

SFC CONCLUDES CONSULTATION ON CONDUCT REQUIREMENTS FOR BOOKBUILDING AND PLACING ACTIVITIES

Summary

In February 2021, the Securities and Futures Commission (the **SFC**) launched a three-month public consultation on proposed conduct requirements for equity capital market (**ECM**) and debt capital market (**DCM**) transactions in Hong Kong. The proposed requirements are aimed at clarifying the roles played by intermediaries in bookbuilding, pricing, allocation and placing activities.

The consultation ended in May 2021 and the SFC's conclusion on the consultation has been published in October 2021. In the consultation conclusion, the SFC has adopted all the key consultation proposals including sponsor coupling, obligations of capital market intermediaries (**CMI**s) and overall coordinators (**OC**s), no rebates to investor clients, and disclosure of identities of underlying investors.

Key Takeaways

The proposed amendment of paragraph 17 of, and the introduction of a new paragraph 21 to, the Code of Conduct for Persons Licensed by or Registered with the SFC (the **Code Proposed Requirements**) are intended to regulate intermediaries involved in bookbuilding, pricing, allocation and placing activities, who are referred to as **CMI**s whereas those **CMI**s acting as the head of the syndicate (such as overall management of an offering, coordinating the bookbuilding or placing activities conducted by other **CMI**s and providing advice to the issuer) are designated as **OC**.

Key changes to the bookbuilding and placing process under the Code Proposed Requirements include:

- **Requirement to have engagement and fees documented at the outset** - Each syndicate **CMI** and **OC** is required to obtain a written appointment from its issuer client before it conducts any bookbuilding or placing activities; the appointment must set out the intermediary's role, responsibilities, fee arrangement, and the fee payment schedule payable to the intermediary. It remains to be seen how this will affect when to sign the underwriting agreements and how the fee is determined at this early stage in practice.
- **New standards of conduct** - **CMI**s (including **OC**s) are required to adhere to new standards of conduct in respect of bookbuilding and securities allocation, including the requirement to prioritise their clients' orders over their own proprietary orders during the bookbuilding process.
- **Duty to act with due skill, care and diligence** - **OC**s should act with due skill, care and diligence when providing advice, recommendations and guidance to the issuer client.
- **Concurrent **OC** and sponsor appointment for IPOs** - Under the Sponsor Coupling requirement, intermediaries are required to have at least one sponsor to an IPO be appointed as a head of the underwriting syndicate concurrently with such sponsor's appointment (both appointments must occur at least two months before the listing application is filed).

Background

The Code Proposed Requirements and Sponsor Coupling requirement are being introduced to align Hong Kong's regulatory standards with the latest findings from the International Organisation of Securities Commissions on addressing conduct risk in capital raising activities, and reflect the SFC's focus following its recent thematic review of licensed intermediaries.

Who do the Code Proposed Requirements apply to?

Firstly, the Code Proposed Requirements are designed to regulate the conduct of CMI, which are defined as licensed or registered persons that engage in providing services to issuers, investors or both in respect of share or debt offerings and involves the following activities conducted in Hong Kong:

- **Bookbuilding activities** - Collating investors' orders (including indications of interest) in an offering in order to facilitate: (i) the price determination and the allocation of shares or debt securities to investors; or (ii) the process of assessing demand and making allocations;
- **Placing activities** - Marketing or distributing shares or debt securities to investors pursuant to bookbuilding activities; or
- **Advising, guiding and assisting** the issuer client in the above bookbuilding and placing activities.

The scope of coverage will be limited to the following types of offerings, provided that bookbuilding is involved:

- a) the offerings of shares to be listed on HKEX. This includes (i) IPOs, which include share offerings in connection with a secondary listing and offer of existing shares by way of IPO; (ii) offerings of shares of a class new to listing; or (iii) offerings of new shares of a class already listed under a general or special mandate; and
- b) the offerings of shares listed on HKEX. This only covers the placing of listed shares to third-party investors by an existing shareholder if it is accompanied by a top-up subscription by the existing shareholder for new shares in the issuer; and
- c) an offering of debt securities listed or unlisted, and offered in Hong Kong or otherwise.

The Code Proposed Requirements do not cover a share offering which has been subscribed by an intermediary as principal deploying its own balance sheet, for onward selling to investors (sometimes referred to as "block transactions") or selling of listed shares by existing shareholders (sometimes referred to as "secondary offering").

