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Hong Kong SFC Fines IPO Sponsors for Due Diligence Failures

In October 2021, Hong Kong's Securities and Futures Commission (**SFC**) reprimanded and fined two sponsors – Ample Capital Limited (**Ample**)[1] and Yi Shun Da Capital Limited (**Yi Shun Da Capital**)[2] – for their respective breaches of their sponsor due diligence obligations on two separate Hong Kong listing applications. In both cases, the sponsor was found to have failed to conduct adequate due diligence of third-party payments which the SFC alleged raised red flags – in the Ample case of channel stuffing in the context of a distributorship business model, and in the case of Yi Shun Da Capital, of a circular flow of funds potentially indicative of an attempt to disguise the original source of funds and facilitate a deceptive or fraudulent scheme.

The latest disciplinary actions come as a reminder of the SFC's determination to crack down on substandard sponsor due diligence, even in cases where the listing applicants do not proceed to listing and the sponsor's failure to conduct adequate due diligence causes no financial loss to investors. The decisions underline the onerous and extensive nature of IPO sponsors' obligation to carry out *all reasonable* due diligence on a listing applicant under Paragraph 17 of the SFC Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission[3] (the **SFC Code of Conduct**). They provide sponsor principals, in particular, with a timely reminder of the need to be alert to the existence of red flags and to conduct independent due diligence by reference to sources external to the listing applicant to ascertain the facts, rather than accept statements or documents provided by the listing applicant's representatives at face value. Key takeaways from the cases are:

- As demonstrated by the Securities and Futures Appeals Tribunal's (**SFAT**) confirmation of the SFC's findings of breach of sponsor duties by Yi Shun Da Capital, the existence of red flags (in that case, the extensive use of third-party payments) requires sponsors to conduct additional independent due diligence to ascertain the rationale for circumstances that are suspicious on their face.

- The SFAT accepted that had proper due diligence been conducted, the sponsor might have come to the conclusion that the third-party payments were not suspicious (there was no allegation that the payments were fraudulent or fictitious) or were justified in the circumstances. What was not acceptable was for the sponsor to accept at face value representations of the listing applicant's representatives: the situation required independent due diligence into the reasons for the extensive use of indirect payments which, without proper explanation in the listing document, risked raising concerns among potential investors.

- To merely verify the existence of the dominant third-party payment method did not constitute the conduct of "all reasonable due diligence" required by the SFC Code of Conduct. And therein lay the sponsor's breach of its due diligence obligations. The potential red flags obliged

1 https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=21PR103
2 https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=21PR104
3 https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code_of_conduct-Dec-2020_Eng.pdf

the sponsor to look in-depth into the payments and their rationale and this meant that the sponsor should have interviewed relevant customers and third-party payers as to why the listing applicant was paid indirectly.

- In the Ample case, the sponsor failed to conduct independent enquiries into the relationship between the listing applicant and a distributor accounting for a significant portion of its sales, despite the HKEX specifically questioning the listing applicant's sales to the distributor.

- Ample also failed to critically assess the reliability of shipping documents provided by the listing applicant, failing to conduct the necessary independent due diligence despite obvious signs that the documents were not reliable.

The SFC has made no secret of its intention to stamp out substandard sponsor due diligence work. These latest decisions underline the need for sponsors to comply strictly with the requirements of Paragraph 17, even where the circumstances do not in fact, but could potentially, indicate fraud or misconduct on the part of the listing applicant or its directors.

SFC's Disciplinary Powers under sections 194 and 196 of the SFO

The SFC's disciplinary actions against Ample and Yi Shun Da Capital relied on the SFC's powers under Part IX of the SFO. Sections 194 and 196 have become the primary mechanisms used by the SFC to "punish" (for want of a better word) sponsors for due diligence failures. They entitle the SFC to fine and/or revoke or suspend the licence or registration of "regulated persons" (i.e. sponsors, their responsible officers and licensed representatives (in the case of licensed corporations) and executive officers and registered individuals (in the case of registered institutions). These powers arise where:

- a regulated person is guilty of misconduct (i.e. has breached any provision of the Securities and Futures Ordinance (the **SFO**), the Companies (Winding Up and Miscellaneous Provisions) Ordinance (**C(WUMP)O**) prospectus provisions, or certain provisions of the Companies Ordinance or anti-money laundering legislation); or

- the SFC considers a regulated person to not be a fit and proper person to be or to remain licensed or registered.

The maximum fine that can be imposed by the SFC is HK$10 million or three times the amount of the profit gained or loss avoided as a result of the misconduct or other conduct which led the SFC to consider the regulated person not to be fit and proper.

The provisions have been used to impose significant fines, for example a fine of HK$375 million imposed on UBS AG and UBS Securities Hong Kong Limited as one of the joint sponsors of three listing applications (China Forestry Holdings Company Limited, Tianhe Chemicals Group Limited (**Tianhe**) and China Metal Recycling (Holdings) Limited) and a fine of HK$224 million imposed on Morgan Stanley Asia Limited as a co-sponsor of Tianhe's 2014 listing. To date, the SFC has revoked the licence of just one sponsor, Mega Capital Asia Limited (**Mega Capital**), in relation to its sponsorship of the 2009 listing of Hontex International Holdings Limited (**Hontex**). The case marked a turning point in SFC enforcement actions against sponsors in a number of respects:

- it also saw the SFC use section 213 of the SFO for the first time to obtain an order from the Court of First Instance to require a listed issuer to compensate investors, by way of a HK$1.03 billion offer to buy back the shares from Hontex's 7,700 public shareholders (both IPO subscribers and secondary market purchasers of the shares).[4] The Court of First Instance's jurisdiction in the case was based on Hontex's admission for the purposes of the section 213 proceedings that it had contravened section 298 of the SFO, the criminal offence of disclosing, authorising or being concerned in the disclosure or dissemination of information which is false or misleading and is likely to induce subscriptions or purchases of shares, where the person knows, or is reckless as to whether, the information is false or misleading.

