



Hong Kong Regulatory Update – SFC Consultation on Bookbuilding (March 2021)

Introduction

The Securities and Futures Commission (the “SFC”) launched a consultation on February 2021 on proposals to set standards for placing and book building activities in Hong Kong.

The SFC notes that despite being one of the world’s largest markets for initial public offerings (IPOs) and debt offerings and although there are rules governing sponsors’ work, stock price stabilisation and the preparation of pre-deal research on securities listed or to be listed on The Stock Exchange of Hong Kong Limited (“SEHK”), there are currently no specific requirements governing the conduct of bookbuilding or placing activities by intermediaries in either the equity or debt capital markets.

The SFC references both reports recently issued by the International Organization of Securities Commissions (IOSCO) to address conflicts of interest and associated conduct risks in equity and debt capital raising and its own thematic review of licensed intermediaries engaged in equity capital market (ECM) or debt capital market (DCM) activities and engagement with both buy-side and sell-side participants.

The SFC identified a number of undesirable activities including:

- The price discovery process being hampered by inflated or opaque demand;
- Brokers without a mandate “swarming” order books at the last minute with orders of unknown quality;
- Lack of alignment in sponsors’ incentives and liabilities especially in larger IPOs where a sponsor may compromise its due diligence enquiries to become the head of the underwriting syndicate and earn higher fees to compensate for sponsor costs and responsibilities;
- The use of X-orders where the identities of investors are concealed which leads to a lack of transparency for the heads of syndicates and can hide unusual, duplicated or fictitious orders;
- A lack of clearly defined roles of the participants in capital raising;
- Fluid incentive structures including late determination of fee arrangements;
- Conflicts of interest where syndicate members and their affiliates place prop trading and client orders;
- Access by syndicate members to non-public information via the order book which can be used to increase their allocation by submitting more favourable orders;
- Payments of rebates to private banks in DMC transactions which are passed onto the banks’ clients leading to different pricing in the securities;
- Rebates of brokerage fees to IPO investors; and
- Lack of proper record keeping of client orders, syndicate discussions and allocation recommendations.



Proposals

Given the high level of industry participation and the enthusiasm from the buy-side for these structural improvements in the process, we expect that the consultation will be implemented largely as laid out in the proposals for the revised Code of Conduct.

The SFC has proposed 3 amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (CoC). The same amendments will be made to the Guidelines for Listing and Placing for GEM Stocks for consistency:

- The addition of a new paragraph 21 covering Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions which would apply to intermediaries conducting book building and placing activities in Hong Kong.
- A proposed amendment to paragraph 17 of the CoC to couple the roles of a head of syndicate and a sponsor.
- The introduction of Schedule 11 to the CoC which sets out the information that a Sponsor Overall Co-ordinator ("OC") must provide to the SFC for an IPO.

Paragraph 17 – Sponsors

Before accepting an appointment by a listing applicant as a sponsor in relation to a listing application, the sponsor should either:

- be independent of the listing applicant (as defined in the Listing Rules) and ensure that it or one of its group companies is appointed at the same time as an OC; or
- obtain written confirmation from the listing applicant that at least one independent sponsor, has been appointed as an OC.

Paragraph 21

Scope of Activities

The CoC applies to the following activities which are conducted in Hong Kong in respect of an offering of shares listed or to be listed on the SEHK or an offering of listed or unlisted debt securities offered in Hong Kong or otherwise to issuers, investors or both:

- "bookbuilding activities" which are defined as collating investors' orders (including indications of interest) in a share or debt offering to facilitate the price determination and the allocation of shares or debt securities to investors or the process of assessing demand and making allocations;
- "placing activities" which are defined as distributing shares or debt securities to investors pursuant to those bookbuilding activities; and
- advising, guiding and assisting the issuer client in those bookbuilding and placing activities.



Types of Capital Markets Intermediaries

The SFC has introduced a new definition so a licensed person engaged in any of the above-mentioned capital market activities is referred to as a “capital market intermediary” (“CMI”).

A CMI which is engaged by the issuer of a share or debt offering is a syndicate CMI.

A CMI which is not engaged by the issuer of a share or debt offering is a non-syndicate CMI.

An “Overall Coordinator” (“OC”) of a share offering is a syndicate CMI which solely or jointly conducts any of the following activities:

- overall management of the offering, coordinating the bookbuilding or placing activities conducted by other CMIs, exercising control over bookbuilding activities and making allocation recommendations to the issuer client;
- advising the issuer client of the offer price and being a party to the price determination agreement with the issuer client;
- exercising discretion to reallocate shares between the placing tranche and public subscription tranche, reduce the number of offer shares, or exercise an upsize option or over-allotment option; or
- acting as the stabilising manager.

