



Hong Kong

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SFC IDENTIFIES CONTINUED DEFICIENCIES IN SPONSOR WORK

On 26 March 2018, the Securities and Futures Commission (**SFC**) issued a Circular to licensed corporations on expected standards for sponsor work¹ (the **Circular**) following the release of their Report on the thematic review of licensed corporations engaged in sponsor business² (the **Report**).

The deficiencies in sponsor work highlighted by the SFC include:

- failure to follow up on apparent red flags during due diligence;
- box-ticking standard due diligence checklists resulting in failure to address issuer-specific matters outside the scope of standard checklists; and
- failure to confirm that persons interviewed had the authority and knowledge to confirm or provide requested information.

The Report notes that these deficiencies were especially common for sponsor work done for GEM IPOs.

Between October 2013 and December 2017, 44 listing applications were returned or rejected due to concerns raised during the vetting process. Sponsors whose listing applications have been rejected or returned are told to expect more frequent SFC inspection visits and supervisory actions.

- 1 <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=18EC23>
- 2 <http://www.sfc.hk/web/EN/files/ER/Reports/Report%20on%20the%20Thematic%20Review%20of%20Licensed%20Corporations%20Engaged%20in%20Sponsor%20Business.PDF>

The Report assessed the standard of sponsor work against the requirements of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**), Corporate Finance Adviser Code of Conduct (**CFA Code**) and the Listing Rules. The Circular draws attention to the standards of sponsor work expected under the Code of Conduct.

I. The Circular - Expected standards of sponsor work

The SFC's Circular notes the following expected standards of good practice for sponsors.

1. Due Diligence

a) Exercising reasonable judgement and applying professional scepticism

Understanding the listing applicant

Sponsors are expected to develop a good understanding of the listing applicant's business through measures such as:

- Verifying the accuracy of the description of the listing applicant's business operations in the listing application by obtaining sales walkthrough documents. Red flags in such documents are third parties' unrelated payments on behalf of customers, contractual arrangements outside of the ordinary course of business and goods not shipped to customers;

- Conducting proper due diligence on major retail or online customers of the listing applicant. This is particularly relevant where certain customers account for a materially larger portion of sales than others; and
- Conducting proper due diligence on the volume of business at the applicant's major retail stores.

Sponsors should perform background research on listing applicants and regularly update it, especially for listing applications which are expected to continue for some time or for listing applicants in fast-evolving industries or regulatory environments.

Due diligence plan and checklist

Sponsors should keep comprehensive records of their due diligence plans. The SFC noted that plans often serve mainly to confirm that broad due diligence measures have been implemented but fail to demonstrate the factors taken into consideration in planning due diligence, the specific measures conducted, issues identified or steps taken to resolve them.

The Circular recommends that:

- Sponsors develop robust, comprehensive and customised due diligence plans at the start of each sponsor engagement. Generic due diligence check lists should not be relied on. Due consideration needs to be given to all major areas of due diligence at an early stage.
- During the listing process, sponsors should adapt due diligence plans and checklists for listing applications. Plans, checklists and subsequent updates should be approved by designated senior members of the Transaction Team and properly recorded.
- Proper records of due diligence documenting the breadth and depth of the due diligence and results should be kept. The records should include specific issues identified, how they were resolved, and a log of all identified material risks and issues and should be accompanied by stand-alone due diligence notes. For example, sponsors should document the criteria for selecting business locations or customer premises for site visits (such as the percentage of sales covered), the names of sites inspected and of persons participating in site visits, any verification work and all instructions or guidance given to participating staff.

Relying on third parties

The SFC reminds sponsors that they are responsible for tasks undertaken by a third party and that they cannot use the work of a third party as evidence that they have discharged their obligation to conduct due diligence. A third party's work in itself is not sufficient evidence of sponsor due diligence.

Sponsors should be able to explain:

- The reasons for relying on a particular third party to discharge their due diligence obligations giving consideration to the third party's qualifications and competence;
- Whether the scope and extent of due diligence to be conducted was communicated to the third party; and
- Whether the third party's work gave sufficient basis to conclude that reasonable due diligence had been conducted and whether further due diligence was necessary, taking into consideration whether:
 - the work was conducted as envisioned by the sponsors;
 - the due diligence met the standards expected of sponsors; and
 - the bases and assumptions for the third party reports or opinions were considered to be fair, reasonable and complete.

