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# SFC Report On Sponsor Inspection Findings

## Introduction

On March 29 2011 the SFC published its Report on Sponsor Theme Inspection Findings (the **Report**). The Report is the work of a specialised team (the **SFC Team**), set up in 2009, which operates as part of the SFC. The SFC Team conducted a "themed" inspection (the **Inspection**) of 17 sponsors, examining their level of regulatory compliance, with a particular emphasis on their role during initial listing applications. Prior to commencing the Inspection, the SFC Team undertook a comprehensive survey (the **Survey**) in 2009 of the sponsors’ market in Hong Kong, in order to better understand the market in general and, more specifically, to oblige sponsors to self report on their standard of regulatory compliance. During the Inspection, the SFC uncovered what it regarded as "certain deficiencies in the work performed by some sponsors as well as some inadequacies in their internal systems and controls"

This newsletter summarises the Report in general, but the issues arising from it which caused the greatest concern to the SFC are as follows:

* substandard due diligence on listing applicants' businesses;
* questionable disclosure to The Stock Exchange of Hong Kong Ltd (the Exchange) during the listing application process;
* failure to maintain proper documentation of due diligence; and
* inadequate internal systems and controls over sponsor work.

The [Report](http://www.sfc.hk/sfc/doc/EN/speeches/public/surveys/11/Sponsor%20report_FINAL.pdf) ([see archive](Sponsor_report_FINAL.pdf)) is available to view in full on the SFC's website.

## Background To The Sponsor Theme Inspection And Report

In 2009, HK$248 billion was raised in IPOs in Hong Kong, making it the world's largest IPO centre. The SFC notes that sponsors have a key part to play, particularly in the context of IPOs, in ensuring that this regulatory framework operates effectively. The Report concedes that directors have the final responsibility for the information contained in the listing documents of an applicant, but emphasises that sponsors have a regulatory obligation to work closely with them and guide them through the whole process, a task to which the SFC attaches vital importance.

### The SFC's focus on sponsors: recent developments

The key role which the SFC attributes to sponsors in relation to Hong Kong's capital markets can be seen from the following regulatory initiatives which have been undertaken in recent years:

* The introduction in 2007 of the "Additional Fit and Proper Guidelines for Corporations and Authorised Institutions applying for or continuing to act as Sponsors and Compliance Advisors" (the **Guidelines**), which oblige those intermediaries wishing to act as sponsors to adhere to their precepts and hold a Type 6 licence.
* The creation of the SFC Team
* The taking of regulatory action against sponsors, both at a firm and individual level, with the majority of these cases being focused on what the SFC perceives to be failures in the area of due diligence.

The Report is the latest development in the SFC's efforts to ensure that sponsors fulfil their responsibilities to the highest standard possible.

### Sponsors: The Key Responsibilities

During the listing application process sponsors have a number of crucial responsibilities under Chapter 3A of the Main Board Listing Rules and Chapter 6A of the GEM Listing Rules. These include

* Assisting in the preparation of the required documentation.
* Performing reasonable due diligence enquiries in order to certify to the Exchange that the listing documents contain sufficient information to permit a reasonable person to form an opinion on the applicant's shares, financial position and profitability.
* Ensuring the applicant complies with all its specific obligations under the Listing Rules.
* Responding to all inquiries from the Exchange with regard to the listing application and providing such information as is needed to verify that the applicant, its directors and the sponsor are complying with their respective regulatory responsibilities.
* Accompanying the applicant to meetings with the Exchange.
* Ensuring that all information submitted to the Exchange is true, accurate and contains no material omissions, and should a doubt later emerge as to any of these qualities with regard to the information supplied, informing the Exchange promptly.

### The Sponsor Survey

The SFC conducted a survey of the sponsor sector in Hong Kong before commencing the preparation of the Report. It dealt with the period between October 2007 and September 2009 and gave an insight into the state of the market at that time:

* Sponsors were involved in 238 and 305 IPO transactions during the years ended 30 September 2008 and 2009, respectively.
* Sponsors employed 1,640 people as at 30 September 2009.
* Total income derived from sponsor work amounted to HK$4,759 million and HK$2,214 million during the years ended 30 September 2008 and 2009, respectively, with the bulk of it coming from underwriting fees.
* Although Bank Sponsors constituted only 6 out of a total of 65 sponsors operative during the Survey Period, they earned over 39% of the total income pool and employed more than 33% of the total staff across the sector.

