

Recent SFC Enforcement Action: 5 Key Takeaways for Hong Kong IPO Sponsors

Sponsors should maintain best practices in IPO engagements in light of increased enforcement action and regulatory scrutiny from the SFC.

Key Points:

- In March 2019, the Hong Kong securities regulator, the Securities and Futures Commission, issued record-breaking fines (together with other disciplinary actions) against several sponsors on Hong Kong IPOs dating back to 2009.
- This enforcement action indicates the SFC's focus on improving the standard of listing sponsors' work and coincides with other sponsor-related regulatory pronouncements, notably the SFC's report on the thematic review of sponsors issued in March 2018.

Background and Recent Developments

The Hong Kong Stock Exchange (SEHK) has long been one of the world's top markets for initial public offerings (IPOs), vying with other international financial centres, such as New York, to claim the crown as the number one IPO market in any given year.¹

IPO sponsors play a critical role in vetting the integrity of new listing applicants, as sponsors are subject to regulatory mandates to conduct reasonable due diligence and to ensure that disclosures in listing documents, and information provided to the SEHK and the SFC during the listing application, are true in all material respects and do not omit any material information.

The Securities and Futures Commission (SFC) has a statutory mandate under the Securities and Futures Ordinance to protect investors, to assist in maintaining financial stability in Hong Kong, and to have regard to "the international character of the securities and futures industry and the desirability of maintaining the status of Hong Kong as a competitive international financial centre" when performing its regulatory functions.² The SFC's view is that the standard of sponsors' work closely correlates with the quality of companies that are listed on the SEHK, and therefore Hong Kong's overall reputation as a leading international financial centre.

For more than a decade, the SFC has sought to address what it perceives to be sub-standard sponsor work on IPOs. The regulator has introduced more prescriptive guidance for sponsors throughout this period, including:

- **2003:** Practice Note 21 to the SEHK Listing Rules
- **2013:** Paragraph 17 of the Code of Conduct for Persons Licensed by or Registered with the SFC (the Code of Conduct) was introduced to help sponsors better discharge their duties with the aim of raising the standard of listing applications
- **2018:** The SFC's report on its thematic reviews of sponsor activities undertaken between 2013 and 2017³

In parallel with issuing regulatory guidance for sponsors in Hong Kong, the SFC also has devoted significant attention and resources to pursuing enforcement action against sponsors. The SFC's ongoing enforcement crusade reached new heights earlier this month when the regulator issued record-breaking fines (totaling HK\$786.7 million, equivalent to more than US\$100 million), together with other reprimands to several financial institutions for their work as sponsors on Hong Kong IPOs dating back to 2009.⁴ The SFC also has disciplined certain individuals acting as principals⁵ for the sponsor work undertaken by these institutions.

Upon the announcement of these enforcement actions, SFC chief executive, Mr. Ashley Alder, commented that “[these] sanctions send a strong and clear message to the market that [the SFC] will not hesitate to hold errant sponsors accountable for their misconduct” and that “the outcome of these enforcement actions for sponsor failures – particularly failings when conducting IPO due diligence – signify the crucial importance that the SFC places on the high standards of sponsors’ conduct to protect the investing public and maintain the integrity and reputation of Hong Kong’s financial markets.”

The SFC’s Enforcement Actions: 5 Key Takeaways

The SFC's enforcement actions perceived deficiencies in sponsor work that the regulator has now largely addressed through the introduction of Paragraph 17 of the Code of Conduct and through the March 2018 report on its thematic review of sponsors. Accordingly, many institutions engaging in sponsor work have already updated their internal policies, procedures, and practices to mitigate the risk that their work falls short of the SFC's regulatory expectations.

However, the provisions in the Code of Conduct clarify that no amount of regulatory guidance will be exhaustive and sponsors are required to assess listing applicants on a case-by-case basis, depending on their particular businesses. Accordingly, the expectations of the SFC and of sponsors may not yet be aligned.