Relying on experts

Experts' opinions are expected to be critically reviewed by the sponsors, and any material discrepancies, irregularities or inconsistencies should be followed up on.

The SFC notes that audits of the listing applicant's accounts do not relieve sponsors of their responsibility to assess applicants' financial and business performance.

Identifying and following up on red flags

Sponsors are required to take reasonable steps to identify red flags and cross-check information obtained from different sources. Any material irregularities should be followed-up and resolved.

Claims that an unusual practice or business conduct is common for a particular industry should be viewed with scepticism. Sponsors should consider the practice from the perspective of whether it calls into question the genuineness of the financials, or the legality and commercial rationale of the listing applicant.

(b) Interview practices

Sponsors should exercise due care in confirming interviewees' bona fides to satisfy themselves that interviewees have appropriate authority and knowledge. In particular:

- sponsors should, as far as possible, conduct interviews at interviewees' business premises, and perform cross-reference checks of multiple types of proof of identity.
- for telephone interviews, sponsors should verify telephone numbers and interviewee identities. Reliance should be placed on telephone numbers provided by listing applicants. Instead sponsors 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.

Sponsors should also document the interviewee selection criteria, reasons and the follow up to a refusal of a selected person to attend the interview, and the name and position of any other person present during the interview.

To ensure that interviewees' representations correspond to those of the relevant company, sponsors may require telephone interview notes to be validated by the interviewees' companies and attach interviewees' identity documents.

2. Proper records

Sponsors are required to keep sufficient records to demonstrate they conducted proper due diligence and adequately investigated contentious issues and record how conclusions were reached.

The SFC recommends sponsors use the decision of the Securities and Futures Appeals Tribunal (**SFAT**) in *Sun Hung Kai International Limited v Securities and Futures Commission* as a guide, which stated that:

"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."

Comprehensive records should be maintained of due diligence on matters which are material to the listing applicant's business including, among others:

- Major customers, suppliers, bankers and creditors as well as the listing applicant's 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
- The existence, validity and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights.

Sponsors should ensure that records can be located and retrieved if/after Transaction Team members leave the sponsor.

3. Resources, systems and controls

(a) Corporate Governance

The Circular notes the following:

- A sponsor's Management is ultimately responsible for the firm's compliance with applicable codes, rules and regulation including operational controls and risk management procedures.
- In line with the Manager-in-Charge (**MIC**) regime, a sponsor's board of directors and other members of Management, including designated committees, should be structured to enable the board to effectively oversee

and control the firm's activities. The firm's organisational structure should be documented and approved by the board and clearly set out 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.

- Sponsors are required to have clear policies requiring the escalation of critical matters to the board, its designated committee or responsible MICs for consideration.
- Management must ensure the appropriateness of the Transaction Team structure for each sponsor engagement. Sponsor Principals are required to maintain effective reporting lines and ensure communication on sponsor work among Transaction Teams and other members of Management.
- The involvement of the sponsor's Management in dealing with key issues is expected to be documented.

(b) Other aspects

One sponsor's compliance manual contained examples of material risks and issues and set the criteria for internal escalation; this sponsor was also about to introduce scenario-based staff training on identifying and resolving material issues.

Sponsors are expected to dedicate sufficient resources to each engagement and provide sufficient training, guidance and management supervision. Transaction Teams must be supervised by sponsor Principals at all times and Principals should attend key due diligence interviews along with junior staff.

On-the-job training should be provided to Transaction Team's junior staff by the sponsor Principal or other senior staff. Escalation policies should give examples of material risks and issues and specify an appropriate threshold for internal escalation. Records should be maintained of the escalation of critical matters and how they were resolved.

(c) Annual assessment of systems and controls

Annual assessments should not rely only on attestations by sponsor Principals.

Compliance with the relevant codes, rules and regulations should be ensured by way of reviews of policies and procedures. Samples of listing applications should be reviewed to ensure effectiveness of the sponsor's policies and procedures.

