



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Report on the Thematic Review of Licensed Corporations Engaged in Sponsor Business

March 2018



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Executive summary

1. The Securities and Futures Commission (SFC) conducted a thematic inspection covering 31 licensed corporations (LCs) engaged in sponsor business (sponsors), reviewing their work undertaken from October 2013 to 31 December 2017, ie, since the introduction of the new sponsor regulatory regime. This report primarily summarises key observations identified by the SFC in this thematic inspection.
2. Serious deficiencies and instances of non-compliance were prevalent in the sponsor work done for initial public offering (IPO) transactions on GEM. For example, some sponsors did not take reasonable steps to follow up on their due diligence despite obvious red flags. This indicates poor professional judgement and a lack of professional scepticism.
3. The deficiencies and instances of non-compliance noted during this review are related to:
 - A. Code of Conduct¹ requirements**
 - I. Due diligence
 - (a) Exercising reasonable judgement and applying professional scepticism
 - (b) Interview practices
 - II. Proper records
 - III. Resources, systems and controls
 - (a) Corporate governance
 - (b) Other aspects
 - (c) Annual assessment
 - B. CFA Code² requirements**
 - (a) Chinese walls
 - (b) Receipt or provision of benefits
 - C. Listing Rules³ requirements**
4. This report also highlights some practices observed during the thematic inspection which meet the standards expected of sponsors for compliance with the applicable requirements. These examples are non-exhaustive and sponsors should not regard them as the only practices for ensuring compliance.

¹ This refers to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct), with specific reference to Paragraph 17 on sponsors.

² Corporate Finance Adviser Code of Conduct.

³ Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (SEHK) (Main Board Listing Rules) and Rules Governing the Listing of Securities on GEM of the SEHK (GEM Listing Rules) (collectively, Listing Rules).



Introduction

5. Between 2009 and 2016, Hong Kong was the world's largest IPO market in terms of funds raised in five of these eight years⁴, including in 2016 when \$195.3 billion was raised⁵.
6. Under the Listing Rules, sponsors should be appointed by listing applicants to assist with their IPOs and be closely involved in preparing the listing documents. Given their critical role in IPO activities, sponsor work has been a recurring theme for the SFC's inspections, which have reviewed sponsors' standards of due diligence in selected IPO transactions and assessed the adequacy of the design and implementation of their systems and controls for complying with the applicable codes, rules and regulations. The SFC's March 2011 report⁶ on the findings of its first thematic inspection of sponsor work cited deficiencies and instances of non-compliance including unsatisfactory due diligence on the listing applicant's business, questionable disclosure to the SEHK during the listing application process, failure to properly document due diligence, and inadequate internal systems and controls over sponsor work.
7. The new sponsor regulatory regime came into effect in October 2013 following the SFC's public consultation⁷. Besides the addition of Paragraph 17 to the Code of Conduct, another key change under the new regime is the requirement for an Application Proof⁸ to be substantially complete when submitted.
8. Subsequently, the SFC conducted a survey of sponsors' preparations for the new sponsor regulatory regime. Those firms which responded to the survey reported general compliance. Nonetheless, the SFC's interactions with sponsors since October 2013 revealed deficiencies and instances of non-compliance in their due diligence and their systems and controls. For example, in vetting listing application draft prospectuses, the SFC identified concerns which should have been discovered and addressed by reasonable due diligence prior to the submission of the listing application. As of the date of this report, 44 listing applications were returned or rejected by the regulators due to sufficiently serious concerns⁹. In other cases, these concerns led to substantial delays in the listing timetable, if not the lapse of the listing applications.
9. On a separate note, many more LCs are now permitted under their licenses to undertake work as sponsors¹⁰. Seventeen of these LCs joined the industry since January 2016. They generally operate with fewer staff but undertake a large number of smaller transactions.

⁴ Source: *Concept Paper on New Board* published by the SEHK in June 2017. Hong Kong ranked no.1 in 2009, 2010, 2011, 2015 and 2016.

⁵ Source: Hong Kong Exchanges and Clearing Limited's 2016 *Annual Report*.

