



SFC Regulatory Bulletin

This special edition of the *SFC Regulatory Bulletin* provides an update on our front-loaded regulatory approach to tackle the greatest risks facing our markets and intervene at an early stage to address persistent problems and emerging threats.

Extreme volatility in the prices of GEM and Main Board stocks in 2015 and 2016 was related to shell-related trading activities and other undesirable market conduct. Many listed companies, particularly those with highly-concentrated shareholdings, were engaging in practices which were unfairly prejudicial to public shareholders.

In response, we established a cross-divisional working group in July 2016, pooling the expertise from our Intermediaries, Corporate Finance and Enforcement divisions to ensure our regulatory actions are coordinated, targeted and effective. The principal objective of the working group, code-named ICE, is to implement a coherent, consolidated regulatory approach to address a range of market quality and corporate conduct concerns.

The main components of this multi-pronged approach include front-loaded regulatory intervention in listing matters, enhanced supervision of intermediaries and focused enforcement actions against senior management and persons with important gatekeeping roles.

Listing regulation and corporate transactions

Under the Securities and Futures (Stock Market Listing) Rules, we may raise objections to a listing application in the pre-listing stage or direct The Stock Exchange of Hong Kong Limited (SEHK) to suspend trading in a listed company's shares. We may also query or object to suspicious corporate transactions, for instance, if they do not appear to make commercial sense.

Supervision

We adopt a front-loaded and risk-based approach to intermediary supervision using a variety of tools, including on-site thematic inspections and off-site monitoring, with a focus on firms' financial soundness and how they conduct business. We place a strong emphasis on senior management accountability under the Manager-In-Charge regime¹, introduced in 2017.

Enforcement

We take focused enforcement action by exercising our powers under the Securities and Futures Ordinance (SFO) to freeze unlawful proceeds, seek disqualification orders against irresponsible directors², discipline sponsors who have failed to discharge their duties and suspend the share trading of listed companies where broader investor interests are at risk.

¹ See the May 2018 issue of the *SFC Compliance Bulletin: Intermediaries*.

² See the May 2017 issue of the *Enforcement Reporter*.

Key policy initiatives since 2016

Joint SFC-HKEX ^a press release on highly dilutive rights issues	2016
Guideline for intermediaries and joint SFC-HKEX statement on GEM stocks Statement on recent GEM listing applicants Guidance on directors' duties and circular to financial advisers on valuations	2017
Circular on sponsor quality Circular on use of nominees and warehousing arrangements New requirements for capital raisings and delisting take effect	2018
Statement on the conduct and duties of directors when considering corporate acquisitions and disposals Statement on backdoor listing and shell activities Circular on dubious private fund and discretionary account arrangements Statement on disclosure of ultimate beneficial ownership of counterparties	2019

^a Hong Kong Exchanges and Clearing Limited

IPO sponsors

Sponsors play a unique role in ensuring market quality. They coordinate the IPO process, give advice to directors and are centrally involved in the due diligence on a listing applicant. Sponsors have to ensure that the listing document contains sufficient information to enable investors to form a valid and justifiable opinion about the applicant's business.

Our recent thematic review of licensed corporations engaged in sponsor business identified a number of deficiencies in their due diligence practices and internal systems and controls. We shared our findings³ and reminded sponsors of their responsibilities and our expected standards.

Due diligence

Recurrent problems in sponsor work include failing to apply professional scepticism and turning a blind eye to obvious red flags uncovered by due diligence. Sponsors should assess the applicant *scrupulously* and *objectively* with a questioning mind and be alert to information which contradicts or brings into question the reliability of the facts they are seeking to understand. Detailed records of due diligence should be kept to demonstrate compliance with regulatory requirements.

³ *Thematic Review of Licensed Corporations Engaged in Sponsor Business and Circular to licensed corporations on expected standards for sponsor work*, 26 March 2018.

Third parties' work

Another issue is over-reliance on third-party professionals such as lawyers and accountants. Sponsors remain ultimately responsible for the quality and substance of the due diligence undertaken by agents they appoint. They must supervise the agents and ensure that they sufficiently understand the depth and scope of the task. They should also be satisfied that the agents may reasonably be relied upon to do the work.

Oversight of junior staff

Ineffective or insufficient senior management oversight of junior staff is also a problem. Sponsor firms have a duty to ensure that effective personnel and controls are in place and every aspect of the sponsor function is properly performed. This includes making sure that at least one senior management staff member has the requisite experience, knowledge and skills to closely supervise each engagement at all times.

