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SFC AND SEHK IMPOSE NEW REQUIREMENTS FOR LISTING APPLICANTS, SPONSORS, UNDERWRITERS AND PLACING AGENTS OF GEM IPOs

Introduction

On 20 January 2017, the Securities and Futures Commission (the **SFC**) and The Stock Exchange of Hong Kong Limited (**SEHK** or the **Exchange**), issued a joint statement regarding the price volatility of GEM Stocks (the **Joint Statement**). The Joint Statement sets out regulatory concerns and reminds listing applicants, sponsors and placing agents of the need to ensure full compliance with the GEM listing requirements, and specifically of the need to ensure that conditions exist to provide an open market in the listed securities. The SFC also issued a Guideline to Sponsors, Underwriters and Placing Agents Involved in the Listing and Placing of GEM Stocks providing guidance on their responsibilities on GEM listings.

The Joint Statement is intended as an initial step to address current concerns with GEM IPO placings while the SFC and the Exchange work on broader reform of GEM.

The Joint Statement contains a number of elaborations of the GEM Listing Rules and the new Guideline to Sponsors, Underwriters and Placing Agents Involved in the Listing and Placing of GEM Stocks (the **Guideline**) cross-refers to the GEM Listing Rules as supplemented by the Joint Statement. The key Joint Statement provisions to be aware of in this respect are that:

- the minimum of 100 shareholders specified by GEM Rule 11.23(b) is only a guide as to whether there is an adequate spread of shareholders. Meeting the minimum requirement does not guarantee satisfaction of the Listing Rule requirement for an open market in the securities. Where the

publicly held shares are overly concentrated, the conditions for an open market may not exist, even if the minimum requirement of 100 shareholders is met;

- a placee who receives any benefit, direct or indirect, and whether financial or otherwise, from any person referred to in Note 2 to GEM Rule 11.23(11) (i.e. directors, the chief executive, substantial shareholders of the issuer or its subsidiaries or any of their close associates) in exchange for taking up the placing securities, will not be regarded as a member of the “public” for the purposes of the public float requirement;
- the SFC and/or the Exchange may take action where arrangements or agreements are made with a view to avoiding the application of the GEM Listing Rules whereby one or more persons takes up or holds securities on behalf of, or acts according to the instructions of, any person referred to in note 2 to GEM Rule 11.23(11);
- the Exchange’s right to reject any preferential arrangements afforded to a placee applies whether the preferential terms are offered by the listing applicant, the underwriters, placing agents or other persons and whether or not the placees are persons referred to in notes 1 and 2 to GEM Rule 10.12;
- specific obligations are imposed on new listing applicants in terms of ensuring an open market in GEM IPOs;

- record keeping obligations are imposed on the listing applicant, underwriters, sponsors and placing agents with respect to their participation in the placing process;
- listing applicants and their sponsors are encouraged to inform the Exchange in advance of any intended placing of securities to any persons referred to in Notes 1 and 2 to GEM Rule 10.12(4);
- the SFC or the Exchange may make enquires if there are concerns that the placing securities are concentrated in the hands of too few holders, or that a large number of placees each hold too few securities, or the conditions for an open market may not otherwise exist. A non-exhaustive list of circumstances that may lead to enquiries is included in the SFC Guideline at paragraph 13(c). The listing applicant, sponsors, underwriters and placing agents need to be in a position to provide all relevant information regarding the placing process and the placees so that there is no unnecessary delay to the listing timetable; and
- the regulators will take action in appropriate circumstances where relevant parties (including placing agents) do not have appropriate policies and procedures in place to ensure that GEM IPO placings are conducted in a fair and orderly manner.

