



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Report on Sponsor Theme Inspection Findings

March 2011



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Executive Summary

1. Hong Kong raised a total of HK\$ 248 billion in initial public offering (**IPO**)¹ activities² in 2009 and is a major IPO centre in the world³. Under the Listing Rules⁴, sponsors should be appointed by listing applicants to assist with their initial applications for listing⁵ and be closely involved in preparing the listing documents.⁶ Sponsors thereby play an important role in IPO activities.
2. The work of sponsors (**sponsor work**) involves giving advice on corporate finance, which is a type 6 regulated activity under the Securities and Futures Ordinance (**SFO**). On 1 January 2007, the Additional Fit and Proper Guidelines for Corporations and Authorised Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers (**Sponsor Guidelines**) became effective.
3. The SFC attaches a great deal of importance to maintaining the integrity of the market and the transparency in fund raising exercises. Reviews of sponsors are conducted from time to time as part of our routine inspections so as to assess sponsors' compliance with relevant legal and regulatory requirements and to require corrective actions where needed. Given that the Sponsor Guidelines have been effective for four years, the SFC considers it appropriate to have a larger scale of review so as to gather more information about the sponsor market landscape and to assess the level of compliance by sponsors. Set out below are the key initiatives the SFC has recently undertaken in supervising sponsors:
 - Establishing a specialised team within the SFC in late 2009, which has since conducted a theme inspection on 17 sponsors, focusing primarily on their work undertaken in initial listing applications (**Sponsor Theme Inspection**); and
 - Conducting a survey on all sponsors in October 2009, to gather more information about the general landscape of the sponsor industry, as well as to require sponsors to self-assess their status of compliance with certain regulatory requirements (**Sponsor Survey**). Based upon the findings of the Sponsor Survey, as at 20 September 2009, there were 73 sponsors in Hong Kong. Six sponsors (i.e. around 8% of the sponsor population) are registered institutions (**Bank Sponsors**). Bank Sponsors play a significant role in the sponsor industry, as they account for 39% of the total income derived from sponsor work and employ over one-third of the population of licensed representatives/relevant individuals engaged in sponsor work (**sponsor staff**). Bank Sponsors (and their sponsor staff) however are under the supervision of the Hong Kong Monetary Authority (**HKMA**) whereas all others are under the supervision of the SFC.

¹ For the purpose of this paper, the terms "IPO", "IPO activities", "IPO transactions", "IPO market" and other similar expressions refer to listings by various methods, e.g. offer for subscription, listing by introduction, placing, etc.

² HKEx Fact Book 2009, published by the Hong Kong Exchanges and Clearing Limited (**HKEx**) in March 2010, page 15.

³ Securities and Futures Commission Research Paper No. 46: A review of the global and local securities markets in 2009, page 3.

⁴ Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (**Main Board Listing Rules**) and Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited (**GEM Listing Rules**) (collectively, **Listing Rules**).

⁵ Rule 3A.02 of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.02.

⁶ Rule 3A.11 (1) of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.11 (1).



4. During the Sponsor Theme Inspection, the SFC noted certain deficiencies in the work performed by some sponsors as well as some inadequacies in their internal systems and controls, including the following:
- (a) Unsatisfactory due diligence on listing applicant's business
 - Failing to properly conduct interviews with major customers of the listing applicant (so as to verify the genuineness of the sales figures) to the standard reasonably expected, by e.g. not effectively verifying the identities of the interviewees, and not following-up on key information missing from the due diligence questionnaires.
 - Failing to disclose and conduct due diligence on a new customer, which emerged shortly after the last audited balance sheet date (but before the listing) and became the largest customer of the listing applicant. The new customer might have implication on the listing applicant's business model (e.g. a gradual shift of business focus from domestic sales to export sales).
 - Unduly relying on a piece of legal advice which was prepared based upon certain facts which did not reflect the full and actual business operation of the listing applicant.
 - (b) Questionable disclosure to The Stock Exchange of Hong Kong Limited (**SEHK**) during the listing application process
 - Making questionable disclosure to the SEHK in relation to the independence of a major supplier of a listing applicant.
 - (c) Failure to maintain proper documentation of due diligence
 - Failing to properly document their due diligence inquiries, and as a result, some sponsors were unable to produce relevant records to demonstrate that they had properly considered and disposed of certain issues, which were *prima facie* material in the relevant circumstances.
 - (d) Inadequate internal systems and controls over sponsor work
 - Deploying inadequate manpower and resources to undertake the level and nature of sponsor work that they undertook at the time of our inspection.
 - Failing to comply with the requirement under the Sponsor Guidelines to conduct annual assessments of their internal systems and controls.
5. The SFC will continue its efforts in overseeing the work of sponsors through inspections and enforcement actions. The SFC will continue to engage in close dialogue whenever necessary with relevant regulators. Arising from the concerns expressed in this report, and with the objective to enhancing the sponsor regulatory regime for better investor protection and market quality, the SFC will review existing requirements relating to the work of sponsors. In the meantime, the SFC will issue a circular to all sponsors reminding them of the relevant regulatory requirements.



Introduction

6. Hong Kong has a robust financial infrastructure and is one of the world's international financial centres. Its importance in the IPO market has been increasing. Notably, in 2006, Hong Kong was the second largest IPO fund-raising market in the world after London⁷. In 2009, Hong Kong became the largest IPO centre in the world⁸ and raised a total of HK\$ 248 billion in IPO activities in that year⁹.
7. Companies listed on the SEHK comprise mainly companies incorporated in Hong Kong or overseas whose business is mainly in Hong Kong and/or PRC. The market capitalisation of H share companies¹⁰ and Red Chip companies¹¹ amounted to 45.14% of the SEHK's Main Board market as at 28 February 2011¹². In addition to Mainland China entities, the SEHK has been actively canvassing corporations from other countries to list in Hong Kong.
8. With the recent growth of the IPO market in Hong Kong, it is imperative that a robust legal and regulatory framework is in place to ensure that investors have access to true, accurate and complete information regarding listing applicants' financial position and business prospects, which in turn allows investors to make informed investment decisions.
9. From an investor protection perspective, true, accurate and complete disclosure in listing documents is crucial in the context of IPO activities in Hong Kong. Although responsibility for the information in listing documents lies primarily with the directors of listing applicants¹³, it is a regulatory requirement that sponsors should also be closely involved in the preparation of the new applicant's listing documents.

