

26 March 2018

Circular to licensed corporations on expected standards for sponsor work

The Securities and Futures Commission (SFC) has identified a number of compliance failures primarily from a recent thematic inspection¹. The SFC reminds licensed corporations to comply with the expected standards as set out in this circular in carrying out sponsor work.

Detailed findings are set out in a *Report on the Thematic Review of Licensed Corporations Engaged in Sponsor Business*

<http://www.sfc.hk/web/EN/files/ER/Reports/Report%20on%20the%20Thematic%20Review%20of%20Licensed%20Corporations%20Engaged%20in%20Sponsor%20Business.PDF>, issued today by the SFC, which highlights a number of deficiencies and instances of non-compliance with relevant provisions in the Code of Conduct², CFA Code³ and the Listing Rules⁴ (including the practice notes) in respect of due diligence practices and internal systems and controls.

In addition, 44 listing applications were returned or rejected⁵ as of the date of the report. In a number of cases, the sponsors' work or the listing application materials were below the expected standard. It is also noteworthy that some individual sponsors handled a relatively large number of the listing applications which were returned or rejected.

Sponsors with a history of returned or rejected listing applications or serious deficiencies and instances of non-compliance may expect more frequent inspection visits and supervisory actions, as these factors may cast doubt on a sponsor's capability to discharge its responsibilities as well as potential compliance risk. Future listing applications submitted by these sponsors may also be subject to closer scrutiny by the regulators.

Separately, the SFC notes that the sponsor population in Hong Kong grew from 75 as at 31 December 2012 to 107 as at 31 December 2017, with 17 sponsors joining the industry since January 2016. This raises concerns that some sponsors, particularly recent entrants, may not have sufficient experience in resolving difficult issues.

The SFC will not hesitate to take enforcement action against sponsors and their senior executives responsible for failure to comply with the expected standards in sponsor work.

The report also highlights practices observed during the thematic inspection which meet the expected standards.

¹ The inspection primarily reviewed the work undertaken by 31 sponsors from October 2013, when the new sponsor regulatory regime was introduced, to 31 December 2017.

² This refers to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, with specific reference to Paragraph 17 on sponsors.

³ Corporate Finance Adviser Code of Conduct.

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

⁵ This refers to listing applications (excluding those relating to transfers of listings from GEM to the Main Board) returned by the SEHK or rejected by the SEHK or the SFC based on publicly available information.



I. Due diligence

(a) Exercising reasonable judgement and applying professional scepticism

Understanding the listing applicant

- Sponsors should have a sound understanding of the business of a listing applicant based on reasonable due diligence⁶. For example, sponsors should, where applicable:
 - obtain sales walkthrough documents to verify if the listing applicant's business operations are accurately described in the listing application. Key issues are often identified in these documents, such as an apparently unrelated third party making payments on behalf of customers, contractual arrangements with customers that are outside the ordinary course of business or goods not being shipped to customers;
 - conduct reasonable due diligence on the listing applicant's major retail or online customers. This is especially relevant where certain customers account for a materially larger portion of sales than others; and
 - conduct reasonable due diligence on the volume of business at the listing applicant's major retail stores. This is especially relevant where particular stores account for a materially larger portion of sales than other stores or industry peers.
- Sponsors should perform background research on the listing applicant and update it regularly, especially if the listing application process is expected to continue for some time or if the listing applicant operates in a fast-evolving industry or regulatory environment.

Due diligence plan and checklist

- Sponsors should keep records of their due diligence plans⁷. However, the SFC found that the plans adopted by sponsors nowadays mainly serve to confirm that broad due diligence measures have been taken, and they often fail to demonstrate the factors considered in planning the due diligence and the specific due diligence conducted as well as the issues identified and the steps taken to resolve them⁸.
- Sponsors should develop robust, comprehensive and customised due diligence plans at the start of each engagement, instead of merely relying on a generic due diligence checklist. It is important to give due and careful consideration to all major areas of the due diligence process at an early stage. If this is done too late (for example, just before the listing application is due to be submitted), sponsors may be under pressure to resolve issues quickly in order to meet the timetable agreed among all the parties.
- During the listing process, sponsors should adapt due diligence plans and checklists for listing applications as needed. Plans, checklists and subsequent updates should be

⁶ As required under Paragraph 17.3(a) of the Code of Conduct.

⁷ As required under Paragraph 17.10(c)(ii)(A) of the Code of Conduct.

⁸ As required under Paragraphs 17.10(c)(ii)(C) and (D) of the Code of Conduct which states that "In respect of each listing assignment, a sponsor should keep records, including relevant supporting documents and correspondence, within its control relating to... the nature, timing and extent of due diligence procedures; and... the results of due diligence performed together with its assessment of these results".



approved by designated senior members of the Transaction Team⁹ and properly recorded.

- Sponsors should keep proper records documenting the breadth and depth of their due diligence and the results, including the specific issues identified and how they were resolved. They should require all material risks and issues identified to be properly logged and accompanied by stand-alone due diligence notes as appropriate. For example, where sponsors and other professional parties conduct site visits to the listing applicant's main business locations or customer premises, sponsors should document the criteria for selecting these sites (such as the percentage of sales covered), the names of the sites inspected as well as those participating in the site visits, any verification work conducted and all instructions or guidance provided to participating staff.