The OC of a debt offering is a syndicate CMI which solely or jointly conducts the overall management of the offering, coordinates the bookbuilding or placing activities conducted by other CMIs, exercises control over bookbuilding activities and makes pricing or allocation recommendations to the issuer client.

Obligations of all CMIs

Assessment of Issuer Client and Offering

A CMI must conduct an adequate assessment of an issuer client before engaging in a share or debt offering including obtaining an accurate understanding of its history, background, business performance, financial condition and prospects, operations and structure and establishing a governance process to review and assess the offering, including any actual or potential conflicts of interest between the CMI and the issuer client.

Appointment of CMI

Before a CMI conducts any bookbuilding or placing activities, it must ensure that it has been formally appointed under a written agreement by an issuer client in the case of a syndicate CMI or another CMI in the case of a non-syndicate CMI.

The written agreement must clearly specify the roles and responsibilities of a CMI, the fee arrangements and the fee payment schedule.



Assessment of Investor Clients

A CMI must assess whether the profiles of its investor clients (e.g., investment preferences and past investment histories) fall within the types of investors targeted in a marketing and investor targeting strategy developed by the OC and issuer client.

A CMI must identify investor clients which are subject to restrictions or require prior consent from the SEHK ("Restricted Investors") and inform the OC before placing an order for such clients.

In debt offerings, a CMI should identify whether its investor clients have any associations with the issuer client, the CMI or a CMI group company and provide information to the OC to enable it to assess if orders from these investor clients may negatively impact the price discovery process.

Marketing

A CMI should only market to its targeted investors. A CMI must allow all of its investor clients which are targeted investors and have indicated an interest in an offering to participate in that offering.

Where shares are only marketed to selected investor clients, the CMI must be satisfied that the shares have been marketed to a sufficient number of clients and the likelihood of undue concentration of holdings is reasonably low.

Order Book

A CMI must ensure that all orders (including indications of interest) placed in an order book represent bona fide demand of its investor clients, itself and its group companies.

A CMI must enquire with its investor clients about orders which appear unusual (e.g., an order which is not commensurate with the investor client's financial profile) before placing an order.

A CMI must ensure transparency in the bookbuilding process and disclose the identities of all investor clients in an order book, except for omnibus orders. For omnibus orders, a CMI must provide information about the underlying investor clients to the OC and the issuer.

Allocation

A CMI must adopt an allocation policy to ensure a fair allocation of shares or debt securities to its investor clients. There are various factors to be considered including client priority, order sizes, price limits and controls to prevent distortion of demand.

Rebates and Preferential Treatment

A CMI must not offer any rebates to an investor client nor pass on any rebates provided by the issuer client.

In an IPO, a CMI must not enable its investor clients to pay less than the total consideration as disclosed in the listing documents.



In a debt offering, a CMI must not enter into any arrangements which may result in investor clients paying different prices for the debt securities allocated.

A CMI must disclose to the issuer client, OC, all of its targeted investors and the non-syndicate CMIs it appoints any rebates offered (e.g., by the issuer client of a debt offering) to CMIs.

The disclosure must set out who are the targeted recipients of the rebates, the terms and conditions of the rebates, the timing for the payment of the rebates and any other preferential treatment of any CMIs or targeted investors (e.g. guaranteed allocations). In a share offering, the disclosure must be made upon becoming aware of any such rebates and in a debt offering, the disclosure must be no later than the time of the deal ‘launch message’ to targeted investors.

Disclosure of Information to OC, Non-syndicate CMIs and Targeted Investors

A CMI must disclose accurate information in a timely manner on the status of the order book to the OC and non-syndicate CMIs it appoints for them to carry out their duties and to its targeted investors for them to make an informed decision.

Record Keeping

A CMI must maintain books and records of:

- assessments of the issuer client, share or debt offering and investor clients;
- audit trails from the receipt of orders (i.e. including indications of interest);
- the placing of orders in the order book through to the final order allocation (including changes in the orders received, details of the rejected orders, order confirmations with each investor client or CMI prior to the final allocation decisions and records of the allocation decisions made with a special focus on large or unusual allocations);
- all key communications with, and information provided to the OC, other CMIs or investor clients, including information about order book (e.g. launch term sheet and book messages);
- where a CMI’s order is placed on an omnibus basis, the intended basis of allocation for all orders with justifications as well as any material deviations from its allocation policy;
- all key communications with the issuer client, such as disclosures made to the issuer client in relation to actual or potential conflicts of interest;
- rebates offered by the issuer client and the payment details;
- any other preferential treatment offered to itself, non-syndicate CMIs or investor clients; and
- information forming the basis of all submissions made to SEHK and the SFC.