Disciplinary actions against sponsor principals

Our investigations examine whether failures are attributable to the sponsor principals and whether their supervision of the transactions was adequate. Recent disciplinary actions include:

- We banned a former sponsor principal of Standard Chartered Securities (Hong Kong) Limited for three years and a former sponsor principal of China Merchants Securities (HK) Co., Limited for 18 months for failing to exercise due skill, care and diligence in handling a listing application.
- We suspended the licence of a former sponsor principal of Sun Hung Kai International Limited for three years for serious deficiencies in sponsor work, including failing to assess the accuracy and completeness of the information submitted by a listing applicant.
- We suspended the licence of a former sponsor principal of UBS AG for two years for failing to discharge his supervisory duties in a listing application.

Case studies

I. Design and execution of due diligence plans

A sponsor failed to adhere to the final due diligence plan prepared by its lawyers and did not document the reasons for not completing the work. Moreover, its due diligence focused on the listing applicant's production figures and it failed to adequately verify sales figures.

Sponsors are advised to avoid a "box ticking" approach. They should design a customised due diligence plan for each listing applicant and adhere to it. Any deviations or updates should be properly documented with the reasons provided.

II. Due diligence on financial information

A listing applicant recorded a significant increase in average customer spending per transaction during the track record period. Our repeated enquiries revealed that a number of individuals spent unusually high amounts on certain days. Moreover, revenue fluctuations did not align with the seasonality of the business. The sponsor was unable to provide satisfactory explanations for these anomalies. We expressed our concerns about the genuineness of the financial information in the listing application. The applicant did not respond and the application subsequently lapsed.

It is important to thoroughly understand a listing applicant's business model, industry environment and associated risks. Sponsors should also verify key business assets (including their physical existence and legal entitlements) and seek the assistance of qualified and reliable experts when required.

III. Customer due diligence

In a number of cases, firms' practices when conducting customer due diligence interviews were unsatisfactory. One sponsor changed its interview plans due to pressure from the listing applicant. Other interviews were arranged by the applicant or conducted in the presence of the applicant's representatives. In some cases, sponsors failed to independently verify customers' identities, enquire into key areas such as transactions and sales or follow up on discrepancies.

Sponsors should independently arrange due diligence interviews which are free from interference. Interviews should be conducted at the interviewees' business premises, and their identities and authority must be verified by multiple items of proof. Sponsors are also responsible for asking unequivocal questions during interviews and keeping complete and accurate notes.

IV. Relying on experts

In one particularly serious case, a sponsor relied on Mainland lawyers to verify certificates of legal title to the listing applicant's assets on the Mainland and made no attempt to understand the reasonableness of the steps taken to verify actual ownership. The law firm only performed a desktop review of the certificates without independently verifying their authenticity or the actual existence of the assets.

Sponsors should supervise and assess the work of third parties to ensure that the due diligence is reasonable and any concerns have been addressed to their satisfaction.

V. Red flags

One sponsor failed to provide satisfactory explanations for a decrease in the listing applicant's cost of inventories and increase in its revenue after years of accumulated losses. It also failed to explain the change of two major suppliers. We wrote to the applicant to express our concerns and requested an explanation of the sponsor's independent due diligence. The applicant subsequently terminated the sponsor engagement and did not proceed with the application.

In a separate case, a sponsor failed to conduct reasonable due diligence on short-term loans to customers which were guaranteed by connected persons including its chief executive officer and a company controlled by its second-largest shareholder. The sponsor did not initially disclose these guarantees, and only did so after several queries from us.

Another sponsor failed to look into third-party payment arrangements between the listing applicant and its customers despite clear red flags which cast doubt on the authenticity of the signatures on the agreements. Sponsors are advised to review the information collected during the due diligence process with a sense of professional scepticism and thoroughly follow up on any red flags.

VI. Supervision of junior staff

One sponsor principal acted as a "signing responsible officer" for a listing application and was involved neither in the due diligence nor the correspondence with SEHK. Furthermore, the sponsor principal did not provide any guidance to the junior members of the deal team who conducted the customer interviews. The team was apparently supervised by a managing director who was not a sponsor principal but nonetheless was involved in the due diligence on the listing applicant's assets and operations.

The job of sponsor principals involves onerous duties and demands a high degree of professional judgment and a considerable investment of time. Sponsors need to ensure that each transaction team is properly and adequately supervised by at least one qualified sponsor principal.

Sponsors with a history of returned or rejected listing applications or serious deficiencies and instances of non-compliance may expect more frequent inspection visits and supervisory actions. In addition, these factors may cast doubt on a sponsor's capability to discharge its responsibilities and indicate potential compliance risk. Future listing applications submitted by these sponsors may be subject to closer scrutiny by the regulators.

Enforcement actions against sponsor firms

Since the launch of the new sponsor regime in October 2013, we have taken disciplinary actions against 11 sponsor firms resulting in fines totalling \$922.5 million.