- The SFC revoked Mega Capital's sponsor licence in April 2012 on the basis of:

  - Inadequate and substandard due diligence work;

  - Its failure to act independently and impartially by agreeing to Hontex's request not to contact the group's customers, suppliers and franchisees directly for interviews and instead allowing Hontex to arrange the sponsor's interviews and its representatives to attend the interviews. Mega Capital further accepted Hontex's representations that certain parties refused face-to-face interviews and allowed Hontex to set up telephone interviews instead. These actions on the part of Mega Capital were taken by the SFC to demonstrate Mega Capital's "inappropriate reliance" on Hontex in conducting due diligence on customers, suppliers and

4 See SFC "Hontex ordered to pay $1.03 billion buy-back offer over untrue IPO prospectus" (20 June 2012)

franchisees. This was the case notwithstanding that Practice Note 21 to the Listing Rules "Due Diligence by Sponsors in Respect of Initial Listing Applications" (the only guide to expected sponsor due diligence at the time) specifies only that the sponsor's assessment of the listing applicant's performance and business plan:

> *"would normally include interviewing the new applicant's senior management and would often involve interviewing the new applicant's major suppliers and customers, creditors and bankers" (at paragraph 13(b) of Practice Note 21 to the Listing Rules) (emphasis added).*

The requirements of Paragraph 16.6(f) of the SFC Code of Conduct regarding sponsors' interview practices[5] were not in force or contemplation at the time of Mega Capital's 2009 sponsor due diligence work on Hontex, nor were they in force when the SFC disciplined Mega Capital in April 2012. It seems somewhat unfair that Mega Capital appears to have been disciplined in 2012 for failure to comply with sponsor due diligence standards (in particular the requirements for conduct of interviews of suppliers, customers and distributors) which only applied to listing applications submitted on or after 1 October 2013 and were actually designed to prevent listing applicants' involvement in the arrangement and conduct of sponsor interviews of customers and suppliers as seen on the Hontex listing.

- Mega Capital's failure to maintain an adequate trail of its due diligence planning and various aspects of its due diligence work. Again the obligation to have and keep a due diligence plan was only introduced in October 2013.

- The failure of Mega Capital's responsible officers to adequately supervise junior staff in conducting due diligence on Hontex.

- Breach of the sponsor's undertaking and declaration to the HKEX confirming that Mega Capital had made reasonable due diligence enquiries and believed the information in Hontex's IPO prospectus to be true in all material respects.

In the SFC's disciplinary action against UBS Securities Hong Kong Limited (discussed above), the SFC partially suspended its Type 6 licence – prohibiting it from conducting sponsor work for one year.

Lack of stated basis for section 194 and 196 disciplinary proceedings

Surprisingly, the various Statements of Disciplinary Action relating to IPO sponsors published on the SFC website (see for example the Statement of Disciplinary Action relating to Ample[6]) state only that the actions are brought in reliance on sections 194 and 196 of the SFO, without mention of the basis for the disciplinary action under section 194(1) or 196(1) – i.e. whether the sponsor is guilty of a breach of one of the "relevant provisions" or considered by the SFC to not be "fit and proper" to be licensed or registered. As the disciplinary action statements then cite the sponsors' failure to discharge their obligations as sponsors – and primarily their failure to conduct all reasonable due diligence in some detail, it's probably fair to assume that the SFC has deemed the sponsor not to be "fit and proper" to conduct sponsor work. This seemingly fundamental statement is however absent from all the SFC's disciplinary statements relating to IPO sponsors. Assuming that this is the case, the logical question is then why, if the SFC considers a sponsor not to be "fit and proper", does it not revoke, or at least suspend, its licence? With the exceptions noted above (Mega Capital and UBS Securities Hong Kong), licence revocation or suspension is not part of the SFC's standard sponsor "penalty" package. On the contrary, as we have seen, the SFC's "go to" disciplinary actions are the imposition of a substantial fine on the sponsor under section 194 or 196 plus a restorative order against the issuer and its directors under section 213 of the SFO to compensate the public shareholders for their loss. This has now provided a well-worn, and perhaps rather convenient route, for the SFC for dealing with fraudulent or misleading prospectus information.

Section 194 and 196 proceedings are disciplinary proceedings against sponsors in which the SFC determines whether it considers the sponsor to be fit and proper. There is a right of appeal against the SFC's decision to the Securities and Futures Appeal Tribunal. In section 213 proceedings, the SFC applies to the Court of First Instance to make orders (either injunctive orders (such as freezing orders to prevent disposal of the issuer's assets in Hong Kong) and/or remedial orders such as restoration orders to compensate investors and/or an order for damages. As confirmed by the Court of Final Appeal's decision in the Tiger Asia case, the Court of First Instance has jurisdiction to make orders sought by the SFC under section 213 notwithstanding that there has been

5 These proposals were only consulted on in May 2012 when the SFC published its "Consultation Paper on the regulation of sponsors" containing the proposals for what is now Paragraph 17 of the SFC Code of Conduct

6 https://apps.sfc.hk/edistributionWeb/api/news/openAppendix?lang=EN&refNo=21PR103&appendix=0

no prior finding by a criminal court or the Market Misconduct Tribunal that the defendant has contravened the criminal or civil market misconduct provisions of Part XIII or XIV of the SFO or the prospectus liability provisions under the C(WUMP)O (sections 40 and 40A for Hong Kong companies and sections 342E and 342F for companies incorporated outside Hong Kong). Further, section 213 proceedings are civil proceedings to which the lower civil burden of proof applies even where the Court is determining whether a criminal provision of the SFO (e.g. section 298 or 384) or the C(WUMP)O (section 40A or 342E) has been breached.

