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SFC Imposes Record Fines for Sponsor Failures

The Securities and Futures Commission (**SFC**) has reprimanded and imposed record fines totalling HK$ 786.7 million on four investment banks for IPO due diligence failures in their sponsorship of applications to list on the Hong Kong Stock Exchange. UBS AG and UBS Securities Hong Kong Limited (**UBS**), Standard Chartered Securities (Hong Kong) Limited (**Standard Chartered**), Morgan Stanley Asia Limited (**Morgan Stanley**) and Merrill Lynch Far East Limited (**Merrill Lynch**) were fined HK$ 375 million, HK$ 59.7 million, HK$ 224 million and HK$ 128 million, respectively, for breaches of their obligations as IPO sponsors.

The IPOs involved were those of China Forestry Holdings Company Limited (**China Forestry**) and Tianhe Chemicals Group Limited (**Tianhe Chemicals**) which applied to list on the Main Board of the Hong Kong Stock Exchange (**HKEx**) in 2009 and 2014, respectively. China Forestry's listing application pre-dated the introduction of the more onerous sponsor due diligence obligations under Paragraph 17 of the Code of Conduct for Persons Licensed by or Registered with the SFC which came into force on 1 October 2013. The due diligence conducted by Standard Chartered and UBS on the China Forestry group was thus measured against the requirements of Practice Note 21 to HKEx's Listing Rules, "Due Diligence by Sponsors in respect of Initial Listing Applications" which had been introduced in September 2003.

The SFC's December 2012 Consultation Conclusions[1] setting out the new sponsor regime stated explicitly that thenew regime applied only to listing applications submitted *on or after* 1 October 2013.[2] However, it would appear from the SFC's Disciplinary Statement on the China Forestry sponsor work that, in relation to the expected standards of customer interviews and the conduct of telephone interviews in particular, the standards applied were in fact those now specified in Paragraph 17.6(f) of the Code of Conduct. At the time of China Forestry's listing application, the obligation on sponsors under Practice Note 21 to the Listing Rules was to assess the listing applicant's "performance and finances, business plan and any profit forecast or estimate … including historical sales, revenue and investment returns etc." which Paragraph 13(b) of Practice Note 21 provides would "*normally involve*" interviewing the listing applicant's major suppliers and customers. There was then no absolute obligation on sponsors in 2009 to interview a listing applicant's customers, and certainly there was no specification that interviews had to be conducted face-to-face and not by telephone. The disciplinary statement for Standard Chartered states that it breached Practice Note 21 to the Listing Rules, but does not specify which obligations were breached.

1. China Forestry IPO: Sponsor Failings by Standard Chartered and UBS

The disciplinary proceedings against Standard Chartered related to the December 2009 listing of China Forestry on HKEx's Main Board. Standard Chartered (then called Cazenove Asia Limited) originally acted as the sole sponsor of the listing application and submitted two listing applications on China Forestry's behalf in April and November 2008.

1 SFC. "*Consultation Conclusions on the regulation of IPO sponsors*". 12 December 2012. Available at https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=12CP1.

2 Ibid. At paragraph 45.

Following a suspension of the listing application due to market conditions, Standard Chartered submitted a third listing application for China Forestry in September 2009.

The SFC found that Standard Chartered had failed to fulfil its due diligence obligations as one of the joint sponsors of China Forestry's listing application. In particular:

a) Standard Chartered failed to conduct adequate and reasonable due diligence inquiries to ensure that the information and representations provided in the prospectus were true, accurate and not misleading since it failed to:

    i) verify the existence of the forests to which the prospectus claimed China Forestry had forestry rights;

    ii) verify that the forestry rights disclosed in the prospectus were appropriately held by China Forestry;

    iii) verify local forestry bureaus' written confirmations that China Forestry's business and logging activities complied with Mainland China's forestry and environmental laws;

    iv) properly review the insurance documents provided as evidence of China Forestry's insurance for the forests disclosed in the prospectus; and

    v) verify the identity and existence of China Forestry's customers and their relationship with the listing applicant;

b) it failed to keep a proper audit trail/ written record of the due diligence work completed for China Forestry's listing application;

c) it breached the sponsor's undertaking to the Hong Kong Stock Exchange and/or filed untrue statements in its sponsor's declaration; and

d) it failed to comply with the regulatory requirements applicable to IPO sponsors, including the Listing Rules of HKEx and Practice Note 21 to the Listing Rules (Due Diligence by Sponsors in respect of Initial Listing Applications).

1.1 Due diligence failures

China Forestry's principal business, as described in its 2009 prospectus, was managing and sustainably developing forests and the harvesting and sale of logs. Key failures identified by the SFC in the sponsor work of UBS and Standard Chartered on China Forestry's listing application related to inadequate due diligence enquiries.

Failure to verify the existence of forestry assets

China Forestry's 2009 prospectus claimed that the group owned around 171,780 hectares of forests in Yunnan and Sichuan in Mainland China. Despite Standard Chartered having conducted site inspections of the forests in December 2007 and in February and May 2008 as the sole sponsor, the SFC investigation revealed that Standard Chartered did not verify the inspected locations against the forest locations as stated in China Forestry's prospectus. Professional parties, including lawyers and forestry experts, involved in some site inspections had not been instructed to verify the existence of the forests disclosed in the prospectus.