	Sponsor firm	Sanctions	Listing applicant
May 19	China Merchants Securities (HK) Co., Limited	<ul style="list-style-type: none"> Reprimanded and fined \$27 million 	<ul style="list-style-type: none"> China Metal Recycling (Holdings) Limited
Mar 19	UBS AG and UBS Securities Hong Kong Limited	<ul style="list-style-type: none"> Reprimanded and fined a total of \$375 million UBS Securities Hong Kong suspended from acting as an IPO sponsor for one year 	<ul style="list-style-type: none"> China Forestry Holdings Company Limited Tianhe Chemicals Group Limited China Metal Recycling (Holdings) Limited
Mar 19	Merrill Lynch Far East Limited	<ul style="list-style-type: none"> Reprimanded and fined \$128 million 	<ul style="list-style-type: none"> Tianhe Chemicals Group Limited
Mar 19	Morgan Stanley Asia Limited	<ul style="list-style-type: none"> Reprimanded and fined \$224 million 	<ul style="list-style-type: none"> Tianhe Chemicals Group Limited
Mar 19	Standard Chartered Securities (Hong Kong) Limited	<ul style="list-style-type: none"> Reprimanded and fined \$59.7 million 	<ul style="list-style-type: none"> China Forestry Holdings Company Limited
Jul 18	CCB International Capital Limited	<ul style="list-style-type: none"> Reprimanded and fined \$24 million 	<ul style="list-style-type: none"> Fujian Dongya Aquatic Products Co., Ltd
May 18	Citigroup Global Markets Asia Limited	<ul style="list-style-type: none"> Reprimanded and fined \$57 million 	<ul style="list-style-type: none"> Real Gold Mining Limited
Mar 17	BOCOM International (Asia) Limited	<ul style="list-style-type: none"> Reprimanded and fined \$15 million 	<ul style="list-style-type: none"> China Huinong Capital Group Company Limited
Aug 16	Quam Capital Limited	<ul style="list-style-type: none"> Fined \$800,000 	<ul style="list-style-type: none"> Gayety Holdings Limited^a
Jan 14	Sun Hung Kai International Limited	<ul style="list-style-type: none"> Reprimanded and fined \$12 million Licence to provide advisory service on corporate finance suspended for one year 	<ul style="list-style-type: none"> Sino-Life Group Limited

^a Now known as Food Idea Holdings Limited.

Corporate transactions

Tackling misconduct by listed companies remains our top priority. We seek to address the following misconduct and regulatory concerns using our front-loaded, multi-pronged approach, including suspending the trading of a company's listed securities:

Concealed share ownership and control

Concealed share ownership and control often appears as a component of shell-related activities, networks of companies, shareholders' vote rigging and "pump and dump" schemes. Some corporate transactions appear to be part of schemes to transfer control without disclosing the identities of the incoming controllers. In some cases, nominee accounts, margin financing, third-party financing arrangements and alternate forms of investment vehicles such as private funds have been used to conceal ownership.

Suspect valuations

Valuation activities are currently unregulated in Hong Kong. Boards are free to appoint any apparently qualified persons as valuers. Listed companies, directors and other professional parties rely on valuation reports and often allow them to override their own professional judgment.

We issued a statement⁴ in 2017 reminding listed company directors of their fiduciary duties in the valuation of corporate transactions along with a circular to remind intermediaries of the duties and standards of care due from financial advisers. Another statement⁵ in July 2019 set out common scenarios in corporate transactions involving serious misconduct or lapses by directors or valuers.

Warehousing of shares and nominee arrangements

We look carefully at arrangements commonly used for improper purposes including warehousing of shares, where actual control is disguised through the use of nominees and where nominee arrangements are used for vote rigging and market manipulation.

We issued a circular⁶ in October 2018 reminding intermediaries to be vigilant in identifying potential red flags which may suggest the use of these arrangements for illegitimate purposes, make follow-up enquiries with clients and report suspicious transactions promptly.

Highly dilutive rights issues

In recent years, we have seen highly dilutive rights issues and open offers structured or conducted in a manner which appeared to be against the interests of minority shareholders. After discussions with us, SEHK introduced a series of measures to address this. Coupled with our front-loaded approach, the result was a substantial drop in the number of these transactions. There were also fewer deeply-discounted share placements, an area where we often directly intervened.

⁴ *Statement on the liability of valuers for disclosure of false or misleading information and Circular to Financial Advisers in relation to their Advisory Work on Valuations in Corporate Transactions*, 15 May 2017.

⁵ *Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals*, 4 July 2019.