Relying on third parties

- Sponsors cannot abrogate their responsibility for due diligence and they remain responsible for matters related to the tasks undertaken by a third party. They should not simply use a third party's work as evidence that they have discharged their obligation to conduct reasonable due diligence¹⁰. In itself, the work of the third party (eg, a legal opinion, an internal control review report or an investigation report) is not sufficient evidence of sponsors' due diligence. Sponsors should be able to demonstrate that they have given due consideration as to whether such work could form the basis for them to discharge their due diligence obligations.
- Sponsors should be able to explain:
 - why they decided to rely on a particular third party to discharge their due diligence obligations, giving due consideration to the qualification and competence of the third party;
 - whether they communicated to the third party the scope and extent of the due diligence to be conducted;
 - whether the work of the third party provided a sufficient basis to determine that reasonable due diligence had been conducted and whether further due diligence was required, taking into consideration:
 - whether the work was conducted as contemplated by the sponsors;
 - whether the due diligence was commensurate with the standards expected of sponsors; and
 - whether the sponsors considered the bases and assumptions for the reports or opinions to be fair, reasonable and complete.

Relying on experts

- Sponsors should critically review the expert's opinion and conduct follow-up work to resolve any material discrepancies, irregularities or inconsistencies¹¹. For example, sponsors should conduct further enquiries if there are any concerns about the information underlying the accountant's report¹². Sponsors should also note that while auditors have

⁹ As defined under Paragraph 17.15(s) of the Code of Conduct.

¹⁰ As required under Paragraph 17.6(g) of the Code of Conduct which states that "A third party's work, in itself, would not be sufficient evidence that a sponsor has discharged its obligation to conduct reasonable due diligence."

¹¹ As required under Paragraph 17.7(d) of the Code of Conduct.

¹² As required under Note 1 to Paragraph 17.7(b) of the Code of Conduct.



audited the listing applicant's accounts, this would not in any way relieve them from their responsibility as sponsors to assess the listing applicant's financial and business performance¹³. Therefore, when dealing with specific due diligence issues, sponsors should also be able to demonstrate that they have considered how an expert's report could form the basis for them to discharge their due diligence obligations and whether additional due diligence is required¹⁴.

Identifying and following up on red flags

- In carrying out due diligence, sponsors should take reasonable steps to identify red flags and cross-check information obtained from different sources¹⁵. For example, sales information obtained from interviews with major customers or total turnover of major industry players obtained from official statistics or consultancy firms should be compared with sales information provided by the listing applicant. Any material irregularities should be properly followed-up and resolved.
- Sponsors should be especially sceptical of claims that an abnormal practice or unusual business conduct is the industry norm or a common practice. This should be of little relevance. Instead, sponsors should focus on whether such practice or business conduct cast doubt on the genuineness of the financials of the listing applicant, its legality and commercial rationale. Sponsors should further seek to understand the potential liability and other implications of such practice or business conduct.

(b) Interview practices

- Sponsors should exercise due care in confirming the bona fides of interviewees in order to be satisfied that they have the appropriate authority and knowledge¹⁶. Without this confirmation, an interview's value as a due diligence measure would be greatly diminished. In particular:
 - sponsors should, as far as possible, conduct interviews at interviewees' business premises and conduct further cross-reference checks of more than one type of proof of identity. If this protocol is not adopted, sponsors should ensure any irregularities are adequately explained and resolved. Sponsors should also take reasonable alternative steps to verify the interviewee's bona fides; and
 - where interviews are conducted by telephone, sponsors should verify the telephone numbers and identities of the interviewees. In particular, sponsors should not rely solely on telephone numbers provided by the listing applicant to verify an interviewee's identity. For example, they could call the general line of the interviewee's company obtained from a reliable public source (such as a telephone directory) to verify the interviewee's position and confirm that the individual participated in the interview.

¹³ As required under Paragraph 13(b) of Practice Note 21 of the Main Board Listing Rules or Practice Note 2 of the GEM Listing Rules.

¹⁴ For the avoidance of doubt, where an entity is assisting in connection with due diligence tasks as well as being responsible for an expert report for a particular listing application, footnote 5 to Paragraph 17.6(g) of the Code of Conduct states that guidance for sponsors in Paragraph 17.6(g) applies to the due diligence tasks and the guidance in Paragraph 17.7 to the work as an expert. As a result, where an expert is assisting with due diligence tasks, it functions as a third party when undertaking those due diligence tasks and the above guidance to sponsors on relying on third parties will apply.

¹⁵ Paragraphs 17.6(a), (b) and (c) of the Code of Conduct.

¹⁶ Paragraph 17.6(f)(iii) of the Code of Conduct.



