly rigid and inflexible and may even be unreasonable and highhanded in certain circumstances. Instead, the Practice Note should provide that the time and effort required to perform reasonable investigation will also depend on the nature of the issuer's business and the sponsor's relationship with the issuer. For instance, in the case of high-risk or high technology business operations, the degree of reasonable investigation may have to be very thorough and intensive.

7.3 For example, sometimes, it may be reasonable for a sponsor to rely on the representations by the management of the issuer without independent verifications. This is a matter for the sponsor's judgement call. The nature of the information involved may dictate the degree and extent of independent verification required for the facts in the representations given by the management. For instance, a sponsor may not need to physically verify or go through all the personnel records to verify the number of workers working in the company's factories. This is because the management would have no incentive to provide the wrong information. Which facts provided by the management should be made the subject of independent verification would depend on what a reasonable sponsor would do in the circumstances.

7.4 It is also important for the Practice Note to provide that a sponsor does not have to perform personally every duty imposed upon it. It may delegate to others the performance of acts which is unreasonable to require the sponsor to perform individually. This is particularly so when the act itself involves professional skill or facilities not possessed by the sponsor itself.

7.5 If the sponsor is disturbed by the inconsistent statements made by the issuer's different personnel or encounters a strong reaction or intimidation, to a particular issue, this may point to the existence of a serious problem. In these circumstances, the sponsor must go to the extraordinary lengths to perform the reasonable investigation.

8. Independent Panel and Review System

A system should be established which provides for investigatory, disciplinary and appeal functions in relation to any breach of the Practice Note. These 3 functions should be separately administered by panels of independent members. The Practice Note should clearly spell out the system. Furthermore, members of the disciplinary and appeal panels should be independent and preferably, have proper legal training so as to ensure that there is no miscarriage of justice.