

August 31, 2022

CHANGES IN HONG KONG SFC REQUIREMENTS FOR “OVERALL COORDINATOR” ROLE RAISE SANCTIONS-RELATED QUESTIONS FOR FINANCIAL INSTITUTIONS SERVING IN THAT CAPACITY

To Our Clients and Friends:

Following a three-month consultation period, the Securities and Futures Commission’s (“SFC”) Code of Conduct (“Code”) provision, paragraph 21, has come into effect on August 5, 2022.[1] The provision outlines new conduct requirements for intermediaries carrying out bookbuilding and placing activities in equity and debt capital market transactions, including, the introduction of enhanced obligations applicable to an Overall Coordinator (“OC”). This client alert discusses these new requirements and how they could raise certain sanctions-related questions for the OC as they consider their new obligations under the Code during their review of the order book.

1. The Role of the Overall Coordinator

The OC is the “head of syndicates” responsible for the overall management of the share or debt offering, coordination of bookbuilding or placing activities, and exercise control over bookbuilding activities and market allocation recommendations to the issuer. In order to address deficiencies in bookbuilding and allocation practices, the SFC has expanded the role of an OC in paragraph 21 of the Code.

In particular, in its Consultation Paper on (i) the Proposed Code of Conduct on Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions and (ii) the “Sponsor Coupling” Proposal (“Consultation Paper”), the SFC highlighted the following key concerns:[2]

- *Inflated demand*: The SFC observed practices where intermediaries knowingly placed orders in the order book which they knew had been inflated. There had also been instances where heads of syndicate disseminated misleading book messages which overstated the demand for an Initial Public Offering (“IPO”). The SFC considered that these inflated orders undermine the price discovery process and can mislead investors.
- *Lack of transparency*: In debt capital market bookbuilding activities, the SFC considered the use of “X-orders,” which are orders where the identities of investors are concealed, as problematic. In these cases, since investors’ identities are only known to the syndicate members who place the orders and to the issuers, the SFC was concerned that duplicated, or potentially fictitious orders might not be identified.
- *Lack of documentation*: Heads of syndicates did not properly maintain records of incoming client orders, important discussions with the issuer or the rest of the syndicate, or the basis for making allocation recommendations. The SFC criticized this practice as it undermined the integrity of

the book-building process, which is meant to be the keeping of contemporaneous records to establish the position in case of any dispute.

In order to plug the gaps in the bookbuilding process identified above, the SFC has expanded the role of an OC to cover additional responsibilities, such as, consolidating orders from all syndicate members in the order book, taking reasonable steps to identify and eliminate duplicated orders, inconsistencies and errors, ensuring that identities of all investor clients are disclosed in the order book (except for orders placed on an omnibus basis), and making enquiries with capital market intermediaries^[3] if any orders appear to be unusual or irregular.^[4]

The OC is under an obligation to advise the issuer on pricing and allocation matters. With respect to allocation, the OC is expected to develop and maintain an allocation policy which sets out the criteria for making allocation recommendations to the issuer, for example, the policy should take account into the types, spread, and characteristics of targeted investors, as well as the issuer client's objectives, preferences and recommendations. The OC should then make allocation recommendations in accordance with the policy.^[5] In practice, the OC's powers are limited to providing recommendations or advice to the issuer on a best efforts basis, and do not go as far as preventing or rejecting an allocation. The final decision on whether to make an allocation lies with the issuer. Therefore, where an issuer decides not to adopt the OC's advice or recommendations, the OC should explain the potential concerns of doing so (*i.e.*, that the issuer's decision may lead to a lack of open market, an inadequate spread of investors, or may negatively affect the orderly and fair trading of such shares in the secondary market), and advise the issuer against the decision.^[6]

2. Potential Sanctions Considerations

These new requirements, however, which aimed to plug the gaps in the bookbuilding process as noted above, may raise new risks or questions for OCs in other regulatory areas, namely whether there may be implications for the OC in terms of its compliance and legal obligations under the various economic and trade sanctions laws and regulations to which the OC may also be subject, such as those issued by the United Nations, United States ("U.S."), European Union ("EU"), United Kingdom ("UK") and others. Specifically, because OCs will now be made aware of the identities of the ultimate investors in an allocation, a financial institution operating as an OC may have concerns about being able to perform its duties under the SFC requirements in cases where an investor has been identified as a possible subject of sanctions under laws that are applicable to the OC.

For example, under U.S. sanctions administered and enforced by the U.S. Department of the Treasury, Office of Foreign Assets Control ("OFAC"), U.S. financial institutions and their foreign branches are generally prohibited from engaging in, approving or otherwise facilitating transactions with individuals and entities designated to OFAC's Specially Designated Nationals and Blocked Persons ("SDN") List. The contours of what kind of activity constitutes prohibited "facilitation" under U.S. sanctions law is not completely defined and is largely fact dependent. Thus, it is unclear whether or not, under U.S. law, the subsequent actions a U.S. financial institution might perform in its role as OC after an investor has been identified as a potential sanctioned person could run afoul of U.S. sanctions

regulations. Similar issues may exist under the laws of other jurisdictions such as the EU or UK, depending on the jurisdictional hooks over the OC in question.

Whether or not there is risk here will depend on a variety of factors, including but not limited to: the precise nature of the OC's actions subsequent to the identification of a sanctions concern (is the OC "approving" or "recommending" action, merely passing along information, recusing itself, etc.); the role, if any, of the OC in actual transactions involving the sanctioned person; the ability of the OC to affect or direct the actual allocation; the precise nature of the sanctions in question; and potentially any contractual protections that may be in place in the underlying operative agreements governing the OC's role.

In addition, OCs will need to weigh the extent to which any potential sanctions obligations, including anti-boycott / blocking statute related, could conflict with the OC's obligations under the Code, to provide adequate allocation advice to the issuer with due skill, care and diligence.^[7]

Our view is that ultimately both sets of risks and obligations can be effectively managed and met, and we are working with clients and industry to understand and address the impact of these new regulations on the policies and procedures of financial institutions serving in the OC capacity.

[1] *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (August 2022), published by the Securities and Futures Commission, https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code_of_conduct_05082022_Eng.pdf.

[2] *Consultation Paper on (i) the Proposed Code of Conduct on Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions and (ii) the "Sponsor Coupling" Proposal* (February 2021), published by the Securities and Futures Commission, <https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=21CP1>.

[3] "Capital Market Intermediaries" is defined as licensed or registered persons that engage in capital market activities, namely bookbuilding and placing activities and any related advice, guidance or assistance. See paragraph 21.1.1 of the Code.

[4] Paragraph 21.4.4(a)(i) of the Code.

[5] Paragraph 21.4.4(c) of the Code.

[6] Paragraph 21.4.2(c) of the Code.

[7] Paragraph 21.4.2(a) of the Code.



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