⁶ A copy of the report can be found on the SFC website:

(http://www.sfc.hk/web/doc/EN/speeches/public/surveys/11/Sponsor%20report_FINAL.pdf)

⁷ A copy of the consultation conclusions on the regulation of IPO sponsors can be found on the SFC website:

(<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=12CP1>)

⁸ As defined under Paragraph 17.15(a) of the Code of Conduct.

⁹ This refers to listing applications (excluding those relating to transfers of listing from GEM to the Main Board) returned by the SEHK or rejected by the SEHK or the SFC, based on publicly available information.

¹⁰ There were 75 LCs permitted under their licenses to undertake work as sponsors as at 31 December 2012 and 107 as at 31 December 2017.



Thematic inspection findings

A. Code of Conduct requirements

I. Due diligence

(a) Exercising reasonable judgement and applying professional scepticism

Code of Conduct requirements

10. A sponsor should have a sound understanding of a listing applicant, its directors, key senior managers and controlling shareholders based on reasonable due diligence¹¹. The sponsor should have performed all reasonable due diligence on the listing applicant (except those matters that can only be dealt with at a later date) before submitting a listing application and should ensure that all material information has been included in the Application Proof¹².
11. A sponsor should exercise reasonable judgement on the nature and extent of due diligence needed in relation to a listing applicant¹³. The sponsor should also examine the accuracy and completeness of information provided by a listing applicant or its directors with a questioning mind and being alert to information that contradicts or brings into question the reliability of such information¹⁴. The sponsor should further perform appropriate verification procedures, such as reviewing source documents, inquiring of knowledgeable persons or obtaining independently sourced information¹⁵.

Deficiencies and non-compliance

12. In Cases A, B, C, D and E below, the responsible sponsors did not take reasonable steps to follow up on their due diligence despite obvious red flags. In Case F, some sponsors only followed standard due diligence checklists without adapting them to the circumstances of specific listing applications.

Case A:

While reviewing a sponsor's transaction files, the SFC noticed a number of significant red flags which cast doubt on the genuineness of the listing applicant's largest customers, which accounted for over 50% of its total sales. For example, certain third parties were heavily involved in the shipment and settlement processes among the listing applicant and its largest customers, but no reasonable due diligence was conducted on these third parties. Furthermore, the SFC noted: (i) material discrepancies between the sales amounts stated in the invoices obtained by the sponsor and the payments made, which could not be reconciled; (ii) significant discrepancies in the weights of goods reported in the bills of lading and the export forms; and (iii) inaccurate descriptions of the goods shipped in the bill of lading. However, the sponsor did not follow up on these issues.

¹¹ As required under Paragraphs 17.3(a)(i) and (ii) of the Code of Conduct.

¹² As required under Paragraph 17.4(a) of the Code of Conduct.

¹³ As required under Paragraph 17.6(a) of the Code of Conduct.

¹⁴ As required under Paragraph 17.6(b) of the Code of Conduct.

¹⁵ As required under Paragraph 17.6(c) of the Code of Conduct.



Case B:

Based on the prospectus disclosures, the listing applicant's five largest suppliers were independent third parties. We learnt from the sponsor that the listing applicant's controlling shareholder held the shares of one of the largest suppliers on trust for a third party. However, many inconsistencies, backdating and other errors were noted in the documentation obtained by the sponsor in support of this trust arrangement, which cast in doubt the validity of the trust arrangement and indicated that the controlling shareholder might actually have a beneficial interest in the supplier. The sponsor did not conduct reasonable due diligence to follow up on these issues. Instead, the sponsor relied on a statutory declaration of the controlling shareholder and a confirmation provided by the listing applicant, which were inadequate to ensure the accuracy of the prospectus disclosure and that there were no material omissions.

Case C:

The sponsor reviewed a background research report on the listing applicant's customers which contained financial information of the customers retrieved from local government offices. The sales to certain customers provided by the listing applicant were significantly larger than these customers' sales and purchases according to the local government's figures. However, the sponsor did not follow up even though this brings into question the reliability of the listing applicant's sales figures.

Case D:

The sponsor did not conduct reasonable follow-up due diligence on an irregular arrangement whereby most customers were understood to have liaised with the listing applicant through representatives and to have paid it through third parties from different countries. The excess authority delegated to the representatives, the opaqueness of the third parties as well as the inconsistencies found in the listing applicant's sales figures cast doubt on the genuineness of the reported sales.