Secondly, the Code Proposed Requirements also subject any OC that leads a share or debt offering to additional requirements. The Code defines the role of an OC as the head of syndicate which conducts any of the following activities:

1. Acts as the overall manager of the offering, coordinates bookbuilding or placing activities, exercises control over bookbuilding activities and makes allocation recommendations to the issuer;
2. Advises the issuer on the offer price and enters into the price determination agreement with the issuer client; or
3. Exercises discretion to reallocate shares between the placing tranche and public subscription tranche, reduces the number of offer shares, or exercises an upsize option or over-allotment option.

It is important to note that under the Code Proposed Requirements, CMI and OCs are classified by reference to the activities they carry out, rather than their respective titles in an offering. This means that, for example, a joint bookrunner in an offering may not necessarily advise on the offering beyond placing its own allocation shares and would therefore not likely be considered an OC.

Key Requirements under the Code Proposed Requirements

Standard of Conduct

- **Assessing the issuer and the offering** - Before engaging in an offering, an OC or a CMI should conduct an adequate assessment of the issuer, and have in place a formal governance process to review and assess the offering. The assessment of the issuer should include an accurate understanding of the history and background, business and performance, financial condition and prospects, operations and structure of the issuer. The assessment of the offering should include any actual or potential conflicts of interest between the OC or CMI and the issuer client as well as the associated risks.

- **Formal appointment agreement** - After the assessment, but before an OC or a CMI provides any services stipulated in the Code, it must ensure that it has been formally appointed under a written agreement. The written agreement should specify the roles and responsibilities of the OC or CMI, the fee arrangements (see also Fee Arrangements below) and the fee payment schedule.
- **Role of the OC** - CMIs acting as OCs are subjected to additional requirements. They should act with due skill, care and diligence when providing advice, recommendations and guidance to the issuer client. The scope of advice includes marketing strategy and pricing and allocation. In respect of marketing advice, the OC should assist the issuer in developing a marketing and investor targeting strategy and inform the CMIs of the same. In addition, the OC should also advise the issuer and its directors on their responsibilities under the requirements of the HKEX applicable to the placing activities and ensure that they understand and meet these responsibilities - whilst this is a pre-existing obligation for sponsor-OCs, this represents an additional obligation for non-sponsor OCs. Noting the respondents' concerns over potential conflicts of interests, the SFC will not require OCs to provide advice to the issuers on syndicate membership or fee arrangements.
- **Record keeping** - A CMI should maintain books and records which are sufficient to demonstrate its compliance with all applicable Code Proposed Requirements. An OC should thoroughly document its key advice given to and the key discussion with the issuer client and all changes in the order book. If the issuer takes any action which would amount to material non-compliance with the requirements of the HKEX related to, for example, the placing activities, the OC should notify the SFC in a timely manner.

Bookbuilding

- **Rebates** - CMIs are restricted from offering to their investor clients or passing on any rebates (e.g. brokerage fee rebates) provided by the issuer and have an obligation to disclose any such rebates offered by the issuer. In addition, CMIs should not permit any of its investor clients to pay for shares at a price that is less than the consideration disclosed in a listing document.
- **Investor assessment** - CMIs should identify investors who may be restricted from subscribing for shares in any offering as prescribed by the rules of the HKEX (e.g. connected clients and core connected persons of an issuer) (**Restricted Investors**) and inform the OC before placing an order on behalf of such clients. To assist CMIs with identifying Restricted Investors in an offering, the OCs are required to specifically advise the issuer of the information which should be provided to syndicate CMIs to enable them to identify whether their investor clients are Restricted Investors and inform the OCs.
- **Order book disclosure** - To ensure that the OCs can identify and eliminate duplicate orders, inconsistencies or error in an offering, CMIs are required to disclose the identities of all investors in an order book, except for orders placed on an omnibus basis (in which case, only the investor's name and unique identification number should be provided to the OCs and the issuer). To alleviate the CMIs' concerns of potential poaching, the SFC requires a CMI (including the OC) which receives information about the investors for orders placed on an omnibus basis to only use this information for placing orders in that specific offering.
- **Allocation policies** - CMIs and OCs are expected to develop and maintain policies on allocation and placing. In addition, OCs should advise the issuer to allocate shares such that an open market and adequate spread of shareholders and the orderly and fair trading of the shares in the secondary market can be achieved. When allocating securities to its investor clients, CMIs should consider the ability for their clients to take up their allocation and monitor whether any order size appears unusual. The implementation of these rules will impose additional duties on CMIs and OCs.
- **Prioritise client orders** - To minimise conflicts of interest that arise when a CMI (or its affiliate) places orders for both its own proprietary trading as well as for its investor clients, CMIs should give priority to investor clients' orders over their own proprietary orders when allocating securities. Furthermore, CMIs should execute proprietary orders as "price taker" orders, so that proprietary orders from CMIs would not influence the pricing of an offering.