As sponsors embark on new IPO mandates, they should bear in mind five key takeaways from the SFC's enforcement actions and March 2018 thematic review report:

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| <p>1 Adopt a holistic approach to due diligence and always focus on substance over form</p> | <p>Sponsors and sponsor principals should avoid adopting a “box-ticking” approach to diligence and compliance, and instead adopt a more substantive and holistic approach to their work on IPO transactions.</p> <p>The guidance set out in Practice Note 21 is not intended to be an exhaustive checklist, and sponsors should supplement their due diligence planning to ensure that any additional factors that are specific to a listing applicant’s business are subject to reasonable diligence.</p> <p>The enforcement actions indicate that the SFC expects sponsor diligence to be sufficiently detailed at an individual product/business line level and at a whole business/group level to identify and address potential red flags (e.g., if a single issue does not appear problematic at a micro level, sponsors should examine whether that issue raises a red flag when compared with data collected from other parts of the diligence process).</p> <p>Sponsors are also reminded to maintain professional skepticism and a suitable professional “distance” from the listing applicant throughout the transaction in order to mitigate the risk that the sponsor’s judgment is compromised.</p> |
| <p>2 Systematically record risks and issues that are identified, and ensure records of decisions (and the rationale for those decisions) can be produced as necessary at a later date</p> | <p>A common feature of the enforcement actions is that sponsors were not able to produce relevant records to demonstrate to the SFC’s satisfaction that sponsors properly considered and actioned major issues (or if certain issues were disregarded, the basis on which such issues were disregarded).</p> <p>Sponsors should consider implementing or revisiting existing policies and procedures to ensure that they are fit for purpose and that all material risks and issues identified during due diligence are documented in an issues log accompanied by stand-alone due diligence notes. This process would be consistent with good record-keeping practices outlined by the SFC in its March 2018 report on the thematic review of sponsor activities.</p> |
| <p>3 Understand the scope of work of professional advisors and interrogate the veracity of their advice</p> | <p>IPO transactions necessitate the involvement of professional advisors, such as lawyers and accounting firms, and sponsors are responsible for coordinating with these advisors.</p> <p>One theme emerging from the enforcement actions is that the SFC criticised sponsors for significantly relying on the work of professional advisors (particularly lawyers) engaged on the relevant IPO transaction. Paragraph 17 of the Code of Conduct clearly indicates that sponsors cannot abrogate their own responsibility by relying on the work of professional advisors and that sponsors should pay close attention to the scope and application of professional advice.</p> |

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| | <p>Sponsors should ensure that they understand the issues on which a professional advisor is advising and, perhaps more importantly, the issues that are expressly excluded from the scope of the advice and the factual circumstances that have been assumed for the purposes of the advice.</p> |
| <p>4 Examine closely and verify the listing applicant's key physical assets</p> | <p>The enforcement actions demonstrate that it is crucial for sponsors to verify the existence of the listing applicant's key physical assets and that the listing applicant has all necessary legal rights (including licences, permits, etc.) in respect of the use of such assets. The SFC is particularly focused on this area due to a spate of SEHK listings by companies that fabricated key physical assets in order to achieve higher valuations.</p> <p>The SFC has clarified through the enforcement actions and through Paragraph 17 of the Code of Conduct and its March 2018 report that sponsors are expected to conduct robust independent diligence (<i>i.e.</i>, verification through sources of information other than the listing applicant itself) to satisfy itself as to the listing applicant's ownership/rights of use of key physical assets.⁶</p> <p>Sponsors are expected to use available resources to verify this information, including using public registries/databases⁷ and conducting sufficient enquiries with relevant governmental authorities, etc.</p> <p>The individual appointed by the sponsor to act as the principal for the transaction should be actively involved in supervising the due diligence undertaken by the transaction team to ensure that the diligence process is sufficiently robust.</p> |
| <p>5 Examine closely and verify the listing applicant's key stakeholders</p> | <p>The SFC expects sponsors to make independent enquiries with a listing applicant's major business stakeholders, including the applicant's customers, suppliers, creditors, and bankers.⁸</p> <p>Sponsors should exercise due care in formulating a criteria for selecting interviewees from the relevant stakeholders and confirming the bona fides of such interviewees in order to be satisfied that they have the appropriate authority and knowledge.</p> <p>The identities of the interviewees should be verified to the sponsor's satisfaction. If interviews are conducted by telephone, sponsors should verify the interviewees' telephone numbers and identities and should not rely solely on the telephone numbers the listing applicant has provided to verify an interviewee's identity. For example, they could call the general line of the interviewee's company obtained from a reliable public source (such as a telephone directory) to verify the interviewee's position and confirm that the individual participated in the interview. All</p> |

of this information, together with details of matters discussed during the interview, should be recorded and retained.