Order records must be kept for 2 years, and all other records must kept for 7 years.

Conflicts of Interest

A CMI must implement policies and procedures to identify, manage and disclose actual and potential conflicts of interest which may arise.

These include when (i) a CMI serves both the interests of its issuer client and investor clients; (ii)



serves the interests of its investor clients when it or its group companies have a proprietary interest in an offering; or (iii) has full discretion over allocations to investor clients or a prop order.

The CMI must have procedures for generating proprietary orders as well as making allocations to such orders. A CMI must always:

- give priority to investor clients' orders over its own proprietary orders;
- only be the price taker in relation to its prop orders and ensure that these orders do not negatively impact the price discovery process; and
- segregate and clearly identify its own prop orders in the order book and book messages.

Prop orders exclude orders placed by a group company for its investor clients or funds and portfolios under its management, except where the CMI has a substantial interest in those funds.

Resources, Systems and Controls

A CMI must have sufficient resources devoted to these activities, implement a formal Chinese wall system, have a formal review and approval system for prop or unusual orders, undertake sufficient due diligence on non-syndicate CMIs and conduct surveillance of electronic and other communications to detect leakage of MNPI or other non-compliance.

Additional Obligations for OCs

Terms of Appointment

Before an OC conducts any activities, it must ensure it is formally appointed by the issuer under a written agreement and the agreement specifies its roles and responsibilities, fee arrangements and the fee payment schedule.

Before accepting an IPO appointment, an OC must ensure that it or an independent group company is also appointed as a sponsor at the same time and the appointments are at least 2 months before the submission of the listing application to SEHK.

Advice to Issuer Client

An OC must:

- ensure that its advice and recommendations to its issuer clients are balanced and based on thorough analysis and are compliant with all applicable regulatory requirements;
- understand the issuer client's preferences and objectives with respect to pricing and the desired shareholder or investor base so that the OC can develop or revise a marketing and investor targeting strategy;
- explain the basis of its advice and recommendations to the issuer client, including any advantages and disadvantages;
- advise the issuer client in a timely manner of key factors that could influence the pricing outcome, allocation and future shareholder or investor base; and
- advise the issuer client and its directors as to their responsibilities in placing activities.



Where the issuer client decides not to adopt an OC's advice or recommendations, the OC must explain the potential effects and advise the issuer clients against making these decisions.

Syndicate Composition & Fee Arrangements

An OC must advise the issuer client in the selection of syndicate CMIs to ensure that they have appropriate seniority and responsibilities, the ratio of fixed and discretionary fees to be paid to syndicate CMIs, the basis of allocation of fixed fees and discretionary fees to syndicate CMIs and the fee payment schedule.

Marketing, Rebates and Preferential Treatment

An OC and the issuer client must devise a marketing and investor targeting strategy for order generation including which investors should be cornerstone investors in an IPO.

An OC must advise the issuer client of the disclosure of any rebates and preferential treatment.

Bookbuilding

An OC must take reasonable steps to ensure that the price discovery process is credible and transparent, the order book has been properly managed and the allocation recommendations made to the issuer client and the final allocation have a proper basis.

An OC must:

- ensure the identities of all investor clients (except omnibus orders) are disclosed in the order book;
- properly consolidate orders in the order book by eliminating duplicated orders, inconsistencies or errors;
- segregate and identify in the order book and book messages any propr orders of CMIs; and
- make enquiries with CMIs which have placed orders which appear unusual or irregular (e.g., orders which appear to be related to the issuer client.)

Pricing

An OC is required to advise the issuer client on the pricing with reference to the results of the bookbuilding activities and prevailing market conditions and sentiment etc.

An OC must advise the issuer client against providing any arrangements where the investor clients would pay less than the total consideration in the listing documents or would pay different prices for the debt securities allocated.

An OC must ensure that the prop orders of CMIs or their group companies or the orders placed by investor clients which have associations with the issuer client, CMIs or their group companies, will not negatively impact the price discovery process.



Allocation

An OC must develop and maintain an allocation policy which addresses:

- the issuer client's objectives, preferences and recommendations;
- the prevailing market conditions and sentiment;
- the types and characteristics and circumstances of targeted investors;
- the spread of investors (for example, the sizes and number of large holdings); and
- the overall subscription rate for the offer.