Fee Arrangements

- **Timing for determining fees** - To minimise potential conduct risk relating to bookbuilding, the Code Proposed Requirements will require that fixed fees payable to OCs and CMI's be determined at the time of appointment. Specifically, OCs and CMI's must set out in their written appointment agreement their fee arrangement with the issuer, including fixed fees as a percentage of the total fees to be paid to all syndicate members participating in the offering. However, the Code Proposed Requirements will not limit the ability for an issuer to pay CMI's discretionary fees to incentivise sales outperformance.
- **Disclosing fee information to the SFC for an IPO** - To assist the SFC in identifying arrangements which deviate from market norms, the OC appointed for an IPO should provide the following information to the SFC no later than four clear business days before the HKEX Listing Committee hearing:
 - the name of each OC;
 - the allocation of the fixed portion of the fees paid by the issuer to each OC;
 - the total fees (as a percentage of the gross amount of funds raised) of both the public offer and the international tranche to be paid to all syndicate CMI's; and
 - the ratio between the fixed and discretionary portions of the total fees to be paid to all syndicate CMI's (in percentage terms).

The SFC regards the timing for fee payment and the enforcement of the fee payment schedule to be commercial matters which the SFC is not in a position to intervene. As such, the SFC has decided to drop the original consultation proposal to require OCs to (i) confirm with the SFC by the listing date that the issuer has determined the allocation of discretionary fees to each syndicate CMI and the fee payment schedule and (ii) inform the SFC, within two weeks after the first day of dealing, of the total monetary benefits (including discretionary fees and bonuses) paid by the issuer to each CMI. While issuers may alter their fee allocations during the course of an IPO, the SFC requires the OC to inform the SFC of any material changes.

Sponsor Coupling

The Sponsor Coupling requirement is aimed at redressing the misalignment between fees and sponsor costs and responsibilities and ensuring quality sponsor work, and requires a listing applicant to appoint at least one sponsor (or the sponsor's affiliate) as an OC for an IPO. The SFC takes the position that there are advantages to the overall IPO process when an OC, as the head of the syndicate, is also the sponsor (either directly or through another affiliate). It is thought that a sponsor's deep knowledge of the listing applicant and responsibility to conduct due diligence work, when combined with the responsibilities of an OC, would enhance the ability of the OC to manage the overall offering.

Under the Sponsor Coupling requirement, for the sponsor-OCs, both the OC and sponsor appointments should be made concurrently and at least two months before a listing application is filed for an IPO. The SFC believes that the Sponsor Coupling requirement would ensure that the work conducted by a sponsor (which typically involves substantial due diligence and advisory work) is reflected by the compensation payable to the sponsor, and would avoid instances where a sponsor may be incentivised to compromise due diligence in order to secure an appointment as the head of a syndicate for an IPO. For the non-sponsor OCs, the appointment should be made no later than two weeks after the listing application is filed.

Getting prepared

Overall, the Code Proposed Requirements will likely have the effect of reducing instances where conflicts of interests may arise for market intermediaries. The Code Proposed Requirements will also provide intermediaries with certainty earlier on in the transaction as to the proportion of fees payable in an offering and the timing of payment. However, intermediaries, particularly those who take up the position of an OC in an offering, will need to be aware of the additional obligations imposed on them, including their duty to advise an issuer properly under the Code Proposed Requirements, record keeping and reporting obligations.

In order to facilitate their compliance with the Code Proposed Requirements, intermediaries should be prepared to:

- formulate an effective control framework staffed with suitably experienced personnel to review and assess the offering, the issuer client and the investor clients;

- formulate a policy governing the communication and information sharing among OCs and CMI in relation to information about the issuer, marketing and investor targeting strategy, identities of investor clients;
- amend in-house engagement letter templates to specify the roles and responsibilities, the fee arrangements and the fee payment schedule;
- put in place measures to prohibit offering to their investor clients or passing on any rebates (e.g. brokerage fee rebates) provided by the issuer, and to disclose any rebates and preferential treatment as required by the Code; and
- ensure adequate internal controls are in place to maintain books and records which are sufficient to demonstrate its compliance with all applicable requirements in the new paragraph 21 of the Code.

To allow reasonable time to implement the necessary operational and system changes to comply with the requirements, the Code will become effective from 5 August 2022. The SFC will also work with the HKEX to introduce appropriate amendments to the Listing Rules which will dovetail with the requirements of the Code in relation to the conduct of issuers and intermediaries involved in bookbuilding and placing activities.

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