Case studies

I. Overvalued acquisitions

A company proposed to acquire a majority interest in a target with minimal net profit and assets. The vendor would provide a profit guarantee for 2019 which was 20 times higher than the net profit realised in 2017. We were concerned that the acquisition might be prejudicial to the interests of shareholders given that the valuation was aggressive and apparently not independently determined. It was also unclear why the company's directors considered the guaranteed profit to be realistic and achievable.

After we issued a letter to the company, it amended the terms of the acquisition but this failed to address our concerns. We issued two letters of concern and the company then proposed to acquire only a minority stake in the target at a substantially lower valuation. Our third letter of concern noted that the new valuation seemed arbitrary and without basis. The company subsequently terminated the acquisition.

Another company proposed to acquire a stake in a target which recorded losses for two consecutive years and had net liabilities. The price was determined in accordance with a valuation based on the company directors' assumptions that the target's estimated revenue growth rates would exceed 40% and its profit margin would turn positive.

It was unclear how the company's directors concluded that these assumptions were reasonable or achievable. We were concerned whether they had discharged their fiduciary duties as directors and issued a letter of concern to the company. It subsequently announced the termination of the proposed acquisition.

II. Dubious acquisitions

A company proposed to acquire a target from its controlling shareholder by issuing new shares. The target's principal asset was a Mainland property to be developed into a commercial complex.

We raised concerns about the acquisition announcement which disclosed that the Mainland government prohibited the target from developing real estate. The company announced that it had obtained a legal opinion that this would not hinder it from carrying out the development project. After we issued a letter of concern to the company, it announced the termination of the transaction.

In another case, a company proposed to acquire a 40.02% stake in a loss-making target with financing from several sources, including Mr A. The company intended to expand its investment property portfolio and develop a new business in the hotel industry, but the target did not appear to have a sizable business in property investment. We raised concerns whether there were any undisclosed relationships or arrangements among the company, the target, their respective controlling shareholders and Mr A.

After we issued a letter to the company, it announced that it would acquire 19% of the target instead of 40.02%, financed entirely by the company's internal cash resources. As the transaction was restructured, we did not pursue the matter further.

⁶ *Circular to intermediaries: Use of "nominees" and "warehousing" arrangements in market and corporate misconduct*, 9 October 2018.

III. Dubious fundraising

A company proposed a placing of new shares to raise money to develop its food and beverage business. The placing price was at steep discounts to net asset value and cash. The company carried no debt. The amount raised from the placing would be small, the company did not appear to have an imminent need for funds and the dilution effect on its shareholders would be significant.

We were concerned that the company's business might be conducted in a manner which is oppressive or unfairly prejudicial to

its shareholders. We issued an initial letter of concern followed by a letter of mindedness. The company subsequently announced the termination of the transaction.

In another case, we suspended the trading of a listed company after it completed two rounds of highly dilutive fundraising and proposed a third round under very suspicious circumstances. We discovered undisclosed connections between some of the directors and shareholders who voted in favour of the fundraisings, and some directors also appeared to be connected to the buyers of the company's shares during the fundraising.

Directors' duties

Many dubious corporate transactions involve directors' negligent conduct or failure to avoid conflicts of interest. This is worrying given the important roles directors play in managing the affairs of the company and guarding shareholders' interests.

Shareholders are highly dependent on company directors having unswerving probity when dealing with conflicts of interest, being professional when deciding on important corporate transactions, and remaining vigilant in promptly and reliably disseminating corporate information.

Directors should ensure that they have first-hand and in-depth knowledge of the business and its prospects and should place themselves in a position where they can fully discharge their duties. Their obligations to investors are embodied in statute, in the common law as well as in non-statutory provisions such as the Listing Rules.

Although independent non-executive directors do not take part in the daily management of listed companies, they nevertheless serve an indispensable role in supervising the corporate management team and protecting shareholders' interests, and by extension, play an important role in helping to safeguard the overall quality of our markets. When they have disagreements with the management team or believe that the interests of shareholders have been compromised, they should openly communicate their views to all shareholders and, if they choose to resign, disclose to investors substantive reasons for doing so.

Directors and senior officers who fail to discharge their duties should expect tough enforcement action. In a recent enforcement case involving a network of listed companies and their associated entities, we worked jointly with the Independent Commission Against Corruption (ICAC) to crack down on a highly suspicious and sophisticated scheme, allegedly designed to defraud shareholders. Our joint operation resulted in four former executive directors of Convoy Global Holdings Limited being charged with conspiracy to defraud by the ICAC.

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Securities and Futures Commission
35/F, Cheung Kong Center
2 Queen's Road Central
Hong Kong

(852) 2231 1222
enquiry@sfc.hk
www.sfc.hk