Sponsor Regulatory Framework

10. Typically, the listing process is initiated by submitting to the SEHK a listing application form, together with other documents required under the Listing Rules¹⁴ including a draft prospectus. Where the SEHK considers that the draft prospectus is not in an advanced

⁷ Securities and Futures Commission Research Paper No. 35: IPO Activities during 2006 and their Performance, page 2.

⁸ Securities and Futures Commission Research Paper No. 46: A review of the global and local securities markets in 2009, page 3.

⁹ HKEx Fact Book 2009, published by the HKEx in March 2010, page 15.

¹⁰ PRC issuers listed on the SEHK which issue shares under PRC law the par value of which is denominated in Renminbi and which are subscribed for and traded in Hong Kong dollars.

¹¹ A company is deemed to be a Red Chip company if (1) the company has at least 30% shareholding held in aggregate directly by Mainland China entities, and/or through companies which are controlled by Mainland China entities; or (2) the company has below 30% but 20% or above shareholding held in aggregate directly by Mainland China entities, and/or through companies which are controlled by Mainland China entities, and there is a strong influential presence, on a judgmental basis, on the company's board of directors. Mainland China entities include state-owned organisations and entities controlled by provincial or municipal authorities. (Definition taken from the HKEx's website at <http://www.hkex.com.hk/eng/index.htm>.)

¹² Figure obtained from Statistics & Research – Securities Market Statistics – China Dimension - Market Capitalisation of China-related Stocks (Main Board and GEM), posted on the HKEx's website at <http://www.hkex.com.hk/eng/index.htm>.

¹³ Rule 11.12 and paragraph 2 of Part A of Appendix 1 to the Main Board Listing Rules. Equivalent provisions in the GEM Listing Rules are Rule 14.23 and paragraph 2 of Part A of Appendix 1.

¹⁴ The documentary requirements are set out under Rule 9.11 (1) to (5) of the Main Board Listing Rules and Rule 12.22 of the GEM Listing Rules.



form¹⁵, it may decline to review the documents and return them to the relevant sponsor. If the SEHK accepts the documents, such documents to the SEHK are also deemed to be filed with the SFC¹⁶. Both the SEHK and the Dual Filing Team of the SFC's Corporate Finance Division (**Dual Filing Team**) will concurrently review, consider and comment on the listing application documents and seek further information where necessary from the sponsor. Submission of revised proofs of the prospectus may be required.

11. Whilst the listing application will be considered at a hearing of the Listing Committee of the SEHK, which may or may not approve the listing application, the SFC has the powers¹⁷ to object to a listing application on certain grounds. The SFC will advise the SEHK whether or not it has any comments on a listing application before or at the time the SEHK makes its final decision on the application. If there are no further comments, the SEHK will proceed to complete the listing process.
12. Under the Listing Rules, sponsors should be appointed by listing applicants to assist with their initial applications for listing¹⁸.
13. Sponsors play a pivotal role throughout the listing process. Specifically, the role of a sponsor includes¹⁹:
 - being closely involved in the preparation of the new applicant's listing documents;
 - conducting reasonable due diligence inquiries²⁰ to put itself in a position to be able to declare to the SEHK, among other things, that the 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 and the financial condition and profitability of the new applicant at the time of the issue of the listing document;
 - ensuring specific requirements in the Main Board Listing Rules²¹ regarding listing application procedures and requirements²² are complied with;
 - using reasonable endeavours to address all matters raised by the SEHK in connection with the listing application including providing to the SEHK, in a timely manner, such information as the SEHK may reasonably require for the purpose of verifying whether the Main Board Listing Rules²³ are being or have been complied with by the sponsor, the new applicant and the new applicant's directors;

¹⁵ Rule 9.03 (3) of the Main Board Listing Rules. The equivalent provision of the GEM Listing Rules is Rule 12.09 and refers to the prospectus being in "anticipated final form".

¹⁶ Pursuant to the Securities and Futures (Stock Market Listing) Rules of the SFO (**SMLR**), which became effective on 1 April 2003.

¹⁷ Under SMLR (please refer to footnote 16).

¹⁸ Rule 3A.02 of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.02.

¹⁹ Rule 3A.11 of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.11.

²⁰ To determine what reasonable due diligence inquiries a sponsor is expected to make, Rule 3A.12 of the Main Board Listing Rules states that a sponsor must have regard to the due diligence practice note at Practice Note 21 to the Main Board Listing Rules. Practice Note 21, which was published in 2005, sets out the SEHK's expectations of the due diligence inquiries that sponsors should undertake in the IPO application process. Equivalent provisions in the GEM Listing Rules are Rule 6A.12 and Practice Note 2.

²¹ In the case of applicants seeking to list on the Growth Enterprise Market of the SEHK (**GEM**), reference should be made to the GEM Listing Rules.

²² Rules 9.03 and 9.05 to 9.08 of the Main Board Listing Rules. Equivalent provisions in the GEM Listing Rules are Rules 12.07, 12.09, 12.10 and 12.12 to 12.15.

²³ In the case of applicants seeking to list on GEM, reference should be made to GEM Listing Rules.



- accompanying the new applicant to any meetings with the SEHK unless otherwise requested by the SEHK, and attending any other meetings and participating in any other discussions with the SEHK as requested by the SEHK; and
- complying with the terms of the undertaking given to the SEHK by the sponsor, which include complying with the Main Board Listing Rules²⁴ applicable to sponsors, and using reasonable endeavours to ensure that all information provided to the SEHK during the listing application process is true in all material respects and does not omit any material information 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 SEHK, it will promptly inform the SEHK of such information.

14. The SEHK is the frontline regulator of all listing-related matters²⁵, responsible for promulgating, implementing and administering the Listing Rules, including the Practice Notes²⁶, which comprise requirements that must be met before a new applicant can be listed on the SEHK, as well as obligations and responsibilities of sponsors. It is also responsible for the administration of the listing process including conducting all vetting of documents relating to the listing application and certain functions under the Companies Ordinance relating to the vetting and authorization of prospectuses as transferred to the SEHK²⁷. It however takes no responsibility for the contents of the listing document and a disclaimer to this effect is contained in every prospectus of a listing applicant.²⁸

15. The SFC, on the other hand, performs the following regulatory functions over sponsors and their activities:

- **Licensing**

Sponsor work involves giving advice on corporate finance, which is a type 6 regulated activity under the SFO. All intermediaries²⁹ therefore must be appropriately licensed (or registered) under the SFO before taking up an appointment as a sponsor.

