

Hong Kong Equities Look For Brighter 2013

Law360, New York (February 14, 2013, 12:35 PM ET) -- Following its leading role in primary equity capital raising for the previous three years, Hong Kong's equity markets made a sharp retreat in 2012. Last year's Hong Kong IPO market likely will be remembered for the following:

- **A Significant Drop in Capital Raised.** According to the Hong Kong Stock Exchange (HKSE), \$10.76 billion was raised in IPOs, a 67 percent drop from 2011, and the exchange's average daily turnover in value terms was down 24 percent for the year. Many of the larger equity deals during the year consisted of secondary fundraising by established issuers, with total secondary funds raised remaining steady compared to 2011 at \$26 billion.
- **Greater Dependency on Committed Investors.** Almost all IPOs of meaningful size depended on significant sales in the IPO to "friends and family" or were substantially supported by multiple cornerstone investors prior to launch. A number of transactions saw the introduction of new bookrunners very late in the process, with participation and economics closely tied to the ability to deliver committed investors.
- **Fewer Non-Chinese Listings.** With the notable exception of the Sunshine Oilsands IPO, and in contrast to the past few years, last year saw few listings on the HKSE by businesses based or controlled outside of China. Several high-profile deals, including the Graff Diamonds IPO, were delayed or canceled. Likely causes include the lower valuations, the poor aftermarket performance and liquidity of some overseas companies that listed in the past few years, and the perceived time and expense that the Hong Kong listing process entails.
- **An Increased Focus on Regulating the IPO Process.** One investment bank's license to advise on IPOs was revoked as the result of performing inadequate due diligence, and the Hong Kong Securities and Futures Commission (SFC) issued a set of proposals intended to bring about heightened levels of responsibility for investment bank sponsors of new listing applications. While it remains to be seen whether the SFC's proposal to make sponsors criminally liable for prospectus misstatements ultimately will become law, a number of the other proposals, including the public disclosure of draft prospectuses at the initial filing stage and the requirement for sponsors to have completed due diligence prior to the initial filing, are now set to come into effect on Oct. 1, 2013. We believe the increased focus on the role of sponsors should be coupled with further steps to streamline the listing process.

What to Expect in 2013

While it is difficult to be certain, there are indications that market sentiment and prospects are improving.

With the successful closing of the IPOs of PICC Group (the largest IPO of 2012 by value) and China Machinery Engineering (the most oversubscribed IPO of 2012) in December, and the Hang Seng Index close to an 18-month high, the Hong Kong markets seem poised for positive momentum into 2013.

Moreover, several of the uncertainties that cast a shadow over the Hong Kong market throughout 2012 — slower Chinese economic growth, China's leadership transition and the 18th Communist Party Congress, financial uncertainty in Europe and the U.S. presidential election — seem less likely to cause concern this year.

The Hong Kong market also may reap an indirect benefit from the inability of the United States Public Accounting Oversight Board (PCAOB) to inspect Chinese accounting firms. Under Sarbanes-Oxley, the PCAOB is required to periodically inspect all accounting firms that audit U.S. reporting companies. Citing national security concerns, Chinese authorities have not been willing to permit these inspections and, to date, the PCAOB's efforts to agree on a regime of joint inspections have been unsuccessful.

The deadline for completion of inspections was Dec. 31, 2012. As of this writing, the PCAOB has not made any public statements that it is taking action. However, the deregistration or suspension of registration of PRC-based accounting firms, including the affiliates of the "Big Four," could commence at any time if an agreement on inspections is not reached.

Upping the ante, the U.S. Securities and Exchange Commission announced on Dec. 3, 2012, that it was bringing charges against the Chinese affiliates of the Big Four accounting firms for violating U.S. securities laws by refusing, in the context of a number of ongoing SEC investigations, to produce documents relating to their audits of China-based U.S.-listed companies. Discussions are ongoing and there is still a likelihood that a deal on inspections will be reached before any accounting firms are deregistered.

However, the prospect of being unable to find an auditor (and the eventual delisting and deregistration in the U.S. that would follow) could further undermine investor interest in U.S.-based China businesses, and could result in some affected companies deciding to exit the U.S. in favor of Hong Kong as a listing venue, or to pursue a dual listing in both venues as a contingency measure (see "Global M&A/China M&A: Looking Ahead to 2013").

Finally, 2013 also could be the year that the first of the previously U.S.-listed China businesses taken private by their founders (a trend we commented on in Insights last year [1]) is relisted in Hong Kong. While such deals likely would be subject to a good deal of regulatory scrutiny in light of allegations of widespread financial and other irregularities, particularly among Chinese businesses that were listed in the U.S. through reverse takeovers, we believe that the majority of U.S.-listed companies that have gone private likely will be suitable candidates for eventual relisting in Hong Kong.

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[1] See "Global M&A," Skadden Insights (January 2012), available at <http://www.skadden.com/insights/global-ma-0>.

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