In sum, the section 194/196 disciplinary action plus section 213 issuer proceedings package could be seen to offer a fairly convenient and speedy method for the SFC to penalise sponsors and obtain compensation for investors compared to the alternative of bringing criminal or civil proceedings under the C(WUMP)O's prospectus liability provisions or the market misconduct regime under Part XIII or XIV of the SFO. Proposals to amend the statutory liability provisions of the C(WUMP)O to clarify who is within the scope of "persons who authorise the issue of a prospectus" and to deal with the lack of mens rea requirement for the criminal provisions, which have been the subject of two SFC public consultations, have come to nought. MMT proceedings against issuers and sponsors have been commenced but are slow and rather cumbersome compared to the disciplinary process under sections 194 and 196 and obtaining orders under section 213 from the Court of First Instance.

SFC Reprimands and Fines Ample Capital Limited for breaches of sponsor due diligence obligations

SFC Disciplinary Proceedings under section 194 of the SFO

On 18 October 2021, the SFC reprimanded and fined Ample HK$5.5 million[7] under section 194 of the SFO for its failure to discharge its sponsor due diligence obligations between 2016 and 2017 in relation to the listing application of COCCI International Limited (**COCCI**) on the GEM of the Stock Exchange of Hong Kong (**HKEX**). A copy of the Statement of Disciplinary Action is available on the SFC's website.[8]

The SFC found that Ample had failed to conduct all reasonable due diligence on COCCI prior to submitting the listing application in breach of the SFC Code of Conduct. In particular, the sponsor failed to:

a) carry out adequate due diligence on cash payments made by a major wholesale distributor (**Distributor**) to COCCI through third parties and keep proper records of its due diligence work;

b) ascertain the background and independence of the Distributor and its associates; and

c) assess the reasonableness of COCCI's sales to the Distributor.

In addition, the SFC found that Ample had failed to critically assess the reliability of the shipping documents provided to Ample by COCCI before relying on them as part of its due diligence.

The SFC also suspended the SFC licence of Tang Ho Wai Howard (**Tang**) for 17 months starting 15 October 2021 through to 14 March 2023 for his failure to discharge his duties as a responsible officer and sponsor principal of Ample in charge of supervising the execution of COCCI's listing application.

COCCI's Application to List on HKEX

COCCI and its subsidiaries engaged in the design, marketing, retail sales and distribution of ladies-wear products under its self-owned "COCCI" brand, selling ladies-wear through various retail outlets and franchisees, online retail websites and wholesale distributors.

COCCI's 2015 revenue was almost double its 2014 revenue, mainly because of its sale of out-of-season products at a discount to the Distributor, which re-distributed COCCI's products principally to Saudi Arabia. The sales to the Distributor accounted for approximately 50% of COCCI's total revenue in 2015 and approximately 23% of its revenue for the first four months of 2016.

COCCI appointed Ample as its sole sponsor in January 2016, and its first listing application was submitted in September 2016. Between October 2016 and March 2017, the SFC and the HKEX commented on COCCI's wholesale business and other matters. As more than six months had lapsed since the first application, COCCI re-submitted a listing application in April 2017 with Ample continuing to act as its sole sponsor. The SFC and HKEX made further comments following the submission of the second listing application: the regulators considered that the revised prospectus still failed to explain and provide sufficient information on various

7 https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=21PR103
8 https://apps.sfc.hk/edistributionWeb/api/news/openAppendix?lang=EN&refNo=21PR103&appendix=0

aspects of COCCI's wholesale business. Ample did not respond to the comments and the second application lapsed in October 2017.

Failure of Sponsor to Conduct Adequate Due Diligence on Suspicious Cash Settlements

Between March and June 2016, 24 deposits totalling more than RMB9.7 million were made by five third parties to COCCI's Mainland bank account to settle payments owed by the Distributor to the principal operation branch of COCCI in the Mainland (**Mainland Branch**). Ample had learnt from COCCI's directors that the sole shareholder and director of the Distributor (**Ms A**) made cash settlements in Hong Kong dollars to the Mainland Branch on behalf of the Distributor by meeting with, and handing over the cash payments to one or more of the third parties previously chosen by COCCI's chairman, and meeting at locations arranged by Ms A and COCCI's chairman or the third parties. The third parties then converted the cash into Renminbi and physically carried the cash to the Mainland and deposited it into the Mainland Branch's bank account. This arrangement was adopted because the Mainland Branch did not have a Hong Kong bank account in Hong Kong for direct deposit of cash by Ms A and the Distributor's payments directly to the Mainland Branch would have been subject to Chinese foreign exchange control regulations.

The SFC contended that a customer's settlement of payments through third parties raises a red flag, because third-party payments can be used to disguise the source of funds and be part of a fraudulent scheme. This was particularly so in this case as one of the third parties was an employee of COCCI's major supplier. The SFC considered that Ample breached its sponsor due diligence obligations under the SFC Code of Conduct in failing to critically assess the reasons for the third-party payments, and failing to conduct independent due diligence to ascertain the truth and completeness of COCCI's representations on the matter. The sponsor also failed to maintain any records to demonstrate its conduct of due diligence, including its alleged discussions with COCCI's directors and reporting accountants relating to the third-party payments.

Failure of Sponsor to Ascertain the Background and Independence of the Distributor and its Associates

Ample knew that the Distributor's business activities were conducted by Ms A and staff members from her jewellery company. There was also information suggesting a connection between the jewellery company and COCCI, for instance: (i) a co-owner of the jewellery company was a company solely owned by a COCCI shareholder; and (ii) a director of the jewellery company was also a director of COCCI's major supplier as well as a director and sole shareholder of a company which is a franchisee of COCCI and a management agent of certain self-operated COCCI retail outlets.