Key points to note on the Guideline is that it includes:

- new guidance for sponsors of GEM IPOs on the matters on which they are required to advise the listing applicant in relation to the GEM listing, and ensuring an open market for the securities. These obligations are additional to sponsors' obligations under the Listing Rules and Paragraph 17 of the Code of Conduct. Sponsors should therefore ensure that their compliance manuals are updated to include the new requirements for GEM IPOs; and
- new guidance for placing agents of GEM IPOs. These impose a number of obligations including requirements for:
 - senior management oversight of the conduct of placings;
 - placing agents to put in place policies and procedures to avoid any undue concentration of shareholdings, and to maximise the likelihood of an

open, fair and orderly market, which should include a marketing programme directed to a wide range of clients;

- conducting KYC; and
- record keeping.

The Joint Statement

The Joint Statement sets out the regulators' findings from monitoring GEM stocks which experienced unusually high price volatility after listing:

- The average first-day price gain was 743% for GEM stocks listed in 2015, and 454% for those listed in the first half of 2016. The comparable figures for Main Board stocks were 5% and 15%, respectively.
- Half of the top 10 first day gainers on GEM in 2015 recorded falls of over 90% in their share prices within a month. Trading prices of GEM stocks listed in 2015 fell by 47% on average within a month of their peak.
- Sharp first-day price movements of recently listed GEM stocks were accompanied by thin trading. The average first-day turnover ratio (i.e. shares traded on the first day divided by the placing shares) was 13% for all GEM stocks listed in 2015 and 15% for GEM stocks listed in the first half of 2016. The comparable figures for Main Board stocks were 42% and 61%, respectively.
- 48 out of the 49 GEM IPOs in 2015 and the first half of 2016 were conducted by way of placing only. A large number of GEM-listed stocks have highly concentrated shareholdings and a small shareholder base. In GEM IPOs in 2015 and the first half of 2016, an average of 25 placees took up 96% of the placing shares and the average number of placees for the entire issue was 135.

Regulatory Concerns

Following a recent review of GEM IPO placings, the SFC noted that in a number of placings:

- a) the allocation of a substantial majority of the offered shares were attributable to a small proportion of the placing agents involved in the transaction, who placed the shares to a small number of placees (**top placees**);

- b) the remaining shares were placed in small quantities of one or two board lots to a large number of placees. Although the number of placees exceeded 100, the final allocations had a substantially similar effect to a share placing made only to the top placees and resulted in a high concentration of shareholdings among the top placees; and
- c) A small number of investors repeatedly appeared as the top placees in GEM IPOs that were otherwise unconnected.

The Exchange is responsible for the provision of a fair, orderly and efficient market for the trading of securities while the SFC has a statutory duty to maintain the fairness, efficiency and orderliness of the market.

The regulators are concerned that the practices identified on GEM IPO placings undermine GEM Rule 11.23 which requires an open market in the securities to be listed on the Exchange. A key concern is that these practices may prevent the development of an orderly, informed and efficient market in the securities.

The Joint Statement thus reminds listing applicants that they should assess prospective investors' likely interest in the offered securities, and determine an appropriate allocation basis that satisfies Rule 11.23 and other relevant GEM Listing Rules. Any preferential treatment afforded to any placee must be disclosed in the listing document.

Failure to comply with any of the requirements of the Guideline by a sponsor or placing agent may result in disciplinary action. The SFC will adopt a pragmatic approach taking into account each firm's particular circumstances when assessing a sponsor's or placing agent's compliance with the Guideline.

Regulatory Requirements

The main listing requirements are:

1. Adequate spread of shareholders

- GEM Rule 11.23 requires an open market in the securities for which listing is sought. GEM Rule 11.23(2) specifies that at the time of listing, there must be an adequate spread of holders of equity securities (with the exception of warrants), the number of which will depend on the size and nature of the listing, but as a guide, there should be at least 100 shareholders, including those holding through CCASS.

- The Joint Statement points out that the minimum of 100 shareholders specified by GEM Rule 11.23(b) is only a guide, and that meeting the minimum requirement will not necessarily mean that the Listing Rule requirement for an open market in the securities is satisfied. The SFC and Exchange indicate their view that where the publicly held shares are overly concentrated, the conditions for an open market may not exist, even if the minimum requirement of 100 shareholders is met.

