



Hong Kong

May 2018

## SFC OUTLINED MARKET REGULATION APPROACH AND FINED CITIGROUP

Mr. Brian Ho of the Hong Kong Securities and Futures Commission (SFC) outlined the SFC's approach to market regulation in a speech<sup>1</sup> on 17 May 2018. The speech covered the April 2018 changes to the Hong Kong Stock Exchange (HKEx) Listing Rules allowing (i) pre-revenue biotech companies and (ii) high growth tech and innovative companies with weighted voting rights (WVR) structures to list on the Hong Kong Stock Exchange, and the measures adopted to safeguard investors' interests. Discussing the SFC's response to regulatory challenges, Mr. Ho noted the tightened GEM listing requirements effective 18 February 2018 (for details of which please see our December 2017 newsletter<sup>2</sup>), and further HKEx Listing Rule changes prohibiting highly dilutive capital raisings post-listing which take effect on 3 July 2018. Mr. Ho's speech, delivered at the Sixth Annual Institute on Corporate and Securities Law in Hong Kong 2018, also referred to a regulatory response to backdoor and shell company listings currently being worked on by the SFC and the Hong Kong Stock Exchange.

Separately, the SFC has reprimanded and fined Citigroup Global Markets Asia Limited HK\$57 million for due diligence failures in performing its role as sponsor of the listing of Real Gold Mining Limited. The failures related to inadequate due diligence in relation to the company's customers and inadequate supervision of junior transaction team members.

The following summarises the key issues raised by Mr. Ho regarding the SFC's current approach to market regulation, including in relation to applications to list on HKEx, and the key factors behind the disciplinary action against Citigroup.

### HKEx Listing Rule Changes: Listing Pre-revenue Biotech Companies and Tech Companies with WVR Structures

The speech first recognised the increased significance of tech and other innovative companies to the Hong Kong securities market, their business need for WVR structures, and the SFC's mandate to ensure Hong Kong's continued competitiveness among global securities markets, as the rationale for the April 2018 HKEx Listing Rule changes. The Stock Exchange's one-share-one-vote requirement had prevented China's leading tech companies, including Alibaba, Baidu and JD.com, from listing on the Hong Kong Stock Exchange, and they listed instead in the US where the rules of the New York Stock Exchange and Nasdaq allow companies with WVR structures to list. Five of the leading seven US-listed Chinese tech companies have WVR structures.

Mr. Ho outlined the SFC's dual role in facilitating the listing of a broad range of issuers to enhance investor choice, while safeguarding investors' interests. The new HKEx Listing Rules aim to balance these two objectives, addressing the needs of business without compromising investor protection standards. For example, the new regime's departure from the one-share-one-vote principle for tech and innovative companies has been balanced by a higher market cap requirement, aimed at limiting applicants to sizable companies that have likely already

<sup>1</sup> Hong Kong Regulation for an Evolving Market. [http://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Speech%20at%20PLI%20Corporate%20and%20Securities%20Law%20conference\\_FINAL%20clean.pdf](http://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Speech%20at%20PLI%20Corporate%20and%20Securities%20Law%20conference_FINAL%20clean.pdf)

<sup>2</sup> <https://www.charltonslaw.com/amendments-to-hkex-main-board-and-gem-listing-rules-take-effect-on-15-february-2018/>

attracted investment from sophisticated investors. Given the obvious risks of listing pre-revenue biotech companies, Mr. Ho noted the additional protections designed to ensure that only quality companies are able to list, such as the higher minimum market capitalisation and working capital requirements.

### **Changing Corporate Behaviour**

The speech also addressed the SFC's efforts to change corporate behaviour to enhance the Hong Kong market. Mr. Ho quoted the use of cross-shareholdings to enhance the value of listed companies within a group as an example of misconduct. Other key concerns are the extreme volatility of GEM stocks and backdoor listings.