However, the sponsor did not satisfy its due diligence obligations required by the SFC Code of Conduct. It did not carry out any further due diligence to ascertain the involvement of the jewellery company's co-owner and director in the Distributor's business activities, nor did it verify the independence of the Distributor or Ms A from COCCI and its supplier.

Failure of Sponsor to Assess the Reasonableness of COCCI's Sales to the Distributor

The SFC considered that given the substantial increase in COCCI's revenue in 2015 due to its sales of products to the Distributor which it then sold in Saudi Arabia, it was crucial that the sponsor carry out sufficient due diligence to determine whether the sales were reasonable.

Ample carried out only minimal due diligence on the Saudi Arabian sales prior to the listing application submission. Despite attending a telephone interview (conducted by COCCI's reporting accountants) with a major Saudi Arabian customer of the Distributor, Ample failed to seek any objective data to verify the information provided by the customer, nor did it conduct any independent search of the customer's background and scale of operations in Saudi Arabia.

Following comments from the SFC and the HKEX after the first listing application submission, the sponsor carried out additional due diligence, including interviewing the Saudi Arabian customer and visiting its retail store in Saudi Arabia.

The SFC refers in its Statement of Disciplinary Action to the HKEX's Guidance Letter GL36-12 (May 2012)[9] on "Distributorship business model – risks and disclosure in listing documents" in which the HKEX states that sponsors are expected to have performed sufficient due diligence work in relation to the fairness and reasonableness of sales to distributors recorded during the track record period. Guidance Letter GL36-12 also highlights the risk of channel stuffing in a distributorship business model, stating that:

> *"[w]hile a sharp increase in sales during the track record period may indicate a vibrant business, there is a risk that*

9 https://en-rules.hkex.com.hk/sites/default/files/net_file_store/gl3612.pdf

these are artificially pumped-up sales, unsustainable by an actual rise in demand from ultimate end-users."

It is noted that the guidance letter (now known as "Guidance on due diligence to be conducted by the sponsor and disclosure in the listing document relating to a distributorship business model") was revised in February 2020, and that these statements were removed.

Failure of Sponsor to Critically Assess the Reliability of the Shipping Documents provided by COCCI

COCCI provided Ample with 25 sets of shipping documents relating to the shipment of its products from the Distributor to the Saudi Arabian customer. The SFC found that the sponsor breached its due diligence obligations in failing to: (i) critically assess the reliability of these documents before relying on them as part of its due diligence; and (ii) identify the red flags which cast doubt on the documents' reliability. For example, the container identification for all 25 sets of bills of lading were labelled "ABCD/111111/TBA", and the dates in most of the bills of lading did not correspond with the sailing schedules of relevant vessels that could be found in publicly available sources.

SFC Disciplinary Action

The SFC concluded in its Statement of Disciplinary Action that Ample breached the following requirements:

i) ***General Principle 2 (Diligence) of the SFC Code of Conduct and paragraph 5.1 (Due skill and care) of the SFC Corporate Finance Advisor Code of Conduct*** – failure to act with due skill, care, and diligence and observe proper standards of market conduct, in the best interests of its clients and the integrity of the market;

ii) ***Paragraphs 17.2(b) and 17.4(a) (Reasonable due diligence) of the SFC Code of Conduct*** – failure to complete all reasonable due diligence on COCCI prior to the listing application submission;

iii) ***Paragraph 17.6(a) (Reasonable judgment) of the SFC Code of Conduct*** – failure to exercise reasonable judgment on the nature and extent of due diligence work required in relation to COCCI taking into account to all relevant facts and circumstances;

iv) ***Paragraph 17.6(b) (Professional scepticism) of the SFC Code of Conduct and paragraph 2 of Practice Note 2 to the Rules Governing the Listing of Securities on GEM of the HKEX*** – failure to examine with professional scepticism the accuracy of information provided by COCCI and be alert to information that contradicted or brought into question the reliability of such information;

v) ***Paragraph 17.6(c) (Appropriate verification) of the SFC Code of Conduct*** – failure to conduct additional due diligence to ascertain the truth and completeness of the information provided by COCCI, after becoming aware of circumstances that could cast doubt on the information provided to it or otherwise indicated a potential problem or risk;

vi) ***Paragraph 17.6(e) (Independent due diligence steps) of the SFC Code of Conduct*** – failure to carry out independent due diligence steps to inquire directly of knowledgeable persons within or external to the listing applicant and in respect of material matters, independently acquire information from sources external to the listing applicant; and

vii) ***Paragraphs 17.2(e) and 17.10 (Proper records) of the SFC Code of Conduct*** – failure to maintain proper records relating to the due diligence conducted (together with its results) in respect of the listing application so as to demonstrate to the SFC its compliance with the SFC Code of Conduct.

The SFC considered that Ample's failure to satisfy its sponsor due diligence obligations to be a result of Tang's failure to discharge his duties as a sponsor principal, a responsible officer, and a member of the senior management of the sponsor. In particular, Tang failed to: (a) exercise due skill, care and diligence in handling the listing application; (b) diligently supervise the transaction team to carry out the sponsor work undertaken by Ample; and (c) ensure that appropriate standards of conduct were maintained by Ample.

In fining Ample HK$5.5 million and suspending Tang for 17 months, the SFC took into account that: (a) substandard sponsor due diligence work could facilitate the listing of companies that are unsuitable for listing; (b) no harm had been caused to the investing public as the listing application had lapsed; (c) two previous compliance advice letters issued to Ample by the SFC should have put it on heightened alert of the need to improve its sponsor due diligence work; (d) Ample has no previous SFC disciplinary record; (e) Ample's financial situation; and (f) Ample and Tang's cooperation with the SFC.