As represented by the sponsor: (i) the due diligence which it performed confirmed that indirect payment is an industry practice; and (ii) the legal opinion which it obtained confirmed that such practice was not illegal or invalid in the relevant jurisdictions. However, the sponsor failed to consider the broader implications of the arrangement on the genuineness of sales of the listing applicant.

The sponsor further advised that the reporting accountants did not raise any concerns about the arrangement. However, the sponsor was unable to demonstrate that it held discussions with the reporting accountants to understand the audit procedures in this regard. In all, the sponsor was unable to substantiate how concerns about the payment arrangement could be satisfactorily addressed.

Case E:

To select interviewees, the sponsor relied on a summary table provided by the listing applicant showing the amounts spent by the top users of its online services. We noted that the amounts for some of the largest users were inconsistent with the raw data generated from the listing applicant's internal system. However, the sponsor did not follow up on this discrepancy.



Case F:

A number of sponsors followed standard due diligence checklists and only adopted a box-ticking approach. This resulted in insufficient due diligence on key aspects of listing applicants' businesses which fell outside the scope of the standard checklists. Even when key aspects of the listing applicant were included by some sponsors in their checklists, they failed to exercise reasonable judgement as to the breadth and depth of what was required, leading to insufficient due diligence. For example, while the prospectus disclosures stressed the listing applicant's organic products, we noted insufficient due diligence on the organic certifications of its largest suppliers.

Practices meeting expected standards

13. One sponsor required the background research on a listing applicant to be regularly updated during the course of a listing application, especially if the listing application process was expected to continue for some time or the listing applicant operated in a fast-evolving industry or regulatory environment. Another sponsor required designated senior members of the Transaction Team¹⁶ to approve the customisation of due diligence plans and subsequent updates.

(b) Interview practices

Code of Conduct requirements

14. A sponsor should:
- i. independently select the major business stakeholders to be interviewed based on objective and proportionate criteria¹⁷;
 - ii. carry out interviews directly with minimal involvement from the listing applicant¹⁸;
 - iii. confirm the bona fides of interviewees to satisfy itself that they have the appropriate authority and knowledge¹⁹;
 - iv. obtain adequate and satisfactory responses to all questions and follow up on any incomplete or unsatisfactory responses or outstanding matters²⁰;
 - v. identify irregularities noted during interviews (for example, an interview did not take place at the interviewee's registered or business address) and ensure irregularities are adequately explained and resolved²¹; and
 - vi. adopt effective and adequate measures to ensure that the records of the interviews are reasonably accurate, complete and reliable in all material respects²².

Deficiencies and non-compliance

15. The practices adopted by some sponsors during due diligence interviews with major business stakeholders (for example, customers, suppliers and bankers) were unsatisfactory. Important interviews with business stakeholders were scheduled at a very

¹⁶ As defined under Paragraph 17.15(s) of the Code of Conduct.

¹⁷ As required under Paragraph 17.6(f)(i) of the Code of Conduct.

¹⁸ As required under Paragraph 17.6(f)(ii) of the Code of Conduct.

¹⁹ As required under Paragraph 17.6(f)(iii) of the Code of Conduct.

²⁰ As required under Paragraph 17.6(f)(iv) of the Code of Conduct.

²¹ As required under Paragraph 17.6(f)(v) of the Code of Conduct.

²² As required under Paragraph 17.6(f) of the Code of Conduct.



late stage of the due diligence process. Sponsors also failed to confirm the bona fides of the interviewees and that they had the appropriate authority and knowledge. Some sponsors also failed to follow up on questions which were not answered during the interviews.

Case G:

The sponsor interviewed certain business stakeholders on the day the listing application was submitted. This clearly does not provide sufficient time for the sponsor to properly consider issues raised in the interviews and resolve potential red flags.

Case H:

The sponsor interviewed some of the listing applicant's major customers and suppliers but did not conduct proper verification of the bona fides of nearly half of the interviewees. This was particularly serious considering that most of the interviews were conducted at the listing applicant's office premises or by ringing the interviewees' telephone numbers provided by the listing applicant without any further verification.