In addition, on 1 January 2007, the Sponsor Guidelines became effective. Since then, intermediaries that have a type 6 licence (or registration) must also meet the eligibility requirements under the Sponsor Guidelines so as to be approved by the Licensing Department of the SFC to undertake sponsor work.

The Sponsor Guidelines spell out in detail the fit and proper and ongoing requirements of a sponsor, such as specific competence requirements, responsibility of management, eligibility criteria of and requirements on sponsor principals, and requirements for maintaining effective systems and controls. The Licensing Department of the SFC serves as a gatekeeper and ensures that only persons who meet the stipulated eligibility requirements and who are appropriately licensed (or registered) are permitted to act as sponsors.

²⁴ In the case of applicants seeking to list on GEM, reference should be made to GEM Listing Rules.

²⁵ Memorandum of Understanding Governing Listing Matters, signed by the SFC and the SEHK on 28 January 2003.

²⁶ Practice Note 21 to the Main Board Listing Rules and Practice Note 2 to the GEM Listing Rules (collectively, **Practice Notes**).

²⁷ The Securities and Futures (Transfer of Functions – Stock Exchange Company) Order.

²⁸ Rule 11.20 of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 2.19.

²⁹ For the purpose of this paper, the term “intermediaries” refers to licensed corporations and/or registered institutions under the SFO.



- **Dual filing**

As discussed in paragraph 10 above, the Dual Filing Team concurrently reviews and considers listing applications with the SEHK. The Dual Filing Team has the power to request further information and to object to the listing if, amongst other things, it appears to the SFC that the application is false or misleading in a material particular. The Dual Filing Team also publishes the Dual Filing Update from time to time to discuss any substantive issues which have come to their attention during the course of reviewing the draft listing documents submitted by sponsors on behalf of listing applicants.

- **Ongoing supervision**

The Intermediaries Supervision Department of the SFC performs ongoing supervision of sponsors (except Bank Sponsors). In particular, it would from time to time perform on-site inspections on sponsors to assess their compliance with the regulatory requirements. Details of our Sponsor Theme Inspection will be discussed in the “Sponsor Theme Inspection” section below.

In respect of Bank Sponsors, the HKMA is responsible for the day-to-day supervision of the performance by them of regulated activities. Notwithstanding the above, the HKMA and the SFC engage in close dialogue whenever necessary in respect of sponsor supervision.

- **Enforcement**

Where appropriate, the Enforcement Division of the SFC will exercise investigatory powers and take disciplinary actions against sponsors if they are in breach of relevant regulatory requirements³⁰.

Supervision of Sponsors by the SFC³¹

16. The SFC attaches a great deal of importance to maintaining the integrity of the market and the transparency in fund raising exercises. Reviews of sponsors are conducted from time to time as part of our routine inspections so as to assess their compliance with relevant legal and regulatory requirements and to require corrective actions where needed. Given that the Sponsor Guidelines have been effective for four years, the SFC considers it appropriate to have a larger scale of review so as to gather more information about the sponsor market landscape and to assess the level of compliance of sponsors. Set out below are the key initiatives the SFC has recently undertaken in supervising sponsors:-

- Conducting a survey on all sponsors in October 2009, to gather more information about the general landscape of the sponsor industry, as well as to require sponsors to self-assess their status of compliance with certain regulatory requirements; and

³⁰ Sections 182, 183 and 194 of the SFO.

³¹ In the remainder of this report, unless the context otherwise requires, references to and discussions on the supervision of sponsors shall not include Bank Sponsors, which fall under the jurisdiction of the HKMA.



- Establishing a specialised team within the SFC in late 2009, which has since inspected a number of sponsors, and more particularly, conducted a Sponsor Theme Inspection on 17 sponsors, focusing primarily on their work undertaken in initial listing applications.

17. Details regarding these supervisory initiatives are set out below, including some of the common deficiencies and compliance issues we noted relating to the conduct of sponsor activities.

Sponsor Survey

18. In October 2009, the SFC conducted a survey amongst intermediaries eligible to carry out sponsor work under their licence/registration. The Sponsor Survey covered the period between 1 October 2007 and 30 September 2009 (**Survey Period**) and gathered information about sponsor work in respect of applications for listing on the SEHK during the Survey Period.

19. Our key observations³² include the following:

- Sponsors handled 238 and 305 IPO transactions³³ during the years ended 30 September 2008 and 2009 respectively.
- Sponsor staff number totalled 1,640 as at 30 September 2009.
- Total income derived from sponsor work (mainly in the form of underwriting fee) amounted to HK\$ 4,759 million and HK\$ 2,214 million during the years ended 30 September 2008 and 2009 respectively.
- While there were only six Bank Sponsors out of a total of 65 active sponsors during the Survey Period, they accounted for 39% of the total income derived from sponsor work and employed over one third of the sponsor staff.

Population

20. The following table provides an analysis of sponsors according to their industry and size, as measured by the number of sponsor staff, as at 30 September 2009.

Table 1: Sponsor types according to industry and size

Sponsor type	Number of sponsors	Number of sponsor staff
Bank Sponsors	6 (9%)	539 (33%)

³² Out of the 73 sponsors, 65 sponsors indicated in the Sponsor Survey that they had undertaken sponsor work during the Survey Period (**active sponsors**). Our analysis focused on the 65 active sponsors.

³³ These transactions excluded (i) transactions in the pipeline and (ii) listing applications where the size of the offering had not been determined. Moreover, a transaction would be counted multiple times where it (i) involved joint sponsors or (ii) was handled by a replacement sponsor.



Sponsor type	Number of sponsors	Number of sponsor staff
SFC licensed sponsors with 20 or more sponsor staff (Larger Sponsors)	14 (22%)	743 (45%)
SFC licensed sponsors with 19 or less sponsor staff (Smaller Sponsors)	45 (69%)	358 (22%)
Total	65 (100%)	1,640 (100%)

21. The above shows that the aggregate number of Bank Sponsors and Larger Sponsors represented only 31% of the sponsor population but they employed in aggregate 78% of total sponsor staff as at 30 September 2009.