SFAT affirms SFC decision to reprimand and fine Yi Shun Da Capital Limited for sponsor due diligence failures

On 19 October 2021, the SFC reprimanded and fined Yi Shun Da Capital HK$3 million[10] for its failures to discharge its sponsor due diligence obligations in the listing application of Imperial Sierra Group Holdings Limited (**Imperial Sierra**) in 2017. This disciplinary action followed a review of the SFC's original decision to sanction Yi Shun Da Capital by the Securities and Futures Appeals Tribunal (**SFAT**).[11] The SFAT upheld the SFC's original decision to sanction Yi Shun Da Capital, but reduced the original fine of HK$4.5 million to HK$3 million.

Imperial Sierra's Application to List on the HKEX Main Board

Imperial Sierra was engaged in commercial property consultancy services, with its main operations centred in the Pearl River Delta area of the Mainland. Its principal revenue came from advisory services on a project-to-project basis, with its top five customers in 2016 contributing to around 76% of its revenue that year. In contrast, its property management services, which provided a regular income stream, accounted for 1.1% of its 2016 revenue. Yip Wik, Aric (**Aric Yip**) was the founder, board chairman, an executive director and the controlling shareholder of Imperial Sierra.

In December 2016, Imperial Sierra, which was seeking to list on the HKEX's Main Board, appointed Yi Shun Da Capital, then known as Zhaobangji International Capital Limited,[12] as its sole sponsor. In March 2017, Imperial Sierra's listing application was submitted to the HKEX. The vetting process gave rise to a number of concerns relating to financial issues; in particular, that there may have been a circular flow of funds. In exchanges with the HKEX, the sponsor was unable to demonstrate that it had conducted reasonable due diligence in respect of the concerns.

In January 2020, by which time the listing application had lapsed, the SFC informed Yi Shun Da Capital that it intended to bring disciplinary action against it for its failure to exercise reasonable due diligence in its role as the sole sponsor based on three main areas of contention:

a) during the three years prior to the listing application, a very high percentage of payments to Imperial Sierra had been made by third parties on debtors' behalf. The third-party payments were extensive: in the first two of the three-year period, third-party payments exceeded 50% of Imperial Sierra's total revenue, and amounted to almost 40% of its total revenue in the third year. Third-party payments were thus close to being the dominant method of payment. The SFC viewed this as highly unusual and given its concern that this method of payment might have been used to disguise the original source of funds and facilitate a deceptive or fraudulent scheme, the SFC considered that the third-party payment arrangements required explanation. However, the evidence indicated that the sponsor's transaction team had made only minimal enquiries. For example, none of Imperial Sierra's major customers involved in the third-party payments were questioned as to why they entered into these arrangements.

b) there were two sets of suspicious transactions indicating the possibility of a circular flow of funds. Firstly, a company acting as a third-party (Guangdong Qitian) paid RMB2.3 million to Imperial Sierra on behalf of a major customer. Two days later, Imperial Sierra remitted RMB2 million back to Guangdong Qitian by way of a personal loan advanced by Aric Yip. Secondly, Imperial Sierra remitted RMB2.2 million to a company (Guangzhou Chengzhi) by way of a personal loan advanced to it by Aric Yip. On the same day, a major customer of Imperial Sierra paid RMB2.7 million to Imperial Sierra. Both Guangzhou Chengzhi and the major customer were beneficially owned by the same person.

c) Over the same period of time, Aric Yip entered into financial arrangements with various "acquaintances", many of whom may have been connected with the third-party payers. Evidence demonstrated that in the financial years ending 2014, 2015 and 2016, Aric Yip withdrew HK$6.3 million, HK$16.5 million and HK$18.8 million, respectively, and as at 31 January 2017, he had made further withdrawals of HK$35 million. The funds were used to facilitate financial arrangements (apparently for loans or investments) between Aric Yip and 11 acquaintances. One of these acquaintances made third-party payments to Imperial Sierra. Another had close relations with a company that was a customer of Imperial Sierra (the acquaintance's beneficial owner was also the customer's beneficial owner).

According to the SFC, the draft prospectus did not disclose any of the above, meaning that if the prospectus had been approved, potential investors would have been ignorant of these matters.

10 https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=21PR104

11 https://www.sfat.gov.hk/files/SFAT4%20-%202020%20-%20Determination%20(19.10.2021)(final).pdf

12 The company was known as Zhaobangji International Capital Limited from November 2015 until December 2017 and as Well Link International Capital Limited from December 2017 until August 2018. After that, it became known as Yi Shun Da Capital Limited.

The SFC therefore alleged that the sponsor had failed to comply with the regulatory requirements for sponsors: in particular, Paragraphs 17.2 – 17.7 of the SFC Code of Conduct and Practice Note 21 to the Listing Rules (Due Diligence by Sponsors in respect of Initial Listing Applications).

The SFC also considered that the sponsor had breached other provisions of the SFC Code of Conduct and the SFC Corporate Finance Adviser Code of Conduct.

In June 2020, the SFC made its final decision. It found Yi Shun Da Capital guilty of misconduct and not to be a fit and proper person to remain licensed by the SFC.[13] It also publicly reprimanded Yi Shun Da Capital and fined it HK$4.5 million under section 194 of the SFO.

The SFC also prohibited Fabian Shin Yick,[14] a former responsible officer, sponsor principal and chief executive officer of Yi Shun Da Capital, from re-entering the industry for 20 months from 15 September 2020 until 14 May 2022 for his breaches of the SFC Code of Conduct and the Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers (**Sponsor Guidelines**). The SFC found that he had failed to: exercise due skill, care and diligence in handling the listing application; diligently supervise his subordinates to carry out the sponsor work; and ensure that Yi Shun Da Capital maintained appropriate standards of conduct.