- Nominees will not be regarded as placees where they take up or hold securities in a placing on behalf of others who are the beneficial owners.

2. Shares "in public hands"

- GEM Rule 11.23(10) requires at least 25% of an issuer's total number of issued shares to be held by the public at all times, unless the Exchange has accepted a lower public float of between 15% and 25% for an issuer with a market capitalisation at listing of over HK\$10 billion. The GEM Rules specify that the following are not regarded as "the public":

- i) the directors, chief executive or substantial shareholders of a non-PRC issuer or any of its subsidiaries, or a close associate of any of them, or a promoter, director, supervisor, chief executive or substantial shareholder of a PRC issuer or any of its subsidiaries, or a close associate of any of them (Note 2 to GEM Rule 11.23(11)); and

- ii) any person whose acquisition of securities has been financed directly or indirectly by a person referred to at (i) above, and any person who is accustomed to taking instructions from a person referred to in paragraph (i) on the acquisition, disposal, voting or other disposition of the issuer's securities registered in his name or otherwise held by him (Note 3 to GEM Rule 11.23(11)).

- The Joint Statement notes that a placee who receives any benefit, direct or indirect, and whether financial or otherwise, from any person referred to in paragraph (i) above in exchange for taking up the placing securities will not be regarded as a member of the "public" for the purposes of the public float requirement.

- The SFC and/or the Exchange will also take action in circumstances where arrangements or agreements are made with a view to avoiding the application of the GEM Listing Rules whereby one or more persons takes up or holds securities on behalf of, or acts according to the instructions of, any person referred to in note 2 to GEM Rule 11.23(11) (as set out at paragraph (i) above).

3. Preferential Treatment

- No preferential terms or treatment as to price or otherwise can be given to a placee on a new listing unless the listing document makes adequate disclosure of such preferential terms or treatment.
- The listing document must disclose, as a minimum, details of the existing shareholders or directors and their respective close associates (each identified on an individually-named basis) to whom it is proposed to place shares, indicating, in each case, the number and/or proportion of shares to be placed to them (GEM Rule 13.02(1)). The Exchange also reserves the right to reject any such proposed arrangements. This applies whether the preferential rights are offered by a listing applicant, the underwriters or placing agents and whether or not the placees are persons referred to in notes 1 and 2 to GEM Rule 10.12.
- Preferential terms or treatment may include any of the following: a guaranteed allocation; an unusually large allocation; an agreement to allocate securities in another IPO; a waiver or rebate of brokerage commission; a put option or offer to repurchase the offered securities after the listing; or any other arrangement entered into on a non-arm's length basis in exchange for placees taking up the offered securities.

4. Responsibilities of New Applicant's Directors

The directors of a new listing applicant are responsible for ensuring that the applicant meets all the requirements for listing equity securities and complies fully with the GEM Listing Rules. They also have an obligation to assist the sponsor in the performance of its role, including its conduct of due diligence.

When ensuring that there is an open market for the securities for which listing is sought:

a) the listing applicant must take due care in deciding, in consultation with the sponsor, the following:

- i) the method of listing, in particular, whether the new applicant should adopt an offer for subscription by, or sale to, the public in addition to a placing tranche;
- ii) the target investor type and placee mix – for example, a new applicant may indicate a preference for a percentage of the shares to be allocated to long-term investors rather than short-term investors, or to institutional rather than retail investors);
- iii) the overall strategy and allocation basis with a view to achieving an open market and an adequate spread of shareholders and to ensure the percentage of shares in public hands meets the relevant requirements under the GEM Listing Rules. This will typically include selecting an appropriate number of underwriters or placing agents taking into account their client base, competence, resources and track record, as well as their allocation strategy; and
- iv) any preferential treatment, financial or otherwise, afforded to placees and the relevant disclosure in the listing document;

b) the listing applicant should seek assistance from the underwriters and the placing agents to adopt an appropriate strategy and allocation basis with a view to achieving an open market and avoiding any undue concentration in the holdings of its shares; and

c) the prospectus should list all the underwriters and placing agents appointed and their contact details to provide additional information to investors about available distribution channels.