Sponsor Principals

22. As at 30 September 2009, Bank Sponsors and Larger Sponsors had more sponsor Principals than Smaller Sponsors.
23. A few Smaller Sponsors also reported having less than two sponsor Principals as required under paragraph 1.3.1 of the Sponsor Guidelines. The SFC has immediately followed up on these cases and noted that they have ceased to conduct/undertake sponsor activities.

Number of transactions handled concurrently

24. During the Survey Period, it was reported that in the vast majority of cases, sponsor Principals and other sponsor staff only handled one to two transactions concurrently.
25. A sponsor however reported that its sponsor Principals had to handle five or more IPO transactions concurrently during the year ended 30 September 2009. This suggested that the firm might not have sufficient resources to handle its sponsor work. The SFC has since looked into this matter and ensured that appropriate remedial actions had been taken forthwith.

Income derived from sponsor work during the Survey Period

26. Total income derived from sponsor work, whether directly or indirectly, amounted to HK\$ 4,759 million and HK\$ 2,214 million for the years ended 30 September 2008 and 2009 respectively, around 90% of which were paid to Bank Sponsors and Larger Sponsors.

Table 2: Fees paid to sponsors

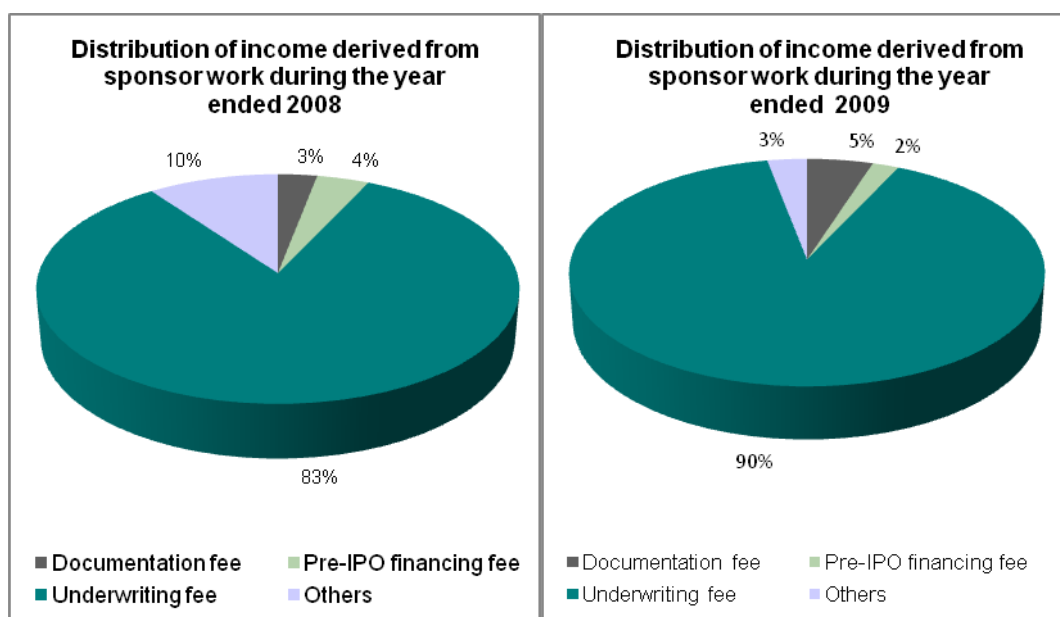
Sponsor type	Fees paid to different sponsors during the year ended -	
	30 September 2008 (HK\$ '000)	30 September 2009 (HK\$ '000)
Bank Sponsors	1,744,138 (36%)	991,923 (45%)



Larger Sponsors	2,365,690 (50%)	1,070,276 (48%)
Smaller Sponsors	648,880 (14%)	151,831 (7%)
Total	4,758,708 (100%)	2,214,030 (100%)

27. The majority of the fees was charged by the sponsors at the firm level. Some sponsors also charged fees in relation to their sponsor work at the group level, mainly in the form of underwriting fees.

Chart 1: Types of fees charged



Other business relationships

28. In addition to the provision of sponsor services, it was noted that the sponsors and/or their group companies would provide other services to the listing applicants concurrently. Services provided include³⁴:

- Asset management;
- Lending and banking facilities;
- Leveraged and structured financing; and
- Pre-IPO placement services.

Joint/sole sponsors

³⁴ Rule 3A.07 of the Main Board Listing Rules provides that at least one sponsor of a new applicant must be independent of the new applicant. A sponsor is not independent if certain circumstances exist at the relevant time until the date of listing, such as if any member of the sponsor group (as defined in Rule 3A.01 (9) of the Main Board Listing Rules) has a current business relationship with the new applicant or a director, subsidiary, holding company or substantial shareholder of the new applicant, which would be reasonably considered to affect the sponsor's independence in performing its duties as set out in Chapter 3A of the Main Board Listing Rules, or might reasonably give rise to a perception that the sponsor's independence would be so affected. Equivalent provision in the GEM Listing Rules is Rule 6A.07.



29. Bank Sponsors and Larger Sponsors mainly acted as joint sponsors in respect of the IPO transactions undertaken during the Survey Period, while Smaller Sponsors mainly acted as sole sponsors, as shown in the table below.

Table 3: Different sponsor types acting as sole or joint sponsors during the Survey Period

Sponsor type	Number of IPO transactions handled during year ended 30 September 2008			Number of IPO transactions handled during year ended 30 September 2009		
	Sole sponsor	Joint sponsor	Total	Sole sponsor	Joint sponsor	Total
Bank Sponsors	3 (3%)	16 (12%)	19 (8%)	10 (7%)	27 (16%)	37 (12%)
Larger Sponsors	55 (53%)	87 (64%)	142 (60%)	59 (43%)	106 (64%)	165 (54%)
Smaller Sponsors	45 (44%)	32 (24%)	77 (32%)	69 (50%)	34 (20%)	103 (34%)
Total	103 (100%)	135 (100%)	238 (100%)	138 (100%)	167 (100%)	305 (100%)

30. Amongst the IPO transactions which involved joint sponsors, the majority of the transactions undertaken by the Bank Sponsors and Larger Sponsors had an offering size of more than HK\$ 1 billion.