In particular, Standard Chartered could not demonstrate that it had visited forests covering 150,000 hectares in Yunnan which China Forestry acquired in 2008, and accounted for more than 90% of its assets. Nor did it commission a report on the impact on the forests of a major earthquake in July 2009.

Failure to verify the existence of forestry rights

China Forestry claimed in its prospectus that it had forestry rights certificates evidencing its legal rights to its forests. UBS and Standard Chartered claimed to have inspected the original certificates and to have had them verified by their Mainland Chinese lawyers. However, the SFC discovered anomalies in the certificates; for example, forest names stated in the certificates differed from those disclosed in the prospectus. The SFC noted that the discrepancies should have prompted the conduct of further due diligence enquiries.

Failure to verify compliance with laws and regulations

China Forestry produced written confirmations purportedly issued by the relevant forestry bureaus stating that the company's activities complied with the relevant Mainland Chinese forestry and environmental laws. However, there was no evidence that the sponsors had verified that the confirmations were in fact issued by the forestry bureaus, or that the information they contained was accurate.

Inadequate due diligence on the forestry assets insurance coverage

The sponsors relied on insurance documents provided by the listing applicant as evidence that its forestry assets had sufficient insurance coverage, but failed to independently verify the documents' authenticity. Despite Standard Chartered's claim that the insurance documents had been reviewed by its transaction team and Mainland Chinese lawyers, the documents contained a number of inconsistencies (e.g. between the forests' locations as stated in the insurance documents and related forestry rights certificates) which the SFC considered should have prompted further due diligence enquiries.

Inadequate customer due diligence

UBS and Standard Chartered had planned to conduct face-to-face interviews with some of China Forestry's Yunnan customers, who accounted for more than 70% of the company's revenue during the final 18 months of its track record period. Instead, telephone interviews were conducted because of the Yunnan Earthquake.

The SFC's disciplinary statement notes that telephone interviews prevent sponsors from verifying customers' existence and their representatives' identity at the customers' place of business. It noted that for China Forestry, telephone interviews also meant that Standard Chartered was unable to assess the impact of the earthquake on the company's business at its place of business and noted that the sponsors should have taken steps to mitigate the limitations of telephone customer interviews.

Inadequacies identified in Standard Chartered's customer due diligence included (without limitation):

- it failed in many cases to carry out independent searches on China Forestry's customers to confirm their identity – there was no evidence of company, address or background searches having been conducted;
- there was no independent verification of interviewees' identity and contact details – China Forestry provided Standard Chartered with customer names and telephone numbers, and the names and job titles of key contact persons;
- Standard Chartered's records of customer interviews lacked important information such as the interviewee's full name and telephone number and the names of other persons attending the interview; and
- customers were asked to confirm whether their orders with China Forestry would be affected by factors such as the 2008 Sichuan earthquake, but not whether the Yunnan earthquake had in fact affected their factories, production or sales.

The SFC's statement of disciplinary[3] action is available on the SFC website.

2. Tianhe Chemicals IPO: Sponsor Failings by Morgan Stanley, Merrill Lynch and UBS

The SFC reprimanded and fined Morgan Stanley Asia Limited (**Morgan Stanley**), Merrill Lynch Far East Limited (**Merrill Lynch**) and UBS for failing to discharge their sponsorship obligations in relation to the 2014 listing application of Tianhe Chemicals. Trading in Tianhe Chemicals' shares was suspended at its request on 26 March 2015 and remains suspended.

The SFC's disciplinary action against the sponsors was based on their failure to follow the SFC's specific requirements for due diligence interviews under Paragraph 17.6(f) of the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**). Paragraph 17.6(f) requires sponsors conducting interviews to:

a) carry them out directly with the interviewee with minimal involvement of the listing applicant;

b) confirm the bona fides of the interviewee and that he or she has the appropriate authority and knowledge for the interview; and

c) identify any irregularities during the interview and ensure that they are adequately explained and resolved.

The SFC found that Morgan Stanley and Merrill Lynch failed to discharge their sponsor duties in relation to Tianhe Chemicals' listing application, in failing to:

3 https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/openAppendix?refNo=19PR20&appendix=0

a) conduct adequate and reasonable due diligence inquiries in relation to Tianhe's listing application and use all reasonable efforts to ensure that the information and representations provided in the Prospectus were true, accurate and not misleading;

b) perform adequate and reasonable due diligence inquiries in relation to Tianhe's customers in that they:

   i) failed to carry out customer interviews directly with the person or entity selected for interview with minimal involvement of Tianhe;

   ii) failed to confirm the bona fides of the interviewees to satisfy themselves that the interviewees had the appropriate authority and knowledge for the interviews; and

   iii) failed to identify and ensure any irregularities noted during the interviews were adequately explained and resolved; and

c) comply with all regulatory requirements applicable to the conduct of a sponsor, including the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange and Practice Note 21 to the Listing Rules.