An OC must make allocation recommendations in accordance with the allocation policy.

Assessment of Investors

In an IPO, an OC must ensure that sufficient information is available to identify Restricted Investors and ensure that they will only be allocated shares in accordance with SEHK Requirements.

In a debt offering, an OC must ensure that sufficient information is available to identify whether investor clients have any associations with the issuer client, CMLs or their group companies.

Disclosures to Syndicate CMLs and Targeted Investors

An OC must:

- share information about the issuer client to other syndicate CMLs to make assessments of the issuer client, identify Restricted Investors and investor clients which have any associations with the issuer client;
- inform other syndicate CMLs of the issuer client's marketing and investor targeting strategy; and
- disseminate material information related to the offering (e.g. launch term sheet and book messages) in a timely manner to all syndicate CMLs and ensure the information is accurate.

Record Keeping

An OC must document and retain for 7 years:

- all changes in the order book throughout the bookbuilding process;
- all key discussions with the issuer client including the composition of the syndicate, fee arrangements, marketing and investor targeting strategy, pricing, allocation policy and disclosures of any actual or potential conflicts of interest;
- key advice or recommendations provided to the issuer client (e.g., allocation rationale, advantages and disadvantages, and any material deviations from the allocation policy);
- the final decisions of the issuer client which deviate materially from the advice of the OC; and
- the rationale for any decisions delegated to it by the issuer client (e.g., pricing and allocation).



Communication with the SFC

An OC must report the following information to the SFC in a timely manner:

- any instances of material non-compliance with the SEHK Requirements;
- any material changes to the information it previously provided to the SFC and SEHK;
- the reasons for ceasing to act as an OC in a share offering transaction;
- in the case of an OC acting as a Sponsor OC, the information specified in Schedule 11; and
- other information as the SFC may require from time to time.

Schedule 11 sets out reporting requirements about syndicate composition and fees.

How we can help

Our dedicated projects team is monitoring the outcome of this Consultation Paper as part of our regular ongoing regulatory change tracking service. If you would like more details of this service or to discuss any changes in your internal policies and procedures in light of the new proposal, we would be delighted to discuss this with you further.



About ComplianceAsia

ComplianceAsia is the longest established compliance consulting firm in Asia Pacific established in 2003 with key offices in Hong Kong, Shanghai, Singapore, Tokyo and London. We have an unmatched track record of completing complex compliance consulting projects for financial firms in the APAC region.

With over 70 staff, including compliance experts with experience in dealing with the SFC, HKMA, MAS, CSRC, JFSA and Asian exchanges, we provide independent, unbiased advice on Asian financial industry legislation and regulations. Our international client base consists of asset managers, hedge funds, private equity funds, family offices, broker-dealers, insurers, wealth managers and investment banks.

Contact Us Today

HONG KONG

Suite 1102
ChinaChem Tower
34-37 Connaught Road
Central

T: +852 2868 9070

SINGAPORE

137 Telok Ayer Street
#03-06
Singapore 068602

T: +65 6533 8834

MAINLAND CHINA

Room 132, Unit 1301-1308
13/F, Shanghai Tower
No.479 Lujiazui Ring Road
Pudong New Area Shanghai

T: +86 147 1431 1859

JAPAN

Level 2
Marunouchi Nijubashi Building
3-2-2 Marunouchi Chiyoda-ku
Tokyo 100-0005

T: +81 3 6837 5483

UNITED KINGDOM

1 St. Andrew's Hill
London
EC4V 5BY

T: +44 (0) 20 7213 0300
M: +44 (0) 7310 972435

Philippa Allen

CEO

E: philippa.allen@complianceasia.com

Alex Duperouzel

Managing Director

E: alex.duperouzel@complianceasia.com

Cherry Chan

Regional Head of Ongoing Support
and Client Services

E: cherry.chan@complianceasia.com

Lachlan Chubb

Regional Head of Regulatory Advisory
and Projects

E: lachlan.chubb@complianceasia.com

Geraltt Owen

Regional Head of Client Relations

E: geraltt.owen@complianceasia.com

Rachel Wu

Head of Mainland China Client Engagements

E: rachel.wu@complianceasia.com

Lucia Liao

Head of Shanghai Office

E: lucia.liao@complianceasia.com

Hanae Kuroda

Compliance Consultant

E: hanae.kuroda@complianceasia.com

www.complianceasia.com



ComplianceAsia