Table 4: Distribution of transactions involving joint sponsors during the Survey Period

Offering size (HK\$' million)	Bank Sponsors		Larger Sponsors		Smaller Sponsors	
	2008	2009	2008	2009	2008	2009
<500	3 (19%)	1 (4%)	3 (3%)	3 (3%)	14 (44%)	13 (38%)
500-1,000	3 (19%)	1 (4%)	4 (5%)	4 (4%)	8 (25%)	5 (15%)
>1,000	10 (62%)	25 (92%)	80 (92%)	99 (93%)	10 (31%)	16 (47%)
Total	16 (100%)	27 (100%)	87 (100%)	106 (100%)	32 (100%)	34 (100%)

Self-assessment

31. Sponsors were also required to perform a self-assessment of their compliance with applicable regulatory requirements. Based on their report, some of the sponsors seemingly had non-compliance issues relating to the following:
- Supervision by sponsor Principals;
 - Reliance on third party professionals;
 - Annual review on systems and controls over sponsor work; and
 - Fulfilment of the continuous professional training requirements.



32. The SFC has sought clarification on these responses and required relevant firms to take corrective steps where appropriate. Separately, we have also informed the Hong Kong Securities Institute of the industry's concern regarding difficulties encountered in sourcing training specific to sponsor work.

Sponsor Theme Inspection

Overview

33. Since late 2009, the SFC has conducted a Sponsor Theme Inspection on 17 sponsors.
34. The main purpose of a Sponsor Theme Inspection is to gauge sponsors' compliance with the relevant regulatory requirements. In the Sponsor Theme Inspection that we have conducted, our review has covered:
- The due diligence work undertaken by the sponsors in selected IPO transactions previously handled by them, in respect of the relevant listing applicant's business activities as well as the financial information and material information provided to the SEHK, keeping in view the specific circumstances and business realities of each transaction; and
 - The sponsors' overall internal systems and controls relevant to their conduct of sponsor activities. The key areas of review included the sponsor's capacity to undertake IPO transactions, the involvement of the sponsor's management in supervising its sponsor staff and the effectiveness of the sponsor's compliance function.
35. In selecting Sponsor Theme Inspection targets, the SFC has ensured that the licensed corporations³⁵ selected for inspection covered sponsors of different sizes. Other than size, the SFC also took into account the comments on the sponsors in respect of their work in certain listing applications and other relevant factors in the selection process.

Key Findings

36. During the Sponsor Theme Inspection, the SFC noted certain deficiencies in the due diligence work performed by some sponsors in the listing application process and in the internal systems and controls over sponsor work. The main or common types of deficiencies that were identified in a few sponsors are described below with case examples.

Unsatisfactory due diligence on listing applicant's business

37. A sponsor should conduct reasonable due diligence inquiries so as to place itself in a position to make a declaration to the SEHK in the listing application.³⁶ The sponsor's declaration³⁷ covers pertinent matters such as compliance with the qualifications for

³⁵ No Bank Sponsors are inspected by the SFC as they are subject to the supervision of the HKMA.

³⁶ Rule 3A.11 (2) of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.11 (2).

³⁷ Rule 3A.13 of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.13. The prescribed form can be found in Appendix 19 to the Main Board Listing Rules, or Form G of Appendix 7 to the GEM Listing Rules.



listing³⁸, sufficiency of particulars and information in the listing document for investors to form a valid and justifiable opinion of the financial condition and profitability of the listing applicant³⁹, and the truthfulness of the information in the listing document with no omission of material information⁴⁰.

38. In order to perform its role properly, the sponsor should acquire a reasonable understanding of the listing applicant's business. To achieve this, the sponsor must exercise judgment as to the nature and extent of its due diligence inquiries, appropriate for the particular listing applicant's business in all material respects. The Practice Notes provide that typical due diligence inquiries should include (among other things):
- Assessing the new applicant's performance and finances, business plan and any profit forecast or estimate. This would normally include interviewing the new applicant's major suppliers and customers, creditors and bankers⁴¹ (**due diligence on major business stakeholders**);
 - Assessing whether there has been any change since the date of the last audited balance sheet included in the listing document that would require disclosure to ensure the listing document is complete and not misleading⁴² (**due diligence on material change in business shortly before listing**); and
 - Assessing whether the assumptions upon which the expert's opinion is based are fair, reasonable and complete; and whether the scope of work of third party professional/expert is appropriate to the opinion required to be given⁴³ (**due diligence on third party professional/expert's work**).

(a) Insufficient due diligence on major business stakeholders

39. As part of its due diligence, the sponsor is required to assess the listing applicant's performance and finances, both historical and projected. This would normally include interviewing relevant business stakeholders, such as the major customers and suppliers of the listing applicant.
40. Given that each case is unique, the Practice Notes do not prescribe the scope of the due diligence exercise on suppliers/customers, nor the manner in which the exercise should be conducted. It is the sponsor's duty to exercise its professional judgment as to what is necessary and appropriate in the given context.
41. The due diligence on the listing applicant's suppliers/customers should not in any circumstances be confused with and limited by the minimum content requirements of listing documents. The sponsor's due diligence should always be guided by the principles laid down in the Practice Notes⁴⁴ and should be of such breadth and depth as is reasonably expected of a sponsor to properly discharge its role.

³⁸ Rule 3A.15 (2) of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.15 (2).

³⁹ Rule 3A.15 (3) of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.15 (3).

⁴⁰ Rule 3A.15 (4) of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.15 (4).

⁴¹ Paragraph 13 (b) of the Practice Notes.

⁴² Paragraph 13 (c) of the Practice Notes.

⁴³ Paragraphs 5, 14 (a) and (e) of the Practice Notes.

⁴⁴ Practice Note 21 to the Main Board Listing Rules. Equivalent provisions in the GEM Listing Rules are Rule 6A.12 and Practice Note 2. Please see footnote 19 above.



42. The manner in which due diligence interviews are conducted can directly affect the quality and reliability of information obtained and, to the extent that such information is relied on when preparing the listing documents, undermine the ability of the sponsor (and in turn, the investors) to properly assess the listing applicant's financial conditions.
43. From our Sponsor Theme Inspection, we noted that the due diligence interview practices adopted by some sponsors were unsatisfactory. As seen in the following case example, where the interview practices adopted could not effectively verify the identities of the interviewees and incomplete/unsatisfactory responses were not followed up by the sponsor, the information obtained, which formed a considerable part of the sponsor's due diligence for verifying the existence of major customers and genuineness of sales as disclosed in the prospectus, might not have been reliable. The consequences can be far-reaching as listing applicants, after their successful listings, may subsequently be found to be deceptive, to have acted fraudulently or provided false information in the IPO application process.