- Separately, sponsors should also document:
 - the criteria for selecting interviewees;
 - if any persons selected refused to attend the interview, what were the reasons and how this was followed up (for example by trying to fix another interview or performing other due diligence); and
 - the name and position of any other person present during the interview (this is especially relevant if representatives of the listing applicant insisted on attending the interview).
- To ensure that the representations made by the interviewees reflect the position of their respective companies, sponsors may request telephone interview notes to be validated by the interviewees' companies with copies of the interviewees' identity documents attached.

II. Proper records

- Sponsors should maintain sufficient records to demonstrate whether they conducted proper due diligence and adequately investigated contentious issues as well as how their conclusions were reached. They should maintain a detailed due diligence plan and document the work conducted.
- In particular, sponsors should be guided by the decision of the Securities and Futures Appeals Tribunal (SFAT) in *Sun Hung Kai International Limited v Securities and Futures Commission*¹⁷, extracted as follows:

“The rules and principles of conduct within which sponsors work demand that they maintain records that are sufficiently exact and detailed to enable them, upon request by the SFC, to provide a ‘proper trail of work done’. Such a trail must include documentation of due diligence planning which itself demands a demonstration that sponsors have turned their minds to what enquiries are necessary by way of reasonable due diligence in the context and circumstances of an application. Importantly, sponsors are required to document the conclusions they reach regarding an applicant’s compliance with the listing rules.

Accordingly, a ‘bare bones’ outline setting out only broad and entirely expected areas of due diligence is insufficient.”

- Sponsors should maintain comprehensive records of their due diligence in relation to matters which are material to the listing applicant’s business, including but not limited to:
 - the listing applicant’s major customers, suppliers, bankers and creditors as well as its directors and senior management;
 - material assets used or to be used in connection with the business;
 - contracts material to the business;
 - legal proceedings and other material disputes the listing applicant or its subsidiaries are involved or may be involved in; and

¹⁷ Please refer to Paragraphs 236 and 241 in its Reasons for Determination dated 27 January 2014 in SFAT No 3/2013.



- the existence, validity and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights.
- Separately, sponsors should bear in mind the high turnover of personnel in the industry and ensure that they can locate and retrieve records after Transaction Team members depart.

III. Resources, systems and controls

(a) Corporate governance

- The Management¹⁸ of a sponsor is ultimately accountable for the firm's compliance with the applicable codes, rules and regulations, including the requirements to maintain satisfactory operational controls and risk management procedures as well as adequate human and technical resources.
- In line with the Manager-In-Charge (MIC) regime implemented by the SFC, the Board of Directors (the Board) and other members of Management, including any relevant committees designated by the Board, should be structured in a way which enables the Board to oversee and control the activities of the firm effectively. The firm's organisational structure should be documented and approved by the Board, clearly setting out, among other things, the MICs responsible for overall management oversight of the firm and the MICs specifically responsible for directing and overseeing the sponsor business, as well as their reporting lines.
- A sponsor should have clear policies requiring critical matters to be escalated to its Board, responsible MICs or its designated committee for consideration.
- Management of sponsors should ensure the appropriateness of the team structure for each sponsor engagement. Sponsor Principals¹⁹ should maintain an effective reporting line as well as communication among their Transaction Teams and other members of Management regarding the sponsor work undertaken.
- Sponsors should be able to demonstrate the involvement of Management in the consideration of key issues.

(b) Other aspects

- Sponsors should ensure that sufficient resources are allocated to each engagement and provide sufficient training, guidance and management supervision over sponsor work.
- Commonly, the junior staff members on a Transaction Team are responsible for the main due diligence under the supervision of the sponsor Principal or other more senior staff. Escalation policies should, among other things, cite examples of material risks and issues and specify an appropriate threshold for internal escalation. Scenario-based training for identifying and resolving material issues should also be provided to staff. This should be supplemented by on-the-job training by the sponsor Principal or other more

¹⁸ As defined under Paragraph 17.15(i) of the Code of Conduct.

¹⁹ As defined under Paragraph 17.15(l) of the Code of Conduct, "Principal" means an individual who meets the criteria stipulated under the Sponsor Guidelines appointed by a sponsor to act as a Principal; in respect of a listing assignment, a Principal means an individual appointed by a sponsor to supervise the Transaction Team.



senior staff. Records should be maintained of the escalation of critical matters to Management and their final resolution.

- Sponsor Principals should adequately supervise their Transaction Teams at all times. They should attend key due diligence interviews together with junior team members to be better informed about the listing applicants and provide timely guidance to the Transaction Team when needed.

(c) Annual assessment of systems and controls

- Annual assessments should not rely solely on the attestation of the sponsor Principals. Reviews of policies and procedures should be conducted to ensure compliance with the relevant codes, rules and regulations. Review of samples of listing applications should be conducted to ensure that key policies and procedures are effectively implemented.

Sponsors should pay regard to the areas of concern discussed in this circular and the *Report on the Thematic Review of Licensed Corporations Engaged in Sponsor Business*, and critically review and enhance their systems and controls as needed to ensure that their conduct standards and control procedures meet the relevant regulatory and legal requirements. The SFC will continue to monitor market and regulatory developments and may take further measures where appropriate.

Should you have any queries regarding the contents of this circular, please contact Ms Seine Luk at 2231 1696.

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