## The Sponsor Theme Inspection And Report

The main aim of the Inspection, which encompassed 17 sponsors, was to assess the standard of compliance with the regulatory regime, with an emphasis on

* The quality of the due diligence work undertaken by the sponsors in IPOs handled in the past, particularly as regards the applicant’s business activities and the financial data and material information submitted to the Exchange.
* The quality of the monitoring systems and controls which the sponsors employed in relation to their activities as sponsors. Areas of particular interest to the SFC Team were a sponsor’s capacity to embark on IPO transactions, the level of supervision by management of sponsor staff and the effectiveness of the sponsor’s compliance function.

The Report, as noted above, uncovered "certain deficiencies in the work performed by some sponsors as well as some inadequacies in their internal systems and controls". The SFC Team divided these into four categories, each of which will now be examined in turn:

### Unsatisfactory due diligence on a listing applicants business

The SFC Team notes that it is a sponsor's duty, as discussed above, under the Listing Rules to carry out a due diligence process which enables it to make a declaration in the application certifying the applicant's suitability for listing and the adequacy of the disclosure in the Listing Document. In order to fulfil this role to a satisfactory standard, the Report highlights the importance for the sponsor of gaining a reasonable understanding of the business which the listing applicant is engaged in. In practical terms, this means that the sponsor must tailor the intensity and nature of its due diligence to the particular characteristics of the listing applicant. The Practice Notes to the Listing Rules contain some guidance on what form due diligence procedures should take, but these are illustrative in nature, particularly as no two listing applications are exactly the same. However the SFC Team uses the guidance from the Practice Notes as a basis for describing what they see as sponsors’ failings in this area, analysing the requirement to undertake proper due diligence under the following three headings:

#### Insufficient due diligence on major business stakeholders

A crucial part of the due diligence process is the evaluation by the sponsor of the listing applicant's performance and finances, both in the past and going forward. The methods used and ambit of this due diligence is left up to the sponsors in the Practice Notes to the Listing Rules, although the Report states that sponsors should always adhere to the principles enunciated in the Notes. A normal part of this procedure is interviewing important stakeholders, such as key customers and suppliers. As these interviews provide the information which sponsors rely on when preparing the listing documentation, it is essential that the interviews be conducted in a manner which is conducive to the production of high quality, reliable information.

However the Inspection found that some of the interview practices utilised were far from satisfactory. In particular, the techniques used in some interviews did not properly identify the interviewee, and some answers which were incomplete and unsatisfactory were not investigated further by the sponsor. This, the SFC Team states, has the effect of undermining the reliability of the information obtained regarding major customers and sales figures, information which formed an important part of the prospectus. The Report even suggests that the acquiring of information in this manner could lead to future actions against the successful listing applicant for deceptive/fraudulent action or for provision of false information during the IPO application.

The Report suggests that the sponsor should conduct the interviews, insofar as possible, for fear that the applicant may wish to influence the information which emerges from the process. If the sponsor does not orchestrate the interviews and permits the applicant to do so, the Report recommends that it carry out further due diligence on the information received, to be sure of its veracity.

#### Insufficient due diligence on a material change in business shortly before listing

The Report quotes the section of the Practice Notes which states that when conducting due diligence, sponsors should consider whether there has been any material change to the applicant's business between the date of the most recent audited balance sheet included in the listing document and the time shortly before listing. The SFC Team emphasises that any such change could have serious repercussions for the business prospects or model of the applicant and may also influence the way in which the applicant is viewed by investors. The Inspection revealed that this assessment had not been properly performed by some sponsors.

#### Insufficient due diligence on third party professional or expert work

It is common practice for the listing applicant and sponsor to engage third party experts or professionals to advise on areas necessitating a certain level of specialist knowledge. This advice can have a considerable effect on the listing application and can even form part of the prospectus, where it will be relied on by investors as they evaluate the prospects of the listing applicant. The SFC Team states clearly that such advice should only be relied on by sponsors to the extent that it is reasonable to do so, and that it is not acceptable for the expert’s opinion to be based largely on information provided by the applicant, without his conducting any independent investigation of that information. An inquisitive approach should be adopted by the sponsor with regard to the expert advice, in that the sponsor should check whether or not the assumptions on which the advice is founded are fair, reasonable and complete, and whether there are any discrepancies between the content of the advice and any other information in the possession of the sponsor.

### Questionable disclosure to the Exchange during the listing application process

Hong Kong operates a prospectus regime founded on the principle of appropriate disclosure, with minimum content requirements detailed in the Listing Rules and Companies Ordinance. Sponsors have an obligation to ensure that information submitted to the Exchange as part of the listing application is true and accurate in all material respects, and also omits no material information.

During the Inspection, the SFC Team found that the quality and level of disclosure made in the prospectus by some sponsors was decidedly substandard. This could cause the legality of the listing applicant’s business affairs at the time of listing to be called into question. Additionally, the SFC Team details the consequences for a sponsor should a material omission occur, which range from a breach of the Listing Rules to a charge of providing misleading information to the Exchange. The latter could amount to an integrity issue, casting doubt on the sponsor's suitability to remain a licensed person.