II. The Report: Deficiencies and non-compliance

The Report is based on the findings of the SFC's inspection of the work of 31 sponsors undertaken between October 2013 and December 2017. It reports deficiencies in sponsor work and instances of non-compliance under the Code of Conduct, the CFA Code and the Listing Rules.

1. The Code of Conduct

Deficiencies in sponsor work and non-compliance were identified in relation to:

- i) The conduct of due diligence in relation to:
 - a) Exercising reasonable judgement and applying professional scepticism; and
 - b) Interview practices;
- ii) Record keeping; and
- iii) Resources, systems and controls, namely:
 - a) Corporate governance
 - b) Annual assessment
 - c) Other aspects.

1.1 Due diligence

Exercising reasonable judgement and applying professional scepticism

The Report details six cases of unsatisfactory sponsor due diligence work. In 5 cases (Cases A-E) sponsors failed to take reasonable steps to follow up on obvious red flags. In Case F, some sponsors followed standard due diligence checklists and failed to adapt their due diligence to the specific circumstances of the listing applications.

Case A

The SFC identified a number of significant red flags which cast doubt on the genuineness of the listing applicant's largest customers which accounted for over 50% of its total sales. Shipment and settlement arrangements among the listing applicant and its largest customers relied heavily on third parties, however, the sponsor failed to conduct due diligence on these third parties.

Other red flags which the sponsor failed to follow up on were:

- i) material discrepancies between the sales amounts stated in invoices obtained by the sponsor and the payments made;
- ii) significant discrepancies in the weights of goods reported in the bills of lading and the export forms; and
- iii) inaccurate descriptions of the goods shipped in the bill of lading.

Case B

According to the prospectus disclosures, the five largest suppliers of the listing applicant were independent third parties. The sponsor claimed that the listing applicant's controlling shareholder held shares of one of the largest suppliers on trust for a third party. However, the trust documentation contained inconsistencies, backdating, and other errors, which should have raised a red flag as to the validity of the trust arrangement, and the likelihood of the controlling shareholder having a beneficial interest in the supplier.

Rather than conduct due diligence to follow up on these issues, the sponsor relied on a statutory declaration by the controlling shareholder and a confirmation provided by the listing applicant, which the SFC considered inadequate to ensure the accuracy of the prospectus disclosure and prevent material omissions.

Case C

The listing applicant's sales to certain customers were found to be significantly larger than suggested by local government figures, which the sponsor had access to and reviewed. The sponsor failed to follow up on the discrepancies despite their calling the figures' reliability into question.

Case D

The listing applicant had arrangements whereby most of its customers liaised with it via representatives and paid it via third parties from different countries. The opaqueness of the third parties, the excess of authority given to the representatives, and the inconsistencies in the listing applicant's sales figures should have prompted the sponsor to conduct an extensive follow-up due diligence on this irregular arrangement.

The sponsor claimed that its due diligence confirmed that indirect payment is a common practice in the industry and that the legal opinion confirmed that such practice was not illegal or invalid in the relevant jurisdictions. The SFC considers, however, that the sponsor should have considered the broader implications of the arrangement on the authenticity of the listing applicant's sales.

The sponsor indicated that the reporting accountants had not raised concerns with respect to the arrangements. However, the sponsor was unable to demonstrate that it had discussed the audit procedures with the reporting accountants. It could not therefore show how concerns relating to the payment arrangements were satisfactorily addressed.

Case E

In selecting interviewees, the sponsor relied on the listing applicant's summary table of amounts spent by the top users of its services. The SFC noted that these amounts were inconsistent with the raw data generated from the listing applicant's internal system. The sponsor failed to follow up on this inconsistency.

Case F

In their due diligence procedures, a number of sponsors adopted a box-ticking approach and failed to due diligence key aspects of the businesses of listing applicants which were outside the scope of the standard checklists. Even when checklists contained key aspects relevant to listing applicants, sponsors failed to exercise reasonable judgement as to the breadth and depth of the due diligence required. An example of this was a listing applicant whose organic products were highlighted in the prospectus disclosures, but insufficient due diligence was conducted on the organic certifications of the largest suppliers.