#### ***GEM Listing***

The SFC's concerns relating to GEM listings include the volatility of newly listed GEM stocks, high first day gains, and highly concentrated shareholdings. Practices such as placing shares in small quantities (usually one or two board lots) to groups of placees, many of whom were also involved in a number of other unconnected GEM initial public offerings (IPOs), needed to be curbed. The SFC and Hong Kong Stock Exchange thus issued a joint statement in January 2017, and the SFC issued guidance to sponsors, underwriters and placing agents, on achieving an adequate spread of shareholders on GEM listings. The regulatory response has apparently been effective: volatility subsequently decreased and first-day price increases averaged only 23% between February and December 2017, when all GEM IPOs included a public offer tranche and shareholdings became less concentrated. A consultation was then held on changes to the HKEx GEM Listing Rules which increased the market capitalisation and public float requirements for GEM listing applicants; imposed a 10% public offer requirement on GEM IPOs; and removed the streamlined procedure for GEM issuers to transfer to the Main Board of HKEx. These HKEx GEM Listing Rules changes took effect in February 2018.

#### ***Highly Dilutive Capital Raisings***

Highly dilutive capital raisings which materially dilute the voting rights and value of public shareholders' investments, the number of which has increased in recent years, have raised investor protection concerns. Other issues relate to an increase in share price volatility and so-called "downward share price manipulation" where insiders were suspected of selling shares on the market and then subscribing for new

shares at very low prices. These transactions typically lacked a commercial justification, raising the issue of the real benefit for companies and their shareholders.

The Hong Kong Stock Exchange responded by publishing a consultation paper on "Capital Raisings by Issuers" in September 2017, which proposed to ban highly dilutive rights issues and open offers altogether and impose conditions on underwriting. The HKEx Listing Rule changes proposed received support from the market and the consultation conclusions were published in May 2018. The new HKEx Listing Rules take effect on 3 July 2018.

#### ***Shell Companies***

The speech noted that 45% of new listing applicants in 2017 reported declining profits in the financial year immediately before listing, compared to just 10% in 2007. Another feature of recent listings was the large number of construction companies being listed - 38 in 2017 compared to just one in 2007. Of the 61 construction companies listed between 2013 and 2016, 30% have already experienced a change in control. Mr. Ho questioned whether these figures suggest that some companies are listing primarily for the so-called "shell value".

#### ***Backdoor Listing***

Shell company listings are linked to the related concern of backdoor listings, which circumvent the requirements for new listings and inject assets into listed companies without going through proper sponsor due diligence and the appropriate vetting process. Usually, very limited disclosure is made about the new business, leaving public shareholders with little information about companies' true intentions, strategy and future prospects.

The SFC and Hong Kong Stock Exchange are apparently looking at a regulatory response to backdoor listings.

### **The SFC's Front-loaded Approach to Regulation**

The SFC currently adopts a front-loaded regulatory approach with emphasis on early targeted intervention.

This approach, which was previously applied principally to post-IPO transactions, is now extended to IPOs. The approach is premised on the Securities and Futures (Stock Market Listing) Rules (SMLR), in particular, the SFC's powers to object to a listing application and to direct a trading suspension under sections 6 and 8 of the SMLR, respectively. The number

of cases involving the potential or actual exercise of SMLR powers increased substantially in 2017 to around 40, from only a few cases per year in the past.

The speech mentioned the SFC's letters of concern issued in relation to certain proposed transactions and its investigatory enquiries under section 179 SFO as examples of its front-loaded approach. The IPO process is thus subject to investigation and intervention at the application stage, and potentially to enforcement proceedings if the SFO is found to have been breached, even in cases where the listing application has been withdrawn.

## **SFC reprimanded and fined Citigroup Global Markets Asia Limited**

The SFC reprimanded and fined Citigroup Global Markets Asia Limited (**Citi**) HK\$57 million for failings in performance of its duties as sponsor of the listing application of Real Gold Mining Limited (**Real Gold**), as set out in the SFC's Statement of Disciplinary Action<sup>3</sup> published on 17 May 2018.

### **Background**

Real Gold's listing application was submitted to the Hong Kong Stock Exchange on 26 May 2008 and re-submitted on 31 December 2008, more than six months after its initial application submission. At the company's request, trading in Real Gold's shares was suspended from 27 May 2011.

The track record period was the three years ended 31 December 2007 and the ten months ended 31 October 2008 (**Track Record Period**).