2.1 Due diligence interviews: listing applicant's involvement

UBS, Morgan Stanley and Merrill Lynch conducted ten customer interviews but did not contact the interviewees directly to set them up, or to confirm the place and mode of interview. Instead, Tianhe Chemicals informed them that two customers were unable to attend interviews face-to-face and one customer refused to be interviewed at its business premises. The SFC found no evidence that the sponsors took any steps to confirm that these customers were unwilling to be interviewed at their own offices.

2.2 Failure to follow-up on red flags in an interview

The sponsors failed to follow-up on the interview with Tianhe Chemicals' largest customer, despite a number of red flags:

- although the sponsors requested a face-to-face interview with the customer at the customer's business premises, they eventually agreed to interview the customer at the listing applicant's premises based on the listing applicant's claim that the customer would normally refuse to allow third parties to visit its premises because of an anti-corruption drive under way in Mainland China at the time; and
- the customer's purported representative refused to provide evidence of his identity and business card and told the sponsors that he only agreed to the interview to help the family of Tianhe Chemicals' CEO.

Some months after the interview, one of the potential cornerstone investors in Tianhe's IPO notified Merrill Lynch that, in conducting its own due diligence on the customer in question, it had tried to contact the representative interviewed by Merrill Lynch by phoning the customer's general line, but was informed by the operator that no such person existed. The SFC found that this should have raised a red flag, either alone or together with the interviewee's behaviour in storming out of the interview. Accordingly, the SFC found that Merrill Lynch was not justified in claiming to be satisfied as to the identity of the person interviewed without conducting additional due diligence to verify his identity.

Morgan Stanley and the other sponsors were found to have failed to conduct any further enquiries to verify that the person interviewed was an authorised representative of the customer and that he had the appropriate authority and knowledge to answer questions on its behalf.

2.3 Unclear interview questions

Tianhe Chemicals produced documents showing that it conducted business with its customers through a subsidiary called Jinzhou DPF-TH Chemicals Co. Limited (**Jinzhou Subsidiary**). Customers were asked in interviews about their business with the "Tianhe Group" rather than with the Jinzhou Subsidiary and no explanation was given as to which companies comprised the group. Only three of the ten interviewees named Jinzhou Subsidiary as the group company with which they did business. The sponsors failed to follow-up with the other seven interviewees to determine which Tianhe entity they did business with.

One of Tianhe's top ten customers later told the SFC that its representative, in describing its dealings with the Tianhe Group, was referring to its dealings with Liaoning Tianhe Fine Chemicals (**Liaoning Tianhe**), a private company wholly-owned by the family of the CEO of Tianhe Chemicals, but not part of the group applying to list.

It was significant that Liaoning Tianhe was not part of the listing group and this was disclosed in the prospectus. Since both the listed and unlisted chemical businesses were called “Tianhe”, the SFC found it inappropriate for the sponsors to have referred only to “Tianhe Group” in their interview questions. It further considered that the sponsors should have required all interviewees to identify the exact Tianhe entity with which they conducted business.

3. SFC’s Disciplinary Actions

The SFC found that Morgan Stanley, UBS, Standard Chartered, and Merrill Lynch had failed to conduct adequate and reasonable due diligence inquiries and comply with the Listing Rules’ Practice Note 21, “Due Diligence by Sponsors in respect of Initial Listing Applications”.

In relation to the China Forestry listing application, UBS and Standard Chartered had also failed to keep a proper audit trail and written records of their due diligence work and breached their sponsor’s undertakings to the Hong Kong Stock Exchange (**HKEx**). The SFC took into account (among other things) that the four sponsors cooperated with the SFC to resolve their regulatory concerns and agreed to independent reviews of their sponsor businesses.

Standard Chartered was reprimanded and fined HKD 59.7 million for sponsor failures in respect of China Forestry’s listing application.

Morgan Stanley and Merrill Lynch were reprimanded and fined HKD 224 million and HKD 128 million, respectively, for sponsor failings in respect of Tianhe Chemicals’ listing application.

UBS was reprimanded and fined HKD 375 million for sponsor failures in respect of the listing applications of China Forestry, Tianhe Chemicals and a third company, which is involved in ongoing disciplinary proceedings and has not been named.

UBS Securities Hong Kong Limited also had its Type 6 licence to advise on corporate finance partially suspended which prevents it from acting as sponsor to any Hong Kong listing application for one year.

The SFC also disciplined two licensed representatives for their responsibility for the sponsor failures. Paragraph 1.3.3 of the SFC’s Fit and Proper Guidelines requires sponsor principals to be aware of the key risks involved in sponsor work and to be responsible for adopting measures to address them. Sponsor principals are required to determine the breadth and depth of the required due diligence work and the amount of resources needed to complete it, and are responsible for supervising the transaction team(s) assigned to the IPO.

The SFC suspended for two years the Type 6 licence of Mr. Cen Tian, a sponsor principal and executive officer of UBS AG and a Type 6 licensed representative of UBS Securities Hong Kong Limited for his role in China Forestry’s listing application. Standard Chartered’s sponsor principal[4] on China Forestry’s listing application, Mr. Joseph Hsu Kar Hing, was banned from the industry for three years.

4 https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR85

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