The SFC's Case against the Sponsor

The SFC's concerns related to whether Yi Shun Da Capital, as sole sponsor, had carried out all reasonable due diligence in relation to the financial issues that were troubling on their face. The SFC did not allege that the third-party payments were either fictitious or fraudulent. Rather, the issue was whether a legitimate risk of a circular flow of funds existed which required the sponsor to conduct a more incisive investigation in conducting due diligence. According to the SFC, given the particular circumstances, the sponsor's discharge of its due diligence obligations under the SFC Code of Conduct required it to look in greater depth at the third-party payments. The SFC considered it essential that the sponsor understood and critically assessed the reasons for the payments, and understood the relationships between the third-party payers and Imperial Sierra's customers. The SFC accepted that after conducting such due diligence, Yi Shun Da Capital might have come to the conclusion that there was no circular flow of funds, or that they could be justified. However, in failing to conduct reasonable due diligence, Yi Shun Da Capital breached its obligations as sponsor.

The SFC also maintained that Yi Shun Da Capital must have known that the issue of third-party payments and other associated transactions would give rise to concerns, since the draft prospectus had allocated several passages to dealing with the issue. This showed that the sponsor had failed to investigate the issues giving rise to concerns and instead had merely relied on a few generalised statements from Imperial Sierra's representatives. It was on this basis that the SFC came to a finding that the sponsor was in breach of the SFC Code of Conduct.

The Sponsor's Appeal to the SFAT

In July 2020, Yi Shun Da Capital sought a review of the SFC's decision.

The sponsor contested the SFC's finding that it failed to conduct all reasonable due diligence. Third-party payments of that nature existed in the PRC. A number of earlier successful HKEX listings revealed the receipt of third-party payments, although they were less extensive than in the present case. Regarding the fact that the third-party payments were not occasional but amounted to a dominant practice, the sponsor's counsel emphasised that the SFC did not allege nor had any evidence to suggest that the third-party payments were fictitious or fraudulent. The sponsor considered an investigation into why the third-party payments were made to be irrelevant. Since the suggestion that the third-party payments were engineered to create the impression that Imperial Sierra's revenues were greater than they actually were was purely speculative, they did not merit extensive investigation.

Regarding the two suspicious transactions, Yi Shun Da Capital submitted that there was nothing inherently suspicious about them and that any suggestion of a scheme involving an engineered flow of funds was purely speculative.

As to Aric Yip's finance arrangements with the 11 acquaintances, Yi Shun Da Capital asserted that their details were revealed, and that the sponsor's due diligence work was presented to the SFC. They did not give rise to concerns provided the withdrawals were properly booked in the company accounts, which they were. The sponsor asserted that as it had ascertained the genuineness and existence of these financial arrangements, it did not need to carry out any further investigation.

13 See the SFAT's Determination dated 19 October 2021 at paragraph 12
14 https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR90

The SFAT's Decision

The SFAT's Deliberations

Referring to its decision in *Sun Hung Kai International limited v SFC*,[15] the SFAT noted the overriding obligation on sponsors to ensure that all information placed before the HKEX and investors generally is "*fully, fairly, and accurately presented*". It reiterated the need for sponsors to adopt an attitude of professional scepticism in assessing representations made by the listing applicant's representatives. In particular, sponsors need to be alert to information that casts doubt on the reliability of representatives' statements and are required to carry out additional due diligence if they become aware of information which suggests that information provided by the applicant may be unreliable or indicates a potential problem or risk. When seeking to verify information that appears to be problematic, undue reliance on management representations, particularly representations that are bland and lack detail, cannot be considered to be reasonable due diligence.

The SFAT considered that:

- if the sponsor's transaction team considered the issue of third-party payments to be sufficiently important to be identified in the draft prospectus, it must then follow that it should have considered the matter to be sufficiently important to warrant due verification;

- if the listing had gone ahead, there would have been a real risk of concern in the market regarding the fact that the indirect form of payment was the dominant form of payment;

- if the third-party payments were looked at in the context of Aric Yip's advances to business acquaintances and the two suspicious transactions, questions would likely arise as to why the listing was allowed to proceed without full and clear explanation of the third-party payments.

The SFAT noted that the draft prospectus failed to mention the possibility that extensive third-party payments might indicate the existence of some form of circular cash flow designed to create the appearance of a higher business turnover than was actually the case. The SFAT found it strange that while this was the SFC's chief concern – it did not appear to have caused concern to Yi Shun Da Capital's transaction team.

Failure of IPO Sponsor to Exercise Due Diligence in Relation to the Third-Party Payments

The sponsor submitted that there had been earlier successful HKEX listings where the prospectus disclosed the receipt of third-party payments; however, according to the SFAT, it was never the SFC's case that third-party payments should always be viewed with suspicion. Rather, the SFC considered that, on its face, this dominant practice clearly constituted more than random commercial happenstance. There was a pattern of people asking others to make third-party payments which raised a question as to the reasons for indirect payment. The SFAT found it insufficient to merely state the fact of the third-party payments. In the circumstances, the conduct of reasonable due diligence required an explanation for why payments were made indirectly.

The sponsor further submitted that it was allowed to rely on the accountants' report, which confirmed that the financial statements gave a true and fair view of Imperial Sierra's financial affairs. However, the SFAT pointed out that the accountants' report did not seek to explain how the financial affairs came into being, nor could the sponsor wash its hands of the issue on the basis that the reporting accountants had found nothing that required it to qualify its report.