### **Failure to conduct adequate and reasonable due diligence inquiries**

Real Gold's prospectus dated 10 February 2009 (**Prospectus**) disclosed that Real Gold owned 97.14% in Shirengou Gold Mine, the Nantaizi Gold Mine and the Luotuochang Gold Mine in Chifeng Municipality in Inner Mongolia, and specialised in gold mining and ore processing into concentrates with gold and other minerals for further sale. It also detailed that:

- a) in 2007, only the Shirengou Gold Mine 50 tpd ore processing facility was in operation, while the commercial production at Nantaizi Gold Mine and the Luotuochang Gold Mine started in July and September 2008, respectively;
- b) between the year ended 31 December 2007 and the 10 months ended 31 October 2008 (respectively the last full year and last 10 months of the Track Record Period), Real Gold's sales increased by more than twenty times;
- c) for the year ended 31 December 2007 and the 10 months ended 31 October 2008, sales to Real Gold's top five customers represented 100% and 95.4% of total sales respectively; and
- d) Real Gold entered into a memorandum of long-term cooperation (**MLC**) with each of three customers who contributed to an aggregate of 35.2% of Real Gold's sales for the 10 months ended 31 October 2008, pursuant to which the customers were obliged to purchase any amount of gold or zinc concentrates Real Gold decided to sell them.

The SFC found that Citi's due diligence was inadequate. Citi's due diligence inquiries provided information that Real Gold's customers for the two periods were completely different, with one exception. There was no evidence that Citi had independently verified the identities and contact details of the customers' representatives when it conducted customer interviews by telephone using numbers provided by Real Gold. It is also not clear whether internet background searches were conducted on Real Gold's customers, and Citi only had a business licence record for one of them. Further, Citi did not request confirmation from customers as to the amounts involved in their transactions with Real Gold.

Confirmations obtained from Real Gold's top 5 customers only confirmed customers' business relationships with Real Gold which exceeded 7 months. One of the three customers who allegedly had an MLC with Real Gold was not interviewed, and another one of the three was not asked about the MLC when interviewed. Citi did not verify the authenticity of the MLCs.

Citi justified its actions by stating that it had put primary emphasis on production-related due diligence based on an assessment of key risks. Production is considered a key risk area for early stage mining companies that produce a commodity with a ready market. Citi also explained that it

<sup>3</sup> <http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/openAppendix?refNo=18PR51&appendix=0&lang=EN>

considered verification of production to be comparable to sales verification. The SFC disagreed with this analysis finding that a company's ability to sell the concentrates it produces from processing mined ore does not necessarily correlate with the existence of resources or reserves.

The Prospectus stated that "given that most of our revenue is derived from the sale of concentrates to our five largest customers, any adverse effect on their ability to purchase our concentrates will have a material adverse effect on our results of operations".

The SFC considered that Citi's approach to customer due diligence did not satisfy the relevant regulatory requirements.

### ***Failure to supervise the transaction team***

The most senior banker involved at the mandate and the kick-off and preparation stage was a managing director, rather than a sponsor principal involved in the due diligence on Real Gold's assets and operations. The sponsor principal was appointed only four months after the kick-off meeting and was a director in another team of Citi's investment banking division with no responsibility for listing applications. The sponsor principal was not involved in conducting due diligence or in correspondence with the Hong Kong Stock Exchange. She thought that her role was that of "signing responsible officer", that she would only play a nominal role and that another person would perform the sponsor principal role. The sponsor principal was not aware that any key issues had been raised.

The due diligence on Real Gold's customers was dealt with by Citi's junior members without adequate supervision. Hence the due diligence issues raised above, such as no verification of identity of the interviewees' phone numbers during phone interviews, were a consequence of junior staff having little supervision from Citi's senior staff.

The SFC therefore considered that Citi failed to properly supervise its staff as required by the Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers<sup>4</sup> and failed to conduct reasonable due diligence inquiries.

In disciplining Citi, the SFC took into account that:

- this is the first and only listing application that has raised concerns as to the standard of Citi's listing sponsor work;
- the breaches and deficiencies occurred only in relation to specific areas of the due diligence Citi conducted on Real Gold's listing application;
- breaches and deficiencies identified were not found to be deliberate, intentional or reckless;
- Citi's due diligence approach reasonably weighted production-related concerns over customer-related concerns, although the SFC does not consider this approach to be compliant with the regulatory requirements;
- Citi engaged its senior management and external counsel early on in order to address the SFC's concerns;
- after Real Gold's listing, Citi strengthened its internal controls and systems for its sponsor work; and
- Citi co-operated with the SFC fully to resolve its regulatory concerns.

<sup>4</sup> <http://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/fit-and-proper-guidelines/Fit and Proper Guidelines.pdf>

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