Case example 1:

The sponsor interviewed some of the major customers and suppliers of the listing applicant by phone and sent out questionnaires via the listing applicant. Based on the sample documentation we reviewed,

- (i) information on the interviewee was scanty and insufficient to demonstrate that he/she was the appropriate person to be interviewed;
- (ii) some of the questionnaires were substantially incomplete; and
- (iii) some of the questionnaires returned were only signed by an individual (purportedly on behalf of his/her company) though one would generally expect to see a company chop affixed on to the questionnaire given the local market practice.

The sponsor did not follow up on the missing information or seek to confirm the identity or job title of the interviewee.

44. If sponsors do not arrange to receive the interview questionnaires or confirmations directly from interviewees, the results of due diligence inquiries might be subject to interception by the listing applicant or be otherwise tainted. In such circumstances, sponsors should perform additional due diligence to satisfy themselves in relation to the results. We consider that it would be more effective if the sponsor was the one sending out and receiving these questionnaires, with minimal involvement of the listing applicant.
45. Third party interviewees may be wary of disclosing or discussing matters that are confidential or otherwise commercially sensitive to them and therefore in some cases, there may be some degree of resistance on the part of the interviewees to cooperate or participate in the sponsor's due diligence interviews. In such circumstances, the sponsor should seek to understand the cause and nature of the resistance. Explaining the scope and process of the interviews can often help to diffuse some of the concerns. The sponsor should be particularly sceptical if the resistance originates or appears to originate from the listing applicant itself.
46. In order to achieve the purpose of such due diligence interviews and be assured that the information obtained is reliable, it is important that the sponsor properly plans, manages and carries out the interviews.



(b) Insufficient due diligence on material change in business shortly before listing

47. As discussed above, typical due diligence inquiries as set out in the Practice Notes include “*assessing whether there has been any change since the date of the last audited balance sheet included in the listing document*”.⁴⁵ Such due diligence inquiry should be properly conducted by sponsors as any material change, particularly in the listing applicant’s financial information, after the last audited balance sheet date may have implications on the business model and/or business prospect of the listing applicant. The information might also affect investors’ assessment of the listing applicant’s financial performance and projections.
48. The following case example illustrates the proposition discussed above:-

Case example 2:

From our review of the transaction files, we noticed certain changes in sales of the listing applicant during the three-month period immediately following the last audited balance sheet date. Specifically, export sales which were immaterial to the listing applicant’s historical operation increased significantly and the increase was mainly attributed to a new customer which had also become the largest customer of the listing applicant.

The change was material and due diligence should have been conducted for the reason that one would perceive there to be a gradual shift of business focus of the listing applicant from domestic sales to export sales, thereby impacting upon the risk profile of the business.

(c) Insufficient due diligence on third party professional/expert’s work

49. In the listing application process, the listing applicant and the sponsor may engage third party professionals and/or experts to assist with matters requiring technical expertise. The information and advice provided by third party professionals/experts can significantly affect the listing application. Such information and advice may also be included in the prospectus, and ultimately, relied on by investors in making their investment decisions.
50. While a sponsor is not expected to identify and deal with issues in such a manner that require specialised knowledge and skills which a reasonable person in the place of the sponsor does not possess, it is only appropriate for a sponsor to rely on the work performed by third party professionals and/or experts if it could satisfy itself that it is reasonable to rely on such information and advice.⁴⁶
51. Sponsors should also ensure that the scope of work done by third party professionals and/or experts is appropriate with reference to the work required. More particularly, unless in exceptional circumstances, it should not be acceptable if the scope of work of the third party professional/expert is so narrow that his opinion is largely based on the representations of or confirmations from the management of the listing applicant, without further independent inquiries or assessment by the third party professional/expert.

⁴⁵ Paragraph 13 (c) of the Practice Notes.

⁴⁶ Paragraphs 5 and 14 (a) of the Practice Notes.



52. Moreover, under paragraph 14(e) of the Practice Notes, in carrying out due diligence inquiries in relation to the expert sections of the listing document, sponsors should assess whether the assumptions disclosed by the expert as those on which the expert's opinion is based are fair, reasonable and complete by reference to the sponsor's knowledge of the new applicant.

Case example 3:

The listing applicant was engaged in a business that was subject to regulation in a jurisdiction. Certain conduct would appear to be *prima facie* in breach of the applicable legal requirements. Legal advice was submitted to the SEHK, stating that there was likely to be no contravention by the listing applicant. Such legal advice was seemingly rendered upon reviewing limited types of transactions entered into by the listing applicant. We noticed, during the course of our inspection, that there were other types of transactions in the normal course of the listing applicant's business, which clearly suggested that there was a contravention of the applicable legal requirements, but were not considered or discussed in the legal advice.

The sponsor should have questioned the basis of the legal advice, given the other information known to the sponsor was inconsistent with the facts and assumptions upon which the legal advice was based. In this case, the listing applicant did not proceed to listing.

53. If the expert's opinion contains statements that are inconsistent with the other information known to the sponsor about the listing applicant's business or business plans, the sponsor is expected not to rely on the opinion but to make further due diligence inquiries so as to clarify the issues.

Questionable disclosure to the SEHK during the listing application process

54. The prospectus regime in Hong Kong is disclosure based, which requires listing documents to comply with the minimum content requirements in the Listing Rules⁴⁷ and in the Companies Ordinance⁴⁸. If certain material information about the listing applicant is not disclosed in the listing document, investors may not have sufficient information to form a valid and justifiable opinion of the shares and make an informed investment decision.
55. In the following case example, we questioned the level and quality of disclosure made in the prospectus.

Case example 4:

During the track record period, the listing applicant was engaged in certain financing arrangements with its suppliers, which were in breach of the local laws and regulations. It was disclosed in the prospectus that these arrangements had been in place for a

⁴⁷ Rule 11.06 of the Main Board Listing Rules provides, in essence, that the listing documents must contain all the specific items of information which are set out in Appendix 1. Equivalent provision in the GEM Listing Rules is Rule 14.08 (4).

⁴⁸ Sections 38/342 of and Third Schedule to the Companies Ordinance.



certain period of time and the listing applicant had ceased to conduct such arrangements prior to listing.