The evidence obtained by the SFC further revealed that Yi Shun Da Capital had interviewed only seven out of the 23 third-party payers which had made payments on behalf of 18 customers. Although it had interviewed 10 major customers who made payments through third parties, none of the major customers were asked about the third-party payments. Seven third-party payments were made pursuant to 'private arrangements' without any further explanation. The SFAT said that this left open the very obvious question as to the nature of the private arrangements and the reasons for them. The SFAT considered it regrettable that these questions were not asked by the sponsor. The SFC pointed to a number of anomalies which suggested that four companies that had made substantial third-party payments in 2014 may not have been conducting genuine businesses. These also warranted further investigation, but were not investigated.

In finding that the SFC had demonstrated a lack of reasonable due diligence on the part of Yi Shun Da Capital, the SFAT concluded that:

i) given that third-party payments constituted a dominant practice in the three years before submission of the listing application, and that this was, on its face, a highly unusual practice whose magnitude alone appeared to go far beyond mere happenstance, the sponsor's transaction team had an

15 Application No. 3 of 2013 https://www.sfat.gov.hk/files/AN-3-2013-Determination.pdf

obligation to conduct a suitable investigation into the third-party payments so that it could explain:

- how the practice had arisen:
- why it had prevailed over three years, and
- why it was a legitimate practice and not one formulated to give a false impression to the market;

ii) sponsor due diligence obligations required a more incisive investigation into the legitimacy of the third-party payment practice, especially given that the sponsor's transaction team was clearly aware that the issue of third-party payments would be of concern to the market, as indicated by its setting aside passages in the draft prospectus to deal with the matter; and

iii) while the SFAT did not have any doubts as to the transaction team's good faith, the failure to look in greater depth at the dynamics of the third-party payment practice clearly amounted to a failure to carry out reasonable due diligence.

The SFAT was therefore satisfied that there was a failure on the part of the sponsor to exercise reasonable due diligence as required by the SFC Code of Conduct.

Failure of Sponsor to Exercise Due Diligence in Relation to Two Sets of Suspicious Transactions

In relation to the two sets of suspicious transactions, SFC asserted that no effective enquiry had been made with the customers and the third-party payers as to the transactions, and that Yi Shun Da Capital failed to review the transactions' underlying documents. In respect of the suspicious transactions, the sponsor submitted that any allegation of a circular flow of funds was purely speculative. Further, for the first suspicious transaction, it was submitted that there was nothing inherently suspicious in the transaction and that it did not require the level of due diligence suggested by the SFC.

The SFAT was satisfied that, in light of the broader context of the third-party payments, these transactions should have been further investigated and that the sponsor had therefore failed to carry out its due diligence obligations.

Failure of Sponsor to Exercise Due Diligence in Relation to Payments Made by Aric Yip to 'Acquaintances'

There was evidence of substantial withdrawals of funds during the track record period by Aric Yip. These were made apparently to facilitate various loan and investment arrangements between Aric Yip and his 'acquaintances'. The draft prospectus disclosed the withdrawals, but no further details were provided regarding their purpose. It was only in response to queries from the regulators that the purpose of the withdrawals was disclosed. The SFC noted that certain acquaintances were third-party payers or entities with connections to Imperial Sierra's customers and it was therefore important to verify the transactions' true nature and purpose.

With respect to the due diligence work conducted, six out of the 11 acquaintances were interviewed enabling the sponsor to obtain confirmation of the reasons for each transaction, the amounts involved, and the fact of the acquaintances' independence from Imperial Sierra and its customers. However, two of the companies interviewed stated that the funds were obtained for 'business needs' – effectively saying nothing.

In addition, although background searches were carried out for ten of the acquaintances, there were discrepancies with two of the interviews. The sponsor considered the discrepancies trivial, but the SFC determined they demanded follow-up action as they related to the 'primary nature of the finance arrangements'.

It was also submitted by Yi Shun Da Capital that the financial arrangements by Aric Yip should not have given rise to any concern as long as the withdrawals were properly booked in the company accounts thus guaranteeing their genuineness. The SFAT disagreed, stating that if, looking at the overall picture, there was a legitimate reason for concern that there may have been a circular flow of funds, then all relevant matters had to be considered, including the significant loan/investment transactions between Aric Yip and the various acquaintances who had, or may have had, some connection to the parties involved. The true issue to be determined here was not whether or not the payments were recorded, but what was the effect of this flow of finance.

It was the SFC's finding that (i) there had been a failure to obtain and review the agreements themselves and the relevant bank records; (ii) there had been a failure to follow-up on unsatisfactory or incorrect responses provided by acquaintances; and (iii) there had been a failure to state in the draft prospectus that four of the acquaintances were either third-party payers or were connected with the top five customers of Imperial Sierra.

The SFAT was satisfied that there was a failure by the sponsor to exercise due diligence.

The SFAT's findings

In respect of the above three areas of concern, the SFAT was satisfied that the sponsor failed to conduct reasonable due diligence.

The Issue of Sanctions

The Objection to the Name 'Well Link'

The first matter raised by the sponsor was the SFC's draft press release citing its past name of 'Well Link International Capital', as it was known from December 2017 until August 2018. The sponsor had objected to the citation of this name because this was the name by which it was known after the impugned sponsorship had been completed and was a name abandoned before the SFC proceedings.

In the SFAT's opinion, the sponsor's contention was misconceived. Sanctions under the SFO are defensive in nature and not penal, and their purpose is to defend the market's integrity and to ensure that the particular harm is not repeated. A threat can only be effectively countered if its source is clearly identified. For an offender to be fully and accurately identified means the name or the names it has been known by must be made known to the market.

The Sufficiency of a Public Reprimand

The sponsor contended that a public reprimand was a sufficient sanction in the circumstances and that a fine was unwarranted. It submitted that the misconduct had not affected the market and that adequate steps were taken to address the failings, and that it had relied upon the expertise and experience of its transaction team led by a person with over 25 years of relevant experience.