The listing applicant should also retain proper documentation as to the matters described in paragraph (i) above.

4. Requirements for Sponsors, Underwriters and Placing Agents Involved in Listing and Placing GEM IPOs

The Joint Statement refers to the new SFC Guideline¹ which sets out the standard of conduct expected of sponsors, underwriters and placing agents (including sub-underwriters and sub-placing agents), as licensed or registered persons under the Securities and Futures Ordinance, which are involved in the listing and placing of GEM IPO securities.

Record Keeping

The Joint Statement requires that proper records must be kept by the sponsors, underwriters and placing agents documenting their respective involvement in the placing process, including, where applicable, a record of:

- a) all notifications to clients;
- b) all orders received;
- c) the rationale for allocation of the securities as well as the reason for rejection of orders; and
- d) the list of placees submitted to the Exchange.

Potential Consequences

A list of placees must be submitted to the Exchange before dealing in the securities commences (GEM Rule 10.12(5)).

The Joint Statement advises listing applicants and their sponsors to inform the Exchange in advance of any intended placing of securities to any persons referred to in Notes 1 and 2 to GEM Rule 10.12(4), i.e.:

- a) the issuer's directors and their close associates;
- b) the issuer's substantial shareholders and their close associates;
- c) the issuer's significant shareholders and their close associates;
- d) the issuer's employees;
- e) the Sponsor and its close associates;

¹ SFC. "Guideline to sponsors, underwriters and placing agents involved in the listing and placing of GEM stocks". 20 January 2017. <http://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guideline-to-sponsors,-underwriters-and-placing-agents-involved-in-the-listing-and-placing-of-gem/guideline-to-sponsors,-underwriters-and-placing-agents-involved-in-the-listing-and-placing-of-gem.pdf>

- f) the lead broker and/or any distributor and any connected clients of either (as defined in Note 2 to GEM Rule 10.12);
- g) customers or clients of the issuer;
- h) suppliers to the issuer; and
- i) the underwriters (if any) and their close associates, if different from (e) or (f) above.

The SFC or the Exchange may reject any allocations to such parties on the ground that the requirements of GEM Rule 11.23(2)(b) are not met. If there are concerns that the placing securities are concentrated in the hands of too few holders, or that a large number of placees each hold too few securities, or the conditions for an open market may not otherwise exist, the SFC or the Exchange may make enquires. A non-exhaustive list of circumstances that may lead to enquiries is included in the SFC Guideline at paragraph 13(c). In these circumstances, the listing applicant, sponsors, underwriters and placing agents should be in a position to provide all relevant information regarding the placing process and the placees so that there is no unnecessary delay to the listing timetable.

The Joint Statement says that the regulators will take action in appropriate circumstances where relevant parties do not have appropriate policies and procedures in place to ensure that GEM IPO placings are conducted in a fair and orderly manner.

The SFC Guideline to Sponsors, Underwriters and Placing Agents involved in the Listing and Placing of GEM Stocks (the Guideline)

The SFC Guideline sets out the standard of conduct expected of sponsors, underwriters and placing agents (including sub-underwriters and sub-placing agents), as licensed or registered persons under the Securities and Futures Ordinance, which are involved in the listing and placing of GEM IPO securities.

Failure to comply with the Guideline's requirements may reflect adversely on the fitness and properness of a sponsor or placing agent (and their representatives) and may result in disciplinary action. The SFC states that it will adopt a pragmatic approach taking account of firms' individual circumstances when assessing compliance with the Guideline.

Intermediaries are required to conduct their activities in accordance with the general principles (GP) set out in the Code of Conduct for Persons Licensed by or Registered with the SFC (the **Code of Conduct**), including acting

honestly, fairly and with due skill in the best interests of their clients and the integrity of the market. The GP also require intermediaries to comply with all regulatory requirements applicable to the conduct of their business activities and their senior management bears primary responsibility for ensuring the maintenance of appropriate standards of conduct and the firm's adherence to proper procedures.