Practices meeting the required due diligence standard

The Report notes the following practices of some sponsors which met the required due diligence standards:

1. One sponsor required background research on listing applicants to be updated regularly during the course of the listing application process, particularly if the application was expected to take some time or the listing applicant was involved in a fast-evolving industry or regulatory environment.
2. Another sponsor required designated members of the Transaction Team to approve the customisation of due diligence plans and subsequent updates.

Interview practices

Deficiencies and non-compliance

The SFC considered some sponsors' practices in relation to due diligence interviews of major business stakeholders to be unsatisfactory. Particular criticisms were that important interviews were scheduled at a very late stage of the due diligence process and some sponsors failed to confirm the bona fides of interviewees and that they had appropriate authority and knowledge. In some cases, questions unanswered by interviewees were not followed up on by sponsors.

Case G

A sponsor interviewed some of the business stakeholders on the day of submission of the listing application, which would not allow enough time to consider issues raised by interviewees or resolve potential red flags.

Case H

A sponsor failed to conduct proper verification of the bona fides of almost half of the interviewees. The SFC was particularly concerned because most of the interviews were conducted at the listing applicant's office premises or by calling the interviewees' telephone numbers provided by the listing applicant without further verification.

Practices meeting the required due diligence standard

Practices identified as meeting the required standard included:

- i) Conducting interviews at the business premises of interviewees and conducting cross-reference checks relying on more than one type of identity proof. For example, interviewees were required to provide business cards and government-issued identity cards or staff cards with photographs.
- ii) For telephone interviews, another sponsor contacted interviewees or reconfirmed their identities by calling the company's general line obtained from a reliable public source such as a telephone directory.
- iii) One sponsor requested notes of telephone interviews to be validated by the interviewee's company and attached copies of the interviewee's identity documents to the notes. This practice was noted to offer the advantage of ensuring that the interviewee's representations reflect the company's position.

1.2 Proper records

Deficiencies and non-compliance

Many of the sponsors could not provide relevant records to demonstrate that major issues had been considered and dealt with. Some sponsors also failed to keep a proper due diligence plan and documentation of due diligence conducted, such as reviews of material business contracts and interviews with a major business stakeholder.

Practices meeting the required due diligence standard

One sponsor had a policy which required all material risks and issues identified to be documented in the form of a log accompanied by due diligence notes.

1.3 Resources, systems and controls

Corporate governance

Deficiencies and non-compliance

The SFC identified insufficient supervision of sponsor work. In one case, the involvement of the sponsor's Management in considering key concerns, including regulators' concern about the ownership of certain material assets could not be demonstrated.

In another case, the Transaction Team failed to escalate critical issues to Management for consideration, including where a listing applicant refused to accept some of the sponsor's due diligence measures and threatened to change sponsors if it insisted on them.

Practices meeting the required due diligence standard

Some sponsors had established committees comprising independent sponsor Principals and senior staff from the risk, legal and compliance departments to supervise, and provide written guidance with respect to, the due diligence process.

Other aspects

Deficiencies and non-compliance

The SFC notes that some sponsors provide insufficient training and guidance to staff and in some cases sponsors had insufficient resources to undertake sponsor work.

In one case, a sponsor Principal was overseeing six active listing applications simultaneously raising doubts as to whether the Principal could adequately supervise all Transaction Teams. Most survey respondents indicated that sponsor Principals and staff handle an average of two to three IPOs simultaneously.

Annual assessment

Some of the sponsors failed to conduct annual assessments of their systems and controls.

Annual assessment by one sponsor was based solely on the attestation by the sponsor Principals, with no details of the work or samples reviewed.

2. The CFA Code

Chinese walls

Deficiencies and non-compliance

The SFC notes that some sponsors failed to maintain effective Chinese walls to prevent the flow of confidential information between sponsors and related listed corporations (**LCs**). In some cases, Transaction Teams passed not yet public information related to listing applications to staff of related LCs before wall-crossing approvals were obtained.

Receipt or provision of benefits

Deficiencies and non-compliance

Some sponsors did not have a written company policy on the provision of benefits to clients, did not comply with the company policy on the receipt of benefits from clients or had insufficient documentation to demonstrate compliance.

3. Listing Rules requirements

Deficiencies and non-compliance

Poor internal control procedures for independence checks, such as not confirming independence of Transaction Team members, directors of the sponsor groups or their close associates, were common among the majority of sponsors.

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