Practices meeting expected standards

16. Some sponsors conducted interviews at the interviewees' business premises and further conducted cross-reference checks relying on more than one type of proof of identity. For example, interviewees were requested to provide their business cards alongside government-issued identity cards or staff cards with their photographs. For telephone interviews, another sponsor contacted interviewees or reconfirmed their identities by ringing the general line of the interviewee's company obtained from a reliable public source, such as a telephone directory.
17. A better practice was noted where one sponsor which requested telephone interview notes to be validated by the interviewee's company with copies of the interviewee's identity documents attached. This has the added advantage of ensuring that the interviewee's representations made reflect the company's position.

II. Proper records

Code of Conduct requirements

18. A sponsor should maintain adequate records so as to demonstrate to the SFC its compliance with the Code of Conduct, and in particular compliance with Paragraph 17 of the Code of Conduct. A sponsor should also document its systems and controls governing sponsor work as well as the annual assessment of them²³.
19. For each listing assignment, a sponsor should keep records, including relevant supporting documents and correspondence, within its control relating to a due diligence plan²⁴, the results of due diligence performed together with its assessment of these results²⁵ and all significant matters arising in the course of the listing process, including

²³ As required under Paragraph 17.10(a) of the Code of Conduct.

²⁴ As required under Paragraph 17.10(c)(ii)(A) of the Code of Conduct.

²⁵ As required under Paragraph 17.10(c)(ii)(D) of the Code of Conduct.



internal discussions and actions taken, regardless of whether or not the relevant matters are disclosed in the final listing document²⁶.

Deficiencies and non-compliance

20. Many of the sponsors inspected were unable to provide relevant records to demonstrate to the SFC's satisfaction that major issues were properly considered and disposed of. In other cases, sponsors failed to maintain a proper due diligence plan and documentation of certain due diligence conducted (for example, a review of a material business contract and interviews with a major business stakeholder).

Practices meeting expected standards

21. One sponsor had a policy requiring all material risks and issues identified to be documented in the form of an issue log accompanied by stand-alone due diligence notes.

III. Resources, systems and controls

(a) Corporate governance

Code of Conduct requirements

22. Management²⁷ of a sponsor should put in place appropriate systems, controls and procedures to govern sponsor work, including adequate supervision and management of staff who carry out the work²⁸. Management or a committee designated by the Management should make decisions on critical matters, such as the resolution of suspicious circumstances, difficult or sensitive issues, conflicting information and material non-compliance by a listing applicant²⁹. Management should also put in place appropriate procedures for the escalation of critical matters³⁰.

Deficiencies and non-compliance

23. We noted insufficient management supervision over sponsor work. In one case, the sponsor was unable to demonstrate Management's involvement in the consideration of key concerns as to, among others, the listing applicant's ownership of certain material assets, which was a concern raised by the regulators. In another case, the Transaction Team failed to escalate critical matters to the Management or its designated committee for consideration, ie, when the listing applicant refused to accept some of the sponsor's due diligence measures and threatened to change sponsors if it insisted on carrying them out.

Practices meeting expected standards

24. Some sponsors established committees comprising independent sponsor Principals³¹ and senior staff from the risk, legal and compliance departments to supervise, and

²⁶ As required under Paragraph 17.10(c)(v) of the Code of Conduct.

²⁷ As defined under Paragraph 17.15(i) of the Code of Conduct to include a sponsor's Board of Directors, Managing Director, Chief Executive Officer, Responsible Officers, Executive Officers and other senior management personnel.

²⁸ As required under Paragraphs 17.11(e) and (e)(iv) of the Code of Conduct.

²⁹ As required under Paragraph 17.11(d) of the Code of Conduct.

³⁰ As required under Paragraph 17.11(e)(vi) of the Code of Conduct.

³¹ As defined under Paragraph 17.15(l) of the Code of Conduct.



provide guidance with respect to, the due diligence process when sponsoring a listing application.

(b) Other aspects

Code of Conduct requirements

25. As discussed above, Management of a sponsor should ensure adequate supervision and management of the staff who carry out sponsor work. Management should also be satisfied that each Transaction Team is properly and adequately supervised by at least one sponsor Principal who has the necessary capacity, capability and competence to supervise³².