1. Specific Requirements of Sponsors

A sponsor, in its capacity as corporate finance adviser, is required by the Corporate Finance Adviser Code of Conduct (the **CFA Code**) to:

- a) use all reasonable efforts to ensure that its client understands relevant regulatory requirements at all stages of a transaction. Upon becoming aware of a client's non-compliance with the regulatory requirements, it should advise the client to bring the matter to the attention of the regulators at the earliest opportunity. If this is declined by the client without valid reasons, the sponsor should consider the need to cease to act (paragraph 6.3 of the CFA Code); and
- b) take all reasonable steps to give its client any information required (including advice on the Listing Rules) to enable its client to make a balanced and informed decision (paragraph 6.4 (b) of the CFA Code).

The Code of Conduct requires a sponsor to:

- a) provide assurance to the Exchange and the market that the listing applicant complies with the Listing Rules and other relevant legal and regulatory requirements (paragraph 17.1 (b) of the Code of Conduct);
- b) advise and guide the listing applicant as to the Listing Rules and other relevant regulatory requirements (paragraph 17.3(b) of the Code of Conduct); and
- c) report to the Exchange in a timely manner where it becomes aware of any material information which concerns non-compliance with the Listing Rules or other legal and regulatory requirements relevant to the listing (paragraph 17.9 (c) of the Code of Conduct).

In addition, a sponsor is required by the GEM Listing Rules to declare:

- a) that having conducted reasonable due diligence enquiries pursuant to GEM Rule 6A.11(2), the new applicant complies with all conditions for listing in Chapter 11 of the GEM Listing Rules (Appendix 7G); and
- b) the number of holders of the shares in public hands, and the percentage of publicly held shares, as required by GEM Rule 11.23 (appendix 7I of the GEM Listing Rules).

2. Specific Requirements of Placing Agents

Placing agents are required to conduct adequate "know your client" (**KYC**) procedures under the Code of Conduct, which include:

- a) taking all reasonable steps to establish the true and full identity of each of its clients, their financial situation, investment experience and objectives (paragraph 5.1 of the Code of Conduct);
- b) being satisfied as to the identity, address and contact details of: (a) the person or entity ultimately responsible for originating the instruction for a transaction; and (b) of the person or entity that stands to gain the commercial or economic benefit of the transaction and / or bears its commercial or economic risk (paragraph 5.4(a)(i) of the Code of Conduct).

3. Guidance to Sponsors

In light of the Joint Statement, a sponsor is expected to use all reasonable efforts to advise the new applicant on:

- a) the relevant regulatory requirements, including the relevant GEM Listing Rules (as supplemented by the Joint Statement) and the potential consequences for non-compliance, specifically the regulators' right to reject allocations to persons referred to in Notes 1 and 2 to GEM Rule 10.12(4) and to make enquiries where there are concerns as to the existence of an open market (as referred to at paragraphs 21 and 22 of the Joint Statement and described above under "Potential Consequences");
- b) the method of listing, in particular, whether the new applicant should adopt an offer for subscription by or sale to the public in addition to a placing tranche;
- c) the target investor type and placee mix;

- d) the overall strategy and allocation basis with a view to achieving an open market and an adequate spread of shareholders, and to ensure that the percentage of shares in public hands meets the GEM Listing Rules' requirements (as supplemented by the Joint Statement). This will typically include selecting an appropriate number of underwriters or placing agents taking into account their client base, competence, resources and track record, as well as their allocation strategy;
- e) the proper disclosure of any preferential treatment (financial or otherwise) afforded to any placees in the new applicant's listing document; and
- f) the retention of proper documentation by the new applicant.

Sponsors are also required to retain proper documentation to demonstrate that the sponsor has used all reasonable efforts to discharge all of its obligations.