We noted from the transaction files that the listing applicant might have conducted other similar arrangements which were not disclosed to the SEHK. When the sponsor sought a legal opinion to confirm if these arrangements would also amount to a breach, it only received a draft legal opinion which was inconclusive with certain material information missing. Notwithstanding the above, the sponsor decided to accept the listing applicant's representation that disclosure was not necessary on the premise that the listing applicant considered itself not to be in breach of the relevant local laws and regulations.

56. The consequences of non-disclosure of material information can be very serious. Failure in disclosing material information or provision of false information not only casts doubt on the accuracy and completeness of the relevant disclosure, but also the legality of the listing applicant's business operations at the time of listing. This could have affected the SEHK's assessment of the listing applicant's suitability for listing.
57. It is the duty of a sponsor to use reasonable endeavours to ensure that all information provided to the SEHK during the listing application process is true in all material respects and does not omit any material information.⁴⁹ If there is material omission, the SFC will consider whether any steps should be taken against the sponsor, taking into account the merits of the reasons and explanations given by the sponsor.
58. On some occasions, an omission may not just be regarded as a breach of requirements under the Listing Rules and Practice Notes. Material and obvious omission could amount to the provision of misleading information to the SEHK. It could even be an integrity issue and may affect the SFC's judgement on the sponsor's fitness and properness to remain as a licensed person. The following is a case example that illustrates the above points:

Case example 5:

It was stated in a prospectus submitted to the SEHK that a major supplier of the listing applicant, namely "Company Z", was an independent third party but had previously been a connected party as it was substantially owned by a director of the listing applicant, namely "Mr A". Mr A had sold all his shares in Company Z to a third party, namely "Mr B", and since then Company Z became an independent third party to the listing applicant.

We however noted from the transaction files that around the time when the above-mentioned submission was made, e-mails were dispatched by the sponsor which indicated that Mr A in fact had also entered into a trust agreement with Mr B under which Mr B was only a nominee shareholder, holding the shares of Company Z on trust for Mr A. If that was the case, Company Z should not have been considered as an independent third party.

⁴⁹ Rules 3A.04 (2) and 3A.11 of the Main Board Listing Rules. Equivalent provisions in the GEM Listing Rules are Rules 6A.04 (2) and 6A.11.



After issuing the prospectus but prior to listing, the SEHK specifically requested, amongst others, clarifications from the sponsor in relation to the shareholding of Company Z and the details of due diligence work performed by the sponsor on Company Z.

In its reply, the sponsor did not mention the trust arrangement at all, notwithstanding its awareness of such arrangement and that the discussion of the implications of the trust arrangement formed part of the due diligence work of the sponsor in considering the independence of Company Z.

Failure to maintain proper documentation of due diligence

59. In the course of performing its role, the sponsor should not only comply, but should also be able to demonstrate to the SFC its compliance, with all applicable requirements. The sponsor is required to maintain proper books and records, and be able to provide a proper trail of work done upon request by the SFC⁵⁰.
60. In respect of due diligence work, the sponsor is expected to document its due diligence planning, significant deviations from its plans, as well as conclusions it has reached in respect of the listing applicant's compliance with certain conditions.⁵¹ The sponsor should be in a position to demonstrate that it has turned its mind to the question of what inquiries are necessary and reasonably practicable in the context and circumstances of the case. The management is also required to establish and maintain effective record retention policies so as to demonstrate that all relevant legal and regulatory requirements are complied with, and which enable the SFC to carry out routine and ad hoc comprehensive reviews or investigations to assess such compliance⁵².
61. In our Sponsor Theme Inspection, we have come across some cases where the sponsor was unable to produce relevant records to show to our satisfaction that it had properly considered and disposed of certain issues, which were *prima facie* material in the relevant circumstances. Quite often, the explanation given by those sponsors was that, following careful deliberation, the issue in question was found to be "immaterial" and therefore the sponsor considered that disclosure was not necessary. On that basis, the sponsor also considered that it was not required to have any records of its due diligence inquiries relevant to that issue. The following case example illustrates this point:

Case example 6:

During the listing application process, the sponsor submitted to the SEHK a list of entities related to the listing applicant that competed or were likely to compete with the listing applicant. The same list had also been included in the prospectus.

From our review of the transaction files, we noted that the list did not include a few entities related to the listing applicant which, based on the business scope described in

⁵⁰ Paragraph 2.3 of the Corporate Finance Adviser Code of Conduct (CFA Code).

⁵¹ Paragraph 4 of the Practice Notes.

⁵² Paragraph IV.6 of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission. See also paragraph 1.2.6 of the Sponsor Guidelines.



their respective business licences, could be engaged in competing businesses. When we asked the sponsor for the reason of not mentioning those entities in the prospectus, the sponsor gave us some explanations and also informed us that it had sought oral legal advice on this issue in preparing the listing documents.

Should proper documentation have been kept by the sponsor, the SFC would not have challenged this issue as the sponsor would have been able to demonstrate the steps taken and the deliberations made in reaching its conclusion.

62. We understand that, in many instances, the issue of whether a matter is material to be disclosed, and whether the disclosure contains sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion of the shares and the financial condition and profitability of the new applicant, could be a judgment call. However, in a situation where the matter bears some significance, even if a conclusion has been reached that the matter is not sufficiently material to warrant disclosure, we would expect that there is documentation showing how such a conclusion has been reached. Only then would a sponsor be able to demonstrate that it has turned its mind to the question of what due diligence inquiries were necessary in the circumstances.
63. In the absence of any satisfactory documentary proof, the SFC might not be convinced that the sponsor has actually considered the issue at stake and conducted reasonable due diligence on that aspect. In such a case, the sponsor may not only be in breach of the requirements to keep proper documentation and trail of work, but also other regulatory requirements relevant to the issue at stake.

Inadequate internal systems and controls over sponsor work

64. Sponsors' deficiencies in complying with the provisions of, including the Practice Notes to, the Listing Rules are discussed in the above sections. In order to qualify and remain eligible as a sponsor, an intermediary must also meet specific eligibility and on-going requirements as set out in the Sponsor Guidelines and all other applicable legal and regulatory requirements.
65. The Sponsor Guidelines prescribe a number of specific fitness and properness requirements on sponsors and their staff, covering topics such as:
- expertise and resources to carry out sponsor work;
 - appointment of transaction teams and sponsor Principals;
 - management responsibility and supervision; and
 - internal systems and controls.
66. Amongst all, one of the most basic requirements is that a sponsor should have at least two Principals (as approved by the SFC) appointed in a full time capacity.⁵³ For each transaction, a Principal should be in charge of the supervision of the IPO transaction team. The Principal should be involved in making key decisions relating to the work

⁵³ Paragraph 1.3.1 of the Sponsor Guidelines.



carried out by the transaction team and must be aware of the key risks in such work and responsible for the measures to address them.⁵⁴

67. From the results of the Sponsor Survey as well as the findings of our Sponsor Theme Inspection, we note that all sponsors, other than those whose activities have been suspended, meet the minimum requirement for the number of Principals and also have appointed at least one Principal to supervise each transaction team.