The SFAT considered it inevitable that sponsors will set up an operational team to bring a listing application to fruition, and that this does not mean that a sponsor can wash its hands of responsibility. The SFAT accepted the position of the sponsor's counsel that whether a public reprimand alone was sufficient turned on the SFAT's view as to the sponsor's culpability. In the SFAT's opinion, that culpability must first be put into the context of the duties imposed on a sponsor in a listing application. As the SFAT stated in *Sun Hung Kai International limited v SFC:"[i]t is clear to us that the regulatory framework insisting on the exercise of due diligence by each and every sponsor is critical to the orderly and transparent working of the market. That is why emphasis is placed on the dual obligation of a sponsor, an obligation not only to the client but, equally importantly, to the integrity of the market."*

The SFAT in *Sun Hung Kai International limited v SFC* went on to state that investors must be able to assess the risk in purchasing shares in an IPO by relying on accurate and relevant information in listing documents. If they are unable to do so, then trust in the market is undermined. If the regulators had not raised concerns about the issue of a circular flow of funds, that concern may have been reflected in the market and may have resulted in concerns as to the integrity not only of the listing but also of the listing process itself.

Accordingly, in the view of the SFAT, evidence of material culpability on the part of a sponsor in the listing process will almost inevitably demand more than a public reprimand.

The Fine

The SFC recognised that Yi Shun Da Capital had not been found culpable of any prior breach of regulatory conduct, but had nonetheless proposed an original fine of HK$14.5 million. In the SFC's final decision, the fine was lowered to HK$4.5 million, the reduction being made in light of the sponsor's difficult financial circumstances. The sponsor submitted to the SFAT that this was manifestly excessive given that it had a clear record, had ceased its sponsor business, and was in dire financial circumstances at the time.

Yi Shun Da Capital also submitted that it would suffer a significant loss in respect of the work done, given the sponsor fees received and the size of the fine. The SFAT had difficulty accepting this submission. It could not be the case that a sponsor is entitled to make a profit for work carried out by it even though that work has been undermined by its own culpability.

Considering all the evidence, the SFAT concluded that Yi Shun Da Capital's essential culpability lay in its failure to look at the broader picture; to recognise that the dominant practice of third-party payments was, at least on its face, so unusual as to raise concern, a concern that was compounded when Aric Yip's very substantial advance of funds to acquaintances for purposes of loans and/or investments was integrated into the overall picture. If sponsors are to fulfil their dual obligation to represent the interests of a listing applicant and to protect the integrity of the market, they must have the ability to be completely objective and to step back and view matters as market participants would view them.

The SFAT accepted that the dominant practice of third-party payments should have been viewed as a major red flag by the sponsor's transaction team and was puzzled why it was not. However, the other failings were not all to be measured at the same level of culpability. In the SFAT's view, the sanction of a public reprimand was appropriate together with a fine of HK$3 million which it considered appropriate given Yi Shun Da Capital's financial position.

SFAT's Determination of the Application for Review

For the above reasons, the SFAT reduced the fine from HK$4.5 million to HK$3 million.

SFC October 2021 Statement

Following the SFAT's decision to uphold the SFC's original decision, on 19 October 2021, the SFC reprimanded and fined Yi Shun Da Capital HK$3 million for failing to discharge its sponsor obligations in the listing application of Imperial Sierra.

The SFC had found that Yi Shun Da Capital had failed to: (i) perform all reasonable due diligence on Imperial Sierra before submitting its listing application; and (ii) ensure that all material information obtained was included in the Application Proof and that the information was accurate and substantially complete.

Failure to perform all reasonable due diligence

The SFC's investigation made the following findings in relation to the third-party payments:

- the sponsor failed to verify Imperial Sierra's customers' relationships with 23 third-party payers and the reasons for the third-party payments;
- no steps were taken to follow-up on four of the seven third-party payers who showed in interviews that they did not know the reasons for the payments;
- the sponsor merely relied on Imperial Sierra's representations as to the reasons the other third-party payers made the payments, without carrying out any independent enquiries; and
- no appropriate follow-up enquiries were made to address red flags concerning the third-party payments.

In respect of the finance arrangements between Aric Yip and the acquaintances, the SFC's investigation found that:

- the sponsor failed to obtain and review the agreements and the bank transaction records relating to the finance arrangements prior to the listing application submission;
- three out of the six acquaintances were unable to explain the reasons or purposes of the finance arrangements when asked by the sponsor, and the sponsor did not follow-up on the matter;
- four of the acquaintances were third-party payers or entities connected with Imperial Sierra's customers, but the Application Proof did not include disclosures about these relationships; and
- there were potential connections between three of the acquaintances and Imperial Sierra's customers, and the sponsor failed to take appropriate steps to verify the nature of the relationships.

The SFC's investigation also revealed that there were suspicious transactions which should have raised a question as to whether Imperial Sierra and/or its chairman had provided financial support for certain customers' payments. However, the sponsor carried out minimal or no due diligence on these suspicious transactions.

Incomplete disclosure in the Application Proof

The SFC's investigation found that the sponsor did not ensure that all material information was disclosed in Imperial Sierra's Application Proof. In particular, it failed to disclose:

- details of the relationships between Imperial Sierra's customers and their third-party payers, or the reasons for the third-party payments;
- that a third-party payer was the spouse of Imperial Sierra's deputy general manager;
- that the significant increase in the "amount due from a shareholder" was principally attributable to withdrawals made by Imperial Sierra's chairman to facilitate the finance arrangements between the chairman and his acquaintances, and certain acquaintances were third-party payers or entities connected with Imperial Sierra's customers; or
- an explanation for the suspicious transactions.

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