### Failure to maintain proper documentation of due diligence

The SFC Team states clearly that it is not sufficient for the sponsor to comply with all the relevant obligations, as it must also keep records which allow it to provide a paper trail to the SFC, demonstrating that it has so complied. In this regard, the SFC expects the sponsor to record its due diligence planning, areas in which marked deviations from these plans occurred and conclusions reached in relation to the listed applicants compliance with certain conditions. The SFC Team states that, in a number of instances encountered during the Inspection, the sponsor was not able to produce records demonstrating that it had addressed certain key aspects of the due diligence process. The explanation given by the sponsors in these circumstances is that they did not consider the issues in question to be "material", and therefore neither disclosed information connected to them, nor did they maintain records of any due diligence procedures made in relation to these issues.

The SFC Team accepts that the assessment of whether or not such information is material and thus subject to a disclosure obligation is a "judgment call", but a sponsor should still record the due diligence procedure used to conclude that the information was immaterial. Furthermore, the Report notes that should the sponsor fail to record this procedure, the SFC may judge that the issue has not been considered properly and that due diligence has not been conducted in the appropriate fashion. The SFC Team warns that such a failure on the part of the sponsor can amount to a breach not only of the obligation to maintain records, but also other regulatory requirements related to the issue in question.

### Inadequate internal systems and controls over sponsor work

The Sponsor Guidelines impose a number of "fit and proper" obligations on sponsors and their staff, with a key obligation being the requirement to have at least two Principals (with one overseeing each transaction team) operating in a full time capacity. The SFC Team note that this requirement has been largely adhered to, but other elements of the Guidelines have been ignored, such as:

* the obligation, under the Guidelines and SFC Code of Conduct[[1]](#footnote-38), to ensure that the level of resources and expertise allocated permit the sponsor's staff to perform their functions. During the inspection the SFC Team discovered that this was not always the case, with the resources allocated not being commensurate with the volume and complexity of work undertaken. Particular attention is given in the report to sponsor Principals taking on too much work, with the likely result being that the level of supervision they can engage in effectively suffers.
* the requirement under the Guidelines to assess annually the effectiveness of the internal systems and controls aimed at guaranteeing compliance with all aspects of the regulatory framework for sponsors. The SFC Team found that many sponsors either did not conduct this assessment, or did so inadequately.

### The SFC circular on sponsors' regulatory obligations

As a follow up to the Report, the SFC issued a circular to all licensed corporations highlighting their regulatory obligations under the regime for sponsors, including all the relevant rules in the Sponsor Guidelines, the Corporate Finance Adviser Code and the Listing Rules. Particular focus is given to the following matters in the Circular:

* the details of the declaration which the sponsors must make to the Exchange as part of the listing application process, particularly that part of it where the sponsor must confirm that "reasonable due diligence inquiries" have been made, with the consequence that it has "reasonable grounds to believe" that the listing document "contains sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares and the financial condition and profitability of the new applicant at the time of the issue of the listing document". The circular also emphasises the consequences for sponsors should they fail to make reasonable due diligence inquiries, noting that "substantial disciplinary sanctions" will ensue, with criminal sanctions under section 384 of the SFO being imposed on sponsors who knowingly submit false or misleading information to the SFC.
* the contents of the undertaking the sponsor must make to the Exchange, especially the part where the sponsor is obliged to "use reasonable endeavours to ensure that all information provided to the Exchange during the listing application process is true in all material respects and does not omit any material information and, to the extent that the sponsor subsequently becomes aware of information that casts doubt on the truth, accuracy or completeness of information provided to the Exchange, it will promptly inform the Exchange of such information".
* the requirements that appropriate resources are allocated to sponsor work and that annual evaluations are made of the internal compliance monitoring systems.

## The SFC's Next Steps

In the conclusion to the Report, the SFC states that as a consequence of the Inspection findings, it will review the current regulatory regime for sponsors. The aim of the forthcoming review, according to the SFC, is to ensure that the regulatory framework serves the twin goals of guaranteeing the quality of Hong Kong's capital markets and safeguards the interests of shareholders. Furthermore, the shortcomings of the sponsors who were subject to the Inspection have been addressed by the SFC, with the more serious failings currently being investigated further. Finally, the SFC notes that as bank sponsors have such a large part to play in the sponsor market, it will liaise closely with the Hong Kong Monetary Authority (**HKMA**) on the issue of sponsor regulation (bank sponsors are subject to the regulatory scrutiny of the HKMA).

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1. General Principle 3 of the SFC Code of Conduct for Persons Licensed by or Registered with the SFC [↑](#footnote-ref-38)