The sponsor should note and record an explanation for any irregularities observed during such interviews (e.g., the interviewee's reluctance to answer specific questions or cooperate with the interview process).⁹

The SFC has criticised sponsors that failed to adequately explain or address red flags that arose during interviews with stakeholders and sponsors that allowed the listing applicant too much involvement in the interview process, thereby compromising the independence of the sponsor's diligence.

More SFC Enforcement Action and a Drive for “Front-Loaded” Regulation

The SFC's record-breaking fines may represent the new high-water mark in sponsor-related enforcement, but there likely will be more enforcement action and regulatory scrutiny of sponsors in the future. In October 2018, the SFC stated that it had investigated 30 cases of suspected sponsor misconduct involving 28 sponsor firms and 39 listing applications. At that time, the SFC also stated that it had issued proposed disciplinary notices to nine firms and four sponsor principals, and was considering more disciplinary notices against other sponsor firms and principals.

In addition to enforcement action, the SFC is also now focused on what it describes as “front-loaded” regulation, which essentially means identifying and addressing market misbehaviour before the misbehaviour happens or while the misbehaviour is happening, rather than pursuing enforcement action for a specific breach or loss after the event. In respect of sponsors and IPO-related regulation, this would mean regulatory intervention at an early stage if the SFC has serious concerns about IPO applications.

The SFC's front-loaded regulation would not only extend to sponsors, but also to listing applicants and post-listing applicants. Issue No. 3 of the SFC's February 2019 Regulatory Bulletin¹⁰ outlined examples of the SFC's front-loaded regulatory actions taken against listing applicants and post-listing applicants, such as requesting the listing applicant to explain the accuracy of its financial information and issuing letters of concern about a proposed acquisition (in both cases the company was unable to provide an explanation and the listing applicant withdrew its listing application).

Overall, the conclusions that can be drawn from the enforcement actions are consistent with the SFC's guidance in its March 2018 report and Paragraph 17 to the Code of Conduct. Taken together, these sources of information provide sponsors with greater clarity as to the SFC's expectations, but bankers should be vigilant to the fact that the application of the rules will differ on a case-by-case basis and should consider carefully how diligence is performed. Most banks engaged in sponsor activities have already implemented procedures designed to comply with these regulatory requirements, but the SFC's latest enforcement actions likely present a good opportunity for banks to take stock and consider whether their procedures are sufficiently robust and fit for purpose.

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Endnotes

- 1 In 2018, the SEHK saw 125 companies raise US\$36.5 billion, making it the number one IPO market in the world according to Refinitiv data.
- 2 Sections 4(a), (c), (f) and 6(2)(a) of the Securities and Futures Ordinance.
- 3 In March 2018, the SFC published its Report on the Thematic Review of Licensed Corporations setting forth the SFC's conclusions following a thematic inspection covering 31 licensed corporations engaged in sponsor business between 2013 and 2017. The report highlighted a number of deficiencies and instances of non-compliance with relevant provisions in the Code of Conduct, Corporate Finance Adviser Code of Conduct and the Hong Kong Stock Exchange Listing Rules in respect of due diligence practices and internal systems and controls.
- 4 The SFC's announcements of the various enforcement actions on 14 March 2019 are available on its website at <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/>
- 5 In respect of a listing assignment, a principal is an individual appointed by a sponsor to supervise the staff appointed by a sponsor to carry out a listing assignment.
- 6 See Paragraph 17.6(e)(ii) of the Code of Conduct and the SFC's recent enforcement actions.
- 7 See Paragraph 17.6(e)(v) of the Code of Conduct and the SFC's recent enforcement actions.
- 8 See Paragraph 17.6(e)(iii) of the Code of Conduct and the SFC's recent enforcement actions.
- 9 See paragraph 17.6(f)(v) of the Code of Conduct and the SFC's recent enforcement actions.
- 10 The February 2019 edition of the SFC's Regulatory Bulletin is available at: [https://www.sfc.hk/web/EN/files/ER/PDF/SFC%20Regulatory%20Bulletin/SFC%20Regulatory%20Bulletin_Listed%20Corporations%20\(Feb%202019\)Eng.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/SFC%20Regulatory%20Bulletin/SFC%20Regulatory%20Bulletin_Listed%20Corporations%20(Feb%202019)Eng.pdf)