68. Nevertheless, there are other requirements under the Sponsor Guidelines, as more particularly described below, that some sponsors have failed to meet or have simply overlooked.

(a) Manpower and resources to undertake sponsor work

69. For the proper performance of the sponsor's role, the management should ensure that the sponsor has sufficient expertise and resources to carry out its work.⁵⁵ The level of human resources and expertise should be commensurate with the volume, size, complexity and nature of the sponsor work that is undertaken by the sponsor. The sponsor should not undertake sponsor work and other corporate finance advisory work beyond its capacity and expertise.

70. During our sponsor inspections, we found that the level of manpower and resources employed by two sponsors were obviously inadequate given the volume of sponsor work that they respectively undertook at that time.

71. For example, in one case, a sponsor Principal was in charge of supervising seven IPO transaction teams concurrently and all of those seven transactions were active. Aside from sponsor work, that sponsor Principal was also involved in other corporate finance work. In another case, there were only eight licensed representatives (which consisted of four sponsor Principals) in total, working concurrently on six active IPO transactions.

72. The SFC was concerned that the sponsors and/or the sponsor Principal in the above cases had taken up too many engagements that went beyond their capacity and capability to properly perform their role and properly supervise the sponsor work in each engagement. Such arrangements were not acceptable to the SFC and immediate corrective steps were taken.

73. The Code of Conduct provides that a licensed or a registered person should have and employ effectively the resources and procedures that are needed for the proper performance of its business activities.⁵⁶ Sponsors should also be diligent when deciding the composition of an IPO transaction team and should have regard to relevant considerations that may affect the standard of sponsor work. More particularly, sponsors should be competent in terms of expertise, manpower and resources and should carry out the sponsor work to the standards expected of them under the relevant rules, regulations, codes and guidelines.⁵⁷

(b) Annual assessment of internal systems and controls

⁵⁴ Paragraph 1.3.3 of the Sponsor Guidelines.

⁵⁵ Paragraph 1.1.2 of the Sponsor Guidelines.

⁵⁶ General Principle 3 of the Code of Conduct.

⁵⁷ Paragraphs 1.1.3 and 1.2.5 of the Sponsor Guidelines.



74. The sponsor should have in place effective internal systems and controls to ensure compliance with all laws and regulations that may be applicable to its work as sponsor.⁵⁸ An assessment on those systems and controls must be conducted annually, so as to ensure that they remain effective.⁵⁹
75. Based on the survey response and findings from our sponsor inspections, we found that some sponsors did not comply with the annual assessment requirement. They either did not perform the annual assessment properly, or did not perform the annual assessment at all. Different unjustifiable excuses were given by these sponsors for the non-compliance, e.g. a few sponsors were simply unaware of the requirement at all.
76. Since the annual assessment on internal systems and controls is a requirement under the Sponsor Guidelines, sponsors are required to duly comply with the annual assessment requirement in order to maintain their eligibility as sponsors.

Way Forward

77. In all of the above-mentioned cases, if appropriate, the SFC has asked the relevant sponsors to take appropriate actions so as to address our concerns and avoid re-occurrence of similar events. Some cases involving serious breaches are subject to further enquiries. Where appropriate, the SFC will follow up with the SEHK to address any disclosure concerns, and would not hesitate to take further and appropriate regulatory actions.
78. Given that Bank Sponsors play a dominant role in the sponsor industry, we have shared our findings and experience in Sponsor Theme Inspection with the HKMA. The HKMA and the SFC will continue to engage in close dialogue whenever necessary regarding the supervision of sponsors. A copy of this report has been provided to the HKMA and the SEHK for their information.
79. The SFC will continue its efforts in overseeing the work of sponsors. Arising from the concerns expressed in this report, and with the objective to enhancing the sponsor regulatory regime for better investor protection and market quality, the SFC will review existing requirements relating to the work of sponsors. Meanwhile, sponsors should duly comply with the relevant regulatory requirements under the Listing Rules (including the Practice Notes), the Sponsor Guidelines, the CFA Code and all other applicable requirements. In particular, the SFC will issue a circular to remind sponsors of:
- the terms of the sponsor's declaration⁶⁰ that all sponsors must provide to the SEHK during the listing application process, including confirmation that the sponsor has "made reasonable due diligence inquiries" such that it has "reasonable grounds to believe and does believe" that the relevant 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 and the financial condition and profitability of the new applicant at the time of the issue of the listing document*". It is important to bear in mind in this context that a sponsor's failure to make reasonable

⁵⁸ Paragraph 1.5.1 of the Sponsor Guidelines.

⁵⁹ Paragraph 1.5.3 of the Sponsor Guidelines.

⁶⁰ Rule 3A.13 of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.13. The prescribed form can be found in Appendix 19 to the Main Board Listing Rules, or Form G of Appendix 7 to the GEM Listing Rules.



due diligence inquiries exposes the sponsor to substantial disciplinary sanctions and, if the sponsor makes the declaration knowing he has failed to make reasonable inquiries, the sponsor may also be exposed to criminal liability for providing false or misleading information under section 384 of the SFO;

- the terms of the sponsor's undertaking to the SEHK⁶¹, in particular, that the sponsor must *"use reasonable endeavours to ensure that all information provided to the [SEHK] during the listing application process is true in all material respects and does not omit any material information 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 [SEHK], it will promptly inform the [SEHK] of such information"*, and
- the requirements under the Sponsor Guidelines, in particular, the requirements to have sufficient resources and capacity in performing the sponsor work and to conduct annual assessments.

⁶¹ Rule 3A.04 of the Main Board Listing Rules. Equivalent provision in the GEM Listing Rules is Rule 6A.04. The prescribed form can be found in Appendix 17 to the Main Board Listing Rules, or in paragraph 21 of Appendix 5a to the GEM Listing Rules.