4. Guidance to Placing Agents

The Guideline requires placing agents (including sub-placing agents) to have a robust marketing and placing strategy and allocation basis aimed at achieving an open market in the offered securities and meeting the requirement for an adequate spread of shareholders. Placing agents are thus required to ensure that the percentage of securities in public hands meets the relevant requirements under the GEM Listing Rules (as supplemented by the Joint Statement).

The Guideline sets out the following specific requirements for placing agents:

- a) Placings should be conducted with sufficient senior management oversight;
- b) Placing agents should put in place appropriate policies and procedures to avoid any undue concentration of shareholdings, and to maximize the likelihood of an open, fair and orderly market in the securities at the time of listings, which should include a marketing programme directed to a wide range of clients. For example:
 - i) placing agents should promptly notify their clients that they have been appointed as a placing agent for a GEM IPO with a brief description of the new applicant and a cautionary statement. The notification should provide factual, fair and balanced information about the GEM IPO placing, but need

not recommend it to clients. In notifying clients, a placing agent is expected to notify all of its active clients of each placing opportunity. However it will also be acceptable for a placing agent to notify only selected clients based for example on clients' risk appetites and past investment preferences when meeting their suitability obligations, provided that senior management is satisfied that a sufficient number of clients are offered the placing opportunity and the chances of undue concentration are reasonably low. The cautionary statement should remind clients of the higher investment risks and susceptibility to higher market volatility of GEM stocks;

- ii) placing agents should allocate a reasonable number of account executives to each placing transaction and the placing opportunity should not be offered to certain clients to the exclusion of other clients;
 - iii) placing agents should endeavour to respond to enquiries from prospective clients who are interested in participating in the placing and to open accounts for these investors in good time for the placing; and
 - iv) placing agents should not afford clients any preferential terms or treatment unless these have already been disclosed in the listing document. Preferential terms or treatment may include a guaranteed allocation, an unusually large allocation, an agreement to allocate securities in another IPO, a waiver or rebate of brokerage commission, put options or offers to repurchase placing securities after listing or any other arrangement entered into on non-arm's length commercial terms in consideration for the placees taking up the securities;
- c) KYC procedures must be conducted properly. Placing agents are required to take reasonable steps to establish the identity of the client and to confirm whether a client intending to subscribe is the beneficial owner of the client's account (as opposed to a nominee of another person) and is independent of the new applicant, its controlling shareholders and directors. Placing agents should exercise caution when relying on a client's declaration of the client's independence and should make further enquiries (e.g. by

way of internet searches) in cases of doubt. Placing agents are expected to pay special attention to the following 'red flags':

- i) clients subscribing for the placing are procured or introduced by the new applicant, its controlling shareholders or directors;
 - ii) clients subscribing for the placing have known business, financial or other relationships (e.g. employees, suppliers or customers) with the new applicant or any of its controlling shareholders or directors;
 - iii) clients subscribing for the placing have familial relationships or share the same address with other placees; and
 - iv) accounts of clients subscribing for the placing are operated by the same person.
- d) Placing agents should establish the sources of funding for the subscription of placing shares before acceptance of the client's subscription using a risk-based approach. They should further ensure that subscriptions are commensurate with the client's financial position.
- e) Subscriptions should be rejected where there is a suspicion that the client may be a nominee of some other person whose identity the placing agent is unable to ascertain, or where the acceptance of subscriptions will result in an inadequate spread of shareholders. This does not apply to subscriptions by nominee companies to whom allocation may be made if the name of the ultimate beneficiary is disclosed or the Exchange's written consent is obtained (GEM Rule 10.12(1)); and
- f) Proper records are required to be kept to demonstrate compliance with the Guideline throughout the entire placing process. Sufficient details should be available covering: (a) all notifications to clients, (b) all orders received, (c) the rationale for allocation of the securities as well as the reasons for rejection of orders and (d) the list of placees submitted to the Exchange.

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