Deficiencies and non-compliance

26. The SFC noted insufficient training and guidance provided by some sponsors to their staff as well as situations which indicated they had insufficient resources to undertake sponsor work. For example, the sponsor Principals might not have the capacity to adequately supervise the Transaction Teams. In one case, a sponsor Principal was reported to be simultaneously overseeing six active listing applications. This raises doubt as to whether the sponsor Principal in question could adequately supervise the Transaction Team considering that most survey respondents reported that their sponsor Principals and their staff would handle, on average, only two to three IPOs simultaneously.

Practices meeting expected standards

27. One sponsor provided examples in its compliance manual of material risks and issues, specified the threshold for internal escalation and had plans to provide scenario-based training to staff on the identification and resolution of material issues.
28. Some sponsors required their sponsor Principals to attend key due diligence interviews together with junior team members. This would allow the sponsor Principals to be better informed about listing applicants and provide timely guidance to the Transaction Team when needed.

(c) Annual assessment

Code of Conduct requirements

29. A sponsor should carry out an assessment annually in order to ensure that its systems and controls remain effective³³.

Deficiencies and non-compliance

30. Some sponsors did not perform any annual assessments of their systems and controls whereas the annual assessment of one sponsor was based solely on the attestation by the sponsor Principals, without detailing the work done or samples reviewed to ensure that key policies and procedures are effectively implemented.

³² As required under Note 2 (B) Paragraph 17.11(c) of the Code of Conduct.

³³ As required under Paragraph 17.12 of the Code of Conduct.



B. CFA Code requirements

(a) Chinese walls

CFA Code requirements

31. A sponsor should ensure that there is an effective system of functional barriers (Chinese walls) to prevent the flow of information that may be confidential or price sensitive between the corporate finance activities and the other business activities³⁴.

Deficiencies and non-compliance

32. Some sponsors failed to maintain effective Chinese walls to prevent the flow of confidential information between the sponsors and related LCs. In some cases, certain information relating to the listing applications which was not yet made public was passed from the Transaction Teams to staff from related LCs before wall-crossing approvals were obtained.

(b) Receipt or provision of benefits

CFA Code requirements

33. A sponsor should neither offer nor accept any inducements in connection with the business of, or a transaction involving, its client without first disclosing the particulars of the inducements to the client. A sponsor should also ensure that it develops and maintains written policies and procedures for the disclosure of the value of gifts given to, or provided by, its staff members above a certain monetary limit, and the circumstances in which they were offered or received³⁵.

Deficiencies and non-compliance

34. Some sponsors either did not have a written company policy governing the provision of benefits to clients, failed to comply with the company policy on the receipt of benefits from clients or could not demonstrate their compliance due to the lack of documentation.

C. Listing Rules requirements

Listing Rules requirements

35. A sponsor should conduct a complete independence check pursuant to Main Board Listing Rule 3A.07 or GEM Listing Rule 6A.07 in order to have a proper basis for its declaration of independence to the SEHK.

Deficiencies and non-compliance

36. The majority of sponsors had poor internal control procedures for independence checks. For example, many sponsors did not confirm the independence of Transaction Team members, directors of the sponsor groups or their close associates (as defined under the Listing Rules).

³⁴ As required under Paragraph 4.3 of the CFA Code.

³⁵ As required under Paragraph 4.6 of the CFA Code.



Way forward

37. In addition to reviewing listing application materials, the SFC will continue to conduct onsite inspections to monitor sponsors' performance and share its findings with the industry.
38. To provide more guidance to listed corporations, listing applicants and sponsors on how the SFC performs some of its functions under the Securities and Futures (Stock Market Listing) Rules (SMLR) and the SFO in relation to listed corporations and other listing matters, the SFC launched the *SFC Regulatory Bulletin: Listed Corporations* in July 2017. As described in the first edition of the Bulletin, to better protect our markets and investors, the SFC issued letters of mindedness to object to a number of listing applications under the SMLR.
39. Going forward, the SFC will not hesitate to employ these and other "real time" regulatory tools when needed to supplement its ongoing supervisory and enforcement efforts to pursue wrongdoers, seek remediation and deter misconduct.